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Small Finance Banks – Challenges and Opportunities

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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. RBI on 16 September 2015 kicked off transformative changes in the financial system of the country by granting licenses to 10 Small Financial Banks which are like the last bricks to be laid in the wall of financial inclusion cemented together by the RBI guidelines. The article discusses the objectives, challenges and opportunities for the Small finance banks in the light of transforming economic landscape of the country.**

***Index Terms*—Financial Inclusion, Microfinance, NBFC, Reserve Bank of Indi**

ABBREVIATIONS

GoI	Government of India
PMJDY	Pradhan Mantri Jan Dhan Yojana
MFI	Micro Finance Institutions
NBFC	Non Banking Financial Company
SFB	Small Finance Bank
MUDRA	Micro Units Development and Refinance Limited
MIS	Management Information Systems
NPA	Non Performing Asset
POS	Point of Sale
KYC	Know your customer
ATM	Automated Teller Machine
PAN	Permanent Account Number

I. INTRODUCTION

Banking and finance sector in India is undergoing revolutionary changes in alignment with the financial inclusion initiative of the Government of India (GoI). Pradhan Mantri Jan Dhan Yojna (PMJDY), one of the key initiatives of the GoI 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 PMJDY 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 GoI 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.

II. EVOLUTION OF SMALL FINANCE BANKS

Reserve Bank of India on August 27, 2013 released a discussion paper on Banking Structure in India – The Way Forward. The paper in one of its key observations highlights that extending banking services to the underserved and unserved sections of the population is a challenge however there is merit in considering access to bank credit and services through expansion of small banks in unbanked and under-banked regions.

A. CRISIL (Financial Inclusion Index (Inclusix)

CRISIL for the first time in 2013 published a comprehensive financial inclusion index (Inclusix) based on four critical parameters of banking services namely branch penetration, deposit penetration, credit penetration and insurance. The index (Chart 1) clearly points to an overall improvement in the financial inclusion in India, driven primarily by the Jan-Dhan, Aadhaar and mobile trinity. Inclusix (on a scale of 100) increased from 35.4 in March 2009 to 50.1 in March 2013 and to 58.0 in March 2016.

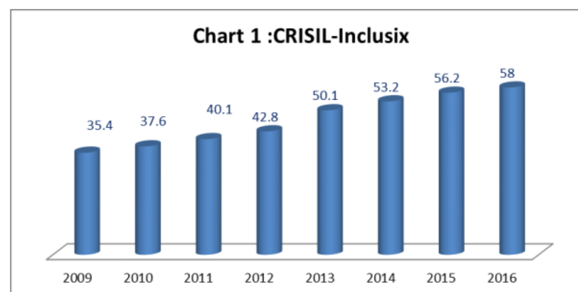

Fig. 1. CRISIL-Inclusix
Source: CRISIL INCLUSIX Report February 2018

Chart 2 clearly indicates that overall availability of banking services has increased significantly over the years although it

still stands at a discouraging level of 58.7% of total households as per census 2011.

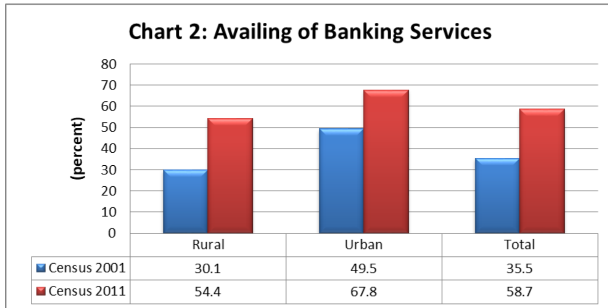

Fig. 2. Availing of banking services

Source: Department of Financial services, GoI

TABLE I
UNBANKED POPULATION

Year	Unbanked Population (in millions)
2011	557
2014	415
2015	233
2017	190

Source: Price water house Coopers (PWC) India 2015 report, World Bank Findex Report 2017

In 2013, the Reserve Bank of India constituted a committee under the chairmanship of Dr. Nachiket Mor to examine the entire gamut of issues surrounding Financial Inclusion. The committee recommended differential licensing in the form of two categories: i) Payments Bank, and ii) Small Finance Banks

Financial inclusion as defined by the Mor Committee comprises of:

- Universal Electronic Bank Account.
- Ubiquitous Access to Payments and Deposit Products at reasonable charges.
- Sufficient Access to affordable formal Credit.
- Universal Access to Investment Products at reasonable Charges.
- Universal Access to Insurance and Risk Management products at reasonable charges.
- Right to Suitability.

The World Bank paper “The Global Findex Database 2017” stressed the need for including the unbanked population in India into the formal financial system through access to formal credit. The World Bank report also estimated the unbanked population in India to be around 190 million.

