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Changing Contours of Microfinance in India

Dr. Shalini Talwar

Abstract

Microfinance, or the practice of extending micro loans to small borrowers who have traditionally been financially excluded, has become one of the most popular financial inclusion and antipoverty strategies in the world. Microfinance has been in existence in the world since centuries but it is taken a formal form in different parts of the globe at different points of time in the past century.

Microfinance in India can be traced back to the early 1970s when the Self Employed Women's Association ("SEWA") of Gujarat formed an urban cooperative bank, called the Shri Mahila SEWA Sahakari Bank, with the objective of extending banking services to poor women employed in the unorganized sector in Ahmedabad, Gujarat. Inspired by the resounding success of the modern microfinance innovation, Grameen Bank, pioneered Muhammad Yunus in Bangladesh, microfinance in India has evolved from small non-governmental organizations lending less than Rs. 500 to women to buy sewing machines or vegetables to sell at market, to private banks that consider it to be a profitable undertaking.

Since their origin in 1970s, Microfinance institutions (MFIs) have contributed significantly in alleviating poverty and in reducing financial exclusion in India. But with the move of microfinance beyond the purview of development institutions and the entry of the private sector, the growing divide between the for-profit MFIs and traditional not-for-profit ones is undermining the credibility of the sector.

The author has written this paper to study and evaluate the role of microfinance in both, the deepening and widening of the outreach of financial services to rural poor and hitherto unreached masses. The study traces the birth of microfinance in India, its subsequent rise to glory with emergence of exemplary organizations like SKS Microfinance and the recent crisis that has mired it in deep controversies.

The paper is intended to present a balanced view of the extent of financial inclusion in India and to explore the way forward for microfinance from this point onwards. The author will also briefly reflect upon the possibility of a bigger role for microfinance institutions in increasing the penetration the financial services in the unreached areas. This is quiet significant because there is a increasing realization in the policy circles that commercial banks may not be the right conduit for reaching out to financially excluded.

Introduction

South Asia has traditionally been inflicted with poverty, low growth rate and social problems. The situation is compounded by the great rural-urban divide. Lack of infrastructure, funding issues, illiteracy and geographical inaccessibility have aggravated poverty and social exclusion of rural masses. The region has grown phenomenally over the years, but poverty continues to remain at a high level and comprehensive studies have now proved beyond doubt that one of the key factors obstructing the poverty alleviation effort is the exclusion of the rural masses from the financial system. Lack of inclusion of a large proportion of population in the financial system produces undesirable socio-political as well as economic effects. The extent of financial exclusion globally is shocking: Financial exclusion is a

Dr. Shalini Talwar
Associate Professor
Sinhgad Institute of Business Management
Mumbai

worldwide problem today. Financial exclusion is a worldwide problem today. A new report, "Half the world is unbanked" finds that: 2.5 billion adults, just over half of the world's adult population, do not use formal financial services to save or borrow. 2.2 billion of the unserved adults live in Africa, Asia, Latin America, and the Middle East.

Of the 1.2 billion adults who use formal financial services in Africa, Asia, and the Middle East, at least two-thirds, a little more than 800 million, live on less than $5 per day (purchasing power parity adjusted).

Ills of financial exclusion and its impact on the general well-being of nations is well documented in the literature. "Financial exclusion may generate lower investment resulting from difficulties in getting access to credit or gaining credit from informal sector at very high interest rates. Particularly, without broad and easy access consequences may be grave for the small business sector and poor sections of the society".

In India, too, the problem of financial exclusion has been hampering the success of poverty reduction drive. While India has grown at a tremendous pace in the past decade, the growth has not been inclusive and the main culprit behind this inequality is inaccessibility of the masses to financial sector and services. Despite various policy initiatives, in India, the financial system is accessible to only a small percentage of the population.

Data derived from the NSSO Study shows that 64.95 million cultivator households and 46.6 million non-cultivator households respectively do not have access to formal financial services. NSSO data reveal that 45.9 million farmer households in the country (51.4%), out of a total of 89.3 million households do not access credit, either from institutional or non-institutional sources. Further, despite the vast network of bank branches, only 27% of total farm households are indebted to formal sources (of which one-third also borrow from informal sources). Farm households not accessing credit from formal sources as a proportion to total farm households is especially high at 95.91%, 81.26% and 77.59% in the North Eastern, Eastern and Central Regions respectively. Thus, apart from the fact that exclusion in general is large, it also varies widely across regions, social groups and asset holdings. The poorer the group, the greater is the exclusion.

