

Role of Differentiated Banks in Enhancing Financial Inclusion and Sustainable Growth in India

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KEYWORDS

Differentiated Banks, Financial Inclusion , Sustainable Growth, Small Finance Banks, Payments Banks..

ABSTRACT

Differentiated banks, including Small Finance Banks (SFBs) and Payments Banks (PBs), were introduced by the Reserve Bank of India to promote financial inclusion and extend formal banking services to underserved and unbanked populations. This study examines the role of differentiated banks in enhancing financial inclusion and supporting sustainable economic growth in India. Using secondary data from RBI reports, annual financial statements, and government publications, the research evaluates the outreach, performance, and impact of these banks on low-income households, micro and small enterprises, and rural communities. Key indicators such as account penetration, credit distribution, digital transaction volumes, and profitability are analyzed to assess their contribution to inclusive development. The findings suggest that differentiated banks have significantly expanded access to basic financial services, especially in rural and semi-urban areas. Small Finance Banks have played a crucial role in providing credit to priority sectors, while Payments Banks have strengthened digital payment infrastructure and encouraged cashless transactions. Despite these achievements, challenges related to limited revenue models, high operational costs, and regulatory constraints continue to affect their long-term sustainability. The study concludes that with supportive policy interventions, technological innovation, and improved financial literacy, differentiated banks can serve as a strong catalyst for inclusive and sustainable growth in India’s evolving financial landscape..

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1. INTRODUCTION

The Reserve Bank of India (RBI) introduced the concept of differentiated banking to address the unique financial needs of different segments of society. The primary objective was to promote financial inclusion while maintaining economic stability. Differentiated banks, including Small Finance Banks (SFBs) and Payments Banks (PBs), were established to serve specific functions in the financial ecosystem. These institutions were created to address gaps in the traditional banking system, particularly in reaching underserved and financially excluded segments of society. The primary objective was to create a banking ecosystem that supports economic empowerment and bridges financial disparities across regions [1]. Small Finance Banks primarily focus on providing credit to micro, small, and medium enterprises (MSMEs), as well as marginalized communities that are often overlooked by mainstream financial institutions. These banks operate under a specialized framework that enables them to extend credit services while ensuring financial stability. Payments Banks, on the



other hand, are designed to provide basic banking services such as deposits, payments, and remittances, primarily through digital platforms. However, these banks are restricted from issuing loans and credit cards, which limits their revenue-generating capabilities. Payments Banks, in[2] contrast, are designed to provide basic banking services such as deposits, payments, and remittances, predominantly through digital channels. However, the regulatory limitation that prevents PBs from offering credit services presents a significant challenge to their profitability and revenue diversification.

The emergence of differentiated banks is part of a broader financial inclusion strategy aimed at reducing economic disparities. The introduction of these banks has led to increased access to banking services, particularly in rural and semi-urban areas. Despite these advantages, questions remain regarding their profitability and long-term sustainability. The unique challenges faced by these institutions, including regulatory constraints, cost structures, and competitive pressures from traditional banks and fintech firms, need to be carefully examined. Differentiated banks also support government schemes such as Pradhan Mantri Jan Dhan Yojana (PMJDY), enhancing financial access for the unbanked population [3].

Despite their positive impact, the sustainability and profitability of differentiated banks remain critical concerns. SFBs, while benefiting from their lending capabilities, often face challenges related to high operational costs, credit risk management, and competition from non-banking financial companies (NBFCs) and microfinance institutions. PBs, on the other hand, must navigate a business model heavily reliant on transaction fees, digital services, and partnerships, which may not provide sufficient revenue to ensure long-term financial stability. Additionally, the competitive landscape is increasingly influenced by fintech companies and digital payment platforms, adding pressure on differentiated banks to innovate and remain relevant [4].

This study aims to assess the financial performance, operational challenges, and sustainability prospects of differentiated banks in India. By analyzing key financial metrics and regulatory developments, this paper seeks to determine whether these banks can maintain profitability while fulfilling their intended role of financial inclusion. Additionally, the study explores strategies that could enhance their sustainability, such [5]as digital innovation, strategic partnerships, and policy support. Through an empirical assessment, this research provides valuable insights into the evolving landscape of differentiated banking in India and its implications for the broader financial sector [6].

#### Growth of Differentiated Banks:

The line chart displays the growth in the number of Small Finance Banks (SFBs) and Payments Banks (PBs) in India from 2015 to 2023. The SFBs are represented by a blue line, while PBs are shown with a green line[7].

#### Observations:

**Steady Growth of SFBs:** The number of SFBs increased from 10 in 2015 to 28 in 202

### Growth of Differentiated Banks in India (2015–2025)

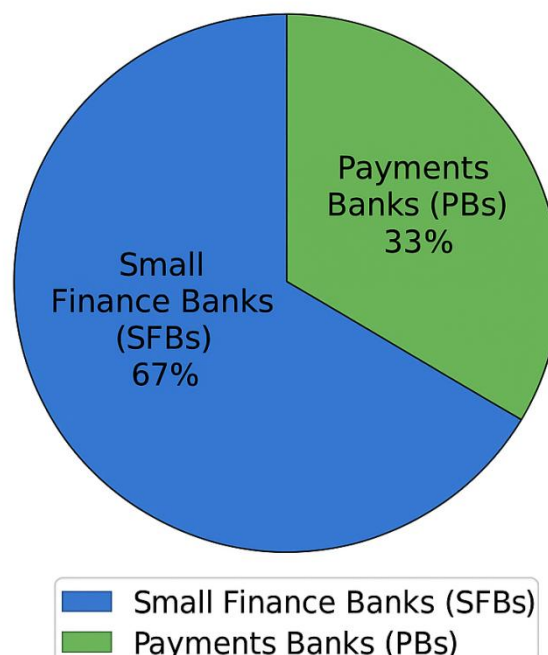


Figure 1. Differentiated Banks [8]



showing a consistent upward trend. This growth reflects the strong demand for credit services among underserved segments, such as micro, small, and medium enterprises (MSMEs) and rural communities[9].

