Comments

Sunil Kumar Singh

Banks have started trimming down interest rates following the slashing of repo rate. This, however, doesn't make refinancing necessarily a better option. A report by Sunil Kumar Singh.

After three long years of wait, the Reserve Bank of India has finally reduced the repo rate—the rate at which the RBI lends overnight funds to banks—by an unexpected and substantial 50 bps, or 0.5 per cent. And with ICICI Bank, Punjab National Bank and IDBI Bank announcing reduction in their lending rates, it appears that banks are heading towards the softening of interest rates.

So, is it the time to close your existing high-cost home loan and shift to another bank that gives a lower interest rate? Perhaps not, advise experts. While rates have declined and are expected to decline further, there're a host of factors you need to consider before taking a decision. Switching a home loan to another bank involves refinancing your home loan balance all over again with the new bank.

Advantages of refinancing

The objective of refinancing home loan is to reduce the financial burden, which has increased because of the rise in interest rates. "If you are able to reduce your EMI substantially, it increases your savings. This gives you enough time to work out on your finances and prepare yourself for any such situation arising in future," says Jitendra P.S. Solanki, Certified Financial Planner & Founder, JS Financial Advisors, Delhi. He says the borrowers who have taken the loan at a high fixed rate of interest benefit most as they not only shift to a lower floating rate but also benefit if rates fall further. The borrowers who took a housing loan few years ago and are repaying as per the high interest rate would be the biggest beneficiaries.

Two parameters

There are two parameters that determine the viability of refinancing. The first is the quantum of rate cut. According to experts, if the cut is up to 35 per cent, it makes little sense to go for refinancing. Let's view this with the help of an example. If you took a home loan of Rs 10 lakh for duration of 20 years and have paid EMIs for five years, you have paid 25 per cent of the total (principal plus interest) to the bank. This, however, does not mean that you have paid 25 per cent of the principal as well, for in the initial installments most the portion is that of interest. As in any loan repayment, the portion of principal is minimal in the beginning and goes on increasing as time passes.

This means that after five years, or one-fourth of the duration, you have paid less than one-fourth of the principal. In other words, you will have to borrow for not three-fourths of the principal but more than that. This largely neutralizes the benefits of cheaper refinancing to some extent. Unless the alternative rate offered is more than 35 bps, there is no point considering the option.

Consider switching loans only if the difference or spread between interest rates is considerable, advise experts. "Generally it makes sense to shift only if the reduction in interests is in the range of 1-2 per cent and also taking into account the remaining tenure of the loan. Doesn't make too much sense to shift for a 0.25 per cent-0.5 per cent reduction," advises Harsh Vardhan Dawar, Director, Wealth Cafe Financial Advisors, Mumbai.

The second parameter relates to the point of time when you go for the switch. The thumb rule is: the earlier during the duration of repayment you go for it, the better. As Solanki says, during the earlier phase of the repayment period, your interest component is much higher in EMIs.

"If refinancing is opted for in the middle of your repayment period, you may end up shelling out more

in total as you will have paid the most part of interest in your previous bank," he says.

The solution

Dawar says one needs to do a proper cost-benefit analysis of the switch before taking a decision. For instance, he says, if you have been with your bank for long and can boast of a good credit history, there is a chance that the bank would reduce your interest rate.

Solanki agrees, "If you are a good borrower, your bank will not like to lose you as a customer and hence may offer the same even if not better deal."

Cost of switching

"One needs to analyze the total cost of switching. Some bankers charge a flat processing fee of Rs 5,000-10,000, which may not be a big factor. With the RBI barring banks from charging any prepayment charges now, the costs have surely come down and is a big boost for home loan borrowers to reduce the high cost of loans," maintains Solanki.

And last, but not the least, do remember that the switch would mean some paperwork. You will also have to spare time.

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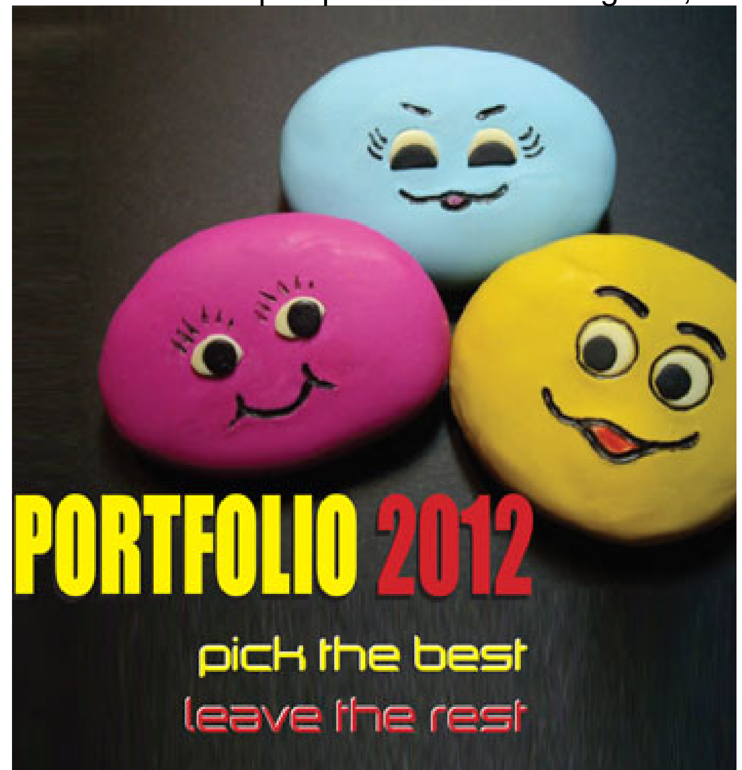
pick the best Leave the rest

Money is like a sixth sense," wrote William Somerset Maugham, "and you can't make use of the other five without it." Money is universally reviled and universally chased. The best thing for lesser mortals like us is to chase and augment it, the denunciation of the pompous notwithstanding. But, with bad economic news all around, how?



