

Small Finance Banks

Glide path for small finance banks to shed the 'small finance' tag

APRIL 2024



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RBI's circular on the voluntary transition of SFBs to Universal Banks provides a glide path for SFBs to shed their 'Small Finance' tag

At present, only AU SFB appears clearly eligible for transition to a Universal Bank

ICRA continues to maintain a Stable outlook on the sector, with the expectation of healthy growth and profitability in FY2025



The Reserve Bank of India (RBI) introduced small finance banks (SFBs) in 2014 with the objective of advancing financial inclusion in India. The aim was to promote savings and extend credit to small business units, small and marginal farmers, micro and small industries and other unorganised sectors. At present, 11 SFBs are operating in India, and on April 26, 2024, the RBI released the eligibility criteria for SFBs to transition into a Universal Bank.



The key eligibility criteria include - scheduled bank status with five years of satisfactory track record, being listed on a stock exchange, meeting regulatory capital adequacy ratio, minimum net worth of Rs. 1,000 crore and profitable operations with controlled asset quality over the last two fiscals. SFBs with a diversified loan portfolio are expected to be preferred for transitioning to Universal Banks.



Transitioning to a Universal Bank would aid SFBs in strengthening their competitive positioning and facilitate portfolio diversification. Universal Banks have relatively lower capitalisation and priority sector lending requirements, along with higher borrower and group exposure limits. Further, removing the 'small finance' tag can lower risk perception and thereby facilitate the improvement and diversification of their deposit franchise.



At present, only AU SFB appears clearly eligible for transitioning to a Universal Bank. While Ujjivan SFB meets all the criteria pertaining to track record and performance, its high share of unsecured loans* (~70% as of March 2024) may hinder its prospects for the transition to a Universal Bank from a portfolio diversification standpoint. ICRA expects more SFBs to become eligible and apply for the transition in FY2026.

*micro-group and individual loans



Background of SFBs and glide path to Universal Bank



In November 2014, the Reserve Bank of India (RBI) released the 'Guidelines for Licensing of Small Finance Banks in the Private Sector' with the objective of advancing financial inclusion.

Out of the 72 initial applicants, 10 were granted 'in-principle' approval to set up an SFB, all of which subsequently commenced operations.



After reviewing the performance of the existing 10 SFBs, the RBI issued Guidelines for 'on tap' Licensing of Small Finance Banks in the Private Sector in December 2019.

Subsequently, two more applicants were approved to commence operations as SFBs, one of which had voluntarily transitioned to an SFB from a Cooperative Bank.



As on March 31, 2024, 12 SFBs were operating in India. However, Fincare SFB merged into AU SFB, w.e.f. April 01, 2024.

The RBI provides guidelines for voluntary transition to Universal Bank

Guidelines for licensing of SFBs provided a transition path for SFBs to convert into Universal Banks. The RBI, vide circular dated April 26, 2024, provided clarity on the eligibility criteria for SFBs to transition into a universal bank, details of which are outlined below:



- Scheduled status with a satisfactory track record of performance for a minimum period of five years



- Shares of the bank should have been listed on a recognised stock exchange



- Having a minimum net worth of Rs. 1,000 crore as of the end of the previous quarter (audited)



- Meeting the prescribed capital-to-risk weighted assets ratio (CRAR) requirements for SFBs



- Having a net profit in the last two financial years



- Having gross non-performing assets (NPA) and net NPA of less than or equal to 3% and 1%, respectively, in the last two financial years

- Additionally, it was stated that eligible SFBs with a diversified loan portfolio will be preferred for transitioning to a Universal Bank. The application for transitioning to a Universal Bank from an SFB shall be assessed in accordance with the 'Guidelines for 'on tap' Licensing of Universal Banks in the Private Sector'.
- Further, the RBI laid out conditions regarding the shareholding pattern, such as no mandatory requirement for having an identified promoter or a lock-in requirement for minimum shareholding for existing promoters during the transition to Universal Bank. However, eligible SFBs transitioning to a Universal Bank shall not be permitted to add new promoters, nor will there be any change to the promoter shareholding plan already approved by the RBI.

