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Justifications of avoiding Riba (Part VIII): The Ponzi scheme

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The Ponzi scheme was named after Charles Ponzi who assured people of supernormal profits from their investments without being involved in any profitable real investments. He was involved with such fraudulent activities in 1920 when he defrauded investors amounting to US$15 million, which is equivalent to more than US$150 million today. Later his fraudulent activities unfolded and he was caught and sentenced to prison. After finishing his sentence, he went back to his motherland Italy and started working with the dictator Benito Mussolini. But Ponzi's luck did not favor him and he was eventually fired. Ponzi died penniless in Brazil but his name is still associated with similar schemes all over the world. In this article, MABROOR MAHMOOD will discuss the features of the Ponzi scheme, how it worked, why it failed, what could make Ponzi successful in his scheme, and how this scheme is related to a Riba-based structure.

The first feature of the scheme was that he 'promised' abnormal returns on people's investments. As soon as he promised a certain return, the investment actually became a debt-like instrument where people deposited their money with Ponzi, thus becoming creditors with an expectation of a 'guaranteed' or 'promised' return and Ponzi himself became a debtor.

After enticing the first batch of people and giving them the promised return within a very short period, he could attract more people into the scheme and the fund balance with Ponzi grew in size very quickly. Once new people were on board, Ponzi was satisfying the previous batch of creditors with the money generated from the new batch of creditors and the process went on.

There was no real investments made by Ponzi with the money; the source of giving a ‘promised’ return was only the new money generated. So at a certain point, Ponzi did not have enough investors to satisfy the previous batch of investors and the scheme eventually collapsed.

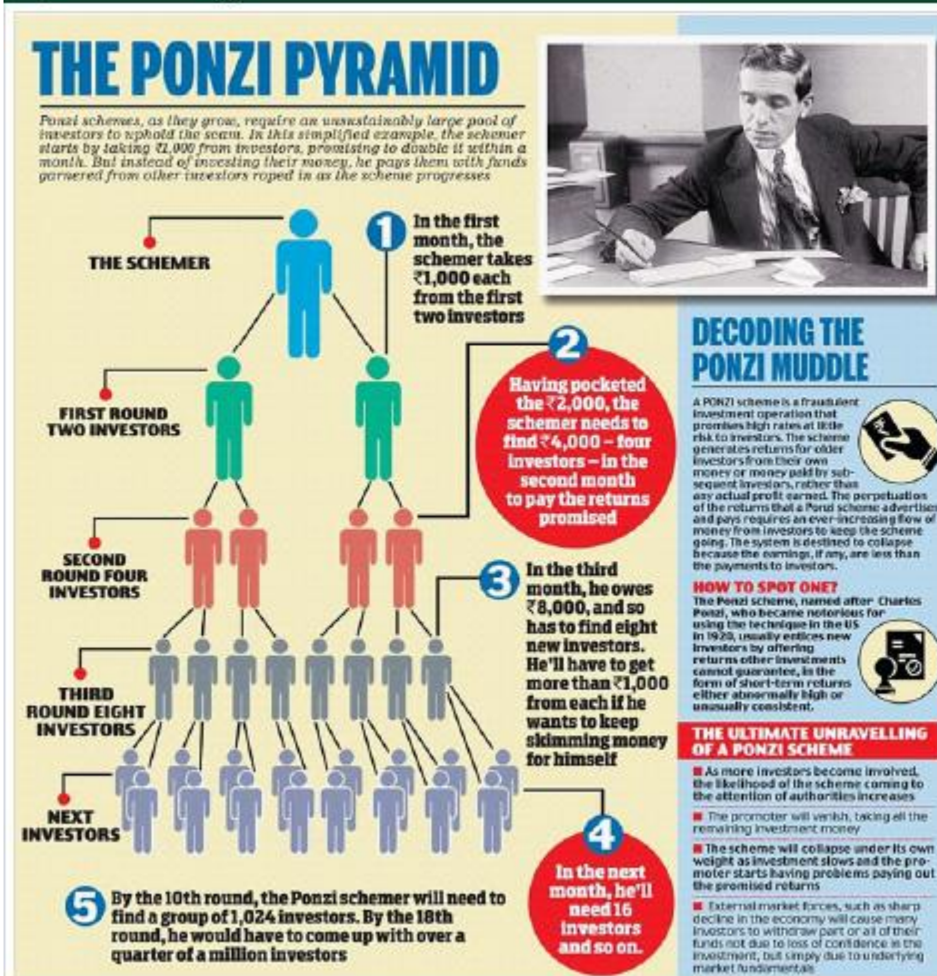

Figure 1: The Ponzi pyramid

Source: http://www.dailymail.co.uk/indiahome/indianews/article-2312590/Inside-Indias-Ponzi-schemes-How-shameless-crooks-swindling-millions-online.html

Now let us see how Ponzi could be successful with his scheme.

The only way he could see success was if he had invested the money to any real investments which could give him consistently better returns over years so that he could satisfy the investors by giving them the ‘promised’ return.

For Ponzi, it was not an easy thing to do. Locating investments giving consistently higher returns required extensive analysis, business acumen and time. So Ponzi did not take the difficult route but rather opted to become too greedy for money and kept playing the new money with the old money.

The Ponzi scheme can be categorized as a classic case of a Riba-based structure where money is exchanged with a higher amount of money over time. Since Ponzi assured a ‘promised’ return over a certain investment, he actually entered into contracts with the investors to exchange a certain amount of dollars today with a higher amount of dollars tomorrow. There was no real investment made, thus there was no connection with the money and the real economy.

Surprisingly, the conventional banks all around us where most of us keep our deposits have some similarities with the Ponzi scheme. Here, the banks assure a certain amount of guaranteed return over our deposits so that people feel encouraged to deposit their savings with the banks.

Now the question is, how do we know that our bank next door where we keep our deposits is not running a Ponzi scheme?

We know that a bank is not running a Ponzi scheme because we assume that the bank is investing our deposits to real investments where the bank itself is making enough money to meet our demands of a ‘guaranteed’ return at maturity.

But think twice. It might also happen that banks are actually making real investments with only a portion of the total deposits and for the rest, they are actually playing with deposits just like Ponzi!

Don’t you think that it is a real possibility when bankers know that they have to struggle to locate real investments for making better returns while there are lines of potential depositors willing to get a ‘promised return’ by depositing the money with them with which they can just play like Ponzi?

How do we know that this not happening?

We know this is not happening because there is constant oversight from the central bank of a country on all these deposit-taking banks to make sure that these banks are putting the deposits in real investments to make enough money to satisfy depositors.

But there are hundreds of thousands of banks all over the world doing business at the same time, and how do we know that all the central bankers in the world are doing their job properly?

Well, we assume that central bankers know everything; they are geniuses. They always check all these banks and their financial ratios to make sure that everything is in order. So they must be doing their job properly.

This is quite an optimistic assumption indeed!

(To be continued)

The views expressed here are the author’s own and do not necessarily represent the views of the institution where he works.