It would, however, be remiss of the author to present such a gloomy picture without putting the things in the correct perspective. While the exclusion data is alarming, it is also true that situation was far worse few decades back and rigorous policy initiative has improved it a lot. Post nationalization, the branches of commercial banks and the RRBs have increased from 8321 in the year 1969 to 68,282 branches as at the end of March 2005. The average population per branch office has decreased from 64,000 to 16,000 during the same period. The new branch authorization policy of Reserve Bank encourages banks to open branches in these under banked states and the under banked areas in other states. The new policy also places a lot of emphasis on the efforts made by the Bank to achieve, inter alia, financial inclusion and other policy objectives.

As on March 31, 2011, the number of 'no-frills' account stood at 7439 lakhs, number of bank branches in rural areas was 33,463 constituting 37.4% of the total bank branches and the number of Kisan Credit Cards was 224.9 lakhs. Figure I shows that rural and Semi-urban offices constitute a majority of the Commercial Bank offices in India. Rural bank offices as a % of total have increased from 22% in 1969 to 41% in 2007. So access to financial system as definitely increased since independence.

Purpose of the Paper

The author has written this paper to study and evaluate the role of micro finance in both, the deepening and widening of the outreach of financial services to rural poor and hitherto unreached masses. The study traces the birth of micro finance in India, its subsequent rise to glory with emergence of exemplary organizations like SKS Microfinance and the recent crisis that has mired it in deep controversies.

The paper is intended to present a balanced view of the extent of financial inclusion in India and to explore the way forward for micro finance in India from this point onwards. The author will also briefly reflect upon the possibility of a bigger role for micro finance institutions in increasing the penetration the financial services in the unreached areas. This is quiet significant because there is a increasing realization in the policy circles that commercial banks may not be the right conduit for reaching out to financially excluded.

The Birth of Micro Finance

Microfinance, or the practice of extending micro loans to small borrowers who have traditionally been financially excluded, has become one of the most popular financial inclusion and antipoverty strategies in the world. Micro finance has been in existence in

the world since centuries but it is taken a formal form in different parts of the globe at different points of time in the past century.

Microfinance in India can be traced back to the early 1970s when the Self Employed Women's Association ("SEWA") of Gujarat formed an urban cooperative bank, called the Shri Mahila SEWA Sahakari Bank, with the objective of extending banking services to poor women employed in the unorganised sector in Ahmedabad, Gujarat. Inspired by the resounding success of the modern microfinance innovation, Grameen Bank, pioneered Muhammad Yunus in Bangladesh, microfinance in India has evolvedfrom small non-governmental organizations lending less than Rs. 500 to women to buy sewing machines or vegetables to sell at market to, private banks that consider it to be a profitable undertaking; their optimism being based on the available data that shows that there 60-70 million poor families in India with an average household credit demand of Rs. 8000. M-CRIL, a leading microcredit rating agency, has estimated an annual demand for Rs. 480 billion credit in India.

Over the years four main windows of microfinance have become active in India Figure II. These include:

Model I Direct financing of individuals or group borrowers by banks.

Model II Direct financing of borrowers facilitated by Government, Commercial Banks and Micro-Finance Institutions (MFIs).

Model III Fulfillment of small borrowers's financing needs through NGOs and MFIs as facilitators and financing agencies.

Model IV The Grameen Bank Model referred above. This model has also made remarkable contribution, as exhibited by the Figure III.

Expansion of Microfinance Over Decades in India

Various studies and reports have proved that microfinance has enabled the rural poor to have a regular source of earnings and reduce their economic vulnerability. In the Indian context, microfinance is no longer the purview of development institutions. While the rhetoric of development has been retained, banks have embraced it as an extremely profitable business, for two reasons. First, Indian banks are required to lend a certain percentage (currently 40%) into priority areas called priority sector lending which includes agriculture, SMEs, and government securities. Compared to returns on government bonds of 6-7%, MFI lending provides returns of 10-14%. Banks, therefore, have expanded investments in these areas. Second, microfinance lending - as it is currently practiced - is simply not very risky. In the absence of individual credit assessments, MFIs lend to groups or through referral, leading to repayment rates of 95% or more. Banks then get the best of both worlds - higher rates of return with very low risk. Figure IV exhibits the market share of different MFIs in terms of loan volume.