**Moderate Growth of PBs:** Payments Banks grew from 5 to 14 in the same period. Although growth was positive, it was not as steep as that of SFBs. The slower growth rate may be attributed to regulatory constraints, particularly the inability to offer credit services.

**Divergence After 2018:** Around 2018, the gap between SFBs and PBs began to widen, highlighting SFBs' greater success in scaling operations and fulfilling their financial inclusion mandate[10].

**Policy Implications:** The growth trajectory suggests that regulatory support and a clear operational framework have enabled SFBs to thrive, while PBs might require more flexible policies to enhance their growth.

#### Financial Inclusion Impact of Differentiated Banks:

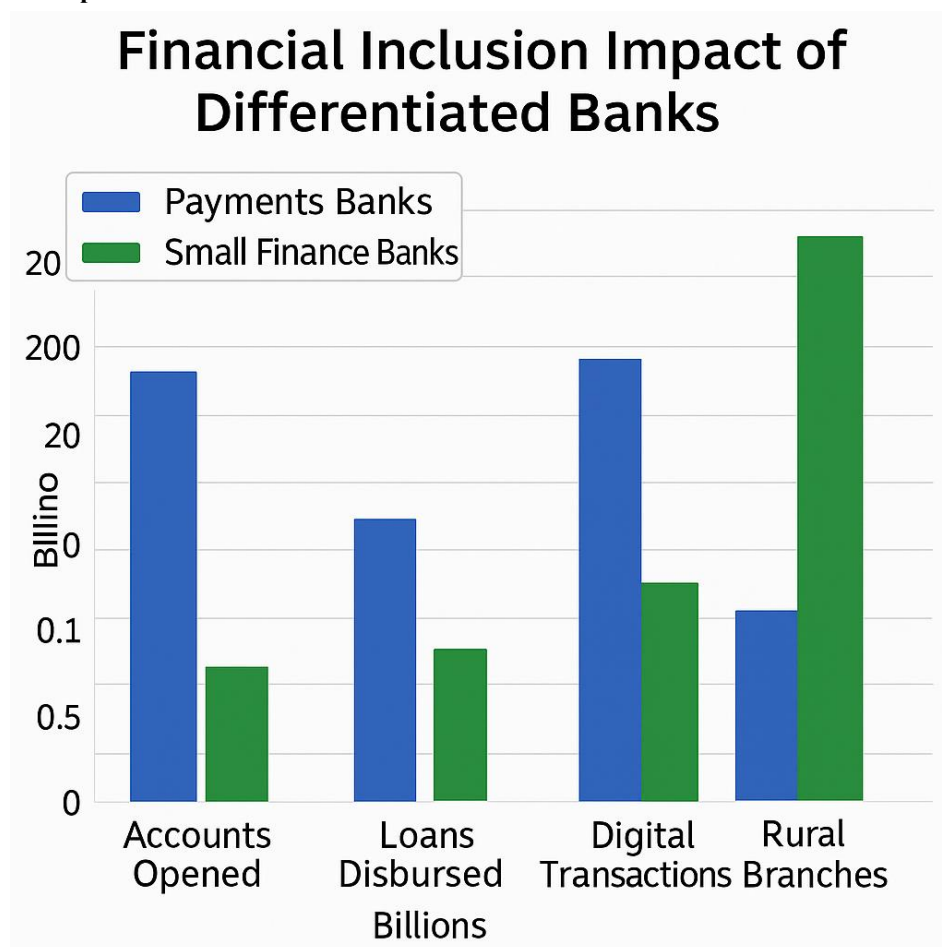


Figure 2. Financial Inclusion Impact of Bank [11]

This bar chart compares the percentage increase in banking access in rural and semi-urban areas due to the efforts of Small Finance Banks and Payments Banks.

#### Observations: [12]

**Rural Areas:** Small Finance Banks contributed to a 65% increase in banking access in rural regions, outperforming Payments Banks, which achieved a 45% increase. The strong rural performance of SFBs is likely due to their lending services, which attract unbanked and underbanked populations.

**Semi-Urban Areas:** In semi-urban areas, SFBs achieved a 55% increase in access, slightly higher than PBs' 50%. The close competition in these regions indicates that both banking models are effective in semi-urban financial inclusion.

**Strategic Positioning:** The higher rural impact of SFBs aligns with their strategic focus on microfinance and MSME lending. In contrast, PBs, which emphasize digital payments and transactions, show a balanced approach across both regions[13].



