

VOLATILITY

The recent volatility and subsequent sharp rises and fall in the stock market have been attributed to various reasons. One of the reasons is excessive leveraging by investors and resultant inability to pay the margin calls. This can also be termed as Margin Trading. The second reason is the structure of Derivatives market. Let us examine the impact of these two factors on volatility in the markets.

There are two very active players who do margin trading in the market, one is those brokers which has a Non Banking Finance Company (NBFC) attached to the broking house and second is broker themselves indulge in quasi margin trading by providing number of days credit to the investors. The NBFCs though are regulated by the RBI, do the margin trading activities through the broker. There are separate set of rules prescribed by each regulating authority namely the RBI and SEBI. RBI has rules for lending against shares and SEBI has rules for Margin Trading. Broadly these rules prescribe that there should be an approved list of securities, Margins are in the range of 50%, and there is a limit on maximum lending. Above all there are reporting requirements to stock exchanges / RBI giving details of lending under each of the schemes.

The NBFC which is an entity regulated by RBI and operating in an activity regulated by SEBI does not adhere to any of the rules prescribed by either regulator are in the range of 10-15%. There are no individual based limits such as Rs.20 lacs in the case of lending against shares in the bank. So long as initial margin is paid unlimited funds are provided for the purpose of trading.

THE NBFCs are equipped with sophisticated software which triggers sales of shares moment the market losses are in excess of margins available with the NBFC. The margins being low, there is very high leveraging and coupled with high volatility in the market sell off are very frequent and there is very little time available to the borrower to arrange for the short fall in margins. The small brokers on the other hand do not have such technology at disposal and do distress selling when the exchange shuts down the terminals for shortage in margins. Such distress selling by both the NBFC and broker, specially when there is drastic fall, are the main reasons of volatility.

RBI, which is the regulating authority for NBFC, should prescribe Lending against shares norms for the entities doing margin-trading business. Information on the extent of lending should be regularly published so that the market knows the extent of leveraging. Secondly exchanges have data on monthly basis on debit balances in broker's accounts. Some rules regarding the same should be prescribed so that quasi leveraging if any is known to the market.

The derivatives market structure also needs a closer look. In absence of physical deliveries in the Futures market there is indiscriminate buying and selling by investors. There is no obligation to settle the trade by giving or taking deliveries; as a result the trades are just swept off the market at the end of the month by exchange of cash only. If the transactions are physically settled then each trade will result in a counter trade of buy or sell by those who do not want to give deliveries, this will help in stabilizing prices and reduce volatility. SEBI needs to review the entire LC Gupta committee report which as defined prerequisites for introduction of various products.

Volatility must be faced with calm and not panic. A sharp fall in prices should result in a review of the valuations of the stocks that you are holding. Has anything changed in the fundamentals of your stock that would result in deterioration of the company performance needs to be examined? If not then look for other factors that caused the fall. If it is a market wide phenomenon then be patient and look for signs of recovery. Though it is always advisable to have stop loss targets, but before acting on the same we should let the market stabilize. This takes about 4-5 days of working to get a clear signal.

Such volatile times result in maximum loss to the day traders and those who leverage beyond their capacity to pay losses. Losses are more than the cash available to pay for the same, hence it results in compulsory squaring off. All such sales result in a flood of exit orders which results in an artificial panic in the market based purely on liquidity factors and not an underlying bear hug.



Volatility in the market will become a social problem if not addressed properly by the regulators. Greed to money is universal. Over indulgence has to be controlled. Proper regulation of margin trading and structural changes in derivatives market would go along way permitting leveraging within prescribed responsible limits only.

Asit C. Mehta

INVESTMENT INTERMEDIATES LTD

E-mail : acmiil@acm.co.in

Group Website : www.nucleusindia.com Online

Trading Portal : www.asitmehta.com

SEBI / Regulatory Registration Numbers :

BSE C.M. : INB 010607233

• NSE C.M. : INB 230607239

• DP Registration (C.M & Derivatives) : IN - DP - CDSL - 28 - 29 Fax: 022-2270 0124

Edited by Deena Mehta, Managing Director,

Asit C. Mehta Investment Intermmediates Ltd. E-mail: damehta@acm.co.in

Registered Office :

Nucleus House, 5th floor, Saki Vihar Road, Andheri (E),

Mumbai - 400072. India • Tel.: 022-2857 7898 or 2857 7614/15/16

Fax: 022-2857 7647

Corporate Office :

67, Poddar Chambers, 3rd Floor, 109, S. A. Brelvi Road,

Fort, Mumbai - 400 001. India • Tel.: 022-2270 0115, 2265 1540