



## India's financial inclusion and small finance banks

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### Abstract

Under the direction of the Indian government, the Reserve Bank of India established the specialized bank known as Small Finance Banks (SFBs). They are made to offer banking services with the express goal of enhancing rural and semi-urban communities' saving practices. SFBs provide underserved populations, including small companies, small farmers, micro-industries, and organizations in the unorganized sector, with basic banking services including deposit acceptance and loan provision. India's small finance banks have been helping to close the financial inclusion gap in the nation. Even with the aim of becoming a developed nation, millions of Indians still lack access to fundamental financial services. The Reserve Bank of India has chosen small finance institutions to fulfill the goal of financial inclusion in order to solve this.

**Keywords:** Financial inclusion, small finance bank, rural development, rural population, microfinance institutions, credit access, reserve bank of India (RBI), licensing requirements

### Introduction

Particularly in rural and semi-urban regions, the Small Finance Bank is a specialized financial organization in India that focuses on offering basic banking and financial services to underserved and unbanked individuals. Financial inclusion is essential to a nation's overall development. The expansion of the rural sector boosts the economy. People in remote regions may make a living and improve their lives when they have access to quality financial services. Nationalizing banks and establishing special banks for rural regions were the first steps in the government's long-term efforts to promote financial inclusion. Additionally, they have implemented microcredit and microfinance initiatives. They have recently made it possible for small finance banks (SFB) to assist more people in obtaining financial services. The goal of all these initiatives is to provide financial services to everyone, particularly in rural regions.

The advent of small finance banks is one of the numerous changes that have occurred in the banking sector in recent years. A team of NITI Aayog headed by Dr. Raghuram Rajan came up with the concept for SFBs. The committee focused on financial sector reforms to provide services to low-income people, small companies, small farmers, and other unorganized sectors. On November 27, 2014, the RBI released rules for creating SFBs, and on September 17, 2015, it awarded licenses to ten firms with the requirement that they become SFBs within a year.

On April 24, 2016, Capital Small Finance Bank, the first SFB, opened for business with 47 branches. There are now 11 SFBs in existence in India, with the goal of providing low-income households and microbusinesses in rural and semi-urban regions with effective, cost-effective, technology-driven operations. In situations when commercial banks are unable or do not offer services, SFBs step in to fill the gap. Additionally, it encourages people to save their extra money and lends to priority sectors. They are therefore the perfect bank to meet their financial inclusion goals.

### Review of literature

**T. Ravikumar (2019)** <sup>[5]</sup>: In his work "Small Finance Banks & Financial Inclusion in India," he looked at the development and effectiveness of small finance banks in India. Despite making relatively modest earnings, his study revealed that SFBs have successfully entered the market. The study came to the conclusion that SFBs, which serve a diversified clientele by operating over 95% of their branches in rural and semi-urban regions, significantly contribute to the advancement of financial inclusion in India.

**J. J. Mohanty (2018)** <sup>[2]</sup>: Using small financial banks (SFBs) to improve financial inclusion in India was the main topic of the paper "Leveraging SFBs in Achieving Financial Inclusion in India." The study emphasized the important role SFBs play in serving neglected and unbanked areas, especially in supporting the expansion of the Micro, Small, and Medium Enterprises (MSMEs) industry.

**P Dhanya and P B Bhanu Devi (2019)** <sup>[1]</sup>: An empirical study that focuses on the risks and difficulties that small finance banks confront, specifically in relation to Coimbatore City. However, neither specific recommendations for strengthening the resilience of Small Finance Banks nor any insights into their financial performance were offered by their study.

**Patel and Fulwari (2021)** <sup>[3]</sup>: an empirical study that focuses on the risks and difficulties that small finance banks confront, specifically in relation to Coimbatore City. However, neither specific recommendations for strengthening the resilience of Small Finance Banks nor any insights into their financial performance were offered by their study.

Examined the expansion of branches, geographic reach, and commercial activity to track the development of Small Finance Banks (SFBs) in India. Within five years of their founding, they found that SFBs had reached more areas, greatly increased their branch network, and seen a sharp

increase in business volume. According to preliminary results, SFBs are on course to meet the objectives for which they were established.

