Quest Journals
Journal of Research in Business and Management
Volume 12 ~ Issue 11 (2024) pp: 36-43
ISSN(Online):2347-3002
www.questjournals.org

Research Paper

A Primary focus on progress of Small Finance Banks in India

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Abstract: *Financial inclusion has been the focus of the policies of the Reserve Bank of India since 2005-06. Along with various initiatives of the Government of India, the RBI approved the setting up of differentiated banking namely Payments Bank (PB) and Small Finance Banks (SFB). SFBs are niche banks set up to undertake basic banking activities for the unserved and underprivileged sections of the population. SFBs mainly cater to the sections like small business units, micro and small enterprises, small and marginal farmers, and the unorganized sector. This paper focus on the progress of SFBs in India in terms of the number of banking outlets, regional spread, population spread and growth of business of Small Finance Banks over the years. It was found that since their establishment, over the period of seven years, there has been considerable expansion of SFB branches with a wider regional spread and substantial increase in their volume of business. Towards the end of the study period it was also found that more SFB branches were set up in semi-urban and rural areas. The preliminary examination of SFBs suggests that they are progressing in the right direction as envisaged in the objectives behind setting them up.*

Keywords: *Financial Inclusion, Differential Banking, Small Finance Banks (SFBs).*

Received 02 Nov., 2024; Revised 09 Nov., 2024; Accepted 13 Nov., 2024

I. Introduction:

Financial inclusion means that individuals and businesses have access to useful and affordable financial products and services that meet their needs – transactions, payments, savings, credit and insurance – delivered in a responsible and sustainable way. The Government has initiated the National Mission for Financial Inclusion (NMFI) by introducing many schemes and plans for the financial inclusion from 2005 onwards. Schemes like Pradhan Mantri Jan DhanYojana (PMGDY), MUDRA scheme, providing universal banking services for every household was the main mission of NMFI. Introduction of Small Finance Banks come under the latter category. In 2015, RBI approved licenses to 10 institutions to commence their operations under the concept of Differentiated banking i.e. Small Finance Banks. Small Finance Bank is a specialized segment of banking created by the Reserve Bank of India (RBI) with an aim to strengthen the Indian economy. Such banks intend to undertake the basic banking activities for under-served and underprivileged sections of the country. Subsequently, the SFBs cater to the requirements of the sections like small business units, micro and small enterprises, small and marginal farmers, and the unorganized sector. These banks also undertake the basic banking activities such as lending and accepting deposits just like other commercial banks. The RBI issued the guidelines of the Small Finance Bank in November 2014, just after the announcement of the Union Budget for 2014-15. Around 72 entities from across the segments applied for the license, while only 10 of them were provided the license of operations.

II. Review of Literature

Small Finance Banks being a recent development there is limited literature available on it. Most studies have discussed their regulatory framework, their role in financial inclusion, and challenges faced by SFBs. These include Jayadev, Singh, and Pawan Kumar (2017), Mohanty (2018), Dhanya and Bhanudevi (2019), Srinivas and Shanigarapu (2020). Arora, Sharma, Pahwa, and Yadav (2018) focus on the important role of SFBs in improving financial inclusion by directing the saving of the unserved rural and semi-urban areas of India towards the organized banking sector, and thereby, promoting growth and development of the economy. They emphasize on 4 As, namely, awareness, affordable, accessible, and accountable banking services.

Jayadev, Himanshu Singh and Pawan Kumar (2017), in his study "Round Table-Small Finance Banks: Challenges-analysed the genesis, and various forms of special vehicles of financial inclusion, comparative study of regulatory compliances of Small Finance Banks with other forms of financial inclusion. Conducted interview with senior executives of Small Finance Banks to elicit their mind views, concludes that Small Finance Banks are adapt suitable Business Model.

AlokMisra and Ajay Tanka (2018), Inclusive Finance India Report- Chapter7-"Small Finance Banks and Payments Banks: Struggle for Differentiation and Business Model continues"- study analyses comparatively, the Small Finance banks and Payment Banks and studies the genesis challenges in future, by studying the individual business profiles of the SFBs, splashes out what challenges industry would face.

Ravikumar, Murugan, and Suhashini (2020) have studied the penetration and performance of SFBs using parameters such as number of branches, advances, deposits, presence in States, net nonperforming assets (NNPA), and capital adequacy ratios (CAR) until March 2019. The study inferred that SFBs has penetrated well across the country with a steady growth in deposits and advances. The ratios like NNPA and CAR reflected sound financial positions over the period of study. They have also examined the challenges faced by SFBs in the form of loan restrictions, cost of banking products, limited area of operation, etc.

