

Tracking Performance of Small Finance Banks against Financial Inclusion Goals

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November 2019

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1. Introduction

In this report, we review a new type of bank, a variation of the universal bank, called the Small Finance Bank (SFB) which was introduced in 2015 with the Reserve Bank of India (RBI) issuing in-principle approvals to ten financial services providers. SFBs are authorised to perform all the banking functions – payments, accepting deposits and lending. This makes them functionally identical to universal banks. However, given the SFBs' financial inclusion focus, there are essential differences brought about by the business-model-level regulatory prescriptions of the RBI. The requirement for fulfilling priority sector lending is higher for SFBs – at 75% of its Adjusted Net Bank Credit (ANBC) compared to the 40% for the universal banks. Also, to benefit small borrowers, SFBs have a restriction on their loan portfolio that requires 50% of the portfolio to be comprised of loans and advances of up to Rs. 25 lakhs. Additionally, there are some differences in prudential requirements as well for SFBs. The minimum paid-up equity capital for SFBs is Rs. 100 Cr, one-fifth of the requirement for universal banks. The minimum capital requirement for SFBs is set at 15%, higher than the 9% prescribed for universal banks. As of August 2019, all of the ten applicants who had received the in-principle approval had converted to SFBs and are continuing operations.¹ Shown below is the timeline of when the license was issued and the various operational starting points of the SFBs.²



Figure 1: Timeline of SFBs' Operations in India

Source – Annual Reports

Before looking into the specifics of the SFB business model, it is essential to understand the model's origins and its link to the microfinance industry. The portfolio outstanding in the microfinance industry as of June 2019 was around Rs. 1.9 lakh crore. This outstanding amount includes lending by all groups – banks, Non-Banking Financial Companies (NBFCs) and Microfinance Institutions (MFIs). The ten SFBs contributed 17% of this amount³ as eight of the ten SFBs were previously NBFC-MFIs. Therefore, the

¹ These ten SFBs are: 1) Au Small Finance Bank Limited 2) Capital Small Finance Bank Limited 3) FINCARE Small Finance Bank Limited 4) Equitas Small Finance Bank Limited 5) ESAF Small Finance Bank Limited 6) Suryoday Small Finance Bank Limited 7) Ujjivan Small Finance Bank Limited 8) Utkarsh Small Finance Bank Limited 9) North East Small Finance Bank Limited and 10) Jana Small Finance Bank Limited, hereby referred to in this note as Au, Capital, Fincare, Equitas, ESAF, Suryoday, Ujjivan, Utkarsh, North East and Jana respectively.

² Jana is the newest SFB, having begun its operations in March 2018; its FY2019 annual report is yet to be published. Hence, most of the ensuing analyses and discussion omit Jana as a datapoint.

³ Section I: Microfinance Industry, Micrometer Issue 30 – June 2019, MFIN. Available at: <http://mfinindia.org/latest-news/micrometer-issue-30-data-as-on-30-june-2019/>

contributing share (in terms of overall microfinance portfolio) of the NBFC-MFI segment has reduced over the years as the eight converted ones were among the largest of the NBFC-MFIs. Over the years, these microfinance institutions have grown to become major suppliers of financial services, especially microcredit, to low-income households. SFBs, with their considerable experience in dealing with low-income-household clientele, are envisaged by the RBI to advance the financial inclusion mandate in India appreciably.

2. Objectives

As stated in the RBI's guidelines for licensing of SFBs in the private sector⁴, the objective of SFBs is to 'further financial inclusion by setting up savings vehicles to the unserved and underserved, and providing credit to small business units; small and marginal farmers; micro and small industries; and other unorganised sector entities'.

SFBs need to engender financial inclusion without compromising on either financial stability of the system or sustainability of the business. At Dvara Research, we are interested in measuring the progress made by SFBs towards achieving this stated goal while also tracking the performance of the SFB business model in becoming commercially sustainable.

Given the objectives of SFBs, tracking their performance would mean not only looking at the conventional banking measures such as financial ratios, customer base, banking network and so on, but also at other metrics such as relevance of products for excluded segments, affordability of the products provided, segment of customers served and so on, to see whether the SFBs are meeting the above-stated objectives. These following sections provide a discussion on the performance of SFBs so far against them.

3. Product Portfolio

3.1. Loans

The applicants for the SFB license were organisations engaged mainly in providing microfinance – with most of them being NBFC-MFIs, the one exception being a Local Area Bank (Capital) (see [Annexure 1](#)). We see in Figure 2 below that the range of the balance sheet sizes⁵ of the companies is quite large with the biggest SFB, Au, having a balance sheet size of Rs. 18,833 Cr and the smallest SFB, North East, a balance sheet size of Rs. 1550 Cr (for Financial Year (FY) ending March 2018⁶). Figure 2 also shows the growth rates of balance sheet sizes for each of the SFBs. At an overall growth rate of 55% in balance sheet size, SFBs grew at a much faster pace in FY 2018 as compared to the consolidated Scheduled Commercial Banks' (SCB)⁷ growth rate of about 8%.⁸

⁴ Guidelines for Licensing of Small Finance Banks in the Private Sector, RBI Circular – Feb 22, 2013. Available at: https://www.rbi.org.in/scripts/bs_viewcontent.aspx?id=2901

⁵ Balance sheet size of a bank = Total assets = Total liabilities + total equity

⁶ Hereby in this report, dates of the format 'FY 201x' should be taken to mean the financial year ending March 201x

⁷ As of March 2018, Equitas, Capital, Ujjivan, Suryoday, Au and Utkarsh were given scheduled bank status. Hence the consolidated SCBs' growth rate includes these banks as well.

⁸ Calculated from Table 57: Consolidated Balance Sheet of Scheduled Commercial Banks, Handbook of Statistics on Indian Economy 2018-19. Available at: https://rbi docs.rbi.org.in/rdocs/Publications/PDFs/57T_HB150920190C620F81CE5040FDA9AC4B3E7DFBDD35.PDF

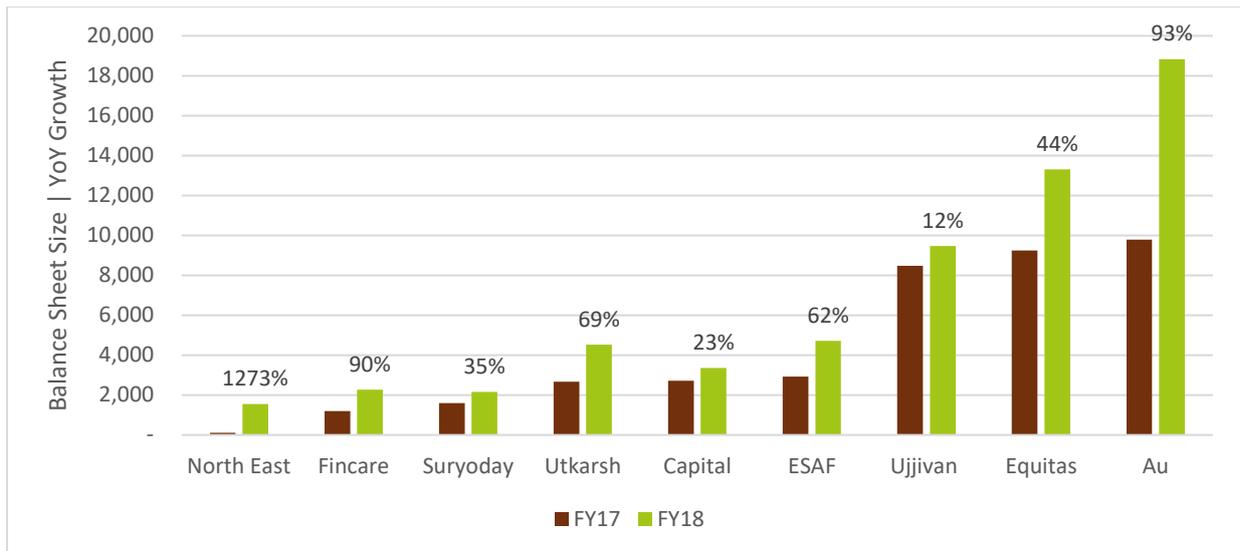


Figure 2: Balance Sheet Sizes of SFBs
Source – Financial Statements from Banks' Annual Reports

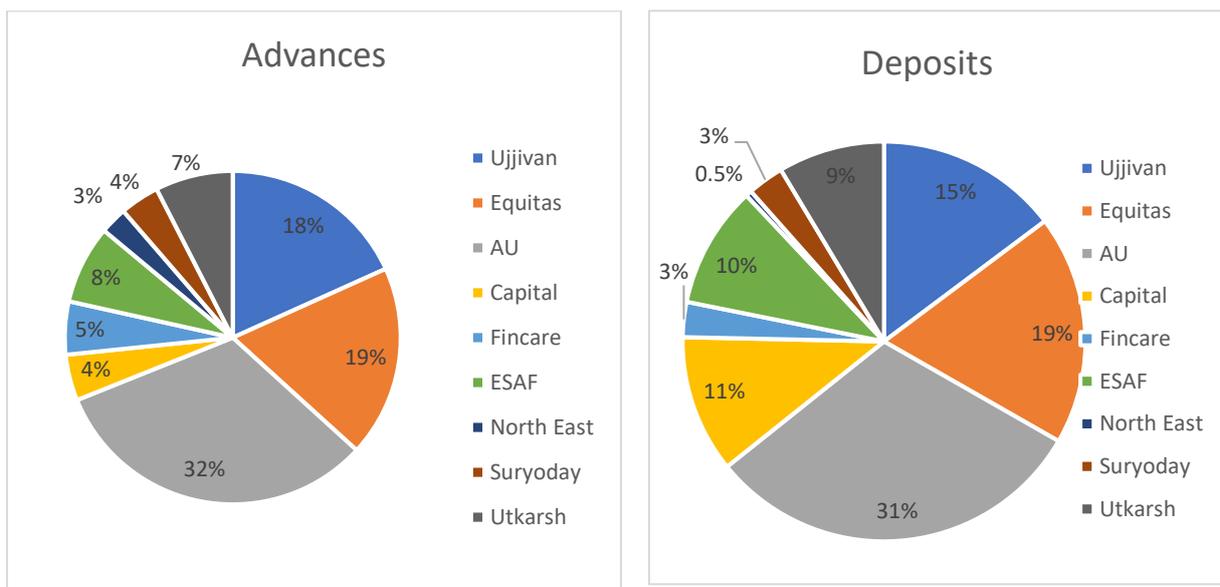


Figure 3: Shares of Advances & Deposits⁹ of SFBs for FY 2018
Source – Financial Statements from Banks' Annual Reports

The lending portfolios of these institutions before their conversion to an SFB were predominantly in microfinance. The qualifying microfinance loan is defined by the RBI¹⁰ and is based on criteria such as limits on the income of the borrower, amount of loan, tenure of the loan, and so on (see [Annexure 2](#)). Post conversion, we see the SFBs diversifying their lending portfolios by offering products such as MSME loans, housing loans, and vehicle loans. Shown below are trends in loan portfolios of the five

⁹ Deposits include demand deposits, including savings and current account deposits, as well as term deposits.

¹⁰Master Circular- 'Non-Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs) – Directions, RBI Master Circular, Issued July 1, 2015 (Updated April 20, 2016). Available at: https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9827#2

SFBs which reported the microfinance¹¹ component of their portfolio over the last two years of operations (until FY ending March 2018).

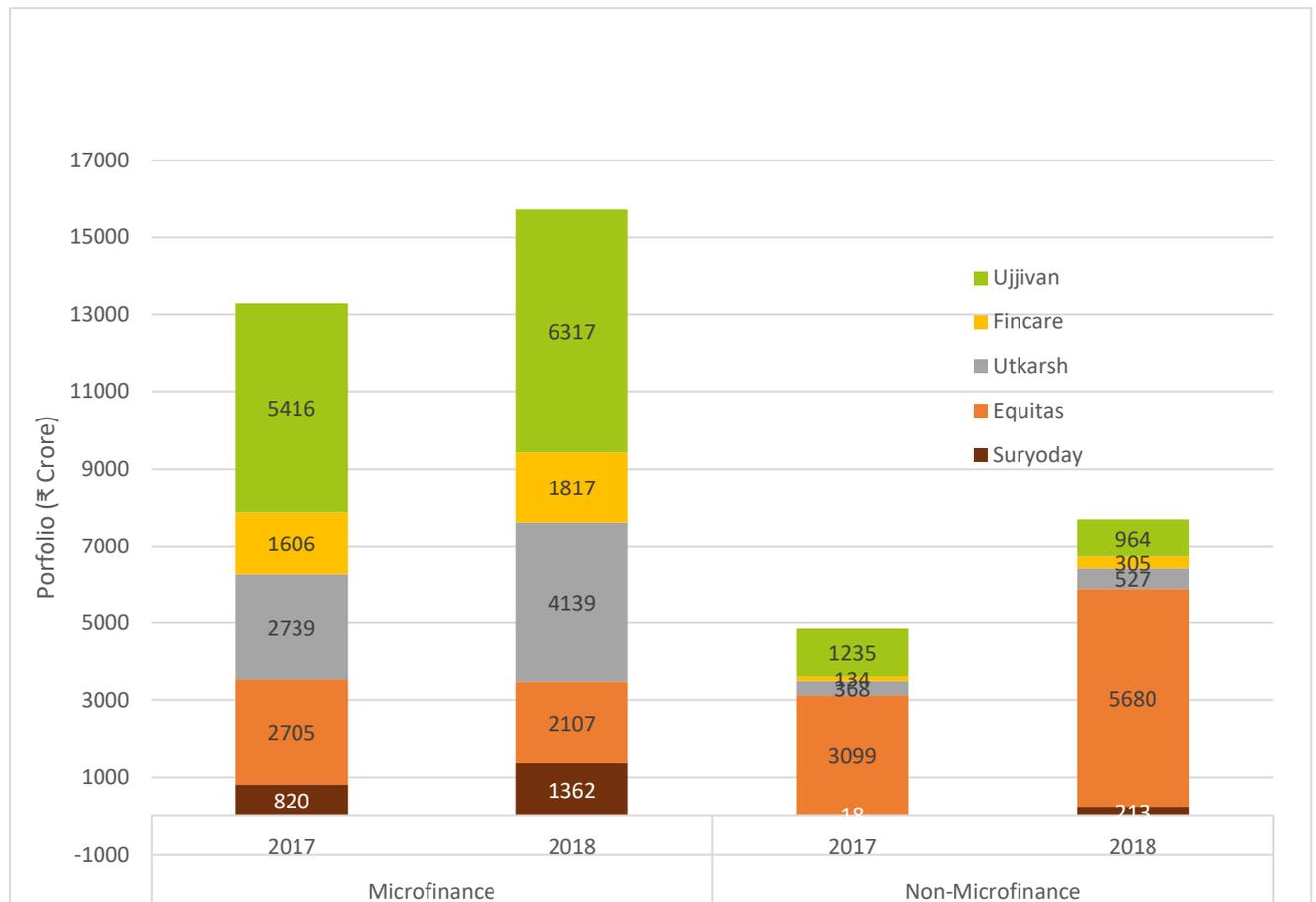


Figure 4: Trends in Microfinance and non-microfinance portfolios of five SFBs
Source – Banks' Annual Reports

Overall, the share of microfinance to non-microfinance loans in these SFBs' loan portfolios did not change drastically and has been in the range of 98% - 81%, except in the case of Equitas, whose proportion fell from 47% to 27%. Equitas' non-microfinance segment grew (by about 83%) to occupy what is now a majority share of about 74% (as of March 2018) of the total quantum of non-microfinance lending of the five SFBs. The remaining banks too showed considerable growth in their non-Microfinance sector portfolio.

