

Small Finance Banks: Navigating Growth Amid Microfinance Challenges

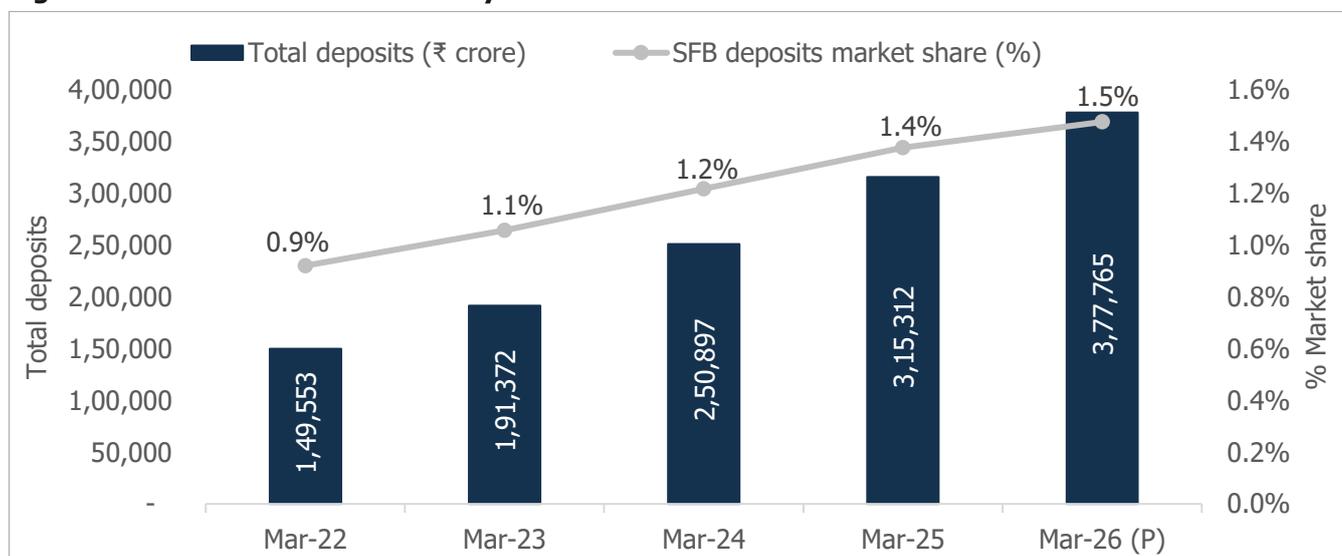
October 10, 2025 | BFSI Research

Synopsis

- Small Finance Banks (SFBs) have evolved rapidly since their inception, demonstrating resilience through multiple disruptions such as demonetisation, NBFC crisis, and the pandemic. The sector has outpaced the broader banking system in both deposits and advances, supported by aggressive branch expansion and a transition from borrowings to a deposit-led liability profile.
- Between FY22 and FY25, SFBs recorded a 28% CAGR in deposits and a 25% CAGR in advances, significantly higher than the industry averages of 12% and 16%, respectively. Market share has steadily improved, with deposits rising to Rs 3.2 lakh crore (1.4% share) and advances at Rs 2.7 lakh crore (1.5% share) as on March 31, 2025.
- A key structural change has been gradual diversification beyond the microfinance (MFI) segment. The share of MFI loans declined from 35% in FY22 to 24% in FY25, with meaningful growth in MSME, vehicle, housing, and Financial Institutions Group (FIG)/corporate loans. Further, RBI, as on June 20, 2025, has reduced the priority sector lending (PSL) norms for SFBs from 75% to 60% of Adjusted Net Bank Credit (ANBC) or Credit Equivalent of Off-Balance Sheet Exposures (CEOBE) (whichever is higher). This is expected to expedite the diversification beyond the MFI segment. Despite an overall improvement in GNPA from 7.2% in FY22 to 2.7% in FY24, it deteriorated to 3.8% in FY25. This was primarily due to stress in the MFI portfolio, where GNPA increased to 6.8% as of March 31, 2025, from 3.2% as of March 31, 2024. Elevated credit costs and high operating expenses have continued to weigh on profitability, with ROTA moderating to 1.0% in FY25 from 1.7% in FY23 and further pressure likely in FY26.
- Despite these headwinds, SFBs remain well-capitalised (Tier I at 19.7%) and are expected to sustain higher-than-industry growth in both deposits and advances. Going forward, the sector's ability to strengthen liability efficiency, improve CASA, and manage MFI-related risks will determine the pace of profitability recovery.

