Badla is not back!

Dr. Tariq Hassan

I am grateful to The News for its backhanded support to the phase-out of badla financing in its editorial "Badla is back" (July 15) – a provocative and totally misleading title which suggests that badla financing had been eliminated and has now been reintroduced. This is simply not true. Even the inference that the process has been rolled back is false. Nonetheless, the editorial makes a very important point in favour of the phase-out of badla financing and, even though it is ostensibly critical of the role of the regulator, I appreciate the spirit behind it.

I reinforce the editorial's underlying message that badla financing should go. There is no turning back. The process of phase-out of badla financing has only been suspended temporarily on account of the current liquidity concerns and to allow banks more time to develop margin financing at the retail level to accommodate small brokers and investors. The replacement of badla funds with alternative modes of financing, including margin financing, has not been stopped. Adjustment to the alternative modes of financing are expected to continue. The regulator remains fully committed to its declared objective and is seeking to achieve this with principled pragmatism.

The regulator does not operate in a vacuum and cannot work in isolation. It needs the support of both the government and the judiciary to implement and enforce the laws it administers. Furthermore, while undertaking reforms, the Regulator cannot ignore economic realities and needs the constant support of the public and the media. It is faced with additional difficulties in carrying out capital market reforms in a running market.

Despite all the odds, the Securities and Exchange Commission of Pakistan (SECP) has managed to carry out important administrative and operational reforms in the capital markets which have considerably improved the transparency, governance, and risk management system at the Stock Exchanges. The SECP now seeks to make fundamental structural and institutional changes without which the earlier reforms cannot be sustained or the primary regulatory objective of protecting investors met. The most important ongoing reforms include the phase-out of badla financing, demutualization of the exchanges, the elimination of group accounts and the introduction of universal client identification.

It was necessary to eliminate group accounts in April, despite the attendant difficulties, in order to do away with the benami system of trading that made enforcement difficult for the regulators. The introduction of universal client identification system is also needed to enhance the regulator's enforcement capability. The demutualisation is imperative to modernise the Stock Exchanges. The phase-out of badla financing is essential to eliminate manipulation and reduce market volatility. The timed phase-out has been suspended, but the process has not been stopped and there is no back-tracking. Badla financing will eventually be replaced by alternative modes of financing.

This is a mechanism of post trade financing of shares unique to Pakistan, that allows weak holders and speculators to buy shares and simultaneously enter into a sell-buy transaction to finance the purchase of shares. Badla financing has been repeatedly identified as the root cause of all major capital market crises in Pakistan since it allows for over-speculation and manipulation by market players. The systemic risk posed by badla financing is particularly detrimental to investor interests and market integrity.

Mindful of this and duty-bound to protect the interests of investors and ensure effective risk management, the SECP initiated the phase-out of badla financing in October 2003, after extensive consultation with key stakeholders, including stock exchanges, brokers, the State Bank of Pakistan, and the government through the Ministry of Finance. As a result of this consultative approach, the time-bound action plan for the gradual phase out of badla financing was developed after discussions with the Stock Exchanges.

The Stock Exchanges have not kept their bargain, nor have the banks been able to provide alternative financing in the desired time frame particularly to small investors and brokers. This situation, compounded by the current liquidity concerns, left the SECP no choice but to suspend the time-bound process for the phase-out of badla financing.

The SECP however remains firm in its resolve to end badla financing. It has come a long way in this process and needs to be supported rather than excoriated. The editorial criticises the SECP's ability without assessing the good intentions and determination with which it is pursuing its goals!

The SECP could scoff at the naivety of the editorial in assuming a hurdle-less race to the finish line of this major reform or question the result it seeks to achieve, but chooses to look at the positive aspect of the editorial's implicit support of its reform effort. The regulator has a commitment to fulfil. Making an exit from the SECP, as suggested by the editorial, is an easy option but would not only be an abdication of responsibility but also undermine the process of reform.

The writer is Chairman of the Securities and Exchange Commission of Pakistan Islamabad

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