### Statement of the problem

An empirical study that focuses on the risks and difficulties that small finance banks confront, specifically in relation to Coimbatore City. However, neither specific recommendations for strengthening the resilience of Small Finance Banks nor any insights into their financial performance were offered by their study. The rural population, especially those who are underserved or not currently served, is not being sufficiently served by commercial banks and other financial institutions. This is mostly because they don't comprehend rural people's credit demands because their primary concentration is on offering financial services to large and medium-sized businesses and urban clients. The vast majority of people in our nation come from low- to middle-income backgrounds. Micro and small businesses, as well as small clients in rural and semi-urban regions, are only partially served by private financial institutions and local money lenders, meaning that formal banking services are still scarce in rural India. A significant step to meet the financial requirements of the neglected and unserved rural people is the establishment of Small Finance Banks by policymakers. Since many of these banks were once Microfinance Institutions (MFIs) and their employees are familiar with the credit demands of rural clients, they have a deeper grasp of the financial needs of the rural population.

### Objectives of the study

- To comprehend the idea of India's small finance banks.
- To examine the role SFBs have played in India's financial inclusion.
- To research SFBs' emergence and licensing needs in India.
- In order to investigate the advantages of turning a small financing bank into a universal bank.

### Research methodology

This work is conceptual in nature. The data used in this investigation is secondary. Information has been gathered from a number of sources, including websites, journals, and published studies.

### India's Financial Inclusion

The concept of providing basic banking and financial services to everyone in society, irrespective of their savings or income, is known as financial inclusion. It focuses on giving economically disadvantaged people access to financial solutions in order to improve their money management and financial literacy. This involves offering the impoverished cost-effective and user-friendly savings and lending services. Startups are progressively expanding access to financial inclusion as a result of the development of digital transactions and financial technology. Essentially, financial inclusion makes sure that, with the help of institutions, vulnerable people may transparently and affordably access the financial goods and services they need.

**PMJDY:** The Pradhan Mantri Jan Dhan Yojana was introduced on August 28, 2014, with the goal of creating zero-balance bank accounts for households without access to banking in order to provide universal banking services. During the fiscal year 2023–2024, an astounding 33 million additional Pradhan Mantri Jan Dhan Yojana accounts were established, increasing the total number of accounts to 519.5 million. In comparison to the previous year's total balance of Rs. 1, 98, 844 crore, the total amount across these accounts climbed to Rs. 2, 34, 997 crore. 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 are some of India's other financial inclusion initiatives in addition to PMJDY.

In order to give underprivileged people access to financial resources and promote saving, financial inclusion is crucial. It is essential to attaining inclusive growth and general economic development for disadvantaged groups. In order to provide disadvantaged people in India with adapted financial goods and services, effective financial inclusion is required.

### Goals of financial inclusion

- By expanding their access to credit, savings, and insurance, financial inclusion aims to assist low-income households in ending the cycle of poverty.
- By granting access to financial services that aid in risk management and shock absorption, it seeks to develop appropriate financial institutions that lessen poverty and inequality.
- Building and maintaining financial sustainability is the goal of financial inclusion, which gives those in need a set amount of money that they otherwise struggle to have.
- Ensuring impoverished individuals have access to the necessary financial services and funds is known as financial inclusion. It aims to establish additional groups that can provide low-cost financial solutions to consumers so they are not limited to a small number of possibilities. Although there are a few conventional banks, there aren't many locations that provide reasonably priced financial assistance.
- It seeks to provide impoverished individuals with individualized financial assistance according to their particular requirements, preferences, and income level.
- The goal of financial inclusion is to make financial services including deposits, money transfers, loans, insurance, and payments accessible to everybody.
- Educating the economically disadvantaged segments of society about financial services and their advantages is the aim of financial inclusion.
- Creating financial solutions that cater to the requirements of society's less fortunate individuals is the main goal of financial inclusion.
- The goal of financial inclusion is to raise awareness of financial ideas and the value of financial planning.
- The goal of financial inclusion is to provide digital financial solutions to the country's economically disadvantaged citizens.

- Giving impoverished people in rural parts of the nation access to banking services via internet or mobile banking is one of the primary goals of financial inclusion.

### The development of small finance banks

A group headed by Dr. Raghuram Rajan was formed by the NITI Ayog (previously the Planning Commission) to suggest changes to the banking system. The committee's 2009 study, also known as "A Hundred Small Steps," recommended the establishment of Small Finance Banks to improve financial inclusion for low-income households, small companies, migrant workers, small and marginal farmers, and other unorganized organizations. SIDBI provided draft recommendations for Small Finance Bank license on August 14, 2014. Following this, the RBI released rules for private sector Small Finance Bank licenses (RBI Press Release, 2014). Consequently, the RBI issued in-principle licenses to ten small finance banks, eight of which were microfinance institutions with a track record of success (RBI Press Release, 2015). The following ten organizations have been granted licenses to carry out their operations within the small finance bank group:

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.

