

# The Role of Small Finance Banks in achieving Financial Inclusion in India

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## Abstract:

Small Finance Banks are a type of niche banks in India which can provide basic banking service of acceptance of deposits and lending. The aim behind setting up of such banks is to provide financial inclusion to sections of the society not being served by the traditional banks, such as small business units, small and marginal farmers, micro and small industries and unorganized sector. Financially excluded people not accessing the benefits provided by Indian government for their economic and social development. When the country achieves complete financial inclusion then only the country will achieve its economic development. The present study is focus on the strategies followed by the government of India for bringing people into the financial inclusiveness. The role played by small finance banks from the inception and facing the challenges in achieving financial inclusion.

This study covers trends of financial inclusion in India from 1956 to 2016 and back ground of new small finance banks. The branch network of the SFBs is rather extensive and diversified. In the year 2019, there were 3533 SFB bank branches throughout the country spread across 31 states and union territories, and 46553 districts. The challenges faced by small finance banks are high costs of transformation efforts and cost of deposit mobilization, competition, controlling of NPAs, and adoption of technology, prudential norms and issues in human resource management. Former RBI deputy governor KC Chakrabarty suggests that whatever model used by small finance banks, it's important that they lessen the burden of the borrower and finance always exploits. Licences for small finance banks are now issued to existing micro finance institutions which create more competition.

**Key words:** Financial inclusion, Small Finance Banks, Economic development, GDP (Gross Domestic Product), Traditional Banks, MSME (Micro Small and Medium Enterprises), Leveraging Small Financial Banks (SFB).

## Introduction:

Banking and finance sector in India is undergoing revolutionary changes in alignment with the financial inclusion initiative of the Government of India. Pradhan Mantri Jan Dhan Yojna (PMJDY), one of the key initiatives of the government was launched on August 28th 2014 and is considered to be the biggest financial inclusion drive in the world. A massive nationwide drive led to the opening of 32.68 crore Pradhan Mantri Jan Dhan Yojna accounts and a total of Rs. 82006.33 crore has been deposited in such accounts (as on 12.09.2018). Several other such initiatives have been launched by government which focus on smart and easy ways of banking. Small Finance Bank is one such innovative solution that has the potential to change the banking landscape in India. Small Finance Banks are a type of niche banks in India and they can provide basic banking service of acceptance of deposits and lending. The aim behind setting up of such banks is to provide financial inclusion to sections of the society not being served by the traditional banks, such as small business units, small and marginal farmers, micro and small industries and unorganized sector. Small Finance Banks can perform all the operations of normal commercial banks, but at a smaller level targeting low income segment.

Financial inclusion simply means to ensure that everyone gets the benefit of the financial services of the nation at an affordable cost in spite of whatever background he belongs. It especially focuses on including Underprivileged and vulnerable group of the society into the economy and providing them with its benefit and thus further causing growth of GDP (Gross Domestic Product) of the country through increase of customer base of the financial institutes which will further results in high profits for future and this cycle will keep going with increasing profits. It enhances GDP growth by broadening the resource base of the financial system by developing a culture of savings among large segment of rural population bringing low-income groups within the perimeter of formal banking sector.

Chakraborty (2011) defined “Financial inclusion is the process of ensuring access to appropriate financial products and services needed by all sections of society including vulnerable groups such as weaker sections and low income groups at an affordable cost in a fair and transparent manner by mainstream institutional players”.

## REVIEW OF LITERATURE

As the present study is focus on the strategies followed by the government of India for bringing people into the financial inclusiveness. The role played by small finance banks from the inception and facing the challenges in achieving financial inclusion an attempt is made to discuss in concise the earlier studies on SFBs and financial inclusion so as to achieve a greater insight into the subject. Here many prominent writers, renowned scholars have examined in different guidelines. Some of the pertinent studies which are alarmed to the present study are presented for a moment.

