● MADHYAM BRIEFING PAPER ●

The NSEL Payment Crisis: The Price of Poor Regulation and Supervision

Rs 5,600 crore appears to be a small amount in scam-ridden India where scams of Rs 40,000 crore are routine. But the scam at the National Spot Exchange Ltd (NSEL) in all probability may even surpass Rs 50,000 crore if one includes all the multiplier effect of the payment crisis. The market mayhem was triggered by the NSEL that suspended trading of all one-day contracts on July 31, 2013, without assigning a clear reason.

Surprisingly, the NSEL has been functioning as an unregulated commodity exchange for the past many years. It is only after the crisis that the commodity forward trading regulator Forward Markets Commission (FMC) — functioning under the Ministry of Consumer Affairs — stepped in as a monitoring agency. Later on, the FMC was brought under the administrative control of the Ministry of Finance. The NSEL is a part of Financial Technologies India Ltd (FTIL), promoted by Jignesh Shah, who, among others, owns MCX Commodity Exchange and MCX-SX Stock Exchange. The NSEL spot trading platform for commodities began "live" trading on October 15, 2008, and currently controls 99 per cent of the market.

NSEL: Spot Exchange or Forward Exchange?

The NSEL was born and allowed to operate in the spot market. It was specifically forbidden to offer forward contracts, or to short-sell products. The NSEL operated with regulatory exemption from

the government, based on riders such as a ban on long-dated contracts and short-selling. But it allowed trading of products that were never approved by the government and that, in the eyes of many, virtually offered assured returns and helped boost volumes till the Ministry of Consumer Affairs stepped in, forcing the NSEL to provide an undertaking that it would not launch any more contracts and that all existing contracts would be settled on due dates, besides stopping a payout to brokers. This led to a payment settlement crisis.

The NSEL launched a number of one-day forward contracts, but some of them were being settled as many as 36 days after the date of transaction.

The most astonishing fact is that a market for immediate trading of commodities, the equivalent of a cash market in stocks, began functioning as a forward market with lax settlement rules. The trade at the spot exchange starts with the seller bringing his goods, which are weighed and checked for quality. Once approved, a warehouse receipt is issued. The seller deposits the receipt at the designated spot exchange. This sets the quantity the seller can trade on the exchange. Finally, the buyer and seller mutually agree to a price and delivery, and settlement is done.

Apparently, every transaction of buy and sell was paired with one leg beyond the specified spot settlement cycle of two days after the trade (T+2). And the NSEL contracts settled within T+10 days were defined as 'spot', but could be carried forward, dodging the FMC regulations, with settlements going as far ahead as T+35. As a result, the buyers benefited from an increase in the value of their positions and they book profits by selling at higher price within the T+35 period.

The NSEL launched a number of one-day forward contracts, but some of them were being settled as many as 36 days after the date of transaction. The supposed reason for the delayed settlement was that one had to account for the peculiarities of certain commodities and time and effort were required to deliver them physically to specific locations. It's become evident through multiple sources — including regulators, brokers and users of NSEL products — that most of the trading on the exchange centred on the so-called pair trades to generate annualised returns of 14-15 per cent, without assuming any commodity price risk.

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Investors bought a near-term settlement contract with a T+2 settlement, and another one with a T+36 settlement was sold simultaneously. The difference in the price of the two contracts — the interest paid to defer payment — was the return for the financier. When the near-term contract was settled, investors became the owners of a warehouse receipt of the commodity purchased. This was effectively pledged to the exchange for the second leg of the transaction — the sale transaction to be settled 36 days later.

However, the buyer of the 36-day contract (effectively, a borrower of funds if he also sold the near-term contract) was levied inadequate

margins for the risk he posed to the system. According to the head of a leading domestic trading house, the margins of 10 per cent were woefully inadequate, considering that the under- lying asset was fairly 'il-liquid'. It's quite evident that the NSEL cannot liquidate stock and settle with trading members with net short positions. Its stock position in some commodities, such as wool and sugar, is fairly large and will drive down prices if they are dumped en masse. In an ideal scenario — in an exchange which practices robust risk management — trading members with open positions should have been levied margins of at least 40-50 per cent to compensate for the liquidity and price risk of underlying commodities. Of course, this would have caused investors' returns to fall from the lucrative 14-15 per cent, but adequate margining would have helped avert the current payment crisis.