We, at Money Mantra, try to answer the question for all sorts of investors – the young and not-very-young, conservative investors and risk takers, men and women. After studying the economic situation and the market, and having consulted the best financial experts, we are in a position to inform our reader how to make a portfolio.

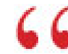
The art and science of portfolio making is discussed at length. Emphasis is on a systematic approach, because only this can maximize returns and minimize risks. Investment objectives, assessment of risk appetite, asset allocation, time horizon, diversification of asset classes – these are some of the factors that have to be taken into account. The write-up on portfolio making will surely help you choose your asset classes and apportion your money in them.

For those interested in equities, we offer a range of stocks from a variety of sectors. Similarly, we have listed a variety of mutual funds. Needless to say, our research and stories are done against the backdrop of economic slowdown. So that we may help you groom your sixth sense! A report from Money Mantra Bureau.

Sunil Kumar Singh

Narendra is a 30-something financially distressed working professional living in Delhi. Sunk in debt,

he was barely able to manage his family's monthly expenses and pay EMIs on home and car loans. He had ambitions to grow rich but didn't have a plan. At the end of each month, all he was left with was a paltry sum that was insufficient to realize his ambitions.



If an investor has 60:40 allocations in equities and debt, respectively, and if equities are giving better returns than debt, he should increase the exposure to equities and withdraw from debt. That way he can maximise returns.

Hemant Beniwal, Director, Ark Primary Advisors Pvt. Ltd., Jaipur

Desperate to get out of this frugal way of living, he sought his friend's counsel who advised him to visit a financial planner. He followed the advice. After a long discussion, financial planner asked him to prepare a portfolio and stick to it. Portfolio? Narendra was baffled, for he was under the impression that only models make portfolios!

Later, however, he came to know that there is something called investment portfolio–that is, a collection or bouquet of investment products or asset classes carefully selected as per one's risk appetite, age and financial goals. The objective is to meet financial goals within a stipulated timeframe with minimum possible risks. The asset classes could include some or all of these–stocks, bonds, debt instruments, cash, bank fixed deposits, mutual funds, gold, exchange-traded funds, real estate or even alternative investment products like commodities, art pieces, etc.

Another advantage of making a portfolio is that it makes an investor disciplined in his approach, especially in the current market conditions when stocks are falling, gold is losing its sheen, banks are shy of raising interest rates on your savings deposits, and mutual funds' NAV are heading southward.

In the fag-end of last year, in a meeting with the heads of various banks, the RBI directed banks not to charge fees from customers closing their accounts due to change of employment or transfer to another city.

The RBI directive came a just a couple of months after the savings bank interest rates were deregulated to create competition and encourage banks to introduce innovative products.

Instead, the deregulation sparked a rate war among some small private banks to lure customers. Big players, however, kept away from hiking interest rates. To stop such customers from fleeing to other banks offering high interest rates, banks brought in account closure charges, maintain analysts.

"The interest rate deregulation saw many banks lure investors with high interest rates. In order to curb investors from switching over to other banks, account closure charges were mooted to be applied. However, the RBI has said this is not applicable and banks cannot charge customers when they close their accounts," says Radhey Sharma, Chief Financial Planner, TheWealthWisher Financial Planners.

Double whammy

Savings bank deposits are an important component of bank deposits, which banks don't want to part with. A major attraction of savings deposits for banks is that it offers a low-cost source of funds. This is evident from the fact that bank groups with higher share of current account and savings account (CASA) deposits, of which savings deposit is a major component, enjoy relatively low cost of deposits.

Another factor why banks don't want to lose their savings bank account pie is that these deposits are a popular product and they constitute about 22 per cent of total deposits of scheduled commercial banks and about 13 per cent of financial savings of the household sector in India.

Banks are also seeing average annual growth of savings deposits, as per RBI data. Savings deposits, which decelerated in the 1990s, accelerated sharply in the last decade when the average growth rate of savings deposits (19.4 per cent) exceeded that of both demand deposits (16.2 per cent) and term deposits (18.2 per cent).

> The recent RBI directive to banks not to impose savings account closure charge on customers either due to a change in employment or a transfer to another city would put banks' balance sheets under stress

Further, according to the RBI, although savings bank deposits represent short-term savings that can be withdrawn on demand, a large part of savings deposits is treated as 'core' deposits, which together with term deposits have been used by banks to increase their exposure to long-term loans, including infrastructure loans.

Thus, savings bank accounts are a very important as well as cheap source of funds for banks. No wonder, banks have been revising savings account closure charges to discourage customers from switching to other banks.

However, analysts believe, the RBI's directive to banks not to charge fees from customers who are closing their accounts due to change of employment or transfer to another city will increase banks' costs. This is simply because even if a customer closes his account owing to change of employment or transfer to another city, it would mean a double jeopardy for banks already hurt by high lending rates and non-performing assets-loss of customer and the loss of revenue by not being able to charge the customer closure charges.

"Many banks which charge high account closure charges will see a negative impact on their revenue flow," Sharma maintains.

RBI's provisions on service charges

There are no specific RBI rulings restraining banks from arbitrarily imposing service charges, except the banking codes by the Banking Codes and Standards Board of India (BCSBI), which are mere guidelines and are not mandatory for banks.

The Indian Banks' Association has dispensed with the practice of prescribing service charges to be levied by banks for various services rendered by them. With effect from September, 1999, the RBI has granted freedom to banks to prescribe service charges with the approval of the respective Board of Directors.