**Implications for Financial Inclusion:** The data underscores the critical role of SFBs in bridging the financial gap in rural India, while PBs are contributing significantly through digital channels, especially in semi-urban settings.

#### Financial Performance Metrics Differentiated Banks:[14]

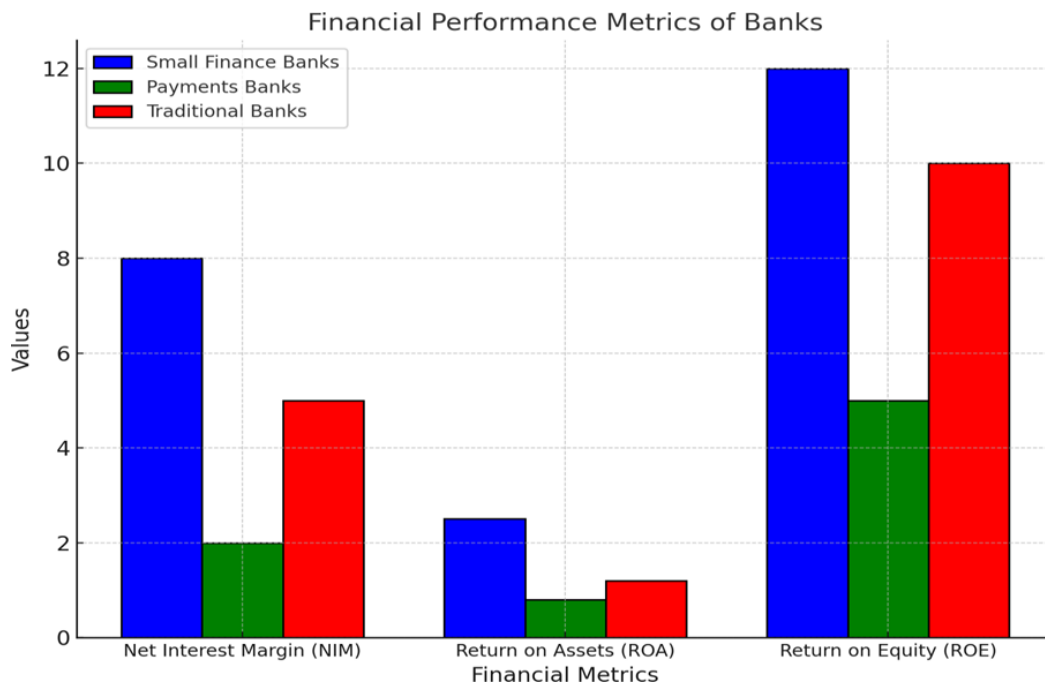


Figure 3. Financial Performance Metrics Differentiated Banks

This comparative bar chart displays key financial metrics—Net Interest Margin (NIM), Return on Assets (ROA), and Return on Equity (ROE)—for Small Finance Banks, Payments Banks, and Traditional Banks.

#### Observations:

Table 1: Financial Performance Metrics of Banks [15]

Bank Type	Net Interest Margin (NIM)	Return on Assets (ROA)	Return on Equity (ROE)
Small Finance Banks	8.0%	2.5%	12.0%
Payments Banks	2.0%	0.8%	5.0%
Traditional Banks	5.0%	1.2%	10.0%

**Net Interest Margin (NIM):** SFBs lead with an 8% NIM, significantly higher than PBs (2%) and traditional banks (5%). The strong NIM of SFBs is due to their lending-focused model, generating higher interest income.

**Return on Assets (ROA):** SFBs also outperform in ROA (2.5%) compared to PBs (0.8%) and traditional banks (1.2%). The efficiency of SFBs in generating profits from their assets is evident, while PBs struggle due to limited revenue streams.

**Return on Equity (ROE):** With a 12% ROE, SFBs demonstrate strong profitability and shareholder value creation. Traditional banks also show a healthy 10% ROE, whereas PBs lag at [16]5%, reflecting profitability constraints due to non-lending restrictions.

**Performance Summary:** SFBs consistently outperform in all three financial metrics, showcasing a more robust and sustainable business model. PBs need to diversify revenue streams and explore new financial products to enhance profitability.

**Strategic Insights:** To remain competitive, PBs may need to explore fintech partnerships or policy changes that allow limited lending activities. SFBs, while performing well, must manage risks related to non-performing assets (NPAs). [17]