Deposit Growth and Market Share

Figure 1: Gain market share steadily



Source: CareEdge Ratings, Company data

Deposit mobilisation for SFBs has been supported by a rapid scale-up in distribution, whereby they expanded their branch network by 1.3x during the FY22-25 period, reaching 7,641 branches by March 2025. Most of this expansion has been in semi-urban and rural markets. This has helped deepen customer penetration and broaden the retail deposit base, which is vital for the long-term stability of the liability franchise.

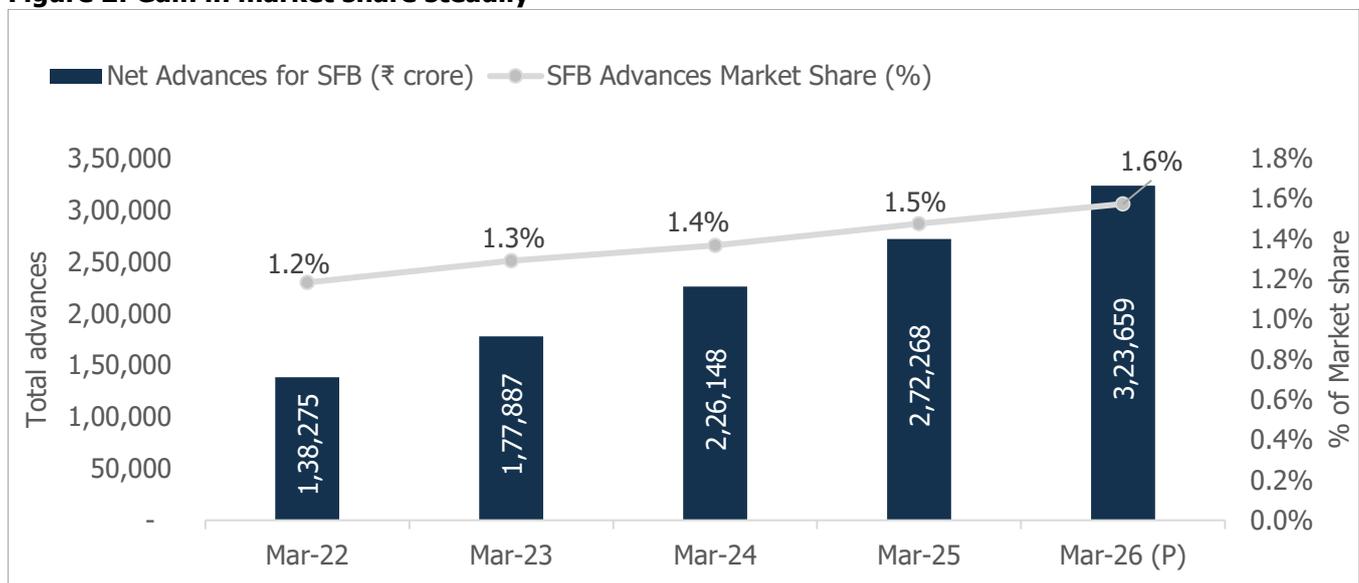
Between FY22 and FY25, SFBs reported a healthy 28% CAGR in deposits and reached a level of Rs 3.2 lakh crore in FY25 compared to Rs 1.5 lakh crore in FY22, far outpacing the broader banking sector’s 12% CAGR. SFBs’ share of system deposits increased from 0.9% to 1.4% during this period.

