

# Small Finance Banks and Financial Inclusion in India

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## ABSTRACT

Small Finance Banks are recent banking initiative of Reserve Bank of India towards promotion of financial inclusion in India. Ten Small Finance banks operate actively across India and most of them got scheduled bank status. 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. This article studies about Small Finance banks' evolution and their performance.

## 1. Introduction

Government of India (GOI) and Reserve Bank of India (RBI) have been taking number of initiatives to bring financially excluded people in to formal financial system. Those financial inclusion initiatives have yield results, but, not as expected. Only approximately 35% of adult population in India had bank account with a formal financial system as per the Global Financial Index study in the year 2013 (Global Financial Index, 2013). So, 65% of the adult population was financially excluded. It reflects weaknesses of financial inclusion initiatives. Earlier financial inclusion initiatives provided mono products and group lending which didn't help financial inclusion agenda in India. GOI realized that 100% financial inclusion would be a dream unless there is a paradigm shift in approach towards financial inclusion. As a result, GOI has changed its strategy from group based approach to individual based approach. Pradhan Mantri Jan Dhan Yojna (PMJDY) has been one of such individual based strategies introduced in the year 2014. PMJDY has succeeded significantly in providing a bank account to each individual in India and mobilizing the savings of poor and downtrodden people of India. As on 6<sup>th</sup> March, 2019, PMJDY opened 34.37 crores bank accounts and mobilized Rs 93567.18 crores through those bank accounts (PMJDY, 2019).

RBI also came up with the strategy of targeting individuals to achieve better financial inclusion through bringing a new banking entity in to the picture. The banking entity brought by RBI is Small Finance Banks (SFBs) in the year 2014. Small Finance banks were established to meet financial services needs of low income people. RBI guidelines on SFBs gave the priority in terms of Geography, Banking penetration, Segment and Products.

As on 16<sup>th</sup> March, 2019, there are Small Finance Banks in India in operation. They are AU SFB, Capital SFB, Fincare SFB, Equitas, ESAF, Suryoday, Ujjivan, Utkarsh, North East Small SFB and Jana SFB.

## 2. Statement of the problem

SFBs are established to promote financial inclusion in India. There are ten SMFs which are actively in to the business. But, the questions which arise here are; Are these SFBs able to sustain in the banking business countering the challenges in a long period? And Are these banks able to serve low income people over a period of time? This article makes an attempt to seek answers for the above questions through research.

## 3. Review of literature

"In the U.S., there are about 7,000 small community banks with an asset size ranging from less than U.S. \$10 million to U.S. \$10 billion or more. They account for about 46% of all small loans to businesses and farms and in terms of the number, they constitute about 92% of all the Federal Deposit Insurance Corporation (FDIC) insured institutions" (FDIC, 2014).

According to RBI paper on Banking Structure in India, Nigeria has set up over 1400 community banks in rural and urban areas.

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, small financial bank has a major role in development of MSME (Micro Small and Medium Enterprises) sector" (Mohanty, 2018).

Viswan (2017) found that RBI and central government try to include weaker section of the community into financial

inclusion programmes for the economic development and majority of the respondents are not aware about the functions of ESAF small financial bank.

In the words of Jayadev M, Himanushu Singh and Pawan Kumar (2016), "Small financial bank are most likely to change the banking sector in India and the challenges faced by the are meeting the mandatory norms and statutory norms of cash reserve ratio and resigning cost-effective banking solutions".

#### 4. Research objectives

1. To track evolution of Small Finance Banks in India and to analyze the functional framework of SFBs
2. To measure and analyze performance of SFBs in India and their role in financial inclusion

#### 5. Research methodology

This study is based on secondary data. Performances of SMBs are taken from their annual reports till 31<sup>st</sup> March 2018. Secondary data are collected from the websites of RBI and Indian Small Finance banks.

#### 6. Evolution, framework and operating guidelines of SFBs

Raghuram Rajan report titled, "A Hundred Small Steps" insisted the need for a prototype strategy for financial inclusion (Government of India, 2009).

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 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).

The Reserve Bank has issued guidelines on licensing of small finance banks (SFBs) in November 2014 with the objectives of serving the low income people.

The small finance banks are intended to increase the reach of financial inclusion in India through giving an avenue to save and to avail credit facility to unserved and underserved people and business units using high technology and low cost operations.

The essence of actions of a small finance bank is to deliver basic banking services to poor and downtrodden people and their businesses. SFBs must open 25% of their branches in unbanked rural centers and they need to extend 75% of its Adjusted Net Bank Credit to priority sector.

Important features of Small Finance Banks comprise;

- Small Finance Banks accept all kinds of deposits.
- SFBs can lend money also.
- Prior approval is required for branch expansion for the initial 3 years.
- Small Finance Banks' area of operation is restricted.
- Small Finance Banks' focus is on financially excluded individuals and their small businesses.
- Small Finance Banks are not allowed to lend to the large scale sector.

Capital Local Area Bank Ltd., Jalandhar has been the first one to start Small Finance Bank operations in India on 24<sup>th</sup> April, 2016.

#### 7. Penetration of small finance banks and their performance

The following table depicts penetration and performance of Small Finance banks in India as on 31<sup>st</sup> March, 2018;

**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
North – East SFB	155	1082.40	125.31	08
Jana SFB	462	9025.00	9650.48	19
ESAF SFB	401	3155.08	2523.09	11
AU SFB	306	10825.00	7923.00	11
Capital SFB	101	1852.99	2850.52	03
Equitas SFB	392	770.66	1078.11	15
Suryoday SFB	241	1574.95	1467.35	09
Ujjivan SFB	187	8047.00	3772.00	22
Utkarsh SFB	405	3210.05	2193.9	11
Fincare SFB	478	228.91	145.484	08

Source: Compiled by author

From the above table, it can be observed that Small Finance banks started to do their banking business in the beginning of 2018 after their transition from Micro Finance Institutions. In a shorter period of time, the penetrations and performances of the SFBs are at satisfactory level at overall perspective. But, few SFBs like North-East SFB and Capital

SFB have taken off only in recent times. Further, according to the annual reports of Small Finance banks, these banks have their branches predominantly in rural and sub-urban areas and serve low income people of those areas which promotes financial inclusion in those areas. Profitability of these banks is at minimum level. For instance, Ujjivan Bank earned Rs 4.75

crores as profit before tax and it was 0.42 after tax as on 31<sup>st</sup> March, 2018. So, Small Finance Banks have to increase their earnings in order to sustain and compete over a long period of time. It should be noted that increase in earning should not be out of charging more from the customers and increase in the earning should be out of cutting the cost of operations by using financial technology in their banking business and in provision of financial services.

## 8. Conclusion

The small finance banks are meant to promote financial inclusion in India. These banks are performing considerably well and they have good potential all over India as financially excluded people are at large in India. Small Finance banks significantly promote financial inclusion in India by establishing almost 95% of their branches in rural and semi-urban areas of the country and by serving to all kind of people including poor and low income people of those areas. Small Finance banks need to adopt innovative technologies in their retail banking business and in the process of providing financial services to their customers which will strengthen their sustainability.

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