Two further banks, Shivalik Small Finance Bank Limited and Unity Small Finance Bank Limited, were granted RBI licenses after these ten banks. The RBI authorized Fincare Small Finance Bank's merger with Au Small Finance Bank on April 1st, 2024. There are eleven small finance banks in India as of April 1, 2024.

### Licensing Requirements of SFBs

Residents' existing Microfinance Institutions (MFIs), Local Area Banks (LABs), and Non-Banking Financial Companies (NBFCs) may apply for a license to function as Small Finance Banks (SFBs). Based on their prior qualifications, the promoter must satisfy the Reserve Bank of India's "Fit and Proper" requirements. The promoter should have at least five years of successful experience in a professional capacity and ten years of experience in the

banking industry. A minimum of ₹100 crore in paid-up equity capital is needed. The only businesses that can apply are those owned by locals. According to the Banking Regulation Act of 1949 and the RBI Act of 1934, Small Finance Banks (SFBs) require authorization in order to function. Since they are publicly traded, they must also abide by the regulations set out in the Companies Act of 2013. According to RBI Act 1934 Sec 42(6)(a), they must be recognized as scheduled banks once they are operating effectively. These banks are required to adhere to specific financial standards established by the RBI, including CRR, SLR, and others. At least 40% of the total paid-up stock must be invested by the promoter of these banks during the first five years of operation. Listing of the banks will become mandatory if the net worth hits 500cr. FDI rules will resemble those of private sector banks, meaning that all sources of funding may contribute up to 74% of total foreign investment. 75% of SFBs' Adjusted Net Bank Credit (ANBC) must be extended to the priority sector. Continuous loans and advances up to ₹25 lakh at the borrower level should make up at least 50% of its loan portfolio. On November 27, 2014, the Reserve Bank released the Guidelines for Licensing of "Small Finance Banks" in the Private Sector. The RBI has published updated recommendations on the subject. The following are the main modifications made to the previous November 27, 2014, Guidelines on Small Finance Banks:

- On-tap, the license window will be open.
- A minimum of Rs. 200 crore in paid-up voting equity capital or net worth is required.
- In order to voluntarily transition into Small Finance Banks (SFBs), Primary (Urban) Co-operative Banks (UCBS) must first have a net value of Rs. 100 crore, which must be raised to Rs. 200 crore within five years of the start of operations. By the way, the combined net worth of all SFBs operating at the moment exceeds Rs. 200 crore.
- As soon as operations begin, SFBs will be granted scheduled bank status.
- From the day operations begin, SFBs will have broad authorization to open banking locations.
- If Payments Banks meet the other requirements outlined in these recommendations, they may request to convert to SFB after five years of operation.

### Small Finance Bank Penetration and Performance

The penetration and performance of small finance banks in India as of March 31, 2024, are shown in the following table:

**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	5
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

As can be seen from the above table, AU Small Finance Banks had an excellent operating performance in the 2023–2024 fiscal year, with advances growing by 25% year over year and deposits growing by 26% year over year. The AU SFB's penetrations and performances are at a suitable level from an overall standpoint in a shorter amount of time. Right now, it seems that only AU SFB is obviously qualified to become a universal bank. Even while Ujjivan SFB satisfies all performance and track record requirements, its large percentage of unsecured loans (70 percent as of March 2024) would make it more difficult for it to become a Universal Bank in terms of portfolio diversification. Both deposits and loans issued by Shivalik Small Finance Bank Ltd. are at their lowest levels. Shivalik Small Finance Bank Limited is at the bottom, having presence in just two states/UTs, while ESAF Small Finance Bank Ltd. is at the top, having presence in 25 states/UTs. In India, Shivalik Small Finance Bank Limited has the fewest banking locations, while AU Small Finance Bank Ltd. has the most.

### Small Finance Bank's transformation into a Universal Bank

Small financing banks (SFBs) may now offer the complete range of financial services and banking products and lend to larger companies by becoming universal banks, according to the qualifying requirements set down by the RBI. To apply to become a universal bank:

1. The SFB must have had a minimum of five years of satisfactory operation.
2. Their shares need to be listed on a reputable stock market.
3. They had to have kept their net worth at least Rs. 1,000 crore.
4. They also need to show steady profitability with minimal bad loan levels over the last two years, as well as fulfill the required capital adequacy standards.
5. With net nonperforming assets of less than 1% and gross nonperforming assets of less than 3% over the preceding two fiscal years, they ought to have been profitable as well.
6. It is anticipated that SFBs having a diverse loan portfolio would be given preference when switching to Universal Banks.