Key regulatory requirements for SFBs and Universal Banks

Parameters	Small Finance Banks (on tap)	Small Finance Banks (initial guidelines)	New Universal Banks
Listing Requirement	Once the SFB reaches a net worth of Rs. 500 crore, listing will be mandatory within three years	Once the SFB reaches a net worth of Rs. 500 crore, listing will be mandatory within three years	Within six years of the commencement of business by the bank
Capital Adequacy Norm	15% (under Basel II standardised approach for credit risk)	15% (under Basel II standardised approach for credit risk)	13% for first three years of commencement of operations
Tier I Capital	7.5%	7.5%	7%
PSL Targets	75% of ANBC	75% of ANBC	40% of ANBC
CRR/SLR Requirements	CRR – 4.5% of NDTL SLR – 18% of NDTL	CRR – 4.5% of NDTL SLR – 18% of NDTL	CRR – 4.5% of NDTL SLR – 18% of NDTL
Minimum Net Worth	Rs. 200 crore (unless it is an urban cooperative bank (UCB) for which the requirement is Rs. 100 crore)	Rs. 100 crore	Rs. 500 crore
Promoter Shareholding	The promoters shall hold a minimum of 40% of the paid-up voting equity capital of the bank, which shall be locked in for a period of five years from the date of commencement of the bank's business If UCBs have diluted the promoter shareholding, it should be maintained at a minimum of 26% at all times for the initial five years	Minimum promoter shareholding of 40%, which will be locked in for a period of five years If the existing non-banking financial companies (NBFCs), MFIs or local area banks (LABs) have diluted the promoter shareholding, it should be at least 26%	Promoter(s) and the promoter group/non-operative financial holding company (NOFHC) shall hold a minimum of 40% of the paid-up voting equity capital of the bank, which shall be locked in for a period of five years
Timeframe for Dilution of Promoter Equity	Promoter shareholding is to be brought down to 26% of the paid-up share capital or voting rights within 15 years from the banking operations' commencement date.		

Source: ICRA Research, RBI; ANBC – Adjusted net banking credit; NDTL – Net demand and time liability; PSL – Priority sector lending; SLR – Statutory liquidity ratio; CRR – Cash reserve ratio

Comparison of key regulatory compliances SFBs and Universal Banks

Parameters	Small Finance Banks (on tap)	Small Finance Banks (initial guidelines)	New Universal Banks
Single borrower and group exposure limit	Single borrower exposure limit of 10% of capital; Group exposure limit of 15% of capital	Single borrower exposure limit of 10% of capital; Group exposure limit of 15% of capital	Single borrower exposure limit of 20% of Tier I capital; Group exposure limit of 25% of Tier I capital Single borrower may be exceeded by an additional 5% as per Board approval
Ticket size norms	Minimum 50% of the portfolio comprising single-borrower loans of up to Rs. 25 lakh	Minimum 50% of the portfolio comprising single-borrower loans of up to Rs. 25 lakh	Not applicable
Branch expansion	Opening at least 25% of its branches in unbanked rural centres		



Benefits and Eligibility of SFBs for Transition

Lower capital requirement

Universal banks have a lower capital requirement and will aid in improving shareholder returns



Higher exposure limits

Higher single-borrower and group exposure limits will aid in taking higher exposures and improve competitive positioning



Removal of 'Small Finance' tag

Removal of 'small finance' tag can lower risk perception and thereby facilitate the improvement and diversification of deposit franchise



Lower PSL requirement

Lower PSL requirements will increase headroom to earn fee income/ income from the sale of PSL certificates and assets



Portfolio diversification

Removing the 50% exposure requirement up to Rs. 25 lakh ticket size and lowering the PSL requirement will facilitate product diversification



