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Economic spillovers of F&O frenzy

It could lead to a drop in household savings, increase indebtedness and drive a wedge between credit and deposit growth

Retail push. Disturbing trends ▪ /iStockphoto

A growing wave of speculative activity in the futures and options (F&O) markets, coupled with a simultaneous deposit shortfall in the banking sector, may not be entirely unrelated. They could threaten India's financial stability and economic well being.

Between FY23-FY24, the number of individuals trading equity derivatives increased from 29 lakh to 40 lakh. This is dominated by those below 30 years of age. The majority — 94 per cent — are trading in highly leveraged index options. This is thanks to:

Digital Accessibility: Thanks to mobile trading apps and online platforms that have democratized access to the F&O markets, young people can participate in high-risk trading activities with unprecedented ease.

Speculative Appeal: The allure of rapid gains attracts many inexperienced investors who often need an understanding of the downside of such volatile instruments.

Easy Access to Payday Loans: The growth of India's payday loan market has also facilitated speculative activities. Young investors can secure short-term loans with just a few taps on their smartphones, which they then use to enter F&O trades. While these loans are more regulated, they are proliferating. SEBI research suggests that easy credit and speculative investments can lead to increasing retail indebtedness.

This trend of retail speculation could have had a pronounced effect on India's savings rate. In 2022-23, household savings as a percentage of GDP fell to a historic low of 5.1 per cent. Savings are the backbone of financial stability, enabling investments in critical infrastructure projects. As more households divert their income away from savings towards speculative activities, the foundation needed for sustainable growth could be compromised.

FIIs and Market Volatility

FIIs' participation in the F&O segment has only increased in recent years. In FY24, FIIs accounted for 17.6 per cent of the F&O market. They typically employ sophisticated trading strategies, including proprietary algorithms, to capitalize on market movements. This creates an environment where retail investors lacking the same expertise and access to advanced tools are often disadvantaged. The recent case involving Jane Street, a Wall Street firm that reportedly made $1 billion in profit from Indian derivatives markets, underscores this disparity.

This speculation-driven boom seems to have significantly impacted the banking sector. The credit-deposit (CD) ratio, which measures how much banks lend relative to their deposits, rose from 64.68 per cent in FY19 to 76.05 per cent by July FY24. This increase perhaps suggests that banks are under more significant pressure to lend in response to rising retail credit demand, partly driven by the easy availability of credit, such as payday loans. The concern is that much of this credit, often sourced at a higher rate, is channelled into unproductive speculative activities, making the banking sector vulnerable.

At the same time, India's broad money supply (M3) has been expanding at a compound annual growth rate (CAGR) of 11 per cent, reflecting increased liquidity within the economy. This too could find its way into speculation.

The Buffett Indicator (Market Cap/GDP) further highlights the consequences of this speculative activity. As of September 2024, the ratio stood at 110.43 per cent, well above the 10-year average of 92.07 per cent. This overvaluation increases the likelihood of a significant market correction unless the risk-seeking money is distributed among new issuances.

Recent SEBI measures on containing volatility and market risk management couldn't have been better timed. Many young retail investors are being drawn in by the allure of quick profits and easy access to credit. At the same time, foreign participation, while boosting liquidity, also contributes to market volatility, leaving retail investors vulnerable. The banking sector is pressured by increased credit demand being used to fund speculative activities rather than productive investments.

These trends could destabilize financial markets, hinder household financial security, and curb economic growth.

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