- **Jeeban Jyotin Mohanty (2018)** in his study titled “Leveraging small financial banks (SFB) in achieving Financial Inclusion in India” the main objective of study was to find out the reason for financial exclusion and the need and importance of small financial banks. He used to conduct the study was through secondary source of information which includes journals, articles published by RBI, IMF, CGAP, Microsave etc. In his study he

concluded that 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.

- **Viswan M G (2017)** in his study titled “A study on the awareness and perception about small financial bank with special reference to ESAF small financial bank” the major objective of the study the perception and awareness level of rural people about small financial banks and to study the strategies and operation of small financial banks in Kerala. Methodology used to conduct the study is through both primary and secondary data. Primary data was collected through a structured questionnaire with a sample size of 50 respondents and secondary source of information was collected through various books, official websites etc. Major findings of the study 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.

- **Pinal Barot (2017)** in his study titled “Financial Inclusion in India” the main objective of the paper is to understand the financial inclusion’s importance, its extent, opportunities and challenges in India along with the present status of financial inclusion in the Indian economy. Some of the major problems in our country are that only certain section of the population is using financial services and financial illiteracy among the poor and underprivileged makes the financial inclusion process more challenging.

- **Jayadev M, Himanushu Singh and Pawan Kumar (2016)** in their study titled “Small Financial Bank: Challenges” the main objective of the study was to find the challenges which has been faced by Small financial banks in India. Findings from the study is that 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.

- **Prantik Ray (2016)** in his study titled “Small Banking in India – Issues and Challenges” this paper deals with the need for financial inclusion, issues, challenges, RBI guidelines for small finance banks. In this paper they discuss the case study regarding the conversion of ujjivan financial service limited to small financial bank and the way forward for financial banks in India. In this study he concluded that small financial bank has great potential for financial inclusion but the performance of such institution has not been satisfactory.

The above studies revealed that they have not covered the role of Small Finance Banks in achieving Financial Inclusion in India. Keeping this background in view the present study has been taken up to evaluate the financial inclusion through SFBs.

### **Objectives of the study:**

The present study is focus on the strategies followed by the government of India for bringing people into the financial inclusiveness, to understand the role of small finance banks to increasing the financial inclusiveness and suggestions for overcome the challenges faced by small finance banks in India.

## Methodology of the Study:

The present study is based on the secondary data. Secondary data collected from journals and the various reports from RBI and Government of India. This data obtained has been fundamental source for gaining knowledge related to the topic that enabled us to present data in this article.

## Scope of the Study:

The present study is confined to the role of Small Finance Banks in achieving Financial Inclusion in India. The study covers all important aspects of SFBs and Financial Inclusion.

## Limitations:

The study is used the secondary data for examine the role of Small Finance Banks in achieving Financial Inclusion in India., which were collected from the published research articles, books and websites. Therefore the accuracy of the data depends on the accuracy ensured in the data presented.

## Financial Inclusion in Indian:

As far as India is concerned it has a long history of putting efforts to have financial inclusion and to some extent, it has been successful as compared to starting stages of building up of Indian economy after independence but there are still many milestones yet to be achieved in this process. And efforts of current government have enhanced financial inclusion in the society to many folds but we still are in the process figuring out to use this in favoring our economy and make everyone in the reach of its benefit and for this, there are various government schemes available. The following are the important schemes in enhancing financial inclusion.

**Table 1: Important Milestones of Financial Inclusion in India**

Year	Details of event
1956	Imperial Bank of India was nationalized.
1968	National Credit Council was set up.
1969	Lead bank scheme was introduced
1971	Priority sector lending norms were laid down.
1975	Regional Rural Banks (RRBs) were established.
1982	National Bank for Agriculture and Rural Development (NABARD) was established

1992	Self Help Groups Linkage Programme was launched to support females of rural areas.
2000	SIDBI foundation was established for making provisions of micro credit.
2012	Finance Department of Government of India passed Microfinance Institutions (Development and Regulations).
2012	Revised Guidelines on Financial Literacy Centres were introduced.
2014	Jhandan yojana, MUDRA
2015	Small finance banks
2016	Payment banks