Competitive positioning

Can offer more varied products, leading to augmentation of fee income profiles



Only one SFB appears clearly eligible for the transition to Universal Bank

Exhibit: Status of SFBs on various criteria for transition to Universal bank

Small Finance Bank	Scheduled status	Track record \geq 5 years	Shares listed on stock exchanges	Minimum net worth of Rs. 1,000 crore	Tier I CRAR > 7.5%	CRAR > 15%	Reported a net profit in the last 2 years*	Gross NPAs \leq 3% in the last 2 years*	Net NPAs \leq 1% in the last 2 years
AU SFB	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Capital SFB	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
Equitas SFB	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
ESAF SFB	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No
Jana SFB	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No
North East SFB	Yes	Yes	No	No	No	No	No	No	No
Shivalik SFB	Yes	No	No	No	Yes	Yes	Yes	Yes	No
Suryoday SFB	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No
Ujjivan SFB	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Unity SFB	Yes	No	No	Yes	Yes	Yes	Yes	No	No
Utkarsh SFB	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes

- Most SFBs do not meet the criteria for asset quality. At present, only AU SFB appears clearly eligible for transitioning to a Universal Bank.
- While Ujjivan SFB meets all the criteria pertaining to track record and performance, the high share of micro-group and individual loans (~70% as of March 2024) may hinder its prospect for transition to a Universal Bank from the portfolio diversification standpoint.
- ICRA expects more SFBs to become eligible and apply for the transition in FY2026.

*Based on reported data/financials for FY2023 and FY2024 (expected)

Source: RBI, financial results and stock exchange disclosures of various SFBs, ICRA Research