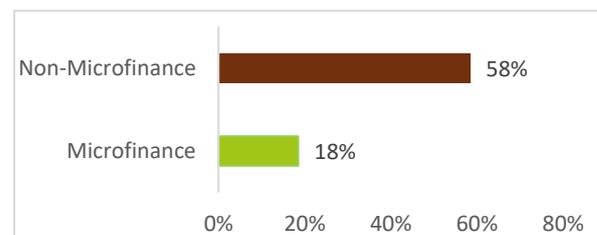


Figure 5: Growth in Microfinance and non-Microfinance portfolios from FY 17 to FY 18
Source – Banks' Annual Reports

¹¹ Note – The microfinance component is self-reported. Definitions across banks may vary.

Box 1: Equitas' Distinctive Origins

Equitas Small Finance Bank stands out as a unique case due to the structure of its formation. RBI's guidelines state that an NBFC/MFI/LAB converting into an SFB will cease to exist after conversion and all their businesses that a bank can undertake must fold into the SFB. And the activities which a bank cannot statutorily undertake are to be divested / disposed of. In case of Equitas, at the time of converting to an SFB, two wholly-owned subsidiaries of Equitas Holdings - Equitas Microfinance Limited (EML) and Equitas Housing Limited (EHL) were merged with another of its subsidiaries, Equitas Finance Limited (EFL), and EFL's name was changed to Equitas SFB. Prior to conversion, each of these subsidiaries had specialised portfolios. For example, EML provided microloans to people from the low-income group, EFL engaged in used commercial vehicle finance, and micro and small enterprise loans and EHL provided micro housing and affordable housing loans. Due to the merger of these three different units, the combined portfolio of Equitas SFB was effectively a diversified one. In contrast, the remaining SFBs were formed either by directly converting to a bank or by forming a subsidiary; thus their current portfolios directly reflect that of their erstwhile microfinance entities.

Apart from the microfinance segment, all the SFBs are now engaged in providing MSME loans, and most of them are engaged in providing housing and other non-microfinance loans.¹² The MSME segment as a whole is not targeted by all the SFBs; there is differential focus based on the categories of MSMEs: Micro, Small and Medium Enterprises.¹³ Ujjivan and Equitas have been focussing on MSE (Micro and Small Enterprises) lending whereas Au, the largest SFB by size, has been focussing on SME (Small

and Medium Enterprises) lending. Figure 6 shows the share of the three SFBs, which disclosed the proportions of their MSME lending to their total portfolios.

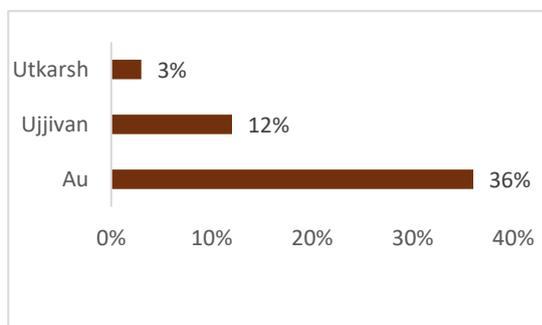


Figure 6: Share of MSME Lending to Total Loan Portfolio

Source - Banks' annual reports

While Au has a relatively large share of MSME lending, most of it is secured lending to the SMEs with only 0.21% of the total lending portfolio going towards SMEs engaged in agriculture.¹⁴ The MSME lending portfolios of most of these SFBs are structured to offer loans to micro-enterprises as well as loans against property to bigger enterprises.

Gold loans and vehicle loans too feature among the new products being offered by all the SFBs since conversion, with the objective of portfolio diversification. However, the SFBs have focussed on their legacy lending strengths, such as Au on vehicle

finance, Capital on Agri to illustrate a few. On the other hand, there are banks like Suryoday, which are new to the non-microfinance segment and would need to work towards developing strength in a new product segment.¹⁵ Moreover, we see that Au, Fincare and Utkarsh have moved towards wholesale lending – lending to other lending institutions such as NBFCs, MFIs, Alternate Finance

¹² Gathered from the SFBs' annual reports

¹³ The definition of MSMEs is on the basis of investment in plant & machinery. The limits are different depending on whether the MSME is a manufacturing or a service unit. *MSMED Act 2006*s.7(1)

¹⁴ Gathered from Au's FY 2018 annual report

¹⁵ Gathered from the SFBs' annual reports

Companies (AFCs) and others.¹⁶ Now that the erstwhile microfinance organisations are functioning as full-service banks, diversification as a strategy has been observed across all the SFBs as an important step to take.

We see in Figures 7 and 8, the geographical¹⁷ distribution of the number of credit accounts and the amount of credit outstanding.

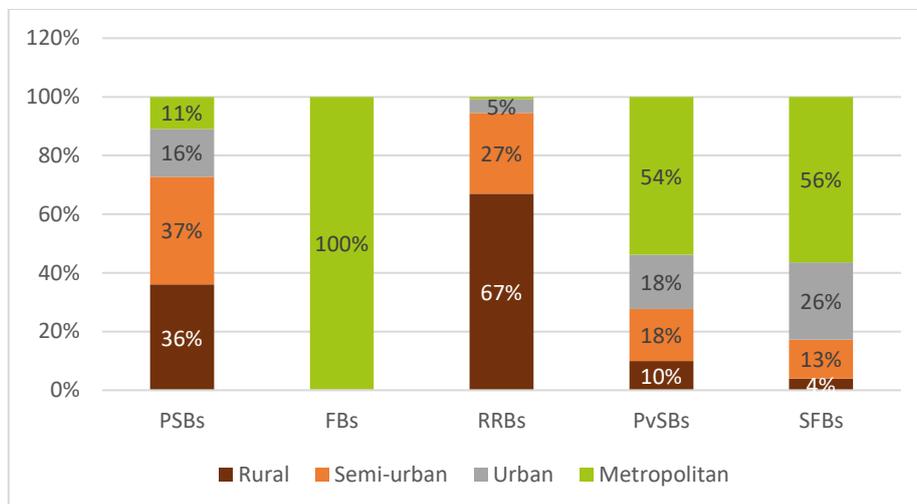


Figure 7: Geographic Spread of Number of Credit Accounts of Bank Groups – March 2018
Source – RBI DBIE¹⁸

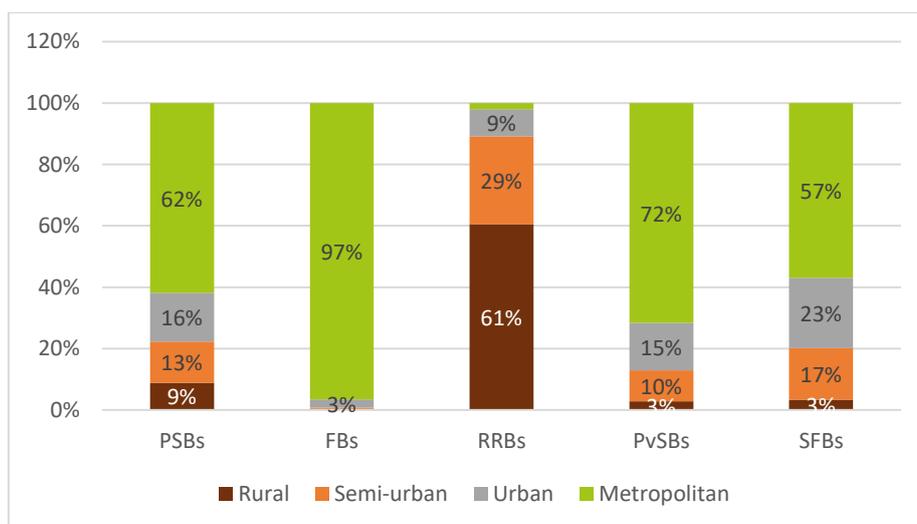


Figure 8: Geographic Spread of Credit Outstanding Amount of Bank Groups – March 2018
Source – RBI DBIE¹⁹

¹⁶ Gathered from the SFBs' annual reports

¹⁷ While this categorisation is strictly not geographic but is instead driven by population sizes of each centre, we use the word 'geographic' to describe the spread of any metric across regions with varying population densities. This is because we do not have a more granular metric that can track geographical spread. However, we can conclude that the more sparsely populated regions are certainly the more difficult centres to serve.

¹⁸ Table No 2.1 Population Group and Bank Group-wise Deposits and Credit (total credit and credit of small borrowal accounts) of SCBs, Basic Statistical Returns of Scheduled Commercial Banks in India – March 2018, RBI Database on Indian Economy. Available at: <https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications>

¹⁹ ibid

We see that both in terms of the number of accounts and amount of credit, the SFBs' focus has been away from the rural and semi-urban areas²⁰, with these areas accounting for less than 20% in both aspects. Therefore, we see that despite the SFBs being former microfinance focussed institutions, they do not have an exclusive or significant rural focus. However, this interpretation must be taken with a pinch of salt, considering that the disaggregated data for SFBs is not available. It may be the case that one or two large urban focussed SFBs may be skewing the data, especially as four of the SFBs²¹ had still not received scheduled bank status at the point of data, thus supplying an incomplete picture.

3.2. Deposits

As most of these banks converted from being non-deposit taking NBFCs, building up a deposit base is a significant task and a necessary one for lowering borrowing costs. The SFB deposit accounts offer higher interest rates compared to the remaining SCBs to attract retail depositors. Below is a comparison of interest rates offered by SFBs and select SCBs²² for their 1-year term deposit (Fixed Deposit) and their Savings Accounts.

Bank	Term Deposit	Bank	Term Deposit
NE	8.00%	SBI	6.40%
Fincare	8.00%	ICICI	6.45%
Utkarsh	8.50%	PNB	6.50%
Au	7.77%	HDFC	6.45%
Suryoday	8.35%	BOB	6.45%
Ujjivan	8.10%	IDBI	6.50%
ESAF	8.25%	Canara	6.50%
Equitas	8.00%	Axis	6.60%
Capital	7.40%	UBI	6.60%
Jana	8.50%	Yes	7.25%

Table 1: Comparison of Interest Rates on Term Deposit Accounts of SFBs and select SCBs²³

Note – Interest rates for 1-year tenures, amount < 2cr

²⁰ Population Groups are classified by RBI accordingly: Rural – up to 9,999; Semi-urban – 10,000 to 99,999; Urban – 1,00,000 – 9,99,999 and Metropolitan – above 10,00,000

²¹ ESAF, Fincare, Jana and North East are the four banks whose data has not been included in the graph

²² Five large banks, each in private sector and public sector have been selected for the sake of comparison of SFBs to universal banks.

²³ Sourced from various bank websites on 30 October 2019

Bank	Savings Account	Bank	Savings Account
NE	6.00%	SBI	3.25%
Fincare	6.00%	ICICI	3.50%
Utkarsh	7.00%	PNB	3.25%
Au	5.00%	HDFC	4.00%
Suryoday	6.25%	BOB	3.25%
Ujjivan	4.00%	IDBI	3.50%
ESAF	4.00%	Canara	3.25%
Equitas	5.00%	Axis	3.50%
Capital	4.00%	UBI	3.25%
Jana	5.00%	Yes	5.00%

Table 2: Comparison of Interest Rates on Savings Accounts of SFBs and select SCBs²⁴

Note – Interest rates for balances less than Rs. 1 lakh

Further information about deposits may be garnered by looking at the geographic spread of the deposits of the SFBs. Figures 9 and 10 look at the deposit amounts and the number of deposit accounts across population groups²⁵ – Rural, Semi-urban, Urban and Metropolitan. We see from the figures that unlike the RRBs, the SFBs do not have a markedly rural focus in their deposit strategy. A majority (62%) of the SFBs' deposit accounts come from semi-urban and urban groups. The SFBs' deposits pattern is closest to that of the Private Sector Banks (PvSB). News reports²⁶ indicate that some banks like Utkarsh, Ujjivan and Fincare have been looking to expand beyond their microfinance borrowers and into a semi-urban and urban clientele. Deposits data of 2019 and onwards will show a clearer picture if this emerging pattern continues to hold.

