A STUDY ON PERFORMANCE OF SMALL FINANCE BANK IN INDIA

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Abstract

The banking sector is essential for any economy, facilitating transactions, mobilizing savings, and supporting growth. In India, achieving financial inclusion for marginalized and low-income groups has been a long-standing

challenge. Small finance banks aim to support financial inclusion by providing credit to small businesses and micro enterprises, with at least 75% of their credit dedicated to the economically weaker sections. SFBs face challenges in profitability, credit risk management, and capital optimization. Strong Net Interest Margins and Return on Assets indicate the need for improved cost efficiency and revenue diversification. The sustainability of Small Finance Banks hinges on strategic financial management, technological integration, and a customer-focused approach.

Key Words: Small Finance Banks, Financial inclusion, Capital Adequacy Ratio, Net Interest Margin, Non-Performing Assets Ratio.

Introduction

The banking sector is essential for any economy, facilitating transactions, mobilizing savings, and supporting growth. In India, achieving financial inclusion for marginalized and low-income groups has been a long-standing challenge. To address this, the Reserve Bank of India (RBI) introduced Small Finance Banks (SFBs) to extend banking services to underserved populations, including small businesses, micro-entrepreneurs, farmers, and low-income households.

Introduced in 2014, SFBs were designed to provide basic banking services and credit access to groups with limited access to traditional banks. At least 75% of their adjusted net bank credit must be directed toward priority sectors, with 50% of their loans below ₹25 lakh. Since their inception, SFBs have significantly advanced financial inclusion and rural development, offering innovative digital banking solutions to a growing customer base.

However, SFBs face challenges such as high operating costs, regulatory compliance, credit risks, and competition from traditional banks and fintech companies. Their transition from microfinance institutions to full-fledged banks necessitated operational restructuring and adherence to stringent regulations.

This study will analyse the performance of Small Finance Banks in India, focusing on their growth, financial performance, and contribution to financial inclusion. It will also evaluate challenges and explore strategies for sustainable growth by examining financial indicators, customer outreach, and policy interventions.

Financial analysis is crucial for understanding an organization's current and future financial strength. It involves examining historical data to inform decision-making and is essential for business managers. The finance function involves assessing financial trends, establishing policies, and implementing internal controls for managing cash flow and capital expenditures. Corporate financial analysis includes evaluating past performance to project future outcomes, using metrics like Days Sales Outstanding (DSO) to assess cash conversion cycles.

HISTORY OF SMALL FINANCE BANKS:

Small finance banks have played a crucial role in providing financial services in rural and underserved areas of India. To qualify as a small finance bank, an institution must have a minimum paid-up capital of ₹100 crores and obtain a license under the Banking Regulation Act, 1949.

These banks focus on populations that traditional banks overlook and can lend up to ₹25 lakhs. Their operations are fully digitized, promoting efficiency and financial inclusion. The Reserve Bank of India (RBI) has granted 'in-principle' licenses to ten small finance banks, with an 18-month deadline to start operations. So far, only Equitas Small Finance Bank has begun functioning.

According to RBI guidelines from November 2014, small finance banks aim to support financial inclusion by providing credit to small businesses and micro enterprises, with at least 75% of their credit dedicated to the economically weaker sections.

These banks operate at lower costs compared to traditional banks and offer essential services, connecting underserved sectors to the formal banking system. Small finance banks, introduced to the Indian banking sector in 2015, aim to extend basic banking services and meet the needs of underprivileged areas. Capital Finance Bank was the first to begin operations on April 24, 2016, with 47 branches.

STATEMENT OF THE PROBLEM:

Efficient small finance bankers can capitalize on opportunities and face challenges effectively. Thus, studying the operational efficiency of banks is essential for developing survival strategies. This study compares the efficiency of Small Finance Banks (SFBs) with established benchmarks to identify areas for improvement.

Such analysis aids policymakers in assessing the effectiveness of initiatives and understanding successful strategies employed by banks. Given their significant role in capital accumulation and economic growth, research

on the banking sector's concentration, competition, efficiency, and profitability carries important policy implications

OBJECTIVES OF THE STUDY:

1. To analyse the financial performance of selected small fiancé banks in India.
2. To evaluate the role of small finance banks in financial inclusion.
3. To study and analyse the CAR, CASA, ROA, NIM, and NPA Ratios.

Research Gap

Previous studies on small finance banks varied in their selection of periods, banks, indicators, and statistical techniques, leading to inconclusive results. Some studies suggest deregulation positively impacts bank efficiency, while others indicate negative or mixed effects. Moreover, there is a lack of long-term studies on ownership performance in India's banking sector.

This study focuses on the impact of reforms during the Global Financial Crisis and examines financial inclusion in India. We will also compare the performance of Indian Small Finance Banks across different ownership groups to assess how ownership affects efficiency in the commercial banking sector.

