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History and Nature of Ponzi Schemes

In August of 1919 Charles Ponzi in Boston received from an acquaintance in Italy an International Postal Reply Coupon. These coupons had been created to handle small international transactions. The recipients of such coupons could exchange them in at their local post office for stamps. Ponzi noticed that the coupon he had received from Italy had been purchased in Spain and found that the reason for this was that the price in Spain was exceptionally low. In fact, the cost of the International Postal Reply Coupon in Spain, given the current exchange rate between the Spanish peseta and the dollar, was only one sixth the value of the U.S. postage stamps it could be traded for in the U.S. This seemed to be an extraordinary opportunity for arbitage.

Ponzi envisioned a massive money making scheme in which dollars funds would be converted into Spanish pesetas to use to purchase International Postal Reply Coupons which would be sent to the U.S. to be redeemed in U.S. postage stamps which could then be sold for dollars. To Ponzi this seemed the opening to fast, unlimited profits. The problem with the scheme was that if anyone began to exploit the discrepancies in the prices of International Postal Reply Coupons in different countries the discrepancies would be corrected and the profit opportunity would disappear.

Ponzi founded a company to expoit the profit opportunity in International Postal Reply Coupons. Its name was The Security and Exchange Company. The Security and Exchange Commission (SEC) was not founded until the 1930's so Ponzi was not trying to mislead potential investors by giving his company a name similar to a Federal agency.

Ponzi circulated literature offering investors a 40 percent return in ninety days. Since the prevailing interest rate was five percent per year this was a very attractive offer. Ponzi's publicity was reaching primarily the immigrant community of the North End of Boston, the community which Ponzi himself was part of.

The investment in Ponzi's scheme began in small amounts in January of 1920. Ponzi then increased the promised rate of return to 100 percent on ninety-day notes and 50 percent on forty-five-day notes. By February the cash flow became a torrent. He had six clerks working

constantly to take in all the money. Ponzi deposited the money in a mutual savings bank. A mutual savings bank is like a credit union in that depositors actually buy shares in the organization. Ponzi soon became the major depositor/ share-holder of the bank and had himself elected president of the bank.

Ponzi was kept busy handling the money, acquiring properties and enjoying a life of luxury. He was so busy with these things that he didn't bother to exploit the discrepancies in the prices of International Postal Reply Coupons. The only profit his organization was making was the five percent interest on the bank deposits.

In July of 1920, the *Boston Post* published an article demonstrating that the scheme was not finnacially possible. There were not enough International Postal Reply Coupons sold to enable Ponzi to pay the returns he promised.

Some investors came to Ponzi to take their money out of his scheme. They were paid off with checks written on Hanover Trust Bank, a bank that Ponzi had acquired control of. Ponzi however convinced many that the *Boston Post* article was irrelevant because he had another, secret scheme for making money that was better than the International Postal Reply Coupon scheme. Ponzi was so convincing that instead of a run on the Security and Exchange Company it had a net gain of two hundred thousand dollars in investment.

A more serious threat arose when the Distric Attorney of Boston ordered that Ponzi's Security and Exchange Company must stop taking new investment until there was an audit of the firm's books. There was another run on the Security and Exchange Company. The *Boston Post* published another article based upon the relevations of a former publicity man of Ponzi's. The publicity man charged that Ponzi was in debt millions of dollars and asked why Ponzi was depositing funds in a bank earning five percent interest a year when he supposedly had means of making profits in excess of 50 percent in forty five days.

The *Boston Post* reporters then discovered Ponzi's past. He was born in Italy but raised in Montreal, Canada. As a young man he had been involved with arranging money transfers by Italian immigrants to their families back in Italy. There were charges that some of the remittances never arrived. In Montreal Ponzi had been sent to prison for forging signatures to checks. After he was released from prison in Montreal he migrated to Boston where he worked at menial jobs such as washing dishes and clerking until 1919 when he found out about the International Postal Reply Coupons.

The newspaper articles and the audit of Ponzi's Security and Exchange Company destroyed the scheme. The Massachusetts State Banking Commission closed down Hanover Trust, the mutual savings bank Ponzi was president of, but not before Ponzi took about one million dollars to a Boston racetrack to bet on some long shots in hope of winning enough to make his company solvent.

When Ponzi was charged with grand larceny and using the mails to defraud he told his public that all of his troubles came from the fact that the wealthy were trying to punish him for giving the "little guys" the opportunity to make a high rate of return. Ponzi was sent to prison but release on parole after three and a half years.

While on parole Ponzi was rearrested. He then jumped bail and went to Florida living under a different name. In Floriada he was again sent to jail for a real estate fraud in which

he was promising a 200 percent return in sixty days. He again jumped bail but was recaptured and extradicted to Massachusetts where he was sent to prison for another seven years. When released from prison he was deported to Italy. In Italy he got a job with the Italian Airline Alitalia where he worked in Rio de Janeiro until the airline closed its Brazilian operation during World War II. Charles Ponzi tried various jobs such as teaching English but was not successful. He died in a charity ward in Rio de Janeiro.

Although a flood of money during the early phases of a Ponzi scheme may mislead people into thinking the scheme can suceed a few simple calculations show the impossiblity of its financial survival. Consider a transaction Ponzi's Boston operation. His organization was taking money and promising to pay 50 percent in forty five days or 100 percent in ninety days. When the organization took in $100 for the ninety-day version it incurred an obligation to pay $200 in ninety days. The way to compare $100 now and the $200 in ninety days is to calculate the present value of the $200 ninety days from now. The discount rate that should be applied is the current market interest rate of five percent per year. The present value of $200 discounted ninety days at 5 percent annual interest is $197.53. Thus the net gain for the Ponzi organization on a $100 accepted was (+$100-$197.53=) -$97.53. That is say, the Ponzi company lost $97.53 on every $100 of investment it accepted. Clearly the more money it took in the farther in debt it became and so there is no way the Ponzi scheme could get into the black by losing money on every transaction.

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