Governance in SFBs - Driving Sustainable Growth and Stability

(Keynote Address by Shri Swaminathan J, Deputy Governor Reserve Bank of India at the Conference of Directors of Small Finance Banks in Bengaluru on September 27, 2024)

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1. Chairpersons and Directors of the Boards of Small Finance Banks; Chief Executive Officers of SFBs; Executive Directors, Chief General Managers and colleagues from the Reserve Bank of India; ladies and gentlemen. A very good morning to all of you.

2. It is an honour to address this distinguished gathering in the inaugural conference of Board of Directors of Small Finance Banks organised by the RBI. As has been mentioned, this conference is in continuation of the Reserve Bank's efforts to reach out to its supervised entities through a direct dialogue with their Boards and Top Management. Our objective is to reaffirm the importance of good governance for maintaining financial stability and fostering sustainable growth.

3. In his address[1] to the Directors of Public and Private Sector Banks last year, the Governor outlined a comprehensive 10-point charter that addressed key aspects such as the role of the Board, its independence, the importance of setting the tone from the top, etc. His speech serves as an excellent blueprint for regulatory expectations from the Boards of Directors, and I encourage you to review it if you haven't already.

4. Today, I would like to discuss three key issues with you: (i) the vital role of Small Finance Banks in promoting financial inclusion, (ii) the necessity of

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[1] *'Governance in Banks: Driving Sustainable Growth and Stability'*, Inaugural Address by Shri Shaktikanta Das, Governor at the Conference of Directors of Banks organised by the Reserve Bank of India for Public Sector Banks on May 22, 2023 in New Delhi and Private Sector Banks on May 29, 2023 in Mumbai.
https://website.rbi.org.in/web/rbi/-/speeches-interview/-governance-in-banks-driving-sustainable-growth-and-stability-1364

strengthening governance and assurance functions for sustainable growth, and (iii) important considerations regarding business models and risks that Boards should be mindful of.

Important Financial Inclusion objective of SFBs

5. As you are aware, the licensing of Small Finance Banks was introduced a decade ago, in 2014, with the primary objective of advancing financial inclusion. Beyond serving as a vehicle to mobilise savings, SFBs were also envisioned to extend affordable credit to underserved and unorganised sectors, such as small and marginal farmers as well as small business units, by leveraging technology to reduce costs and improve accessibility.

6. India, today, stands at a pivotal moment in her development trajectory. In the last 75 years, we have transformed ourselves from an agrarian economy into one driven by industry and services. However, translating our GDP into higher per capita Gross National Income comparable to developed economies will require a comprehensive approach towards inclusive and sustainable economic growth. This will *inter-alia* entail education, skill development, employment generation, and more pertinently further deepening of financial inclusion. Thus, the goal for small finance banks is not ‘small’. On the contrary, it is very significant, as SFBs play a crucial role in extending financial services to the underserved, fostering entrepreneurship, and driving inclusive growth that will be essential for India’s progress towards becoming a high-income economy.

7. In a developing country like India, it is imperative for the financial sector, including small finance banks to strike a balance between profitability and social objectives. This can be achieved through a strategic focus on sectors that deliver high social impact, ensuring that financial growth is aligned with the broader goal of inclusive development. It is therefore essential for SFBs to actively participate in extending credit under various Government Sponsored Schemes to promote greater accessibility of affordable credit, especially among the vulnerable sections of the society.

8. As the target group of such lending is mostly the marginalised and underserved sections of the society, it is essential for the SFBs to adopt responsible lending practices. It is disheartening to come across egregious practices by some SFBs, such as charging excessive interest rates, collecting instalments in advance as well as not adjusting such advance collections against loan outstanding, levying of usurious fees, etc. It is also observed that grievance redressal mechanism is far from adequate in most SFBs.

9. I therefore feel that periodically reviewing how your bank is fulfilling its financial inclusion objectives is an area that Boards should give much deeper consideration to. It is not just about meeting regulatory requirements such as priority sector lending but also about assessing the true impact of your efforts on underserved communities. Boards can reflect on whether the bank is genuinely reaching marginalised groups, such as low-income households, small businesses, and rural populations, and how effectively it is using technology and innovative products to bridge financial gaps, as these were the objectives of having a differentiated licensing for SFBs.

Strengthening Governance

10. An effective governance framework is the foundation of resilient and well managed institutions, especially in the context of banks. There needs to be a clear division of responsibilities between the Board and the management to ensure smooth functioning of the bank. While the Board is responsible for setting the overall strategic direction, establishing policies, and ensuring that the bank adheres to regulatory frameworks and ethical standards, the management is responsible for the execution of the Board's strategy and operations. It is the Board's role to provide oversight, asking the right questions and holding the management accountable for executing the bank's strategy within the agreed risk appetite.

11. In this context, it is imperative that the views of the Board are clearly articulated and documented in the minutes of the meetings of the Board and its various sub-committees. It is said that the *'palest ink is better than the best*

memory'. Proper documentation serves as a vital record of the Board's deliberations, decisions, and rationale behind those decisions, ensuring transparency and accountability in governance. Clear minutes not only provide a historical account of the Board's discussions but also serve as a reference for future decision-making, helping to maintain continuity and clarity in governance practices.

12. Boards should prioritise proper succession planning for top management. Having just one Whole Time Director (WTD) can create potential vulnerabilities, especially in times of transition or unforeseen circumstances. Without a well-thought-out succession plan, the bank may face leadership gaps that could disrupt operations and affect strategic decision-making. A broader pool of experienced leaders also contributes to better governance and more resilient management structures. We observe that while the SFBs are strengthening their Boards by bringing in new directors, some SFBs are yet to ensure the presence of at least two Whole Time Directors. I would request these banks to expeditiously consider appointing more WTDs.