²⁴ ibid

²⁵ Population Groups are classified by RBI accordingly: Rural – up to 9,999; Semi-urban – 10,000 to 99,999; Urban – 1,00,000 – 9,99,999 and Metropolitan – above 10,00,000

²⁶ Acharya. N., (2017, October). Small finance banks on deposit mobilisation spree on 1st year of operation. *Business Standard*. Retrieved from: https://www.business-standard.com/article/finance/small-finance-banks-on-deposit-mobilisation-sprees-on-1st-year-of-operation-117100400547_1.html

Ghosh. S., (2018, December). Fincare SFB to woo urban customers to grow deposit base. *LiveMint*. Retrieved from: <https://www.livemint.com/Industry/KtnAWa8VIL53hjYdtPABvI/Fincare-SFB-bank-branches-interest-rates-deposit-rates.html>

Pani. P., (2019, May). Ujjivan Small finance Bank plans giant technological strides. *The Hindu Business Line*. Retrieved from: <https://www.thehindubusinessline.com/money-and-banking/ujjivan-small-finance-bank-plans-giant-technological-strides/article27393607.ece>

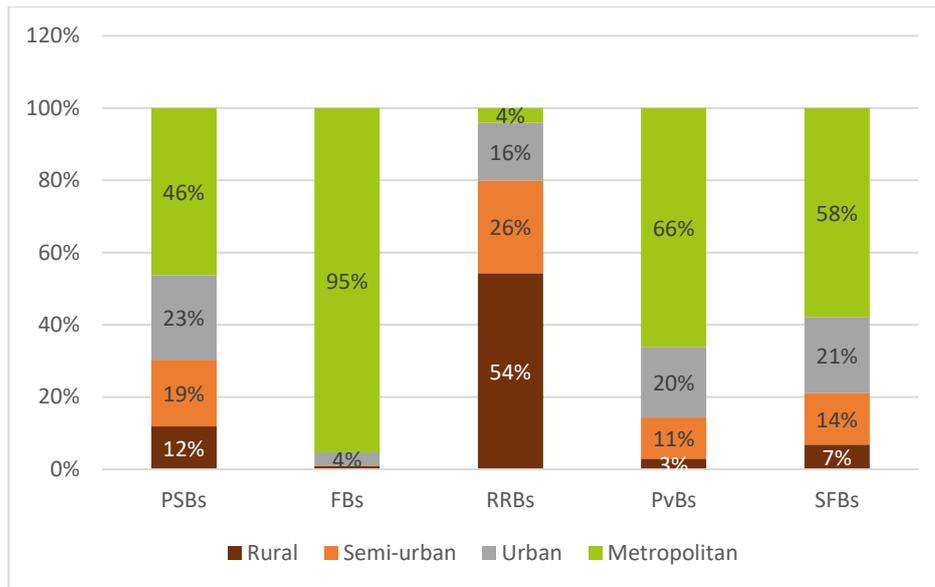


Figure 9: Geographic Spread of Deposit Amounts of Bank Groups – March 2018
Source: RBI DBIE²⁷

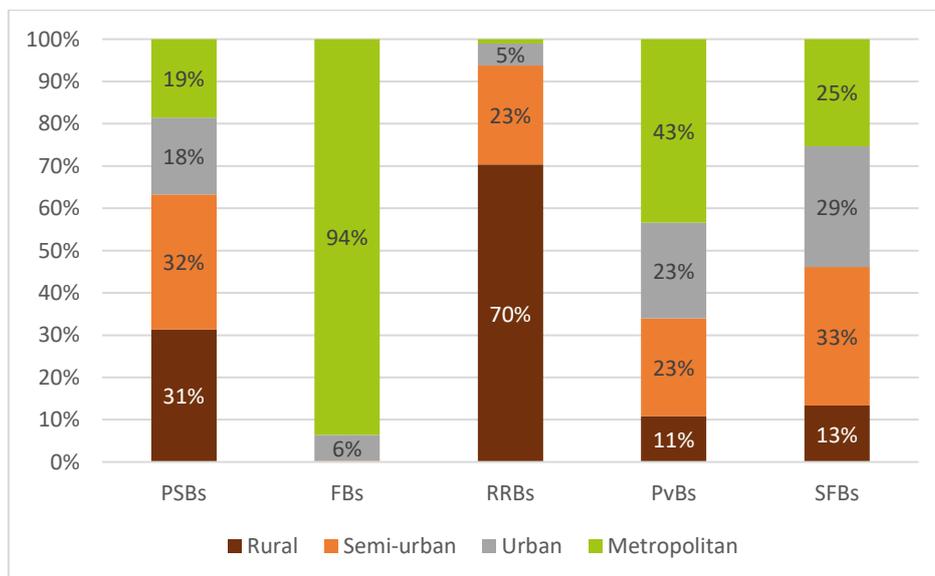


Figure 10: Geographic Spread of Number of Deposit Accounts of Bank Groups – March 2018
Source: RBI DBIE²⁸

²⁷ Table No 2.1 Population Group and Bank Group-wise Deposits and Credit (total credit and credit of small borrowal accounts) of SCBs, Basic Statistical Returns of Scheduled Commercial Banks in India – March 2018, RBI Database on Indian Economy. Available at: <https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications>

²⁸ Table No 2.1 Population Group and Bank Group-wise Deposits and Credit (total credit and credit of small borrowal accounts) of SCBs, Basic Statistical Returns of Scheduled Commercial Banks in India – March 2018, RBI Database on Indian Economy. Available at: <https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications>

3.3. Third-Party Products

Products offered by SFBs are not just limited to loans or deposits but also include distribution of third-party products such as insurance and mutual funds. Information on income obtained from the distribution of third-party products can be gleaned from the statement of profit and loss component, ‘commission and brokerage’. Shown below in Figures 11 and 12 are the ratios of ‘other income’, and ‘income from commission exchange and brokerage’ to their total income. In addition to the commission component, there are typically other components like profit/loss from sale or purchase of assets and miscellaneous income in ‘other income’. These values of other income and commission ratios for the SFBs are like those of other banks (see [Annexure 3](#)), demonstrating a level of engagement of SFBs in third-party products similar to that of universal banks. However, it is unclear whether the sale of third-party products was made to low-income clientele or not and whether this is driven by a board-driven strategy to focus on this clientele. The highest ratio here is that of Au, which has close to 13% of its total income coming from commission, exchange and brokerage.²⁹ Au’s considerable share of other income may be due to its large urban presence: 56%³⁰ of its bank branches are in Metropolitan and Urban areas³¹.

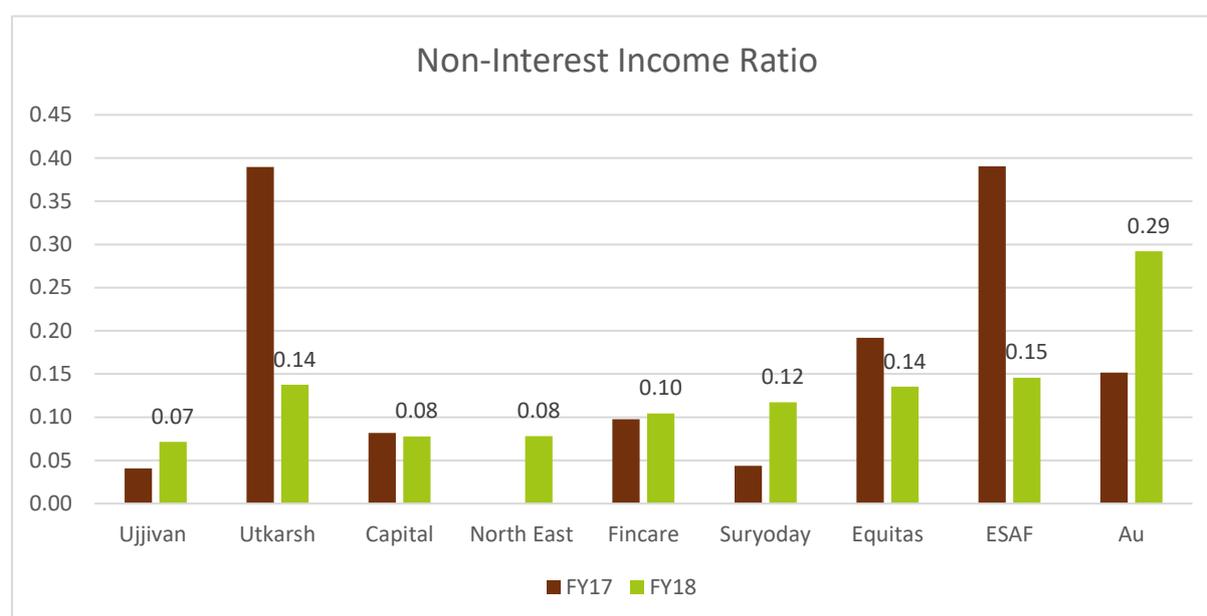


Figure 11: Ratios of Non-Interest income (Other Income) to Total Income of SFBs - FY 2017 & 2018

Source – Author’s calculations from financial statements³²

²⁹ Au’s third-party product franchise includes partnerships with 17 mutual funds, and three insurance companies to offer health insurance, life insurance and general insurance products.

³⁰ Calculated from Directory of Commercial Banks in India, RBI Database on Indian Economy – updated as of August 2019. Available at: <https://dbie.rbi.org.in/DBIE/MOFSelectParam.jsp>

³¹ Metropolitan and Urban are ‘Population Groups’ classified by RBI based on population numbers: Rural – up to 9,999; Semi-urban – 10,000 to 99,999; Urban – 1,00,000 – 9,99,999 and Metropolitan – above 10,00,000

³² Non-Interest Income Ratio = Other Income/ Total Income

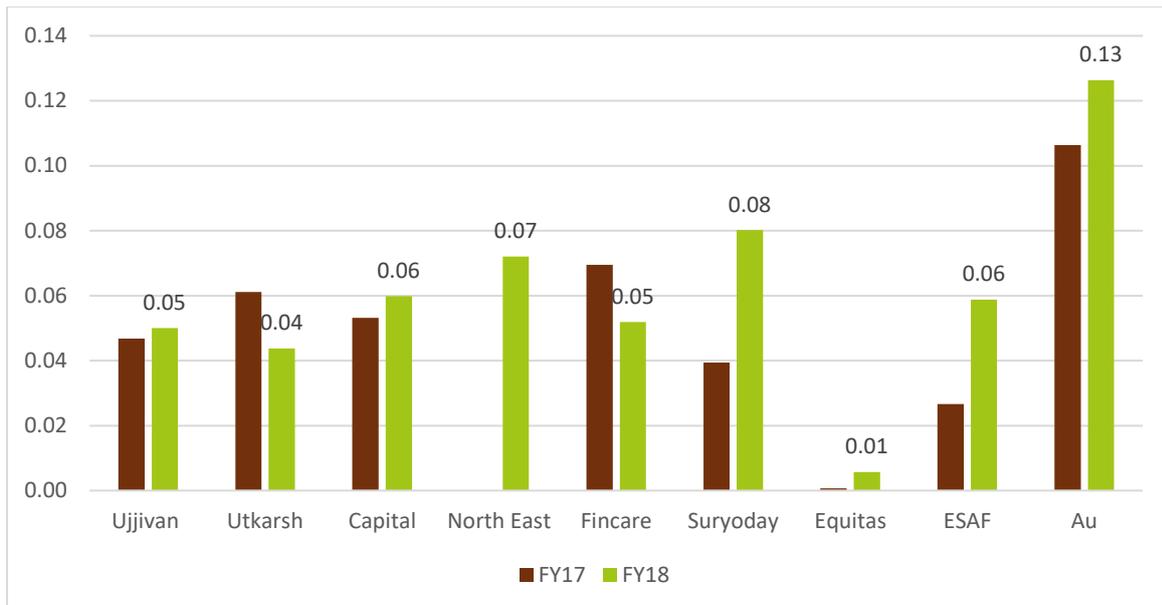


Figure 12: Ratios of Income from Commissions, Exchange & Brokerage to Total Income of SFBs - FY 2017 and 2018

Source – Author's calculations from financial statements

4. Deposits as a Source of Funding

Deposits for most of the SFBs are a new product offering, due to their former standing as NBFC-MFIs. This section looks at the nature of the SFBs' deposits, their role as a source of funding, and the nature of cost of funds for the SFBs. Seen below are the deposit amounts and the CASA ratios (Current Accounts and Savings Accounts ratio of a bank is the ratio of deposits in current and saving accounts to total deposits of the banks) for the financial year ending March 2018.

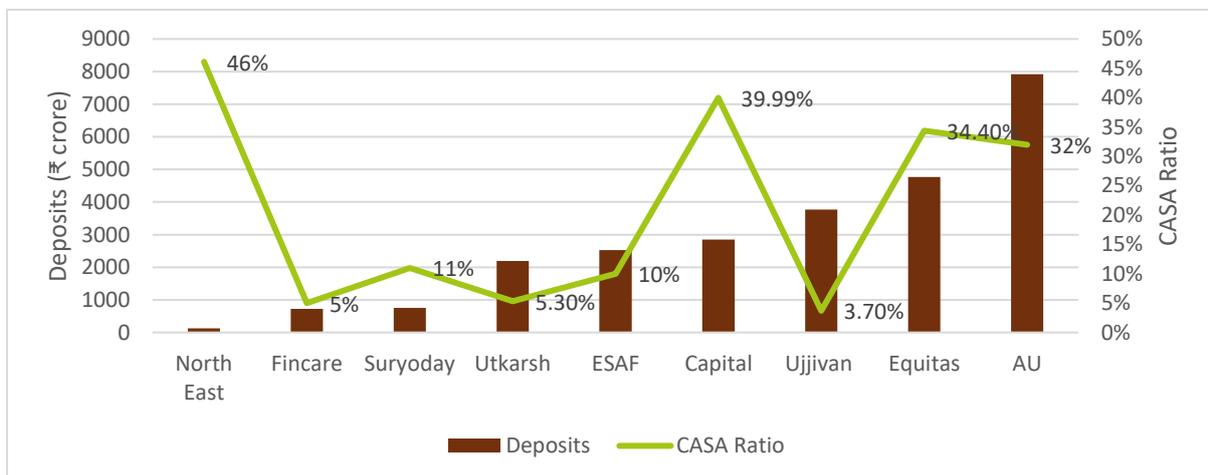


Figure 13: Deposit amounts and CASA ratios of SFBs for FY 2018

Source – Banks' Annual Reports

The total deposit base closely corresponds to the balance sheet size of the SFBs (see Figure 2). It must be noted here that FY 2017-18 was the first year of operations for most of the SFBs. Thus, nine out of ten SFBs (except for Capital) were raising deposits for the first time. One of the strategies for building deposits may be by using the existing borrower base to open bank accounts. Au's FY18 annual report mentions how 85% of the deposit accounts were opened from a 'non-Au' borrower. However, this

