Small Finance Banks: The Big Institutional Move in Banking and Financial Inclusion Arena

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Abstract. A vibrant banking policy should facilitate the evolution and growth of banks and micro credit institutions, which focus on low income households, agriculturalists, tiny and small scale industries and underbanked citizens aiming at self-employment and entrepreneurship. These institutions should include such specialist institutions as may be promoted by voluntary action, private enterprise or NGOs for meeting the banking needs of the poor or small players. In the contemporary policy, 'differentiated banks' serving niche interests, local area banks, payment banks etc. are contemplated to meet credit and remittance needs of small businesses, unorganized sector, low income households, farmers and migrant work force. Small Finance Banks, to whom licences have recently been issued by the RBI, are a step in this direction.

Key words: Small Banks, Small Finance Banks, Differentiated Banks, Microfinance, Financial Inclusion, Niche Bank

1 Introduction

"If the misery of the poor be caused not by the laws of nature, but by our institutions, great is our sin."

- Charles Darwin

Financial inclusion has emerged as one of the important national objectives of the country, especially in last two decades. The Government of India and the Reserve Bank of India have been making concerted efforts to promote financial inclusion of the unbanked and underbanked regions, sectors and societal segments. Efforts to reach the large sections of the hitherto financially excluded Indian population have in the past included steps like nationalization of banks, building a widespread branch network of scheduled commercial banks, co-operatives and regional rural banks (RRBs), introduction of mandated priority sector lending targets, lead bank scheme, formation of self-help groups, local area banks (LABs) etc. However, change is a perennial requirement and innovative reforms have to conceptualized in view of the experience gained, emerging needs and lacunae observed in the existing setup.

A vibrant banking policy should facilitate the evolution and growth of banks and micro credit or microfinance institutions, which focus on low income households, agriculturalists, tiny and small scale industries and underbanked citizens aiming at self-employment and entrepreneurship. These institutions should include such specialist institutions as may be promoted by voluntary action, private enterprise or NGOs for meeting the banking needs of the poor or small players. Third-tier banks should be promoted and strengthened to be autonomous, vibrant, effective and competitive in their operations. Banks should devise appropriate criteria suited to the small industrial sector and be responsive to its genuine credit needs but this should not be by sacrificing canons of sound banking. Borrowers also need to accept credit discipline. The need to review and revolutionize the present banking/finance institutional set up has also been felt for some time now. Small Finance Banks, to whom licences have recently been issued by the RBI, are a step in this direction.

Since April 2014, the Reserve Bank of India (RBI) has granted 23 banking licences to new players - two were given universal banking licences (April 2, 2014), 11 were issued payments banks licences (August 19, 2015) and 10 have now been given licences for small finance banks (September 16, 2015). The niche banks - small finance banks and payments banks -have been set up to further the regulator's objective of deepening financial inclusion. Going ahead, RBI is planning to come up with "on tap" licences which means there will not be any cut-off date for applying for the licences.

With the Reserve Bank of India announcing the issuance of licences for setting up 10 small finance banks, the present phase of diversification and expansion of the banking system appears to be complete. Both payments banks and small finance banks were key recommendations of the committee on financial inclusion chaired by DrNachiketMor and reflect the need to address the huge problem of delivery of meaningful products and services to a new class of consumers through the creation of new organisational structures and business models. Unlike the payments banks, which can take deposits but not provide credit except to the government, the small finance banks are essentially scaled down versions of commercial banks, with both deposit-taking and loan-making functions. They are required to provide at least 75 per cent of their loans to borrowers classified as priority sector and at least 50 per cent of their loans must be small credit i.e. below Rs 25 lakh each.

2. *Policy Background for Small Banks*

Based on the recommendations of the Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham) (1998), Committee on Financial Sector Reforms (Chairman: Dr. Raghuram G. Rajan) (2009), there has been a recognition within the Government of India and the Reserve Bank of India (RBI) think tanks about the need for an explicit policy on banking structure in India. Accordingly, in 2013 RBI came out with a first draft of guidelines for licensing of new banks in the private sector and later that year it came out with a policy discussion paper on 'Banking Structure in India – The Way Forward'. One of the observations in the discussion paper was that in India, where extending banking services to the underserved and unserved sections of the population is a challenge, there is merit in considering access to bank credit and services through expansion of small banks in unbanked and under-banked regions.

Subsequently, in the Union Budget 2014-2015 presented in July 2014, the Hon'ble Finance Minister announced that:

"RBI will create a framework for licensing small banks and other differentiated banks. Differentiated banks serving niche interests, local area banks, payment banks etc. are contemplated to meet credit and remittance needs of small businesses, unorganized sector, low income households, farmers and migrant work force".