However, in order to ensure fair practices in banking services, the RBI constituted a working group to formulate a scheme for ensuring reasonableness of bank charges, and to incorporate it in the Fair Practices Code, the compliance of which would be monitored by the BCSBI. The BCSBI was set up in 2006 as a collaborative effort of RBI and banks, on the lines of a similar set up in UK to oversee the banking code, a voluntary code for banks. As per the BCSBI codes related to fees and service charges, banks would display in their branches:

- A notice about the tariff schedule that a customer can ask to see this free of cost;
- A list of services which are rendered free of charge;
- A notice incorporating charges leviable for non-maintenance of minimum balances in the savings bank account, collection of outstation cheques, issue of demand draft and cheque books, account statement, account closure and charges for deposit/withdrawal at ATM locations;
- Banks would give customers details in their tariff schedule of any charges applicable to the products and services chosen by customers;
- Banks would also provide customers information about the penalties liable in case of non-observance/violation of any of the terms and conditions governing the product/services

chosen by them;

- If banks increase any of these charges or introduce a new charge, it would be notified one month prior to the revised charges being levied/becoming effective.

There are many ways a housewife saves money in a typical Indian household, but this money largely remains stashed into vaults without being invested for capital growth. If good investment planning and a little bit of financial discipline is followed this money can generate huge return.

Look after the pennies and the pounds will look after themselves—so goes an old English saying. But ever wondered where this could fit perfectly? The answer is easy: our households.

The fact that even small sums of money can add up over time is perhaps best understood by a typical Indian housewife. However, what she perhaps doesn't know is how to invest this small kitty in the best possible way.

There are many ways a housewife gets money—often in cash, as gift from elders on family get-togethers or on occasions of festivals. Another familiar practice in many Indian households is that housewives take small amounts of money from their husband's wallet without his knowledge—not for her personal use but as a saving to supplement her husband's income and also as a support in a rainy day. This is how housewives, who don't have any income source, save money.

Let money work for you

But while no one doubts the prudence of keeping small sums of money as a buffer, it would be a good deal made better if she invested this money in a proper and profitable way.

Financial planners believe the amount of money saved by a housewife can grow immensely and come in handy in the event of an emergency. For this, however, she has to let this money work for her, and this can happen if right financial instruments are chosen.

Housewives tend to postpone investing because they often think a large amount of money would be needed to get started. However, experts say they can start investing even with small amounts instead of waiting for a windfall of cash. For instance, for a housewife who is a budding investor, can start with as amount as small as Rs 500, say experts.

Suresh Sadagopan, Founder, Ladder7 Financial Advisories, says, "If she simply wants to spend the saved money for her personal consumption or meeting petty expenses, then she can opt for opening a bank deposit. She can also spend this money in planning a surprise trip to a tourist destination for the entire family

once a year. However, if she wants to invest this money to grow overtime to meet her children's education expenses, she can invest this money into mutual funds and equities. Further, she can also open a PPF account in her child/children's name and deposit the amount regularly into it for a secured and regular income after a certain period of time."

Experts also add that since a housewife doesn't have any income tax liability, she has more flexibility in picking up right investment products in tune with her financial goals.

Take informed decision

However, while picking the investment instruments, she should have some knowledge of the product she is investing in. If she is naive about finances, she must take advice of an expert or someone who has knowledge about different investment products. Otherwise, the investment could go haywire, experts say.

According to K Ramalingam, Director and Chief Financial Planner, Holistic Investment Planners, Chennai, a housewife can invest the money saved in the following ways.

First, she needs to work on creating an emergency reserve. This can be equivalent of three- to six-month expenses. This money can be parked in liquid funds or floating rate funds. Then, he says, she needs to take a mediclaim policy for herself and other family members.

As a third step, she needs to take an online term insurance policy for the breadwinner of the family. She should not fall prey for the heavy front-loaded Ulips. She needs to focus on term insurance. Online term insurance is cheaper by 60 per cent than the offline/agent-provided version.

As a next step, she could go for seeking an insurance cover for the property if the family has got any, says Ramalingam. "If the family has got any property, it needs to be insured against any natural perils like flood and earthquake. Though the possibility of these perils happening to your property seems to be very remote, if it happens you will be financially ruined," he says.

And, after doing all the above things, Ramalingam says the housewife can consider starting an systematic investment plan or SIP in mutual fund or can contribute regularly in PPF for long term financial goals.

Start with small amount

Housewives could also look to park their savings in sweep-in accounts or recurring deposit schemes in banks, say financial planners. The assumption here is that the money she gets is not huge. Radhey Sharma, Chief Financial Planner, TheWealthWisher Financial Planners, says, "With a sweep-in account, she can have the money over a defined limit, say Rs 1,000, swept away into larger interest earnings deposits. If she needs money urgently, she can pull this out at any time, so it is very liquid."

Over a period of time, she can keep parking the money in sweep-in accounts. Once it builds up to a

substantial amount, she can look to lock the larger amount in a long term FD to earn more interest, he says.

Recurring deposits are another way of ensuring savings growth over time, advises Sharma. In recurring deposit schemes in banks, one can invest from Rs 100 to Rs 1,000 every month for a period of up to five years. The interest will be ranging from 6 to 10 per cent per annum depending on the tenure.

Gold could be another way of investing the savings, advises Sharma. Well-known jewelers offer monthly investment options starting from Rs 500 and multiples. These are for a period of 12 months and, at the end of the year, gold worth the total amount, plus some bonus, is given. Some of them buy back the gold from investors at current market rates, he says. Gold exchange traded funds (ETF) could be another option, he says. "Hoarding physical gold can be quite cumbersome. An alternative is gold ETF where fund houses buy a big amount of gold and trade the units on the stock exchange. There is no entry or exit charge, but brokerage is charged by the fund. The minimum investment is one unit of the fund."