Several initiatives by the Government helped reduce the country’s unbanked population significantly between 2011 and 2017. It is pertinent to note that which the country has made much headway in financial inclusion, usage rates of the bank accounts have plenty of room for improvement.

Since bank account creation is an integral part of the agenda, banks are directly involved in addressing the needs of various segments of the society. However, traditionally, banks have not focused much on the economically backward class. The high risks and costs pertaining to small transactions, minimal profitability and absence of physical collateral in most cases discourage financial institutions from focusing on the economically marginalized population.

The Reserve Bank of India on 16 September 2015 kicked off some transformative changes in the financial system of the country by giving licenses to 10 Small Financial Banks. The main aim of this initiative was to bring the unbanked section of the society under the purview of the formal banking system. Eight of the ten entities were microfinance NBFCs reiterating RBIs agenda of financial inclusion. The entities granted licenses have commenced their operations and are as under:

- Au Financiers (India) Ltd., Jaipur
- Capital Local Area Bank Ltd., Jalandhar
- Disha Microfin Private Ltd., Ahmedabad
- Equitas Holdings P Limited, Chennai
- ESAF Microfinance and Investments Private Ltd., Chennai
- Janalakshmi Financial Services Private Limited, Bengaluru
- RGVN (North East) Microfinance Limited, Guwahati
- Suryoday Micro Finance Private Ltd., Navi Mumbai
- Ujjivan Financial Services Private Ltd., Bengaluru
- Utkarsh Micro Finance Private Ltd., Varanasi

III. RBI GUIDELINES ON SMALL FINANCE BANKS

Small Finance Banks (SFBs) are like the last bricks to be laid in the wall of financial inclusion cemented together by the Reserve Bank of India guidelines. The scope of activities of a Small Finance Bank would primarily be to undertake basic banking activities of acceptance of deposits and lending to unserved and underserved sections including small business units, small and marginal farmers, micro and small industries and unorganized sector entities.

Some of the other guidelines stipulated in this regard are:

- Minimum paid-up capital of Rs 100 crore has been stipulated for the entity setting up SFBs
- Prudential regulatory norms for SFBs will be suitably calibrated given the financial inclusion focus of these banks and will be declared from time to time by RBI.
- SFBs must allocate 75% of their lending to priority sector, such as agriculture, small business, micro credit, education, or housing.
- 50% of an SFB’s lending must be comprised of advances less than 25 lakhs to ensure credit reaches the underserved sections of the market.
- SFBs are required to open at least 25% of its branches in unbanked rural centres.
- The bank’s total lending to a single borrower is capped at 10%, and for a group it is capped at 15% of capital funds.

IV. Objectives of Small Finance Bank

The objective behind setting up of Small Finance Banks was to expand the access to financial services in rural and semi-urban areas. These banks have the power to function almost like a normal commercial bank, but at a much smaller scale. It can offer basic banking services, accept deposits and lend to underserved sections of customers, including small business units, small and marginal farmers, micro and small industries, and even entities in the unorganized sector.

The objective of setting up of Small Finance Banks is to further financial inclusion by:

- Provision of savings vehicle primarily to unserved and underserved sections of the population.
- Supply of credit to small business units, small and marginal farmers, micro and small industries and other unorganized sector entities through high technology and low cost operations.

The bigger banks have strength but the last mile connectivity is not their focus, and given the scope of activities of the Small Finance Banks, they are complementary to the commercial banks in catering to the Banking needs of all segments of the society.

V. Benefits of Small Finance Banks

Focus on relationship banking and less capital requirements of SFBs promote the lending to small borrowers, and hence improve financial inclusion. Their confinement to a particular region helps them understand the needs and business potential of that area and this develops core competence through relationship banking in financing agriculture, SMEs, industries, and thus serve their credit needs better. SFBs require less infrastructure and staff and hence have low operational expenses.

SFBs have a sizeable market opportunity and since most of them were previously functioning as MFIs/NBFCs they will have the following additional benefits:

- *Diversification:* Diversification of a range of products to create a complete product suite comprising primarily savings and credit, as well as distribution of insurance, pension, mutual funds, payment/remittance facilities and access to ATMs. A holistic product suite is likely to result in improved customer loyalty and reduced delinquency as customers will not want to compromise their access to high quality, secure savings services.
- *Leverage Low Cost Structures:* SFBs will have significantly lower operational expenses than that of traditional banks because of their low cost infrastructure and high productivity/low salary structure of their staff. Thus, SFBs can use their low cost structures to rapidly achieve profitability.
- *Branding:* An SFB license allows MFIs to create differentiated brands and leverage these to create long term client relationships.
- *Diversified Funding Base:* Mobilizing savings deposits may not be cost effective initially but in the long run and with customer-centric offerings, the SFBs may mobilize savings at costs lower than debt, particularly if they address the untapped demand for illiquid and customized savings deposits.
- *Deepening Rather Than Widening:* SFBs, by definition, will cater to the low-income segment and can offer a comprehensive product suite. SFBs will have an opportunity for vertical penetration with an expanded range of products, unlike the MFIs/NBFCs that expand horizontally with limited number of products.
- *Impact on Customers Financial Well-Being:* A range of products gives low income segment people the tools they need to manage the fluctuations in their income and expenses better, protect themselves against risk and to seize opportunities as they arise.
- While there is significant market potential and opportunities for SFBs, they have to be cognizant of the costs involved and the challenges associated with the transformation from their existing MFI structure.