SCOPE OF THE STUDY:

This study aims to evaluate the performance of small finance banks in India using secondary data. The study focuses on analysing financial and operational aspects through ratio analysis to assess their capital adequacy ratio, non-performing assets ratios, CASA ratios, return on assets ratios, and net interest margin ratios.

The study will cover financial data from 2020 to 2024, allowing a comparative analysis of small finance bank performance over time.

METHODOLOGY OF STUDY:

This study uses a descriptive and analytical research design. It is based on secondary data, the financial statements such as annual reports for the past 5 years from 2020 to 2024.

Sample Size:

The sample size for this study is based on the annual reports of five companies: Au Small Finance Bank, Capital Small Finance Bank, Equitas Small Finance Bank, Suryoday Small Finance Bank, and Shivalik Small Finance Bank. These annual reports were obtained from the official websites of the respective companies, following their initial public offerings (IPOs) from 2020 to 2024.

Sources of Data Collection

The secondary data was gathered from the annual reports of listed companies, including Au Small Finance Bank, Capital Small Finance Bank, Equitas Small Finance Bank, Suryoday Small Finance Bank, and Shivalik Small Finance Bank.

STATISTICAL TOOLS:

The financial tools used for analysis are ANOVA, charts, and various ratios. I.e., Capital adequacy ratio, non-performing assets ratio, current Account and Savings Account ratio, return on assets ratio, Net interest margin ratio.

Limitations of the Study

The study relies solely on secondary data from various journal articles and the company's annual reports, and is limited to a five-year period.

Literature Review

Dr. Nandhini and Dr. V. Rathnamani (2021)[1] conducted a study analyzing various parameters related to the operations of small finance banks (SFBs). The objective was to explore the significance of SFBs through a comparative analysis with other commercial banks. The researchers compared Equitas SFB with a nationalized bank and a private sector bank in Tamil Nadu.

Kumud Khatri (2020)[2] examined the current relevance of SFBs and their role in enhancing financial inclusion. The study aimed to compare the advantages of SFBs with those of established financial institutions and to assess the potential for further development of SFBs concerning financial inclusion and financial intermediation.

Shama and Gurunathan (2022)[3] found that small finance banks play a vital role in India by serving marginalized segments of the economy. These banks provide essential services to small-scale farmers, small businesses, and micro-enterprises. By catering to a significant portion of the population, they contribute positively to the country's economic growth. This study is based on secondary data from previously published articles, and aims to assess the credit risk associated with small-scale banks in India using a descriptive research design that involves collecting and analysing quantitative data.

Sasidharan (2021)[4] examined ESAF Small Finance Bank, which offers basic banking services such as deposits and loans. As a new and rapidly growing bank in Kerala, ESAF distinguishes itself from other banks. The report explores the unique features of ESAF Small Finance Bank, the various financial products it offers, and its innovative models that benefit society. Through our research, we found that ESAF Small Finance Bank is evolving into a significant financial institution.

Results and Discussion:

Non-Performing Assets Ratio (NPA)

The Non-Performing Assets Ratio (NPA), also known as the Non-Performing Loan (NPL) ratio, is a key metric used to assess the financial health of a bank or lending institution. It represents the proportion of a lender's loan portfolio that has become delinquent, meaning the borrower has failed to make timely payments on the principal and/or interest for a specified period (usually 90 days or more).

Null Hypothesis: (H_0) There is a no significant difference exists between NPA of SFBs in India.

Alternative Hypothesis: (H_1) There is significant difference exists between NPA of SFBs in India.

NPA	2019-20	20-21	21-22	22-23	23-24
AU SMALL FIINACE BANK	0.017	0.043	0.02	0.017	0.017
EQUITAS SMALL FINANCE BANK	0.0151	0.0152	0.0237	0.0114	0.0112
CAPITAL SMALL FINANCE BANK	0.0125	0.0113	0.0136	0.0136	0.014
SURYODAY SMALL FINANCE BANK	0.028	0.094	0.118	0.031	0.029
SHIVALIK SMALL FINANCE BANK	0.0283	0.0395	0.0289	0.023	0.02

Sources: Secondary Data

ANOVA

Source of Variation	*SS*	*df*	*MS*	*F*	*P-value*	*F crit*
Between Groups	0.007183	4	0.001795812	4.384081	0.010459	2.866081
Within Groups	0.008192	20	0.000409621			
Total	0.015376	24				

Interpretation: In the ANOVA table, the P-value is 0.010459. This is a pre-determined threshold, often set at 0.05 (or 5%). If the p-value is less than or equal to the significance level, the result is deemed "statistically significant".