According to Sharif Mohd. (2018) in his study titled "A Study on Performance of Microfinance Institutions in India," microfinance institutions play a crucial role in promoting socio-economic development and implementing government programs aimed at poverty eradication. These institutions operate effectively in both rural and urban areas. The author also highlights that the government is taking initiatives to enhance financial literacy among the population through the implementation of various banking policies and schemes.

Banu M. (2019) found in his paper, the financial analysis of small finance banks in India, conducted through CAMEL rating 2061, revealed a significant correlation between the public, private, and foreign banking sectors in terms of return on investments, equity, and advances. The study found that the cash-deposit ratio and credit-deposit ratio positively influenced short-term liquidity. However, the net interest margin and investment ratios did not demonstrate any impact on the solvency position across all three banking sectors.

Nitin Kumar and Sarita Sharma (2021) in their research paper titled "Performance of Small Finance Bank (An Early Reflection)," examine the financial performance of different types of banks, including public banks, private banks, and small finance banks. The study highlights that the Reserve Bank of India periodically issues guidelines to enhance the capabilities of small finance banks. The authors also note that initially, small finance banks were primarily focused on aiding the rural population, with less emphasis on profit generation.

III. Objectives of the Study:

The present study starts with understanding the conceptual framework of Small Finance Banks in India with its regualtion, then focus on objectives and importance of Small Finance Banks in India. The paper also seeks to trace the progress of SFBs in India in terms of increase in the number of banking outlets by SFBs, their regional spread by examining their gross advances (i.e. Central, Eastern, Northeastern, Northern, Southern, Western regions), and population group-wise spread (Metropolitan, Urban, Semi-Urban, and Rural) areas across the country. Along with the growth of bank is measured in terms of deposits collected, profitability using Return on Assets, different components of liabilities, and CAGR of SFBs. The paper also analyses the Challenges faced by Small Finance Banks in India.

IV. Research Methodology:

The study is based on secondary data for the period of 2016-17 to 2022-23. The data has been collected from the RBI Database on Indian Economy (RBI-DBIE), CRISIL Reports, Market Intelligence and Analytics Reports and also using the Annual Reports of Small Finance Banks. The growth has been measured using simple statistical tools like ratios, annual growth rates, percentages and graphical representation.

V. Analysis & Interpretation:

The first objective of the study is to understand the concept of Small Finance Banks in India with its features and importance. Small Finance Banks (SFBs) were set up with a specific mandate—to expand financial inclusion, cater to the unbanked segment and increase lending to the priority sector including the micro, small and medium enterprises and agriculture. The RBI set stringent guidelines that act as safeguards and boost the credibility and performance of the SFBs. These niche banks are required to direct 75 per cent of their loans to the priority sector, while the same for other scheduled commercial banks is pegged at 40 per cent. At least 50 per cent of the SFBs' credit portfolio should comprise loans of up to Rs 25 lakh. The SFBs are also required to go public within three years of reaching a net worth of Rs 500 crore, as per the RBI guidelines, first issued in 2014. In return, the SFBs, which come under the ambit of private sector banking, enjoy concessions or easier norms. As set by RBI, the minimum capital requirement for these banks currently is Rs 200 crore as against Rs 100 crore set in the initial phase. The amount is Rs 1,000 crore for licensing new full banks now, though it was Rs 500 crore earlier—

a move apparently designed to discourage industrial houses from entering the banking space. Therefore, the SFB route provided a relatively easier way for many entities wishing to enter the banking space.

Following are the objectives of the SFBs in India:

- To strengthen the financial inclusion and promote small business units, small and marginal farmers, micro and small enterprises, and unorganized sectors through high technology low-cost operations.
- To give specific data of around 90% of small businesses that has no links with the formal financial institutions.
- To identify and expand access to financial services of sections that are neglected by the other private and public sector banks.

The functioning of small finance banks depends on if the resident individual has more than 10 years of banking experience. The companies registered, owned and controlled by residents will be eligible for setting up small finance banks. Small finance banks have the potential to make better opportunities unlike major banks because they solely focus on underserved people. The promoters of small finance banks need to be eligible to be considered a part of small finance banks. RBI is usually the intelligent bodies behind reviewing the organisations, companies whole apply for being promoters of small finance banks. Promoters' initial offering to the small finance banks should be at least 40% and gradually brought down throughout the years. The RBI needs to approve all the plans regarding the expansion of the small finance banks in the initial 5 years stage.

