Penetration and Challenges of Small Finance Banks in India

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Abstract

Reserve Bank of India has been taking numerous initiatives to promote financial inclusion in India since 2010. One of the recent innovative financial inclusion initiatives is granting permission for the establishment of Small Finance Banks. Small Finance Banks were established to serve the low income people with tech-enabled banking services. There are ten active small finance banks in India. Small Finance Banks have a lot of challenges in terms of branch establishment, lending, deposit mobilization and operating expenses. This article focuses on the penetration of Small finance Banks across India and challenges being faced by them.

1. Introduction

Small Finance Bank (SFB) is the banking initiative aimed at promoting financial inclusion through serving the people and businesses of marginalized people with tech-enabled products and services. Small Finance Banks are similar to small community banks of the United States of America. Reserve Bank of India (RBI) published draft guidelines for the establishment of SFBs in November 2014 (RBI, 2014). On receipt of the applications, RBI granted SFB license for ten entities. All the ten entities which got a license to start SFB started the banking business in India. SFBs have certain regulations with respect to their lending and area of operations. SFBs need to extend 75 per cent of their Adjusted Net Bank Credit (ANBC) to the priority sectors notified by the RBI (RBI, 2014). Further, SFBs have to focus on regions and areas which are not served adequately by the banking system. As of today, there are ten Small Finance Banks in India in operation namely AU SFB, Capital SFB, Fincare SFB, Equitas, ESAF, Suryoday, Ujjivan, Utkarsh, North East Small SFB and Jana SFB. This article focuses on the penetration of SFBs and the challenges by them.

2. Review of Literatures

Zhang (2007) found that “large banks tend to use less expensive loan technologies, including credit scoring and other transaction-based lending technologies, whereas small regional banks are committed to producing soft information about firms and thus providing substantial loan packages to customers”.

DeYoung, Hunter, and Udell (2004) showed that “the small bank competitive advantage, with regard to relationship lending technology, is due to the organisational structure and other factors, such as the information traits of relationship lending”.

“Small financial bank has huge potential in unbanked and underserved areas where local and corporative banks have underperformed. Similarly, the small financial bank has a major role in the development of the MSME (Micro Small and Medium Enterprises) sector” (Mohanty, 2018).

The RBI discussion paper on “desirability and practicality of having small and localised banks as preferred vehicles for financial inclusion among other aspects of banking

ISSN: 2278-4632
Vol-10 Issue-6 No. 17 June 2020

structure" mentioned that innovative approaches are required to bring poor in to formal financial services (Reserve Bank of India, 2013).

Nachiket Mor Committee Report proposed two banking systems namely horizontally differentiated banking system (HDBS) and the vertically differentiated banking system (VDBS) keeping payments, deposits, and credit as the bases (Reserve Bank of India, 2014).

Small Finance Banks have a lot of challenges in terms of branch establishment, lending, deposit mobilization, and operating expenses. The Small Finance banks need to survive and sustain despite all the challenges mentioned and to meet the objective of existence – Financial Inclusion.

III. Penetration and Performance of Small Finance Banks

The following table depicts the penetration and performance of Small Finance banks in India as on 31st March 2019;

Table -1: Penetration and Performance of Small Finance banks in India

Name of the bank	Number of branches	Loans advanced (Crores)	Deposits (Crores)	Presence in number of States	NNPA In Per cent	CAR In Per cent
North – East SFB	179	1383.97	267.35	09	0.32	22.82
Jana SFB	202	6,217.08	4,198.70	23	0.55	23.90
ESAF SFB	424	4,548.28	4317.00	14	0.77	27.59
AU SFB	322	22819.00	19422.00	11	1.30	19.30
Capital SFB	129	2,608.78	3,667.26	05	0.93	17.47
Equitas SFB	392	11,704.00	9,007.00	15	1.44	22.44
Suryoday SFB	382	2712.00	1593.00	11	0.80	36.00
Ujjivan SFB	474	13,811.84	7,379.00	24	0.30	19.00
Utkarsh SFB	436	4,665.70	3,791.30	11	0.12	24.14
Fincare SFB	569	3,530.00	2,043.00	13	0.30	23.60

Source: Compiled by author

From the above table, it can be observed that the penetration and performance of Small Finance Banks. In a shorter period of time, SFBs have established 3,509 branches throughout India predominantly in rural and sub-urban areas to serve low income people of those areas. Deposits and Advances of SFBs have grown steadily over the period. The profitability of these banks is at a minimum level. So, Small Finance Banks need to develop technology enabled innovative products and services which can be taken to the financially excluded people and these products are to be offered at an affordable cost in order to make a profit and to sustain in the banking business.