Spot trading is a minuscule part of NSEL's total business volume and most of its revenue comes from forward contracts, for which it has no mandate.

The Modus Operandi

In June 2007, when the Government granted a license to NSEL, the underlying idea was that the futures market could not function efficiently without an efficient physical market. Many commodities are traded in both spot and futures markets. The spot market is for trading today, whereas the futures market is for future delivery. A forward contract is a legal commitment made by a seller to deliver a pre-specified amount at an agreed time at a particular price.

Spot exchanges were supposed to be electronic trading platforms similar to mandis for spot delivery contracts for sale and purchase of agricultural commodities, metals and bullion. This was supposed to be an innovative Indian experiment in the trading of goods and a form of direct marketing by sellers of commodities, distinct from what was commonly known as "commodity exchanges". Spot exchanges were meant to leverage the latest technology for trading of goods.

Spot exchanges were supposed to be an electronic market where a farmer or trader could discover the prices of commodities and buy or sell goods immediately to anyone across the country. All contracts on the exchange were compulsory delivery contracts, i.e. at the end of the day the seller had to give delivery and the buyer had to take delivery on a net basis (intra-day squaring off was allowed). Another mandatory requirement was 'ready contracts', meaning a contract which provides for the delivery of goods and the payment of a price, either immediately, or within a period not exceeding 11 days (T+10 contract) after the date of the contract.

The more-than-11-day contracts' tenure was illegal. The NSEL started offering assured returns of 12-15 per cent to investors; as a result, its business boomed.

The NSEL's mandate was only to offer a spot trading platform. The NSEL is not a recognised forward contract exchange like MCX. But, as a shady package deal, traders were allegedly allowed to take positions in NSEL and sell the same on MCX — which is not the same thing. Also, it was

operating T+25 contracts right from the beginning and pairing trade of T+2 and T+25 or T+2 and T+35 — which had no legal basis.

The more-than-11-day contracts' tenure was illegal. The NSEL started offering assured returns of 12-15 per cent; as a result, its business boomed. It achieved a turnover of Rs 2,182 crore by the end of the first year in 2009, and its daily turnover touched Rs 1,000 crore. Today, spot trading is a minuscule part of its total business volume of Rs 300,000 crore and reportedly most of its revenue comes from forward contracts, for which it has no mandate.

Another blatantly illegal but popular product was *vyaj badla*, an ingenious risk-free guaranteed return scheme where the financier held a warehouse receipt for the goods and the NSEL stood counter-guarantee for any failed transaction. As part of a pair trade, or vyaj badla cycle, a

The Regulatory Vacuum

Paul Joseph, former Director (Stock Exchanges) in the Department of Economic Affairs, retired in 2008 and soon joined Jignesh Shah (the promoter of the NSEL), signed a notification dated June 5, 2007. It is this notification that helped the NSEL take advantage of the technicality of 'one-day forward' contracts and launch spot markets across the country. The NSEL went live on October 15, 2008.

Though the plea taken was that the amendment would help farmers get better prices, as the regional terminals where farmers bring their produce are controlled by cartels that beat down prices, in actual terms it placed the functioning and control of NSEL Spot Exchanges outside the purview of the Forwards Markets Commission (FMC) and without clear-cut powers of the Centre or the States to regulate it.

To undo the damage, the Department of Consumer Affairs issued another notification on February 6, 2012, appointing the FMC as the designated regulatory agency for the National Spot Exchange. Technically, now, for any forward contract, the NSEL had to seek the FMC's permission. But it was too late in the day and the damage was already done. The notification of February 6, 2012, made another amendment to the Forward Contracts (Regulation) Act stipulating that all information or returns relating to trade, if requested for, are to be provided to the Centre or the FMC. This, again, seems to be a weak regulation which speaks only of providing information or return of trade. There are no powers for search and seizure.

