GUEST COLUMN

KRISHNAN SITARAMAN

# SFBs: The canter on a chequered terrain

Segmental and geographical expansion, undergirded by strong and increasing presence in semi-urban and rural markets with large untapped potential, will help small finance banks (SFBs) clock robust 25-27 per cent growth in advances this financial year, just shy of 28 per cent in the previous year.

Net interest margins (NIMs) could, however, contract 15 basis points (bps) year-on-year as SFBs continue to diversify into secured asset classes that fetch lower yields.

Also, with credit cost expected to increase 40 bps amid rising delinquencies in the unsecured segments (including microfinance), the return on assets is likely to decline nearly 40 bps to 1.7 per cent this financial year.

Growth in credit will be split across traditional and new segments, with the latter set to achieve nearly 40 per cent growth. New asset classes chosen by SFBs may vary in line with their initial segment focus but would typically entail secured segments. With sharper focus, the share of secured lending is slated to rise to 65 per cent by financial year 2025 (FY25) from 62 per cent in FY24. However, NIMs could compress to 7.2 per cent as yields on secured loans are typically 6-7 percentage points lower than on unsecured loans.

To combat this and achieve balanced credit growth, the funding side is crucial.

At 30 per cent for FY24, deposit growth has outpaced credit growth for SFBs, in contrast to the overall banking sector. However, this has come at a higher cost: the share of the relatively more expensive bulk term deposits rose 7 percentage points to almost 30 per cent of total deposits as of FY24. Correspondingly, the share of current and savings account deposits dropped to 28 per cent from 35 per cent; and that of retail term-deposits also fell.

**All said, growth prospects for SFBs remain buoyant, anchored by comfortable capitalisation and ever-increasing presence in underpenetrated markets**

Amid challenges in deposit mobilisation, SFBs will need to explore alternative, non-deposit funding routes at a competitive cost. Securitisation is gaining currency: transactions have increased to ₹9,000 crore in FY24 from ₹6,300 crore in FY23. As an additional channel, SFBs will seek more refinancing lines from financial institutions. Cost of deposits will remain structurally higher for SFBs than for universal banks as they offer a 50-250 bps premium in interest rates across similar deposit categories. Diversification into alternative funding avenues should lend stability to cost of funding.

The pre-provisioning profitability of SFBs could dip 10 bps to 3.5 per cent this fiscal because of NIM compression and flat operating expenses. Meanwhile, gross non-performing assets (GNPA) are likely to rise to 2.9 per cent in FY25, from 2.3 per cent in FY24. This is due to early signs of stress stemming from borrower overleveraging, particularly in microfinance and unsecured personal loans. Sub-segments within secured asset classes that cater in part to a similar customer segment could also see delinquencies increase.

As seen in the aftermath of the pandemic, SFBs with more diverse and secured portfolios will be more resilient. Amid their evolving asset-liability model and its impact on earnings, SFBs remain well-capitalised. They have raised equity of over ₹8,000 crore in the past three financial years, including almost ₹2,700 crore raised by a few via initial public offerings, to meet their licensing requirements.

All said, growth prospects for SFBs remain buoyant, anchored by comfortable capitalisation and ever-increasing presence in underpenetrated markets. It will also be propelled by systemic emphasis on financial inclusion and universal banking aspirations. The latter may take time to materialise though given the stringent eligibility criteria for application and ultimate licensing being subject to regulatory due diligence. Until then, SFBs shall continue to co-exist as a niche segment alongside traditional universal banks, that largely cater to the peripheral customer segment of the formal financial system. In the milieu, the ability of SFBs to ramp up their low-cost, retail deposit franchise, while organically transitioning to newer asset classes and maintaining asset quality in the process, will bear watching.

*(The writer is chief ratings officer, CRISIL Ratings)*

# Now boarding

## Governance premium is set to go up by many notches and banks will be put through the wringer, reports **RAGHU MOHAN**

"We are dedicated to establishing a global model of risk-focused supervision, one that emphasises strong risk discovery and compliance culture," said Reserve Bank of India (RBI) Deputy Governor Swaminathan J. He was speaking at the '*High-Level Policy Conference of Central Banks From the Global South*' in Mumbai last week. And the statement was taken by a few bankers to mean that Mint Road's senior supervisory managers will proactively keep digging for signs of mess in the banks they are assigned to.