VI. Threats and Challenges to Small Finance Banks

SFBs will face stiff competition as the number and types of players in the financial services space expands. They will also 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 discussed 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. There are two facets of the challenge posed 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 creative in developing strategies in order to mobilize deposits.

There should be a healthy mix of current accounts and savings accounts in any Banks portfolio, as they are low cost funds that increase the net interest margin. In case of SFBs, considering the target segment served, it is expected that majority of the deposit mobilization will be through savings accounts and term deposits. It will take at least 3-4 years before which SFB can increase deposits to a level where the cost of deposit mobilization reduces to become a low-cost, sustainable source of fund for SFBs.

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 that targets the loan segment for up to Rs 10 lakhs. While SFBs are permitted to disburse loans up to Rs 25 lakhs, they may not start out by disbursing loans of this size.

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. The lack of capital often results in the use of low-cost and locally developed solutions which do not conform to the industry best practices. 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.

The commercial banks target higher use of internet and phone banking by their clients to reduce the costs of branch-based services. In case of SFBs, their target clientele does not yet have the awareness and infrastructure to use such channels. 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 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 sets for different functions within the Bank. Professional HR and operational practices will have to be adopted to conform to the core values, 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.

Change Management: SFBs as they transform from MFIs/NBFCs have to undergo massive organizational changes and will require comprehensive and efficient change management processes. The key challenges to be addressed will be:

a) SFBs will have to set up multiple channels for customer acquisition for different products. They will require different sales channels for liabilities and credit acquisition and to focus on cross selling between these channels. Another challenge will be to establish robust and efficient team of professionals handling operations and credit.
b) SFBs will have to hire fresh employees with prior banking experience. This would result in a cadre of new employees joining the team and affecting the existing organizational culture. The management has to ensure that old employees do not feel threatened by the fresh additions to the team and the new team also adjusts to the culture of the transformed entity.

Developing a Risk Management framework: Developing an effective risk management framework and controls is a major challenge faced by SFBs. Greater manual intervention in processes due to use of local and low-cost technology reduces the number of systematic controls, increasing the probability of internal fraudulent activities by employees. International experience shows that small banks are vulnerable to failure if they do not have a diversified credit base and are focused on relationship banking rather than centralized process-based operations. SFBs operating in India will have adopt a flexible risk management system to ensure long term growth and stability.

Savings to Fuel the Liabilities: With inter-bank borrowing limits, SFBs will have to make rapid strides in developing mechanism to attract and retain savings for their liabilities. This may prove to be a hindrance for most of the SFBS as they were primarily known to the low-income segment as a lender. SFBs will have to make major changes in their strategy to change this brand perception and market position. SFBs are not used to allocating significant funds for marketing and brand building, as their loan products are driven more by “pull” strategy rather than “push” strategy.

VII. The Road Ahead - Strategies for Small Finance Banks

SFBs can create convenient avenues/touch points to trigger customers to save regularly. Fortnight/monthly group meetings are clearly a good place to source savings. The following strategies can be adopted by the SFBs to remain competitive in the market and also provide the last mile connectivity in the ambitious financial inclusion programme of GoI.

Designing of specific products for the target group: SFBs have to be innovative in designing financial products that reflect the mental models and suit the needs and cash flows of the target segment. Research suggests that the main reasons why low income households save are marriage, education, construction of houses and medical expenses though not strictly in the same order. Marketing of long-term, illiquid savings products during the harvest season and the provision of highly liquid savings accounts during sowing/weeding seasons are some of the tactics that SFBs can employ for rural markets.

SFB customers can also ride on the growing agent networks servicing RuPay cards. The customers can also be motivated to use RuPay cards (issued by SFBs for their account holders) to transact at ubiquitous agent networks, as well as RuPay enabled POS terminals, thus doing away with the need to keep cash for purchases.

Reduction in cost of operation: Technological features like mobility, digitization and automation can play a major role in assisting SFBs to keep their administrative and personnel costs under control in this high-volume, low-value business. Administrative cost, which comprises establishment and operating costs for offices and branches, paper trail, technology and communication expenditure, can be comprehensively reduced by use of technology.