The NSEL made the most of the regulatory vacuum to set up spot trading operations in 52 commodities, including bullion (gold, silver, platinum), agri-products (cereals, fibres, spices), metals (steel, copper) and energy in 16 states of India. The NSEL's good fortunes can be attributed to the fact that it was virtually allowed to run the operations without any controls, checks and balances, in a regulatory vacuum from 2007 till February 2012.

mill-owner may buy a commodity from the NSEL, or from a mandi, using cash or agrifinancing from a bank. These stocks were stored at warehouses owned or rented by the mill-owners, who would enter a long-term higher price forward contract to buy the stock from the financier at the end of 25 days or 35 days. In the process, the mill-owner may recover his money and the financier got the difference between the two contract prices — approximately 14-16 per cent per annum returns.

The NSEL violations were first noticed in May 2011, when a sub-committee of RBI and Ministry of Consumer Affairs officials was apprised about the lack of regulatory measures in the spot exchanges. But nothing happened for eight months. Though New Delhi woke up and brought the NSEL under the purview of FMC in February 2012, yet nothing much changed on the ground except the NSEL being made to furnish weekly and fortnightly trade data. Even as early as February 21, the FMC knew of 55 contracts having a settlement period of more than 11 days, and instances of short-selling. Why is it that, despite the Ministry of Consumer Affairs and FMC finding large-scale violations as early as April 27, 2012, the NSEL was allowed to continue for 16 months, till August 6, 2013? For close to two years, the Government kept dilly-dallying. Though the FMC submitted a draft legislation for regulating spot exchanges to the Ministry, and the MCA issued a showcause notice to the NSEL on April 27, 2012, there was no follow-up action.

Despite the Ministry and FMC finding large-scale violations as early as April 27, 2012, why the NSEL was allowed to continue trading in the illegal contracts for 16 months, till August 6, 2013?

Finally, the endgame began on July 13, 2013, when the MCA ordered the NSEL to settle all existing contracts by their due dates and not issue any further contracts. The NSEL had a practice of deliver-now-pay-later contracts; the FMC wanted this practice to stop. When the NSEL informed its members that henceforth contracts would have to be settled within 11 days on a trade-to- trade basis — that is, payment against delivery of the commodity — the forward traders were not interested in spot trading and demanded immediate settlement. As a result, the NSEL ran into trouble.

The Missing Settlement Guarantee Fund

Behind these trades was the NSEL guarantee of settlement and it should, therefore, be legally bound to pay, whether or not counter parties pay in. It is alarming as to how the Settlement Guarantee Fund (SGF), comprising cash, FDRs, bank guarantees or assets, has shrunk from Rs 839.53 crore on July 29 to Rs 65 crore now. The purpose of the SGF is to ensure that all stakeholders are not affected in case of default. The shrinking of the SGF perhaps indicates a widespread notion: powerful politicians and bureaucrats — the hidden investors — are abandoning the sinking ship and being paid off on the sly.

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This raises many important questions: can the NSEL escape the noose by arranging to settle the contract value between the parties? Who approved the system of margining in the clearing house? Is the Settlement Guarantee Fund (SGF) adequate for sudden adverse events? Was it subjected to a stress test? Should non-defaulting brokers be deprived of margins lying in SGF due to the recklessness of others? Should the liability of the NSEL be limited to the corpus in SGF that comprises the collection of margins of the members? And were margins collected from beneficial owners of positions since spot contracts have morphed into forward contracts or futures?

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Close to 13,000 investors have lent money through the NSEL platform to less than 25 borrowers, using a two-legged buy/sell contract that the government and the FMC found illegal. None of these high net-worth individuals would have lent money to a group of little-known borrowers, had it not been for the exchange. The product operated like a *vyaj badla* scheme, where money was lent in exchange for warehouse receipts and repaid after 25 or 30 days when the receipt was returned to the borrower. However, in most cases, the contracts were rolled over beyond 25 days, with the lender collecting just the interest amount.

The fact that 25- to 50-day future contracts were being traded on the NSEL and that some structured products offered by brokers on the exchange were offering assured annual return of 14-15 per cent to investors, was publicly known for some time.

The Fake Warehouse Receipts

Many of the warehouses and stocks claimed by the NSEL appear to be suspect, as quite a few warehouse-keepers appear to have issued forged or false documents. In many cases, where warehouse-keepers were themselves involved in trading, what was the sanctity of their declaration and receipts as they could always manipulate the stock position? In some cases, the stocks were pledged to more than one financial institution.