Source: RBI DBIE

### Small Finance Banks:

Bank is type of financial institution which basically provides services such as accepting deposit and providing loan facilities to their customers. A bank which has been established under by a special act in the parliament or under the company's act 1956 is considered as a commercial bank. Reserve Bank of India (RBI) is the governing body that has been taking care of the banking industry in our country. Over the past few years our banking industry has gone through numerous changes in which recent change has been emergence of concept Small Finance Banks. Small Finance Bank are those banks provide financial inclusion to disadvantaged section like micro, small and medium business enterprises, and other unorganised sectors who are not been taken care by other banks and financial institution. In the year 2015, RBI has initiated a financial inclusion policy by setting up a different type of bank in our country. RBI has issued a provisional license for ten companies on September 17, 2015 to operate as small finance bank in India. Capital Finance Bank is the first bank that started as a small finance bank in the country. They began operations with 47 branches on April 24, 2016. Initially 10 institutions got license to operate their dealings in the group of small finance bank below table shows list of SFB's and their brief history.

**Table 2: A brief back ground of new Small Finance Banks.**

Name of the institution	Nature of activity
<b>Au Financiers India</b>	Au Financiers is an asset finance company incorporated in 1996 as a non-banking finance company. The main asset portfolio includes vehicle loans, small secured business loans for MSMEs. Motilal Oswal Private Equity Advisors, ChrysCapital, Kedaara Capital, Warburg Pincus, and International Finance Corporation

	have substantial ownership in the company and have geographical presence across 10 states in northern India.
<b>Capital Local Area Bank</b>	Capital LAB is the largest among the surviving local area banks. Set up in January 2000, the bank has been operating in five contiguous districts in Punjab. As of March 2015, Capital LAB has Rs 1506 Cr of deposits and Rs 926 Cr of advances on its balance sheet; it has 39 branches and has been consistently profitable.
Disha Microfinance	Disha Microfinance started in 2009 offers financial services to rural and semi-urban areas of Gujarat, Rajasthan, Madhya Pradesh and Karnataka. Along with microfinance loans, it offers credit linked insurance and retirement solutions. It has more than Rs 200 Cr of assets under management as of 2014. The company is backed by equity investors like India Value Fund. As of March 2015, Disha Microfinance covers close to 8600 villages with 71 branches across 39 districts. A unique feature of this company is it offers credit to only women borrowers.
<b>Equitas Microfinance</b>	Based out of Chennai, Equitas was formed in 2007 as a microfinance institution. Since then, it has diversified its businesses through a holding company into different verticals like housing finance and used commercial vehicle financing. Equitas has operations in 124 districts across seven states with 361 branches, but its main business still comes from Tamil Nadu.
<b>Evangelical Social Action Forum (ESAF) Microfinance</b>	ESAF society started as an NGO in 1992 in Kerala. Its objectives were to deal with unemployment and poverty. ESAF started its microfinance business in 1995. In 2006, the society acquired Pinnai Finance and Investments. It currently offers products like micro loans, social security services like insurance and pension and money transfer. ESAF has operations in Tamil Nadu, Kerala, Madhya Pradesh, Maharashtra, Chattisgarh, and Jharkhand. ESAF predominantly offers loans to women borrowers under the joint liability group model of lending.
<b>Janalakshmi Financial Services</b>	Janalakshmi Financial Services is the third largest urban MFI of India with more than Rs 3800 Cr. It has 23 lakh customers served through 233 branches with a presence across 17 states and in 151 cities. Janalakshmi is backed by investors such as Michael and Susan Dell Foundation, Lok Capital and Bellwether