According to the report released M-CRIL Microfinance Review some time back, India has the largest microfinance industry in the world with the unbelievable growth rate of 62% per annum in terms of numbers of new clients and 88% per annum in terms of portfolio over the past five years and around 27 million borrower accounts. Figure V presents CRILEX M-CRIL's index of microfinance growth in India for end-March 2011 and an estimate for 30 September 2011.

With over 27 million borrower accounts served by Indian MFIs by March 2010, this segment represents a significant component of the financial system as exhibited in the Figure VI. It is interesting to note that Indian microfinance units represent 40% of the total number of micro-borrower accounts (in the entire Indian financial system). It also exceeds the number of borrower accounts served by the Regional Rural Banks by as much as 50%.

From 2003 to 2009, the number of microloans extended to the poor in India grew from 1.0 million to 26.7 million. Coverage of microfinance has increased tremendously across the states. Andhra Pradesh has the highest coverage of 411% followed by Tamil Nadu (290%), Kerala (265%), Karnataka (144%) Orissa (123%) and West Bengal (106%). as shown in Figure VII.

Microfinance has been successful in India as it has provided a viable alternative to the exploitative moneylenders. It comes as no surprise that the size of microfinance market has grown from $12 million in 2003, to more than $7 billion now and it is expected to grow to $50 billion soon. The depth and width of microfinance is also tremendous, with women's self-help groups (SHGs) reaching out to about 50 million people and another 20 million being covered by microfinance institutions (MFIs).

Microfinance in India is funded by private and public capital. Private capital comes from private sector banks, private equity investments and funds from the capital markets. ICICI Bank, the largest private bank

in India, had 1.2 million microfinance clients in 2005 and a portfolio of $227 million. In little more than a year, ICICI had 3 million clients, targeting 25 million more in years to come. Other banks, such as ABN Amro, Citibank, YES Bank and others have also joined the fray, operating on a partnership model. Public sector banks are also very active in microfinance and they operate as integrated micro-lenders, creating self-help groups (SHG) to which they disburse loans directly rather than through an intermediary.

SKS microfinance, Basix, Share, Spandana and Cashpor are main microfinance institutions in the country. Participation of private, commercial organisations has increased competition and the consumers of micro finance are reaping the benefit. The microfinance sector has grown significantly from 1980s from the concept of SHGs, that provided their clients with much-needed savings and credit services to a multi-billion dollar industry, with the Small Industries Development Bank of India and the National Bank for Agriculture and Rural Development devoting sizeable financial resources to microfinance. Now, the top five private sector MFIs reach more than 20 million clients in nearly every state in India and are recognized as global leaders in the industry. Table I shows top 10 microfinance institutions by outreach.

Sudden turn of events.... how things went completely wrong for the blue-eyed boys of Indian financial sector

Since their origin in 1970s, Microfinance institutions (MFIs) have contributed significantly in alleviating poverty and in reducing financial exclusion in India. But with the move of micro finance beyond the purview of development institutions and the entry of the private sector, the credibility of the sector is being undermined by the growing divide between the for-profit MFIs and traditional not-for-profit ones.

As mentioned in the preceding sections, big private sector players, including ICICI Bank, have entered the microfinance sector in a big way. Obviously the allure lies in profit margins, though there is a regulatory element too. It has been made mandatory for banks to be involved in micro and priority sector lending. However, many private banks are lending way above the regulatory requirement.

The second half of the past decade can be called the golden era of 'Indian Microfinance'. SKS Microfinance, one of the biggest microfinance company in India, setup in 1998 to provide microfinance to the poorest sections of the Indian society that earn a per capita less than INR 6,000 ($120) per year, had a historic IPO in 2011. Over the years, its profits have grown at a fast pace: before the recent debacle earnings per share at SKS shot up by 346%. Its return on assets was 6.8. Other companies have also fared very well during this period and performed well by global standards too, as exhibited in Table II.