While volume growth has been strong, improving deposit quality remains the next frontier. The sector’s CASA ratio stood at 26.2% as of March 2025, which is modest compared to peer private and public sector banks. Lower CASA translates to a higher overall cost of funds—7.3% for SFBs in FY25 versus ~5.3% for the broader banking sector. Building a stable, low-cost CASA base will therefore be critical to sustaining profitability and competitiveness. The improving liability profile is also reflected in the Credit-to-Deposit (C/D) ratio. While the industry’s C/D ratio rose to 80.5% by FY25 from 71.9% in FY22, SFBs’ ratio moderated to 86.3% from 92.5% in FY22, indicating a more balanced use of deposits to fund advances. This moderation suggests that as deposit mobilisation strengthens, the pressure to rely on higher-cost borrowings is reducing.

Going forward, CareEdge expects deposit momentum to remain strong, projecting 21% growth in FY26 compared to the industry’s 12%. The sector is likely to capture 1.5% of system deposits by FY26.

Credit Growth and Market Share

Figure 2: Gain in market share steadily



Source: CareEdge Ratings, Company data

SFBs have consistently outpaced the broader banking industry in credit growth, reflecting their strong focus on financial inclusion and expansion into underserved markets. Between FY22 and FY25, SFBs delivered a robust 25% CAGR in advances, compared to 16% CAGR for the overall banking system. This sharp differential highlights the sector’s ability to scale rapidly despite structural constraints such as a branch-heavy model, smaller balance sheet sizes, and geographic concentration.

Drivers of Growth: The strong momentum in advances has been driven by a combination of factors:

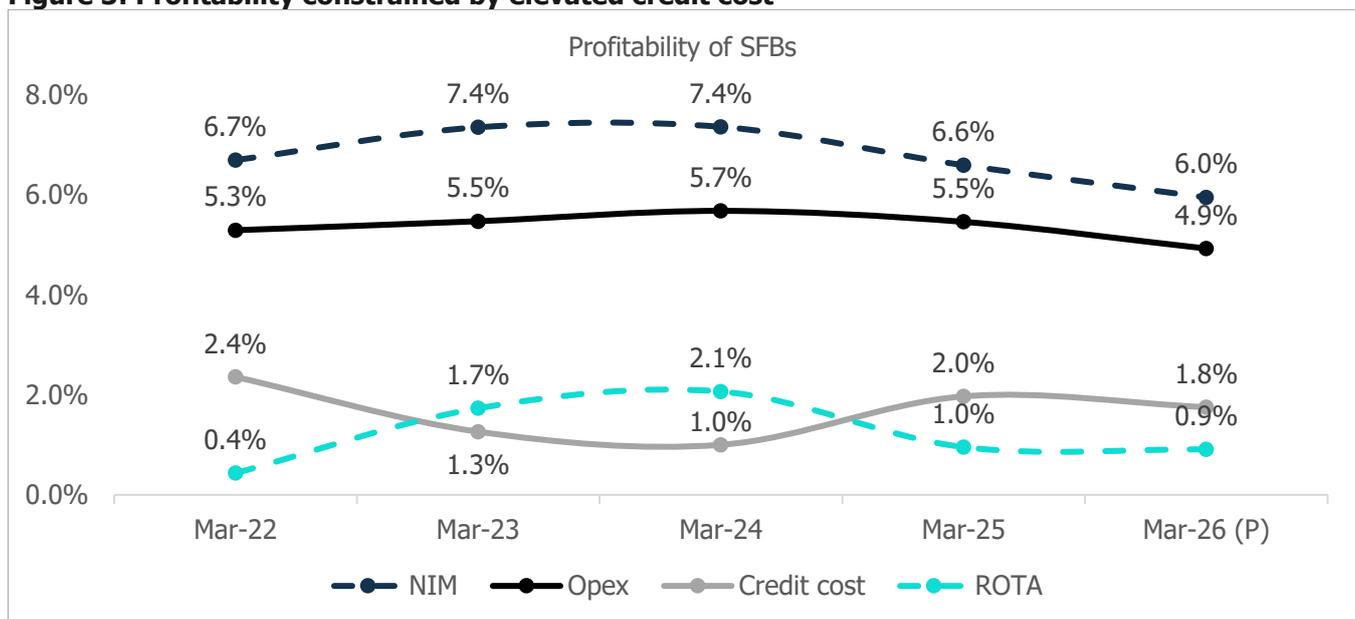
- **Portfolio diversification:** While microfinance loans continue to form a large part of the book, there has been substantial growth in secured segments such as MSME, vehicle finance, and affordable housing. These segments have not only supported growth but also improved portfolio quality.
- **Improved customer franchise:** The shift towards deposit-led funding has strengthened liability stability, enabling sustained credit expansion without over-reliance on wholesale borrowings. Further, regulatory requirements and strategic intent have ensured that SFBs penetrate deeper into rural and semi-urban markets, tapping into segments underserved by larger banks

