Working Paper

BADLA SYSTEM : A REAPPRAISAL

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(Dr. RAMESH GUPTA)

ABSTRACT

The badla system, which allowed transactions to be carried forward from one trading valan to the next, was banned by the SEBI in March 1994. SEBI was hoping that for the purpose of speculative trading, an internationally accepted system of options and index future trading would replace the indigenously evolved badla system. To call badla trading a kind of forward trading is misleading. Badla is **carryover of a transaction and not a forward transaction**. While derivative trading (i.e., futures and options trading) is a trading in future-risk among different participants in the stock market, mostly used as a hedging device.

To have a strong cash market with sufficient liquidity, some element of leveraged (i.e., speculative) trading is necessary. Now this is possible only if the system provides : a) facility to buy shares on margin, and b) facility to sell short.

Badla system fell into disrepute because of its faulty implementation and lack of proper monitoring by concerned stock exchange authorities. Particularly, the margins collected were low, allowing excess leveraged trading and not having proper monitoring and surveillance. With proper framing of rules and regulations, chances of its misuse would be reduced considerably; without incurring large efficiency losses associated with financial regulations. These costs associated with financial regulations include both the direct element (the `compliance cost') and the indirect element (i.e., the damage inflicted on the competitiveness, dynamism and innovativenss of the system, the possible reduction in investor choice, the distortions included in market behavior and business practice etc.). Further, regulatory framework should also ensure **competitive neutrality** among different participants on the stock exchanges.

SEBI reconsidered its decision and badla was reintroduced in July 1995 with severe conditions. In this paper, these conditions are critically evaluated. A few modifications are suggested.

1. not to insist on segregation of transactions at the time of trading,
2. not to insist on separate identification of each transaction with an audit trail and limit of 90 days for completion of transaction,
3. not to impound profits and streamline the daily and carryover margin requirements.
4. financiers not to trade on securities but allowed to hold securities with them,

Suggested changes would make the system cost effective, less complex, easy to implement, and will ensure **level playing field** among different market participants.

BADLA SYSTEM : A REAPPRAISAL**

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1. INTRODUCTION

The badla system, which allowed transactions to be carried forward from one trading period to the next, was banned by the SEBI in March 1994. The system was conceptually sound and it helped enhance liquidity in the market by facilitating margin trading and short selling. However, the system fell into disrepute because of its faulty implementation and lack of proper monitoring by concerned stock exchange authorities. Particularly, the margins collected were low, allowing excess leveraged trading. Stock Exchange authorities had a lot of discretion in fixing havala rates, margins for bulls and bears and limits for carry over business. Often this discretion was used to accommodate problematic brokers and avoid immediate settlement problems. Authorities were hesitant to take action against their own fraternity members for two reasons: one, it was mutually beneficial and two, very often they were helpless. If a broker declares himself a defaulter, exchange authorities could not do much as they had very small deposits from the brokers.

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1. Badla Trading : A Primer and A Proposal (March 1995)
2. The Badla System : Revisited (March 1995)
3. Badla Committee (G.S.Patel) Report - A Critique (June 1995)

When SEBI abolished the badla system in 1994, In conceptualizing the badla system too much emphasis has wrongly been put on the word **forward** , and this certainly does make it a system of forward trading.

2. DIFFERENCE BETWEEN BADLA AND DERIVATIVE TRADING

Badla system is concerned with only settlement part of a transaction which has already been executed at current price in cash market and has nothing to do with trading or hedging in risk which is the main purpose of options and/or future trading. Through badla a trader is allowed to postpone the settlement of an outstanding position in a given valan to the next valan by paying badla charges and by depositing a margin to cover any risk which may arise due to price change in ensuing valan. It allows traders to do leverage trading as they do not have to pay full amount for their purchases at the end of current valan and thus, they get a longer period for squaring off their transaction. Thus their operating cycle become longer than one valan. Similar thing can be said in the case of a sale position; they do not have to make the delivery at the end of current valan, and their operating cycle become little longer. Thus, in badla system there is an inbuilt mechanism to buy shares on margin and it also provides a facility for short sale.