RBI Guidelines for SFBs

The guidelines issued by the prime regulators of banks and financial institutions in India, the RBI, for the small finance banks are:

1. Minimum paid-up equity capital must be INR 100 crore.
2. Every such small finance bank must carry the words "Small Finance Bank" in its name.
3. SFBs must obtain prior approval of the RBI to carry out financial operations like the distribution of mutual fund units, pension and insurance products, and so on.
4. These banks must have 25% of its branches set up in unbanked parts of the country.
5. Small Finance Banks must maintain a CRR (Cash Reserve Ratio) and SLR (Statutory Liquidity Ratio)
6. SFBs in India are required to extend 75% of its ANBC (Adjusted Net Bank Credit) to the sectors that are eligible to be classified as priority sector lending by the RBI.
7. At least 50% of its loan portfolio should constitute loans and advances of up to INR 25 lakh
8. SFBs may transit to a universal bank, however, they need to fulfil the minimum paid up capital/ net worth requirements as per the universal banks
9. Such banks cannot act as a BC (Business Correspondent) for other banks. Although, they can have their own BC network.

Scope of Activities

1. The small finance banks shall primarily undertake the basic banking functions of accepting deposits and lending to the small business units, micro and small industries, marginal farmers, and unorganized sector.
2. SFBs can also undertake other non-risk sharing simple financial services that do not require any commitment of own funds like distribution of mutual funds, pension and insurance products, etc.
3. Such banks can also become an Authorized dealer in foreign exchange business as per their clients' requirements
4. Small finance banks have general permission to open banking outlets from the date of business commencement subject to a conditional requirement of opening at least 25% of its branches in unbanked rural areas
5. There will not be any restrictions in the small finance banks' area of operations. However, preference will be given to applicants who set up the bank in a cluster of under-banked areas in the initial phase itself.
6. The other financial and non-financial activities of the promoters, if any, should be kept distinctly ring-fenced and not merged with the banking business.

Analysis on Progress of Small Finance Banks in India

The objective of analysis starts with understanding of inception of number of Small Finance Banks in India. On September 16, 2015, the RBI gave an "inprinciple" approval to ten entities including Microfinance Institutions (MFIs), Non-Banking Finance Companies (NBFCs) and Local Area Banks (LABs) for establishing SFBs. The table below is the list of Small Finance banks in India with their head quarters and year of their establishment as a small finance bank in India.

Figure No. 1: Table showing the List of Small Finance Banks in India

Name of the Bank	Location/ Headquarters	Year of establish-ment as SFB	Erstwhile Classification
Equitas Small Finance Bank	Chennai	2016	NBFC – MFI
Capital Small Finance Bank	Jalandhar, Punjab	2016	Local Area Bank
AU Small Finance Bank	Jaipur, Rajasthan	2017	Asset Financing NBFC
ESAF Small Finance Bank	Thrissur, Kerala	2017	NBFC – MFI
Fincare Small Finance Bank	Ahmedabad	2017	NBFC – MFI
Ujjivan Small Finance Bank	Bengaluru	2017	Urban Co-operative Bank
Utkarsh Small Finance Bank	Varanasi	2017	NBFC – MFI
Suryoday Small Finance Bank	New Bombay	2017	NBFC – MFI
Shivalik Small Finance Bank	Noida, Uttar Pradesh	2017	NBFC – MFI
JanaLakshmi Small Finance Bank	Bengaluru	2018	NBFC – MFI
North East Small Finance Bank	Guwahati	2018	NBFC – MFI
Unity Small Finance Bank Ltd	New Delhi	2021	Took over P& M Co-op Bank (PMC)

Source: Company reports, RBI-DBIE

The above table reveals the number of small finance banks in India from the year 2016-till date. The data relating to their headquarters, year of establishment & erstwhile classification is also covered in the table. This table indicates that many MFIs and small business units' license were approved for commencing their operations as SFBs.

