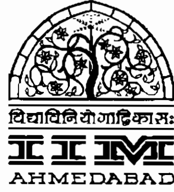

Working Paper

THE BADLA SYSTEM REVISITED

By

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THE BADLA SYSTEM REVISITED

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ABSTRACT

This paper is an attempt to examine the issues underlying the current debate about reintroducing the badla system. The differences between badla system on one hand and options and futures markets on the other are highlighted. Then it is argued that for an efficient security market, facility of buying stocks on margin and facility to sell short is a must. In the absence of an acceptable central depository system and due to cumbersome procedure of share transfers, badla system is the most appropriate settlement system under Indian conditions to meet the demands of a strong and efficient security market.

Badla system in the past fell in disrepute mainly because of a faulty implementation and monitoring system. There were frequent payment crises and settlement delays. Stock Exchanges were functioning as closed clubs of brokers ignoring general interests of investing public. With the change in power equation between Executive Director and the member brokers on the one hand and composition of the Governing Board of Stock Exchanges on the other, it can be hoped that necessary control and monitoring system for successful operation of badla system would be strictly adhered to. Two things would need to be ensured -

a) No compromise in fixing havala rates. These rates must reflect the current market price at the end of the trading period. Correct havala rates would facilitate marking to the market of carry over business, and thus reduce the settlement risk in the ensuing period.

b) Collection of full margins on the entire carry over business (on gross basis). The margin percentage should be sufficiently high (say, 35 percent of havala rate) so as to act as a deterrent to high speculation (so called bubble trading) and be adequate for guaranteeing the performance of the contract in the ensuing settlement.

The author also argues that SEBI's insistence that carried over transactions not be squared off but must be settled by delivery and payment within 90 days is impractical and ill-advised. One must realize that our trading system is very different from the one prevalent in other countries, and it is impossible to identify transaction-wise carry over business in our trading system.

The Badla System Revisited

About a year ago, SEBI scrapped the badla system as it existed then. Hopes were that the indigenous badla system could be replaced with an internationally accepted system of **futures and options** trading. The demand for introducing futures and options is linked to the needs of institutional investors. It is argued that if India has the same trading and settlement practices as prevalent abroad, familiarity alone will encourage foreign portfolio investors to put in more money than they would otherwise. Also, the way badla system operated in the past created occasional payment crises on the stock exchanges and periods of high volatility in market prices. However, these were the problems of implementation and monitoring of trade and settlement by stock exchange authorities.

With the passage of time since the ban on badla system, regulators and the financial community are realizing that the two systems are not akin to each other and serve different purposes. Badla is a system which allows carry over of the settlement of transactions from one period to another, under the Options trading system one party would have an option to enforce the settlement. Thus, option trading is more of trading in risk sharing among different participants in the stock markets, where one party is ready to pay a premium for protecting its gains to the other party who is willing to bear that risk. Unlike a futures contract which implies both a right and an obligation to buy or sell an asset at the forward price at pre-specified date in the future, an option represents only a right but not an obligation to buy or sell the asset at a future date at the exercise price.

Now let us look at what a **forward market** really means. A long position on a forward market is a firm contract to buy shares on a pre-determined future date at an agreed price. Since there is a firm contract to buy after a fixed duration, this forward price is normally going to have a definite relation ship with current market price. Forward price would be nothing but current market price plus the applicable interest charges. If price deviates too much, traders (with adequate financing facility in formal or informal market) would arbitrage between the two markets and bring the prices in equilibrium. Thus both markets, that is cash and forward markets would function in a perfect tandem. Since Forward transactions require only margin deposit and not the full payment immediately, they, in essence, merely facilitate trading on margin. But then, the carry over of a long position with badla charges is the same as a long forward contract. The holder of the long position is committed to purchasing the scrip at the settlement price plus the interest charge. Since carry over transactions also require margin deposit the indigenous system is completely in tune with so called futures markets. One may point out here, that forward market in an individual security does not exist anywhere in the world because it is redundant. (The only exception is Australia where this has been introduced recently on experimental basis).