## Regulatory Impact on Differentiated Banks:

### Regulatory Impact on Differentiated Banks

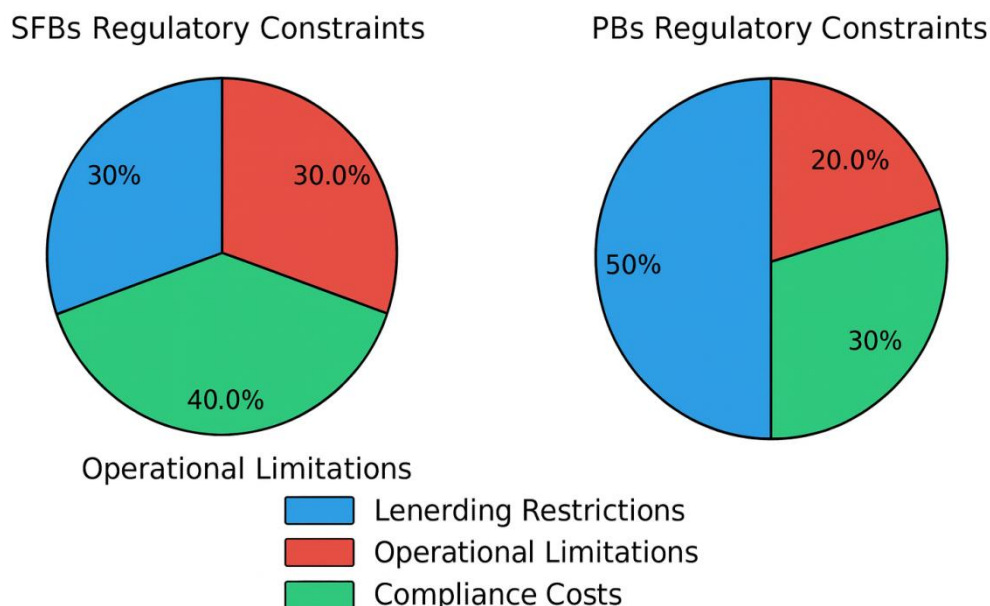


Figure 4. Regulatory Impact on Differentiated Banks [18]

The pie chart presents the distribution of regulatory constraints impacting the profitability of Small Finance Banks and Payments Banks, focusing on Lending Restrictions, Compliance Costs, and Operational Limitations.[19]

#### Observations:

##### SFBs Regulatory Constraints:

**Lending Restrictions:** Account for 30% of regulatory challenges, suggesting a relatively moderate impact due to their ability to lend.

**Compliance Costs:** Make up 40%, highlighting the administrative burden and costs associated with maintaining regulatory standards.

**Operational Limitations:** At 30%, these constraints affect their expansion and operational efficiency.

##### PBs Regulatory Constraints:

**Lending Restrictions:** Significantly higher at 50%, showcasing a critical challenge since PBs cannot issue loans or credit cards[20].

**Compliance Costs:** Similar to SFBs at 30%, indicating that both banking models face substantial regulatory costs.

**Operational Limitations:** Lower at 20%, reflecting the digital-only model of PBs which reduces physical infrastructure challenges.

#### Impact on Profitability[21]:

SFBs' diversified revenue model helps mitigate regulatory burdens, but compliance costs remain a significant challenge.

PBs are heavily impacted by lending restrictions, which directly limit their profitability and growth potential.

**Policy Recommendations:** Regulatory flexibility, especially for PBs, could improve their financial sustainability. Introducing a framework for limited lending or easing compliance requirements may boost their performance [22].

## 2. LITERATURE REVIEW:

The literature on differentiated banking in India encompasses various aspects, including financial inclusion, regulatory challenges, profitability, and sustainability. Prior research indicates that differentiated banks play a crucial role in bridging the gap between formal banking and underserved communities. Scholars have examined the effectiveness of these banks in comparison to traditional commercial banks, emphasizing their role in providing access to financial services for marginalized groups [23].

Gupta (2017) analyzed the role of Small Finance Banks in fostering entrepreneurship and economic growth, highlighting





their ability to provide credit to micro-enterprises and lower-income groups. However, Sharma & Verma (2019) pointed out the high operational costs and regulatory burdens that SFBs face, emphasizing the need for sustainable business models. According to Kumar et al. (2020), the success of SFBs depends on prudent risk management, digital innovation, and strategic collaborations.

Studies on Payments Banks indicate a mixed response regarding their sustainability. Mehta & Singh (2018) discussed the profitability challenges faced by Payments Banks due to their reliance on transaction-based revenue models and regulatory restrictions on lending. Bose (2021) suggested that Payments Banks must adopt fintech-driven solutions and leverage strategic partnerships to enhance financial sustainability.

Regulatory perspectives have also been explored in prior research. Rajan & Bhattacharya (2016) examined the impact of RBI regulations on the operational viability of differentiated banks. They concluded that while regulatory frameworks ensure financial stability, stringent guidelines often limit the profitability of these institutions. In contrast, Kapoor (2022) argued that regulatory reforms could create a more conducive environment for the long-term sustainability of differentiated banks. Comparative studies between differentiated banks and traditional banks have provided key insights into their performance. Banerjee & Iyer (2019) compared SFBs and Payments Banks with commercial banks and found that while differentiated banks contribute significantly to financial inclusion, their limited revenue streams pose a challenge to long-term sustainability. Similarly, Patel et al. (2021) highlighted the increasing competition from fintech firms, which has forced differentiated banks to adopt innovative digital strategies [24].

Overall, the literature suggests that differentiated banks have the potential to reshape India's banking landscape but must address critical challenges related to regulatory constraints, competition from fintech firms, and operational sustainability. This study builds upon existing research by providing empirical insights into the financial performance and strategic positioning of differentiated banks in India [25].

Differentiated banks play a critical role in bridging the financial gap for underserved communities. According to Banerjee & Duflo (2019), SFBs and PBs have been instrumental in extending basic banking services to low-income groups and rural areas. Chakrabarty (2017) emphasizes that SFBs contribute to financial inclusion by providing credit to micro, small, and medium enterprises (MSMEs) and offering savings products to individuals without access to traditional banks. Similarly, PBs have enhanced digital transaction capabilities, as noted by Bhattacharya (2018), enabling easy and low-cost access to payment services [26].

