A Study On The Relationship of Stock Market Scams and Non-Performing Assets

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ABSTRACT

The Indian stock market saw many frauds/scams in the past decades. These activities stumbled the investors' belief many times in the stock market and due to which this market is seeing drastic fluctuations from a very long time. And in the times of increasing non-performing assets (NPAs) combined with the fears of potential stock market frauds, the financial markets of India are suffering badly. In this study, I tried to compare the relationship between NPAs and Stock Market Scams (SMCs) and listed out possible scenarios where such relationships have impacted the financial sector of the Indian economy.

Abbreviations : *Stock Market Scams – SMCs, Non-Performing Assets – NPAs.*

METHODOLOGY

This study is done by comparing and analysing various possible ways to connect SMCs and NPAs. The relationship is studied through the help of correlation in order to prove the mathematical relationship between SMC and NPA. Scenarios and Trends are studied in order to give a theory about the kind of relationship that SMC and NPA have.

INTRODUCTION

The following is the ***most common stock market frauds*** that were happened in the Indian Stock Market (these are explained in detail giving an example that how these scams can be planned and executed) :

1. Tips & Recommendation Fraud

   This is one of the most common and widely exercised fraud/scams in the Indian Stock Market. The fraudsters try to attract the traders/investors by convincing them by promising them a profit as much as **3-10%** per day and **30-40%** per month. *This is note that one of the wealthiest people in the world, Warren Buffet, has got a yearly return of around 22%. And these people are promising other people, such returns on a monthly basis.* But these fraudsters are able to assure the people that the tips that they provide would be 90% accurate.

   These fraudsters market among the investors that they have given a minimum 40% return in the past to their old clients. When people ask for trial tips before subscribing to their tips and recommendation program in order to verify their genuineness, they

easily agree. {Although, most good companies clearly deny recommendations without getting complete registration}.

These trials help the fraudsters to make the investors/traders victims. The tips that are provided in these trials come out to be 100% accurate. Seeing the results, people subscribe from these fraudsters and pay high fees. However, after the registration, none of their tips works well. Let us see how they are able give 100% accurate tips in the trial period:

Suppose, these fraudsters agree to give a trial period for 3 trading day. That is, they agree to give 1 recommendation to buy or sell a stock for three trading day. But there is a hidden side to this scheme that the investors do not know. During these three days, they don’t send the tips to just 1 person. They generally send the tips to thousands of people.

Let us say, they started with 1000 people initially to send the tips.

Day 1: On day 1, these fraudsters send messages to sell a stock to 500 people and to buy to other 500 people for the same stock. Obviously, either the stock will go up or go down (they generally choose a volatile stock so that the probability of stock not changing price is zero). Therefore, on day 1, they have send a successful tip to 500 people. They, discard the other 500 people for whom the tip didn’t worked.

Day 2: On day two, they again send message to sell another stock to 250 people and buy the stock to other 250 people. Obviously, again one group will receive correct recommendation. They again discard the other group whom they sent wrong tip.

Day 3: On last day of tip, they send buy suggestion to 125 people and sell suggestion to other group of 125 people. Hence, 125 people will receive a correct tip for three consecutive days.

Now, these 125 people will now think that all the recommendations provided by these fraudsters for three continuous days are correct. Therefore, many of the people from this group will subscribe to the tips and recommendation plan and become a victim of one of the most common scams in Indian stock market. Let us assume that the charge for sending tips is Rs 15,000 for a year. If even 100 people are trapped in this swindle, these fraudsters easily make around 15,000*100 = Rs 15 lakhs.

Soon after subscribing to the tips from these fraudsters, the investors/traders start losing money. The tips aren’t working anymore. Overall, these people lose they money apart from paying a heavy registration fee for taking tips and recommendations.

2. Pump and Dump

Pump and Dump is a micro-cap stock (penny stocks) fraud, where the fraudsters try to inflate the price of these micro-cap stocks by providing misleading information to

investors/traders. They try to increase the price of these penny stocks by giving the fake news.