Need for Strong Cash Markets With Sufficient Liquidity

Let us assume our goal is to have a strong cash market with sufficient liquidity where prices do not swing wildly. To achieve this, some element of speculative trading is inevitable. Limited and managed speculation facilitates rational formation of justifiable prices in a free market, where market operators trade on the basis of their view of the direction of price movement and not necessarily because they want to take or make physical deliveries. Such traders provide liquidity on the opposite

side of the traders who want to buy or sell for delivery only. Regulatory attempt should be to facilitate such speculation in an orderly manner rather than eliminate it.

To facilitate creation of strong cash market with sufficient liquidity what one needs to provide for is facility

a) of buying shares on margin (where only part payment is made and thus leverage trading becomes possible)

b) to sell short (where a trader sells the shares even though he does not presently own it, but plans to purchase it in future at a cheaper price).

Buying on Margin

In highly developed markets, the banking system provides the requisite finance for security trade. For **margin buying**, let us look at the existing practice in U.S. The Central Bank in U.S. allows almost all listed securities to be used as collateral for margin loans. The margin requirement is 50 per cent which means that an investor buying on margin has to pay only 50 percent of the purchase price and the balance is available from the banking system. The purchased securities are kept as collateral. If prices decline and the borrower's equity position falls below a certain level (known as **maintenance margin**), there is a margin call and borrowers are supposed to deposit additional funds. If the account holder fails to deposit the extra amount demanded, a part of his existing holding is auctioned off to bring his collateral to the desired level. A strict follow-up of margin requirements ensures smooth functioning of the market.

However, this system works well when there is **scripless trading**. Transfer of securities and ownership record is maintained by electronic book keeping entries, rather than physical movement of securities. Transfer of ownership of securities is instantaneous. There is no problem of delay in ownership transfers, dated transfer forms, fake share certificates etc.

Given the share ownership transfer system in India (where paperless trading is still far far way), margin buying is possible only if banks are ready to provide clean overdraft facility to the brokers which seems unlikely. Even if RBI permits unlimited lending against securities, the system is not going to work smoothly, because the collateral securities would have to be transferred in banks's name and would remain in bank's possession. Securities would not be easily available for brokers to trade in. Even if the banking system is persuaded to provide funds for security trade, the system would be cumbersome and impractical having high transaction costs. The much argued for relaxation in banking norms for broker community is not going to solve the problem, as it would help only a few high net worth individuals and brokers who are holding these securities on a long term basis as an investment and not as securities to trade in.

Selling Short

For an efficient cash market in securities it is essential that if some investors, who are forming declining price expectations, should be able to trade, 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. For an efficient market, short sale is a must as it provides liquidity in the market and acts as a counter force in the market to prevent sharp rise or fall in prices.

If the trading system does not allow for short sales, the big bulls by virtue of their financial strength (they can raise funds from informal sector) can buy huge quantities of shares for delivery which would have the effect of pushing up the prices stratosphererically. Since their buying is done with a view to ultimately selling, when these shares come for selling, there would be a corresponding sharp fall. Small investors would be caught unawares. This is where the role of the short seller needs to be appreciated. By intermittently puncturing sharp rallies through short selling, the short seller provides a measure of restraint to unbridled up moves. At the same time, when the market declines, the short seller, in covering short position, provides a break to a rapid downslide.

Now a question arises as to why a short seller should receive badla charges when he does not even own the share.

It is argued that they hardly make any investment and still earn an income in the form of badla charges, and therefore, return on their investment is very high. But proponents of such view forget that badla income is not merely a return on investment but a large part of this income consists of compensation for risk taking. Let us not forget that in a rising market the dice is loaded against short seller. While a forward buyer can always borrow money (from within or outside the market) to finance his purchase, a short seller cannot borrow shares to deliver. In an oversold market, the short sellers can be held to ransom by long buyers who may insist on taking delivery of shares. In such situations, short sellers are compelled to pay 'undha badla' which are comparatively very high. Moreover, the short seller is bearing the market price risk which can easily wipe out his gains on account of badla income. Thus, badla income should not be construed as return on investment. For a short seller it is compensation for risk taking.

