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Impact of Covid 19, Pandemic on Small Finance Banks

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Abstract

The COVID-19 pandemic posed unprecedented challenges to the global financial system, with Small Finance Banks (SFBs) in India bearing a significant force due to their focus on serving underserved and weak segments. This study examines the versatile impact of the pandemic on SFBs, encompassing operational disruptions, decline in asset quality, liquidity stress, and shifts in lending behavior. The moratorium on loan repayments and the economic slowdown led to increased non-performing assets (NPAs), especially among micro, small, and medium enterprises (MSMEs) and informal sector borrowers. Despite regulatory support from the Reserve Bank of India and government-backed schemes like the Emergency Credit Line Guarantee Scheme (ECLGS), SFBs faced challenges in maintaining profitability and credit growth. On the positive side, the crisis accelerated digital transformation and adoption of technology-driven solutions for customer service and collections. This paper highlights the resilience of SFBs in adapting to a rapidly changing environment and underscores the need for stronger risk management frameworks and digital infrastructure to withstand future shocks. This paper is conceptual paper, which concludes with insights into the resilience of SFBs and future strategies for stability and growth in a post-pandemic world.

Keywords: Small Finance Bank, Covid 19, Pandemic, Financial Performance, Financial Inclusion

INTRODUCTION

The Reserve Bank of India (RBI) launched Small Finance Banks (SFBs) in 2015 with the main goal of providing banking services to the under banked and unbanked, especially in rural and semi-urban areas. Tiny business units, tiny and marginal farmers, micro and small industries, and unorganized sector organizations are among the underserved and unserved segments of society that SFBs are intended to provide with basic banking services, such as deposit mobilization and loans. These banks are governed by the same regulations as commercial banks and are required to conduct their business in an open, technologically advanced manner.

The RBI released criteria for SFB licensing in November 2014. Ten organizations, including Ujjivan Financial Services, Equitas Holdings, and AU Financiers, were given "in-principle" approval in September 2015 following a stringent screening procedure. With an emphasis on inclusive finance, the majority of these organizations were microfinance institutions (MFIs) or non-banking financial businesses (NBFCs) making the switch to full-service banks. Key features of SFBs include,

- Minimum capital requirement of, 200 crore.
- 75% of adjusted net bank credit (ANBC) must be lent to the priority sector.
- At least 50% of loans must be below 25 lakh.
- Requirement to maintain a 25% branch presence in unbanked rural centres.

SFBs have been instrumental in broadening access to formal credit and banking services for low-income populations, micro-entrepreneurs, and small enterprises. They merge the outreach and credit-distribution capabilities of MFIs with the regulatory supervision and credibility linked to traditional banking. Throughout the years, SFBs have contributed to enhancing financial accessibility in underserved areas, promoted savings mobilization, and facilitated direct benefit transfers (DBTs) as part of various government welfare initiatives.
This paper focuses the study on impact of Covid 19, pandemic on small finance banks. Study also focuses on operational changes in small finance banks after Covid 19.

LITERATURE REVIEW

The Reserve Bank of India (RBI) in its 2021 Financial Stability Report noted that Small Finance Banks (SFBs) experienced a rise in Gross Non-Performing Assets (GNPA), particularly within unsecured and microfinance portfolios. The loan moratorium, coupled with income losses due to the pandemic, resulted in increased delinquencies among borrowers from the informal sector. CRISIL Ratings (2021) indicated that the GNPA levels for SFBs surged significantly, particularly during the second and third quarters of FY21, reaching over 6% in certain banks such as Ujjivan SFB and Jana SFB. In a paper titled "Pandemic Shock and Credit Risk," Das (2021) observed that small-ticket loans, which are frequently provided by SFBs were particularly susceptible during the lockdown, resulting in a decline in asset quality.

The COVID-19 pandemic has had far-reaching consequences on global economies, and the banking sector, particularly **Small Finance Banks (SFBs)** in India and other emerging economies, has faced significant disruptions. This literature review synthesizes recent studies examining how COVID-19 has affected the operational, financial, and regulatory aspects of SFBs.