Further, Net Non-Performing Assets (NNPA) of Small Finance Banks are considered as one of the indicators of the performance of SFBs. NNPAs of SFBs, presented in the table, indicate that all SFBs except AU SFB and Equitas SFB have the NNPA of less than one per cent. AU SFB and Equitas SFB have NNPAs of 1.30 per cent and 1.44 per cent. NNPAs of SFBs show the efficiency of the SFBs.

Capital Adequacy Ratio (CAR), also known as capital to risk-weighted assets ratio, assesses the financial strength of SFBs using capital and assets. CAR is a measure of how much capital an SFB has, and it is reported as a percentage of a bank's risk-weighted credit exposures. A bank with a high capital adequacy ratio above the minimum requirements possesses high solvency. Therefore, the higher a bank's CAR, the more likely it is to be able to withstand a financial downturn or other unforeseen losses.

The Basel III norms stipulated a capital to risk weighted assets of 8%. However, as per RBI norms, Indian scheduled commercial banks are required to maintain a CAR of 9% while Indian public sector banks are emphasized to maintain a CAR of 12%.

Capital Adequacy Ratios of SFBs are really convincing and they have CAR more than the minimum requirement of 9%. AU SFB, Ujjivan SFB and Capital SFB have CAR less than 20 per cent. All other SFBs have CAR more than 22 percent. Suryoday SFB tops in terms of CAR with 36 per cent. Therefore, SFBs enjoy a high amount of solvency, liquidity and efficiency. And they can withstand any financial crisis if arises.

IV. Challenges of Small Finance Banks

Small Finance Banks are intended to provide banking services to the financially excluded people and their businesses in rural and backward areas of India. SFBs can engage in the banking businesses as performed by the commercial banks in India. SFBs can accept deposits and can give advances. However, there are many regulatory constraints in terms of lending and branch expansion, and financial products. 75 percent lending should be provided to priority sectors and 25 per cent branches should preferably be in rural areas. Further, SFBs should present themselves distinct from other Indian and Foreign banks that do banking business on a larger scale with enormous experience, expertise, relevant technologies, and innovative financial products.

One of the biggest challenges of SFBs is the development of financial products and services suitable to the marginalized and downtrodden people and their businesses that can be offered at a low cost. Offering innovative financial products and services at the cost is possible only when technology disruptions. But, technology acquisition and management is another challenge for SFBs.

Meeting regulatory compliances and balancing profitable banking business pose a decisive challenge to SFBs in India.

Thus, SFBs face the challenges of lending restrictions, building distinct business models, low cost financial products and services, acquisition and management of disruptive technologies, cut throat competition, small scale operations and compliance management.

V. Conclusions

Small Finance Banks are designed to promote financial inclusion in those areas that are financially excluded. SFBs have penetrated well throughout India in a short period. SFBs have opened 3509 bank branches and established significant numbers of Asset Management Centers, Ultra Small Branches and Business Correspondences. Deposits and Advances of SFBs have grown steadily over the period. Further, SFBs perform well even though they make a minimum amount of profits. NNPA ratio and CAR indicate their sound financial positions over a period of time. SFBs face the challenges of lending restrictions, building distinct business models, low cost financial products and services, acquisition and management of disruptive technologies, cut throat competition, small scale operations and compliance management.

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Invention (IJBMI) ISSN (Online): 2319 –8028, ISSN (Print): 2319 –801X www.ijbmi.org || Volume 7 Issue 2 Ver. III || February. 2018 || PP—08-18

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