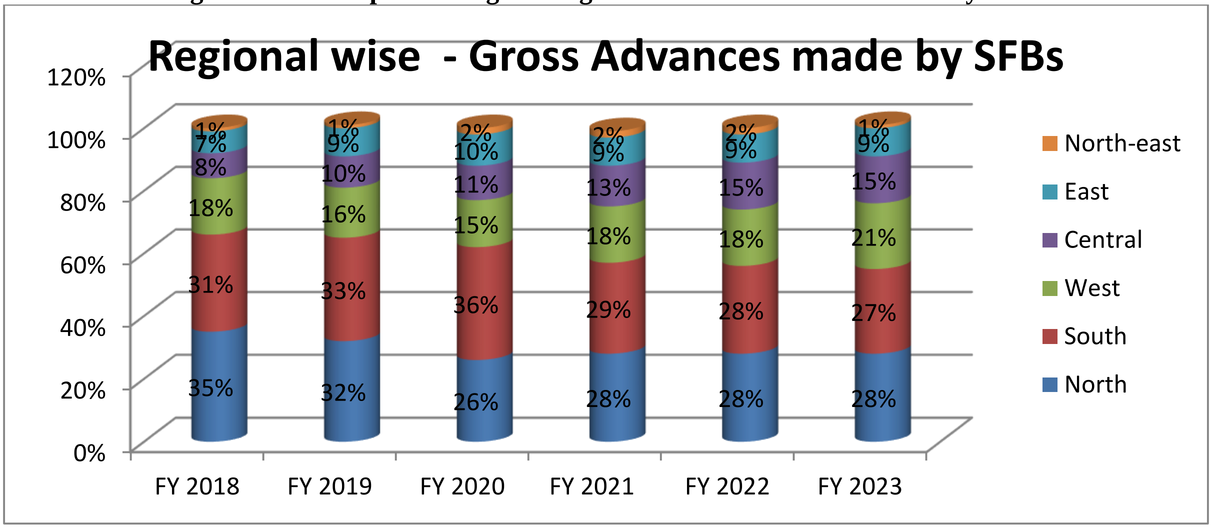
Figure No. 2: Table showing the number of banking outlets by Small Finance Banks

	No. of Banking Outlets			Growth in %	
Name of SFBs	**2021**	**2022**	**2023**	**2022**	**2023**
AU SFB	744	919	1027	23.5	11.8
Equitas SFB	861	869	922	0.9	6.1
Ujjivan SFB	575	575	629	0.0	9.4
Jana SFB	585	715	754	22.2	5.5
ESAF SFB	553	575	700	4.0	21.7
Utkarsh SFB	558	686	830	22.9	21.0
Fincare SFB	806	919	1231	14.0	33.9
Suryoday SFB	556	565	577	1.6	2.1

Source: Company reports, RBI-DBIE, CRISIL MI&A

The above table shows the number of banking outlets of selected SFBs in India during the years 2021-2023. It is seen that number of banking outlets of each of the selectedSFBs had increased continuously over the three years period. Among the above SFBs, ESAF SFB growth rate is highest, followed by Fincare SFB indicating the good progress of SFBs in India over the years.

