Framework of Small Finance Bank – A Next Step to Financial Inclusion

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Abstract

The Banking Sector has a transformation with the advancement in the innovative strategy to streamline lower most segments of the people through the formation of new banking Institution – Small Finance Bank. This banking platform has marked a tremendous differentiation in identifying all individuals who have been untouched in the realm of banking sector. However this earmark has the potential of penetrating the banking and credit services with a different banking model to the massive population. In this context an attempt has been made to identify the regulatory framework of small finance bank and the impact of its inception among the other commercial banks, its challenges that it need to incorporate the regulatory and compliances and technology management along with other balancing portfolio.

KEYWORDS: Small Finance Bank, Eligible Promoters and Portfolio.

Introduction

In the modern era, there are more advancement in technology and banking industry that need to be revised and regulated for the improvement of customer's requirement. There are millions of people who rely more on informal financing. The Indian Financial system has undergone a wide range of opportunities for the promotion of financial inclusion. Incredibly that seemed to identify the new class of bank that cater the low income and underserved customers. In 2014, the Reserve Bank of India (RBI) announced a framework for developing "small finance banks," a new class of bank that would cater to low-income and underserved customers. In a country where more than 200 million people do not have a bank account and many more rely day-to-day on cash or informal financing, the RBI move signalled recognition that India's financial system needed to do more to promote financial inclusion.

Need for the small finance bank

India is the largest microfinance market in the world, and although microfinance in India is restricted to simple, unsophisticated loans, the sector has thrived, lending to hundreds of millions of unbanked citizens. In

2016, the final year before India's small finance banks began operating, microfinance institutions (MFIs) in India had a collective loan book of 639 billion rupees ($9.4 billion). But the proliferation of microfinance in India has been a double-edged sword. On the one hand, microfinance institutions have developed deep community ties and reached customers that most mainstream financial institutions have overlooked. On the other hand, the sector lacks clear regulation and oversight, an issue that has had devastating consequences for borrowers.

At the height of the microfinance market in 2010, a wave of borrower suicides exposed what was happening behind the scenes: Many of India's microfinance customers had become over-burdened by debt. In response, the state of Andhra Pradesh imposed stricter lending parameters and greater oversight over microfinance institutions, causing such a shock to providers that the sector collapsed. The RBI responded shortly thereafter with its own regulations on microfinance. The regulator's more recent creation of small finance banks signified its recognition that overdependence on microfinance was not an adequate model for meaningful financial inclusion.

Nevertheless, of the 10 organisations approved in 2015 and to become India's first small finance banks, eight were microfinance institutions. This suggests that the RBI recognized MFIs' role and capacity for delivering services to the unbanked and financially underserved, and saw their potential in helping build the foundation of a more inclusive financial system.

The "small finance bank" designation requires 75 percent of bank credit and 50 percent of loan portfolios serve low-income customers, small businesses and other priority sectors like farmers and students. It also gives institutions license to develop a wider range of products to fit customers' financial needs, providing an opportunity for deeper social impact than microfinance institutions have.

Having the license to operate as a bank will also mitigate institutional risk and improve credibility because, unlike microfinance, the banking sector is very clearly (and heavily) regulated by the Reserve Bank of India.

Small finance Bank

Small finance bank is a type of niche bank, which can provide banking services like accepting deposits and lending but mainly focusing on small businesses, small and marginal farmers, small and micro industries. Small finance banks can perform all the operations of normal commercial banks, but at a smaller level targeting low-income segment.

Small finance Bank will primarily focus on low-income, unbanked and underserved customers, and both banks have already started adapting their products and services to cater to their target customers' unique needs:

First, this target customer base – which includes Suryoday and Utkarsh's microfinance customers – has savings, but typically only small amounts, which need to be highly liquid to cover unexpected expenses.

Second, many microfinance customers are unaccustomed to or unable to deal with formal institutions with fixed hours and rigid processes. Owners of tailoring shops or vegetable stands, for instance, have daily cash flows and would require almost daily access to a bank account.

Third, most customers do not live in close proximity to a bank branch. Establishing a network of brick and mortar branches is expensive for banking institutions. While mobile and online banking are alternative options, India's financial services customers are not adopting digital banking as quickly as customers in other emerging markets.

