What's next for the capital market ecosystem

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It feels like we've lived through a decade in the last four years in the markets. The sheer number of changes and developments in such a short period of time is stunning. I still remember February and March 2020, when we were preparing for the absolute worst at Zerodha. But what transpired was the exact opposite—something I couldn't have predicted in my wildest dreams.

The number of active retail investors in India increased from about 3 million in January 2020 to nearly 12 million in January 2022. To put that in perspective, India had 2 million active investors in January 2017 and 3 million in January 2020. Individual investors accounted for 39% of the cash market participation in 2029, which shot up to 45% in 2021. Mutual fund SIP flows rose from Rs 8000 crores in January 2020 to Rs 14750 crores as of May 2023. This surge in activity wouldn't have been possible without Aadhaar, Digilocker, and UPI (India Stack). The credit goes to the government for enabling countless fintechs like Zerodha to be digital first.

The flip side of this is the impact of this sudden surge in activity on the market structure. This market phase also coincided with the introduction of several progressive and landmark regulations that have made the Indian markets among the safest globally. I am not just saying that as the head of an Indian brokerage firm, but having seen the market structure of larger markets like the United States and Europe. From 2020–23, the US markets saw several of the worst excesses, like the meme stock mania, the special purpose acquisition company (SPAC) boom and bust, and the mania in zero-day stock options.

The US markets also had to contend with their legacy issues with clearing and settlement. The other major debate around this time was the practice of payment for order flow. Unlike India, where all orders are executed on stock exchanges, most orders in the United States are executed off-exchange by market makers. This raises obvious transparency concerns.

In the same period, despite the dramatic spike in activity, Indian markets functioned without a hitch, barring the day when crude oil prices went negative and financial intermediaries faced issues. But this was a global issue and not an India-specific issue. This was possible due to the progressive regulations of SEBI, and I'll highlight a few key ones.

In 2019, SEBI made it mandatory for all securities to be settled to client demat accounts, which removed the scope for misuse of securities.

1. The depositories introduce the e-DIS (Electronic delivery instruction slip) and TPIN mechanisms, removing the need for a power of attorney (POA).
2. Starting in December 2020, SEBI implemented the peak margin requirement, which reduced the leverage in the system.
3. In 2023, SEBI introduced new rules around segregating and reporting client funds to clearing corporations.

So where are we today, and where do we go from here?
The post-pandemic idiosyncrasies disrupted a lot of trends, but they have largely resolved themselves. The world is also a much gloomier place today. Interest rates in advanced countries are at levels we haven't seen in 15 years. Money now has a cost. As interest rates rose, the euphoria of the last 3–4 years has all but disappeared. Most measures of stock market participation are slowly reverting to pre-pandemic trends, but overall participation remains much higher than pre-pandemic levels.

Despite the post-pandemic bump in stock market participation, the biggest challenge for Indian markets is their shallowness. There are just 3.37 crore unique mutual fund investors; if you add unique demat accounts, the total number goes up to maybe 6–7 crore. Pre-pandemic, this was maybe less than half. So, that's the size of the investor base in India. It gives you an idea of how far we have to go.

Where do we go from here?
The short answer is, I don't know. Having said that, India is one of the rare bright spots in an otherwise gloomy global economy. I'm not just saying this as an Indian bull, but there aren't a lot of markets globally that offer the same opportunity set. We're seeing what's happening in China, despite the opportunity set, the lack of legal protections is forcing investors to flee the markets. But that doesn't mean we don't have challenges. If there's a recession in the US and other advanced markets, India cannot remain unaffected. But we will outperform on a relative basis.

While the Indian economy is on the cusp of taking off, there's a lot of work to be done. Despite all the progress on ease of doing business, a lot more can be done to encourage startups and simplify regulations. One of the greatest blessings for India is its demographic divide, but it may also become a curse given the recent advancements in artificial intelligence (AI). Automation seemed like a distant threat for a long time, but this time it feels different. The Indian youth are dramatically underskilled, and this is a huge issue. Our governments should operate under the default assumption that advancements in AI will cause massive societal upheaval.

Then there is climate change, the mother of all existential issues. It might sound odd to talk about climate change in the context of financial markets, but if humanity as a whole is doomed, what good is it if the stock market goes up? Climate change is a social, economic, financial, and existential risk all rolled into one.

But coming back to the markets, I recently shared a tweet about how the Indian markets, despite being at lifetime highs, have no momentum. Activity in the

markets on most metrics is moderating. If economic risks in advanced economies materialize, our markets will be affected. Again, it may be fair to assume that we won't see a roaring bull market in the foreseeable future.

But to reiterate, despite the moderation in the past year, market participation is much higher than pre-COVID levels. All the developments in Aadhaar, UPI, and Digilocker have made it possible for any fintech to be fully online and serve all Indians without the need for a large physical footprint. One of the more exciting developments in the India Stack is the operationalization of the Account Aggregator framework. Now fintechs have easy access to the banking, insurance, and investment data of all Indians with their consent. This will spawn numerous businesses, which will further feed the virtuous cycle of the deepening of the financial markets.

Having said that, when the next bull market comes, our financial markets have never been more prepared to handle it. All the regulatory changes in the last five-odd years have made our markets more resilient. These regulations have ensured that systemic risks don't accumulate in under-observed and lightly regulated areas of the markets. The odds of rude surprises are far lower than ever. That doesn't mean things won't happen, but thanks to the proactive regulatory framework, our financial markets are more than prepared to handle the next leg of growth.