

## AN EMPIRICAL ANALYSIS OF SMALL FINANCE BANKS PERFORMANCE IN INDIA

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### Abstract

With an emphasis on profitability, asset quality, financial inclusion, and operational efficiency, this study attempts to conduct an empirical analysis of the performance of Small Finance Banks (SFBs) in India. We use both descriptive and inferential statistics to assess the relative performance of a subset of SFBs using secondary data from the Reserve Bank of India (RBI), SFB financial statements, and industry reports from FY 2018 to FY 2023. Panel data regression and t-tests are used to test hypotheses. Although SFBs have demonstrated encouraging development in financial inclusion and loan portfolio diversification, the report concludes that issues with asset quality and profitability still exist.

**Key words:** Performance, small finance banks, development, banking system

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### Introduction:

The Reserve Bank of India (RBI) established Small Finance Banks (SFBs), a type of speciality bank, with the intention of advancing financial inclusion. Small business units, small and marginal farmers, micro and small industries, and unorganised sector organisations are among the underserved and unbanked segments of society that these banks are intended to assist. In response to the Nachiket Mor Committee on Financial Inclusion's recommendations, the RBI initially put up the idea of SFBs in its 2014 "Guidelines for Licensing of Small Finance Banks in the Private Sector."

SFBs function as full-fledged banks with a more focused mission than universal commercial banks, and they are licensed under Section 22 of the Banking Regulation Act, 1949. They must make sure that at least 50% of their loan portfolio is made up of loans up to ₹25 lakh, and they must provide at least 75% of their adjusted net bank credit to the priority sectors. Their lending activities are kept concentrated on small-ticket loans and financially vulnerable groups because to this regulatory environment.

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Increasing access to fundamental banking services including savings accounts, fixed deposits, and remittance facilities in rural and semi-urban areas is one of SFBs' main goals. They are also essential in providing credit to clients who are typically shut out of traditional banking services. They are not permitted to do sophisticated financial services like trading in derivatives or issuing credit cards, but they are permitted to perform nearly all fundamental banking operations, such as taking deposits and making loans.

These banks have increased their presence throughout India since the first group of SFBs was introduced in 2016, which included well-known brands like AU Small Finance Bank, Equitas Small Finance Bank, and Ujjivan Small Finance Bank. They have shown creative ways to handle banking, frequently using technology to lower expenses and improve customer service.

Hence, small finance banks play a crucial role in India's financial system by establishing a link between the country's formal banking establishments and its economically marginalised communities. These banks play an important role in reducing poverty, fostering entrepreneurship, and promoting economic empowerment at the local level by emphasising inclusive growth.

## Review of Literature

The Reserve Bank of India (RBI) launched Small Finance Banks (SFBs) in 2015 with the goal of advancing financial inclusion by offering basic banking services to underserved groups such micro and small businesses, small and marginal farmers, and unorganised sector organisations. The financial performance of SFBs in their brief history of operation has been examined in a number of studies, with an emphasis on profitability, asset quality, operational effectiveness, and growth sustainability.

SFBs have demonstrated encouraging early performance, with consistent increase in advances and deposits (Patel and Shah, 2021). Due to higher lending rates in the microcredit industry, their study shows that return on assets (ROA) and net interest margins (NIMs) are comparatively high when compared to typical banks. However, high operating expenses and the requirement for intense customer service models continue to limit profitability.

In their comparative study of SFBs and regional rural banks (RRBs), Gupta and Roy (2022)

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discovered that SFBs have greater loan portfolio diversification and better cost-to-income ratios. Their results imply that although SFBs are more technologically advanced and nimble, their substantial exposure to borrowers from the unorganised sector exposes them to higher asset quality concerns, particularly during economic downturns.

Although the RBI's Financial Stability Report (2023) observes a sharp increase in Gross Non-Performing Assets (GNPA) for certain players, it also recognises the resilience of SFBs throughout the COVID-19 epidemic. Sharma (2023), who links increased non-performing assets (NPAs) to disturbances in borrower cash flows and suggests strong credit evaluation and monitoring systems, supports this.

Mehta (2020) points out that one of the main issues facing SFBs is their small capital base, which limits their capacity to grow and withstand financial shocks. The literature has also underlined the necessity of legislative evolution to support long-term sustainability, such as facilitating the shift to universal bank status.

In general, the research currently in publication expresses cautious optimism about the financial performance of SFBs. Although they have achieved impressive strides in expanding financial access and increasing margins, maintaining sustainability requires controlling credit risk, increasing operational effectiveness, and strengthening institutional capacity.

## Objectives

- To assess the financial performance of SFBs in terms of profitability, efficiency, and asset quality.
- To evaluate their role in advancing financial inclusion.
- To identify trends and challenges in their performance.

## Hypotheses

**H1:** There is a significant impact of operational efficiency on profitability (ROA, ROE).

**H2:** Asset quality (GNPA ratio) has a negative correlation with profitability.

**H3:** There is a significant difference in performance indicators of SFBs before and after the COVID-19 pandemic.

**H4:** CASA ratio positively affects net interest margin (NIM).

## Research Methodology

### *Data:*

The present study depends on the secondary data. The data for the study has been obtained from various published sources such as banks annual reports, journal, magazines and other relevant sources. The specific sources are as follows:

- RBI Annual Reports
- Financial Statements of 6 selected SFBs: AU SFB, Equitas SFB, Ujjivan SFB, Suryoday SFB, ESAF SFB, and Jana SFB
- CRISIL and CARE Ratings

### *Sample and Sampling:*

The study has been followed purposive sampling technique for the data collection. In total six listed small finance banks have been considered for the study.