With a sudden turn of events for worse, India's star enterprise, the private microcredit industry, is facing the biggest crisis since its inception. The industry has come under intense regulatory and media scrutiny after a spate of suicides in Andhra Pradesh that were linked to borrowers' inability to repay their loans. In the past few years, microfinance has expanded rapidly with large amount of loans extended to small borrowers, with many loans being extended to same borrowers.

Eventually, the debt accumulated to such an extent that repayments became too high for poor people to handle comfortably. Further, extensive media reports of high profits earned by private microfinance institutions, made the villagers feel cheated. The problem took a political complexion in Andhra Pradesh, where encouraged by political leaders belonging to the opposing party to the one in power, many villagers stopped repaying their loans. This was followed by enactment of laws to restrict lending by microcredit firms.

The Andhra Pradesh government issued an Ordinance on October 14, 2010. The Ordinance required these institutions to stop their operations and apply for registration with the government. The ordinance laid down that they could resume their operations only after the registration process was completed. The AP government legislation effectively shut down all private sector microfinance institutions operating in the state. In the first half of FY2011, MFIs in Andhra Pradesh disbursed Rs 5,000 crore to borrowers whereas in the second half of the same year, the disbursement went down to only Rs 8.5 crore . Lending all over the country seems to have been affected as can be seen in the reduced size of the loan portfolio of SHARE Microfin Limited ("SHARE") and Asmitha Microfin Limited two of the largest MFIs in India. They have only Rs 4,000 crore loaned to over 5 million poor women in 18 Indian states now whereas prior to the crisis, the combined outstanding loan portfolio had been as high as Rs 6,750 crore.

The furor and excessive media spotlight triggered the government of India's move to halt MFI lending as it feared that it would not be able to recover its loans to them. This had significant impact as the government funds nearly all the priority capital extended to the microfinance industry. The flourishing industry suddenly became asphyxiated, being squeezed on one side by defaults and on other side by the cutting off of the

main line of credit. Figure VIII The crisis has deepened to the extent that MFIs are facing the threat of bankruptcy.

Deeper Issues

The recent crisis is occupying the minds and attention of policy makers and analysts, but a closer look reveals that problems with private MFIs in India are more deep seated as shown in figure 9.

Micro Borrower's Dimension

The micro borrowers are mired in poverty and the loans are generally taken for meeting some immediate need. Loans intended for some income-generating activity often get used for consumption purpose, leaving the borrower with no means to repay. This group of borrowers is traditionally extremely poor, illiterate and unreached, with complete ignorance about financial services and their advantages. They have no security to offer and their credit histories are not documented. All these impediments result in loans at high rate of interest, mounting debt burden and inability to service the repayment requirements. MFIs borrow from banks at around 12% and lend at anything between 25% and 30%. This can be hugely profitable.

MFIs' Dimension

Microfinance is a specialized activity. Lending to rural poor is more than just a profitable commercial activity. A lot of expertise is required to understand the typical problems of each micro borrower and judge his ability to repay. Lack of trained personnel with understanding of social as well as financial issues is hampering the growth of private MFIs in India. There are multiple problems that plague private MFIs in India.

The biggest challenge is the shortage of funds and high cost of whatever funds are available. Most MFIs are themselves not allowed by the regulatory authorities to accept deposit and depend on government and other funding agencies for their needs. MFIs are not allowed to mobilize deposits unless they convert themselves into a non-bank finance company (NBFC). The problem here is that the minimum start-up capital required to register an NBFC is Rs. 20 million, which is usually beyond the reach of most MFIs. And even if they somehow register as NBFCs, they need an 'investment grade' rating from credit rating agencies before they can mobilize deposits. Getting an 'investment grade' is very difficult as most of these MFI-NBFCs have typical geographical concentration and non-collateralized loan portfolios. Further, MFIs have problems raising funds through equity issues: NGOs cannot invest in MFI equity, because of their charitable status under the Section 11 and 12 of the Income Tax Act, 1961. Recourse to foreign funds has also been plugged by the regulators as the regulation on equity investment in MFIs requires that foreign equity must be a minimum of US $500,000, and should not exceed 51% of total equity; implication being that to raise US $500,000 foreign equity, MFIs would be required to raise an equal amount, almost Rs 23 million, from India which is almost impossible. Further, since 2002, MFIs are no longer allowed to raise debt from foreign donors and development finance institutions through the 'External Commercial Borrowing' (ECB) route.