Swaminathan's portfolio includes the powerful Department of Supervision, and the RBI may well have signalled it is set to turn the governance knob higher.

Coming as it were after the high-profile second edition of its brass' interface with the boards of private banks (on November 18 in Mumbai) to reiterate the role of boards and independent directors (IDs).

And old peeves remain: boards are becoming "executive" in nature (with just about every other file being forwarded to it). IDs' remuneration continues to be poor compared to what's on offer in wider India Inc and a closer scrutiny of their roles has seen many turning down invites to such positions.

As for climate change and cyber security, it's tough to find people with experience to onboard; non-banks pay far more for such talent. A small pool of IDs has led to boards being packed with the retired — be they bankers, civil servants or those drawn from the RBI; many of whom may not be current with themes in banking and finance. In state-run banks, serving central bank officials on their boards is a clear case of conflict of interest.

**ON THE TABLE**

- **Who wants to be an independent director?** Not many really given the feeling that remuneration is not aligned to what is expected of them
- **The executive board:** There is a feeling that the board is overburdened. What should be in the domain of the professional management is being pushed to the board
- **The counterview:** You can't sign up to be on the board and then quibble the task is onerous
- **What sets apart a bank board?** A bank is a custodian of public trust. Given the transformative role expected of them, its board is unlike a non-bank's

**More than a business card**

What makes a bank board job different from the same at a non-bank?

"The responsibility of an ID of a bank is of a much higher order as compared to that of a firm in the real economy because a bank is a regulated entity. The boards can discharge these responsibilities by striking the right balance between being overly intrusive and extremely hands off," says NS Vishwanathan, non-executive (part-time) chairman, Axis Bank, and former DG-RBI (who is also the former chairperson, College of Supervisors).

He adds, "More importantly, board members should avoid falling into group-think while at the same time not suspect the management on everything they do. As for not getting experts in ESG or cyber-security on boards, you can always get advisors. There are ways of dealing with these issues."

"Not only are banks custodians of public trust (being deposit-taking entities), they also have to keep abreast of fast-moving changes which impact their business model with the principal challenge emanating from risk and digitisation," notes Vimal Bhandari, who serves as chairman-HDFC MF Trustee Company, and as ID on Escorts Kubota (he was also a former ID on RBL Bank's board).

Another layer of complexity, he says, is "the important socio-economic transformative role banks play in our society which adds to the canvas, making the role of boards more challenging."

Mint Road ruffled feathers the day it released a discussion paper on '*Governance in Commercial Banks in India*' (June 11, 2020). Corner-room occupants at private banks felt their powers were sought to be clipped. Informal conversations among chief executive officers (CEO) were on how to present their views to RBI; a few large institutional investors made inquiries to get a sense of the regulatory plot.

Among the pain-points: committees on nomination and remuneration, audit, and risk management were to have only non-executive directors. CEO-chatter went as follows: Either they were bosses or not. Is the board to be executive in nature even as it is not to interfere in day-to-day operations?

**IN EUROPEAN BANKS, YOU HAVE A SUPERVISORY BOARD FOR GOVERNANCE, ANOTHER FOR MANAGEMENT OF BUSINESS**

In European banks, you have a supervisory board for governance; another for management of business. The draft, it was felt, appeared to be mid-way. A view gained ground that Mint Road had been singed by governance failures: Infrastructure Leasing & Financial Services, Dewan Housing Finance Corporation, Yes Bank, and Punjab & Maharashtra co-operative bank; all too soon after an asset quality review set rolling in 2015. And the governance pendulum had swung to the other extreme.

**The unfolding plot**

What does SC Garg make of bank governance? The former union finance secretary opines: in the case of state-run banks, "government and RBI nominee directors are seen in a better light and get a lot of respect given whom they represent. But there's still a lot to be said on the effectiveness of board oversight."

Here's a gem from the PJ Nayak Committee formed to review governance of boards of banks in India (May 13, 2014): "In one bank, the taxi-fare reimbursement policy gets the same coverage as the non-performing assets recovery policy".

Other issues which figured were: the purchase of premises, provision of leased residential accommodation for officers, details of a lecture by a bank's boss at a college, the extensive coverage of the finance minister's visit to the bank, and disciplinary action against manager-level employees.