Right now, it seems like only AU Small Finance Bank is qualified to become a universal bank. From the perspective of portfolio diversification, Ujjivan SFB's significant percentage of unsecured loans (70 percent as of March 2024) may make it more difficult for the company to make the switch to a Universal Bank, even though it satisfies all performance and track record requirements.

### Advantages of Switching to Universal Banks

- **Lower capital requirement:** Universal banks will help increase shareholder returns and have a lower capital requirement.
- **Higher exposure limits:** Increased exposure limitations for both single-borrowers and groups will facilitate greater exposures and enhance competitive positioning

- **Removal of 'Small Finance' tag:** Eliminating the "Small Finance" label can help enhance and diversify the deposit franchise by reducing the impression of risk.
- **Lower PSL Requirement:** Reducing the standards for Priority Sector Lending (PSL) will give more opportunity for fee revenues and revenue from the sale of PSL assets and certificates.
- **Portfolio diversification:** Product diversification would be made easier by decreasing the PSL requirement and eliminating the 50% exposure rule up to a ticket size of Rs. 25 lakh.
- **Competitive positioning:** Able to provide a wider range of items, which will increase fee income profiles.

### Findings

- In India, small banks with the potential to improve financial inclusion include Urban Co-operative Banks and Local Area Banks. Their overall performance hasn't been good, though. We need to address a number of important concerns, such as these small banks' size, number, capital needs, exposure restrictions, corporate governance, and regulatory requirements, in order to increase their effectiveness.
- It is possible for banks to prosper or fail in a dynamic economy. Therefore, even though more people need basic financial services, the number of local banks is probably going to decline over time. This circumstance emphasizes the necessity of routine institution licensing in order to guarantee a steady flow of financial services to satisfy the priority sector's demands.
- Making the switch to a universal bank would help SFBs diversify their portfolios and improve their competitive posture.
- In addition to having greater borrower and group exposure restrictions, universal banks have comparatively lower capitalization and priority sector lending criteria.
- Additionally, taking away the label of "small finance" might help strengthen and diversify their deposit franchise by reducing risk perception.

### Conclusion

People who have historically been underserved by the banking sector can now access basic banking and financial services through Small Finance Banks. These banks are essential in helping disadvantaged and low-income groups enhance their socioeconomic circumstances. Small Finance Banks are a more developed and specialized type of financial institution than previous ones like RRBs, LABs, and Cooperatives.

Small Finance Banks facilitate financial inclusion programs and make a substantial contribution to economic growth by concentrating on offering services to people who have limited access to traditional banks. In rural and semi-urban regions, their presence has resulted in better banking services, allowing locals to improve their social and economic well-being. In particular, microcredit has shown itself to be an effective instrument for empowering marginalized people and promoting progress.

All things considered, small finance banks play a crucial role in improving rural communities and furthering initiatives for financial inclusion. They unquestionably have an influence on socioeconomic growth, highlighting the vital role they play in assisting underprivileged areas.

### Suggestions

- The RBI and the Indian government developed small finance banks to offer improved banking services to all societal segments. SFBs must use low-cost operational systems built on the newest technology tools in order to accomplish this goal.
- Employing qualified personnel and utilizing cutting-edge technology are these banks' two main difficulties. To manage deposits and market new items, current staff members require training. These banks can employ reasonably priced mobile technologies to reach rural regions with limited or nonexistent financial infrastructure.
- Small businesses and micro and small industries typically receive financial help from SFBs. Additionally, they must offer training to teach rural residents how to manage their enterprises more effectively.
- The majority of these banks' clients reside in rural and semi-urban regions, and many of them lack basic knowledge about how to manage their meager savings. Being financially literate might assist them in making prudent corporate financial decisions.
- Potential borrowers should be identified by the concerned SFB officer before loans are sanctioned. The bank should also determine if the project is viable and only lend money to those that can create jobs and enough extra revenue to cover loan payback.
- Before approving a loan, the project's cost should be calculated to prevent overfunding, and appropriate funding should be provided to cover social commitments while assessing their ability to be repaid.

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