The funds that are available for MFIs are also at a very high cost because unlike Bangladesh and a number of other countries, the government of India has not given the benefit of grants/subsidized funding to the Indian MFIs. For example, in Bangladesh, PKSF lends to MFIs at 4-6% p.a. (less than half the market interest rate), but in India the MFIs have to raise debt at prevailing market interest rates, usually between 11-13.5% p.a. To compound the problem, Reserve Bank of India, has issued directives for microlenders restricting annual interest rates to 26 percent and limiting total lending to 50,000 rupees per borrower. These challenges have seriously impaired the MFIs ability to compete and grow into self-sustaining, profitable organizations.

Apart from the high cost of funds, the profits of the MFIs are further eroded by the high transaction costs that they need to incur in order to reach out to the widely geographically dispersed micro borrowers. Despite growing numbers, most MFIs have remained limited in their operations due to high cost of outreach. Thus, most MFIs continue to be small regional players with no national ambition or leverage. The top ten private sector microfinance providers in India together serve less than 5% of the unbanked population of India approximately 20 million clients.

Not only do MFIs continue to be small in size, but also remain limited in scope. Due to stringent regulatory environment, only a handful of MFIs, such as VSSU (West Bengal), SEWA Bank, Ahmedabad and the BASIX local area bank KBSLAB offer savings as RBI regulated entities.

Above all, Indian MFIs suffer from lack of prudent policy, strong legal support and integrated regulatory framework that as of now is fragmented across many government agencies.

Recommendations and Conclusion

Microfinance in India is currently being provided by three sectors: the government, the private sector and charities, but the private sector has out-performed the government initiative to a large extent. The private sector MFIs have grown at a fast pace by offering suitable products and effective services to meet the typical needs of the rural poor. Between 2008 and 2010, the number of clients of MFIs grew by an average of 61% each year, with loan portfolios growing 85% per year. As against this, The AP (the state in the eye of MFI storm) government-backed microfinance SHG program grew its client base by 13.6% and its loan portfolio by 28% during the same period.

An October 2010 White Paper by Intellecap stated "the MFI's combination of door-step service, easy credit, frequent small-value repayments and the group guarantee is attracting borrowers who are no longer so naïve that they cannot weigh the attractions of these factors against the lower rates of government programs". Further, a World Bank report found that government loan administrators sometimes demand bribes of up to 20% of the loan amount before loan requests are granted. This makes borrowing from government as expensive as that from the private sector.

There is no doubt that private microfinance institutions have touched the lives of millions of people at the "bottom of the pyramid" (BoP), a section of population that lives on almost non-existent and erratic incomes. But the deeper issues and the current crisis seem to have clipped the wings of the private microfinance industry.

"Microfinance started work to help the poorest," says Rajesh Mishra, General Manager of Cashpor India. "But now you can see that it's a business. The sector is growing. You can say that [the current crisis] is a side-effect of that growth." Nothing can negate the contribution of MFIs so far and the role that they have to play in future.

According to a 2007 estimate by the World Bank, 80% of India's 1.2 billion people live on less than $2 a day. If India has to achieve the Millennium Development Goals set by United Nations, microfinance and MFIs have to play a pivotal and strategic role. No growth targets can be achieved unless the 400 million BoP people are brought into the ambit of the financial system and the best way to reach them is microfinance. The industry just needs to grapple with the current crisis and resolve the intrinsic issues such as exorbitant interest rates, unplanned multiple loans to same borrowers, sources of funds, regulatory fragmentation etc.

From the MFIs' Standpoint, they need to take decisive action to:

- Reduce the transaction costs that would enable them to charge lower interest rates
- Take firm policy decision on multiple loans to same borrowers

From Government's Standpoint, it needs to:

- Create a more positive environment where MFIs have recourse to many sources of funding
- Have more centralized and intergrated regulatory framework for MFIs operating in different states

Thus what needs to be done is a simple alignment of the interests of the private MFIs with the national goal of financial inclusion. Enabling policy environment encouraging private enterprise with a reasonable pursuit of profits is required at the national level.

