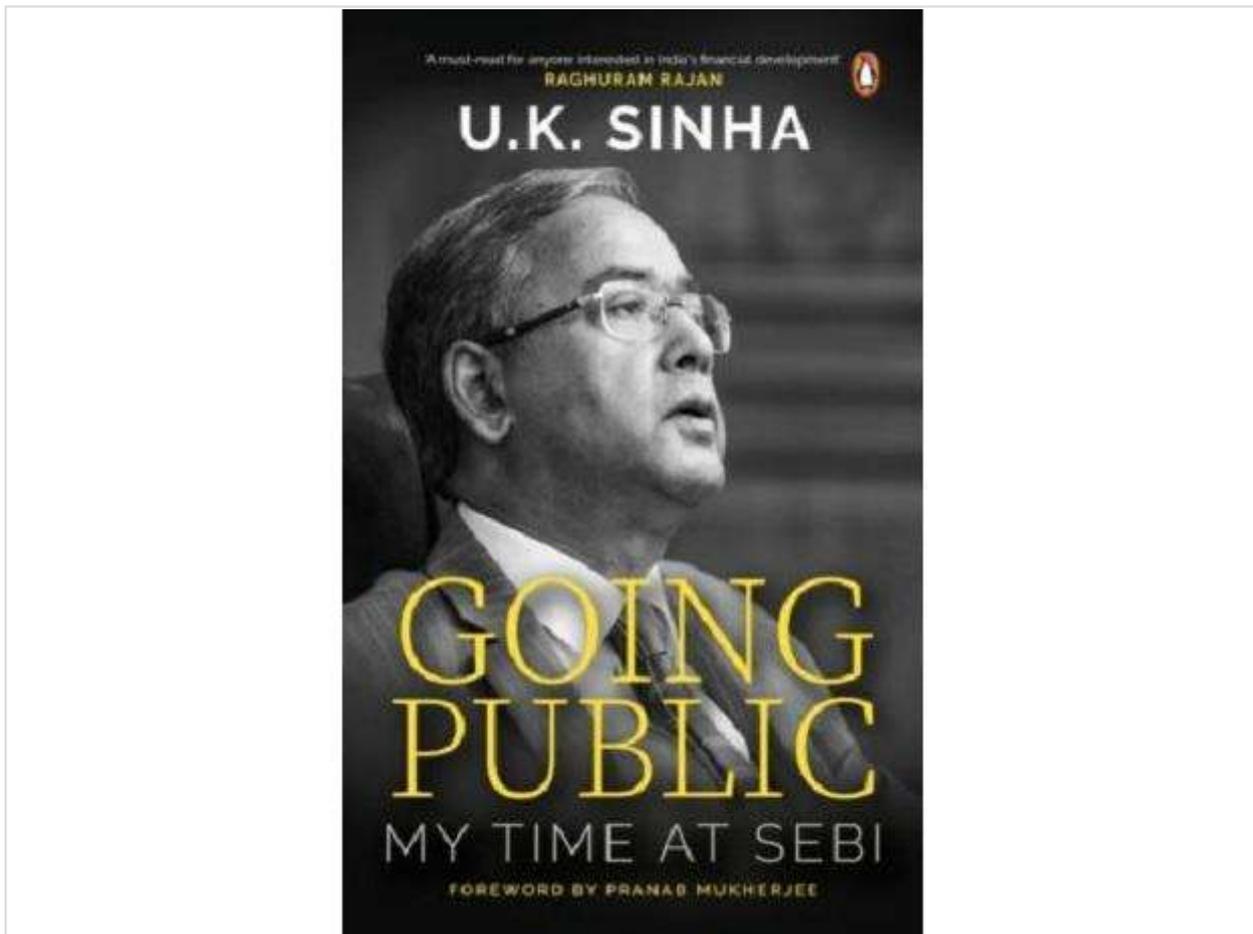


How UTI crisis unfolded: Former Sebi chairman UK Sinha revisits the drama

The decision to stop the encashment of US-64 unit was a step that shocked investors and the entire capital market. Former SEBI chairman U K Sinha revisits the drama in his new book