Credit growth has been driven by semi-urban and rural borrowers—mainly small traders, MSMEs, and self-employed individuals—along with secured retail products like vehicle and housing loans, enabling SFBs to earn higher yields while advancing financial inclusion.

Further, RBI, as on June 20, 2025, has reduced the priority sector lending (PSL) norms for SFBs from 75% to 60% of Adjusted Net Bank Credit (ANBC) or Credit Equivalent of Off-Balance Sheet Exposures (CEOBE) (whichever is higher), thereby lightening their regulatory requirement and enhancing operational flexibility. This change allows SFBs to diversify their loan book beyond MFI and redeploy capital into lower-risk, higher-yielding assets.

High Credit Costs Constrain Profitability Despite Growth

Figure 3: Profitability constrained by elevated credit cost



Source: CareEdge Ratings, Company data

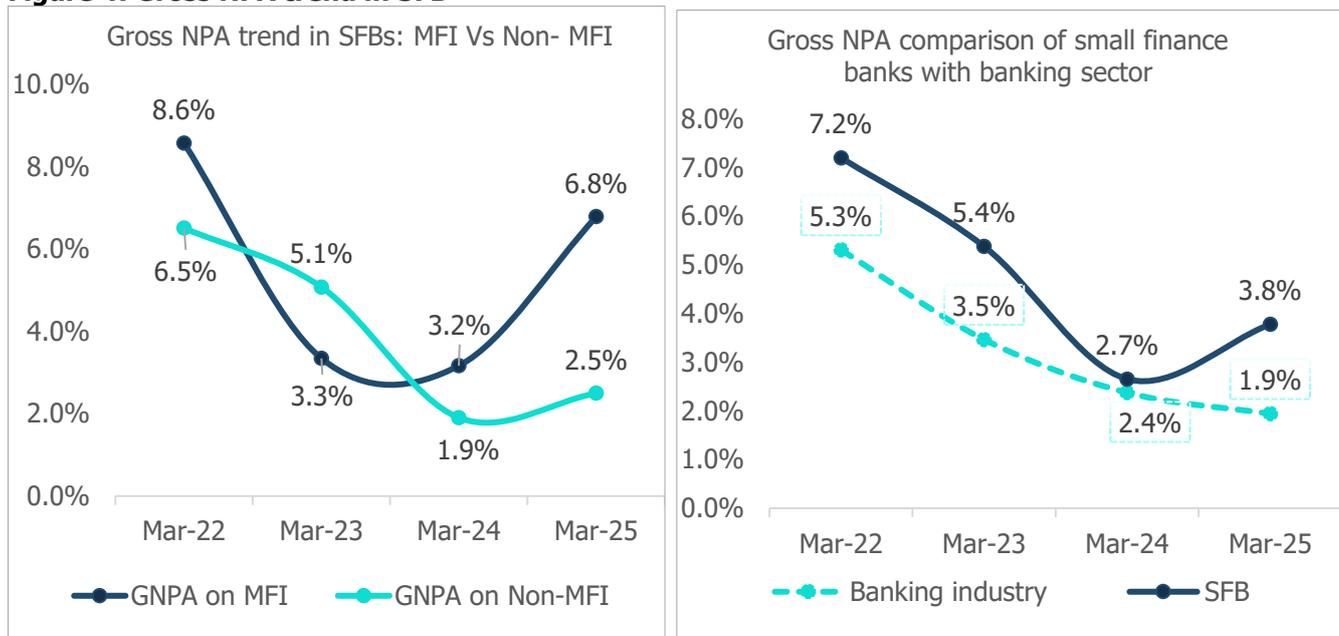
SFBs have historically reported higher yields and strong Net Interest Margins (NIMs) compared to the broader banking sector, driven by their borrower profile and dominance of microfinance loans. NIMs peaked at 7.4% in FY23 and FY24, reflecting the high-yielding nature of MFI and MSME portfolios. However, as portfolio diversification toward secured products such as housing and vehicle loans has gathered pace, yields have begun to moderate. Consequently, NIMs declined to 6.6% in FY25 and are projected to ease further to around 6.0% in FY26.