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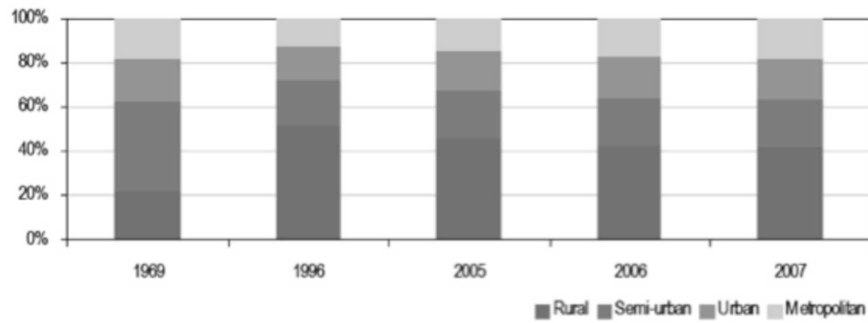
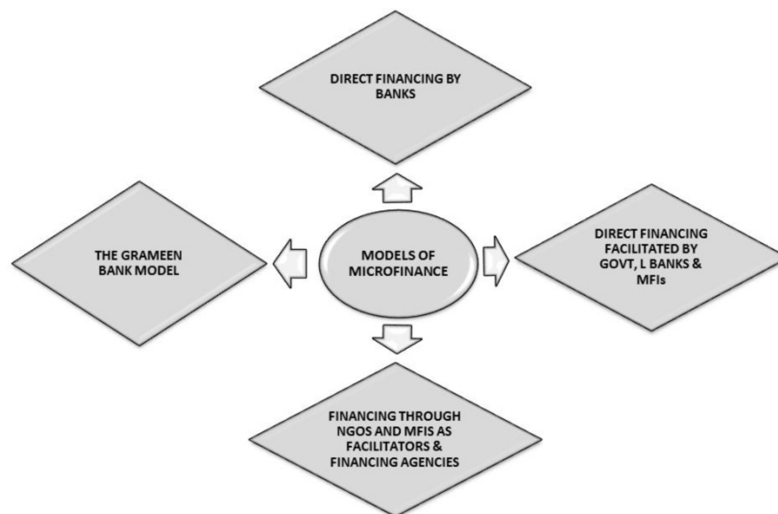


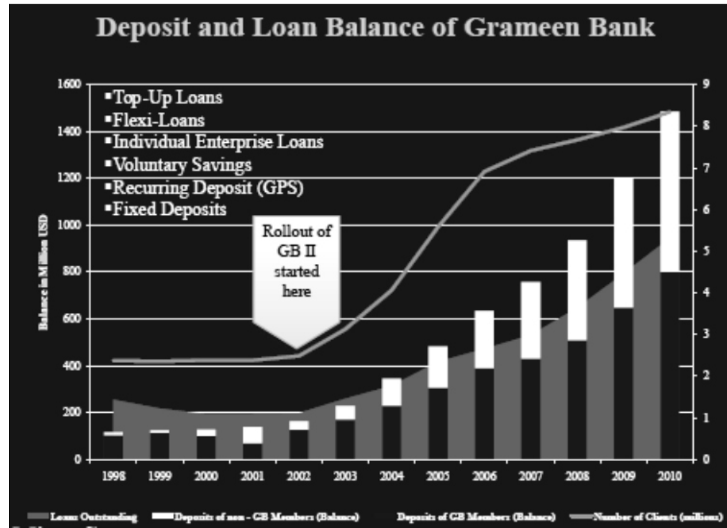
Source: Rakesh Mohan, RBI, IDBI Gilts Ltd.

Figure I : Distribution of Bank Offices in India



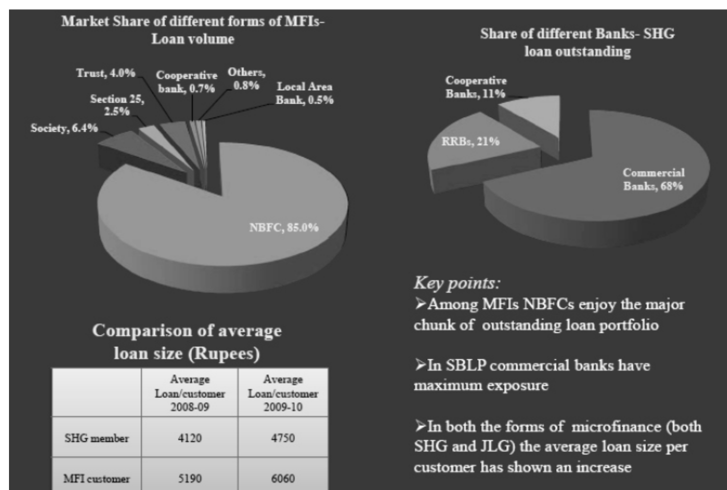
Source: Developed by the author

Figure II : Models of Microfinance in India



Source: http://www.microsave.org/briefing_notes/grameen-ii-8-lessons-from-the-grameen-ii-revolution