In developed markets with a central depository system, it is very easy to borrow shares. In USA, for example, a short seller is able to borrow shares belonging to other clients from a broker by paying a nominal charge. Brokers can lend the shares because all the shares are held in brokers' name, though beneficial owners are their clients. Such lending does not involve any physical transfer of shares. All he has to do is to instruct central depository to make electronic entries showing different client and/or broker ownership while retaining original beneficial ownership in his books.

The facility of borrowing shares is not available in India. Firstly, our tax laws do not support it. If someone was to lend his shares (to be replaced by the borrower later), the tax authorities would consider such transfer as a sale and charge capital gains tax. Secondly, in the absence of a paper less

trading (for which the prerequisite is a central depository system), lending of shares becomes practically impossible. Short sales are generally effected for a short duration (the open position is covered very soon), and given our share transfer procedures which involves considerable delay, such lending of securities is almost impossible, cumbersome and prohibitively expensive.

Seen this way, badla system is the most appropriate settlement system ever devised for Indian conditions where facility of margin trading and lending of securities through a central depository system is not available. However, the way badla system operated in the past was full of problems, but they were problems of implementation and monitoring. That is what I plan to discuss next.

Problems in Badla System in the Past

In the past, most of the problems with badla transactions related to inadequate margins and absence of a full and fair enforcement of an agreed upon system. Thus, it was more of a management problem. First, I would like to highlight the problems which we had in the past -

Frequent Delays in Settlements and Payment crisis

Badla system permitted unsettled transactions to be carried forward in future. Such carry over was permitted at **havala rates** which normally were the current market prices at the close of a trading period. The difference between various transacted prices and the havala rate (known as **standard differences**) was settled, i.e. paid or received, during the current period itself. Thus, in a way there was a practice of marking to the market of net outstanding position in a scrip, except that it was done only once at the end of the trading period rather than on a daily basis. Thus, the so called price fluctuation risk was minimized a great deal. The only risk was due to changes in market prices during ensuing trading period, a risk which is also inherent in any new transaction.

However, in the past when prices of volatile stocks fluctuated a great deal, brokers became reluctant to pay the difference between their transaction price and the havala rates fixed by the stock exchange authorities. For example, during the period between December 1990 and March 1991 when the market was declining and the settlements were getting delayed, make-up prices announced by the Stock Exchange authorities were much higher than the ruling current prices (e.g., for settlement No.12/90-91 on Ahmedabad Stock Exchange Reliance havala rate was Rs. 170 while the market price was Rs. 130, and for settlement No.13/90-91 Reliance havala rate was Rs.150, while the then market price was Rs.100-110). Authorities could not keep up with the fall in the stock prices. The operators knew that their real losses were much larger than the payments currently demanded by the exchange. The operators knew that authorities would ask for more money in the next settlement as new havala rates would be much lower than the earlier rates. Operators get concerned about the total losses for which they have to pay in coming settlements, and therefore, opt not to honor even present payments. In Ahmedabad, this had been the precise cause due to which many innocent brokers and investors had to bear the brunt of losses. Delayed settlements were the major contributor to the present state of affairs. If settlements were done on time, the computed losses would have been smaller and operators would have continuously adjusted their outstanding positions as prices were changing. However, the market remained closed and settlements were delayed for weeks. With every

decline in prices, cumulative losses of the bull operators and, therefore, the payments to be made became larger. As there was no settlement for a considerable length of time, honest brokers could not collect the price differences from their clients, as payments did not become due until pay-out of previous settlement was completed. Losses kept on accumulating, liabilities kept on increasing and operators (including big clients) began refusing payments.

