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STUDY ON IMPACT OF NON-PERFORMING ASSETS IN SMALL FINANCE BANKS (SFBS) IN INDIA

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ABSTRACT

The Indian banking sector has witnessed the emergence of Small Finance Banks (SFBs) with the primary objective of promoting financial inclusion by providing credit to underserved and unbanked sections of society. However, with a focus on lending to high-risk segments such as small businesses, low-income groups and rural borrowers, SFBs face a great exposure to credit risk, leading to a rise in NPAs. Non-Performing Assets (NPAs) pose a persistent challenge to the financial stability and profitability of Small Finance Banks (SFBs) in India. This study aims to investigate the impact of NPAs on the operational and financial performance of SFBs over a five-year period from 2018-2019 to 2022-2023. Key performance indicators such as Gross NPA Ratio, Net NPA Ratio, NPA to Total Assets Ratio, Net Profit Margin, Return on Assets (ROA), and Return on Equity (ROE) are analyzed. The study also explores the distribution of NPAs across priority and non-priority sector lending. The findings of the study aim to provide insights into how rising NPAs influence the financial health and sustainability of Small Finance Banks, ultimately contributing to the formulation of better risk management strategies and policy decisions.

Keywords: *NPA, ROA, ROE, SFBs Net Profit Margin, Total Assets Ratio*

INTRODUCTION

In the context of banking, a Non-Performing Asset (NPA) refers to loans or advances that are in default or arrears, where the borrower has not made scheduled payments for a specified period, typically 90 days or more. Once this threshold is crossed, the loan is considered “non-performing” and it is a significant indicator of a bank’s asset quality. The level of Non-Performing Assets directly impacts the financial health and profitability of a bank. According to the Reserve Bank of India in a circular from 2007, has stated “An asset becomes non-performing when it ceases to generate income for the bank”. The RBI has set specific criteria for classifying loans as NPAs based on, if the borrower fails to repay the interest or principal on a loan for 90 days or more, the loan is classified as an NPA. This is standard practice in financial systems globally. NPAs represent assets that have ceased to generate income for the bank, which means the bank is not receiving the interest that it was expecting from the loan. NPAs are a critical issue for banks, particularly for Small Finance Banks (SFBs), as they have direct impact on the financial health, liquidity and profitability.

SMALL FINANCE BANKS (SFBS) IN INDIA

SFBs have emerged as vital components in the evolving Indian Finance landscape. Small Finance Banks are financial institutions that offer services to unbanked and underserved regions of the country. They are registered as a public limited company under the Companies

Act, 2013 and are licensed under section 22 of the Banking Regulation, 1949. They are primarily governed by Banking Regulation Act, 1949 and RBI Act, 1934 and other relevant statutes. They can perform nearly all functions of a typical commercial bank, but on a much smaller scale. Small Finance Banks are a type of Differentiated Bank in India.

SMALL FINANCE BANKS AND NPAS

Small Finance Banks (SFBs) are a relatively new category of banks in India that were introduced with the aim of promoting financial inclusion by providing banking services to unbanked and underserved segments of society, including small farmers, micro-enterprises and low-income individuals. SFBs are mandated to serve communities in rural and semi-urban areas, where economic activities may be more vulnerable to external shock, such as natural disasters, poor agricultural seasons and economic slowdowns. Given this focus on high-risk borrowers, NPAs in SFBs tend to have a more pronounced impact compared to larger commercial banks.

While the goal of SFBs is to provide financial services to the underserved, they also face the challenge of managing higher risks associated with their loan portfolios, which include agricultural loans, microloans and small business loans. This leads to an inherently higher probability of defaults and subsequently a higher level of NPAs in comparison to larger, more diversified banks.

REVIEW OF LITERATURE

Reserve Bank of India (2014 & 2015) – Policy Framework has laid out the objectives and operational guidelines for SFBs. The emphasis was on providing savings vehicles and credit to small business units, marginal farmers, micro and small industries and other unorganized sector entities. These documents act as the regulatory and conceptual backbone for scholarly and practitioner analysis.

