



## **AN EMPIRICAL STUDY ON THE THREATS AND CHALLENGES TO SMALL FINANCE BANKS WITH SPECIAL REFERENCE TO COIMBATORE CITY**

**P.Dhanya**

*Assistant Professor/ Part time Ph.D Research Scholar, Dr.N.G.P.Arts and Science College (Autonomous), Coimbatore-48, T.N, India*

**Dr.P.B.Banudevi**

*Professor and Head, Dept of Commerce Finance, Dr.N.G.P.Arts and Science College (Autonomous), Coimbatore-48, T.N, India*

### **ABSTRACT**

*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 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. This article discusses the objectives, challenges and opportunities and threats for the Small finance banks in the light of transforming economic landscape of the country.*

**KEY WORDS**—*Financial Inclusion, Banking Services, Microfinance, Reserve Bank of India*

### **I. INTRODUCTION**

The High Level Committee on Financial Sector Reforms (Government of India, 2009) headed by Raghuram Rajan in its report, "A Hundred Small Steps", emphasised the need for a paradigm shift in the strategy for financial inclusion. It said that emphasis should be shifted from the existing public sector dominated, large-banking structure to improved efficiency, innovation, and value for money. Motivated financiers with low cost structure who also have the capacity to make decisions quickly are to be encouraged to start banks. It therefore recommended that entry to private, well-governed, deposit-taking small finance banks be allowed.

The RBI discussion paper (Reserve Bank of India, 2013a, Reserve Bank of India, 2013b) focussed

on "desirability and practicality of having small and localised banks as preferred vehicles for financial inclusion" among other aspects of banking structure. The paper emphasised that deepening the engagement of formal banking for low income households and providing access to the unbanked will require increasingly innovative approaches (including channels, products, interface, etc.). Such a framework will need to be localised, customised and contextualised to suit the differing needs of different localities and will need to address issues such as the development of an overarching macro policy environment, long-term financial sustainability of microfinance institutions, increasing outreach by capacity building and effective governance, and broad-based research and monitoring/evaluation.

Following this, the Reserve Bank's report (2014) on Comprehensive Financial Services for Small Businesses and Low-Income Households popularly known as the Nachiket Mor Committee Report came up with two broad designs for the banking system in the country the horizontally differentiated banking system (HDBS) and the vertically differentiated banking system (VDBS) based on the functional building blocks of payments, deposits and credit. In an HDBS design, the basic design element remains a full-service bank that combines all three building blocks of payments, deposits, and credit but is differentiated primarily on the dimension of size or geography or sectoral focus. This could also be referred to as the institutional design configuration. In a VDBS design, the full-service bank is replaced by banks that specialise in one or more of the building blocks of payments, deposits, and credit. This could also be referred to as the functional design configuration. In reality, most banking systems would have a mix of both designs (Reserve Bank of India, 2014).

## II. REVIEW OF LITERATURE

M Jayadev, H Singh, P Kumar - IIMB management review, 2017 - Elsevier

A recent innovation in the Indian banking structure has been the formation of a new banking institution—small finance banks (SFBs). These banks are expected to penetrate into financial inclusion by providing basic banking and credit services with a differentiated banking model to the larger population. In this context the new SFBs have multiple challenges in coming out with a new, differentiated business model. The challenges include building low cost liability portfolio, technology management, and balancing the regulatory compliances.

Prantik Ray,(2016) XLRI Jamshedpur, India, Small Banks in India—Issues and Challenges. This paper discusses the need for financial inclusion of a large priority sector in India that is left unbanked or informally-banked. It discusses the RBI policy to further financial inclusion and the recent licensing of Small Finance Banks in order to achieve so. Small finance banks start with great promise of catering to rural and urban poor and the unbanked segment of population but they also face huge challenges in terms of building the required capacity, infrastructure to service a wide variety of clients and also to train its existing manpower to reorient themselves for offering a more full-fledged service than a typical MFI.

## III. OBJECTIVES OF THE STUDY

1. To identify the role of Small Finance Banks in Financial inclusion of the society.
2. To analyse the threats and challenges faced by the Small Finance Banks.

## IV. SMALL FINANCE BANKS

**Small Banks** are physical banks whose aim is to provide basic banking products such as deposits and supply of credit, but in a limited area of operation. Small banks are expected to meet credit and remittance needs of small businesses, farmers, micro and small industries, unorganised sector, low income

households and migrant work force through high technology-low cost operations.

A new type of bank named **Small Finance Banks (SFBs)** introduced in the Indian Banking Structure in the year 2015 to cater the specific requirement of niche customers. These banks aim to strengthen Financial Inclusion and extending basic banking services in the country.

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.

The concept of Small Finance banks is not completely new as these types of institutions have already existed in many developed countries. In the year 2015, RBI gives license to 10 applicants to set up Small finance Banks in India. 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.

## V. 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.

## VI. LIST OF SMALL FINANCE BANKS IN COIMBATORE

1. Suryoday Small Finance Bank
2. Ujjivan Small Finance Bank
3. ESAF Small Finance Bank
4. Fincare Small Finance Bank
5. Equitas Small Finance Bank Ltd
6. Janalakshmi Financial Service Bank

## VII. SWOT ANALYSIS

### Strengths

- 1) The country has huge population out of which 70% of the population lives in the rural areas of the country. Therefore, banks of both public and private sector have advantage of the situation as the untapped and unbanked rural population can become a big market for the banks.
- 2) The banking sector of the country is quite big having a large number of players in the form of public and private sector banks. India has 57 grameen banks with more than 17,000 branches across the country. Thus, with the existence of these specialized banks who already deal with the rural consumer government can easily increase the momentum of financial inclusion.

## Weaknesses

- 1) A majority of people fall in the lower income group also who are unable to meet their basic needs even and they are the ones who are to be brought in the purview of banking especially. Also, despite so many efforts a number of accounts opened under Jan Dhan Yojana are dormant with not even a single transaction done within 45 days after opening of the account.
- 2) The success of financial inclusion depends upon strong technology in terms of network, more number of towers etc all this needs to be improved as this is a weak area where the country needs to do improvement.
- 3) Lack of awareness about banking facilities and availability of different financial products and services among rural population is a big weakness of the economy.

## Opportunities

- 1) The country has a large unemployed population which can be utilized for promoting financial inclusion by making them a part of the delivery mechanism of the process in the form of business Correspondents (BCs) and business facilitators (BFs) and this unemployed population of the economy can be used for spreading financial literacy and bringing about financial inclusion.
- 2) A survey can be done on the targeted group to know about their choices and preferences about the type of financial products required. 3) Existing institutions such as grameen banks can be used effectively to expand access to financial services to the Poor.

## VIII. 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

1. **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.
2. **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.

3. **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 under banked, 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.

4. **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.
5. **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.
6. **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.
7. **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.

8. **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:
  - ❖ 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.
  - ❖ 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.
9. **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.
10. **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.

## IX. CONCLUSION

Small Finance Banks reiterate the Reserve Bank of India’s commitment to achieve financial inclusion by supporting the development of institutions that offer innovative ‘high technology, low-cost operations’ driven financial services. Eight out of the 10 institutions who have been granted provisional licenses are MFIs that have a track record of providing scalable microcredit services.

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 overcome challenges faced by the small finance banks. 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.

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. Moreover, in a dynamic economy banks either emerge or collapse in the upcoming year Small Finance Bank will be having a vital role in economic development and will provide a huge support to the Indian banking sectors.

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