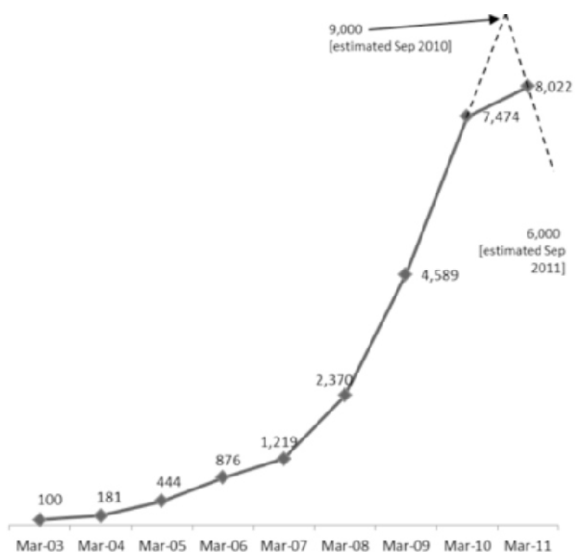
Figure III : Deposit and Loan Balance of Grameen Bank Model



	Average Loan/customer 2008-09	Average Loan/customer 2009-10
SHG member	4120	4750
MFI customer	5190	6060

Source: Adapted by microsave from State of Sector Report 2010

Figure IV : Market Share of Different MFIs

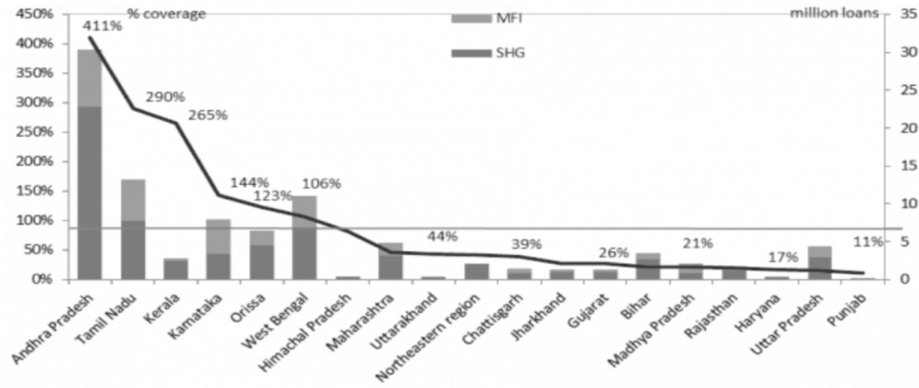


Source: M-CRIL

Figure V : Crilex - M - Cril's Index of Microfinance Growth in India

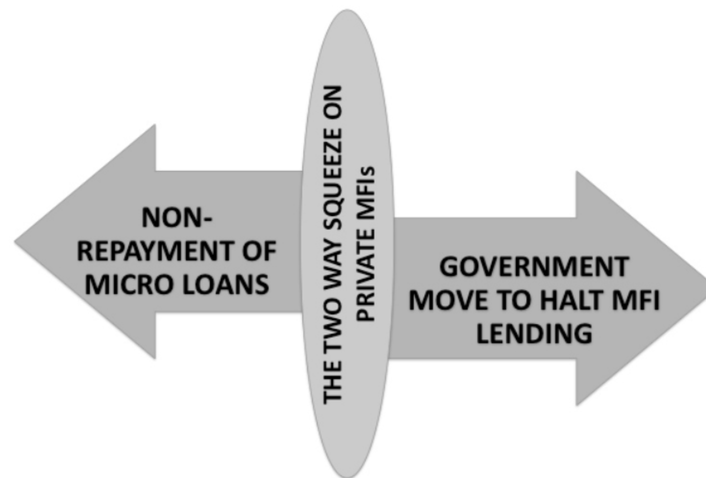
Source: M-CRIL Microfinance Review

Figure VI : Microfiance, A Significant Sub-Sector of India's Financial System



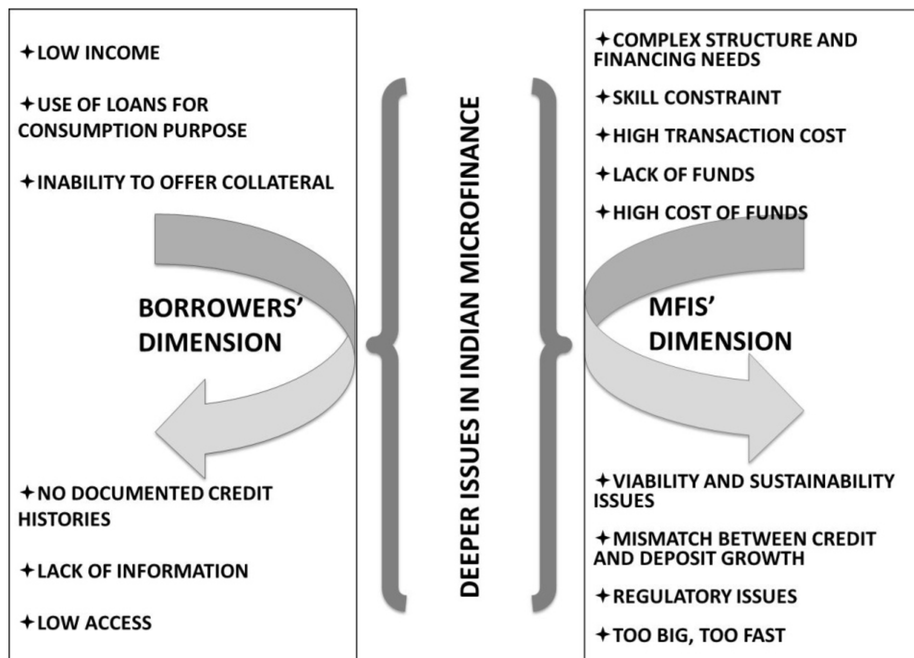
Source: http://financialaccess.org/node/3848

Figure VII : Coverage of Eligivle Population by Microfinance, Loans (MFIS + SHGS)



Source: Developed by the Author

Figure VIII : The Two way Squeeze on Private Sector MFIs



Source: Developed by the Author

Figure IX : Deeper Issues in Indian Microfinance

Table I : Top 10 Microfinance Institutions by Outereach (Rs. Billion)