Chatterjee, D., Sekhar, S. C., & Babu, M. K. (2022 in this paper they focus on significant roles of the banks in supporting the people, the lives, and the economies in this unpredicted state of affairs. The study offers an analysis of secondary data which is gathered from different research articles published on the Covid-19 outbreak. Additionally, this paper offers suggestions to Indian banks on the adoption of innovative strategies for the improvisation of financial lives and the economy.

Kaur and Singh (2022) examine governance practices in SFBs and their impact on financial resilience. The study reveals that strong governance frameworks enhance the ability of these banks to navigate financial crises. It discusses how risk management strategies and regulatory compliance contribute to stability. The research suggests that governance reforms can further strengthen the sector and improve investor confidence.

Prasad and Soni (2022) analyze the profitability determinants of SFBs in India. Their econometric study identifies key factors such as interest margins, cost efficiency, and loan repayment trends. The findings show that profitability fluctuates due to changing economic conditions. The study also suggests that efficient cost management strategies and better loan recovery mechanisms can improve financial performance.

Rajan and Acharya (2022) provide a comprehensive analysis of the evolution of SFBs and their role in financial inclusion. The study highlights that these banks serve as a new paradigm for inclusive banking. It assesses their financial strength and resilience during economic crises, emphasizing their contribution to the broader banking sector. The authors suggest that regulatory support and financial innovations can further enhance the impact of SFBs.

Sahoo and Nair (2022) use a stochastic frontier approach to evaluate the technical efficiency of SFBs. The study finds that asset and liability management plays a crucial role in determining efficiency levels. It suggests that while some SFBs achieve high efficiency, others struggle due to operational inefficiencies. The research emphasizes the importance of continuous monitoring and strategic financial planning to improve overall performance.

Sengupta and Vardhan (2022) focus on financial stability and systemic risks in SFBs. The study highlights the challenges these banks face in maintaining stability amid economic disruptions caused by the pandemic. It finds that some SFBs effectively manage risks through diversification and prudent financial policies. However, the paper warns that prolonged financial distress could pose threats to the stability of the sector.

Sharma and Srivastava (2022) analyze digital transformation in SFBs and its impact on financial health. The study finds that digital banking innovations improve efficiency and customer accessibility. It highlights the role of online platforms and mobile banking in expanding financial services. However, the research also identifies challenges such as technological costs and cyber security threats that need to be addressed for sustainable growth.

Chauhan. (2021) mentioned in his paper that small Finance Banks and the COVID-19 impact. The paper analyzes the effects of the COVID-19 pandemic on the operations, asset quality, and financial resilience of Small Finance Banks (SFBs) in India, particularly those with large exposure to the microfinance sector.

Kadiyala, P., & Ascioglu, A.(2024). According to the authors in their research paper, they are making conclusion that borrower defaults increased notably to 95.29% during the month of April 2020, when Covid lockdowns were fully in place. However, borrowers rebound back almost immediately, either making full or partial payments, such that defaults had fallen to 5.92% by December 2020.

MDPI. (n.d.). Article page. Journal of Risk and Financial Management, *16*(5), 260.

In the above article they mentioned the inverse relationship between economic policy uncertainty and digital banking usage among private banks in India. The outcome highlights

the advantage of credit card usage at PoS over ATMs during uncertain times due to better protection against fraud and the flexibility of postponing payments. Moreover, the positive coefficient for branches suggests that banks with a larger number of branches have a greater advantage in reaching a larger audience and providing convenient access to digital services.

Mohania, S., & Mainrai, G. (2020).In this paper author mentioned the challenges faced by banking sector during covid 19, pandemic. Like the banking sector is facing a number of challenges with regard to operations, asset quality, and earnings.

Perwej, A. (2020).The study aims to assess the multifaceted impact of the COVID-19 pandemic on the Indian banking sector, focusing on liquidity challenges, asset quality deterioration, and the efficacy of regulatory measures implemented by the Reserve Bank of India (RBI)

Prarthana, B. Z., Ashok, K. R., Mahendran, K., & Bhuvaneswari, S. B. (2021) In this research paper, authors has conducted a survey from clients of microfinance institution and they find out the results of the government-imposed lockdown that affected their livelihood and curbed their source of income.