Index futures and/or options trading is a trading in risk among different participants in the stock market. It is a hedging device. Investors who are holding large portfolios may want to protect themselves from excessive market risk by taking position in index futures and/or options markets. This is kind of a portfolio insurance for which a premium is paid in the form of purchase price of an option. This kind of trading has nothing to do with cash markets, except that current prices in the cash market in combination with future expectations determine the premiums for buying options.

On derivative trading, one needs to proceed cautiously. It is important that the underlying cash market work efficiently and appropriate system are first developed, before trading in derivative is taken up. Without getting into much controversy, let me just ask a few simple questions to the people who advocate derivative trading. For example, NSE is strongly advocating trading in **Nifty Index futures** for better risk management and hedging for investors. Questions to be asked are :

a) How many investors in India holds Index Nifty portfolio ?
b) What are their needs for hedging ?
c) How many players do we expect in the market ?
d) Would this number make it a competitive market ?
e) If there are only few genuine players, then what would be mechanism of pricing these derivative products ?

It is of paramount importance that before we introduce derivative trading a kind of survey among **Indian investors** across the country is necessary. - If the number who holds index portfolios and need hedging is small, then market is not going to be competitive and would not be driven by demand and supply for such an insurance, but only by gambling instinct. Foreign Institutional Investors (FII) and some suave brokers may benefit from this kind of trading, but it would be at the cost of small investors and inexperienced but adventurous brokers. It is not going to help in savings mobilizations and/or resource allocation among industry which are the main functions of any stock ex change. It may be applauded by international community, but for most of the Indian investors across the country it is going to be only a new form of gambling. My humble suggestion to the powers and opinion makers is please do the demand analysis for such a step, survey the investors in India.

3. TRADING AND SETTLEMENT PRACTICES

On the stock exchanges around the world, generally there are two kinds of settlements done. One is done on rolling basis in which each transaction is settled after a given number of days. For example, T+5 means every trade would be settled on the fifth working day from the transaction day. If borrowing facilities are available, for example in USA, investor can choose to make 50 percent down payment if he wants to leverage his portfolio,

similarly can borrow the securities if he wants to do the short sale. Investor who borrows funds and/or securities does not have to observe any time limit to square off the transaction, so long the borrower meets the margin requirements.

The other kind of settlement is known as batch settlement, where all the transactions done during a trading period (known as valan in India) are netted at the end of this trading period and only net position is settled. Now to settle a position, each trader must have delivery ready in case of outstanding sale position in a scrip and funds available in case of net purchase position. If a trader does not have sufficient fund and/or securities, he would have to square off his outstanding position in the current valan itself. Depending upon the outstanding position of the market towards the end of settlement, intra-valan prices fluctuates widely. Thus, each valan is devoid of any linkages with coming valan which hampers the long-term price formation.

Further, absence of badla facility gives an unfair advantage to large operators who have access to large funds and hold inventory of various scrips in their portfolio. If these big operators have outstanding position at the end of valan and still expect that prices in the next valan would be favorable to them, they can on their own carry over their respective positions by financing among themselves in case of a net purchase position, or by providing securities in case of a net sale position. These big operators also

have access to various group companies, mutual fund schemes etc. and thus they can lengthen their operating cycle by mutually convenient internal arrangement. Thus, the system is loaded against small investor and trader, as they are forced to square off position while the big operators are not. We must have **level playing field**.

4. WHY BADLA TRADING IS A MUST IN INDIA

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To have a strong cash market with sufficient liquidity, where prices do not swing wildly because of a mismatch in short- term demand and supply of a given scrip, some element of leveraged (i.e., speculative) trading is necessary. In speculative trading a trader forms his own expectation for future and assumes risk by keeping his trade position open. If he expects price of a security to rise he would buy it, and if price to fall he would sell it. Speculator is different from an investor in the sense that he takes a larger position than funds available with him (leverages his purchases), or sells the security even though he does not presently own them, but hopes to purchase them in future at a lower rate (known as short-sale). Now this is possible only if the system provides : a) facility to buy shares on margin, and b) facility to sell short.

