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Role of Small Finance Banks in Financial Inclusion and Rural Development

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Abstract

Small Finance Banks (SFBs) are a new type of financial services that facilitate access to credit, savings, and other essential financial tools. In India, with a vast rural population and a significant unbanked segment, financial inclusion has been a persistent challenge. This paper delves into the genesis, objectives, and impact of SFBs on financial inclusion and rural development in India. This study employs a descriptive research design to analyze the role of small finance banks (SFBs) in rural and semi-urban India. Secondary data, primarily from the Reserve Bank of India (RBI) and other government sources, have been used to gather information on the number, distribution, and performance of SFBs. The findings show that SFB growth has been instrumental in improving rural credit, particularly in the agricultural sector, where they provide affordable loans in areas often neglected by commercial banks. With continued efforts in financial literacy and community engagement, SFB are poised to play a crucial role in enhancing the livelihoods of rural communities and contributing to India's overall economic development.

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Banking Institutions, Financial Inclusion, Financial System, Small Finance Banks.

Introduction

Financial inclusion, the process of ensuring access to affordable financial services for all, is a cornerstone of inclusive growth (RBI, 2024).

In India, with a vast rural population and a significant unbanked segment, financial inclusion has been a persistent challenge.

The establishment of Small Finance Banks (SFBs) was a pivotal step towards addressing this issue. These niche banks were envisioned to cater to the financial needs of underserved and unbanked segments, particularly small businesses, marginal farmers, and micro-enterprises (Kambali, 2022). This paper delves into the genesis,

objectives, and impact of SFBs on financial inclusion and rural development in India.

Overview of Financial Institutions in India

1. Banking Institutions: This category includes commercial banks (public, private, and foreign), regional rural banks (RRBs), and cooperative banks. They provide a range of services, including accepting deposits, extending credit, and offering various financial services.

2. Non-Banking Financial Companies (NBFCs): NBFCs such as asset finance companies, investment companies, and infrastructure finance companies are crucial in providing credit, particularly in rural and semi-urban areas.

3. Development Financial Institutions (DFIs): DFIs like the National Bank for Agriculture and Rural Development (NABARD) and the Small Industries Development Bank of India (SIDBI) focus on sector-specific development through long-term financing. Banks, being the most prominent financial institutions, account for over 50% of financial market assets in India. They play a critical role in mobilizing deposits and providing loans, thus acting as intermediaries in the economy.

Literature Review

The literature on financial inclusion underscores its critical role in poverty reduction, economic growth, and social development (Ravikumar, 2019). Studies have highlighted the challenges faced by marginalized populations in accessing formal financial services (Ravikumar, 2019). The emergence of microfinance institutions and the subsequent evolution of SFBs have been explored in the context of providing financial services to the bottom of the pyramid (BOP). However, research on the specific impact of SFBs on financial inclusion and rural development in India is still in its nascent stages.

Materials and Methods

This study employs a descriptive research design to analyze the role of SFBs in India. Secondary data, primarily from the Reserve Bank of India (RBI) and other government sources, has been used to gather information on the number, distribution, and performance of SFBs. Additionally, published reports, research papers, and news articles have been consulted to understand their impact on financial inclusion and rural development.

Genesis of Small Finance Banks

Small Finance Banks (SFBs) were conceived by the Reserve Bank of India (RBI) under the Government of India's initiative to enhance financial inclusion. These niche banks are designed to provide essential banking services, particularly in underserved and unbanked regions, targeting small businesses, marginal farmers, micro-enterprises, and other segments in the informal economy (Chaturvedi, 2022). The idea of SFBs was recommended by the Committee on Financial Sector Reforms, chaired by Dr. Raghuram Rajan, which aimed to extend financial services to the rural population, low-income households, and small businesses.

Historical Context of Small Finance Banks in India

RBI issued guidelines for SFBs on July 17, 2014, and after extensive consultations, the final guidelines were released on November 27, 2014. Following this, 72 applicants expressed interest, and an independent panel led by Usha Thorat was appointed to evaluate the proposals. Ultimately, ten entities were granted licenses, with Capital Small Finance Bank being the first to commence operations on April 24, 2016. These institutions were primarily NBFCs, now operating under the regulatory framework of the RBI.

Current Status and Scope of Small Finance Banks in India

As of now, there are 12 operational SFBs in India, with a focus on providing financial services to micro-enterprises, unorganized entities, and low-income households in rural and semi-urban areas. The scope of their operations includes priority sector lending, microfinance, technology-driven banking services, mutual fund distribution, and retail and corporate banking. Moreover, SFBs play a pivotal role in community development by promoting self-help groups and supporting social initiatives.

Objectives of Small Finance Banks

The key objectives of SFBs in India are:

- To offer basic banking services to underprivileged and underserved populations.
- To enhance financial inclusion by supporting small business units, marginal farmers, micro-enterprises, and the unorganized sector through cost-effective, technology-driven operations.
- To gather and utilize specific data on small businesses, most of which lack access to formal financial institutions.
- To identify and extend financial services to sections of society neglected by mainstream commercial banks.

Presently, 12 small finance banks are operating in India with a primary objective to provide financial services to micro-enterprises, unorganized entities, and low-income households in rural and semi-urban areas through high technology-low-cost operations.

The scope of small finance banks includes providing banking services, microfinance, priority sector lending,

technology-driven operations, mutual fund distribution, retail banking, corporate banking, promotion of self-help groups and contributing to community development.