Later, the discussion draft of the 2013 guidelines was released for public comments in July 2014. Based on the comments and suggestions received on the draft guidelines, the guidelines for licensing of small finance banks in the private sector were finalised in November 2014 and eventually Small Finance Bank licences have been issued to 10 entities in September 2015, out of 72 applicants. Local focus and the ability to serve smaller customers were the key criteria in licensing such banks. Accordingly, eight out of the ten selected entities are players who were already operating in the microfinance sector since this may be a more appropriate vehicle for local players or players who are focussed on lending to unserved / underserved sections of the society. The licences have conveyed the in-principal approval to these entities, which are required to commence their banking operations within next 18 months. These small finance banks will be given scheduled bank status once they commence their operations, and found suitable as per Section 42 (6) (a) of the Reserve Bank of India Act, 1934.

It may be mentioned that India did experiment with small banks following an announcement made by the then Finance Minister in the Union Budget in August 1996 and the RBI issued guidelines for setting up of Local Area Banks (LABs) that year. The LABs were conceived as low cost structures which would provide efficient and competitive financial intermediation services in a limited area of operation, i.e., primarily in rural and semi-urban areas.LABs were required to have a minimum capital of Rs. 5 crore and an area of operation comprising three contiguous districts. Presently, four LABs are functioning satisfactorily.

Taking into account the fact that small finance banks can play an important role in the supply of credit to micro and small enterprises, agriculture and banking services in unbanked and under-banked regions in the country, the RBI has decided to licence new “small finance banks” in the private sector.

3. *Role of Small Finance Banks:*

i) *Objectives and role envisaged*: The objectives of setting up of small finance banks will be to further financial inclusion by

a. provision of savings vehicles (by accepting small deposits), and

b. 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.

At least 50 per cent of a small bank’s loan portfolio should constitute loans and advances of upto Rs. 25 lakh i.e. small loans, to small borrowers. The maximum loan size and investment limit exposure to a single and group borrower would be restricted to 10 per cent and 15 per cent of its capital funds, respectively. Further, it will be required to extend 75 per cent of its Adjusted Net Bank Credit to the sectors eligible for classification as priority sector lending by the Reserve Bank.

It is expected that the small finance bank should primarily be responsive to local needs and set up the bank in a cluster of under-banked States / districts, such as in the North-East, East and Central regions of the country.The annual branch expansion plans of a SFB should be in compliance with the requirement of opening at least 25 per cent of its branches in unbanked rural centres (population upto 9,999 as per the latest census).

In addition to the basic deposit and credit activities, a SFB can also undertake other non-risk sharing simple financial services activities, not requiring any commitment of own fund, such as distribution of mutual fund units, insurance products, pension products, etc. with the prior approval of the RBI and after complying with the requirements of the sectoral regulator for such products. The small finance bank can also become a Category II Authorised Dealer in foreign exchange business for its clients' requirements.

The operations of the bank should be technology driven from the beginning, conforming to generally accepted standards and norms; while new approaches (such as for data storage, security and real time data updation) are encouraged. The bank should have a high powered Customer Grievances Cell to handle customer complaints.

ii) *Eligible promoters*: Resident individuals/professionals with 10 years of experience in banking and finance; and companies and societies owned and controlled by residents were eligible to set up small finance banks. Existing Non-Banking Finance Companies (NBFCs), Micro Finance Institutions (MFIs), and Local Area Banks (LABs) that are owned and controlled by residents could also opt for conversion into small finance banks.

An existing NBFC/MFI/LAB, for converting itself into a small finance bank, was to have a minimum net worth of Rs. 100 crore or it shall infuse additional paid-up equity capital to achieve net worth of Rs. 100 crore, apart from obtaining all other approvals. It may be noted that on conversion into a small finance bank, the NBFC / MFI will cease to exist and all its business which a bank can undertake should fold into the bank and the activities which a bank cannot statutorily undertake be divested / disposed of.

iii) *Scope of activities*: The small finance bank shall primarily 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 unorganised sector entities.

The minimum paid-up equity capital for small finance banks shall be Rs. 100 crore. Though there will not be any restriction in the area of operations of small finance banks;

however, preference will be given to those applicants who in the initial phase. These banks will not have any hindrance to expand to other regions in due course. After the initial stabilisation period of five years, and after a review, RBI may liberalize the requirement of prior approval for annual branch expansion plans and scope of activities of the small finance banks.

iv*) Prudential norms and other requirements*: The small finance bank will be subject to all 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 small finance bank will be required to use the words "Small Finance Bank" in its name in order to differentiate it from other banks.

The small finance bank may choose to continue as a differentiated bank. However, if in future it aspires to transit into a universal bank, such transition will not be automatic, but would be subject to it applying to RBI for such conversion and fulfilling minimum paid-up capital / net worth requirement as applicable to universal banks; its satisfactory track record of performance as a small finance bank for a minimum period of five years and the outcome of RBI's due diligence exercise.