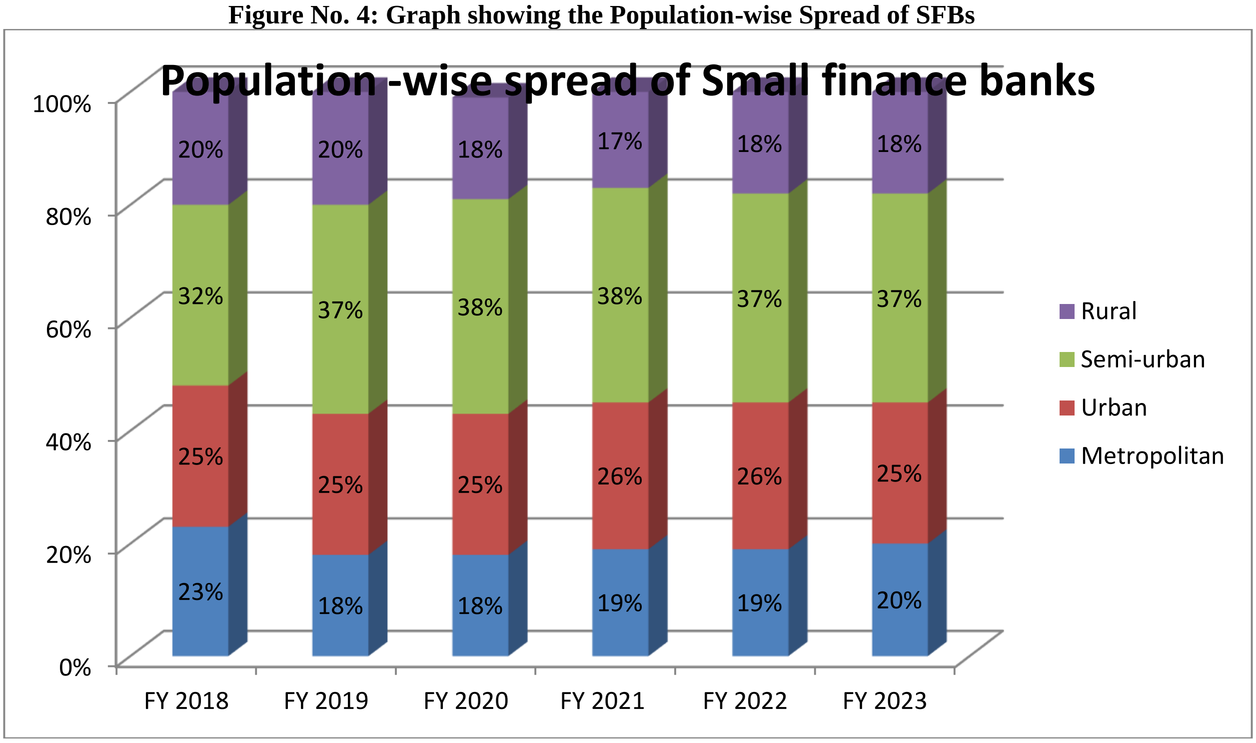
Figure No. 3: Graph showing the Region-wise Gross Advances made by SFBs



Source: Company reports, CRISIL MI&A

The above graph clearly reveals that the objective of RBI to set up small finance banks to cater to the needs of people across India is justifiable as the graph shows the region wise spread of gross advances made by small finance bank. All the small finance banks in north, south, east, west and north-east regions have made the advances made by these banks.

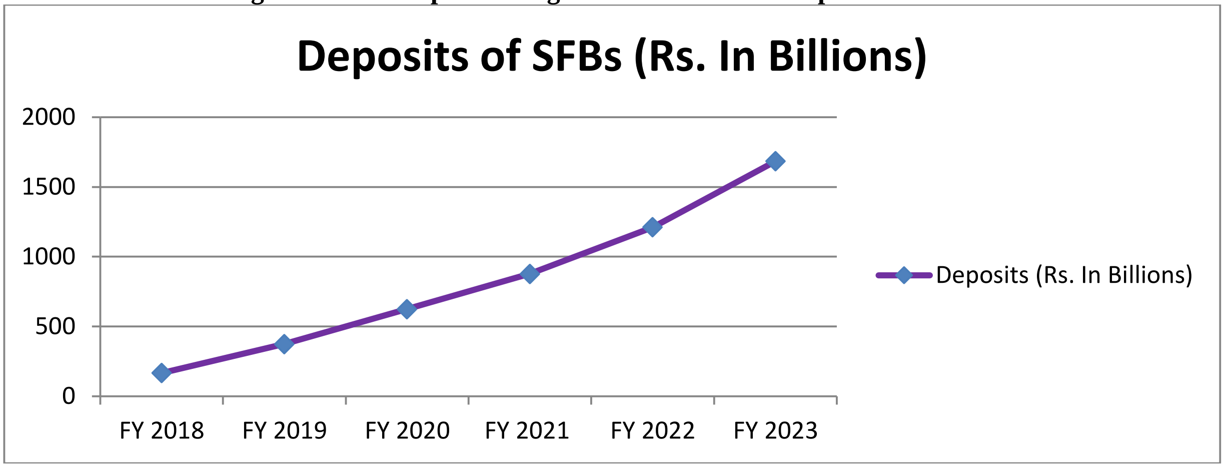
Figure No. 4: Graph showing the Population-wise Spread of SFBs



Source: Company reports, CRISIL MI&A

The above graph clearly reveals that the objective of RBI to set up small finance banks to cater to the needs of rural and semi rural areas of our country is again proved as the graph shows the population wise spread of small finance banks in India from the Financial year 2018-2022. It also shows that more than 50% of SFBs are located in the semi-urban and rural areas when compared urban and metropolitan areas. This is a clear indication that the goal of achieving financial inclusion is very near & growth in semi-urban and rural areas is commendable.