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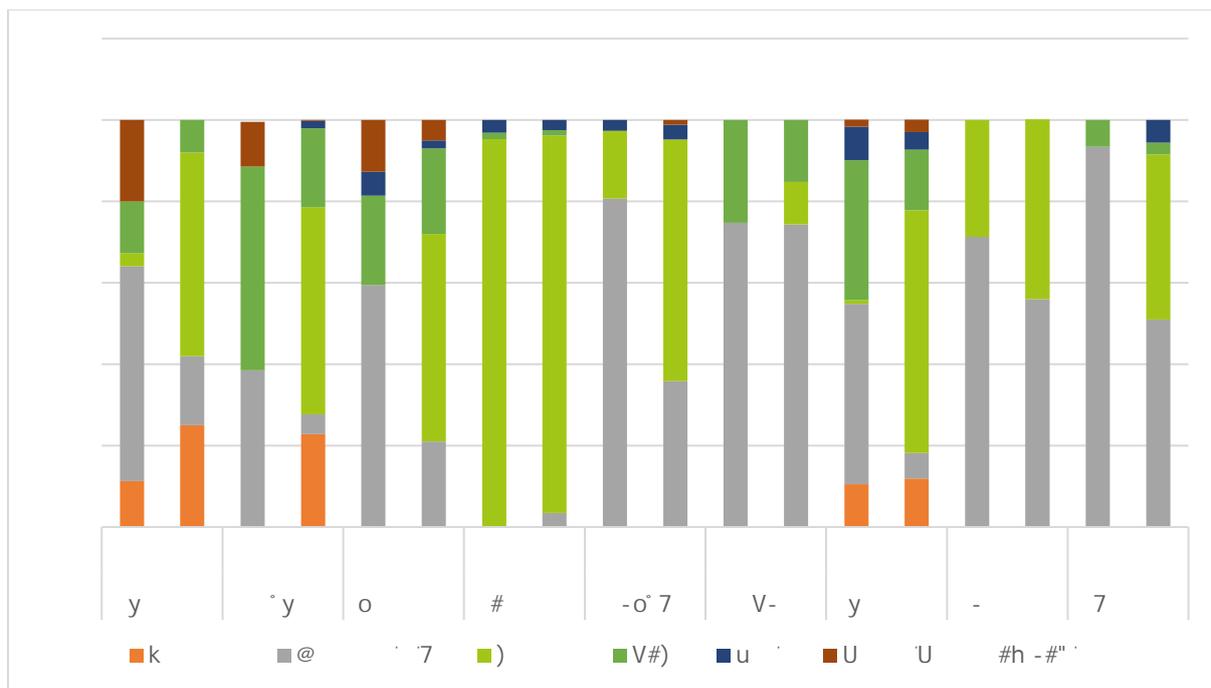


Figure 14: Funding Profile of SFBs for FY 2017 and 2018

Note1 - Total amount includes bank borrowings + deposits

Note2 - Further granularity in borrowings not available for Equitas SFB

Source - Banks' Annual reports

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converted to SFBs in January and February 2017 respectively, had managed to raise a modicum proportion of deposits in 2017 (amounting to Rs.18.7 Cr and Rs.206.4 Cr respectively). Equitas, the second applicant to convert to an SFB in September 2016 too had the time to build a relatively larger deposit share at Rs.1921.3 Cr by the end of FY18. Capital has continued its strategy of sourcing funds from mainly retail deposits. Thus, it can be seen here that the SFBs continue to rely rather heavily on wholesale funding despite permissions to harness retail deposits. However, we can expect this picture to change over the coming years as the SFBs grow into their roles of full-service banks and improve on building deposits.

The deposits and other sources of funds give us an idea on how the SFBs' cost of funds could look. Looking at the cost of funds is important from a financial inclusion perspective because it also gives us insight into the SFBs' lending rates. One way to get a clearer picture of lending is to look at the Marginal Cost of Funds Based Lending Rate (MCLR). The MCLR is a bank-specific internal benchmark which acts as the minimum interest rate at which a bank can lend. The MCLR comprises of the marginal cost of funds, negative carry on account of CRR, operating costs and tenor premium³⁵. Shown below in Figure 15 is the MCLR of SFBs for 1-year tenor.

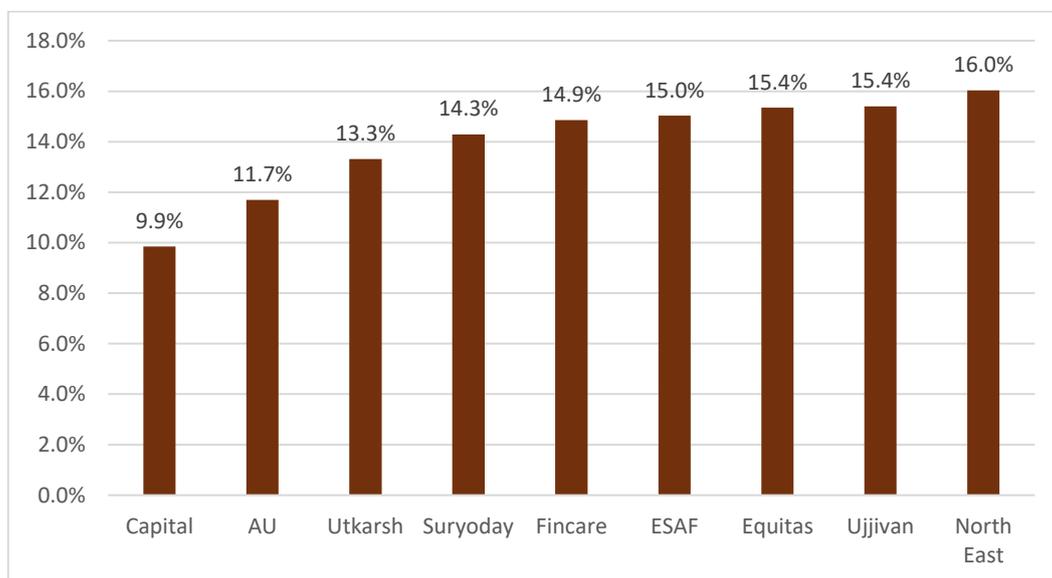


Figure 15: 1-year Marginal Cost of Lending Rate (MCLR) of SFBs for September 2019
Source – MCLR rates from each of the banks' websites

We see that SFBs exhibit a wide variation in their MCLR, ranging from North East's 16% to Capital's 9.9% (range = 6.1 percentage points). In comparison, the ranges of 1-year MCLR for Public Sector Banks, Private Sector Banks and Foreign Banks are 0.55, 2.25 and 4.05 percentage points respectively.³⁶ The average 1-year MCLR for SFBs as of September 2019 stands at 14%³⁷. In comparison, the total average of the public sector, private sector and foreign bank groups (not including SFBs) as of August 2019 is at 8.57%; an average raised by the PvSBs (whose MCLR were averaging at 9.35%). As a portion of the MCLR comes from the cost of funds, the MCLR picture can be

³⁵ Tenor premium is the premium charged to the borrower for the risk associated with long-term tenors

³⁶ RBI's Notification 2019-2020/653 – Marginal Cost of Funds Based Lending Rate for the month August 2019, September 9, 2019. Available at:

<https://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/PR653ACBCD7908EA44E7D8DBCCC3BD1BAEA20.PDF>

³⁷ Average calculated from the SFBs' 1-year MCLR rates given on their respective websites

correlated with the earlier discussion on funding, wherein FY 2018 North East had the lowest percentage of deposits in the funding portfolio and Capital the highest.

Operating cost³⁸ is one of the other important components of the MCLR calculation. It is significant in the case of SFBs on account of them having incurred sizable expenses due to the conversion exercise – setting up bank branches, training and upgrading management capacity, setting up MIS and compliance systems and so on. This upsurge in costs subsequently may have affected the bottom line and the lending rates as well. We see below in Figure 16, the operating expense³⁹ ratios (OER) of the SFBs for the FY ending March 2018.

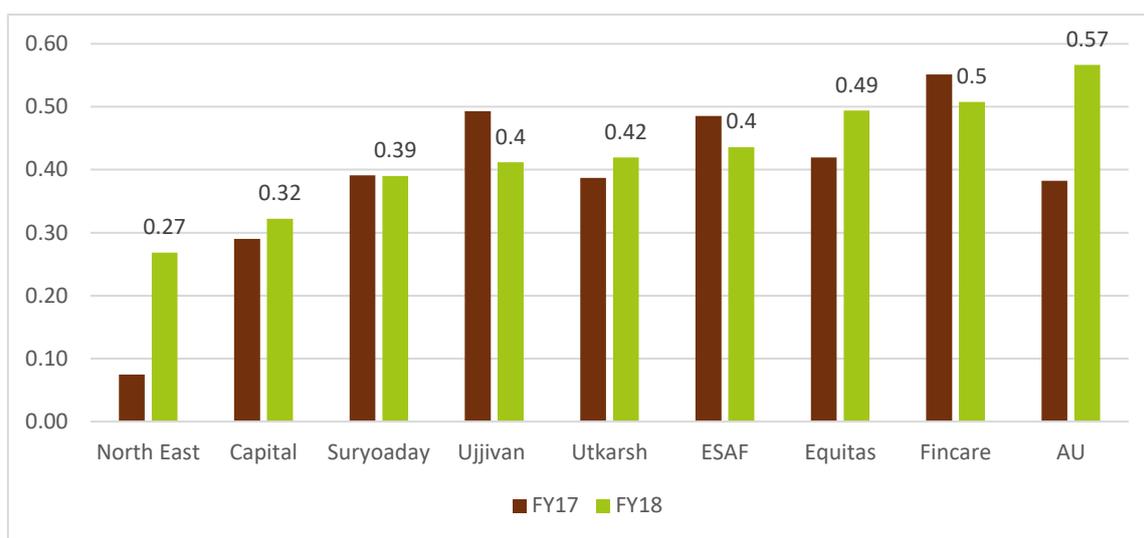


Figure 16: Operating Expense Ratios of the SFBs – FY 2017 and 2018
Source – Author's calculation from bank financial statements⁴⁰

Au and North East started their operations in April and October 2017 respectively, hence incurred higher costs in FY18. In comparison, the aggregate operating expense ratio for SCBs in FY18 was 0.22.⁴¹ (See [Annexure 4](#) for OER of select SCBs)

Figure 16 shows that though North East's Operating Expense Ratio (OER) was the lowest at 0.27, its MCLR is highest at 16% (Figure 15). Thus, it appears that OER has not carried much weight in influencing the MCLR rate. The MCLR may then be shown to be significantly influenced by the amount of deposits; the high rate being due to North East's particularly low proportion of deposits as a source of funding (See Figure 14). In comparison, we see that Capital too has a low OER of 0.32 and a low MCLR, perhaps owing to their large proportion of deposits as a source of funding and their prior existence as a bank even before conversion to an SFB.

In the table below, we see in a comparison of cost of funds that the SFBs have a cost of funds which is close to double that of both public sector and private sector banks. It must be noted here that the

³⁸ This does not include costs of providing those services which are separately recovered by way of service charges. All operating costs associated with providing the loan product, including the cost of raising funds is included in this head. Ibid, s. 6(b)

³⁹ 'Operating expenses' is mainly composed of payments to employees, property maintenance costs, personnel fees and so on

⁴⁰ Operating expense Ratio = Operating Expenses/Total Income.

⁴¹ Calculated from Table IV.8: Trends in Income and Expenditure of Scheduled Commercial Banks, Operations and Performance of Commercial Banks – Dec 2018. Available at: <https://www.rbi.org.in/scripts/PublicationsView.aspx?id=18743>

number below does not include costs of ESAF, Fincare, Jana and North East as they received scheduled bank status after March 2018 and were thus not covered in RBI's data.

Bank Group	Cost of Funds ⁴²
Foreign Banks	3.70%
Public Sector Banks	5.08%
Private Sector Banks	5.16%
Small Finance Banks	10.29%
All Scheduled Commercial Banks	5.05%

Table 3: Bank Group-wise Cost of Funds – FY 2018

Source – RBI DBIE Database⁴³

Again, it stands to be seen if the difference between the MCLR, OER and the cost of funds of the SFBs and the remaining banks reduces with time, as the SFBs are nascent in their operations and most of them had incurred significant conversion costs in converting from NBFC-MFIs to full-fledged banks.

5. Profitability

The profitability of the SFBs took a hit in FY2017 due to the aftermath of demonetization in the form of credit costs and setting aside provisions. Despite the shock, the Return on Assets (RoA) of most of the SFBs stayed positive, more than the average -0.2% of all SCBs but lower than the 1.3% average of private banks.⁴⁴ The SFBs' average was brought down to a large extent by Fincare's low, negative ratios. Fincare's losses in FY18 were due to a significantly larger amount of provision and contingencies. The provisions were despite only a moderate decrease in asset quality ratios (see Figure 14). The Return On Equity (RoE) for SFBs varies widely, ranging from Au's 13.7% to Fincare's low of -24.8%, and averaging 0.15%. In this case, the ratios are not even comparable to the private banks' average of 11.1%. SFBs' average Net Interest Margin (NIM) at 8% is much higher than the SCBs' average of 2.7%.

This high value of NIM is testimony to the high interest spread enjoyed by SFBs. The advantage arises from the wide difference between the interest rates provided on deposits and the interest rates received from advances. While the deposit rates of the SFBs are set at only about 1.5 percentage points higher than the select SCBs (from Tables 1 and 2), the interest rates received on the lending portfolios as a whole are at a much higher rate owing to their large shares of microfinance portfolios. While we do not have pricing data, some SFBs have been found to price their MSME loans at rates higher than that of SCBs. For example, Jana's 'business loan for entity' is offered at a rate of 24% per annum.⁴⁵ It is unclear what the exact drivers of such pricing are.

⁴²According to RBI's definition, Cost of Funds=100*(Interest Expended)/ average (Deposits + Borrowings) for Current and Previous Years.