CASA Ratio (CASA):

The CASA ratio in banking refers to the proportion of a bank's total deposits that are held in current and savings accounts (CASA). A higher CASA ratio indicates that a larger portion of a bank's funds are sourced from low-cost deposits, which can lead to lower funding costs and improved profitability.

Null Hypothesis: (H_0) There is no significant difference exists between CASA of SFBs in India

Alternative Hypothesis: (H_1) There is a significant difference exists between CASA of SFBs in India

CASA RATIO	2019-20	20-21	21-22	22-23	23-24
AU SMALL FIINACE BANK	0.14	0.23	0.37	0.38	0.33
EQUITAS SMALL FINANCE BANK	0.2047	0.34	0.5201	0.4228	0.32
CAPITAL SMALL FINANCE BANK	0.3631	0.4007	0.4216	0.4188	0.383
SURYODAY SMALL FINANCE BANK	0.1125	0.1145	0.188	0.171	0.201
SHIVALIK SMALL FINANCE BANK	0.3	0.311	0.292	0.311	0.2798

Sources: Secondary Data

ANOVA

Source of Variation	*SS*	*df*	*MS*	*F*	*P-value*	*F crit*
Between Groups	0.168552	4	0.042137898	7.810129	0.000582	2.866081
Within Groups	0.107906	20	0.005395289			
Total	0.276457	24				

Interpretation: In the ANOVA table, the P-value is 0.000582. This is a pre-determined threshold, often set at 0.05 (or 5%). If the p-value is less than or equal to the significance level, the result is deemed "statistically significant".

RETURN ON ASSETS RATIO (ROA):

The Return on Assets (ROA) ratio is a financial metric that measures how efficiently a company utilizes its assets to generate profit. It indicates how much profit a company makes for each rupee (or other currency unit) invested in its assets. A higher ROA suggests that a company is more effective at converting its assets into earnings.

Null Hypothesis: (H_0) There is no significant difference exists between ROA of SFBs in India

Alternative Hypothesis: (H_1) There is a significant difference exists between ROA of SFBs in India

RETURN ON ASSETS (ROA)	2019-20	20-21	21-22	22-23	23-24
AU SMALL FIINACE BANK	0.016	0.013	0.019	0.018	0.016
EQUITAS SMALL FINANCE BANK	0.0139	0.017	0.011	0.0189	0.02
CAPITAL SMALL FINANCE BANK	0.0052	0.007	0.0092	0.0122	0.0127
SURYODAY SMALL FINANCE BANK	0.025	0.002	0.013	0.009	0.0174
SHIVALIK SMALL FINANCE BANK	0.0018	0.0026	0.0005	0.0007	0.0008

Sources: Secondary Data

ANOVA

Source of Variation	*SS*	*df*	*MS*	*F*	*P-value*	*F crit*
Between Groups	0.000791	4	0.000197636	9.386227	0.000194	2.866081
Within Groups	0.000421	20	0.000021056			
Total	0.001212	24				

Interpretation: In the ANOVA table, the P-value is 0.000194. This is a pre-determined threshold, often set at 0.05 (or 5%). If the p-value is less than or equal to the significance level, the result is deemed "statistically significant".

NET INTEREST MARGIN RATIO (NIM):

The net interest margin (NIM) ratio is a key financial metric that measures a bank's profitability by assessing the difference between interest income generated from assets and interest paid on liabilities, expressed as a percentage of the bank's interest-earning assets. It essentially indicates how effectively a bank is utilizing its assets to generate income after accounting for the cost of funding those assets.

Null Hypothesis: (H_0) There is no significant difference exists between NIM of SFBs in India

Alternative Hypothesis: (H_1) There is a significant difference exists between NIM of SFBs in India.

NET INTEREST MARGIN (NIM)	2019-20	20-21	21-22	22-23	23-24
AU SMALL FIINACE BANK	0.054	0.053	0.057	0.061	0.054
EQUITAS SMALL FINANCE BANK	0.0911	0.0844	0.0854	0.09	0.0836
CAPITAL SMALL FINANCE BANK	0.0352	0.034	0.0374	0.0419	0.0394
SURYODAY SMALL FINANCE BANK	0.117	0.071	0.086	0.095	0.09
SHIVALIK SMALL FINANCE BANK	0.0406	0.0416	0.0416	0.0505	0.0595

Sources: Secondary Data

ANOVA

Source of Variation	SS	df	MS	F	P-value	F crit
Between Groups	0.011797	4	0.002949319	39.00648	3.54E-09	2.866081
Within Groups	0.001512	20	0.000075611			
Total	0.013309	24				

Interpretation: In the ANOVA table, the P-value is 0.0001(3.54E-09). This is a pre-determined threshold, often set at 0.05 (or 5%). If the p-value is less than or equal to the significance level, the result is deemed "extremely statistically significant".