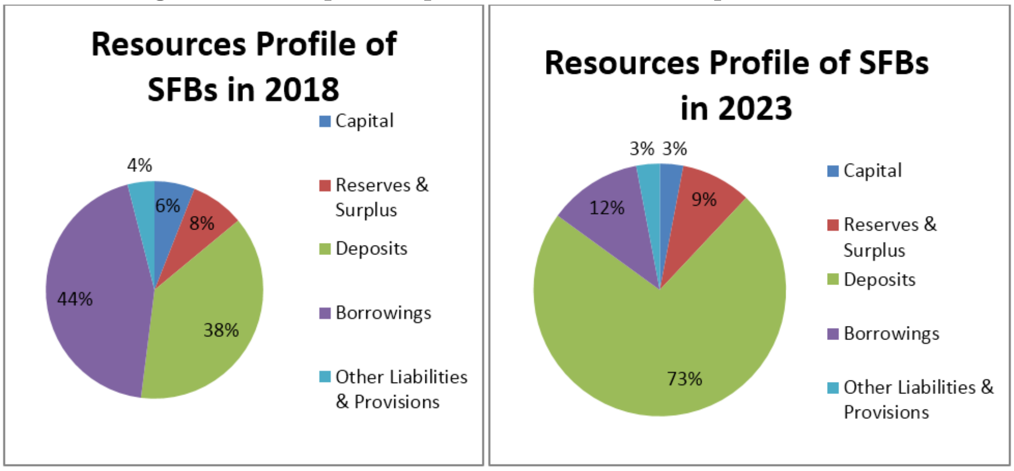
Figure No. 5: Graph showing the Growth rate of Deposits of SFBs



Source: Company reports, RBI-DBI, CRISIL MI&A

The above graph clearly indicates that SFBs have a significant growth potential as most of them were functioning as NBFCs/MFIs previously. Immediately after commencement of their operation, all SFBs focused on increasing their deposit base. Their overall deposit base doubled to around 375 billion as of March 31, 2019 from 167 billion 2017 to 1684 billions in the year 2023. There is a cumulative annual rate of growth in deposits is 58% from the year 2017 to year 2023.

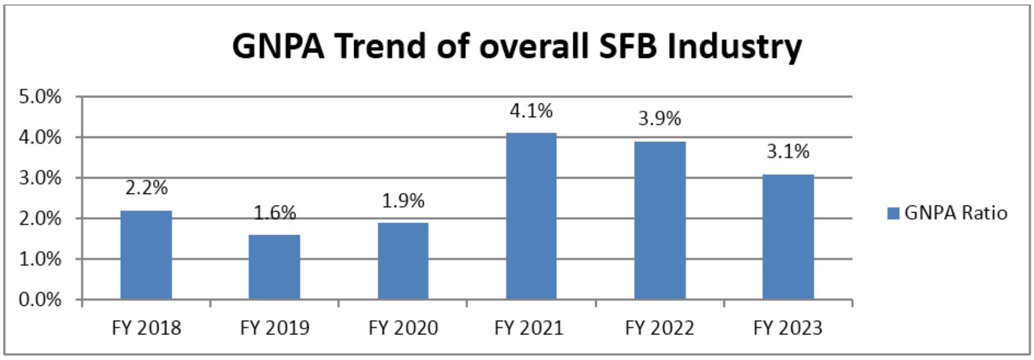
Figure No. 6 Graphical representation of Resource profile of SFBs



Source: Company reports, CRISIL MI&A

The resource profile of SFBs has completely transformed from 2018 to 2023 where deposits have grown from 38% in 2018 to 77% in 2023 and borrowings have been reduced from 44% in 2018 to 12% in 2023. This indicated that SFBs asset-liability management profile remains good owing to conservative liquidity policy, mobilization of deposits and shorter tenure loans.

Figure No. 7: Graph showing the GNPA Trend of overall SFB Industry



Source: Company reports, CRISIL MI&A

The table above shows the GNPA Ratio of overall SFBs in India. GNPA means the Gross Non Performing Assets Ratio of the SFBS. It is evident that GNPA ratio was improving from FY 2018 to FY2020 showing continuous fall in the ratio but in the FY 2021 it has increased drastically because the entire economy was effected deeply after COVID pandemic. After FY2021 again the GNPA trend is falling showing that SFBs are improving on NPAs. This also indicates the growth of SFBs.