Problem of Inadequate Margins

As the practice was prevalent, stock exchange authorities collected margins only on net position of a broker in a scrip. The net position often disguised the real extent of speculative involvement of the brokers. Let me give an example to understand the menace which this practice caused. In a given settlement period, broker A bought 100 TISCO shares on behalf of client X from broker B and then did a second transaction in which he sold 100 TISCO shares to broker C on behalf of client Y. As per practices of the exchange, net position of broker A in Tisco was zero, and he was not required to deposit any margin. However, he collected margins from both his customers X and Y. This collected margin remained with the broker. If broker A is a prudent broker, he would be content to earn interest on this money. However, in reality, brokers were not content with their commission and interest income. They also indulged heavily in transacting on their own account. Without putting a single rupee of their own, they could easily speculate and pay margin from the funds collected from clients for any net outstanding position. This practice of collecting margins on net position had a tremendous multiplier effect on speculative activity on a stock exchange and seems to have been the root cause of the payment problems often faced by Bombay and Ahmedabad Stock Exchanges.

Stock exchange authorities collected very low margins on unsettled business and were hesitant to take action against brokers, because if a broker declared himself a defaulter, exchange authorities could not do much as they had very small deposits from the brokers.

Further, most of the brokers did not comply with margin requirements. Despite margin requirements being abysmally low, brokers indulged in unfair and even unethical practices to avoid these margins. Some of the common practices to avoid margins were:

i) *Chalu-upla* in which the modus operandi was that the deal on which margins were payable were reversed in the books of the transacting parties just before the settlement period came to a close, and thus, taken-off the books. Since in the books there was no outstanding business, no margins were deposited with the Stock Exchange authorities. However, the deals remained very much alive and were re-entered in the books at the beginning of the next settlement period and the earlier position was restored. Thus, transactions were carried forward to the next settlement period without depositing the required margins.

ii) Another tactic used by the brokers to evade margins was *vandhas* (objection memos). With tacit approval of the counter-part broker, parties reported a transaction to the exchange authorities which did not match in quantity or price and an objection memo was filed. Once

an objection memo was filed, pending reconciliation, the deal was off the purview of a particular settlement. Parties did not have to pay margins on these transactions. Later, by exchanging debit and/or credit notes (known as kapalis), the parties used to legitimize the deal.

What Can be Done

To develop a healthy investor-oriented secondary markets, following suggestions are made:

1. *Collect Margins on Gross Business of the Brokers*

Better administration of margins on purchase and sale is needed. Though regulations provide for collecting the margins on *gross position*, in practice, on almost all the Stock Ex changes margins are collected on the *net position* of a broker in a given scrip. In practice the rule is difficult to enforce unless Stock Exchange authorities require reporting of all trans actions done by a broker. To ensure smooth settlement it is essential that margins are collected on the *gross position* of a broker rather than on the *net position* in a given scrip. Further, margins should be high enough to ensure completion of transactions on settlement dates. The principle of leverage must come into play.

In other countries, trading in securities on margin is allowed but it is highly regulated and regularly monitored. The margin requirement should not be a matter of negotiation or whims and fancies of the Stock Exchange authorities, but should be based on realistic assessment of the risk involved in carrying forward the settlement of a transaction. Margins could be uniform for all securities, or could vary depending upon price volatility of each scrip. If the latter method is adopted scientific empirical studies should be carried out to determine the margin percentage in each scrip. For example, scrips like ACC, Reliance, TISCO, and L & T would require larger percentage than say, scrips like Hindustan Lever, Cadbury, Ponds etc. Stock Exchanges authorities need to evolve a clear cut policy on margin requirements. In past, due to low margin requirements, trading on small equity was common. Margin requirements as a percentage of market value should be sufficiently high as to act as a deterrent to high speculation and ensure performance of the contract during the ensuing settlement period. Further, the policy should be stable and enforceable.