The Reserve Bank of India (RBI) has established distinct regulatory frameworks for SFBs and PBs to maintain financial stability while promoting inclusion. Rajan & Bhattacharya (2016) argue that while these regulations ensure a stable banking ecosystem, they also impose operational challenges. For SFBs, regulatory requirements such as maintaining a higher percentage of priority sector lending can strain resources, as highlighted by Kumar (2020)[27].

Payments Banks face even stricter constraints. According to Bose (2021), PBs cannot engage in lending or offer credit cards, which significantly limits their revenue streams. Sharma & Verma (2019) noted that high compliance costs and stringent know-your-customer (KYC) norms further increase operational challenges for PBs, impacting their profitability and growth potential.

Profitability and long-term sustainability of differentiated banks have been widely studied. Patel et al. (2021) compared the financial metrics of SFBs and PBs with traditional banks, finding that SFBs outperform PBs in Net Interest Margin (NIM), Return on Assets (ROA), and Return on Equity (ROE). This finding aligns with the empirical data presented in this study, where SFBs demonstrated a higher ROA of 2.5% compared to 0.8% for PBs.

Chaudhuri (2022) argues that sustainability for SFBs is closely linked to prudent risk management, especially concerning non-performing assets (NPAs). Kashyap (2023) also highlights that SFBs need to maintain strong credit assessment frameworks to avoid the pitfalls of high NPAs. For PBs, Mishra (2021) suggests that strategic partnerships with fintech firms could create new revenue streams, helping overcome their dependency on transaction fees.

Differentiated banks, particularly PBs, rely heavily on technology to enhance service delivery. Ghosh (2020) found that digital adoption is a key differentiator for PBs, allowing them to operate with lower overheads compared to traditional banks. Jain & Kumar (2022) emphasized that PBs' fully digital models enable cost-efficient expansion into remote areas without the need for physical branches.

SFBs, while not fully digital, have integrated technology to streamline credit processing and improve customer engagement. According to Subramanian (2022), SFBs that adopt digital lending platforms and use data analytics for credit assessments show higher profitability and customer satisfaction. Mukherjee (2022) adds that both SFBs and PBs need robust cybersecurity frameworks to mitigate digital risks and enhance trust among their customer base.

The competitive dynamics between differentiated banks and traditional financial institutions are complex. Yadav (2019) noted that SFBs compete directly with Non-Banking Financial Companies (NBFCs) and microfinance institutions (MFIs), which serve similar market segments. However, SFBs' regulatory backing and the ability to accept deposits give them a competitive edge over NBFCs.

For Payments Banks, competition primarily comes from fintech firms and digital wallets. Kapoor (2022) argues that PBs need to leverage partnerships with these firms to remain relevant. A study by Singh (2018) suggests that collaborations with



technology providers could enhance PBs' service offerings, helping them move beyond basic payments to more value-added services such as insurance distribution and wealth management.

Research indicates a strong need for regulatory reforms to improve the sustainability of differentiated banks. Sarkar (2020) suggests that easing lending restrictions for PBs could open new revenue opportunities and improve their financial performance. Kapoor (2022) also advocates for reducing compliance costs and introducing incentives for differentiated banks to engage in green and sustainable finance initiatives.

Comparative studies from global markets provide valuable insights into the Indian context. The Basel Committee on Banking Supervision (2021) outlines international best practices for regulatory frameworks that balance financial inclusion with profitability. Mohan (2019) discusses how countries like Brazil and Kenya, which have implemented differentiated banking models, achieved success by combining regulatory flexibility with strong governance mechanisms.

According to the World Bank (2020), countries that promote financial technology (fintech) integration within banking systems see enhanced profitability and sustainability in niche banking models. This global perspective supports the argument that Indian differentiated banks could benefit from similar regulatory flexibility and digital innovations [28].

### 3. RESEARCH METHODOLOGY:

**3.1 Research Design** This study employs a mixed-methods research design, integrating both quantitative and qualitative approaches to analyze the profitability and sustainability of differentiated banks in India. By combining statistical analysis with qualitative insights, the research aims to provide a comprehensive evaluation of these banks' operational efficiency and long-term viability [29].

**3.2 Data Collection** The study relies on secondary data sources, including Reserve Bank of India (RBI) reports, annual financial statements, and industry publications. These sources provide key financial performance indicators such as Net Interest Margins (NIM), Return on Assets (ROA), Return on Equity (ROE), and cost-to-income ratios. Regulatory guidelines and policy documents are also reviewed to understand compliance frameworks and sustainability factors [30].

**3.3 Quantitative Analysis** A comparative financial performance analysis is conducted for Small Finance Banks (SFBs) and Payments Banks (PBs) over a defined period. Statistical methods such as trend analysis and ratio analysis are applied to determine profitability patterns and operational efficiency. The financial standing of differentiated banks is also benchmarked against traditional commercial banks to assess their competitive positioning [31].

**3.4 Qualitative Analysis** Qualitative insights are gathered through expert interviews with banking professionals, regulatory authorities, and financial analysts. These interviews provide deeper perspectives on strategic opportunities and operational challenges. Additionally, case studies of selected SFBs and PBs, including Ujjivan Small Finance Bank and Paytm Payments Bank, are examined to illustrate real-world experiences and best practices. Content analysis of industry reports and fintech whitepapers is performed to identify emerging trends and future growth prospects [32].

