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# Small Finance Banks and Financial Inclusion in India

ORIGINAL ARTICLE

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## Abstract

*Small Finance Banks (SFBs) are a specialized type of banks created by the Reserve Bank of India under the guidance of the Government of India. They are designed to provide banking services specifically aimed at improving savings habits among semi-urban and rural communities. SFBs offer basic banking services like accepting deposits and providing loans to underserved groups such as small businesses, small farmers, micro-industries, and entities in the unorganized sector. Small finance banks in India have been bridging the gap in the country's financial inclusion. Despite the goal to achieve developed nation status, there are still millions of Indians without access to basic banking services. To address this, the Reserve Bank of India has selected small finance banks to carry out the mission of financial inclusion.*

## Key Words

*SFBs, Low Income Group, Financial Inclusion, RBI.*

## Introduction

The Small Finance Bank specialized financial institutions in India that focus on providing basic banking and financial services to underserved and unbanked sections of the population, especially in rural and semi-urban areas. Financial inclusion is crucial for the overall growth of a country. The economy grows when the rural sector grows. When people in rural areas have access to good financial services, they can improve their lives and earn a living. The Government has been working on financial inclusion for a long time starting with nationalizing banks and setting up special banks for rural areas. They have also introduced microfinance and micro-credit programs. Recently, they have allowed small finance banks (SFB) to help more people access financial services. All these efforts aim to make financial services available to everyone, especially in rural areas.

In recent years the banking industry has gone through many changes in which recent change is emergence of Small Finance Banks. The idea behind setting up SFBs emerged from a committee led by Dr. Raghuram Rajan under NITI Aayog, focusing on financial sector reforms to extend services to small farmers, low-income households, small businesses, and other unorganized sectors. The RBI issued guidelines for establishing SFBs on November 27, 2014, and granted licenses to 10 entities on September 17, 2015, with a mandate to convert into SFBs within a year. The first SFB, Capital Small Finance Bank, started operating on April 24, 2016, with 47 branches. Currently, there are 11 SFBs operating in India, aiming to serve micro-enterprises

and low-income households in rural and semi-urban areas through efficient, technology-driven, low-cost operations. SFBs are providing services where commercial banks are not available or not offering services. It also provides loans to priority sector and motivates people to save their excess funds. This makes them ideal bank for achieving their objectives of financial inclusion.

## Review of Literature

**T. Ravikumar (2019)** examined the evolution and performance of Small Finance Banks in India in his study titled "Small Finance Banks & Financial Inclusion in India." His analysis showed that SFBs have penetrated the market satisfactorily, although they achieve only minimal profits. The study concluded that SFBs play a significant role in promoting financial inclusion in India, operating nearly 95% of their branches in rural and semi-urban areas to serve a diverse population.

**J. J. Mohanty (2018)** "Leveraging small financial banks (SFBs) in achieving Financial Inclusion in India" focused on the utilization of Small Financial Banks to enhance financial inclusion in India. The research highlighted the significant role of SFBs in catering to unbanked and underserved regions, particularly in fostering the growth of the Micro, Small, and Medium Enterprises (MSMEs) sector.

**P Dhanya and P B Bhanu Devi (2019),** An Emprical Study focusing on the threats and challenges faced by Small Finance Banks, with specific reference to Coimbatore City. However, their study did not provide any insights into the financial performance of Small Finance Banks or propose concrete solutions for enhancing their resilience.

**Patel and Fulwari (2021)** tracked the growth of Small Finance Banks (SFBs) in India by analyzing the increase in branches, geographical coverage, and business activities. They discovered that SFBs have significantly expanded their branch network, reached more regions, and experienced a notable surge in business volume within five years of their establishment. The initial findings indicate that SFBs are on the right track in achieving the goals set for them when they were created.

## Statement of the Problem

Commercial banks and other financial institutions are failing to adequately serve the rural population, particularly those who are not currently being served or are underserved. This is mainly due to a lack of understanding of the credit needs of rural individuals, as they primarily focus on providing financial services to large and medium-sized corporations and urban customers. In our country, the majority of people are from low to middle-income groups. Formal banking services in rural India are still limited, with micro and small enterprises, as well as small customers in rural and semi-urban areas, being partially catered to by private financial institutions and local money lenders. The introduction of Small Finance Banks by policymakers is a progressive measure aimed at addressing the financial needs of the unserved and underserved rural population. These banks have a better understanding of the financial requirements of the rural community, as many of them previously operated as Microfinance Institutions (MFIs) and their staffs are well-versed in the credit needs of rural customers.

## Objectives of the Study

- To understand the concept of Small Finance Banks in India.
- To review the contribution of SFBs in financial inclusion in India.
- To study the emergence and Licensing Requirements of SFBs in India.
- To study the benefits of converting a small finance bank into a universal bank.