In highly developed markets, the banking system provides the requisite finance for security trade. Short term lending with

securities as collateral is possible only when we have scripless trading where ownership can instantaneously be transferred. Given the share ownership transfer system in India, margin buying is possible only if banks are ready to provide clean overdraft facility to the brokers. This seems unlikely. The much argued for relaxation in banking norms for brokers will not solve the problem, as it would help only a few high net worth individuals and brokers who are holding the securities on a long term investment basis and not as stock in trade.

Similarly for an efficient working of securities markets, it is essential that investors, who expect prices to decline, should be able to sell, even though they do not presently own securities, and take advantage of expected price decline. In the absence of carry over facility, short sale is not possible and prices do not reflect the price expectations of all market participants. The facility to short sale a security is absolutely necessary to provide liquidity in the market and act as a counter force to prevent sharp rise or fall in prices.

In developed markets with a central depository system, it is very easy to borrow shares. Such lending does not involve any physical transfer of shares. The transactions are handled electronically. The other problem is that of the capital gains tax laws. Lending of securities in India is deemed to be a transfer and it attracts capital gains tax. Mere changes in capital gains tax

laws are not going to solve the problem. Short sales are generally effected for a short duration (the open position is covered very soon, and given our share transfer procedures which involve considerable delay, such lending of securities is almost impossible, cumbersome and prohibitively expensive.

Seen this way, the badla system is the most appropriate settlement system for Indian conditions. It is a system that evolved in response to the absence of margin trading and lending of securities through a central depository system.

5. REGULATORY BAN ON BADLA REMAINS INEFFECTIVE

SEBI has officially banned the badla but genuine need of the trade could not be suppressed and people have found ingenuous ways of getting around the rules. Let me begin with new modus operandi of badla on regional stock exchanges and possibilities of its happening on National Stock Exchange (NSE) also.

Before ban on badla, investors with surplus money to invest would do badla through their brokers. these financiers would get the market determined badla rates and would also receive shares as a security for lending the money to finance somebody else's purchases. But now, since the badla is officially banned, big brokers borrow money at fixed interest rates. This money is deployed in renewal of transactions. Renewal is a mechanism to

postpone the settlement of transactions at closing prices without any apparent consideration. The modus operandi is the same, except that financing of badla transactions now are kept out of books of accounts. The interest paid to the financier is much lower than what the brokers earn in renewal transactions. Since renewals are not recognized by the Stock Exchanges, the entire process is unofficial and, therefore, carries greater risk. Thus, the returns to the financier have decreased and his risk has increased. The only beneficiaries have been the brokers.

When one examines critically the current settlement procedure on NSE, one can find badla can easily by done in most efficient and most secretive manner. The modus operandi is the same which large brokers used to employ in old badla system and was popularly known as `Chalu upla'. Let me explain how it can be, and probably is being done, presently at NSE.

NSE provides special facilities for institutional investors and custodians. Trades done on behalf of institutions and who are custodial participants are settled separately. These trades, known as custodial trade, are settled outside the clearing house system through intra-custodian and inter-custodian settlements. Only the net position of these custodial participants which remains outstanding is settled through clearing house. Thus, so long a trade is marked as custodial trade, settlements can be done among custodial participants themselves. Now imagine, if one of this

custodial participant has outstanding position and cannot deliver, all he has to do is to find another willing custodial participant who would be prepared to lend the securities and/or funds. This arrangement need not be reported to the NSE authorities. This arrangement is no different from the practice of `chalu upla' which was practiced by big brokers in the old badla system. These brokers were making private arrangements among themselves to settle outstanding business and only net vis-a-vis remaining segment of the market was cleared through the stock exchanges. In fact, under the old system, `chalu upla' arrangements were at least reported to the stock exchanges and net position of the market was known to everybody; but the system prevalent on NSE is such that nobody would ever know about it so long there is a willing party who is also a custodian participant.