A Paradigm shift from micro financial institution to small finance bank

There is a shift of all micro finance institution to small finance bank for the micro finance customers had become the customers of small account holders for a wide range of products and services. The account holders of small finance bank get only a limited size of loan product from a micro finance institution. The needs and aspirations of low income and rural Indians need to influence financial sector into financial inclusion. The small fiancé bank is looking beyond simple metric of "income improvement" for the indicators of positive social impact, like employment characteristics, customer distribution between urban and rural markets. The small finance bank takes the responsibility to demonstrate their full potential in India's new model for financial inclusion. It was identified that the costs associated with the transition will be a good investment. Long-term, operating as banks will put these businesses on a stronger risk, profit and impact trajectory. The suitable changes to current framework, has necessitated a change in the structure for continuous authorization of universal banks in the private sector in the current financial year. 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.

The draft guidelines for licensing of small banks in the private sector were formulated and released for public comments by RBI on July 17, 2014

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.

In India an experiment with small banks was taken up 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. 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 above and 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. While permitting small banks, however, the issues relating to their size, capital requirements, area of operations, exposure norms, regulatory prescriptions, corporate governance and resolution need to be suitably addressed in the light of experience gained. Hence RBI has come out with following guidelines for licensing of small finance banks in the private sector.

Registration, licensing and regulations

The small finance bank shall be registered as a public limited company under the Companies Act, 2013. It will be licensed under Section 22 of the Banking Regulation Act, 1949 and governed by the provisions of the Banking Regulation Act, 1949; Reserve Bank of India Act, 1934; Foreign Exchange Management Act, 1999; Payment and Settlement Systems Act, 2007; Credit Information Companies (Regulation) Act, 2005; Deposit Insurance and Credit Guarantee Corporation Act, 1961; other relevant Statutes and the Directives, Prudential Regulations and other Guidelines/Instructions issued by RBI and other regulators from time to time. The 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.[2]

Objectives

The objectives of setting up of small finance banks will be for furthering financial inclusion by (i) provision of savings vehicles primarily to unserved and underserved sections of the population, and (ii) 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.[2]

Eligible promoters

Resident individuals/professionals with 10 years of experience in banking and finance; and Companies and Societies owned and controlled by residents will be eligible as promoters 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 can also opt for conversion into small finance banks after complying with all legal and regulatory requirements of various authorities and if they conform to these guidelines. However, joint ventures by different promoter groups for the purpose of setting up small finance banks would not be permitted. As local focus and the ability to serve smaller customers will be the key criteria in licensing such banks, this may be a more appropriate vehicle for local players or players who are focused on lending to unserved / underserved sections of the society. Accordingly, proposals from large public sector entities and industrial and business houses, including from NBFCs promoted by them, will not be entertained.

Promoter / Promoter Groups as defined in the SEBI (Issue of Capital & Disclosure Requirements) Regulations, 2009 should be 'fit and proper' in order to be eligible to promote small finance banks. RBI would assess the 'fit and proper' status of the applicants on the basis of their past record of sound credentials and integrity; financial soundness and successful track record of professional experience or of running their businesses, etc. for at least a period of five years.

Scope of activities

The small finance bank, in furtherance of the objectives for which it is set up, 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. It 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. It cannot set up subsidiaries to undertake non-banking financial services activities.

The annual branch expansion plans of the small finance banks for the initial five years would need prior approval of RBI. The annual branch expansion plans should be in compliance with the requirement of opening at least 25 per cent of its branches in unbanked rural centres (population up to 9,999 as per the latest census).

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 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. These applicants will not have any hindrance to expand to other regions in due course. It is expected that the small finance bank should primarily be responsive to local needs. 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.

The other financial and non-financial services activities of the promoters, if any, should be kept distinctly ring-fenced and not commingled with the banking business.

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.

Capital requirement

The minimum paid-up equity capital for small finance banks shall be ₹100 crore (US$15 million). In view of the inherent risk of a small finance bank, it shall be required to maintain a minimum capital adequacy ratio of 15 per cent of its risk weighted assets (RWA) on a continuous basis, subject to any higher percentage as may be prescribed by RBI from time to time. Tier I capital should be at least 7.5 per cent of RWAs. Tier II capital should be limited to a maximum of 100 per cent of total Tier I capital. As small finance banks are not expected to deal with sophisticated products, the capital adequacy ratio will be computed under Basel Committee’s standardised approaches.

Promoter's contribution

The promoter's minimum initial contribution to the paid-up equity capital of such small finance bank shall at least be 40 per cent. If the initial shareholding by promoter in the bank is in excess of 40 per cent, it should be brought down to 40 per cent within a period of five years. The promoter's minimum contribution of 40 per cent of paid-up equity capital shall be locked in for a period of five years from the date of commencement of business of the bank. Further, the promoter’s stake should be brought down to 30 per cent of the paid-up equity capital of the bank within a period of 10 years, and to 26 per cent within 12 years from the date of commencement of business of the bank.