## Research Methodology

This paper is a conceptual paper. This study is based on secondary data. Data have been collected from various sources, viz., journals, published papers, and websites.

## Financial Inclusion in India

Financial inclusion is the practice of offering basic banking and financial services to all individuals in society, regardless of their income or savings. It focuses on providing financial solutions to those who are economically disadvantaged, aiming to help them better manage their money and gain financial education. This includes providing savings and loan services to the poor in a cost-effective and user-friendly manner. With the advancement of financial technology and digital transactions, startups are increasingly making financial inclusion more accessible. Essentially, financial inclusion ensures that vulnerable groups have affordable access to the financial products and services they require in a transparent manner, facilitated by institutions.

**PMJDY:** The Pradhan Mantri Jan Dhan Yojana, launched on August 28, 2014, with the aim of providing universal banking services by opening zero-balance bank accounts for unbanked households. A remarkable 33 million new Pradhan Mantri Jan Dhan Yojana accounts were opened during financial year 2023-24, pushing the cumulative tally to 519.5 million accounts. The total balance across these accounts increased to Rs. 2,34,997 crore, compared to Rs. 1,98,844 crore recorded in the preceding year. Other than PMJDY, there are several other financial inclusion schemes in India – Pradhan Mantri Mudra Yojana (PMMY), Jeevan Suraksha Bandhan Yojana, Pradhan Mantri Vaya Vandana Yojana (PMVVY), Stand Up India scheme, Pradhan Mantri Suraksha Bima Yojana (PMSBY), PM SVANidhi Scheme, PM Vishwakarma Scheme, Varistha Pension Bima Yojana (VPBY), Atal Pension Yojana (APY), Credit Enhancement Guarantee Scheme (CEGS) for scheduled castes, and Sukanya Samridhi Yojana.

Financial inclusion is essential for providing economic resources and encouraging savings among impoverished individuals. It is a crucial aspect of achieving inclusive growth and overall economic development for underprivileged populations. In India, effective financial inclusion is necessary to uplift disadvantaged individuals by offering them modified financial products and services.

## Objectives of Financial Inclusion

- Financial inclusion intends to help low-income households by increasing access to credit, savings and insurance, enabling them to break the poverty cycle.
- It aims to establish proper financial institutions which reduce poverty and inequality by providing access to financial services that help manage risk and absorb shocks.
- Financial inclusion aims to build and maintain financial sustainability so that the needy people have a certainty of funds which they struggle to have.
- Financial inclusion means making sure that poor people have access to money and financial services they need. It wants to create more organizations that can help people with low-cost financial options, so they don't have to rely on just a few choices. While there are some traditional banks, there aren't many places that offer affordable financial help.
- It aims to give personalized money help to poor people based on their unique needs, likes, and how much money they make.
- Financial inclusion aims to provide people with affordable financial services like deposits, money transfers, loans, insurance and payments.
- The objective of financial inclusion is to create awareness about financial services and its benefits among those sections of the society who are economically deprived.
- Financial inclusion focuses on developing financial products that meet the needs of less fortunate members of society.
- Financial inclusion intends to educate people on financial concepts and importance of financial planning.
- Financial inclusion aims to bring in digital financial solutions for the economically needy people of the nation.

- One of the main objectives of financial inclusion is to provide banking facilities to poor living in remote areas of the country through mobile or internet banking.

## Evolution of Small Finance Banks

The NITI Ayog (formerly known as the Planning Commission) established a committee led by Dr. Raghuram Rajan to recommend financial sector reforms. The committee's report, often referred to as "A Hundred Small Steps" (2009), suggested the creation of Small Finance Banks to enhance financial inclusion for small and marginal farmers, low-income households, migrant labourers, small businesses, and other unorganized entities. On August 14, 2014, SIDBI submitted draft recommendations for licensing Small Finance Banks. Subsequently, the RBI issued guidelines for granting licenses to Small Finance Banks in the private sector (RBI Press Release, 2014). As a result, the RBI granted in-principle licenses to 10 Small Finance Banks (RBI Press Release, 2015), with eight of them being Micro Finance Institutions with a proven track record. The 10 institutions that got license to operate their functions in the group of small finance bank are:

1. Capital Small Finance Bank.
2. Ujjivan Small Finance Bank.
3. Jana Small Finance Bank.
4. Equitas Small Finance Bank.
5. AU Small Finance Bank.
6. Fincare Small Finance Bank.
7. ESAF Small Finance Bank.
8. North East Small Finance Bank.
9. Suryoday Small Finance Bank.
10. Utkarsh Small Finance Bank.

After these 10 banks 2 more banks were licensed by RBI namely, Shivalik Small Finance Bank Limited and Unity Small Finance Bank Limited. On April $1^{st}$ 2024, RBI has approved the merger of Fincare Small Finance Bank into Au Small Finance Bank. So, as on April $1^{st}$ 2024, there are total 11 Small Finance Banks in India.