However, gold ETFs require a demat account. Lastly, he adds, she can even think of investing some amount in mutual fund Systematic Investment Plans (SIPs). Several mutual fund companies offer SIPs for as low as Rs 500 per month. Depending on what she is saving for i.e. how far away her goal is, she can invest in either equity diversified mutual funds or MIPs.

Avoid defaults on your home loan. If you default for some reason, don't ignore communication from the bank

Ramesh was looking for a property in an upmarket location in Gurgaon. He had a cushy job in a multinational firm but was living in a rented accommodation. One fine morning, he saw an advertisement in a newspaper about a four-bedroom apartment in a condominium located in a posh area. "This is what I wanted," Ramesh thought. A few days later, he visited a bank and applied for a home loan. It was for the first time that he had applied for any type of bank loan. The bank assessed his financial credentials and sanctioned him loan with an EMI of Rs 40,000 per month for the 15-year loan tenure.

For four to five months, Ramesh religiously paid his EMIs on time, but after that he became casual and irresponsible. The bank called Ramesh up to remind him about his liabilities, but his cavalier attitude did not change. He even paid no heed to the recovery agents who came to meet him for negotiation. He was capable to service the debt, but he was under the impression that the bank could do no harm.

His impression proved to be groundless. One day, a number of banks officials knocked at his door and handed over him a court notice which made it clear that his apartment was being attached by the bank and would be auctioned to recover the outstanding dues. As usual, the comeuppance was painful.

No standard process

Age-old financial wisdom has it that you should borrow only as much as you can afford to repay. But many homebuyers like Ramesh lose sight of this adage. If you thought defaults happened in the US only during the subprime crisis, think again. Though it's difficult to quantify the cases of property repossession by banks and other lending institutions, such incidents are not unheard of in our country. At any rate, home loan borrowers are finding it increasingly difficult to pay back their loan on time, thanks to runaway inflation, rising interest rates, and high property prices.

"Cases of property repossession have definitely risen over the last year as high interest rates and high inflation have made loan repayment very difficult," says Amit Shukla, Managing Consultant, AS & Associates Advocates and Legal Consultants, Lucknow.

Although repossession or foreclosure of a property has the same legal meaning in India, the process of repossession here is different from that prevalent in the US, maintain legal experts.

"In India, there is no fixed term after which the banks start issuing notices to a defaulter; it varies with the bank. Lenders usually give due notices to the defaulter after giving him sufficient time to settle his outstanding amount," says Shukla.

Further, there is no one-size-fits-all norm or standard of property repossession in India, experts say. As Om Ahuja, CEO (Residential Services), Jones Lang LaSalle India, says, "There is no uniform and fixed norm for property repossession in India, as each bank has different standards of initiating process of repossession of property. While some banks have a high tolerance level and thus are more flexible in dealing with defaulters, others are not like so."

Adhil Shetty, CEO, bankbazaar.com, adds, "Foreclosure norms in India are not crystal clear. Foreclosure of a property would happen when a person's loan account with the bank becomes a non-performing asset which usually happens if the person defaults on paying six monthly installments. When this happens, the finance institution initiates summary proceedings against the borrower for recovery of their dues."

Backed by Act

A lender has the right to repossess a property (whether movable or immovable) to recover its dues by auctioning it and this right is backed by two Acts of law called the Securitization & Reconstruction of Financial Assets and Enforcement of Security Interest (Sarfaesi) Act, 2002, and the Security Interest (Enforcement) Rules, 2002.

"The Sarfaesi Act empowers banks and financial institutions with the right to recover the mortgaged property in case of loan defaults without the intervention of the court. This means the lenders can take immediate action and bring into effect the takeover of the property in question quickly. Usually, a bank provides sufficient notice period to the borrower before this final action is implemented," says Shetty.

The foreclosure process begins when a borrower defaults on loan payments (usually mortgage payments), and the lender files a public default notice, called a Notice of Default or Lis Pendens. After a specific period of time and with a court decree, the financial institution can attach the property for it to be auctioned off, he adds.

However, attaching a property is the last resort. As Navin Kumar Garg, FCA, Garg Navin & Company, Chartered Accountants, New Delhi, says, "Repossession is the last resort a bank or

lending institution takes to. Banks and lending institutions try their best to cooperate with the defaulter. They remind him through notices and recovery teams. They warn him of the forfeiture of the property."

This process of sending notices, reminders and recovery agents generally lasts for a year or two. During this period, if the customer accepts and proceeds ahead with repaying the loan, it's good for him. However, if the borrower doesn't respond to repeated notices by the bank and avoids negotiations with the bank for a year or two, then the bank is left with no option but eviction by invoking the Sarfaesi Act.

Life after foreclosure

Once the property is repossessed, the bank or the lending institution has to auction it publicly by inviting proper bids as it cannot sell it privately. After the sale, the bank retains whatever is owed to it and gives back the remainder of the amount to the borrower.

"Once the lender takes control of the property, an independent valuation is conducted with the help of an independent chartered surveyor who fixes two values for the property. One is the market value of what the property is actually worth and another is termed as the distress value, which is around 15 to 20 per cent lower than the market value. Due to the circumstances under which the auction is conducted, the property is almost always quoted with the distress value for the minimum bidding price at the auction. The property is then put up for auction, which is advertised in newspapers and also in certain websites," says Shetty.

However, experts maintain that once the property is repossessed by the bank, this is not the end of the world, as a home owner can still remain hopeful of getting it back if it is not auctioned off. "If the borrower gives assurance to the court or the bank that he has managed funds to repay the loan, then he might be able to buy back his repossessed property before it is auctioned, but it depends on case to case," says Garg.