Business Standard January 04, 2020 Last Updated at 19:59 IST



Unit Scheme-1964 (US-64) was the biggest and most popular scheme of UTI. It was sold and

repurchased from unit holders not based on the correct inherent value of the portfolio (net asset value) but on artificial prices fixed by the management. A practice that accentuated this problem was that from 1993-94, when UTI started distributing a dividend to unit holders that was much more than the actual income of the scheme during the year. In some years, a dividend as high as 28 per cent was paid, whereas the actual income during the year was less than 10 per cent. In order to continue this practice, the accounting policy was also changed. The basic principle of distributing a dividend is to utilise the surplus made during the year. Upon changing the accounting policy, the surplus and reserves began to be utilised year after year. Obviously, it was not a sustainable practice.

Guaranteed schemes

All investors must by now be familiar with the oft-repeated disclaimer, which goes: 'Mutual fund investments are subject to market risk. Please read the offer document carefully before investing.' The value of investments can fluctuate depending upon market conditions, and it is difficult to guarantee what the actual value after a given period, say one or two years, will be. This is unlike a fixed deposit in banks, or

small saving scheme run by post offices wherein the repayment of the principal as well as the agreed interest on maturity is guaranteed. This is one of the important reasons why banks are monitored very strictly by the RBI. As a further safeguard, the RBI also runs a Deposit Insurance and Credit Guarantee Scheme (DICGS). In case of small savings, the deposits are guaranteed by the Government of India.

By the same logic, if an assured return is to be provided in a mutual fund scheme, somebody has to provide that guarantee. Mutual funds, which have a very small capital of their own, do not have that financial strength. This is why SEBI insists that if a guaranteed return is to be provided to the investors in a mutual fund, then the sponsors (the institutions setting up the mutual fund) must provide this guarantee. SEBI does not permit mutual funds to offer any assured return unless such a guarantee is provided by the sponsors. However, UTI unfortunately continued to launch assured return schemes (ARS) without its sponsors providing any guarantee. The arguments advanced by UTI was that it had created a fund called Development Reserve Fund (DRF), whose corpus in 1998 was Rs 600 crore, which could provide the guarantee. UTI also felt that DRF would grow at the rate of Rs 125 crore per annum. The JPC later held that the management of UTI had made an erroneous projection about DRF being sufficient. It held the then executive trustee and chairman responsible for making this projection before SEBI. Ultimately, when the crisis of 2001 took place, there wasn't sufficient money in DRF to pay back the investors. What further complicated the problem was, that though in the initial years ARS were launched only for one year, later they were launched for longer terms, thereby exposing UTI to more uncertainty and making it more vulnerable.

All of this propelled the crisis in early 2001 when it was discovered that UTI had no means to meet the shortfall between the amount promised to the shareholders and the actual value of the portfolio. The JPC arrived at the decision that IDBI was accountable for ARS. Its nominees were the ones who had taken the decision. When SEBI asked UTI who its sponsors were so that they could be asked to take up the responsibility, UTI replied that it had no sponsors! Ultimately, it came upon the government to step in and take on UTI's liabilities.

US-64 erupts

The Ketan Parekh scam and the circumstances around it led to a massive decline in the prices of shares in the market. It was inevitable that shares held by the schemes of UTI, more so US-64, eroded in value. This of course prompted investors to start selling their units to avoid further losses. More and more unitholders came forward seeking encashment of their investments, resulting in an unusually large redemption in US-64 during April–May 2001. As the redemption price (repurchase price) fixed artificially by UTI was much higher than the net asset value (NAV), i.e. the actual value of the portfolio, redemption put even more strain on the scheme. It would have been only a matter of time before US-64 would have had no shares in its portfolio to sell and pay off the unitholders. What exacerbated the public's anger was that preferential treatment was given to large investors such as SBI or ICICI. Both of these banks particularly had nominees in the UTI board. They knew the state of affairs there much before the rest of the world, and were the first to encash their units. On 2 July 2001, the UTI board took the unprecedented step of refusing to pay the US-64 unitholders for the next six months, and suspended the repurchase/redemption.