Name	Outreach (No)	Loans Out standing	Own Funds	Borrowings
Asmitha Microfin Ltd.	8,78,455	7.1	0.8	7.1
SKDRDP	8,07,170	4.9	0.2	5.4
Bhartiya Samruddhi	5,74,293	2.6	0.6	4.0
(ASA) Grama Vidiyal	3,62,624	2.0	0.5	1.6
BISWA	3,52,352	1.7	0.5	1.8
Equitas Microfinance	3,39,158	2.9	1.1	1.8
Total	3,39,158	82.0	15.6	73.0
SKS Microfinance	35,20,826	24.6	6.6	19.9
Spandana Spoorthy	24,32,189	18.7	3.1	14.8
Share Microfin Limited	15,02,418	12.2	1.7	9.7
Bandhan	14,54,834	5.3	0.5	6.9

Source: Microfinance India-State of the Sector Report, 2009

Table II : Indian Microfinance Institutions : A Global Comparison

Country	OSS	ROA	Profit margin	Average loan US$	Yield on Gross portfolio
Kenya	118.1	-1.0	-0.2	463	31.3
Uganda	116.1	2.7	9.4	325	53.7
Bangladesh	106.6	-0.3	-1.2	80	24.3
Pakistan	85.1	-6.6	-47.4	187	27.9
Philippines	113.0	0.5	6.7	288	38.5
Brazil	133.6	6.4	19.4	820	41.5
Mexico	113.2	3.0	10.2	468	62.8
Indonesia	142.8	3.1	15.4	915	22.5
India	111.4	0.7	7.9	146	21.2

Source: Microfinance India-State of the Sector Report, 2009