It is an irony that even in the most efficient stock exchange of India, big operators can have an advantage over the small operators who have to square off their transaction within a valan, while big operators can take advantage of inter-valan price fluctuations. Why this in-built discrimination in the system ? Why not introduce badla system which would provide **level playing field** and small investors/brokers would be at par with custodian participants and take advantage of longer operating cycle for their trade.

6. APPROPRIATE SYSTEM FOR CARRYOVER FACILITY

If we accept our given level of infrastructure developments i.e., financial institutions, processes and system, we should have some kind of carry over facility of the trade to provide for margin trading and short selling, the most important question that arises in this context is what would be the appropriate system under Indian conditions.

As we have noted earlier in the first paragraph of this paper, we will have to develop a system which would eliminate and/or reduce chances of such misuse considerably; and therefore some kind of rules and regulations has to be framed. One question which always remains is what should be established principles for guiding policy and by which to judge intervention. While no definitive statement of principles commanding unanimous support has ever emerged, those apparently enjoying majority support can be identified. The list would include, inter alia, (a) the principle of `**competitive neutrality**, namely the desire to ensure that regulations causes minimal disturbance to the competitive balance existing between financial intermediaries, i.e., prudential requirements should be applied in a flexible manner leaving intermediaries with maximum freedom to adjust to changing circumstances and should aim at ensuring competitive neutrality amongst intermediaries; (b) the principle that every effort be made to minimize the damage done to the efficient functioning of the

financial system and (c) regulations should not impair the provision of a reasonably full spectrum of risk-return investment opportunities, including a `safety haven' for the small unsophisticated investor.

In discussions on the efficiency of the financial, system, the following aspects are usually addressed[***] (a) allocative efficiency, or the extent to which savings gravitate to those investment outlets offering the highest prospective risk-adjusted rates of return; (b) operational efficiency, or the extent to which real resources are consumed during the savings transfer process; (c) `dynamic efficiency', namely the ability of the financial system to adapt, in an `optimal' fashion, to the changing needs of the users of the financial system.

Therefore attempts to minimize the efficiency losses associated with financial regulation are concerned with minimizing the `costs'- both direct (the `compliance cost') and indirect (i.e., the damage inflicted on the competitiveness, dynamism and innovativenss of the system, the possible reduction in investor choice, the distortions included in market behavior and business practice etc.) imposed on the financial system.

[***]Campbell Committee Report on Australian financial system, Australian Government Publishing Service, 1981).

With some of these principles in mind, let us explore what would be a satisfactory regulatory which would serve the purpose. But then let us also remember that there is no full proof method of insulating financial systems from the lack of probity in human behavior. Pushed to an extreme, regulation can do more harm to the market than any crook.

7. SEBI - REINTRODUCES BADLA SYSTEM

In July 1995, based on G.S.Patel Committee report, SEBI decided to reintroduce a revised carryforward system, subject to the following prudential conditions and precautions :

a) **Infrastructure Requirement - Screen based trading**
For a stock exchange, SEBI's prior permission is necessary to introduce carryforward system. Stock exchanges should have suitable infrastructure, including screen based trading, and effective monitoring and surveillance system. Arrangements would have to be made for immediate rectification of `vandhas' (objection memos) and for enforcement of ban on `kapli' system and `chalu upla' transactions. A considerable amount of responsibilities has been laid on the Executive Director for surveillance, audit and reporting.

b) **Twin-track system - Classification of Transactions**

Exchanges would introduce twin track system to segregate carry-forward transactions from cash transactions. At the end of each trading day, transaction would be demarcated and reported separately for (a) delivery, (b) jobbing, and (c) carry forward. Transactions marked for delivery must result in delivery in the settlement period itself and can neither be offset by an opposite transaction nor carried forward.

c) **90 days time limit**

Each carry forward transaction to be identified by an identity number and this number is to be maintained until its final settlement. Maximum of 90 days for carryforward of transaction is allowed with a facility to square off up to fifth settlement, following which there will be compulsory delivery or payment. Brokers would be required to submit monthly auditor's certificate (later on modified by self certification) that there is no violation of time limits.