	Microfinance Fund.
<b>Rashtriya Gramin Vikas Nidhi (RGVN) (North East) Microfinance</b>	RGVN is a society strated in 1990 and converted into a micro finance institution in 2010. The society was founded to develop and support NGOs and community based organisations in the north-eastern part of the country. The company is headquartered in Guwahati and has presence in five states—Assam, Arunachal Pradesh, Meghalaya, Nagaland, and Sikkim. The company has more than 2.2 lakh borrowers who are served through 104 branches.
<b>Suryoday Microfinance</b>	Suryoday received license as a microfinance institution in 2009. It has presence in seven states though its primary business (up to 65%) comes from the states of Maharashtra and Tamil Nadu. The focus of the firm is on the women borrowers from the weaker sections of society. As of March 2015, Suryoday has 164 branches through which it is serving 6.05 lakh customers.
<b>Ujjivan Microfinance</b>	Having started operations in 2005, Ujjivan Microfinance is the fourth largest MFI in the country. It has Rs 3270 Cr of assets under management and serves over 20 lakh clients through 463 branches. The company was started to provide financial solutions to the urban poor and is backed by investors such as the CDC Group, Sequoia Capital, Lok Capital, and International Finance Corporation among others.
<b>Utkarsh Microfinance</b>	Utkarsh Microfinance, started in 2009, has a presence in the central and northern areas of the country. Headquartered in Varanasi, Utkarsh is backed by investors such as Lok Capital, Norwegian Microfinance initiative, Aavishkaar Goodwell, International Finance Corporation and Commonwealth Development Corporation. In a short span of six years, Utkarsh has built a customer base of 600,000 with a network of 271 branches.

Source: <https://www.bankexamstoday.com>.

The objectives of setting up of small finance banks will be for furthering financial inclusion by

- (i) provision of savings vehicles primarily to unserved and underserved sections of the population, and
- (ii) supply of credit to small business units; small and marginal farmers; micro and small industries; and other unorganised sector entities, through high technology-low cost operations.

## Geographic Network:

The branch network of the SFBs is rather extensive and diversified. We see that the geographical diversity in the home location of the applicants<sup>52</sup> is responsible for the decent spread of the SFB network throughout the country. As of August 2019, there were 3533 SFB bank branches throughout the country spread across 31 states and union territories, and 46553 districts. Even the northeast region is covered due to North East SFB which has a presence in all the seven North-Eastern states. The following table shows the number branches of small finance banks region wise.

**Table 3: SFB branches in geographical regions.**

Geographic region	Ratio of SFB branches to total number of branches
Central	1.7%
Eastern	1.6%
North eastern	3.1%
Northern	2.6%
Southern	2.6%
Western	2.9%

*Geographic spread of SFB branches September 2019*

*Source: RBI DBIE*

## Challenges Faced By Small Finance Banks:

SFBs will face stiff competition as the number and types of players in the financial services in India. They have to overcome specific challenges as they transform from their current profile of MFIs to the SFBs. MFIs/NBFCs in India are based on a business model driven by credit. Some of the challenges faced by SFBs are mentioned as under:

**High Costs of Transformation:** SFBs will have to bear the incremental cost of infrastructure, human resources and organizational transformation. Some of the areas which might entail high costs are upgrade of MIS and loan origination systems to a core banking solution, establishing risk management and treasury functions, developing savings products, managing the transformation from a credit only institution to a diversified financial institution, hiring new staff, training and optimum utilisation of existing staff and other infrastructure costs. This will add to the recurring and fixed costs and based on historical evidence from market sources, such wide ranging changes will have a break even period of 3- 5 years.

**Efforts and Cost of Deposit Mobilization:** SFBs have no prior experience of deposits handling as majority of them were functioning as MFIs. Here the SFBs have to face two challenges in this domain. Firstly they will have to compete with established public sector and regional rural banks. These banks enjoy higher trust in the community, are well placed in the rural markets, and are aggressively trying to enhance their market share. Their existing infrastructure, reputation, business correspondent network, and expertise in deposit mobilization will be a threat for SFBs. Secondly, the cost of deposit mobilization will be higher for SFBs considering the rural



segment they will be catering to and historically in the past, these segments have had low average deposit sizes. They will need to invest in the infrastructure that enables them to mobilize deposits through establishing a physical branch network, business correspondent network, ATM network, and strategic partnership with banks. Given the non-existent track record in mobilizing deposits, it could be difficult to inspire the trust and confidence among consumers required to attract deposits. Since their competitors are existing banks with a track record of handling customers' deposits, SFBs will have to be creative in developing strategies in order to mobilize deposits.