Warning signs

The problems at UTI did not emerge overnight in 2001. Warning signs had appeared after the first two decades of its existence, when the mutual fund space had been opened for competition and UTI had lost its monopoly. The fact that UTI was not subjected to SEBI jurisdiction and was simultaneously performing the role of a mutual fund as well as a term-lending institution created worry in the minds of policymakers and market experts. The ministry of finance wrote to UTI as early as 1992 stating that investor protection guidelines of SEBI must apply to it, and it should create an asset management company for its mutual fund functions. In 1993, UTI set up a committee under N Vaghul, chairman of ICICI, to examine the issue, wherein Vaghul clearly recommended that SEBI's jurisdiction should be extended to UTI's mutual fund schemes. Even the JPC inquiring into the Harshad Mehta related scam offered similar recommendations towards the end of 1993, and the government supported this view. Finally, from 1994, UTI came under the voluntary compliance of SEBI mutual funds regulations for all its new schemes. However, US-64 and ARS remained out of SEBI jurisdiction.

Starting 1996, the RBI started raising concerns about the administration of UTI and wrote multiple letters to the ministry of finance to amend the UTI Act and curb activities such as extending loans and advances, and discounting of bills, all of which were not provided for in the original Act. These services were similar to those provided by banks and term-lending institutions, and actually contributed to lowering the credit discipline in the country. But UTI kept stonewalling reforms. It sent alternative proposals guided by its own assessment of the extraordinary role it was playing in the growth of the economy. The RBI kept reminding the government, but no substantial measures were taken until the crisis in 2001. Another committee set up by UTI to inquire into the affairs of US-64 submitted its report in early 1999, which pointed out several lacunae in the working of UTI. It was official that US64 had a severe shortfall. The government agreed to subscribe to the public sector undertaking (PSU) shares held in US-64, and a new scheme—Special Unit Scheme-99 (SUS-99)—was carved out. The government provided Rs 3,300 crore to buy these shares at face value against their actual value of Rs 1,500 crore. Another committee was set up under the chairmanship of Y H Malegam to review UTI's competitive position.

UTI had an equity research cell (ERC) of expert financial analysts that was supposed to give advice on buying and selling decisions about a particular security based on research. The JPC commented that the recommendations of the ERC were neglected and overlooked. The Tarapore Committee, which was appointed to look into the investment decisions of erstwhile UTI, identified eighty-nine companies where a substantial amount of money had been invested, but the decisions didn't seem to have been made logically, but had been made for extraneous considerations. The Tarapore Committee recommended a special audit of these investment decisions.

In some cases, it was noted that while one set of logic had been given to buy a security, within four days a contrary recommendation had been made and the same security was sold at a loss. Several other instances of irregularities and unprofessional approach were highlighted. So there was no dearth of warning signs, expert opinions, and findings of committees. But the operations continued without any structural changes.

Drama around US-64

The practice of a government nominee on the UTI board was discontinued in 1997, but the government and SEBI were expected to be watchful. The UTI management also didn't do much to keep the government informed. On 18 May 2001, Subramanyam, the then chairman of UTI, wrote a letter to the finance secretary. Even in this letter, there was no mention of the impending crisis. On the contrary, it was mentioned that the NAV was Rs 9.50, and based on certain projections, the scheme was likely to earn more by 30 June and be in a position to declare a dividend of 12 per cent and maintain an NAV of Rs 10. It was discovered later that this communication from the chairman was never processed in file by the joint secretary or anyone else and presented before finance minister Sinha. Subramanyam met Joint Secretary Bhagwati in the last week of June. According to him, he appraised Bhagwati about the deteriorating condition and requested him to apprise the finance secretary and the finance minister. But, according to Bhagwati, Subramanyam met him without any prior appointment. It was a casual and informal conversation. Since 30 June and 1 July fell on a weekend, it appears that neither the finance secretary nor the joint secretary informed the finance minister until 2 July, the date of the board meeting. The decision to stop the encashment of US-64 unit was a step that shocked the entire capital market in the country. The government was soon to come in for serious criticism about its own role.

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