Stock exchange listing

Proposals having diversified shareholding subject to the initial minimum shareholding of promoters and a time frame for listing of the bank will be preferred. However, after the small finance bank reaches the net worth of □500 crore (US$77 million), listing will be mandatory within three years of reaching that net worth. However, small finance banks having net worth of below □500 crore (US$77 million) could also get their shares listed voluntarily, subject to fulfillment of the requirements of the capital markets regulator.

Foreign shareholding

The foreign shareholding in the small finance bank would be as per the Foreign Direct Investment (FDI) policy for private sector banks as amended from time to time. As per the current FDI policy, the aggregate foreign investment in a private sector bank from all sources will be allowed up to a maximum of 74 per cent of the paid-up capital of the bank (automatic up to 49 per cent and approval route beyond 49 per cent to 74 per cent). At all times, at least 26 per cent of the paid-up capital will have to be held by residents. In the case of Foreign Institutional Investors (FIIs) / Foreign Portfolio Investors (FPIs), individual FII / FPI holding is restricted to below 10 per cent of the total paid-up capital, aggregate limit for all FIIs /FPIs / Qualified Foreign Investors (QFIs) cannot exceed 24 per cent of the total paid-up capital, which can be raised to 49 per cent of the total paid-up capital by the bank concerned through a resolution by its board of directors followed by a special resolution to that effect by its General Body. In the case of NRIs, the individual holding is restricted to 5 per cent of the total paid-up capital both on repatriation and non-repatriation basis and aggregate limit cannot exceed 10 per cent of the total paid-up capital both on repatriation and non-repatriation basis. However, Non-Resident Indian (NRI) holding can be allowed up to 24 per cent of the total paid-up capital both on repatriation and non-repatriation basis provided the banking company passes a special resolution to that effect in the General Body.[2]

Voting rights and transfer/acquisition of shares

As per Section 12 (2) of the Banking Regulation Act, 1949, any shareholder's voting rights in private sector banks are capped at 10 per cent. This limit can be raised to 26 per cent in a phased manner by the RBI. Further, as per Section 12B of the Act ibid, any acquisition of 5 per cent or more of paid-up share capital in a private sector bank will require prior approval of RBI. This will also apply to the small finance banks.

Prudential norms

The newly set up small finance banks should ensure that they put in place a robust risk management framework. 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 CRR and SLR. No forbearance would be provided for complying with the statutory provisions.

In view of the objective for which small finance bank will be set up, it will be required to extend 75 per cent of its Adjusted Net Bank Credit (ANBC) to the sectors eligible for classification as priority sector lending (PSL) by RBI. While 40 per cent of its ANBC should be allocated to different sub-sectors under PSL as per the extant PSL prescriptions, the bank can allocate the balance 35 per cent to any one or more sub-sectors under the PSL where it has competitive advantage.

The maximum loan size and investment limit exposure to a single and group obligor would be restricted to 10 per cent and 15 per cent of its capital funds, respectively. Further, in order to ensure that the bank extends loans primarily to small borrowers, at least 50 per cent of its loan portfolio should constitute loans and advances of up to ₹25 lakh (US$38,000).

After the initial stabilisation period of five years, and after a review, RBI may relax the above exposure limits.

In addition to the restrictions placed on banks' loans and advances to its directors and the companies in which its directors are interested under Section 20 of the Banking Regulation Act, 1949, the small finance bank is precluded from having any exposure to its promoters, major shareholders (who have shareholding of 10 per cent of paid-up equity shares in the bank), the relatives [as defined in Section 2 (77) of the Companies Act, 2013 and Rules made there under] of the promoters as also the entities in which they have significant influence or control (as defined under Accounting Standards AS 21 and AS 23).

Additional conditions for NBFCs/MFIs/LABs converting into a bank

An existing NBFC/MFI/LAB, if it meets the conditions under these guidelines, could apply to convert itself into a small finance bank, after complying with all legal and approval requirements from various authorities. In such a case, the entity shall have a minimum net worth of ₹100 crore (US$15 million) or it shall infuse additional paid-up equity capital to achieve net worth of ₹100 crore (US$15 million). 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. Further, the branches of the NBFC / MFI should either be converted into bank branches or be merged / closed as per the business plan. The small finance bank and the NBFC / MFI cannot co-exist.