2. *No Compromise in Fixing Havala Rates*

Under no circumstances, should the Exchange Authorities com promise in fixing up the havala rates to save the completion of current settlement. The principle of marking the outstanding business to market prices at the end of each settlement must be enforced. As explained earlier, in the past brokers took the liberty of fixing the havala rates below current market prices so as to save some brokers from default or give them more time to arrange payments of standard differences. It solved the problem for the current settlement, but the problem gets accumulated and very soon it becomes unavoidable for a Stock Exchange to face a payment crisis and a break down in settlement system. To save one or two brokers in the current settlement, the entire system is put at risk and this must be avoided. In the past, Stock Ex changes were functioning as closed clubs run by the brokers and

for the brokers, ignoring general public interests. There were plenty of rules and regulations on the books but enforcement was lacking. Complicated enforcement procedures most often resulted in condoning the offense or accepting a compromise. but hopefully now, with the change in power equation between the Executive Director and brokers on the one hand and changed composition of the Governing Board of Stock Exchanges on the other, these kind of compromises can be avoided. Any breach must be considered a felony offense for which Executive Director must be held responsible.

SEBI's Conditions for Reintroducing Carry Forward:

There are two other issues which I would like to address, and these have to do with the SEBI requirements for reintroducing the badla system on Indian stock exchanges. The first requirement is that carried over transactions would not be allowed to be squared off in the ensuing settlements but will be settled by delivery and payment. The second requirement is that in no case a transaction shall be allowed to be carried forward beyond a period of 90 days.

To examine whether a carry over system can be designed in which these two conditions can be met, let us look at the Indian trading and settlement practices.

In India we have a so called valan (trading period) which is generally of one week's duration. All transactions entered into during this period are bunched together and settled for each scrip on a net basis. This means that for an example, if a broker has 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 transactions for a trading period, the individual transaction looses it's identity. What is left is the net position in a given scrip. Now this position must be settled (that is payment made and delivery taken) in a cash market. Earlier, when the carry forward system was operative, there was a possibility of carrying forward the net position at havala rates and settle the difference between various transacted prices and the havala rate (known as standard differences) by making or receiving the payment during this period.

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. 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 impractical. 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 of say settling transactions on T+5 basis, it would mean that a transaction entered to-day 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 settlement are continuous.

Given this, the requirement by SEBI that transactions cannot be carried forward beyond 90 days and cannot be squared off during ensuing settlement periods is impossible to implement and ill-advised to insist upon.

SEBI also insists that carry over transactions shall be subject to an initial carry over margin of 30% and an additional margin of 15% should be put up for each subsequent carry forward. Now this requirement is intended to ensure adequate margins as security for performance guarantee of the carry over transactions in the ensuing settlement periods.

Here, let us be clear, that there is no carrying forward of a position beyond one settlement period. Each net position brought forward from the previous period together with new transactions during the current trading period create a new net outstanding position in a scrip, which is settled either by delivery or by using the carrying forward facility. Therefore, we should look at a settlement one at a time without worrying about future settlements. However, as a general rule of any trading business, a broker must have adequate capital to support his current business activities (which would also include a carry over position). Here, the general capital adequacy norms of SEBI for brokers should be strictly enforced. This compliance has nothing to do with and should not get affected by whether SEBI allows carry over facility or not.

Given Indian legal and financial framework, one can only conclude that badla system is the most ingenuous system in the absence of appropriate institutional arrangements like central depository system and the banking facility for margin trading. Just because we are different, let us not be apologetic about it. We need foreign funds, we can certainly educate the foreign financial institutions about our system and given our institutional development and financial system, show its superiority and inevitability. Let us also not forget, that our 'parta system'(generally associated with Birla firms) was designed long before the West discovered marginal costing. Likewise, our stockist system in distribution of cold-drinks has recently been acknowledged as a superior system by Pepsi management in Indian environment. They have even indicated that they would try to experiment it in other countries of South-east Asia who have similar socio-economic development. Let us reintroduce badla system until an acceptable central depository system and the money lending to share traders are not in place.