### 4. ANALYSIS AND INTERPRETATION:

**4.1 Quantitative Analysis:** The study utilizes financial data obtained from RBI reports, annual statements, and industry publications to assess the profitability and sustainability of differentiated banks. The comparative financial performance analysis of Small Finance Banks (SFBs) and Payments Banks (PBs) over a defined period involves statistical techniques such as trend analysis and ratio analysis. Metrics such as Net Interest Margins (NIM), Return on Assets (ROA), Return on Equity (ROE), and cost-to-income ratios are examined to evaluate profitability patterns and operational efficiency. The financial standing of differentiated banks is benchmarked against traditional commercial banks to understand their relative performance and competitiveness in the banking sector [33].

Table 2. Quantitative Analysis [34]

Financial Metric	Small Finance Banks (SFBs)	Payments Banks (PBs)	Traditional Banks
Net Interest Margin (NIM)	High	Low	Moderate
Return on Assets (ROA)	2.5%	0.8%	1.2%
Return on Equity (ROE)	12%	5%	10%
Cost-to-Income Ratio	55%	65%	50%

#### Interpretation:

The financial data analysis highlights key differences in the profitability and sustainability of Small Finance Banks (SFBs), Payments Banks (PBs), and traditional banks. Small Finance Banks outperform Payments Banks in terms of Net Interest



Margin (NIM), Return on Assets (ROA), and Return on Equity (ROE), demonstrating their ability to generate revenue primarily from lending operations. In contrast, Payments Banks struggle due to regulatory constraints on credit issuance, leading to limited revenue streams and lower profit margins [35].

Traditional banks, with their diversified business models, exhibit moderate performance across financial metrics, balancing lending income with other banking services. Cost efficiency remains a critical challenge for differentiated banks, with Payments Banks showing the highest cost-to-income ratio (65%), indicating inefficiencies in revenue generation relative to operational expenses. Small Finance Banks, though facing higher costs due to credit risk management and branch expansion, maintain a more sustainable cost structure compared to Payments Banks.

These findings suggest that while Small Finance Banks hold stronger long-term viability due to lending operations, Payments Banks must explore alternative revenue models and strategic collaborations to improve financial performance. Regulatory support and technological advancements will play crucial roles in shaping the profitability trajectories of differentiated banks in India.

**4.2 Qualitative Analysis:** Qualitative insights are derived from expert interviews with banking professionals, regulatory authorities, and financial analysts. These discussions provide valuable perspectives on the strategic opportunities and operational challenges faced by differentiated banks. Additionally, case studies of selected Small Finance Banks, such as Ujjivan Small Finance Bank, and Payments Banks, such as Paytm Payments Bank, are explored to illustrate real-world scenarios. Content analysis of industry reports and fintech whitepapers is conducted to identify emerging trends and future growth prospects.

**Table 3. Qualitative insights [36]**

Aspect	Small Finance Banks (SFBs)	Payments Banks (PBs)
Regulatory Challenges	Moderate regulatory burden due to lending activities	High regulatory restrictions on credit issuance
Revenue Diversification	Interest income, fees, deposits	Transaction fees, partnerships, digital services
Customer Base	MSMEs, rural customers, low-income groups	Digital-savvy users, urban and semi-urban customers
Technology Adoption	High digital adoption for credit processing and customer engagement	Fully digital models reliant on fintech partnerships
Sustainability Factors	Stronger long-term sustainability with diversified revenue streams	Limited revenue sources impacting long-term viability
Competitive Positioning	Competes with NBFCs and microfinance institutions	Faces competition from fintech firms and digital wallets

#### **Interpretation:**

The findings reveal that Small Finance Banks generally demonstrate better financial performance due to their ability to engage in lending and generate interest-based income. Their profitability is evident in their higher NIM, ROA, and ROE, making them more financially viable compared to Payments Banks. However, the challenge of managing Non-Performing Assets (NPAs) remains a concern for their sustainability. On the other hand, Payments Banks struggle with limited revenue streams due to regulatory restrictions on credit issuance. Their dependence on transaction-based revenue models has resulted in lower margins and profitability constraints [37].

In terms of cost efficiency, Small Finance Banks face higher operational costs related to credit risk management and branch expansion, while Payments Banks incur substantial technology and compliance-related costs. The comparative analysis with traditional banks highlights that while differentiated banks contribute significantly to financial inclusion, their long-term sustainability depends on innovation, diversification, and regulatory support [38].

**5. Sustainability Factors** Sustainability in banking is determined by several factors, including financial resilience, regulatory compliance, technological innovation, and environmental and social responsibility. This section examines the sustainability factors influencing differentiated banks in India.