Growth Trajectory of Small Finance Banks

Since their inception, SFBs have shown remarkable growth. By March 2020, the number of SFB branches had surged to 4,307, with significant presence in underserved states like Madhya Pradesh and Rajasthan. Notably, 39% of these branches are in semi-urban areas, while 26% are in urban regions. SFBs have rapidly expanded their footprint, accounting for approximately 10% of all small loan accounts in the banking sector. According to an Investec report, three listed SFBs—Ujjivan, AU SFB, and Equitas—experienced a 50% compound annual growth rate (CAGR) in their advances between March 2018 and December 2020.

List of Small Finance Banks in India

Eleven major Small Finance Banks are operating currently in India. They majorly provide credit to people belonging to rural and semi-rural backgrounds and play a key role in helping improve the savings of underprivileged parts of society (Khan, 2019).

Comparative Analysis: Small Finance Banks vs. Commercial Banks

While SFBs have demonstrated their effectiveness in serving the underserved, they face competition from

commercial banks, which have also expanded their reach to rural areas (Ray & Shantnu, 2021). A comparative analysis reveals that SFBs have a distinct advantage in terms of their focus on micro-finance, agility, and understanding of the rural market. However, commercial banks possess a larger branch network and a wider range of products and services.

Impact of Small Finance Banks on Financial Inclusion and Rural Development

SFBs have made significant strides in expanding financial inclusion in India. By establishing a presence in underserved regions, they have brought formal banking services closer to the doorstep of millions. Studies have shown that SFBs have increased credit penetration, particularly among women and small businesses (Chatterjee, 2022). Moreover, they have contributed to savings mobilization, helping to build financial resilience among the rural population.

The impact of SFBs on rural development is evident in various sectors. In agriculture, SFBs have provided credit for crop production, input purchases, and post-harvest activities. This has led to increased agricultural productivity and income generation for farmers.

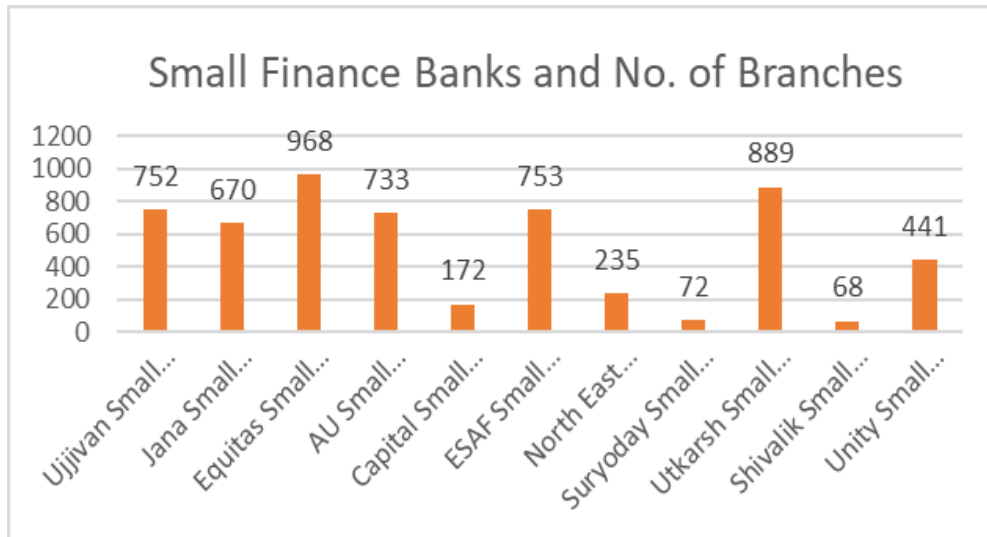
Additionally, SFBs have supported rural entrepreneurship by providing credit and other financial services to small businesses, thereby creating employment opportunities and stimulating rural economies.

Table.1 List of Small Finance banks currently operating in India

S. No	Bank Name	Commenced	Headquarters
1.	Ujjivan Small Finance Bank	1 February 2017	Bangalore
2.	Jana Small Finance Bank	29 March 2018	Bangalore
3.	Equitas Small Finance Bank	5 September 2016	Chennai
4.	AU Small Finance Bank	19 April 2017	Jaipur
5.	Capital Small Finance Bank	24 April 2016	Jalandhar
6.	ESAF Small Finance Bank	17 March 2017	Thrissur
7.	North East Small Finance Bank	17 October 2017	Guwahati
8.	Suryoday Small Finance Bank	23 January 2017	Navi Mumbai
9.	Utkarsh Small Finance Bank	23 January 2017	Varanasi
10.	Shivalik Small Finance Bank	26 April 2021	Noida
11.	Unity Small Finance Bank	1 November 2021	Delhi

Source: Reserve Bank of India Website

Figure.1 Number of currently operating branches of small finance banks



Source: Reserve Bank of India Website

Figure.2 Small Finance Banks and its Head Office



Conclusion

Small Finance Banks represent a significant step towards democratizing financial services and fostering inclusive economic growth in India. By focusing on underserved segments, such as small businesses, micro-enterprises,

farmers, and low-income households, SFBs have the potential to transform access to credit, savings, and other essential financial tools. Their innovative, technology-driven approaches are pivotal in building financial resilience and promoting economic stability at the grassroots level.

The growth of SFBs has been instrumental in improving rural credit, particularly in the agricultural sector, where they provide affordable loans in areas often neglected by commercial banks. With continued efforts in financial literacy and community engagement, SFBs are poised to play a crucial role in enhancing the livelihoods of rural communities and contributing to India's overall economic development.

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