Asset quality stress continues to weigh heavily on profitability. The microfinance portfolio, which remains a sizeable share of SFB books, has been particularly volatile. Despite overall GNPA improving to 3.8% in FY25, MFI GNPA spiked to 6.8%, leading to elevated provisioning requirements. Credit costs are expected to remain high in FY26 as SFBs work through the stress in this segment, offsetting gains from yield advantages.

Operating expenses represent another structural challenge. SFBs incur significantly higher cost-to-income ratios than universal banks, reflecting their branch-intensive operating model, mandated rural presence, and ongoing technology investments. In FY25, operating expenses stood at 5.5% of assets, compared to ~2% for the broader banking sector. Lower business volumes per branch and relatively smaller scale limit operating leverage, further constraining profitability.

The combined effect of moderating NIMs, elevated credit costs, and high operating expenses has resulted in a subdued return ratio. Return on Average Assets (ROTA), which improved to 2.1% in FY24, fell sharply to 1.0% in FY25. Excluding one large SFB, ROTA dropped by an additional ~30 bps, indicating weaker profitability at most of the institutions. Return on Equity (RoE) has also remained below expectations. CareEdge Ratings expect further moderation, with ROTA likely to hover around 0.9% in FY26.

Figure 4: Gross NPA trend in SFB



Source: CareEdge Ratings, Company data

SFBs have witnessed significant fluctuations in asset quality over the last five years, reflecting their borrower profile and concentration in the MFI segment. After sharp deterioration during the pandemic (FY20–FY22), collection efficiencies improved, and Gross NPAs (GNPA) declined. GNPA fell from a peak of 7.2% in FY22 to 3.8% in FY25, underscoring the sector’s ability to recover post-COVID.

The microfinance portfolio, which still accounts for nearly one-third of SFB advances, has shown renewed vulnerability. GNPA in the MFI segment, which had improved to 3.2% in FY24, spiked to 6.8% in FY25. This level was higher than the broader MFI industry average by over 60 basis points, indicating weaker borrower resilience within SFB portfolios. Elevated slippages from overleveraged rural borrowers, coupled with uneven economic recovery in certain regions, contributed to this rise.

In contrast, diversification into secured segments has supported overall asset quality. GNPA in non-MFI portfolios improved steadily, declining to 1.9% in FY24 before moderating slightly to 2.5% in FY25. MSME, vehicle, and housing loans have exhibited relatively stable repayment trends, reflecting better collateralization and stronger underwriting practices. This divergence highlights the benefit of portfolio diversification in reducing concentration risk.

Conclusion

According to Sanjay Agarwal, Senior Director, CareEdge Ratings, "While the pressure on profitability of SFBs is expected to continue in FY26, transition to the revised PSL norms will provide them more flexibility in lending and allow derisking of their portfolio in the medium term. Their journey—marked by resilience through major disruptions such as demonetisation, the NBFC crisis, and the COVID-19 pandemic—underscores their deep commitment to financial inclusion."

Said Priyesh Ruparelia, Director, CareEdge Ratings, "FY26 is expected to be a pivotal year, with many SFBs focusing on stabilising profitability and enhancing operational efficiency amid challenges in credit cost, which is expected to remain in the range of 1.8-2.0%."

Said Dr Sudam Shingade, Associate Director, CareEdge Ratings, "In the medium to long term, SFBs' ability to improve liability efficiency, strengthen deposit quality, and manage microfinance-related risks and technology adoption will be crucial for sustaining profitability. As they evolve toward universal banking characteristics, SFBs are poised to play a vital role in expanding financial access and fostering inclusive economic growth."

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