Chakrabarty and Bhatia (2016), critically examined the transformative potential of Small Finance Banks (SFBs) in enhancing financial inclusion in India, particularly by converting Microfinance Institutions (MFIs) and Non-Banking Financial Companies (NBFCs) into formal banking entities. The study argued that while MFIs and NBFCs had established a strong presence in underserved regions, their limited capabilities especially in deposit mobilization restricted their ability to provide holistic financial services. By becoming SFBs, these institutions could accept deposits and extend credit under regulatory oversight, thereby formalizing the credit system and reducing dependency on informal lenders. The authors emphasized that the localized knowledge and grassroots reach of these entities positioned them well to serve rural and low-income populations. However, they also identified operational challenges, including the need for technological investment, regulatory compliance and capacity building. Overall, the study concluded that SFBs have significant potential to address financial exclusion, provided they navigate the transition from informal practices to formal banking effectively.

Sengupta and Aubuchon (2017), conducted a comparative study of Small Finance Banks (SFBs), cooperative banks and Regional Rural Banks (RRBs) to evaluate their roles in promoting financial inclusion. They found that SFBs offer a more robust business model due

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to their stronger regulatory framework and better governance compared to cooperative banks, which often face governance challenges, and RRBs, which are more susceptible to government intervention. However, SFBs also face significant challenges, particularly in terms of infrastructure and scalability, as they lack the extensive branch networks of cooperative banks and RRBs. The study emphasized that while SFBs have the potential to improve financial inclusion, their growth is hindered by the need for substantial investments in infrastructure, technology and human capital.

SCOPE OF THE STUDY

The rise in Non-Performing Assets (NPAs) has a significant adverse impact on the performance of small finance banks (SFBs). One of the most immediate consequences is a decline in profitability, as SFBs are required to make higher provisions for potential loan losses. This provisioning reduces their net income, and since SFBs typically operate within margins, even moderate increase in NPAs can threaten their financial viability. This study aims to conduct a comprehensive analysis of NPAs and their impact on the performance of SFBs in India. Furthermore, the study examines the effect of NPAs on the overall performance of SFBs by focusing on key profitability metrics including the Net NPA Ratio, Net Profit Margin, Return on Assets and Return on Equity. The study intends to provide an understanding of how NPAs influence the financial health and operational efficiency of SFBs in India over a study period.

OBJECTIVES OF THE STUDY

- To examine the year wise provision and segregation of gross NPA provided by SFBs from 2018-2019 to 2022-2023.
- To find out NPA under the priority and non-priority sector lending in SFBs.
- To evaluate the impact of NPA on performance of the SFBs with respect to profitability during the study period.
- To analyze the extent and magnitude of Non-Performing Assets of Small Finance Banks in India.

HYPOTHESIS OF THE STUDY

H_0: There is no significant impact of Non-Performing Assets on Profitability of Small Finance Banks.

H_1: There is significant impact of Non-Performing Assets on Profitability of Small Finance Banks.

RESEARCH METHODOLOGY

The study adopts a quantitative research approach to evaluate the impact of Non-Performing Assets (NPAs) on the performance of Small Finance Banks (SFBs) in India. The research is based on secondary data collected from reliable sources such as handbook of statistics of Indian Economy, financial statements of SFBs. Data spanning for 5years from 2018-2019 to 2022-2023 is analyzed to observe trends and patterns in Gross and Net NPAs, provisioning, sector-wise NPA distribution and financial performance indicators.

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Key financial ratios used in the analysis include Gross NPA Ratio, Net NPA Ratio, NPA to Total Assets Ratio, Net Profit Margin, Return on Assets and Return on Equity. The study uses Annual Growth Rates (AGR) to identify the year wise movement in NPAs and profitability metrics. Regression analysis is used to explore the relationship between NPAs and performance indicators like ROA, ROE and Net Profit Margin.