d) **Financiers and their securities**

The financiers funding the carry forward transactions being lenders of funds should not be permitted under any circumstances to square up their positions till repayment of the loan. Shares received by such financiers against

those transactions should be deposited and kept in safe custody of the clearing house of the stock exchange/ or its authorized agent.

e) **Capital Adequacy Norms and Margins**

Margins on carry forward transactions were imposed on gross basis at the rates of 20, 30, 40 and 50 percent on positions carried forward at the end of 1st, 2nd, 3rd and 4th and 5th settlements respectively (with compulsory delivery/payment at the end of the 6th settlement). These were the daily margins. For collection of margins there was a provision also for marked to market on weekly basis.

In the absence of capital adequacy norms in July 1995, the broker-wise outstanding position on any day in respect of carry forward transactions was not to exceed 25 percent of a broker's total transactions on that day.

Changes in October 1995

The above requirements were later on in October 1995 modified by introducing capital adequacy norms of 3% for individual members and 6 % for corporate members in respect of their outstanding positions. Similarly, minimum base capital of Rs. 10 for Calcutta and Bombay stock Exchanges, Rs. 7 lacs for Delhi and Ahmedabad and Rs. 5 lacs for other stock exchanges were also specified.

With the introduction of these capital adequacy norms, the condition stipulating graded margins of 20 to 50 percent on carryforward transaction was replaced by

1) Minimum daily margin of 15 % on gross position

2) The profits to the extent of at least 25 percent should be impounded while fixing the carry over margins.

3) The rates of carryover margins would not be less than the rates of daily margins.

4) Margins are to be levied on mark to market system based on a weekly basis.

5) The exchange may impose as hoc margins also in cases of individual brokers or scrips if the situation so demands.

6) Earlier limit of 25% of carryover business to the total business was removed. However, limits and sublimits on business has been put. There will be an overall limit of Rs. 7.5 crores with sub-limits of Rs. 4 crores each for sale and purchase position with a sub-limit of Rs. 1 crore in respect of each script outstanding at the close of the business.

8. COMMENTS AND SUGGESTIONS ON EACH OF THESE REGULATORY NORMS

A) Infrastructural Requirements:

For a stock exchange to have screen based trading and effective surveillance and monitoring system, there cannot be two opinions. A considerable amount of responsibilities has been laid on the executive director for surveillance, audit and reporting. However, no thought has been given to how he is going to perform these tasks in the absence of any new initiative for change in the management structure or the decision making processes of stock exchanges. Radical thinking for restructuring of management systems, processes and power distribution among various functionaries of Stock Exchanges is required.

B) Classification of Transactions:

For greater transparency and strict monitoring, the Committee has suggested that at the end of each trading day, members should be made to demarcate all transactions as those meant for delivery, for jobbing, for carry-forward and for trading on own account, and report on these separately. One wonders what purpose this information is going to serve and how accurate this information would be when traders themselves do not know at the time of transacting whether they are going to square it off in this valan, or carry it forward to the next valan or would take delivery. This decision of a trader would

invariably depend on price trends in the remaining period of the valan, availability of finances and whether the market is overbought or oversold at the end of the valan period. Instead of overloading the exchange authorities with detailed information about each transaction of individual brokers, let authorities concentrate their energy and time on ensuring that there is correct and full reporting of gross outstanding position.