⁴³ 10. Bank Group-wise Select Ratios of Scheduled Commercial Banks – up to March 2018, Statistical Tables Relating to Banks in India, RBI DBIE. Available at: <https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications>

⁴⁴ Chart 2.1: Select Performance Indicators, Chapter II Financial Institutions: Soundness and Resilience, Financial Stability Report Issue No.19- June 2019. Available at: <https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/FSRJUNE2019E5ECDDAD7E514756AFEF1E71CB2ADA2B.PDF>

⁴⁵ Sourced from Jana's website, accessed on 8 Nov 2019. Available at: <https://www.janabank.com/loans-ent/business-loan-for-entity/>.

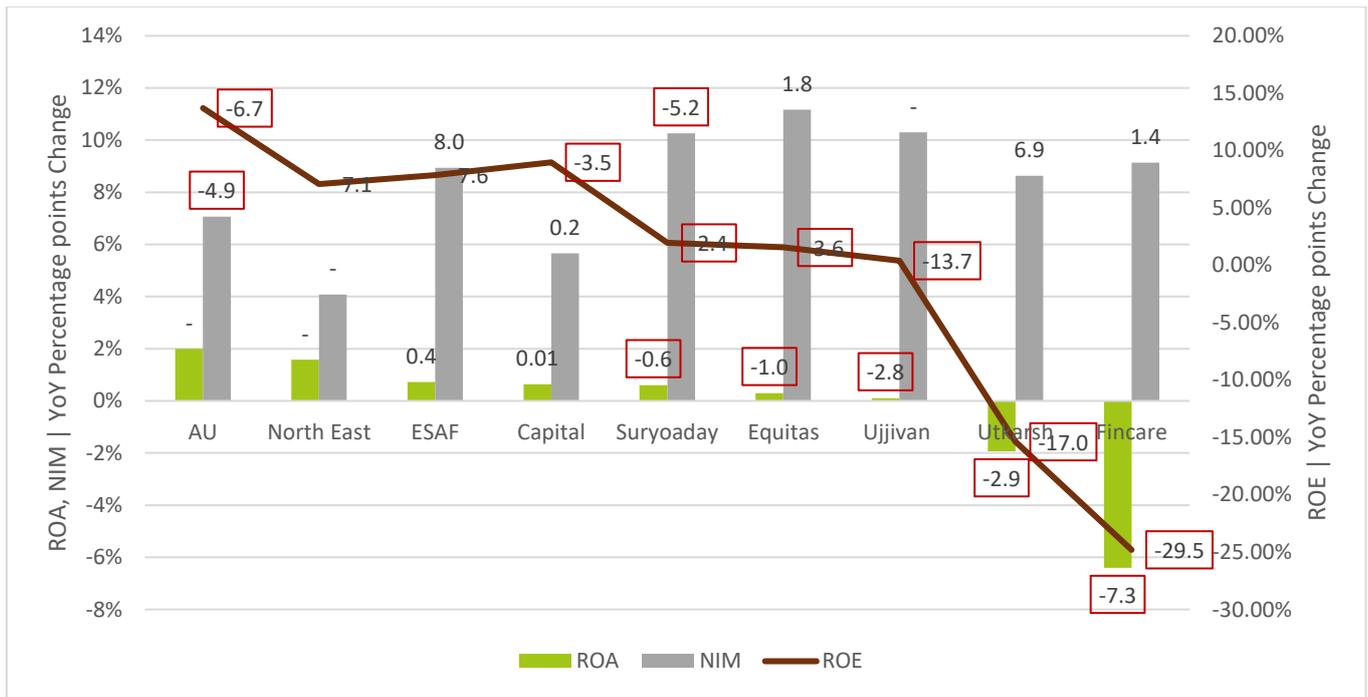


Figure 17: Profitability Ratios of SFBs in FY 2017 and 2018

Note – Data labels depict the percentage point change from the previous year (FY17). Red outlined numbers highlight a decrease.

Further affecting the bottom line were the high operational expenses made by the organisations to convert to SFBs. The cost-income ratio is a measure of efficiency for the banks as it reflects the extent to which non-interest expenses make a charge on the net total income (total income – interest expense). The lower the ratio, the more efficient is the bank⁴⁶. We see below that the ratios are not too varied, ranging from North East’s low of 54% to ESAF’s high of 82%. Again, these values for the SFBs are much higher than those of universal banks. (See [Annexure 5](#) for values of select SCBs)

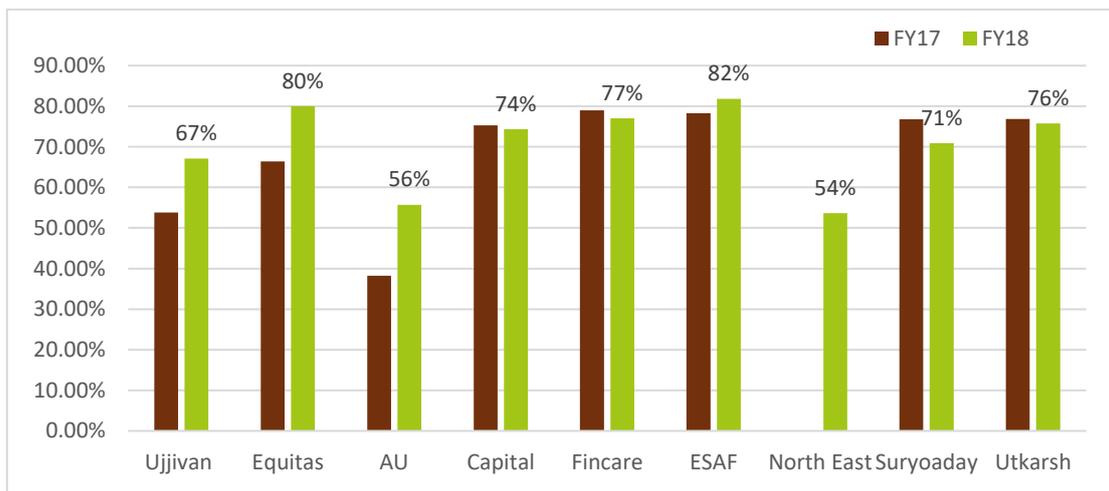


Figure 18: Cost to Income Ratio of SFBs

Source: Banks’ Annual Reports

⁴⁶ Formula = Non-interest expenditure/ Net Total Income * 100, from RBI’s Glossary. Available at: <https://www.rbi.org.in/Scripts/Glossary.aspx>

Unlike universal banks whose minimum capital adequacy ratio (CAR) must be 9%, SFBs have their minimum CAR at 15%. The average CAR of SFBs at 24.38% is higher than the average of 16.4% of private sector universal banks. The differential between the minimum requirement and the actual is also higher for SFBs as compared to other SCBs. However, the higher capital ratios may be attributed to equity infusions into the SFBs at the time of conversion. Therefore, this analysis would be more thorough if done again later when the SFBs have ‘settled’ into their operations as full-service banks.

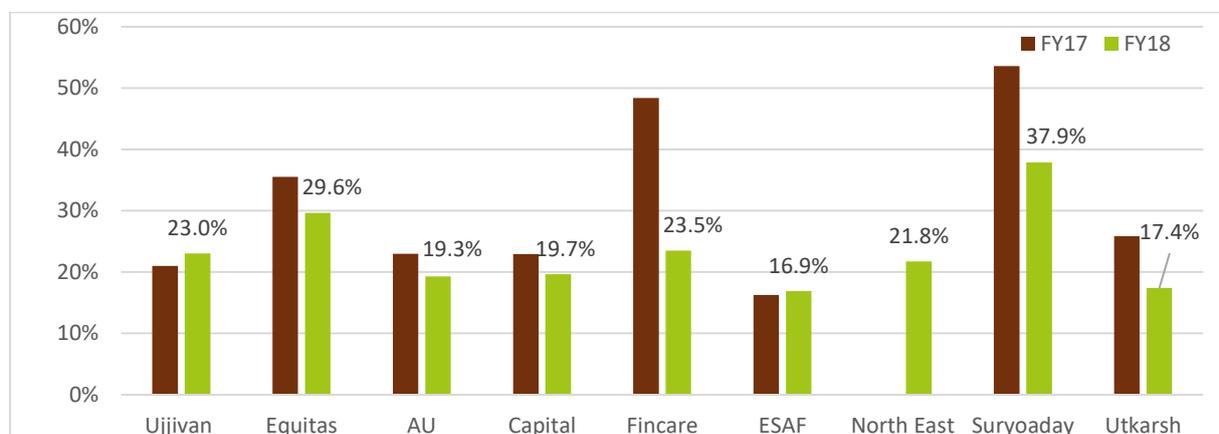


Figure 19: Capital Adequacy Ratios of SFBs for FY 2017 and 2018

Source: Banks' Annual Reports

Many of the SFBs saw an increase, if only a moderate one, in their NPA ratios (Figure 20 and 21). As an exception, we see that Suryoday drastically brought its GNPA and NNPA ratios down from an exceedingly high level to one now comparable to the other SFBs. Another steep change, albeit a negative one, was that of ESAF's ratios, which saw a drastic increase from 2017 to 2018 to become the worst-performing portfolio in terms of asset quality among the SFBs⁴⁷. The asset quality of all SCBs which have their GNPA at 11.6%⁴⁸ is higher than the SFBs, with an average GNPA of 2.27%⁴⁹. However, this would be an incomplete comparison, as the SFBs, with their microfinance-heavy portfolios, are closer to Microfinance Institutions (MFIs), which have historically demonstrated better asset quality ratios⁵⁰. In contrast, SCBs ratios have been burdened by bad corporate loans in the past decade. Therefore, we must look at these ratios again in the future when the SFBs will likely have more diversified lending portfolios and credit risks.

⁴⁷ While neither ESAF's nor outside publications discuss the causes for this remarkable jump, we may attribute the drop in performance to the drought that hit Kerala in 2016 and lasted through 2017. A large portion (57.74%) of ESAF's lending portfolio is in Kerala. Additionally, a majority of their lending (57.44%) has been in the agriculture and allied activities sectors.

⁴⁸ Chart 2.1: Select Performance Indicators, Chapter II Financial Institutions: Soundness and Resilience, Financial Stability Report Issue No.19- June 2019. Available at: <https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/FSRJUNE2019E5ECDDAD7E514756AFEF1E71CB2ADA2B.PDF>

⁴⁹ Averaged from GNPA ratios stated in annual reports.

⁵⁰ As of June 2019, the PAR > 30 of the microfinance industry stands at 0.93%. This PAR value has been arrived at after removing delinquencies above 180 days.

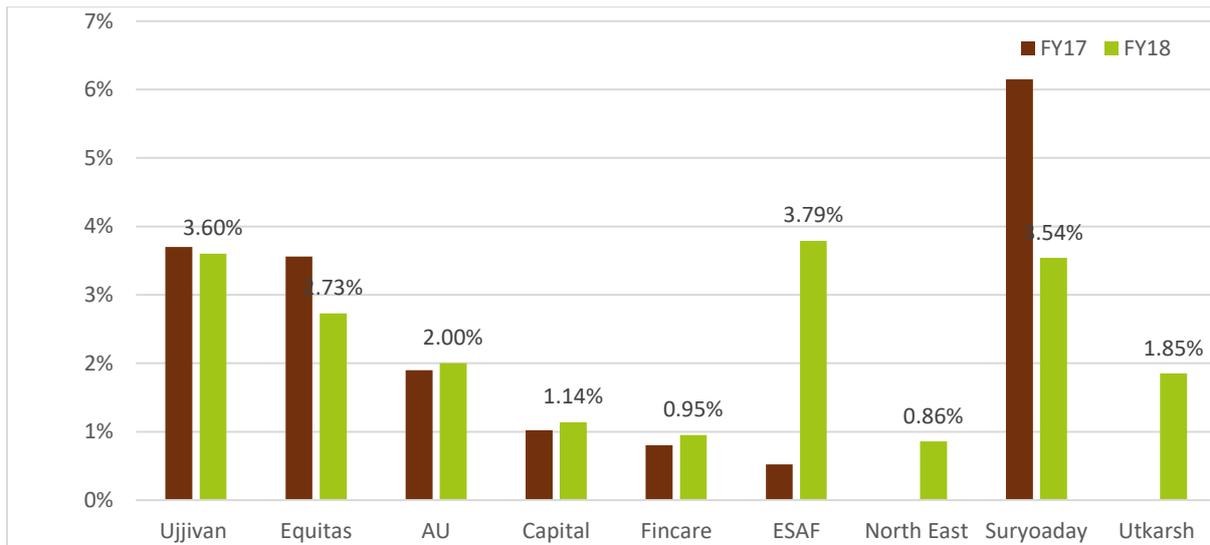


Figure 20: GNPA Ratios for SFBs for FY 2017 and 2018

Source: Banks' Annual Reports

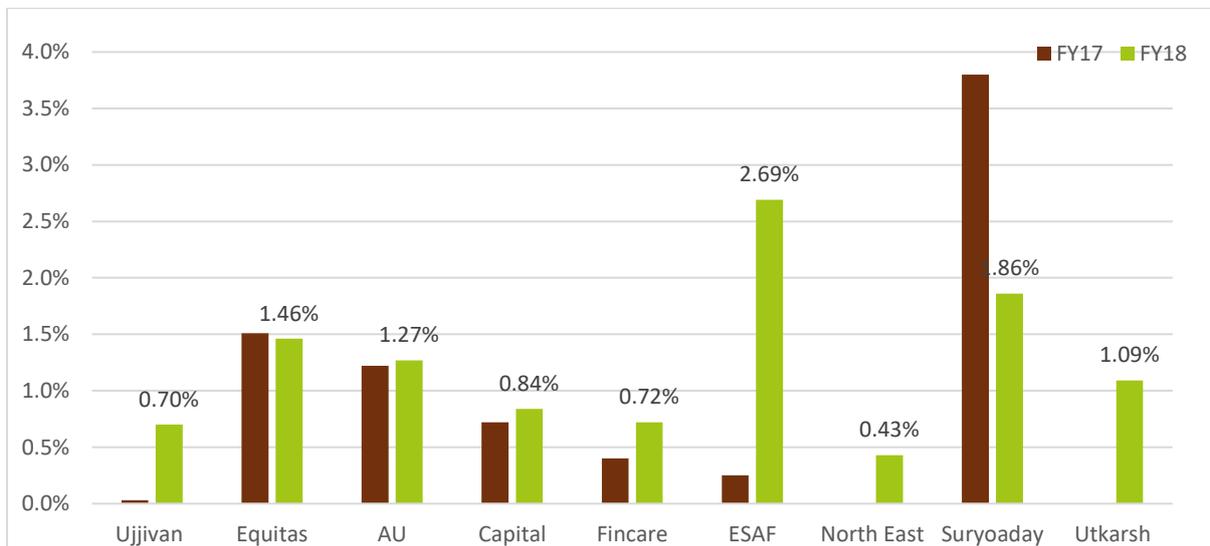


Figure 21: NNPA Ratios for SFBs for FY 2017 and 2018

Source: Banks' Annual Reports

The discussion so far has looked at measures concerning business sustainability for SFBs given the regulatory prescriptions laid out by the RBI. The following sections discuss the performance of SFBs against measures of financial inclusion. While we may gain some insight about the extent of achievement against the financial inclusion mandate by the SFBs, it still is unclear whether this has translated to access and use of SFBs' services by a customer base that is entirely new to banking. This is on account of non-availability of public data that can help to arrive at this conclusion⁵¹. We, therefore, look at available data on the geographical reach to paint a clearer picture.