Figure No. 8: Table showing the profitability ratios of SFBs

RoA	**FY 2019**	**FY 2020**	**FY 2021**	**FY 2022**	**FY 2023**
Interest Earned	14.1%	14.5%	12.9%	11.8%	12.7%
Interest Expended	6.6%	6.7%	6.0%	5.0%	5.1%
Net Interest Income	7.5%	7.8%	6.9%	6.8%	7.6%
Op. Ex Ratio	6.1%	5.8%	4.9%	5.3%	5.5%
Other Income	2.0%	1.7%	2.1%	1.6%	1.5%
Credit Cost	0.9%	1.3%	2.2%	2.3%	1.2%
Return on Assets	1.6%	1.9%	1.5%	0.7%	1.8%

Source: Company reports, CRISIL MI&A

In the financial year 2020, the RoA of was increased. However the outbreak of COVID-19 followed the nationwide lockdown and the credit cost was increased for the FY 21. The second wave of COVID-19 the SFB industry RoA was sharply declined to 0.7% thereafter the good progress is seen in the performance of SFBs in 2023.

Small Finance Banks (SFBs) play a crucial role in promoting financial inclusion in India. Most of these banks are from MFI background and they cater to the banking needs of underserved sections of society, including small businesses, low-income households, and rural communities. While SFBs have made significant progress since their establishment, they still face several challenges that hinder their growth and ability to serve their target segments effectively. Some of the key challenges faced by SFBs in India are

Limited Access to funds:

Access to funds is crucial for the growth and sustainability of SFBs. However, many SFBs face challenges in raising funds, especially in the initial stages. Unlike traditional banks, SFBs have limited access to low-cost deposits as they cannot offer a full range of banking products and gaining customer trust is biggest challenge. Banks need deposits from customers to lend, Mobilising granular deposit is crucial and hence they adopt strategy of paying high interest on savings and Fixed deposit. They heavily rely on other sources of funds such as wholesale borrowings, external commercial borrowings, and securitization. However, these sources often come at a higher cost, impacting the profitability and lending capacity of SFBs.

Asset Quality and Credit Risk:

Maintaining a healthy asset quality and managing credit risk is another significant challenge for SFBs. SFBs typically serve customers with limited credit history or no collateral, making it difficult to assess their creditworthiness accurately. This increases the risk of defaults and non-performing assets (NPAs). Moreover, due to their focus on priority sector lending, SFBs are exposed to sectors that are more susceptible to economic fluctuations and external shocks. Therefore, SFBs need to have robust credit risk management frameworks in place to mitigate these risks effectively.

Technology and Infrastructure:

Technology plays a vital role in enhancing the efficiency and reach of SFBs. However, many Small Finance Banks face challenges in adopting and implementing advanced technology due to the background of Micro Finance Industry , limited resources and infrastructure. Building and maintaining a robust technology infrastructure requires significant investment, which can be a strain on the financial resources of Small Finance Banks. Additionally, ensuring data security and protecting customer information is crucial in the digital era, and Small Finance Banks need to invest in robust cyber security measures to safeguard customer trust.

Small Finance Banks in India have made significant progress in promoting financial inclusion and serving the underserved sections of society. However, they still face several challenges that need to be addressed for their sustained growth and success. Overcoming regulatory compliance issues, improving access to funds, managing credit risk, adopting advanced technology, and effectively competing with established players are key areas that SFBs need to focus on. By addressing these challenges, SFBs can continue to play a crucial role in driving inclusive economic growth in India.

VI. Conclusion

In conclusion, Small Finance Banks have emerged as significant players in the Indian banking sector, driving financial inclusion and catering to the unique needs of underserved communities. Over the eight years the spread of SFBs has increased to banking outlets across the country. The regional spread which were initially in the favour of Southern and Northern region due to the presence and growth of the two large SFBs, namely, Equitas SFB and Capital SFB, in their region of origin as MFI and LAB, respectively. By the end of 2022-23, the spread has become more balanced due to the emergence of new SFBs and their spread across various regions of the country. Likewise, the branches have better spread in semi-urban and rural areas by the year 2022-23. The GNPA trend of the overall SFB industry has improved indicating that as SFBs have improved its financial performance like scheduled commercial banks in India. The return on assets ratio of the SFBs is also improved indicating their progress after the hit of COVID-19. This shows that future is near where the SFBs will become competitors to scheduled commercial banks in India.

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