C) **90 days limit and separate identity for each transaction**

In the current system of trading and settlement, SEBI needs to introspect whether it is possible to identify a transaction which has been carried forward and observe the time limit. Since there is bunching of transactions for settlement purposes, and only the net position in a scrip is delivered or carried forward, an exercise to identify the carried forward transaction and putting an audit trail on it is impractical. To illustrate, if a broker bought 500 Reliance shares in one transaction and sold 200 shares in the second transaction, sold another 400 shares in the third transaction and again bought 300 shares in the fourth transaction during this trading period, then all that a broker has to do is to settle the four transactions by taking delivery for remaining unsold 200 shares. In this bunching and netting of transaction for a trading period, the individual transaction losses it's identity. Identification of a transaction is possible in the

system prevalent abroad, where each transaction is settled by taking or giving delivery. It is generally done on a **rolling basis** i.e., if the practice is to say settling transactions on T+5 basis, it would mean that a transaction entered today would be settled on the ensuing 5th working day. There is no bunching of transactions for settlement. There is nothing called a trading period for each settlement. Trading and settlements are continuous. Given this, the requirement by SEBI that transactions cannot be carried forward beyond 90 days is impossible to implement and ill-advised to insist upon.

D) **Financiers:**

The financiers are lenders of funds and securities given to them are held in trust. These financiers should not be allowed to use these securities for their trading purposes. Question comes who should be holding these securities and how to ensure that those holding it would not use it for their trading purposes. SEBI insisted that they should be kept with Clearing house of the stock exchanges.

This could have been a perfect arrangement, if somehow financier can be ensured that their shares are in safe custody. It is a matter of trust. A financier who is not a member of stock exchange may not want to keep the shares with stock exchange authorities and would like to keep in his

possession. And for this reasons, suggestion that Vyaj badla shares should be allowed to be given to financiers. To prevent vyaj badla financiers from circular trading, the condition may be imposed that they must return the shares bearing the same distinctive numbers.

E) **Capital Adequacy norms, limits, sub-limits on outstanding business and Margins**

To deal with these issues, first one has to evolve the general principles about the purpose and the extent of such restrictions. Prudential norms are prescribed to make sure that the functioning of the stock exchange system does not get endangered. Further, a regulatory agency cannot get into micro management of risk for a particular stock exchange. SEBI should broadly specify these requirements and put lot more emphasis on ensuring that each stock exchange is fully enforcing the prescribed norms.

Capital adequacy - prescribed capital adequacy norms of 3 percent for individuals and 6 per cent for corporate brokers are prudent and reasonable. There should be no modification on these.

Margins - The badla should be a simple business where an outstanding position (net sold or bought) could be carried forward by paying carrying forward charges and making a deposit called margin (which was on lines of `good-faith deposits' and not the down payments). Good faith deposit is to protect the broker against

risk in the event of adverse price moves in the interim between settlement. They were never meant to be down payment as interpreted and understood by regulatory authorities. The ideas was to protect investors from fluctuations, if prices became very volatile, margins were raised; otherwise normally 15 per cent margin should be considered adequate. If there is high volatility, authorities should take serious note of entire market functioning - should smell manipulation in a price and act fast. If volatility on a scrip is high than increased the margins on that scrip, in very exceptional cases going up to 100 per cent.

Daily and carry over margins of 15 percent are reasonable and should be kept. Marked to market covers the past losses as of now, while daily and carryover margins are meant to cover the future losses due to volatility in prices for an open position.

Changes introduced in October 1995 seems to be very reasonable, except that the profits to the extent of at least 25% should be impounded while fixing the carry over margins does not make economic or regulatory sense.

As for as limits and sub-limits are concerned, so long as a broker is fulfilling the capital adequacy norms and depositing required margin on time, they do not serve any purpose. However, on a given scrip if there is suspected cornering, inside trading or some other unusual movement, sub-limits for such scrips can be

prescribed. However, this can be left for each stock exchange authorities to decide for itself. But it has to be Executive Director's decision and not the elected officials of the stock exchange who may have conflict of interest.

9. IN THE END

In the end, it can be said that given our trading and settlement system and the present state of financial infrastructure, SEBI should accept and reintroduce the badla system without any apologies. Unnecessary complexity in rules and regulations can make a system prohibitively expensive and cumbersome to implement. System has to be cost effective otherwise there would not be any takers. SEBI should be concerned about policies which would allow to have it a macro control over trading and settlement; micro management should be left with local stock exchange authorities who are supposed to act as self-regulatory organizations (SRI's). Emphasis should be on reporting of total outstanding business and effective collection of necessary margins.