RBI Grants Licensing for Small Finance Banks: Notes for UPSC Current Affairs

It was announced by the Reserve Bank of India in September 2015 that it had granted an in-principle licence for small finance banks to ten applicants. The Reserve Bank of India's (RBI's) granting of licences for setting up small finance banks (SFBs) is a significant step towards extending formal finance access for enterprises now dependent on high-cost unorganised sector funding.

Objectives of the RBI initiative

The objectives of setting up of small finance banks are as follows:

(a) To further the aim of financial inclusion by providing an avenue of savings for the general masses

(b)To ensure the supply of credit for small business units, small and marginal farmers,micro and small industries; and other unorganised sector entities is maintained.

What are Small Finance Banks (SFBs)?

Small finance banks are a type of niche banks common in India. These small finance banks with the approved licences, can provide basic banking services such as acceptance of deposits and lending to those sections of the Indian economy not serviced by mainstream nationalised banks. These sections include small business units, small and marginal farmers, micro and small industries and unorganised sector entities.

A brief summary of the regulations involving SFBs are highlighted below:

- Existing non-banking financial companies (NBFC), microfinance institutions (MFI) and local area banks (LAB) can apply to become small finance banks.
- They can be promoted either by individuals, corporate, trusts or societies.
- They are established as public limited companies in the private sector under the Companies Act, 2013.
- They are governed by the provisions of Reserve Bank of India Act, 1934, Banking Regulation Act, 1949 and other relevant statutes.
- The banks will not be restricted to any region.
- They were set up with the twin objectives of providing an institutional mechanism for promoting rural and semi urban savings and for providing credit for viable economic activities in the local areas.

- The promoters should have 10 years' experience in banking and finance. The promoters stake in the paid-up equity capital will be at least 40% initially but must be brought down to 26% in 12 years. Joint ventures are not permitted. Foreign shareholding will be allowed in these banks as per the rules for Foreign Direct Investment (FDI) in private banks in India.
- At net worth of ₹500 crore, listing will be mandatory within three years. Small finance banks having net worth of below ₹500 crore could also get their shares listed voluntarily

Key takeaways of the RBI Initiative

- The SFBs are expected to focus primarily on accepting deposits and lending to small business units, small and marginal farmers, micro and small industries and other unorganised sector entities, currently underserved by regular commercial banks.
- The key takeaway of this move is the RBI's efforts to promote niche banking. Commercial banks are largely interested in funding large and medium corporations, or giving out loans for home and vehicle purchases. On the other hand, it is not easy for diamond cutting and polishing units, job work fabricators or small restaurant owners to get working capital finance support. Lending to them is a specialised affair, just as gold financing is.
- These are segments where regular banks have gradually withdrawn, with their place being partly taken by various non-banking financial companies. SFBs can probably do even better in filling the gap. The entities that have been given licences are mainly microfinance institutions that have already reached out to remote hinterlands. Currently, they are mainly on-lending funds from banks, which work out to be rather costly for the ultimate small borrowers. As a result, there were little to no regulations regarding these institutions for a time and this initiative aims to fix that.
- Becoming SFBs will allow them to directly take deposits, which will bring down their cost of funds and translate into lower interest rates for clients. Regional rural and urban cooperative banks ought to have performed this role, which they clearly haven't — not least due to political interference and being weighed down by high fixed costs.
- The SFBs may be in a better position to exploit the huge business opportunity in funding small and medium enterprises. The RBI expects them to be high technology-low cost operators, while also bringing in innovations in service delivery.
- It is heartening to see the RBI change its conservative image, which ensured that till early 2014, only 12 new bank licences had been awarded since the economic reforms of 1991, that brought about the era of liberalisation in the Indian economy. India needs a more dynamic and flexible banking system. The SFBs and payments banks are a good initiative in that direction. Extending the formal banking system's reach will also ensure better monetary transmission, important for the effectiveness of the RBI's own interest rate policy actions.