For example, If the fraudsters want to increase the price of XYZ microcap stock, then they will send messages like a big company is taking over a that stock; or that micro-cap stock is giving a bonus of 1:1; or A large-cap is buying 50% stake of that micro-cap stock etc.

The fraudsters want the retailers to buy the shares of these stocks as much as possible. Let us see what the main aim of these fraudsters is.

- First, these fraudsters buy a cheap penny stock at a large volume.
- Then they send fake messages or emails to millions of investors/traders recommending them to buy that stock.
- Those who take this news as true, start buying stocks of these companies.
- Because of this increased demand, the price of that stock starts increasing.
- When the share price reaches a good price, then these fraudsters sell their stocks and get good returns.

After selling their stocks at high prices, these fraudsters then stop sending email/messages to the people. Moreover, the price of these stocks becomes very volatile, as they are not worth that high price. Hence, soon the price of these stocks falls heavily and the retail investors lose their money.

3. Fake Messages In The Name Of Brokers

Many people invest in the stock market on the recommendation of their stockbrokers or advisers. As these people trust blindly on their brokers, they don't research much about the stock after receiving the recommendation/tips. Instead, they just buy these stocks trusting their advisers.

In this scam, a lot of fraudsters, trap the retail investors/traders by using their trust in their brokerage firm. They send messages in the names of their brokers recommending them to buy certain stocks. As these people, misunderstood the message and think that it is sent by their brokers, they buy the recommended stocks.

However, as the recommendation did not truly send by their brokers. Hence, the stock prices fall soon and these investors/traders lose a huge amount of money.

Let's see why these fraudsters send these messages to retail investors/traders:

Initially, these fraudsters send the recommendations to buy the same stock to their paid subscribers. Then, they try to inflate the price of these stocks by sending fake messages in the name of registered brokers to general people. When the stock price starts increasing, they suggest their paid subscribers sell the stock and get a good return. Therefore, their paid customers are satisfied with the recommendation and continue to their monthly/yearly paid recommendation plan.

In the end, it’s the retail investors only who end up losing their money by blindly following the fake recommendations. This is the third most common scams in Indian stock market that every investors/trader should be aware of if they want to safeguard their money.

4. Circular Trading

   Circular trading is a fraudulent scheme where sell orders are entered by a broker who knows that offsetting buy orders for the exact same number of shares at the same time and, at the same price, have either been or will be entered.

   If circular trades persist, they can create a false sense of activity around a stock that may influence its price. For example, if the trading price of a security was on a trajectory to fall below levels desired by certain shareholders, a circular trade could serve to buttress the share price by giving the impression that new owners are buying the stock at the desired level. This activity might convince others, who are not privy to the scheme, to buy into the stock as they assume the trades indicate there is growing interest in the stock. There may even be some presumption that the company is about to release news that, once made publicly known, would drive up the price.

   However, since the circular trade scheme does not introduce any real change in ownership nor represent any actual action about to be announced, there is no basis for that perception. If the shares do rise in price as result, the value is fraudulently inflated. Once the scheme is discovered, that artificial escalation of the stock price will collapse in on itself, taking with it the funds invested by others.

   Some initial public offerings (IPOs) and penny stocks may be especially susceptible to circular trade schemes, particularly if certain shareholders want to create the appearance of intense trading activity and buzz surrounding a stock. The intention is to encourage the stock to be pumped up, driven by the attention the cycle of trades attracts. A circular trading scheme typically requires several participants to create the illusion of shares being acquired by new owners when, in fact, the same shares are simply passed through with no actual change in value.

   Day traders might fall victim to such a scheme if they are looking for new investment opportunities, see volume activity on a stock, and buy into it expecting the shares to escalate in value.

Non – Performing Assets (NPAs)

Non-performing assets(NPA) is defined as a credit facility in respect of which the interest and installment of Bond finance principal has remained ‘past due’ for a specified period of time. An amount due under any credit facility is treated as “past due” when it has not been paid within 30 days from the due date.