Secondly, the home owner can also challenge the bank's repossession attempt in a court of law. "If a home owner feels that the bank is wrong in initiating the repossession process, he can file a case against the bank in a Debt Recovery Tribunal (DRT) or a High Court but not in a district court. The DRT may pass stay order on the case or ask the appellant to enter into negotiation with the bank to resolve the issue. If the case is filed in the High Court, the court may direct the home owner to pay certain amounts of the outstanding later, extend the loan repayment term or decrease the EMIs," says Shukla.

Once the case is in the DRT, it can pass order about the restoration of possession if it is proved that the bank is not right in proceeding under the provisions of the Sarfaesi Act, he adds.

Know your rights

Consumers must be aware of their legal rights in the event of an imminent foreclosure, says Shetty. First of all, all debtors and borrowers have rights under the Fair Debt Collection Practices Act (also known as the Consumer Credit Protection Act) to avoid or stop abusive, repetitive and unfair debt collection practices. Creditors can only call you at certain hours. Furthermore, you might also be entitled to a loan modification based on a change in financial situation. Loan modification is a change in the terms of a current loan, which could vary from interest rate reduction to principal amount reduction.

The borrower can also approach a debt counseling center to seek help in overcoming the debt situation by taking stock of their assets and also getting help in negotiating a loan modification deal with the bank to prevent losing the property.

Banking Ombudsman is another body which has been organized to provide assistance to borrowers if it is indeed proved that the bank in question did not give a fair chance to the borrower, he adds. Besides, as Garg of Garg Navin & Company says, banks and lending institutions have set

up their own grievance redress cells to deal with distressed property cases which a customer can approach.

You can assert your rights, but the best way is to go the old-fashioned way: borrow as much as you can repay.

The Indian commodity derivatives market is growing at a fast pace in volumes and value. There are 21 commodity exchanges operating in the country, including five national commodity exchanges and 16 regional, commodities-specific exchanges. To ensure smooth and transparent working of commodity futures trading in these exchanges, the Forward Markets Commission was constituted as regulator under the Ministry of Consumer Affairs, Food & Public Distribution.

On the face of it, everything is in place. But volatility and sharp rise in futures prices continue to bother investors as well as the authorities. The situation has been compared with the Harshad Mehta scam in securities. The manipulation in price is benefitting a few traders at the expense of thousands of genuine traders, hedgers, exporters and farmers. Is there something fundamentally wrong with the way commodities are traded on exchanges?

Well, one thing is sure: everything is not right in the commodity market. A number of measures have been suggested, ranging from the recommendation to ban futures trading to opening it up for foreign players. What are the reforms that are needed? We have sketched the contours of the market, highlighted the problems it faces, and listed out the steps needed to make it better for investors. Read on:

Commodities' traditional position as an alternative investment asset has a lot to do with its negative correlation with the US dollar and is known to be an effective hedge against inflation. But historical returns of commodities have largely been independent of stocks and bond returns. Because of these features, investors across the world have been investing in commodities for years (including agri-commodities, metals and materials, precious metals and energy commodities) to diversify their portfolio, reduce risk and generate high returns.

Futures trading in India

In India, commodity exchanges were set up to support small farmers, traders and exporters by minimizing their risk in futures market and for price discovery of their produce. To ensure smooth and transparent working of commodity futures trading in these exchanges, the Forward Market Commission (FMC) was constituted as regulator under the Ministry of Consumer Affairs, Food & Public Distribution.

There are 21 commodity exchanges operating in the country, including five national commodity exchanges and 16 regional commodity (commodities-specific) exchanges. National exchanges are: Multi Commodity Exchange of India Ltd., Mumbai; National Commodity & Derivatives Exchange Ltd., Mumbai; National Multi Commodity Exchange of India Limited, Ahmedabad; Indian Commodity Exchange Limited, New Delhi; and Ace Derivatives & Commodity Exchange Limited, Mumbai.Commodities futures trading in India is growing rapidly. According to FMC, the value of commodities traded on all commodity exchanges surged to Rs 181.3 lakh crore ($3.5 trillion) in the last fiscal from Rs 119.5 lakh crore a year earlier. Trading in agri-commodities jumped 51 per cent, while that in crude oil, natural gas and other energy products increased 23 per cent.

Excess volatility

However, of late Indian commodities market has been seeing excessive volatility in futures prices, especially agri-commodities that has raised various questions about the efficiency of the entire commodity market. For instance, in the futures market, between December and April, mentha oil prices increased 83.98 per cent, cardamom by 59 per cent, and chana by 10.4 per cent.

Industry body Assocham has recently urged the government to investigate manipulations by some

traders at the National Commodity Exchange of India (NCDEX) which show huge price distortions and weak regulatory provisions.

According to SK Jindal, Chairman of Investments Committee, Assocham, “The situation is akin to the Harshad Mehta scam in securities. A few manipulators have hijacked the NCDEX.”
He says turmeric which was trading at Rs 35 per kg in January 2009 was manipulated to increase beyond Rs 150 per kg within a year. But in a few months, the same was brought down to around Rs 40 per kg. Similarly, the price of black pepper was Rs 225 per kg in April 2011 was manipulated to rise beyond Rs 432 per kg in March 2012, marking an increase of 95 per cent.

In the case of gaur seed and gaur gum, the price manipulation is unbelievable, says Jindal. The normal price of normal guar bean in the season is Rs 10 per kg, while guar seed is traded at Rs 25 per kg and guar gum at Rs 50 per kg. Unfortunately, due to a fraud played by a few rogue traders, the prices were increased to Rs 291 per kg for guar seed and Rs 959 per kg for guar gum on March 21.

This manipulation in price and fraud is benefitting a few traders while thousands of genuine traders, hedgers, exporters and farmers are losing money, he added. This artificial price increase is also against the interest of farmers who will not be able to buy expensive guar seed for their next crop.