4. *Microfinance and financial inclusion: Case Studies of MFIs scaling up to SFBs*

Small Finance Banks, as the name suggests, have small depositors and small borrowers as their targeted clientele. Thus, small banks will essentially be operating on the same turf as microfinance companies. This explains why the RBI chose to give small finance banks (SFBs) licences mainly to microfinance companies (MFIs) that already had the experience and core competence in the area. Let us look at what some of these players bring to the table:

Janalakshmi Financial Services:

Hitherto known as Janalakshmi Microfinance, this Bengaluru based entity can boast of being the third largest MFI in India. (The first two being Bandhan, which has since been upgraded to a Universal bank and SKS Microfinance, which applied for a SFB licence but didn't win the approval from RBI). It also is India's largest urban MFI having a customer base of more than 23 lakh with presence in more than 150 cities across 17 states and having assets under management (AUM) worth more than Rs 3700 crore. Its promoter Sh Ramesh Ramanathan is quiet a pioneer in the field of urban microfinance and has been a member of various expert committees including NachiketMor committee (Committee on Comprehensive Financial Services for Small Businesses and Low-Income Households, report 2013). The financial inclusion priority of this entity has been to make available small credit access in tier-2 and tier-3 cities. Its commitment to the goal of financial inclusion is bolstered by the fact that the holding stakes of the promoters are held in a charitable foundation ensuring that the profits flow back to the cause and not to the promoter's kitty.

Ujjivan Financial Services:

Founded in 2005 as a microfinance firm for the urban poor, this entity has outreach across 24 states and has more than 20 lakh clients. It has been the fourth largest MFI in India, with AUM pegged around Rs 3300 crore. Its vision as a SFB is to increase the proportion of individual loans in its lending portfolio from the current 10% to 40% over next four years. Its current workforce of around 8000 is likely to swell to 11000 in next two years.

ESAF Microfinance:

Formed in Thrissur, Kerala, this organization has carved out a niche in offering loans to women under the joint liability group model of lending. Through its efforts, many women have successfully started their self-employment enterprises in Kerala at small scale. It is one of the few financial institutions successfully operating in the naxal-affected areas of Maharashtra, Jharkhand and Chattisgarh.

RGVN (North East) Microfinance:

This Guwahati based microfinance institution has been active in microfinance arena since 1995. This institution has the main aim of developing and nurturing community based organisations and NGOs in the Northeast India. It focus on basic savings and credit activities for the goal of financial inclusion. Currently it is active in five North-Eastern states namely Assam, Nagaland, Arunachal Pradesh, Meghlaya and Sikkim with a network of more than 100 branches.

The following table summarizes the priority focus of some of the MFIs that have been granted the SFB licences recently:

Name of SFB	Financial inclusion focus area(s)
Janalakshmi Financial Services Ujjivan Financial Services ESAF Microfinance RGVN Microfinance Disha Microfinance UtkarshMicroofinance	• Tier-II and Tier-III cities • Urban Poor • Women borrowers &Naxal affected districts of Maharashtra, Chattisgarh& Jharkhand • North-East region (nurturing community based organisations) • Underbanked households in rural & semi-urban areas • Underpenetrated areas of North India

5. **Conclusion**

Considerable optimism surrounds these small banks for taking basic banking services, including acceptance of deposits and lending operations, to unserved and underserved sections of the population. Financial experts are going to the extent of calling this initiative as the biggest banking reform since the bank nationalisation of 1969. These SFBs, as microfinance institutions, were already in the lending space and have presumably developed the capacity to effectively monitor borrowers and assess risks. To the extent that their borrower constituency will be a natural target for their deposit-related services, the efforts required to scale up this new part of their business should not be too onerous. For SFBs, the real constraint is scale and this requires geographic focus. The selection process has taken care to ensure that the 10 licensees are spread broadly across all parts of the country.

These banks would enjoy an edge over the conventional MFIs because of lower cost of funds, better liability franchise and reduced political risks. MFIs were only re-financing to the small borrowers at a spread that they earned. They were not allowed to raise money on their own and had to use the money borrowed at high interest rates from the commercial banks. The small banks on the other hand will be allowed to collect deposits and therefore their cost of funds will come down substantially, the benefit of which shall be passed on to the eventual borrowers as well, in the form of lower interest rates (as compared to nearly 20-24% that a typical MFI charges its borrowers). Thus, the scenario looks bright for the financial inclusion and small credit access.

This institutional diversification is indeed welcome but some caution is advisable in assessing the prospects for success of SFBs. The success of the Prime Minister's Jan DhanYojana in achieving virtually full penetration of no-frills accounts may prove to be a constraint in their pursuit of deposit accounts. They will face the challenge of persuading a large number of potential customers to either switch from commercial banks or open up a second account. Beyond this, on the loan side of the business, as they seek to grow their lending volumes, they will be in direct competition with the priority sector mandates of commercial banks. For this new category to be given a fair chance of success there is a need for some re-alignment of roles and responsibilities between different categories of banks in relation to no-frills accounts and priority sector loans. Notwithstanding these concerns the setting up of small finance banks represents a significant move in banking and financial inclusion arena.

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