Due to the improvements in the payment and settlement systems, recovery climate, upgradation of technology in the banking system, etc., it was decided to dispense with 'past due' concept, with effect from March 31, 2001. Banks are required to furnish a Report on NPAs as on 31st March each year after completion of audit. The NPAs would relate to the banks' global portfolio, including the advances at the foreign branches.

SCENARIO

Suppose a bank computes its NPAs at a valuation of Rs. 5,000 crores. But this is not revealed to the public. The bank maintains it as a secret and continues to show this amount as *"Good Performing Assets"* in its balance sheet.

This is done because the bank wants to keep its stock price intact and does not want any downfall in the stock market as through window dressing, it wants to hide the actual situation due to the following reasons :

- To Save the Profitability :

  NPAs put detrimental impact on the profitability at banks as banks stop to earn income on one hand and attract higher provisioning compared to standard assets on the other hand.

- Credit Contraction :

  The increased NPAs put pressure on recycling of funds and reduces the ability of banks for lending more and thus results in lesser interest income. It contracts the money stock which may lead to economic slowdown.

- Creditability :

  Credibility of banking system is also affected greatly due to higher level NPAs because it shakes the confidence of general public in the soundness of the banking system. The increased NPAs may pose liquidity issues which is likely to lead run on bank by depositors. Thus, the increased incidence of NPAs not only affects the performance of the banks but also affect the economy as a whole.

In order to do this, the bank is involved in a **SMC** *(Stock Market Scam)* by manipulating the balance sheets in order to maintain untrue/manipulated stock prices of the bank. So, in this type of scenarios, **a rise in NPAs induces the market participants to get indulged in a SMC**.

DATA ANALYSIS & TREND ANALYSIS

In this, mathematical and situational proof of the relationship between SMC and NPA will be derived.

Case 1 - In 1992, after the Harshad Mehta securities scandal — in which the broker used bank funds to rig up stocks — almost all banks faced a huge build-up of non-performing assets (NPAs).

Case 2 – When Punjab National Bank Fraud was done, though there was a huge plummet in the prices of PNB stock price and the overall stock market was down. But one cannot see any changes in the probability of potential Stock Market Scam (SMC).

Case 3 – Scenario studied under the above head where the bank did window dressing due to rise in NPAs and thus, committing a Stock Market Scam (SMC).

Trend Analysis

We can see that in *case 1 and case 3,* due to some increase in SMC, the amount of NPAs has increased, thus, showing a **positive relationship between SMC and NPA.** This can be written as

when some Stock Market Scam (SMC) happens, there is a positive increase in the amount of Non-Performing Assets (NPAs)

Also, when *case 2* is analyzed, we can say that change in NPA due to some other factors ***does not necessarily have an impact*** on the probability of occurrence of a Stock Market Scam (SMC).

So, we can say that, among these two factors :

Variable Factor : **Stock Market Scam (SMC)**

Dependent Factor : **Non-Performing Assets (NPAs)**

Data Analysis

When we take State Bank of India as an example, I have used **correlation** as a rule to prove the relationship between the SMC and NPAs. The **annual averages of SBI stock** is taken for a period of 2000-2009. Also, the **Gross NPA** ratio is also taken for the same time period. The a correlation analysis was done on them.

Hypothesis:

When stock/financial market scam happens, it is assumed that the stock prices falls.

We got a correlation coefficient of **(-0.859665886)** indicating a **negative relationship** between stock market prices and NPAs.

But since we that there is also a **negative relationship between stock market scams and stock market prices** (hypothesis), thus, there will be a **positive relationship between stock market scams and NPAs.**

CONCLUSION & RECOMMENDATIONS

So, from this study we can conclude that there is a relationship between stock market scams and non performing assets. Also, we can see that one factor is a variable factor (SMC) and one is a dependent factor (NPA) in this relationship. Through Trend Analysis and Data Analysis, I am able to prove to some extent that there is a mathematical and observation proof of such relationship and thus, when a stock market scam is occurred, there is an increase in Non-Performing Assets. In data analysis, through a linked relationship between stock market prices, scams and non-performing assets, we can say that a positive relationship between stock market scam and non-performing assets exists.

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