“It is unbelievable that the fodder for animal is priced at Rs 291 per kg, much more than the price of cereals and pulses being used for human consumption,” he said. “The prices for guar have gone up by 120 per cent in the past one month, 700 per cent in the past four months, 875 per cent in the past 12 months and 1,300 per cent in the past 18 months.”

Not that the FMC has not intervened and taken any corrective measures. It has, for instance, suspended futures trading in guar gum and guar seed and has imposed special margins in cardamom, soyabean, potato, chana, menthe oil, yellow soyameal and pepper futures contracts.

Further, in the beginning of April, following the excessive volatility in the prices of soyabean, rape/mustard seed, chana and refined soya oil contracts, the FMC decided to revise the open position limits in the said contracts.
Speculation or fundamentals?

Is there something fishy going on in the commodity exchanges? Is commodity futures trading in the grip of over-speculation? Or are fundamentals driving up futures prices?

While experts attribute the rise on agri-commodity futures to fundamentals, they don't count out the speculation factor completely either. Naveen Mathur, Associate Director, Commodities & Currencies, Angel Broking, says, “Although prices of mentha oil, cardamom and chana futures rose sharply during December 2011 to April 19, the rise was largely attributed to the inherent fundamentals of the respective commodities.”

Experts point out that cardamom prices rose due to persistent dry weather and crop failure in Idukki district, causing fall in production. Similarly, mentha oil prices rose due to a number of factors ranging from lower availability of the commodity to the strong buying by the traders due to the firm spot demand from pharmaceutical industries. Prices of chana futures rose due to expectations of lower output for the crop. However, as Basant Vaid, Senior Research Analyst, Bonanza Portfolio Ltd, says, “A possibility of speculation in these commodities market cannot be ruled out as well.”

There's another aspect to the whole story—the relatively younger nature of commodity exchanges in India. National commodity exchanges in India began operation as late as in 2002-2003, making India still an evolving commodity futures market.

Ramlal Maheshwari, Senior Research Analyst, Fairwealth Securities, maintains, “Indian commodity market is still in its very early stage wherein any asymmetric information causes a deep impact over prices. Such price volatility had only been seen in the commodities in which India controls prominent market share in global market, for example guar seed and guar gum, mentha oil and turmeric.”

Another factor spurring volatility is the duopoly in commodity futures trading, analysts say. “Certain commodities are only traded on a particular exchange. For example, mentha and cardamom are only listed and traded on MCX, whereas NCDEX has a monopoly over commodities like jeera and gur. So, only the respective exchanges can be utilized for any trading requirements,” adds Vaid of Bonanza Portfolio.

Reforms measures

The fact that commodity futures are not only an investment and trading instrument but are also a hedging tool against inflation and an effective price discovery mechanism leaves much room for manipulation too. Where there are investors, there are bound to be speculators, hedgers and arbitrageurs. So, the crucial question now is how to maintain a balance and develop an efficient commodity futures market that protects a genuine investor's wealth?

There should be segregation of hedgers and speculators positions, Maheshwari of Fairwealth Securities says. Just like in the US futures markets, the US Commodity Futures Trading Commission (CFTC) segregates and publishes positions of money managers, speculators, etc, the same structure should be enforced to Indian commodity markets, he maintains. A related step could be active monitoring of the suspicious trading activities.

“Controlling the position limit both at broker and client levels is required. Ensuring that no one utilizes the loopholes in trading norms by the help of stricter KYC can be one measure to control volatility,” maintains Vaid of Bonanza Portfolio. Another crucial reforms measure could be opening the commodities futures trading to foreign investors, add experts. Foreign investors are not allowed in futures trading in India as of now which, if allowed, could add depth and liquidity in the market, experts believe.

“The FII inflow into the Indian commodity futures is an initial step in the right direction to further prop up the booming Indian commodity bourses and create more transparency. Foreign investment will bring in higher participation in the market and more liquidity, which could lead to more efficient price discovery and turnover,” says Joyal Thomas, Analyst, Geojit Comtrade.

He says FII inflows will help in financial innovation and development of hedging instruments and open up competition in financial markets, improving the alignment of asset prices to fundamentals. Increasing the margin requirement to 100 per cent when a particular commodity taps the maximum or minimum price band in a day is another step to check volatility in commodity futures, he suggests.

Mathur of Angel Broking highlights another aspect, “Entry of foreign institutions, along with domestic financial institutions like banks and mutual funds, will help create depth and liquidity in the markets. Penetration in the far month futures contract would be higher leading to effective risk management by corporate involved in commodities value chain.”
More teeth to FMC

A major thrust to reform in the commodity market would grant more investigative and administrative powers to the FMC, argue experts. “Unprecedented price volatility in global financial markets over the past two to three years calls for stronger regulatory rules and frameworks. As the Indian commodity market is growing, speculators also deepen their pockets and hence the rise in special margins won't serve its real purpose. I rather advocate for strong regulatory law and increased power for FMC to act against any speculative intentions,” says Maheshwari of Fairwealth Securities.

However, this looks difficult unless the Forward Contract (Regulation) Amendment Bill (FCRA) is passed by Parliament. The passage of the Bill is imperative because it would upgrade the crucial legal and regulatory system mandatory for the rapid growth in the commodity futures market.

The Bill vests powers in the FMC to impose penalties in cases of failure to furnish information or

comply with the directions of the Commission, indulging in insider trading or fraudulent and unfair trade practices, and in case of contravention of the provisions of the Forward Contract Regulation Act, 1952. This will ensures that unfair trade practices are controlled up to a significant extent, maintains Vaid of Bonanza Portfolio.

Maheshwari of Fairwealth Securities says, “The amendment Bill will transform the role of the FMC from a government department to an independent regulator (similar to Sebi).”
Need to introduce options

The passage of the Bill would also lead to introduction of options derivatives-a major hedging product-in the Indian commodity market. One of the main reasons why there's so much volatility in the market is that there is an absence of hedging products such as commodity options which, once introduced, would rein in sharp rise and bring in more investors into the commodity derivatives trading.