SI No	Bank Name
1	Janalakshmi Financial Services Pvt Ltd (Jana Small Finance Bank)
2	AU Financiers India Ltd (AU Small Finance Bank)
3	ESAF Microfinance (ESAF Small Finance Bank)
4	Suryoday Microfinance Private Ltd (Suryoday Small Finance Bank)
5	Equitas Holdings Private Ltd (Equitas Small Finance Bank)
6	Ujjivan Financial Services Private Ltd (Ujjivan Small Finance Bank)

### **Period of Study**

FY 2018–FY 2023

### *Tools for Data analysis:*

The study has been depends on various statistical tools to satisfy its objectives. Basically the study relied upon Descriptive Statistics, Correlation Matrix, Panel Data Regression i.e.,(Fixed Effects) Paired Sample t-test for pre- and post-pandemic comparison.

**Panel Regression Model:**

$$ROA = \beta_0 + \beta_1(BS) + \beta_2(LPM) + \beta_3(CASAR) + \beta_4(NII) + \varepsilon$$

**Variables**

- **Dependent Variables:** ROA,
- **Independent Variables:** Bank Size (BS), Loan Portfolio Mix(LPM), CASA Ratio(CASAR), Non-Interest Income(NII)

**Data Analysis and Results****5.1 Descriptive Statistics**

<b>Bank</b>	<b>ROA (%)</b>	<b>BS</b>	<b>LPM</b>	<b>CASAR</b>	<b>NII</b>
AU SFB	1.8	15.2	1.5	5.9	45.3
Equitas SFB	1.4	12.5	2.2	7.1	52.1
Ujjivan SFB	2.1	18.0	3.1	9.2	49.7
Suryoday SFB	-0.8	-6.2	6.7	7.8	61.2
ESAF SFB	1.2	11.8	3.8	8.3	54.9
Jana SFB	0.6	6.0	4.5	8.7	57.6

The above table shows the descriptive statistics of the sample banks. As the table depicts Ujjivan small finance banks has highest ROA followed by AU small finance bank and Equitas small finance bank. However, Suryoday SFB has negative performance. Further, the table also shows that in terms of banks size Ujjivan stands larger in the SFB sector in the country followed by AU SFB and Equitas SFB. This clearly shows the sample SFBs are in better profit except Suryoday SFB.

### Correlation Matrix

Variable	ROA	BS	LPM	CASAR	NII
ROA	1	0.87	-0.61	0.65	0.58
BS	0.87	1	-0.69	0.72	0.55
LPM	-0.61	-0.69	1	-0.46	-0.52
CASAR	0.65	0.72	-0.46	1	0.67
NII	0.58	0.55	-0.52	0.67	1

In the above tables the results of pearson correlation has been presented. As the result shows ROA has positive correlations with all other variables except GNPA. It has higher correlation with Bank size followed by LPM and CASAR. However, there are no evidences of multicollinearity in the results.

### Panel Regression Results

Adjusted R<sup>2</sup>: 0.68

Variable	Coefficient	Std. Error	p-value
Intercept	0.015	0.004	0.001
BS	0.007	0.002	0.003
LPM	0.018	0.005	0.000
CASAR	0.012	0.003	0.002
NII	0.04	0.002	0.003

In the above table the results of panel regression has been presented. The independent variable is financial performance, particularly we applied ROA with the banks size, Loan Portfolio Mix, CASA Ratio and Non-Interest Income are the independent variables. The adjusted R<sup>2</sup> is 0.68 this reveals the independent variables largely influence on the dependent variable. A unit change in the independent variable leads to 0.68 unit change in the in the dependent variable. However, the beta coefficients shows all the independent variables

significantly influence on the dependent variable. Hence, it can be interpreted that, Asset quality and operational efficiency significantly affect profitability.

### Paired t-test (Pre vs Post-COVID ROA)

Metric	Mean (Pre)	Mean (Post)	t-Value	p-Value
ROA	1.56%	1.12%	2.92	0.011

To examine whether is there any change significant change in the financial performance in pre and post covid-19 Paired sample t-test has been conducted. As the results shows significant decline in ROA post-COVID-19.

### Findings

- **Profitability** is highest for AU, SFB and Ujjivan SFB, largely driven by diversified product offerings.
- **Asset quality** is a persistent challenge, especially for Suryoday and Jana SFBs.
- **NIMs** are relatively high across the board, indicating higher lending rates, possibly reflecting credit risk.
- **Operational efficiency** significantly influences performance metrics.

### Conclusion and suggestions

There are large number of initiatives by the central and state governments to bring everyone under the umbrella of financial inclusion. Small finance banking is part of such initiation. Though there is a surge in the number of small finance banks in Indian economy their performance is still a matter of debate. The present study made an attempt to examine the impact asset quality on the financial performance. The results of the study indicate the asset quality significantly influence on the financial performance of the SFBs. Hence, based on the findings of the study it can be concluded that the asset quality has significant impact on the financial performances of SFBs in India.

### Suggestions

1. Strengthen credit risk assessment mechanisms.

2. Leverage technology for cost reduction.
3. Diversify income sources beyond interest income.
4. Increase CASA deposits for more stable funding.

### Limitations and Future Scope

- Study limited to 6 SFBs due to data availability.
- Future research could incorporate customer satisfaction and impact assessment at the grassroots level.

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