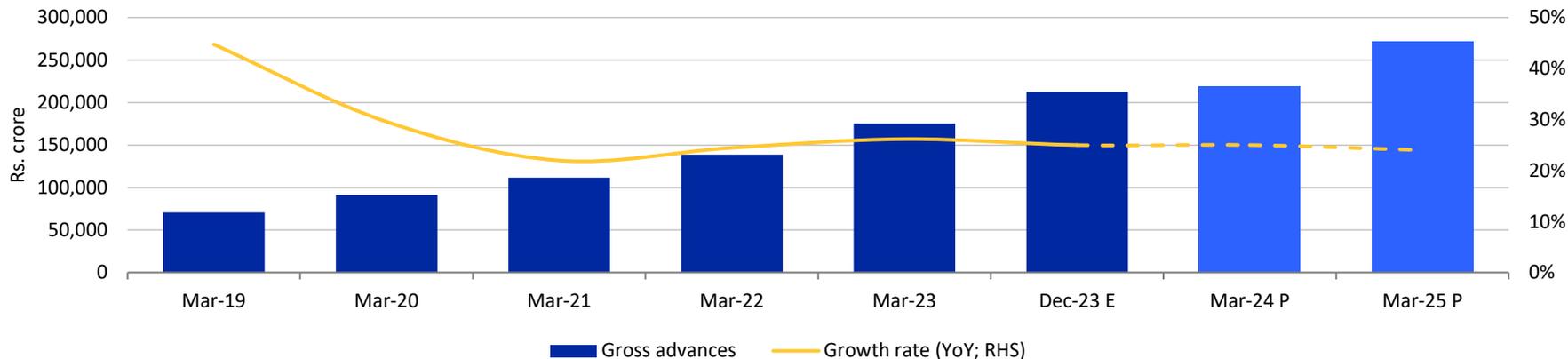


SFB Sector Performance Update

Growth driven by buoyant credit demand and product diversification

Sector remains on growth trajectory

EXHIBIT: Trend in growth of SFBs' gross advances

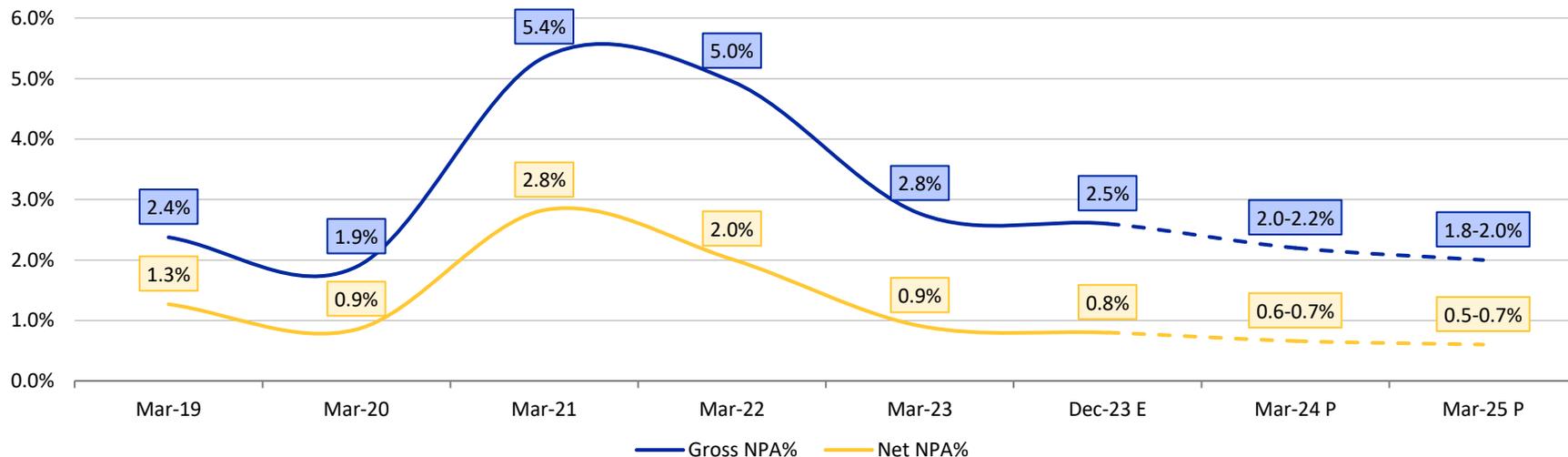


Source: Financials/investor presentations of SFBs, ICRA Research; E – Estimated; P – Projected.

- While the portfolio growth was lower in H1 FY2024 as several SFBs witnessed a slowdown in disbursements, consistent with past trends, disbursements picked up pace in H2 FY2024.
- ICRA expects a healthy portfolio growth of 22-25% during FY2024-FY2025, driven by buoyant credit demand and increasing product offerings.
- Given the growth outlook, ICRA does not envisage a sizeable capital requirement and expects the capitalisation position to remain adequate.

Improving asset quality, aided by gradual improvement in borrowers' cash flows

EXHIBIT: Trend in asset quality indicators of SFBs

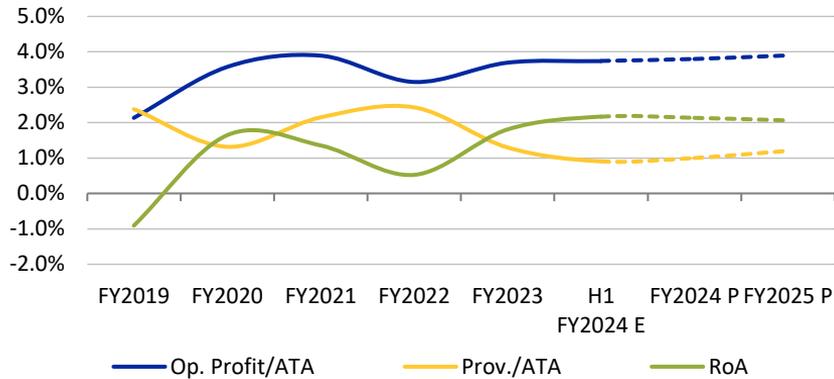


- The gradual improvement in borrowers' cash flows, which led to recoveries and sizeable write-offs, helped improve asset quality indicators in FY2023. The momentum continued in 9M FY2024, with SFBs registering a decline of around 30 bps and around 10 bps in GNPA and net NPAs (NNPAs), respectively.
- While there was an uptick in delinquencies in Q3 FY2024, ICRA estimates an overall reduction of 60-80 bps in the GNPA in FY2024, aided by some write-offs/sale to ARCs. Thereafter, ICRA expects the industry to report steady-state GNPA in the range of 1.8-2.2% in the near term.