ANALYSIS AND DISCUSSION

TABLE I

GROSS NPA RATIO OF SMALL FINANCE BANKS IN INDIA

(Amount of Rs. In Crores)

Year	Gross NPA*	AGR	Gross Advances*	AGR	Gross NPA Ratio*
2018-2019	1087	-	62775	-	1.7
2019-2020	1709	57.22	91509	45.77	1.9
2020-2021	5971	249.39	111589	21.94	5.4
2021-2022	6911	15.74	140003	25.46	4.9
2022-2023	8608	24.56	184808	32.00	4.7

Source: Computed (* Handbook of statistics of Indian Economy)

The Gross NPA ratio of SFBs in India has shown notable fluctuations between 2018-2019 and 2022-2023. In 2018-2019, the gross NPA stood at Rs.1,087 crores with a Gross NPA ratio of 1.7 percent. The following year, both Gross NPAs and Gross Advances grew significantly, resulting in a slight increase in the NPA ratio to 1.9 percent. However, in 2020-2021, there was a sharp rise in NPAs by 249.39 percent, reaching Rs. 5,971 crores, likely due to the impact of the COVID-19 pandemic on borrowers' repayment capacity. This surge led to the highest Gross NPA ratio in the period, at 5.4 percent. In the years that followed, although both Gross NPAs and Advances continued to grow, the NPA ratio gradually declined to 4.9 percent in 2021-2022 and further to 4.7 percent in 2022-2023. This indicates a relative improvement in asset quality despite the expansion in lending. Overall, while the absolute amount of NPAs has increased, the decreasing trend in the NPA ratio in the last two years suggests better credit management and recovery efforts by the Small Finance Banks.

TABLE II

NPA TO TOTAL ASSET RATIO OF SMALL FINANCE BANKS IN INDIA

(Amount of Rs. In Crores)

Year	Gross NPA*	Total Assets*	Total Assets AGR	NPA to Total Asset Ratio*
2018-2019	1087	3351.83	-	1.3

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2019-2020	1709	4321.20	28.92	1.3
2020-2021	5971	5329.88	23.34	3.7
2021-2022	6911	6371.24	19.54	3.4
2022-2023	8608	7153.92	12.28	3.2

Source: Computed (* Handbook of statistics of Indian Economy)

The NPA to Total Asset Ratio Small Finance Banks (SFBs) in India provides insight into the proportion of non-performing assets relative to the total assets held by these banks. In 2018-2019, the Gross NPA stood at Rs. 1,087 crores against total assets of Rs. 3351.83 crores, resulting in an NPA to Total Asset Ratio of 1.3 percent. This ratio remained unchanged in 2019-2020 despite increases in both NPAs and total assets. A sharp rise in Gross NPAs during 2020-2021, driven possibly by the economic disruption from the COVID-19 pandemic, led the ratio to jump to 3.7 percent, indicating deteriorating asset quality. However, in subsequent years, while both Gross NPAs and total assets continued to increase, the NPA to total asset ratio showed a gradual decline to 3.4 percent in 2021-2022 and further to 3.2 percent in 2022-2023. This downward trend suggests an improvement in asset quality and possibly better risk management practices by the banks, even as the growth rate of total assets reduced.

TABLE III

PROFITABILITY RATIO OF SMALL FINANCE BANKS IN INDIA

Year	Net NPA Ratio	Net Profit Margin (%)	Return on Assets (%)	Return on Equity (%)
2018-2019	1.0	7.01	0.56	8.14
2019-2020	0.8	5.60	0.44	7.75
2020-2021	2.7	5.54	0.47	6.23
2021-2022	2.0	7.97	0.64	9.04
2022-2023	0.9	10.84	0.87	12.13

Source: Computed

The profitability ratios of Small Finance Banks (SFBs) in India from 2018-2019 to 2022-2023 reflect notable trends in their financial performance and efficiency. In 2018-2019, SFBs reported a Net NPA ratio of 1.0 percent, with a Net Profit Margin of 7.01 percent, Return on Assets of 0.56 percent and Return on Equity of 8.14 percent, indicating healthy profitability. In 2019-2020, while the Net NPA ratio improved to 0.8 percent, all profitability indicators slightly declined, suggesting rising costs or lower income growth. A significant deterioration occurred in 2020-2021, with the Net NPA ratio spiking to 2.7 percent likely due to pandemic related stress though the Net Profit Margin and ROA remained relatively stable. From 2021-2022 onward, the performance of SFBs improved. The Net NPA ratio declined to 2.0 percent and profitability indicators rebounded, with ROA rising to 0.64 percent and ROE to 9.04