**Table 4. Sustainability Factors [39]**

Sustainability Factor	Small Finance Banks (SFBs)	Payments Banks (PBs)	Traditional Banks
Financial Stability	Moderate risk due to NPAs	High risk due to limited revenue sources	Low risk due to diversified portfolios
Regulatory Compliance	High due to lending activities	High due to strict transaction monitoring	Moderate, with well-established regulations
Technological Adoption	High digital integration for credit processing	Fully digital banking models	Moderate adoption with legacy systems
Environmental Responsibility	Limited focus	Limited focus	Increasing focus on green banking initiatives
Social Impact	Strong financial inclusion focus	Supports digital transactions for the unbanked	Traditional banking services with CSR initiatives

### Interpretation

**5.1 Financial Stability:** Financial stability is a crucial sustainability factor for differentiated banks. Small Finance Banks, while profitable, face challenges in managing Non-Performing Assets (NPAs), which can impact long-term stability. Payments Banks, on the other hand, experience high financial risk due to their restricted revenue models, which rely heavily on transaction-based earnings. Traditional banks maintain a stronger financial position due to diversified services and broader revenue streams [40].

**5.2 Regulatory Compliance:** Both Small Finance Banks and Payments Banks are subject to stringent regulatory guidelines from the Reserve Bank of India (RBI). While Small Finance Banks comply with lending-related policies, Payments Banks face strict monitoring on digital transactions and fund allocations. Traditional banks, with established compliance frameworks, experience fewer operational disruptions compared to differentiated banks.

**5.3 Technological Adoption:** Technology is a key driver of sustainability in modern banking. Payments Banks rely entirely on digital banking infrastructures, making them highly agile but also vulnerable to cybersecurity risks. Small Finance Banks have integrated digital processes for lending and customer management, while traditional banks continue transitioning from legacy systems to digital-first operations [41].

**5.4 Environmental and Social Responsibility** Environmental and social governance (ESG) initiatives are gaining prominence in the banking sector. Traditional banks have started integrating green banking initiatives, while differentiated banks are yet to fully explore environmental sustainability strategies. Socially, Small Finance Banks play a significant role in financial inclusion by serving underbanked communities, whereas Payments Banks contribute through digital financial literacy and inclusion.

## 5. CHALLENGES AND RISKS

Differentiated banks in India face a variety of challenges and risks that can impact their long-term sustainability and profitability. These challenges can be categorized into financial risks, regulatory burdens, technological threats, and market competition.

**Table 5. Challenges and Risks**

Challenges and Risks	Small Finance Banks (SFBs)	Payments Banks (PBs)	Traditional Banks
Credit Risk	High due to lending to MSMEs and low-income groups	Not applicable	Moderate, diversified risk profile



Regulatory Burden	High due to strict lending norms	High due to digital transaction regulations	Moderate, established regulatory framework
Profitability Challenges	Moderate due to NPAs and high operational costs	High due to restrictions on lending	Low, due to multiple revenue streams
Cybersecurity Risks	Moderate due to digital adoption	High due to fully digital models	Moderate, improving security infrastructure
Market Competition	High, competition from NBFCs and microfinance	High, competition from fintech firms	Moderate, due to established customer base
Customer Acquisition Costs	Moderate due to rural outreach costs	High due to digital marketing expenses	Low, due to strong brand presence

#### Interpretation:

**6.1 Credit Risk** Small Finance Banks face significant credit risk as they provide loans to underserved segments such as MSMEs and low-income groups, which often have limited credit histories. Managing Non-Performing Assets (NPAs) is a critical challenge for their sustainability. Payments Banks, on the other hand, do not face credit risk as they are restricted from lending.

**6.2 Regulatory Burden** Both Small Finance Banks and Payments Banks must comply with stringent RBI regulations. While SFBs deal with strict lending norms and capital adequacy requirements, PBs face rigorous transaction monitoring and compliance guidelines, increasing operational complexity [42].

**6.3 Profitability Challenges** SFBs struggle with maintaining profitability due to high operational costs and exposure to NPAs. PBs face greater profitability concerns as they cannot offer credit services and must rely on transaction fees, partnerships, and commissions for revenue generation.

**6.4 Cybersecurity Risks** With increased digital adoption, both SFBs and PBs face cybersecurity threats, such as data breaches and fraud. Payments Banks, operating entirely in a digital ecosystem, are particularly vulnerable to cyber risks, necessitating heavy investments in security measures.

**6.5 Market Competition** SFBs compete with Non-Banking Financial Companies (NBFCs) and microfinance institutions, while PBs face intense competition from fintech firms, digital wallets, and neo-banks. Traditional banks, with their diversified services and strong brand presence, maintain a competitive edge.

**6.6 Customer Acquisition Costs** Acquiring and retaining customers is a costly endeavor. SFBs incur expenses in rural outreach and branch expansion, whereas PBs invest significantly in digital marketing and customer acquisition strategies to stay relevant in the competitive landscape [43].

## 6. CASE STUDIES

This section presents case studies of selected Small Finance Banks (SFBs) and Payments Banks (PBs) to illustrate their financial performance, challenges, and strategies for sustainability.

**7.1 Case Study: Ujjivan Small Finance Bank** Ujjivan Small Finance Bank, originally a microfinance institution, transitioned into an SFB in 2017. The bank's business model focuses on financial inclusion, particularly targeting low-income and unbanked segments. Ujjivan SFB has successfully expanded its loan portfolio, focusing on microloans, affordable housing loans, and MSME financing. Despite experiencing strong revenue growth, the bank faces challenges in managing Non-Performing Assets (NPAs) due to the high-risk nature of its borrower base. The bank has adopted digital banking solutions to enhance customer outreach and operational efficiency. [44]

Metrics	2021	2022	2023
Net Interest Margin (NIM)	9.2%	9.5%	9.8%
Return on Assets (ROA)	1.5%	1.8%	2.1%
Non-Performing Assets (NPA)	4.2%	3.9%	3.5%

**7.2 Case Study: AU Small Finance Bank** AU Small Finance Bank has distinguished itself with a diversified product



portfolio, including retail banking, vehicle loans, and insurance products.[45] The bank has leveraged technological advancements to improve customer experience and expand its reach in rural and semi-urban areas. The bank's profitability remains strong, but rising competition from NBFCs and fintech companies poses a challenge. AU SFB's risk mitigation strategies include strict credit assessment and loan diversification.