As Thomas of Geojit Comtrade points out, “The introduction of options is very much the need of the hour amid questions over the existence of commodity trading. Options bring with it limited downside risk and flexibility. The introduction of options could potentially provide significant cash flow relief to traders. Options will actually make it easier for farmers and smaller participants in the derivatives market as trading lot sizes will be lower than in futures contracts, where the minimum traded quantity for most farm products is 10 tons. Investing in an option could minimize losses as premium to buy (call option) or sell (put option) is relinquished in the event of prices moving unfavorably.”

Investment in commodities can take various forms-commodity derivatives (futures and options), commodity ETFs, commodity stocks and commodity mutual funds. Although investor exposure to commodities has been through all these platforms, it's the commodity futures that have emerged as the most common way to invest in commodities. There're various reasons for that. For one, commodity futures play a major role in managing the price volatility or hedging and are an effective risk management tool. Secondly, commodity futures help in price discovery of a commodity. Thus hedging through futures can benefit any market participant, be it a farmer, producer, exporter, importer of a commodity, etc.

Futures are basically exchange-traded contracts where one party (a farmer, trader, etc.) agrees to sell or buy the financial instruments or physical commodities for delivery at a predetermined future date and price. However, futures contracts by their very nature are one of the riskiest investments too. This is because, unlike options where the holder of the contract has the 'right' to buy or sell the underlying asset at expiration, the holder of a futures contract is 'obligated' to fulfill the terms of his/her contract. So, in the case of the commodity futures, both sides become obligated to buy or sell the commodity named in the contract or settle in cash at a predetermined time for a set price.

Traders in futures contract tend to make money when price moves their way. But the downside can be financially upsetting as they are contractually obligated to fulfill the terms of the agreement. “The futures trading does throw up shortcomings like legal obligations, the initial and daily variation margins. They can cause a significant cash flow burden on traders or hedgers,” Thomas maintains. There is another risk in commodity trading-susceptibility to market risks and volatility. Like any other asset class, they are subject to speculation or demand-supply dynamics. Besides, factors like floods, drought production and yield of a commodity and geopolitical consideration too can impact commodity prices.

Experts therefore add that options can minimize the risk factor (which is quite high in the Indian commodity exchange) for an investor.

Should futures be banned?

Since futures prices mirror the demand-supply fundamentals of any given commodity, whether in India or in the US, banning futures trading is not going to be a long-lasting and effective means to control manipulation and volatility, experts argue. Thomas says, “The extent to which excessive

price volatility is a function of speculative trading in the futures markets has been debated over by panelists from academic, government and institutional sectors time and again. The financialization of the commodity markets has really widened fluctuations on price trends but is not a self-evident proposition that commodity futures amplify volatility." Vaid of Bonanza Portfolio says, "Banning commodities is not the permanent solution to control excessive volatility in the market. We have seen that commodities that have been banned from futures trading, like guar seed and guar gum, are still trading very strong in the spot market. Banning just puts a momentary effect to the prices and the speculation molds itself to some other shape and continues."

Experts suggest instead of outright futures ban, steps should be taken to make the commodities market more efficient. As the organized commodity market is relatively younger, there are some inherent weaknesses. One of them is the unorganized physical markets. "This factor hinders the growth of commodities market both in spot and futures," points out Mathur. Spot price is the cash price at which investors can buy the physical commodities.

Further, he says, lack of appropriate and adequate storage/warehousing facilities, suboptimal infrastructure, irrigational facilities, research for better yield crop, etc, are some of the major impediments in the commodities space.

Do commodity futures add to price rise?

Perhaps it is one of the most contentious subjects. However, there have been instances in India when despite banning futures retail prices continued to move upwards. For instance, in May 2009, sugar futures were banned as a follow-up action to check rising prices. However, sugar prices continued to rise even after the ban. In January 2010, when the futures trading ban was in place, retail sugar prices soared to Rs 50 per kg largely because of the shortfall in production. After a year or so the ban was lifted.

As Mathur of Angel Broking says, "Surveys and studies conducted so far by various committees have proved that, although price rise in certain commodities were accelerated after the introduction of futures trading, it is not the only cause for the rise."Recently, soybean prices have increased sharply due to tight supplies of oilseeds globally as well as domestically. This has caused prices to gain by around 30 per cent in the domestic spot markets, while the gains were comparatively lower in futures market which rose around 27 per cent. While in case of sugar, due to strong fundamentals in the domestic and global markets, spot prices declined by around 2 per cent, but NCDEX futures fell by around 1.3 per cent, he adds.

Conclusion

Thomas of Geojit Comtrade says, "With price levels in the country still high in spite of adequate measures, the commodity futures market has been in the firing line. It is held responsible for fuelling inflationary distress. However, the alarm over commodity futures is bizarre." In other words, the commodities market in India is on the cusp of a makeover. Much depends on the FCRA Amendment Bill that is waiting to be passed. If the Bill sees the light of the day, it would bring the Indian commodity futures market at par with global peers.

Sunil Kumar Singh

With the help of algorithmic and high-frequency trading strategies, stock traders in india and world over are getting faster access to streaming real-time market data and are executing order in milliseconds. But what importance these trading strategies hold for a retail stock market investor in india?

Trading in stocks, commodities or currencies has seen generational change in terms of technology application and today it has gone much beyond using just phone, fax or emails. If you've been an

avid investor in indian stock markets or least a keen market observer, you must have remembered the age-old style of stock trading - called open outcry system - prevalent in early 90's before electronic trading was introduced.