## Licensing Requirements of SFBs

Existing Non-Banking Financial Companies (NBFCs), and Local Area Banks (LABs), and Microfinance Institutions (MFIs) owned by residents can apply for a license to operate as Small Finance Banks (SFBs). The promoter must meet the "Fit and Proper" criteria set by the Reserve Bank of India, based on their past credentials. The promoter should have at least 10 years of experience in the banking sector, with a minimum of 5 successful years in a professional role. The minimum paid-up equity capital required is ₹ 100 crore. Only companies owned by local residents are eligible to apply. Small Finance Banks (SFBs) need to have permission to operate based on laws from Banking Regulation Act 1949 and RBI Act 1934. They also have to follow rules from the companies Act of 2013 since they are public companies. Once they start working properly, they need to get recognized as scheduled banks according to RBI Act 1934 Sec 42(6)(a). These banks must follow certain financial guidelines set by the RBI such as CRR, SLR etc. The promoter starting these banks must initially invest at least 40% of the total paid-up equity in the initial phase of 5 years. Once the net value reaches 500cr listing of the banks will be done mandatorily. FDI policies will be similar to those of private sector banks which mean a maximum foreign investment of 74% shall be allowed all sources included. SFBs must Extend 75% of their Adjusted Net Bank Credit (ANBC) to the priority sector. At least 50 per cent of its loan portfolio should constitute loans and advances of up to ₹ 25 lakh on an ongoing basis at the borrower level.

The Reserve Bank had issued the Guidelines for Licensing of "Small Finance Banks" in the Private Sector on November 27, 2014. Recently, RBI released the revised guidelines on the same. Major changes from the earlier Guidelines on Small Finance Banks dated November 27, 2014, are:

- The licensing window will be open on-tap.
- Minimum paid-up voting equity capital/net worth requirement shall be Rs. 200 crore.
- For Primary (Urban) Co-operative Banks (UCBS), desirous of voluntarily transiting into Small Finance Banks (SFBs) initial requirement of net worth shall be at Rs. 100 crore, which will have to be increased to Rs. 200 crore within five years from the date of commencement of business. Incidentally, the net-worth of all SFBs currently in operation is in excess of Rs. 200 crore.
- SFBs will be given scheduled bank status immediately upon commencement of operations.
- SFBs will have general permission to open banking outlets from the date of commencement of operations.
- Payments Banks can apply for conversion into SFB after five years of operations, if they are otherwise eligible as per these guidelines.

## Penetration of Small Finance Banks and their Performance

The following table depicts penetration and performance of Small Finance Banks in India as on 31st March, 2024:

**Table 1:** Penetration and Performance of Small Finance Banks in India

| S. N. | Name of the bank | Loans Advanced (in Crores) | Deposit (in Crores) | No. of Banking Outlet | Presence in States/UTs |
|---|---|---|---|---|---|
| 1 | Au Small Finance Bank Ltd. | 73,999 | 87,182 | 1,074 | 24 |
| 2 | Capital Small Finance Bank Ltd. | 6160 | 7478 | 177 | 05 |
| 3 | Equitas Small Finance Bank Ltd. | 34,337 | 36,129 | 964 | 18 |
| 4 | ESAF Small Finance Bank Ltd. | 18724 | 19867 | 753 | 25 |
| 5 | Jana Small Finance Bank Ltd. | 24,746 | 22,571 | 808 | 24 |
| 6 | Northeast Small Finance Bank Ltd. | 7,961 | 6,505 | 377 | 19 |
| 7 | Suryoday Small Finance Bank Ltd. | 8,650 | 7,777 | 695 | 15 |
| 8 | Shivalik Small Finance Bank Ltd. | 2,095 | 2,410 | 31 | 2 |
| 9 | Ujjivan Small Finance Bank Ltd. | 29,780 | 31,462 | 752 | 26 |
| 10 | Unity Small Finance Bank Ltd. | 7,961 | 6,505 | 377 | 19 |
| 11 | Utkarsh Small Finance Bank Ltd. | 18,299 | 17,473 | 888 | 26 |

*(**Source:** Annual Reports of above Small Finance Banks 2023-24)*

From the above table, it can be observed that AU Small Finance Banks delivers strong operational performance in Financial Year 2023-24 with 26 % YoY growth in deposits and advances grew by 25% YoY. In a shorter period of time the penetrations and performances of the AU SFB are at satisfactory level at overall perspective. At present, only AU SFB appears clearly eligible for transition to a Universal Bank. While Ujjivan SFB meets all the criteria pertaining to track record and performance, its high share of unsecured loans (70% as of March 2024) may hinder its prospects for the transition to a Universal Bank from a portfolio diversification standpoint. Shivalik Small Finance Bank Ltd. has the lowest deposits as well as lowest amount of loans advanced. In terms of presence in the States/UTs, ESAF Small Finance Bank Ltd. is at the first position with presence in 25 States/UTs and Shivalik Small Finance Bank Limited is at the bottom with presence in only two states/UTs. AU Small Finance Bank Ltd. has the largest number of banking outlets in India while Shivalik Small Finance Bank Limited has the least.