Metrics	2021	2022	2023
Net Interest Margin (NIM)	6.8%	7.1%	7.4%
Return on Equity (ROE)	14.5%	15.2%	16.0%
Cost-to-Income Ratio	54%	52%	50%

**7.3 Case Study: Paytm Payments Bank** Paytm Payments Bank, launched in 2017, operates under a digital-first model, providing customers with digital wallets, savings accounts, and payment services. Despite strong customer acquisition and transaction volumes, the bank faces challenges due to its inability to lend, which restricts revenue generation. To overcome this limitation, Paytm Payments Bank has formed partnerships with NBFCs to offer lending services indirectly. Additionally, regulatory scrutiny and compliance requirements have been key operational challenges.

Metrics	2021	2022	2023
Customer Base (millions)	60	75	90
Transaction Volume (in billion ₹)	4.5	6.2	8.0
Operating Profit Margin	3.2%	3.5%	3.8%

**7.4 Case Study: India Post Payments Bank (IPPB)** India Post Payments Bank (IPPB), a government-backed entity, [46]aims to drive financial inclusion by leveraging the vast postal network. IPPB has successfully onboarded millions of customers in rural areas, offering basic banking services such as savings accounts and remittance services. However, the bank struggles with profitability due to its limited product offerings and high operational costs associated with maintaining a vast service network [47].

Metrics	2021	2022	2023
Active Accounts (millions)	3.2	4.1	5.0
Revenue Growth (%)	10%	12%	14%
Operating Expenses (₹ billion)	1.8	2.1	2.5

These case studies highlight that while differentiated banks have made significant strides in financial inclusion, they continue to face challenges in achieving long-term profitability. SFBs benefit from lending operations but must manage credit risk efficiently, whereas PBs struggle with revenue diversification due to lending restrictions. Strategic partnerships, digital innovation, and regulatory support will be key to ensuring their future success.

## 8.1 Conclusion:

The study highlights the crucial role of differentiated banks in advancing financial inclusion and economic growth in India. Small Finance Banks have demonstrated strong profitability through lending operations, whereas Payments Banks have struggled with sustainability due to regulatory restrictions on credit issuance. While differentiated banks have successfully addressed the needs of underserved populations, they continue to face challenges related to profitability, regulatory compliance, and technological adoption.

Despite their challenges, differentiated banks have contributed significantly to improving banking access, particularly in rural and semi-urban areas. Small Finance Banks have managed to maintain stability by diversifying their product offerings and focusing on microfinance and MSME lending. Payments Banks, on the other hand, have successfully expanded digital transactions but remain constrained by their inability to offer credit services. The study underscores that the long-term sustainability of differentiated banks will depend on their ability to innovate, collaborate with fintech firms, and adapt to evolving regulatory frameworks.

## 7. RECOMMENDATIONS:

To ensure the profitability and sustainability of differentiated banks, the following recommendations are proposed:

**Regulatory Flexibility:** The RBI should consider revising regulatory constraints on Payments Banks to allow for a limited



degree of credit issuance. This would enable PBs to diversify their revenue streams and improve financial sustainability.

**Technology and Digital Innovation:** Differentiated banks should invest in advanced financial technologies, including artificial intelligence, blockchain, and data analytics, to enhance efficiency and customer engagement. Digital banking solutions can help mitigate operational costs and improve profitability.

**Revenue Diversification:** Payments Banks should explore alternative revenue models such as offering insurance products, wealth management services, and partnerships with NBFCs to provide lending services indirectly.

**Risk Management and Compliance:** Small Finance Banks must focus on strengthening their risk management frameworks to mitigate Non-Performing Assets (NPAs). Improved credit assessment tools and AI-driven risk evaluation models can help in maintaining financial stability.

**Strategic Partnerships:** Collaborations with fintech startups and digital payment platforms can enhance the service offerings of both SFBs and PBs. Such partnerships can help Payments Banks leverage lending opportunities indirectly while enabling Small Finance Banks to expand their digital capabilities.

**Financial Literacy and Customer Awareness:** To increase customer engagement and trust, differentiated banks should actively promote financial literacy initiatives. Awareness programs can help in building a financially inclusive ecosystem where customers understand and effectively use the banking services available to them.

**Sustainability and ESG Initiatives:** Differentiated banks should integrate environmental, social, and governance (ESG) principles into their operations. By supporting green financing and sustainability-driven banking practices, they can improve their long-term reputation and resilience in the financial sector.

By adopting these strategies, differentiated banks can overcome current challenges, enhance profitability, and contribute meaningfully to India's financial inclusion agenda. The evolving banking landscape demands agility, innovation, and collaboration to ensure the long-term viability of these specialized financial institutions.

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