Empowering Assurance Functions

13. Boards should accord due importance to assurance functions, namely, risk management, compliance and internal audit. These functions play a critical role in identifying and mitigating risks, ensuring compliance with laws and regulations as well as safeguarding the organisation's integrity.

14. Boards should ensure that heads of assurance functions are positioned appropriately within the organisational hierarchy and granted direct access to the Board. Dual-hatting, or combining assurance responsibilities with operational or management duties, undermines the independence and objectivity of assurance functions by creating conflicts of interest. Therefore, any dual hatting of assurance functions, should be avoided.

Key risks to reflect upon

15. Small Finance Banks have demonstrated strong growth since their inception, now accounting for 1.18 percent of total banking assets (as of March 2024). This is a substantial rise from 0.44 percent in March 2018. The deposit base has grown at a 32 per cent compounded annual growth rate (CAGR) over the last five years whereas net advances recorded a CAGR of 26 per cent. While the business growth in Small Finance Banks is indeed impressive, it is imperative that Boards remain vigilant for hidden and emerging risks that could jeopardise their long-term success.

16. In this context, I would like to highlight a few areas that Boards could keep in mind.

Business model

17. Firstly, I would urge Boards to consider the sustainability of their growth strategies and business models by conducting a thorough review of both the liability and asset sides of the balance sheet. Specifically, they should assess whether there is an overdependence on high-cost term deposits or bulk deposits from a limited number of institutions. Additionally, they should evaluate any substantial asset exposures that could adversely impact the bank if they were to sour. These are essential aspects that the Board and its Risk Management Committee must scrutinise to ensure long-term stability and resilience.

Credit risks

18. Secondly, I would like to emphasise proper credit risk underwriting. While many banks have expanded into unsecured retail lending, hoping to leverage the diversification benefits it offers, there is an underlying correlation risk that becomes more pronounced during economic downturns. In such scenarios, the credit profile of a large segment of borrowers can be significantly impacted, leading to higher default rates. This highlights the importance of rigorous underwriting processes that carefully assess the creditworthiness of borrowers, rather than relying solely on automated systems or algorithms. Effective

underwriting should consider a comprehensive range of factors, including income stability, credit history, and the overall economic environment, to ensure that loans are made judiciously.

19. Further, while digital lending solutions have streamlined the process and made access to credit easier, on-the-ground presence for collections remains crucial. Resorting to coercive recovery practices as a means of mitigating risk is not a sustainable solution. Such practices not only harm the bank's reputation but can also lead to legal and regulatory repercussions. A better approach is to implement collection strategies that prioritise communication and collaboration with borrowers. This includes strictly adhering to fair practices code and adopting an empathetic approach while dealing with stressed loan book.

Cyber-security risk and third-party dependencies

20. Thirdly, I would like to address the issue of cyber security and IT vulnerabilities. Being relatively new entities, SFBs have used technology to enhance their product offerings and customer service. However, with their increasing digital footprint, these banks face significant operational risks from growing cyber threats, digital frauds, and possible data breaches.

21. The cyber security landscape is evolving rapidly, and SFBs must stay ahead of emerging threats to protect their customers' data and maintain operational resilience. The SFBs should adopt robust business continuity plans and effective IT outsourcing strategies. There is also a need to ensure rigorous change management processes, comprehensive data protection measures, vigilant transaction monitoring, stringent access controls and network security protocols. These measures will help SFBs to significantly enhance their IT resilience against possible disruptions.

Operational Risk

22. Fourthly, while I have covered cybersecurity threats, I would also like boards of SFBs to be mindful of the larger issue of operational risks. During periods of rapid growth, the focus on increasing market share, launching new

products, and acquiring customers can lead to a neglect of essential risk management practices. For example, hastily onboarding new customers without thorough KYC due diligence or rushing the deployment of technology solutions without adequate testing can increase the likelihood of frauds, errors and service disruptions. Growth is important for the success of Small Finance Banks. However, it must not come by overlooking operational controls.

23. Another significant area of concern for operational risk is the high attrition rate among staff in Small Finance Banks. While the branch network and employee headcounts are expanding, the sector faces a very high attrition rate of nearly 40 per cent, particularly among frontline staff and junior management. Such elevated turnover, though mostly at the entry and junior management levels, poses substantial operational risks, as it can lead to a loss of institutional knowledge, disruption in service delivery, and increased training costs for new hires. To mitigate these risks, Board-level efforts are essential to focus on employee retention strategies at all levels. Further, the absence of succession planning for critical managerial positions is a common issue across SFBs, which requires immediate attention from Boards to ensure a smooth transition of leadership and maintain operational effectiveness.

Conclusion

24. In conclusion, SFBs with their outreach to rural and semi-urban areas, are intended to be one of the key enablers in credit offerings to individuals, weaker sections, entrepreneurs, SHGs/JLGs and MSMEs. They have a large role to play in achieving our aspirational goal of becoming a developed nation by 2047.

25. As RBI celebrates 90 years of its foundation this year, we have set deepening financial inclusion as one of our cherished objectives for RBI@100. RBI, with its continued commitment towards a financially inclusive India, has taken several measures to support these segments ranging from Priority Sector Lending targets to the introduction of TReDS for MSMEs. A new chapter in this book is the Unified Lending Interface (ULI) platform which aims at “enabling

frictionless credit" with the 'new trinity' of JAM-UPI-ULI, further propelling India's growth story.

26. SFBs should strive to harness this opportunity and other such opportunities offered by latest technological innovations for efficient and cost-effective service delivery. Further, with robust governance and effective board oversight, SFBs can capitalise on their strengths while meeting growth and stability objectives.

27. With this, I wish you all the best for the coming sessions and hope that you find these sessions professionally enriching and stimulating. Thank you!

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