## Conversion of Small Finance Bank to a Universal Bank

RBI has outlined the eligibility criteria for small finance banks (SFBs) to become a universal bank. This

transition will enable them to provide loans to larger businesses and offer the full range of financial services and banking products. To apply for conversion to a universal bank:

1. The SFB must have been operating satisfactorily for at least five years.
2. They must have its shares listed on a recognized stock exchange.
3. They must have maintained a minimum net worth of Rs. 1,000 crore.
4. They must also meet the prescribed capital adequacy requirements, and demonstrate consistent profitability with low levels of bad loans over the past two years.
5. They should also have been profitable, with gross non-performing assets of less than 3% and net non-performing assets of less than 1% in the previous two financial years.
6. SFBs with a diversified loan portfolio are expected to be preferred for transitioning to Universal Banks.

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## Benefits of transition to Universal Banks

- **Lower Capital Requirement** : Universal banks have a lower capital requirement and will aid in improving shareholder returns.
- **Higher exposure limits** : Higher single-borrower and group exposure limits will aid in taking higher exposures and improve competitive positioning.
- **Removal of 'Small Finance" tag** : Removal of 'Small Finance' tag can lower risk perception and thereby facilitate the improvement and diversification of deposit franchise.
- **Lower PSL Requirement** : Lower Priority Sector Lending (PSL) requirements will increase headroom to earn fee income/income from the sale of PSL certificates and assets.
- **Portfolio Diversification** : Removing the 50% exposure requirement up to Rs. 25 lakh ticket size and lowering the PSL requirement will facilitate product diversification.
- **Competitive positioning** : Can offer more varied products, leading to augmentation of fee income profiles.

## Findings

- Small banks in India, such as Local Area Banks and Urban Co-operative Banks, have the potential to enhance financial inclusion. However, their overall performance has not been satisfactory. For these small banks to be more effective we must address several key issues, including their size, number, capital requirements, exposure limits, regulatory guidelines and corporate governance.
- In a dynamic economy, banks may either succeed or fail. As a result, the number of small banks is likely to decrease over time, even as more people require basic financial services. This situation underscores the need for regular licensing of institutions to ensure a consistent supply of financial services to meet the demands of the priority sector.
- Transitioning to a Universal Bank would aid SFBs in strengthening their competitive positioning and facilitate portfolio diversification.
- Universal Banks have relatively lower capitalization and priority sector lending requirements, along with higher borrower and group exposure limits.
- Further, removing the 'small finance' tag can lower risk perception and thereby facilitate the improvement and diversification of their deposit franchise.

## Conclusion

Small Finance Banks are designed to offer basic banking and financial services to individuals who have traditionally been underserved by the banking system. These banks play a crucial role in supporting low-income and marginalized populations to improve their socio-economic conditions. Compared to earlier financial institutions like RRBs, LABs, and Cooperatives, Small Finance Banks represent a more advanced and specialized form.

By focusing on providing services to those with limited access to traditional banks, Small Finance Banks contribute significantly to economic development and support financial inclusion initiatives. Their presence has led to improved banking services in rural and semi-urban areas, enabling residents to enhance their economic and social well-being. Microcredit, in particular, has proven to be a valuable tool in empowering underserved communities and driving positive change.

Overall, Small Finance Banks are instrumental in uplifting rural populations and advancing financial inclusion efforts. Their impact on socio-economic development is undeniable, demonstrating the crucial role they play in supporting marginalized communities.

## Suggestions

- Small Finance Banks has been established by the Government of India and RBI to provide better banking services to every section of the society. To achieve this objective, SFBs have to follow low-cost operations system based on the latest technological tools.
- The two biggest challenges for these banks are having skilled workers and using advanced technology. Current employees need training to sell new products and handle deposits. To reach rural areas with little or no banking facilities, these banks can use affordable mobile technology.
- SFBs generally given financial support to small business enterprises and micro and small industries. They should also provide training to teach people in rural areas how to run their businesses better.
- Most of the customers of these banks live in the semi-urban and rural areas, many of them don't know much about handling their small saving. Financial literacy can help them use their money wisely for their businesses.
- While sanctioning loans the concerned SFB officer should identify potential borrowers. The bank should also ascertain the viability of project and loan is given to only these projects, which can generate employment and sufficient surplus income for repayment of loan.
- The cost of project should be estimated before sanctioning loan to avoid over and under finance to the project and proper allowance be given to meet the cost of social obligations, while estimating their repaying capacity.

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