Banks are precluded from creating floating charge on their assets. For such NBFCs / MFIs, which succeed in obtaining licences to convert into small finance banks, if they have created floating charges on their assets for secured borrowings which stand in their balance sheets on the day of conversion into a bank, RBI will permit grandfathering of such borrowings till their maturity, subject to imposition of additional capital charge in order to protect the interest of the depositors.

If the existing NBFCs / MFIs / LABs have diluted the promoters' shareholding to below 40 per cent, but above 26 per cent, due to regulatory requirements or otherwise, RBI may not insist on the promoters' minimum initial contribution as indicated in paragraph 6 of the guidelines.

Business plan

The applicants for small finance bank licences will be required to furnish their business plans along with project reports with their applications. The business plan will have to address how the bank proposes to achieve the objectives behind setting up of small finance banks and in the case of an NBFC / MFI applicant, how the existing business of NBFC / MFI will fold into the bank or divested / disposed of. The business plan submitted by the applicant should be realistic and viable. In case of deviation from the stated business plan after issue of licence, RBI may consider restricting the bank's expansion, effecting change in management and imposing other penal measures as may be necessary.

Corporate governance

The Board of the small finance bank should have a majority of independent directors. The bank should comply with the corporate governance guidelines including 'fit and proper' criteria for directors as issued by RBI from time to time.

Other conditions

If a promoter setting up a small finance bank desires to set up a Payments Bank, it should set up both types of banks under a Non-Operative Financial Holding Company (NOFHC) structure. However, a promoter will not be granted licences for both universal bank and small finance bank even if the proposal is to set them up under the NOFHC structure

Individuals (including relatives) and entities other than the promoters will not be permitted to have shareholding in excess of 10 per cent of the paid-up equity capital of the bank. In case of existing NBFCs / MFIs / LABs converting into small finance bank, where there is shareholding in excess of 10 per cent of the paid-up equity capital by entities other than the promoters, RBI may consider providing time up to 3 years for the shareholding to be brought down to 10 per cent.

The small finance bank cannot be a Business Correspondent (BC) for another bank. However, it can have its own BC network.

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, a detailed technology plan for the same should be furnished to RBI.

The bank should have a high powered Customer Grievances Cell to handle customer complaints. The small finance banks will come under the purview of RBI’s Banking Ombudsman Scheme, 2006.

The compliance of terms and conditions laid down by RBI is an essential condition of grant of licence. Any non-compliance will attract penal measures including cancellation of licence of the bank.

Transition path

The small finance bank may choose to continue as a differentiated bank. If 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. On transition into a universal bank, it will be subjected to all the norms including NOFHC structure as applicable to universal banks.

Challenges for small finance Banks

- The growth of small finance banks (SFBs) in fiscal 2018 has slowed down due to the process of transition from their erstwhile avatar as NBFCs. According to a report by ICRA, SFBs reported a 17 per cent growth in their assets under management (AUM) at □51,498 crore as on March 31, 2018. However, in FY2017, when SFBs were operating as micro finance institutions, their AUM had grown by 26 per cent.

- SFBs started their operations as banking institutions in June 2018 and managed to transition well from MFIs, despite challenges such as raising of capital, diversification of liability profile, identifying and converting branches, diversifying the product portfolio, and recruiting staff.
- Apart from the migration process, SFBs' growth was also affected by demonetisation. While microfinance dominates the asset mix of SFBs, focus on product diversification has led to a reduction in the share of microfinance to 51 per cent as on March 31, 2018, from 61 per cent as on March 31, 2017, with SFBs establishing their presence in retail asset classes, such as vehicle loans, loan against property (LAP) and housing finance.
- As per the report, demonetisation severely impacted the asset quality of SFBs, largely driven by slippages in microfinance loans, with gross NPAs at 8.95 per cent as on March 31, 2018. Incrementally, while on a consolidated basis, the asset quality of SFBs is likely to be supported by diversification into relatively lower-risk products and providing for/writing-off legacy NPAs.
- On deposit mobilisation, ICRA said SFBs have made good progress with deposits forming 43 per cent of the borrowings as on March 31, 2018. Further, funding from refinance institutions accounted for 20 per cent of the borrowings, while the share of bank funding and debentures declined due to the repayment of older borrowings.

Conclusion

Inclusion of both payment banks and small finance bank will mark biggest revolution after the nationalization of banks in the Indian banking section. It will make banking more competitive and more inclusive for both borrowers and depositors thus making banking more affordable to the common man. The era of consumers has finally come. Now it is upto the requirements of customers to decide the changing phases of Indian Banking System.

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