Can one imagine 10-12 per cent of India's wool consumption lying in a single warehouse in Ludhiana?

In most cases, actual stocks do not tally with the quantities mentioned in the warehouse receipts. This only implies that fake warehouse receipts were being used. For instance, according to the NSEL's latest stock position, 11190.5 tonnes of raw wool — almost a quarter of India's annual wool production — is stored in the warehouse of ARK Imports in Ludhiana on July 26. Can one imagine 10-12 per cent of India's wool consumption lying in a single warehouse? The stocks of jeera, shown in the NSEL's two warehouses at Unjha in the Shivganga area, are reportedly pledged to ICICI Bank. Similarly, Mohan India warehouses in Delhi, where the NSEL claimed to have deposited sugar stocks worth over Rs 1,000 crore, reportedly have to recover Rs 150 crore from the NSEL.

Likewise, large-scale discrepancies can be found in stocks of paddy, sugar and wool. Raw wool, castor seed, castor oil, cotton wash oil, paddy and steel were some of the favoured traded commodities, inviting between Rs 3-10 lakh investment from small and medium traders — at least 10,000 of whom lost their hard-earned money in the NSEL scam.

The Need for Thorough Investigation and Strict Regulations

The most important issue in this scandal is where all the money, running into Rs 5,600 crore, has gone. To which accounts was the investors' money transferred, and where has it gone from those accounts? Who will investigate the money trail? Will it ever be recovered?

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To begin with, thorough investigation into the functioning of the entire Jignesh Shah group of companies should be conducted in a coordinated manner by all the investigating agencies of the country, including the Central Bureau of Investigation (CBI), Income Tax Department, Serious Fraud Investigation Office (SFIO) of the Ministry of Corporate Affairs (MCA), Directorate of Revenue Intelligence (DRI), Enforcement Directorate, Economic Offences Wing of the Ministry of Finance, Central Warehousing Corporation (CWC) and other official agencies.

In addition, the Competition Commission of India (CCI), should also be roped in since the NSEL, with a market share of 99.99 per cent, can be defined as a dominant undertaking coming under the purview of the CCI for all its allegedly irregular behaviour in the market space.

Are Commodity Futures Exchanges Serving Indian Farmers?

The commodity futures exchanges were supposed to help Indian farmers in two important ways: price discovery and hedging of price risk in a commodity. These laudable objectives have remained null and void as most farmers cannot afford to pay the heavy membership fee to become a member of the commodity futures exchanges. In addition, the minimum lot size for trading in the futures market is much more than the marketable produce of most medium and small cultivators, who lack the skills needed for trading on electronic exchanges. There are also no terminals in the villages; as a result, commodity exchanges are nothing but rich persons' casinos.

The business of commodity futures exchanges is thriving while the percentage of agri-commodities has declined from 19.5 in 2007-08 to 11.8 per cent in 2012-2013. Also, as per FMC data, more than 99.9 per cent of all trading in commodity futures exchanges is speculative — without any physical delivery. It is the only market of its kind where the seller has no real need to sell (things they don't even own like crude oil) and the buyer has no need or intention to buy or accept physical delivery and stock it. What possibly could a person do with crude oil when he does not own a refinery? Is this what India wants?

An integrated approach on the part of all these agencies alone can track the money running into thousands of crores of rupees that has been siphoned off and find out how the money lent by thousands of investors has been deployed.

The NSEL, or any of the group companies controlled by the promoter, be debarred from entering into any new financial commitments and payments, till the investigation is complete and all financial obligations arising out of the default of the NSEL are settled.

In view of the significant co-relation between the price rise of essential commodities and the functioning of these exchanges, as also the number of suicides committed by investors, it is proposed that all commodity futures exchanges should be closed until a strong regulatory regime is put in place. To develop effective regulatory mechanisms for the functioning of commodity exchanges, a high-power committee should be immediately appointed by the government.

— Neeraj Mahajan and Anil Tyagi

Neeraj Mahajan and Anil Tyagi are Associate Editor and Editor respectively of Gfiles (www.gfilesindia.com). Gfiles has filed a public interest litigation in the Supreme Court on the NSEL payment crisis.

Data Notes:

Lakh is 100,000.

Crore is 100,00,000.

1 US$ = Rs 62 (October 2013).

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