⁵¹ For instance, data on the number of deposit accounts that are opened by individuals who do not have any other bank account, data on individuals whose credit records were created in credit bureaus for the first time through loans obtained from SFBs

6. Geographic Network

The branch network of the SFBs is rather extensive and diversified. We see that the geographical diversity in the home location of the applicants⁵² is responsible for the decent spread of the SFB network throughout the country. As of August 2019, there were 3533 SFB bank branches throughout the country spread across 31 states and union territories, and 465⁵³ districts. Even the northeast region is covered due to North East SFB which has a presence in all the seven North-Eastern states. Table 5 demonstrates how the distribution of the SFB branches is spread evenly across the six geographical regions.

Geographic Region	Ratio of SFB Branches to Total Number of Branches
Central	1.7%
Eastern	1.6%
North Eastern	3.1%
Northern	2.6%
Southern	2.6%
Western	2.9%

Table 4: Geographic Spread of SFB Branches – September 2019

Source – RBI DBIE

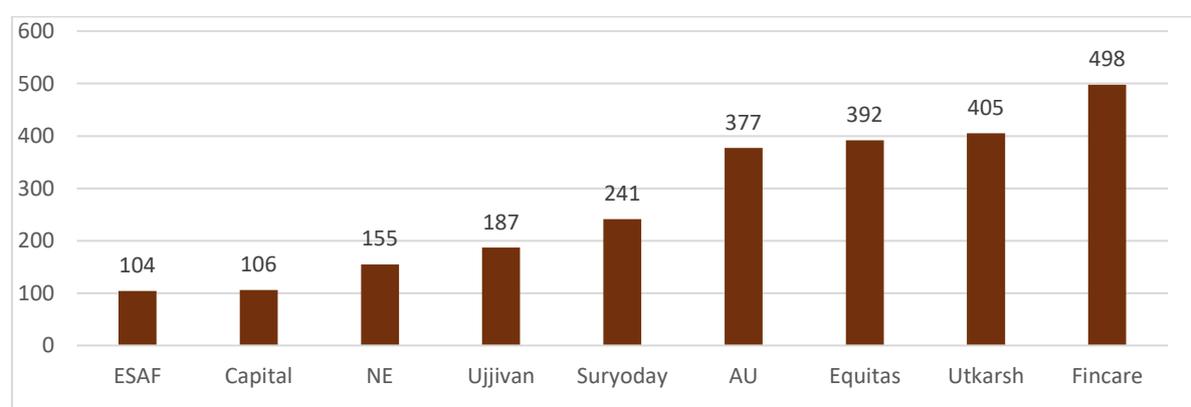


Figure 22: Number of Branches of SFBs in March 2018

Source – Annual Reports

Further, we see from Figure 23 that even with the relatively small number of SFB bank branches, the geographic network in terms of coverage of districts is rather high at 65%. (of districts) Interestingly, we see that the coverage of Payments Banks (PB) is remarkably high, at 87%. However, it must be noted here that of the six operational PBs and their 818 branches, the India Post Payments Bank (IPPB) accounts for a massive 79% (650 branches) of the total PB branches. Thus, if the IPPB branches were not to be considered, then the coverage number drops considerably to 8.3%.

⁵² The base locations of the 10 SFBs are: Jalandhar, Chennai (2 SFBs), Navi Mumbai, Varanasi, Bengaluru (2 SFBs), Jaipur, Ahmedabad and Guwahati.

⁵³ The count for the total number of districts as per the 2011 Census was 640. However, this number has increased over the years. The current total now stands at 731 (Source: <http://www.goidirectory.gov.in/district.php>). However, the MOF data source used for the geographic network discussion has the total number of districts at 711.

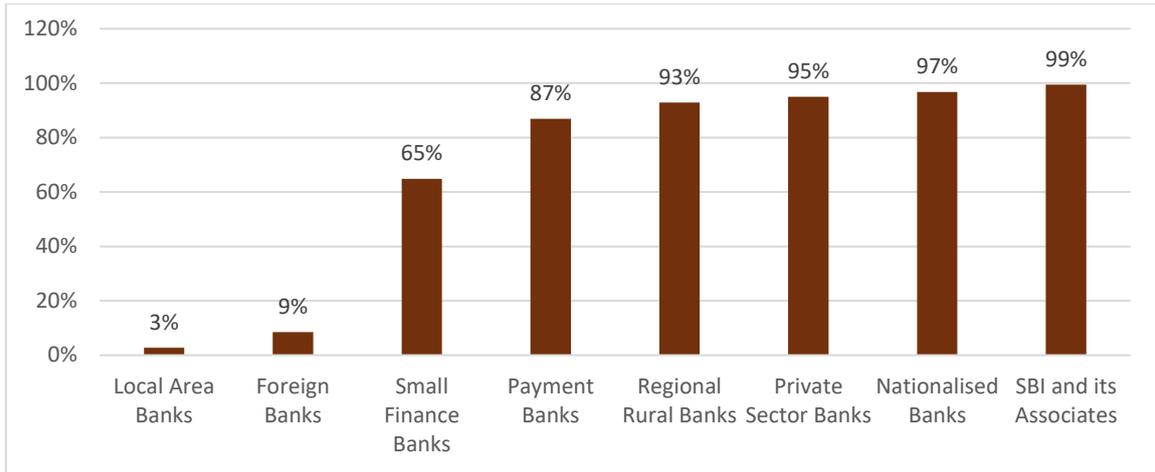


Figure 23: Bank Group-wise Coverage of Districts – September 2019⁵⁴
Source – RBI DBIE⁵⁵

Figure 24 below shows the spread of branches of the different bank groups split across the different population groups.⁵⁶

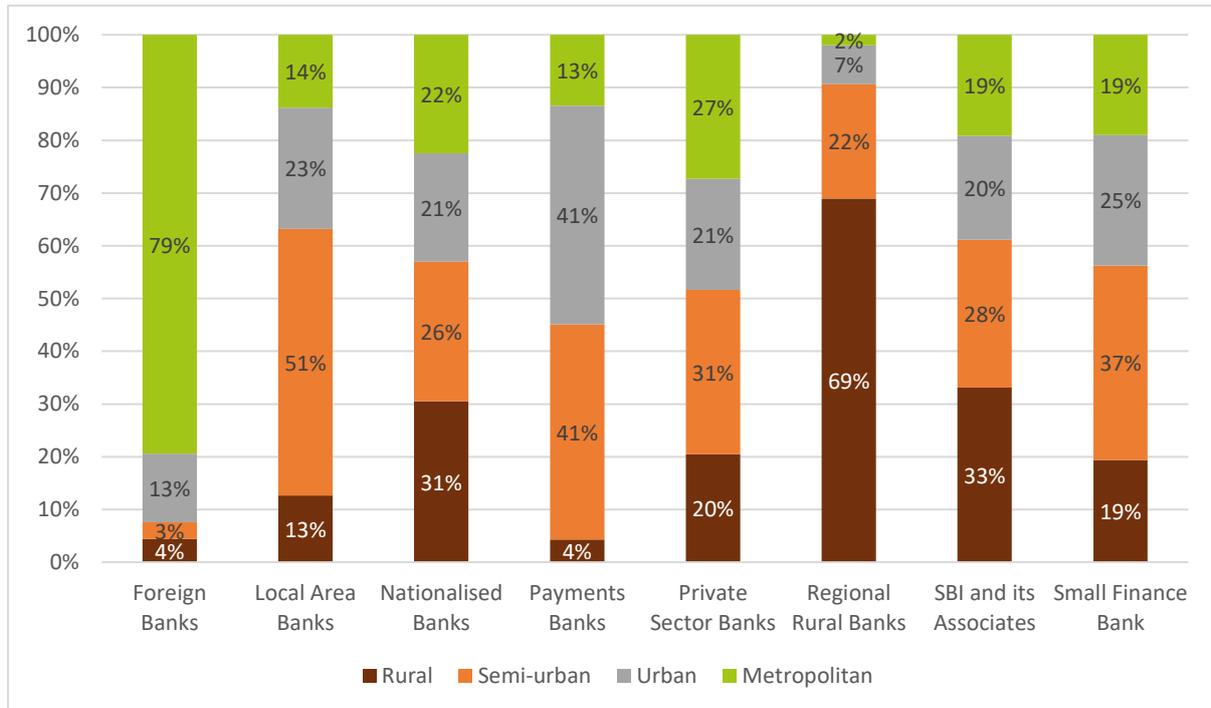


Figure 24: Branch Spread of the Bank Groups
Source: RBI DBIE⁵⁷

⁵⁴ Measured against a total of 717 districts

⁵⁵ Directory of Commercial Banks in India, RBI Database on Indian Economy – updated as of August 2019. Available at: <https://dbie.rbi.org.in/DBIE/MOFSelectParam.jsp>

⁵⁶ Population Groups are classified accordingly: Rural – up to 9,999; Semi-urban – 10,000 to 99,999; Urban – 1,00,000 – 9,99,999 and Metropolitan – above 10,00,000

⁵⁷ Directory of Commercial Banks in India, RBI Database on Indian Economy – updated as of August 2019. Available at: <https://dbie.rbi.org.in/DBIE/MOFSelectParam.jsp>

We see that a large proportion (37%) of the total bank branches of SFBs are in Semi-urban areas. The remaining branches are spread somewhat evenly across the different population groups, with the urban branches on the higher side. We see that this split of branches is most like that of the PvSBs.

The RBI’s guidelines for licensing of SFBs states that the annual branch expansion plans should be following the requirement of opening at least 25% of its branches in unbanked rural centres (population up to 9,999 as per the latest census).⁵⁸ RBI defines a centre as ‘The revenue unit (and not the locality) classified and delineated by the respective State Government, i.e., a revenue village/ city/ town/ municipality/ municipal corporation, etc., as the case may be, in which the branch is situated.’⁵⁹

Before continuing into a discussion on the distribution of bank branches at a centre-level, it must be noted that the database of bank branches used in the analysis here includes only those centres which are ‘banked’. Hence, there is no true understanding of how many centres continue to remain unbanked, and therefore what the reach of the banking network in the country is.

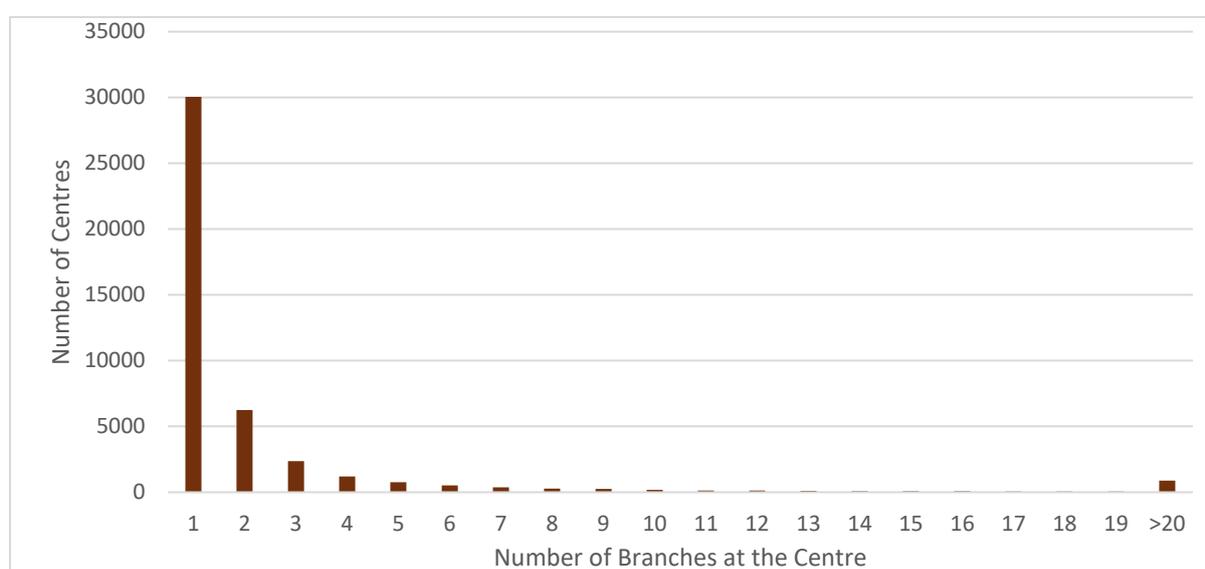


Figure 25: Centre level Analysis of Bank Branches
Source: RBI DBIE⁶⁰

From Figure 25, we see that a large number (30050, forming 20% of the total number) of bank branches (across the bank groups) operate singly in a location with no other bank branches in that location. We continue with the analysis at the centre level, but in greater detail by looking at the bank group-wise split of the bank branches.