Source: Financials/investor presentations of SFBs, ICRA Research; E – Estimated; P – Projected

Earnings to remain healthy with expected improvement in operating efficiency

EXHIBIT: Trend in SFBs' operating profit

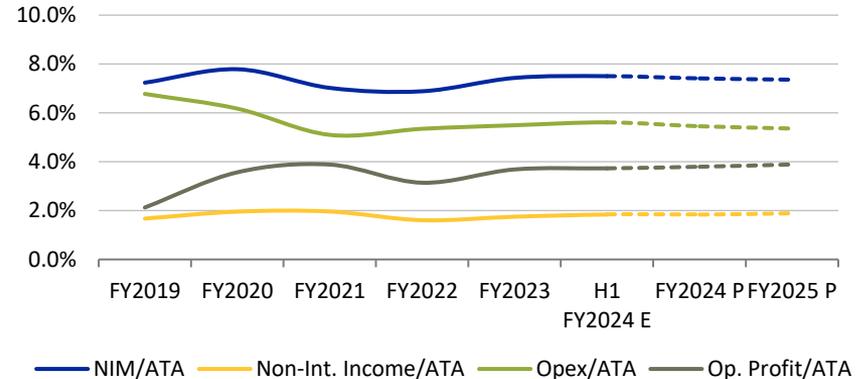


Source: Financials/investor presentations of various SFBs, ICRA Research; E – Estimated; P – Projected; Ratios for H1 FY2024 are annualised

- Buoyant demand and steady expansion by SFBs across geographies
- Increasing product offerings
- Benign credit costs on the back of improving asset quality



EXHIBIT: Trend in SFBs' key earnings parameters



Source: Financials/investor presentations of various SFBs, ICRA Research; E – Estimated; P – Projected; Ratios for H1 FY2024 are annualised



- Slowdown in deposit traction and build-up of a stable current account savings account (CASA) franchise
- Margin pressure amid rising cost of funds
- Unfavourable regulatory developments



SFB Sector Outlook

ICRA carries a Stable outlook on the sector as it expects healthy growth and profitability in FY2025

Outlook - Stable

AUM Growth	Asset Quality	Funding and Liquidity	Profitability	Capital
				
<p>CAGR of 22-25%</p> <p>Driven by buoyant credit demand and product diversification by small finance banks (SFBs), ICRA expects a portfolio growth of 22-25% during FY2024-FY2025</p>	<p>GNPA – 1.8-2.2% by March 2025</p> <p>Reported asset quality continues to improve driven by write-offs, recoveries and sales to ARCs. SFBs expected to report steady-state GNPA in the range of 1.8-2.2% in the near term</p>	<p>Rs. 60,000-63,000 crore in FY2025</p> <p>Additional funding (including deposits) is required to support growth, apart from refinancing existing/maturing lines/deposits</p>	<p>RoA of 2.0-2.2% in FY2025</p> <p>Margins could witness modest pressure, but range-bound credit costs and better operating efficiency would support profitability in FY2025</p>	<p>Adequate</p> <p>No sizeable capital requirement, considering the growth outlook</p>



ICRA's Ratings in the Sector

List of ICRA-rated SFBs as on March 31, 2024

Name of the SFB	Issuer Rating	Long-term Rating	Outlook	Short-term Rating
Fincare Small Finance Bank Limited	[ICRA]A		No outlook; Rating on Watch with Positive Implications	
Jana Small Finance Bank Limited		[ICRA]A-	Stable	
Suryoday Small Finance Bank Limited		[ICRA]A	Stable	[ICRA]A1+
Unity Small Finance Bank Limited	[ICRA]A-		Stable	
Utkarsh Small Finance Bank Limited		[ICRA]A+	Stable	[ICRA]A1+

Source: ICRA Research



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