**Competition:** Competition will be fierce as SFBs will be facing competition from existing banks and non-bank financial companies (NBFCs) who may be looking to extend their reach to serve the unbanked and underbanked, especially in semi urban and rural areas. Some existing banks are relying on their brand along with technology to enter into semi-urban and rural areas to fill the gap. SFBs will have to rise to the challenge of differentiating themselves from the other players in this changing landscape. They will also be competing with the MUDRA, a government initiative launched in September, 2015 for micro units.

**Controlling NPAs:** The challenge for SFBs would be to control NPAs as an unfavourable monsoon would have an adverse impact on farm loans. Similarly, any slowdown in the industrial sector will impact the small and medium-sized enterprises (SMEs), which will face liquidity crunch. Therefore, on both these counts, they would be at a disadvantage compared to the commercial banking system. Banks are able to diversify their portfolio by lending to all sectors which includes retail, services and manufacturing, while these banks would be left with dealing with the smaller ones only.

**Adoption of Technology:** Use of technology can substantially cut down the operational costs for SFBs, however these banks do not have the required capital to invest in technology. This results in greater operational challenges, impacts adoption, and leads to an increase in manual intervention in processes, thus impacting both efficiency and cost. Further, since SFBs are concentrated in rural and semirural areas, technology adoption remains a challenge due to infrastructural issues like lack of electricity and broadband connectivity. Thus, SFBs will have to rely more on traditional branches to service their customers while also focusing on innovative channels such as mobile money and point-of sales devices.

**Prudential Norms:** The SFBs will be subject to all the prudential norms and regulations of RBI as applicable to existing commercial banks including requirement of maintenance of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR). The regulation also requires SFBs to ensure that a single shareholder holds not more than 40% stake in the organization, and this must be reduced in a phased manner to 26% in 12 years. The foreign shareholding in SFBs will be as per the Foreign Direct Investment (FDI) policy for private sector banks as amended from time to time. Reduction in foreign ownership will also be a challenge for these banks considering the scarcity of domestic equity sources.

**Issues in Human Resource Management:** SFBs employees have to be expertise in micro lending operations with limited exposure to market deposit, insurance or pension products. The credit teams are not well versed with the credit assessment techniques being followed at the commercial banks. The greatest challenge for SFBs will be to identify and hire personnel with specialized and relevant skill suits for different functions within the

Bank. Professional HR and operational practices will have to be adopted to build the core values, to plan for the great vision and mission statement of the organization. This may lead to increased compensation expectations of new incumbents and also market competition to hire the best in industry.

### **Conclusion and Suggestions:**

Small finance banks are a type of niche banks in India which can provide basic banking service of acceptance of deposits and lending. In this study covered crucial milestones of financial inclusion in India from 1956 to 2016 and back ground of new small finance banks. The branch network of the SFBs is rather extensive and diversified. We conclude that the geographical diversity in the home location of the applicants<sup>52</sup> is responsible for the decent spread of the SFB network throughout the country. As of August 2019, there were 3533 SFB bank branches throughout the country spread across 31 states and union territories, and 46553 districts. Even the northeast region is covered due to north east SFB which has a presence in all the seven north-eastern states. The challenges faced by small finance banks are high costs of transformation efforts and cost of deposit mobilization, competition, controlling NPAs, adoption of technology, prudential norms and issues in human resource management. Former RBI deputy governor KC Chakrabarty suggests that whatever model small finance banks take, it's important that they lessen the burden of the borrower and finance always exploits. He laughed when people say finance helps. Small finance banks need to be sympathetic to their customers if they want to remain relevant. Licences for small finance banks are now issued to existing micro finance institutions which are already in the business of lending to small and tiny entities. But once they establish small finance banks, they can increase their loan size to their customers. And they can also receive deposits, distribute mutual funds, insurance products etc. Hence we can expect competition to increase in the rural banking and existing banks have to gear up to face it. As per RBI licence, new small finance banks are to be set up within 18 months this time period is longer hence try to reduce this period.

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