Singh, S., Chamola, P., Kumar, V., Verma, P., & Makkar, N. (2023). This paper emphasizes management in association with government and financial institutions to design short-term as well as long-term strategies that may enhance their sustainability in the market. MSMEs are being forced to reassess their business strategy and modify their operating model as a result of the uncertain/unpredictable climate. Many levels of strategy aid in revitalizing the company and providing future possibilities to move forward if the government schemes positively impact the perception of entrepreneurs.

Operational Challenges:

Several researchers have noted that the COVID-19 lockdowns and social distancing measures severely impacted the daily operations of SFBs, particularly due to their reliance on physical branches and personal interactions. According to Jain and Sahu (2021), the movement restrictions and closure of branches led to a temporary halt in banking services in rural areas, where digital penetration remains low. Moreover, frontline staff faced risks related to health safety and logistical constraints.

Financial Stress and Asset Quality

The financial health of SFBs was significantly strained during the pandemic. SFBs, which primarily cater to the unbanked and under banked segments, faced a steep rise in **non-performing assets (NPAs)** due to widespread defaults by small borrowers. As Mishra (2022) reported, the moratorium on loan repayments and subsequent restructuring of loans under RBI's COVID-19 relief measures masked the actual stress on asset quality in the short term but revealed deeper vulnerabilities once the measures were lifted.

Digital Transformation and Fintech Integration

One positive outcome has been the accelerated adoption of digital banking services. Studies by Sharma and Iyer (2022) show that many SFBs increased investments in digital infrastructure to maintain customer engagement and offer remote banking services. However, the digital divide still posed a significant challenge in rural and semi-urban regions, limiting the effectiveness of such strategies.

Regulatory Support and Government Relief

Government and regulatory bodies, including the Reserve Bank of India (RBI), introduced a series of policy measures to support the banking sector. RBI's targeted long-term repo operations (TLTROs), liquidity infusions, and changes in provisioning norms provided some relief to SFBs (Reserve Bank of India, 2021). However, literature suggests that while these measures were necessary, they were insufficient in addressing structural weaknesses in the sector.

According to Kumar and Thomas (2023), SFBs have started realigning their business models by focusing more on asset-light operations, leveraging partnerships with fintech firms, and expanding digital outreach. These strategic changes are likely to shape the future resilience of SFBs.

RESEARCH METHODOLOGY

This study uses a **quantitative research methodology** based on secondary data sourced from the annual reports of Small Finance Bank ,articles available on web, newspaper etc.

Quantitative Analysis: Financial data of SFBs pre- and post-pandemic (FY 2019–20 to FY 2021–22) was analyzed to assess the impact on parameters like loan disbursement, NPAs, deposits, capital adequacy, and profitability. Sample Small finance banks operating in India.

DATA ANALYSIS AND OBSERVATIONS

It has been observed that impact of covid 19, pandemic affected on small finance Banks on the following aspects, which include

1. **Financial Impact**
2. **Operational Disruptions**
3. **Accelerated Digital Transformation**
4. **Impact on Financial Inclusion**
5. **Policy and Regulatory Relief**
6. **Strategic Shifts Post-COVID**

1. Financial Impact:

A. Asset Quality Deterioration:

- Non-Performing Assets (NPAs) saw a substantial rise during the pandemic.
- Borrowers, particularly micro and small enterprises (MSMEs), informal workers, and self-employed individuals, experienced significant income disruptions.
- Moratoriums and restructuring temporarily concealed the actual stress, but after the pandemic, numerous accounts transitioned into NPAs. Example: Ujjivan SFB indicated that GNPA surged beyond 9% in FY21, marking a considerable increase from the 2-3% range prior to COVID.

B. Loan Growth Slowed:

- Loan disbursements experienced a significant decline during lockdowns as a result of restricted mobility and uncertainty among borrowers.
- Numerous Small Finance Banks (SFBs) adopted a more cautious approach to lending in light of increasing credit risk.

C. **Increased Provisions:**

- Higher provisioning for potential credit losses affected profitability.
- Provisions as a percentage of assets improved to **5–6%** in some banks.

D. **Profitability Decline:**

- Operating profits took a hit due to both lower disbursements and higher credit costs.
- Some banks reported **net losses** in FY21.

