SFBs: Looking for innovation

While small finance banks are solvent and working well, we need to ask if there has been a breakthrough in stretching the inclusion agenda beyond MFIs

ILLUSTRATION: AJAYA KUMAR MOHANTY

It has been a decade since the process of licensing small finance banks (SFBs) was announced. In terms of staying power and survival, SFBs have done much better than other banks. Following the reforms of 1991, the Reserve Bank of India (RBI) was open to licensing private-sector banks and multiple licences were issued. In all 14 licences for universal banks were given in three tranches. Of these, from the first tranche of 10 banks, three were merged with other banks. In the next two rounds of four licences, one bank had serious problems with its business model and the moral fabric.

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Similarly, after the announcement of new local area banks (LABs) in the Budget speech of 1996, 10 in-principle licences were issued over five years. Only six of them commenced operations and two quickly folded up. Of the remaining four, only two exist, one having successfully transitioned to an SFB and the other ceasing operations.

Along with those for SFBs, eleven in-principle licences were issued for payments banks. Of those one has got an in-principle licence to transition to an SFB and just four remain. The RBI is not issuing any further licences to payments banks and LABs.

Considering the somewhat patchy success of other categories of banks, SFBs have been remarkably successful. All in-principle licences were operationalised. Fincare SFB voluntarily merged with AUSFB in the normal course, without a crisis. Later two more SFB licences were issued. In these years there was no existential crisis for any SFB.

However, it is useful to see how SFBs have done vis-à-vis the objectives enunciated in the guidelines. Therein may lie some "survival" strategies that trump the intended objectives.

The draft guidelines issued by the RBI on July 17, 2014, envisaged setting up "small" banks, with restricted but contiguous areas of operations, to get a local feel. The intent was focused geographical growth and deepening financial inclusion. By November 27, 2014, the guidelines were modified to set up small "finance" banks, with unrestricted areas. The guidelines stated "preference will be given to those applicants who in the initial phase 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 regional focus in the original guidelines became a suggested "preference" in the final guidelines. The final guidelines had other requirements — that banks would lend 75 per cent of their adjusted net bank credit (ANBC) to the priority sector, and 50 per cent of the books would comprise loan sizes of less than ₹25 lakh.

One of the explicit objectives of the SFBs was the "provision of savings vehicles primarily to unserved and underserved sections of the population", apart from credit through technology-led low-cost operations.

The shift from "small" banks to small "finance" banks happened based on the feedback received by the RBI from the microfinance lobby, most of which already had pan-Indian operations and were looking to convert themselves into banks. The developmental imperative was trumped by viability and profitability, indicating a practical shift in position.

How have the SFBs fared on the objectives in the guidelines? More than 99 per cent of the accounts are for loans of less than ₹25 lakh. They represent around 75 per cent of credit limits approved as of March 2025. If we were to look at the numbers even more closely, around 92 per cent of the accounts have a ticket size of less than ₹2 lakh. The average ticket size of the loans is the smallest, even smaller than the ticket size of regional rural banks (RRBs), which are state-owned, on the inclusion parameter. In terms of focus on the central, eastern, and northeastern regions, SFBs have done much better than the banking average. While RRBs have fared better in the central region, the SFB numbers in the Northeast is nothing short of spectacular, possibly because one of the licensees is from the Northeast. In fact, this raises the question on whether the original design of "small" banks with a regional focus would have been better. But that is a bridge we have crossed. Overall, on credit, the objectives have been more than achieved.

However, on deposits, SFBs do not have much penetration in the household sector. Almost 45 per cent of their deposits come from institutions, including financial institutions. On the other hand, the RRBs get 93 per cent of their deposits from households. Even within the household sector, deposits from women are significantly lower than in RRBs and the number is comparable to the deposits raised by public-sector banks.

Based on these numbers we can say that SFBs have done well on the inclusion parameters on credit, something eight of the 10 SFBs used to do in their earlier avatar as microfinance institutions (MFIs). They have not been able to integrate the inclusive customers (particularly women) meaningfully in the savings programme. Instead of bulk loans from banks, these institutions in their new avatar are taking bulk and expensive deposits from institutions. It, therefore, has a paradoxical balance sheet, where the asset side leans heavily on inclusion, and the liability side leans towards institutional deposits.

So the question is — even as the institutional viability and solvency continues, did the SFBs achieve anything significantly better than their earlier avatar as MFIs? There is no significant out-of-the-box breakthrough on savings, particularly when benchmarked with RRBs, and there is no significant difference in the pricing of the loans in comparison with MFIs. Therefore, while the SFBs are solvent and working well, we need to ask if there was a breakthrough in stretching the inclusion agenda beyond MFIs by creating a new category of banks.

In this context, when the RBI recently reduced the requirements of priority-sector obligations from 75 per cent of ANBC to 60 per cent, one wonders if the regulator is pulling the SFBs towards being universal banks rather than pushing inclusion. That the RBI has not cracked a whip on the inclusion parameters vis-à-vis savings is understandable because it does not want any adventures on savings. However is the SFB model distinct from that of MFIs? This is a question to ponder.

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