⁵⁸ II.4. of Guidelines for Licensing of Small Finance Banks in the Private Sector, accessed from: https://www.rbi.org.in/Scripts/bs_viewcontent.aspx?id=2901

⁵⁹ Notes on tables on Master Office File (MOF) database. Available at: https://dbie.rbi.org.in/DBIE/doc/Notes_on_MOF_Tables.pdf

⁶⁰ Directory of Commercial Banks in India, RBI Database on Indian Economy – updated as of August 2019. Available at: <https://dbie.rbi.org.in/DBIE/MOFSelectParam.jsp>

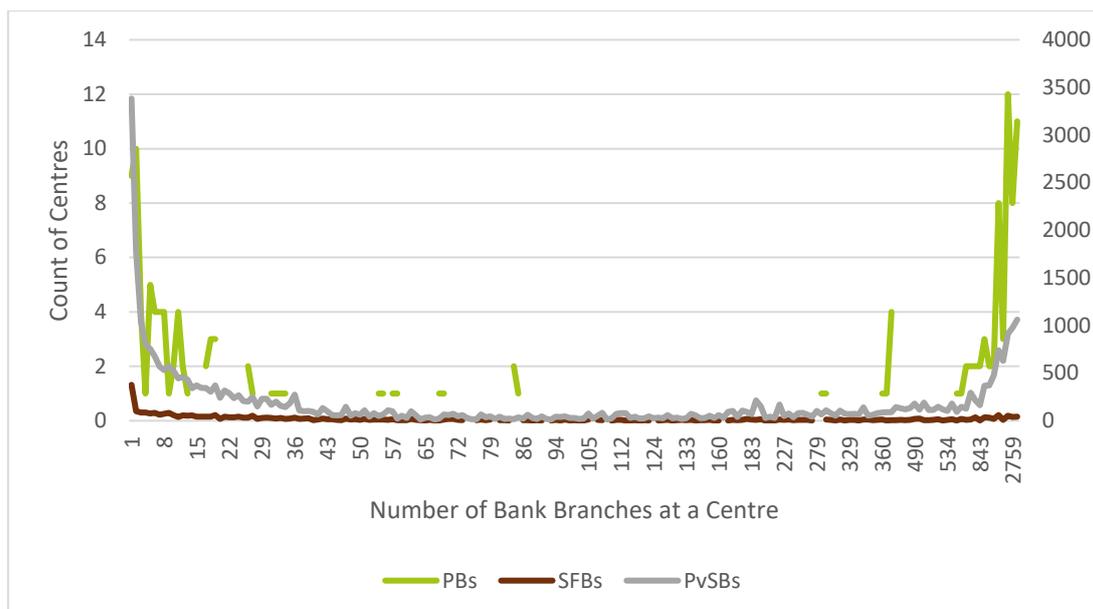


Figure 26: Centre level bank group-wise distribution of bank branches
 Note – Data on India Post Payments Banks not included in Payment Banks' numbers.
 Source: RBI DBIE⁶¹

We see from Figure 26 that the general trend across bank groups is that there is a spike at the level of low-density centres (with <20 bank branches per centre), and this drops to a flat line that further comes back up and spikes at the high-density centres (with > 600 branches per centre). However, comparing SFBs and PvSBs⁶², the pickup in the number of SFB branches at the high-density locations (typically Metro and Urban locations) is rather gradual. We can conclude from this that the SFBs' focus on expanding into high-density areas is not as much as the PBs or even the PvSBs. This may be attributed to the financial inclusion focus of the SFBs, and that their areas of specialisation were not urban-focused prior to converting into SFBs.

Since we do not know how many centres are unbanked, we instead consider those locations which have five or fewer bank branches as underbanked locations. We see from Figure 27 that 21% of all the SFB branches are in the underbanked areas. A more granular analysis looking at locations with one, two, three and four bank branches also showed a similar distribution; the SFBs' choice of branch locations closely followed that of the PvSBs. The highest proportion is quite obviously that of regional rural banks at 76%.

⁶¹ Directory of Commercial Banks in India, RBI Database on Indian Economy – updated as of August 2019. Available at: <https://dbie.rbi.org.in/DBIE/MOFSelectParam.jsp>

⁶² The Private Sector Bank group comprises of 22 Indian private sector banks as per RBI classification, available here: <https://m.rbi.org.in/CommonPerson/english/scripts/banksinindia.aspx#IB>. This does not include SFBs

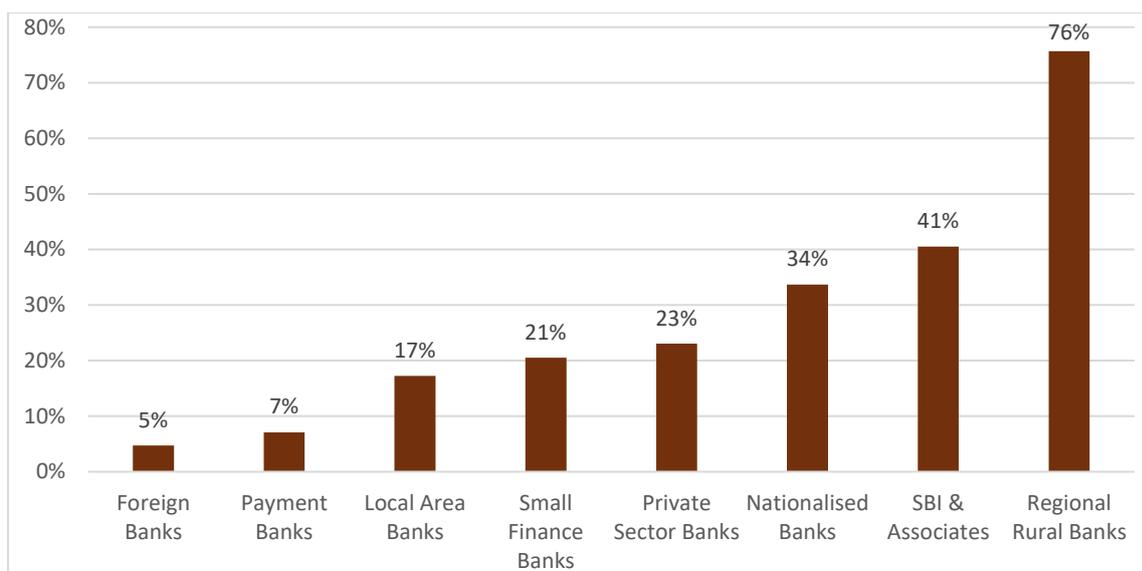


Figure 27: Proportion to total bank branches in underbanked areas

Data source: RBI DBIE⁶³

7. Customer Base

As seen above, the SFBs are spread across the country. The total customer base of all the SFBs is close to 2 crores, and this includes both loan and deposit customers. The table below shows the customer base of each of the SFBs.

SFB	Customer Base (in lakh)
Jana	45.0 (as of Sep 2018)
Ujjivan	37.0 (as of March 2018)
ESAF	33.0 (as of May 2019)
Equitas	25.0 (as of 2015)
Fincare	13.0 (as of Dec 2018)
Utkarsh	12.0 (as of June 2017)
Au	11.0 (as of Jan 2019)
Suryoday	8.5 (as of March 2018)
Capital	6.3 (as of June 2019)
North East	5.2 (as of March 2018)

Table 5: Customer Base of SFBs
Source – Newspaper reports⁶⁴, Annual reports

⁶³ Directory of Commercial Banks in India, RBI Database on Indian Economy – updated as of August 2019.

Available at: <https://dbie.rbi.org.in/DBIE/MOFSelectParam.jsp>

⁶⁴ Jana: Rawat.V.S. (2018, Sep 25). Jana Small Finance Bank to hire 1,000 fresh employees for planned expansion. *Business Standard*. Available at: https://www.business-standard.com/article/finance/jana-small-finance-bank-to-hire-1-000-fresh-employees-for-planned-expansion-118092500842_1.html

As the SFBs are expected to fulfil the mandate of financial inclusion, it would be particularly useful if one were to have further insights into the composition of the customer base of these banks. For example, Ujjivan, in their 2018 Annual Report, talks about how 73% of their retail deposits were from new-to-banking customers. It would be good to have similar reporting done by the other SFBs too.

Figure 28 shows the total number of accounts across loan sizes and the outstanding credit amounts in these accounts split by bank groups, as of March 2018.

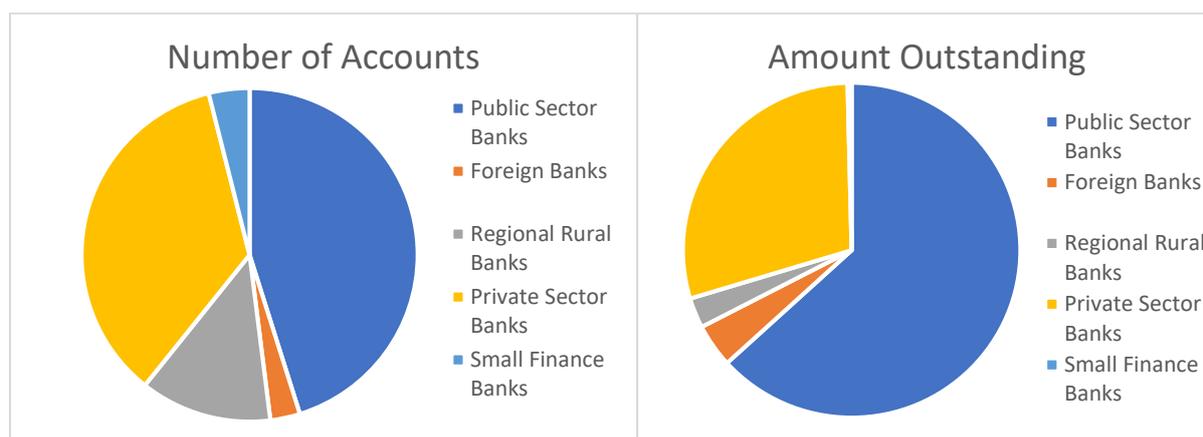


Figure 28: Number of Accounts & Amount Outstanding of Bank Groups – March 2018
Source – RBI DBIE⁶⁵

We can see from the graphs that while the SFBs have barely made a dent in contributing to the total credit amount outstanding, they have made considerable headway in contributing to the number of accounts. This contrast can be attributed to the financial inclusion focus of the SFBs with there being a restriction on lending (at least 50% of lending to amounts less than Rs. 25 lakhs). This focus can be seen in the split of the outstanding amounts across loan sizes in the figure below. (See [Annexure 6](#) for PSBs and PVSBS).

Capital: Saxena. R. (2019, July 9). Capital Small Finance Bank raises ₹43 crore from Amicus Capital. *Livemint*. Available at: <https://www.livemint.com/industry/banking/capital-small-finance-bank-raises-43-crore-from-amicus-capital-1562685110344.html>

Fincare: Ghosh. S. (2018, Dec 26). Fincare SFB to woo urban customers to grow deposit base. *Livemint*. Available at: <https://www.livemint.com/Industry/KtnAWa8VIL53hjYdtPABvl/Fincare-SFB-bank-branches-interest-rates-deposit-rates.html>

ESAF: (2019, May 13). Kerala-based ESAF Small Finance Bank net soars 234% to Rs 90 Cr on higher interest income, NPA management. *Firstpost*. Available at: <https://www.firstpost.com/business/kerala-based-esaf-small-finance-bank-net-soars-234-to-rs-90-cr-on-higher-interest-income-npa-management-6624571.html>

Utkarsh: Law.A. (2017, June 26). Utkarsh Small Finance Bank looks to cross-sell insurance; plans 400 branches. *Business Line*. Available at: <https://www.thehindubusinessline.com/money-and-banking/utkarsh-small-finance-bank-looks-to-crosssell-insurance-plans-400-branches/article9737609.ece>

⁶⁵ Table No. 4.7 – Bank Group-Wise Outstanding Credit Of Scheduled Commercial Banks According To Size Of Credit Limit – March 2018. Basic Statistical Returns of SCBs in India, RBI Database on Indian Economy. Available at: <https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications>

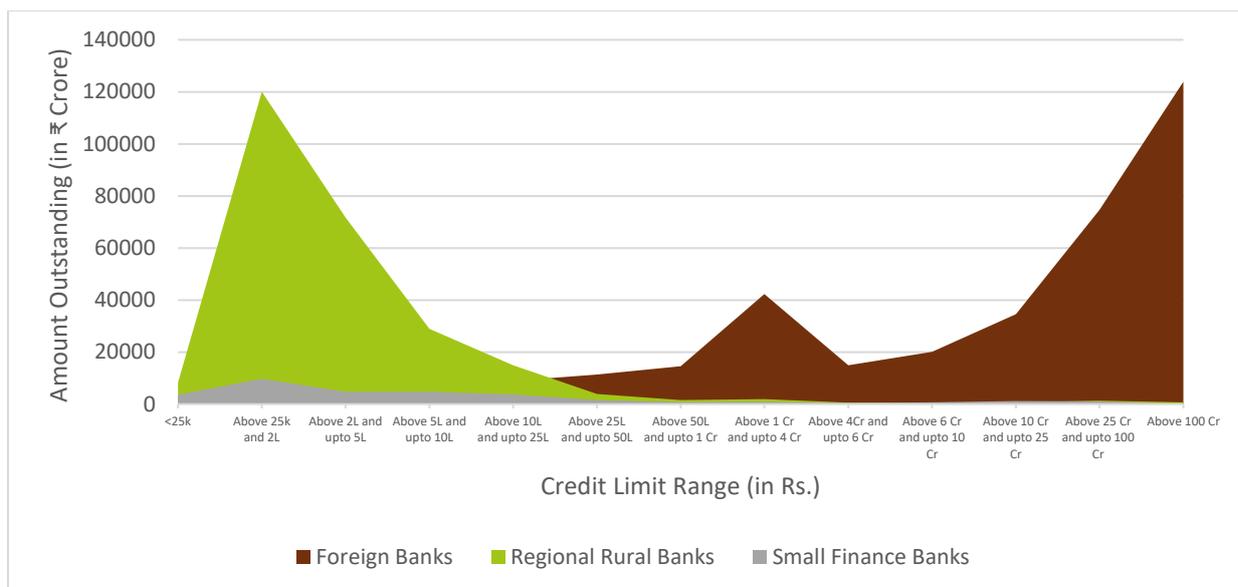


Figure 29. Distribution of bank group credit according to loan sizes – March 2018
Source: RBI DBIE⁶⁶

Not surprisingly, we see that the distribution of the loan-size wise outstanding amounts of the SFBs is skewed to the left, in the region of below Rs. 25 lakhs, and that there is a substantial density in the range of loan sizes between Rs. 25,000 and Rs. 2 lakhs. This left-skewed high density of the SFBs' is driven by their large microfinance portfolio.