2. Operational Disruptions

A. **Branch Network Challenges**

- Lockdowns affected branch operations, especially in rural and semi-urban areas.
- Cash management and customer servicing became difficult.

B. **Staff Availability**

- Field staff was unable to conduct physical visits for loan recovery or on boarding.
- Health concerns and restrictions disrupted day-to-day functioning.

3. Accelerated Digital Transformation

- SFBs rapidly adopted **digital on boarding, mobile banking, and fintech integrations**.
- Remote KYC, digital payments, and customer support became critical.
- However, many rural customers lacked digital literacy or access to smartphones, creating a **digital divide**.

4. Impact on Financial Inclusion:

A. **Access to Banking Disrupted**

- Low-income and rural customers faced temporary exclusion due to limited digital access or closed branches.
- However, SFBs played a key role in delivering **Direct Benefit Transfers (DBT)** and emergency relief funds.

B. **Shift in Customer Segments**

- Many SFBs began diversifying to less risky or salaried segments.
- Reduced dependence on cash-based informal borrowers became a trend.

5. Policy and Regulatory Relief:

- **RBI Measures**:
  - Loan moratorium (March–August 2020)
  - Restructuring 2.0 for stressed borrowers
  - Emergency Liquidity Assistance for banks
- **Government Schemes**:
  - Emergency Credit Line Guarantee Scheme (ECLGS) boosted MSME lending
  - Credit guarantee schemes reduced bank risk on new loans

These measures **helped stabilize liquidity and delay loan stress**, but the **underlying asset quality concerns resurfaced** once the relief period ended.

6. Strategic Shifts Post-COVID

- Focus on **collections and recovery** rather than new disbursements.
- Greater investment in **technology and automation**.
- Conservative lending practices, more stringent credit appraisal.
- Growing interest in **co-lending models** with NBFCs or fin techs to diversify risk.

RESULTS:

- SFBs showed resilience despite operational and credit risks.
- The pandemic accelerated digital adoption but exposed digital divide.
- Government and RBI interventions were crucial in stabilizing operations.
- A shift toward more conservative lending and higher capital buffers was evident.

DISCUSSION:

- Strengthen digital infrastructure and literacy among rural customers.
- Develop crisis-response credit models tailored to informal economy borrowers.
- Encourage diversified lending to reduce sectoral concentration risk.
- Build partnerships with fintech firms for scalable solutions.

The COVID-19 pandemic acted as both a stress test and catalyst for change in the SFB sector. While it exposed vulnerabilities in operations and credit management, it also opened avenues for digitization and deeper financial inclusion. The lessons learned should inform future regulatory frameworks and internal strategies for SFBs to ensure sustainability and resilience.

While Small Finance Banks in India faced significant challenges during the COVID-19 pandemic, their resilience, supported by policy measures and digital transformation, facilitated a robust recovery. Ongoing efforts to enhance efficiency and financial inclusion will be crucial in sustaining their growth and stability in the post-pandemic era.

LIMITATIONS:

This paper is based on secondary data. The study is limited to specific period only. Study has considered the Impact of covid 19, only taking into consideration small finance banks.

Suggestions for future research

Scope for further research on the same topic

- Study the delayed impact of restructured loans turning into NPAs.
- Investigate sector-wise loan performance (MSME, agriculture, informal sector).
- Evaluate credit risk models and how SFBs may need to revise them post-COVID.

CONCLUSION:

The COVID-19 pandemic posed unprecedented challenges to the global financial system, with Small Finance Banks (SFBs) in India bearing a disproportionate share of the burden. This study reveals that while SFBs played a vital role in providing financial services to underserved and vulnerable segments, their operational and financial resilience was severely tested during the crisis. Disruptions in repayment cycles, heightened credit risk, and constraints in capital adequacy significantly impacted their profitability and asset quality.

However, the pandemic also served as a catalyst for transformation. Many SFBs accelerated their digital adoption, streamlined internal processes, and diversified their portfolios to manage risk more effectively. Supportive regulatory measures by the Reserve Bank of India, including moratoriums and liquidity infusions, were instrumental in cushioning the immediate financial shocks.

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