Cut to the present. Stock trading in india is on the cusp of a grand makeover where trading is being done in one thousandth, yes you read it right, of a second.

Enter the world of high-frequency trading (hft) and algorithmic trading!

However, the stock market regulator, sebi, is known for expressing reservations against hft and algorithmic trading (or algo trading) and, on a couple of occasions, its chief UK Sinha has favored limiting speed of these computer-driven advanced trading techniques, citing risks they pose to the entire financial market.

Just a few weeks back, speaking at a conference he is reported to have said, “earlier, it was 200 micro second speed, then 20 micro second and then 8 micro seconds, and there are still demands to reduce it even further. At some stage, this has to stop. What we need to look at is whether it is serving any public good.”

Sinha is not alone who's sounding caution over hft and algo trading. There's been a debate globally on the usefulness of these fast trading strategies where large institutional investors allegedly get the crucial price advantage owing to the breakneck speed at which trading is executed by using these trading techniques.

But what exactly are hft and algo trading and how they actually execute trade which is humanly impossible? This report is an attempt to demystify hft and algorithmic trading and explain the related concepts.

Algo trading

Simply speaking, algo trading is an automated trading system that utilizes very advanced pre-programmed mathematical models for making transaction decisions in stocks, currencies or commodities. Algo trading is mainly used by large institutional investors due to the large amount of stocks they deal with every day.

Large blocks of shares are usually purchased by dividing the large share block into smaller lots and allowing the complex algorithms to decide when the smaller blocks are to be purchased.

In other words, an algo trading strategy uses mathematical formulas to track real time market data and execute trades with minimum impact on the market. However, complex algorithms allow investors to get the best possible price without significantly impacting the stock's price and increasing purchasing costs.

In india, back in 2009, sebi had allowed brokers to offer algorithmic trading facilities to institutional clients in order to cut transaction time and for speedy trade execution. Further in May 2010, the national stock exchange's wholly-owned subsidiary nse.it had launched two software products - algostudio and strategystudio - which help brokers in algorithmic trading on both bse and nse.

High-frequency trading

High-frequency trading or hft is a bit different from algo trading. The basic difference lies in the fact that while every hft is algorithmic, every algorithmic trade is not necessarily high frequency. In other words, while algo trading uses pre-programmed mathematical models to track real time market data, hft employs super fast computers to track even the minutest price discrepancy in stocks, currencies and commodities, and execute orders in a millionth part of a second in order to make profit by quickly buying and selling stocks at the slightest price differential.

As per estimates, algo trading and hft account for as much as 60 per cent of transactions on the

new york stock exchange and nasdaq, the two of the world's most liquid bourses. However, in india their share is miniscule.

“From reliable source, we came to know that only 20 to 25 per cent of the volume of nse, but nse not given any official confirmation,” says sanjeevi. G, vice president, derivative strategies & automated algorithmic trading, fortune wealth management company India, Coimbatore.

Obstacles

In india, although the volume of trading commanded by algo trading and hft is not as huge as in advanced western markets, but it is expected to gain momentum in the coming years. There're many challenges to overcome before hft and algo trading becomes a popular trading strategy in india.

The first is shy-high running cost of hft and algo trading platform. For example, as Sanjeevi. G says, to install and operate five terminals of hft platform it costs a whopping rs 1,00,000 per month and v-sat connection is a must.Secondly, the inbuilt strategy which is extended by the hft venders is suitable only for institutions. Thirdly, lack of experience staff in this field is another obstacle, according to him. The statutory legal charges are another obstacle and stamp duty between the states should be rationalized, he adds.

Pros & cons

However, like any new technology or concept, algorithmic trading and hft too have had their own share of controversy with many fearing misuse of these technologies and large institutional investors getting undue advantage over small investors who lack access to these sophisticated technologies.

Nevertheless, as Sanjeevi. G says, “We find only advantages in algorithmic trading and hft, no doubt it will bring more volume and liquidity in Indian equity market.”

One of main advantages of algorithmic trading and hft is that human errors are eliminated, he says. Besides, trading is 100 per cent disciplined and in a pre-determined way. Further, since the parameters are pre-fixed trading is away from greed and fear.

In addition, he says, arbitrage transactions are possible only through hft now a days and it can be used 24*7 and simultaneously in different asset classes in number of exchanges.

He says not only institutional investors, hft and algo trading are beneficial to even small investors for above reasons.

Flash crash

The term 'flash crash' was coined following the us stock market's sharp plunge and recovery on may 6, 2010. This was the first and the last incidence of flash crash.

The 'flash crash' is attributed to the massive plunge of 700 points on the dow jones industrial average (one of the most closely-watched us benchmark indices) before recovering in a matter of minutes. The sell order was executed so fast that it set off a sudden and wild fluctuation on the index and wiped off nearly $1 trillion of investor wealth within minutes.

The flash crash brought into focus some of the dangers of fast trading. There were allegations that the blinding speed at which high-frequency trade is executed led to the crash. Even subsequent investigations by the us authorities revealed that hft aggravated volatility and sell off with its rapid-fire trading techniques.according to the findings by the us commodity futures trading commission and the us securities and exchange commission, on may 6, 2010, the prices of many us-based equity products experienced an extraordinarily rapid decline and recovery. That afternoon, major equity indices in both the futures and securities markets, each already down over 4 per cent from their prior-day close, suddenly plummeted a further 5 to 6 per cent in a matter of minutes before

rebounding almost as quickly.Many of the almost 8,000 individual equity securities and exchange traded funds traded that day suffered similar price declines and reversals within a short period of time. Following the crash of may 6, 2010, stock market regulators worldwide, including in india, have become extra cautious and have been taking steps to regulate automated trading when prices swing too wildly. As sanjeevi. G says says, “our regulators are closely watching the developments in this field to prevent flash crash.”