Use of digital applications by operating staff for lead management, customer on-boarding, e-KYC and customer servicing will help SFBs collect data in ‘digitized’ format. Customer loan applications can be routed through workflows, automatically underwritten upto a specified amount using specified rules and disbursed through electronic payment modes to reduce paper trail and administrative resource consumption.

The automation can be taken a step further by issuing loan agreements in a customer’s digital locker, which can be accessed via branches or other digital channels. Transactions in cash (disbursal and collections) can be permitted through biometric integration at point-of-sale terminals at local shops/CSCs without the requirement of a field staff’s presence in the area. Adoption of self-service options will help in improving operating staff productivity and reducing administrative costs involved in application processing and cash management.

Customer on-boarding and e-KYC: Mobility-enabled customer on-boarding forms, data pre-population through Aadhaar/PAN integration, credit report generation through credit bureaus and de-duplication checks are some of the features which if effectively implemented can positively impact sales force productivity and decrease turnaround time for processing of deposit and loan applications. Mobility on-boarding solutions will allow the SFBs to service customers in geographies that were previously under banked or unbanked.

Enhanced use of technology: Technology is the biggest enabler when it comes to making financial services available in the remotest part of the country. With improving technological infrastructure (the Internet, 3G and 4G networks), customers are making transactions without any physical contact with a brick and mortar branch. As a result, transaction costs have fallen and distance from a physical outlet is no longer a reason for financial exclusion.

Analytics can be used by the SFBs at a macro and micro level to effectively identify areas of growth, undertake marketing activities and retain existing customers. At the macro level, insights generated through geospatial analytics can be used to estimate population in an area, identifying hotspots for strategic placement of staff or branches and identification of growth areas. Analytics studies based on existing customer data can assist SFBs to effectively segment customers and build segment-specific marketing campaigns. At the micro level, customer repayment history and his/her association with partners can provide insights to retain the customer through new products or retain a possible churn.

Human Capital Development: The goal of having a defined human resource system in any organization is to help the individual employees to accomplish their career goals and to work together. In order to accomplish this goal, human resource management (HRM) must be an integral part of the strategic plans of any organization and must have the explicit support of

senior management and promoters. SFBs will have to invest significantly to equip their operating staff with marketing skills and they also need to be trained on how to build trust and cultivate a brand image. Suitable staff incentive schemes can be devised to motivate and boost the confidence of the employees. Since most of the SFBs have transformed from "credit only" to "deposit mobilizing" institutions, they will have to primarily focus on the following areas

- Designing suitable products and processes
- Finalization of delivery strategy
- Communication strategy to pitch demand for liability products
- Hiring of the front line force
- Regulatory compliance and effective risk management framework

Further for SFBs to be successful, each one of the employees must be productive, efficient and must work in perfect co-ordination with other employees. All employees, regardless of their level or designation in the hierarchy must align themselves to the same goals:

- Identify with the SFB's vision, mission and objective.
- Understand their role and how they can contribute to the mission.
- Have the capacity, resources and environment which can help them achieve their business goals.
- Receive encouragement, constructive feedback and opportunities to develop and improve.

The role of HRM is to provide systems and tools that will provide these key elements to help the individuals within the SFB to develop into highly motivated and successful individual.

VIII. Conclusion

The main objective of financial inclusion is to ensure access to formal credit for people who depend on informal sources for fulfilling their financial needs, at an affordable cost in a fair and transparent manner, and to promote financial education.

The Government and the Reserve Bank of India (RBI) have made several concerted efforts to promote financial inclusion. These efforts include launch of co-operative banks and regional rural banks, introduction of priority sector lending, formation of self-help groups, appointment of business correspondents, etc. These initiatives helped to bring in a large section of the unbanked population under the formal banking system. However, a significant portion of India's population still remains devoid of access to even basic formal credit facilities mainly due to lack of last mile connectivity. The RBI, to address this key concern, issued guidelines for setting up of Small Finance Banks which will complement the commercial banks in achieving the goal of full financial inclusion.

Small Finance Banks can leverage technology, allowing crores of under-banked and unbanked individuals to join and benefit from the banking system. The JAM trinity (Jan Dhan–Aadhaar–Mobile) has created the building blocks for a digital financial infrastructure:

- Jan-Dhan Yojana, the largest financial inclusion drive in the world has ensured that almost all households in India have at least one member with a bank account.
- Aadhaar has paved the way for digital authentication for access to financial services.
- India has 103 crore mobile users, out of which more than 25 crore people own a smartphone (likely to grow to 40 crore by the end of 2018), making India the world's second-biggest smartphone market.

Small Finance Banks will help bring a revolutionary change in the Indian banking system. It will help in making banking more competitive and more inclusive for both borrowers and depositors, making banking more affordable to the common man. RBI also allowed Small Finance Banks to open accounts without a wet signature, relying completely on digital signatures and electronic verification, making on-boarding of customers easier for geographically distant places where opening a physical branch may not be feasible.

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