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percent. By 2022-2023, SFBs showed strong financial recovery and efficiency, as the Net NPA ratio dropped to 0.9 percent, Net Profit Margin reached a high of 10.84 percent, and both ROA and ROE improved to 0.87 percent and 12.13 percent respectively. These trends reflect improved asset quality, stronger income generation and more efficient capital use by SFBs over time.

TABLE IV

ASSOCIATION BETWEEN NET NON-PERFORMING ASSETS AND NET PROFIT MARGIN OF SMALL BUSINESS BANKS IN INDIA

REGRESSION STATISTICS			
Multiple R	**R Square**	**Adj. R Square**	**Std Error**
0.93	0.87	0.62	434.50

Source: Computed

ANOVA					
	df	**SS**	**MS**	**F**	**Sig. F**
Regression	1	5244349	5244349.48	27.78	0.01
Residual	4	755171	188792.88		
Total	5	5999521			

Source: Computed

TABLE V

ASSOCIATION BETWEEN NET NON-PERFORMING ASSETS AND RETURN ON ASSETS OF SMALL BUSINESS BANKS IN INDIA

REGRESSION STATISTICS			
Multiple R	**R Square**	**Adj. R Square**	**Std Error**
0.87	0.76	0.51	9757.04

Source: Computed

ANOVA					
	df	**SS**	**MS**	**F**	**Sig. F**
Regression	1	1194706846	1194706846	12.55	0.04
Residual	4	380799511	95199877		
Total	5	1575506358			

Source: Computed

TABLE VI

ASSOCIATION BETWEEN NET NON-PERFORMING ASSETS AND RETURN ON EQUITY OF SMALL BUSINESS BANKS IN INDIA

REGRESSION STATISTICS			
Multiple R	**R Square**	**Adj. R Square**	**Std Error**
0.85	0.74	0.49	4184.71

Source: Computed

ANOVA					
	df	**SS**	**MS**	**F**	**Sig. F**
Regression	1	195446258	195446258	11.16	0.04
Residual	4	70047198	17511799		
Total	5	265493457			

Source: Computed

The above regression analysis examining the association between Net Non-Performing Assets and Net Profit Margin, ROA and ROE of SFBs in India which reveals a strong and statistically significant relationship between the three variables. The correlation coefficient (Multiple R) is 0.93, 0.87 and 0.85 indicating a very strong positive association. The R Square value of 0.87, 0.76 and 0.74 suggests that approximately 87%, 76% and 74% of the variation in the Net Profit Margin, ROA and ROE can be explained by Net NPAs. However, the Adjusted R Square, indicating a moderate explanatory power. The ANOVA table supports the significance of the regression model, with a F-statistic of 27.78, 12.55 and 11.16 and a p-value (Sig. F) of 0.01 and 0.04, which is well below the conventional threshold of 0.05. This confirms that the model is statistically significant and that Net NPAs have a meaningful impact on the Net Profit Margin, Return on Assets (ROA) and Return on Equity (ROE). Overall, the findings imply that as Net NPAs vary, there is a significant and measurable effect on the profitability of SFBs in India.

CONCLUSION

Non-Performing Assets (NPAs) continue to be a critical challenge for Small Finance Banks (SFBs) in India, given their exposure to financially vulnerable sectors such as small businesses, self employed individuals and rural borrowers. This study has revealed that the rising levels of NPAs adversely affect the profitability, liquidity and overall financial health of SFBs. In conclusion, tackling NPAs in SFBs requires a balanced approach involving regulatory oversight, internal governance improvements and innovative risk mitigation strategies. With focused reforms and stronger operational frameworks, SFBs can continue to fulfill their mission of financial inclusion while maintaining financial stability.

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