"In private banks, governance is far better not necessarily because of the quality of directors, but that the capital markets and more stringent regulatory oversight are significant factors. Now, given the difference in standards of governance (between state-run and private banks and the increasing share of the latter), a new fault-line may be opening up in the banking sector," Garg points out.

And which is? The share of state-run banks in credit will soon fall below that of private banks, and the latter may not be as indulgent towards parts of India Inc. given the premium placed on governance and capital; both in fact will track each other.

This puts into relief Governor Shaktikanta Das' observation (June 5, 2023) that raising financial resources would not be a constraint for banks with robust governance frameworks as they can command a governance premium.

"This premium, in turn, will be driven by the quality of leadership at the top," said Das. Deputy governor Rajeshwar Rao, contextualised, "As we strive to become a developed country by 2047, financial institutions will need extraordinary amounts of financial resources."

Yet, the complaint that boards' compliance burden has gone up (and needlessly at that, feel some) persists. As Ravi Duvvuru, member-advisory group to the Regulatory Review Authority (RRA 2.0) set up by the RBI views it, the RRA's efforts to rationalise compliance led to the withdrawal of over 400 circulars, streamlining processes, fine-tuning reporting requirements and reducing complexity.

However, supervisors may still impose additional oversight requirements based on their annual examinations of banks. But then this should not be cited as a reason to question the responsibilities of boards.

"Rather, individuals who choose to serve as IDs of highly regulated and supervised entities should be aware of the inherent demands and responsibilities that come with the role. At the end of the day, the choice is theirs," as he puts it.

As for not getting folks with enough understanding of emerging areas like ESG, this will take time.

Research on ESG is evolving fast, but there's a serious need to encourage science-based research rather than conjectures which are yet to be proved scientifically; very few institutions offer STEM (science, technology, engineering, and mathematics)-based courses on it.

"Getting IDs on bank boards qualified in ESG will take a decade more, but in the interim, banks should bring in experts on the subject to assist the board," feels Sankar Chakraborti, chairman-ESGRisk.ai and group CEO-Acuité Ratings. He concedes a few private banks have made progress on ESG, but state-run banks "have some distance to catch up with them. It's an evolving area and it will be sometime before we settle down on these matters".

Another irritant is the Banking Regulation Act (1949). According to Narendra Murkumbi, (the youngest ever independent director to sit on a bank board at 35 years; he was appointed to ICICI Bank's board in January 2006), an issue that needs to be rethought is common directorships.

"To the extent, you say that a company where the bank's independent director is a promoter or a whole-time director can't have a lending relationship with a bank is fair." But what is not, according to him (who is also the vice-chairman of Ravindra Energy) is "prohibiting banks that have a common ID with a company from lending to it reduces considerably the availability of qualified candidates".

So, how is one to look at governance and the heartburn over how the banking regulator has gone about the task?

Here is Andrew Bailey, Governor, Bank of England in 2016 (prior to his current charge), "My assessment of recent history is that there has not been a case of a major prudential or conduct failing in a firm which did not have among its root causes a failure of culture as manifested in governance, remuneration, risk management or tone from the top."

"Governance in private banks is far better not because of the quality of directors, but because of more stringent regulatory oversight"

S C GARG
Former Union finance secretary

"The responsibility of an ID is of a much higher order compared to that of a firm in real economy because a bank is a regulated entity"

N S VISHWANATHAN
Former deputy governor, RBI

"Individuals who choose to serve as IDs should be aware of the inherent demands and responsibilities...the choice is theirs"

RAVI DUVVURU
Member-advisory group, Regulatory Review Authority (RRA 2.0) set up by RBI

"The socio economic transformative role banks play in our society adds to the canvas, making the role of boards more challenging"

VIMAL BHANDARI
Chairman-HDFC MF Trustee Company, ID, Escorts Kubota board

"Getting on boards IDs qualified in ESG will take a decade more, but banks should bring in experts on the subject to assist"

SANKAR CHAKRABORTI
Chairman-ESGRisk.ai & Group CEO-Acuité Ratings

"Prohibiting banks having a common ID with a company from lending to it reduces the availability of qualified candidates"

NARENDRA MURKUMBI
Vice-Chairman, Ravindra Energy