CAPITAL ADEQUACY RATIO (CAR):

Capital adequacy ratio is the ratio which determines the bank's capacity to meet the time liabilities and other risks such as credit risk, operational risk etc. In the simplest formulation, a bank's capital is the "cushion" for potential losses, and protects the bank's depositors and other lenders.

Null Hypothesis: (H_0) There is no significant difference exists between CAR of SFBs in India

Alternative Hypothesis: (H_1) There is a significant difference exists between CAR of SFBs in India.

CAPITAL ADEQUACY RATIO(CAR)	2019-20	20-21	21-22	22-23	23-24
AU SMALL FIINACE BANK	0.22	0.234	0.21	0.236	20.1

EQUITAS SMALL FINANCE BANK	0.2361	0.2418	0.2516	0.238	0.217
CAPITAL SMALL FINANCE BANK	0.1911	0.198	0.1863	0.1887	0.2739
SURYODAY SMALL FINANCE BANK	0.354	0.515	0.379	0.337	0.284
SHIVALIK SMALL FINANCE BANK	0.1309	0.1308	0.217	0.234	0.202

Sources: Secondary Data

ANOVA

Source of Variation	*SS*	*df*	*MS*	*F*	*P-value*	*F crit*
Between Groups	62.50917	4	15.62729168	0.988886	0.436197	2.866081
Within Groups	316.0585	20	15.80292465			
Total	378.5677	24				

Interpretation: In the ANOVA table, the P-value is 0.436197. This is a pre-determined threshold, often set at 0.05 (or 5%). If the p-value is more than or equal to the significance level, the result is deemed "statistically not significant".

Findings of the study:

- The average NPA among SFBs significantly declined due to the strong recovery of loans and improved financial discipline.
- In FY2024, variation among SFBs reduced, indicating more consistent performance and effective risk management across the sector.
- The variation in CASA ratios among SFBs are low, indicating more stable customer deposit patterns and uniform banking operations.
- SFBs experienced a high average Return on Assets (ROA) in FY2020 due to favourable business conditions and growth opportunities.
- There was significant variation in NIM across SFBs, driven by differing levels of growth and business strategies especially in income generation due raising inflation effect cost of funds generating also increased.
- The average CAR was relatively low as many SFBs were still in their early stages, with growing demand and limited capital base.

SUGGESTIONS:

Based on the ratio analysis of Small Finance Banks (SFBs) in India, the following recommendations can help improve their performance and financial health:

- Focus on increasing low-cost deposits through an improved Current and Savings Account (CASA) ratio.
- Diversify revenue sources by expanding non-interest income, such as service fees and investment products.
- Improve asset-liability management to optimize interest earnings and reduce funding costs.
- Enhance operational efficiency by adopting technology-driven banking solutions to reduce costs.
- Strengthen risk assessment frameworks to ensure better loan quality and lower credit losses.
- Encourage cross-selling of financial products such as insurance and investment services like selling the Mutual funds to increase non-interest income.
- Ensure continuous capital infusion through retained earnings, fresh equity, or tiered capital instruments.
- Optimize capital utilization by investing in high-yielding and low-risk assets.
- Comply with RBI regulations on capital adequacy to maintain financial stability.
- Expand branch networks in semi-urban and rural areas to attract more savings and current account deposits.
- Offer competitive interest rates and innovative digital banking solutions to retain depositors.
- Conduct financial literacy programs to educate people about banking benefits and encourage savings.
- Implement stringent credit appraisal mechanisms to ensure loans are given to financially sound borrowers.
- Use early warning systems and proactive loan recovery strategies to prevent defaults.
- Leverage AI and digital lending platforms to assess borrower creditworthiness more effectively.

Conclusion:

Small Finance Banks (SFBs) represent a new phase in the Indian banking system, focusing on financial inclusion.

For effective financial performance, several recommendations are essential:

- ✓ Maintain consistent high ratios for revenue generation.
- ✓ Adjust the depreciation rate to better reflect earnings and mitigate risks.
- ✓ Write off expenses directly from the balance sheet to avoid inflating profits.
- ✓ Ensure a high yield on cash equivalents and monitor capex sustainability with a low ratio.
- ✓ Verify the credibility of reported earnings by examining cash generated from operations.
- ✓ Be cautious of rising auditors' fees, which may indicate a lack of objectivity.

Despite progress, SFBs face challenges in profitability, credit risk management, and capital optimization. Strong Net Interest Margins and Return on Assets indicate the need for improved cost efficiency and revenue diversification. A robust Capital Adequacy Ratio is vital for stability, while enhancing low-cost deposits and implementing effective risk management are crucial for maintaining asset quality.

In summary, the sustainability of Small Finance Banks hinges on strategic financial management, technological integration, and a customer-focused approach. By addressing these challenges, SFBs can continue to thrive and contribute significantly to India's financial landscape.

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