8. Conclusion

We see from the discussion above that SFBs have largely done well in maintaining profitability despite the more stringent regulatory mandates of the RBI, such as higher priority sector lending requirement and loan size restrictions. This has been driven by the high spread between deposit and lending rates and holds despite their cost of funds for SFBs being double that of public and private sector banks. However, one must not jump to conclusions about the success of the SFB model towards meeting the objectives of financial inclusion as they are still very nascent in their functioning as full-service banks. It appears that the SFBs' strategy and expansion are most akin to that of private sector banks⁶⁷. What is notable is that despite being erstwhile microfinance institutions, the SFBs' business, lending and to an extent deposit-taking, do not see rural centres being serviced considerably more than what is being done by existing banking models (except for RRBs). Thus, given the strategy adopted so far by SFBs, it brings into question how well the business-model-level regulatory prescriptions help in fulfilling a financial inclusion mandate. Additionally, a more granular understanding of the benefits at the customer level is required. We need to understand how many of the previously unbanked/underbanked populations are being catered to by SFBs. We see currently that much of the SFB branch network is in the semi-urban and urban areas. It is unclear whether these branches are catering to such customers of these areas. It may, however, be a positive sign that all the ten applicants are still functioning and appear to be continuing operations smoothly and expanding. A repeat of the analysis using data for a longer period (of operations) would yield more insights into the sustainability of the SFB model and the utility of having a business model-level regulatory approach as laid down by the RBI.

⁶⁶ Table No. 4.7 – Bank Group-Wise Outstanding Credit Of Scheduled Commercial Banks According To Size Of Credit Limit – March 2018. Basic Statistical Returns of SCBs in India, RBI Database on Indian Economy. Available at: <https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications>

⁶⁷ As seen from figures 9, 10 and 21.

Annexures

Annexure 1 – Table of Applicants

Sl. No.	Applicants	SFB Name used in this Document
1	Capital Local Area Bank Ltd., Jalandhar	Capital
2	Equitas Holdings P Limited, Chennai	Equitas
3	Suryoday Micro Finance Private Ltd., Navi Mumbai	Suryoday
4	Utkarsh Micro Finance Private Ltd., Varanasi	Utkarsh
5	Ujjivan Financial Services Private Ltd., Bengaluru	Ujjivan
6	ESAF Microfinance and Investments Private Ltd., Chennai	ESAF
7	Au Financiers (India) Ltd., Jaipur	Au
8	Disha Microfin Private Ltd., Ahmedabad	Fincare
9	RGVN (North East) Microfinance Limited, Guwahati	North East
10	Janalakshmi Financial Services Private Limited, Bengaluru	Jana

Annexure 2 – Criteria for a loan to be a ‘Qualifying Asset’⁶⁸

- a. loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding Rs. 1,00,000 or urban and semi-urban household income not exceeding Rs. 1,60,000
- b. loan amount does not exceed Rs. 60,000 in the first cycle and Rs. 1,00,000 in subsequent cycles;
- c. total indebtedness of the borrower does not exceed Rs.1,00,000 Provided that loan, if any availed towards meeting education and medical expenses shall be excluded while arriving at the total indebtedness of a borrower;]
- d. tenure of the loan not to be less than 24 months for loan amount in excess of Rs. 30,000 with prepayment without penalty;
- e. loan to be extended without collateral;
- f. aggregate amount of loans, given for income generation, is not less than 50 per cent of the total loans given by the MFIs
- g. loan is repayable on weekly, fortnightly or monthly instalments at the choice of the borrower

⁶⁸ Master Circular- ‘Non-Banking Financial Company-Micro Finance Institutions’ (NBFC-MFIs) – Directions, RBI Notification – July 1, 2015. Available at: https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9827#2

Annexure 3 – Ratios of Other Income, and Commission, Exchange & Brokerage to Total Income of Select SCBs

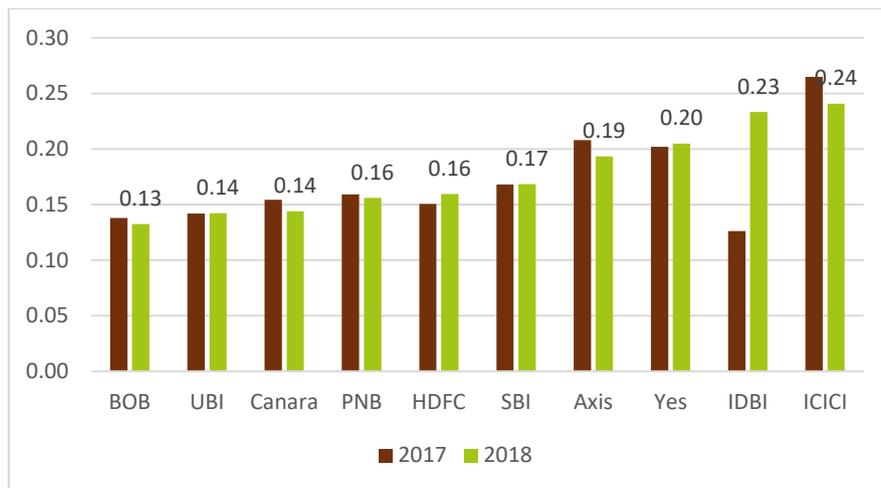


Figure 30: Ratio of Other Income to Total Income of Select SCBs
Source – Banks' Annual Reports

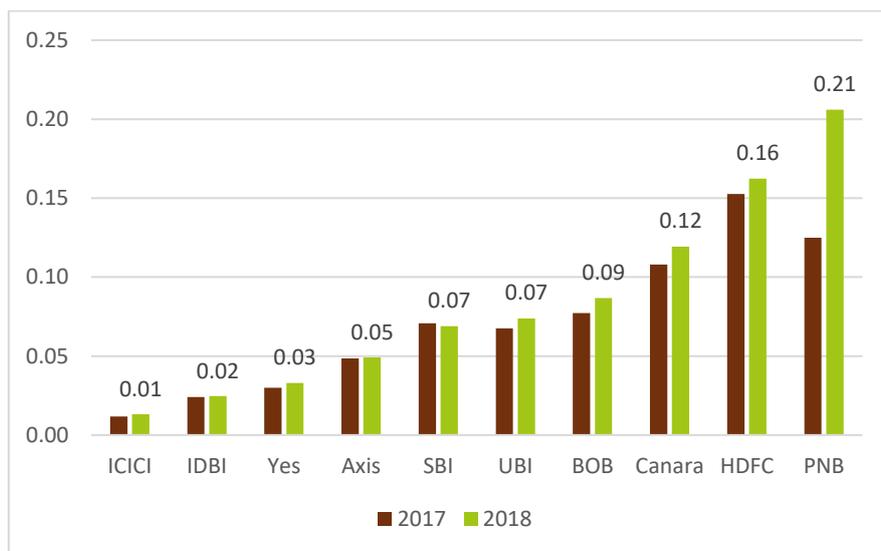


Figure 31: Ratio of Income from Commission, Exchange & Brokerage to Total Income of Select SCBs
Source – Banks' Annual Reports

Annexure 4 – Operating Expense Ratios of Select SCBs

Operating Expense Ratio = Operating Expenses/ Total Income

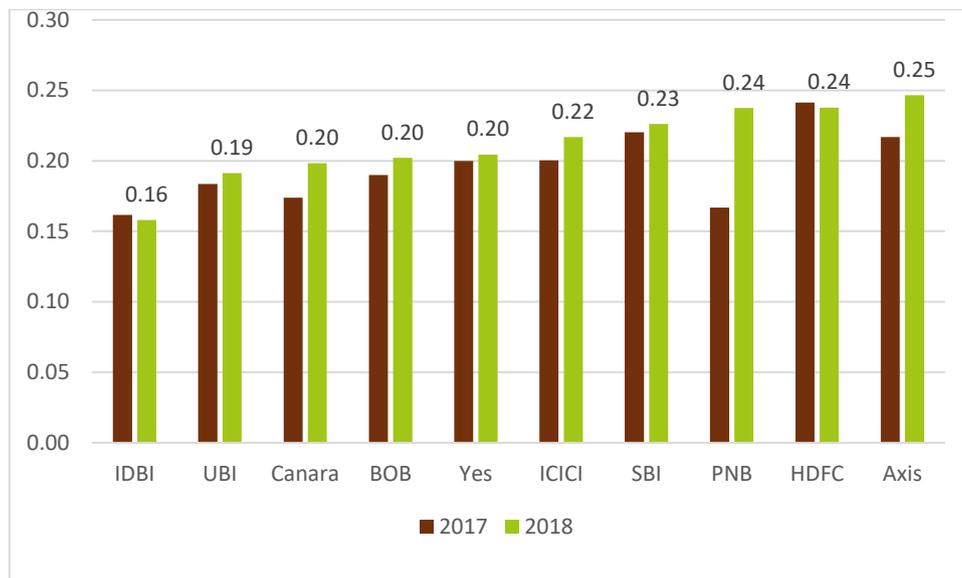


Figure 32: OER of Select SCBs - FY 2017 and 2018

Source – Banks' Annual Reports

Annexure 5 – Cost Income Ratio of Select SCBs

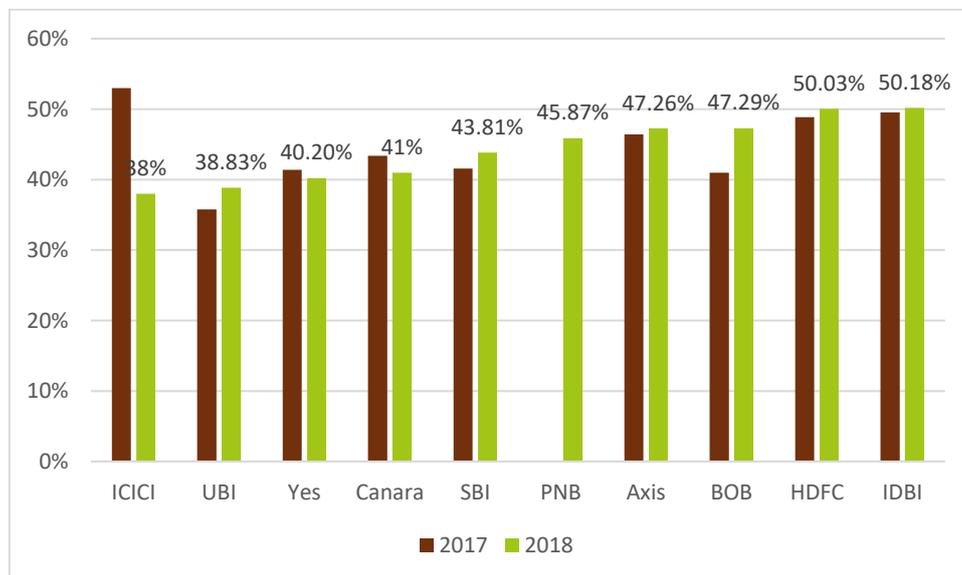


Figure 33: Cost Income Ratios of Select SCBs - FY 2018 and 2017

Source – Banks' Annual Reports

Annexure 6 - Distribution of bank group credit according to loan sizes – March 2018

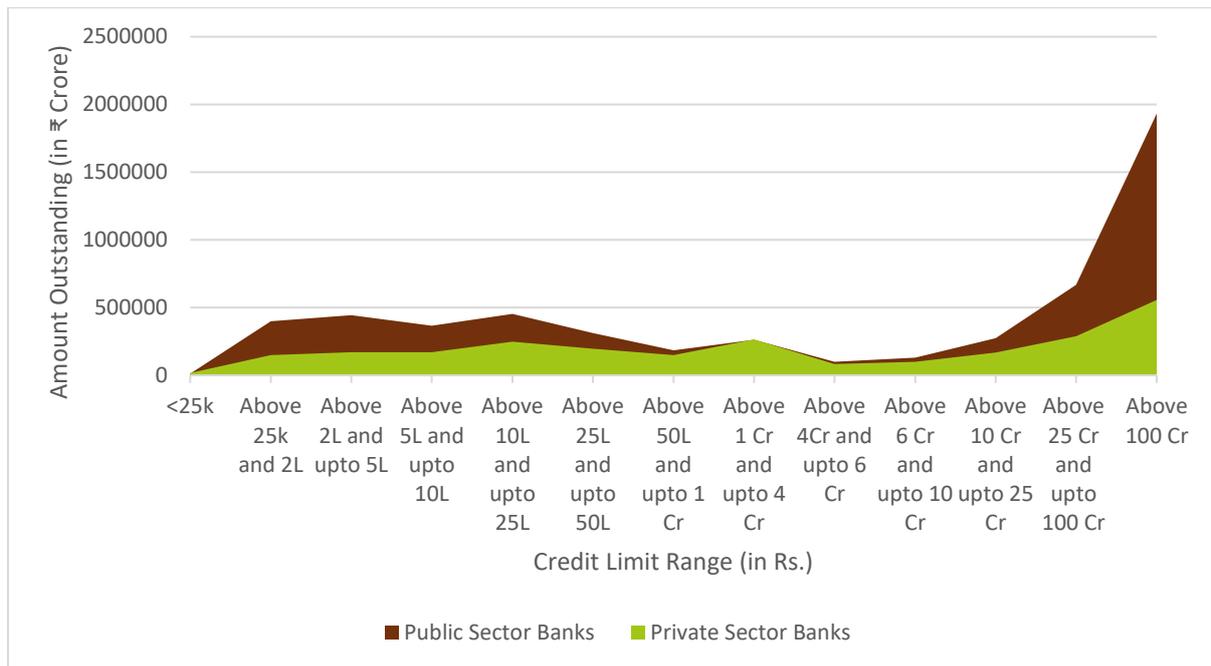


Figure 34: Distribution of Bank Group (PSBs and PvsBs) Credit according to loan sizes
 Source – RBI DBIE⁶⁹

⁶⁹ Table No. 4.7 – Bank Group-Wise Outstanding Credit Of Scheduled Commercial Banks According To Size Of Credit Limit – March 2018. Basic Statistical Returns of SCBs in India, RBI Database on Indian Economy. Available at: <https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications>