



what is
Microfinance

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01 Introduction

Each session is designed to be used alone or in conjunction with other sessions, depending on the specific needs of the trainee. However, they are logically ordered to build a step-by-step introduction to the world of microfinance.

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What is Microfinance

To respond to the demand for financial services among low-income people, mostly located in developing countries, new products and methodologies were developed in the 1970s, an industry known as microfinance. In developing countries, where these services are more needed, they are often underdeveloped or even absent. Microfinance aims to fill this gap and give access to financial services such as savings, credit, insurance and money transfer to people that otherwise would remain unserved.

It is generally accepted that microfinance is a powerful economic development tool. Microfinance institutions (MFIs) deliver basic financial services to poor and low-income people, or microentrepreneurs, with little or no access to the formal financial system. MFIs developed specific products and methodologies to overcome the shortfall of collaterals of clients and therefore make them eligible to get loans and other financial services.



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What makes microfinance different from other anti-poverty tools is the idea of improving the living conditions of the poor through their own efforts. Credit is given to support “microbusinesses”, allowing low-income people to respond to economic opportunities. For them, the main constraint is a small investment in working capital, and microcredit allows them to overcome this obstacle.

It is important to make clear from the beginning the importance and at the same time the limits of microfinance. It is an economic development tool among many and alone it is not the definitive answer to poverty alleviation. Its effectiveness has been tested and demonstrated but it should be used in conjunction with other tools; the poorest of the poor, for instance, need other forms of support before being able to make use of loans. These limitations give the exact background in which microfinance should be placed as an extraordinarily powerful instrument against a particular portion of poverty.

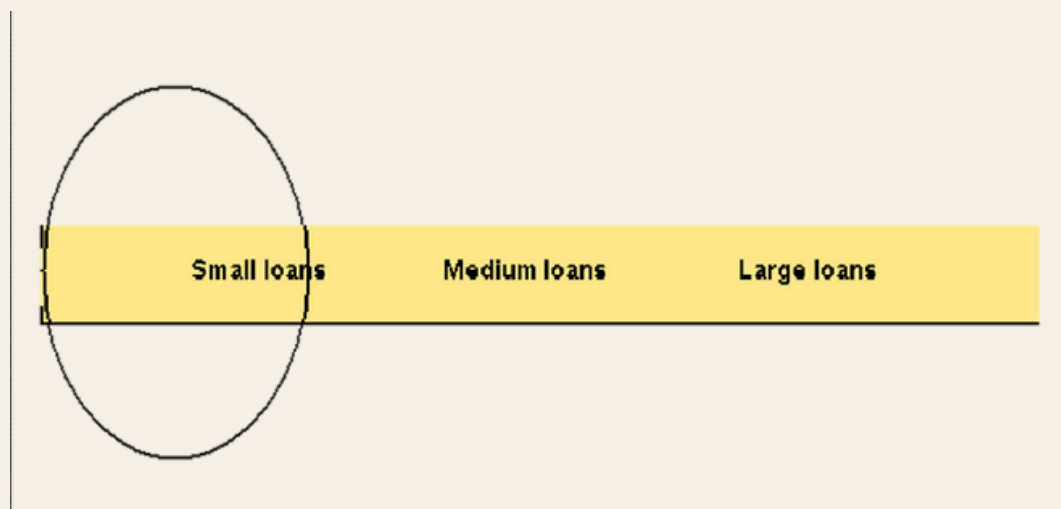


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What is Microcredit

A microcredit is a small credit given to a client by a bank or another institution. Microcredit can be offered, often without collateral, to an individual or through group lending. Group lending is a mechanism that allows a number of individuals to obtain a loan through a group scheme. The incentive to repay is based on peer pressure; if one person in the group defaults, the other group members must make up the payment amount. Individual lending, in contrast, focuses on one client and does not require the formation of groups (see “Methodologies”).

Figure 1.1 Loans size provided by microfinance institutions



Microcredit has been proven to be an effective tool against poverty, enabling those without access to the formal financial system to borrow the small amount of funds they need and start or develop small businesses.

04 Definition of a Microenterprise Institution

The definition of microenterprise varies from country to country but according to the general definition given by ACCION International, a network of microfinance institutions (see box 2.1), a microenterprise is “a small-scale business in the informal sector. Microenterprises often employ less than 5 people, can be based out of the home and are often the sole source of family income but can also act as a supplement to other forms of income. Examples of microenterprises include small retail kiosks, sewing workshops, carpentry shops and market stalls”.



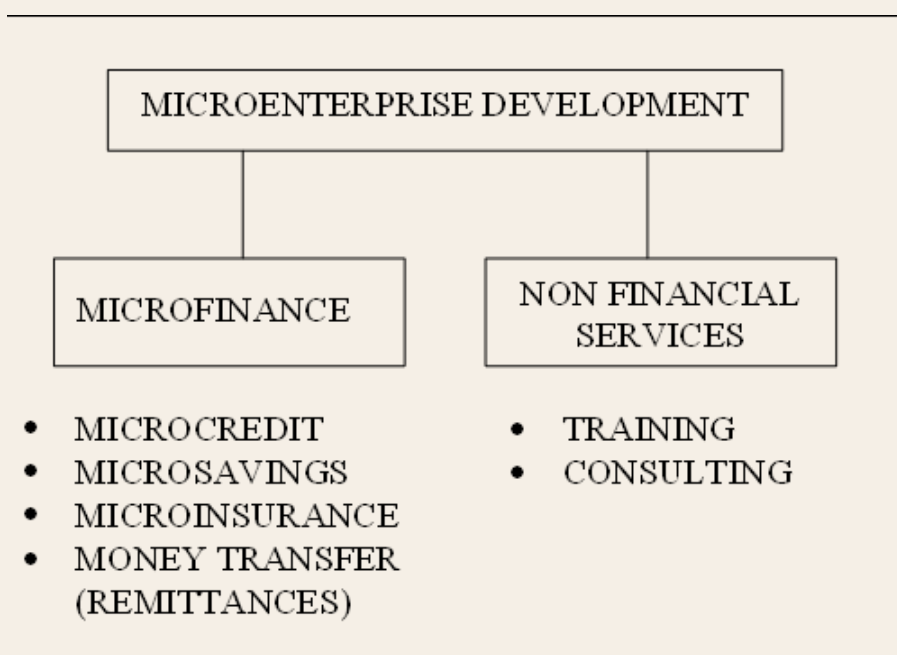
Microentrepreneurs, or economically active poor, are businesspeople who, through microfinance, take advantage of economic opportunities that otherwise would remain unmatched due to financial constraints.

05 Microcredit and Microfinance

The use of the terms "microcredit" and "microfinance" is sometimes incorrect, primarily due to historical reasons. The lack of clarity in their use, even in the sector of development, is the reason why these two ideas must be clearly differentiated from the beginning.

Microcredit is a part of the field of microfinance. Microcredit is the provision of credit services to low-income entrepreneurs, while microfinance includes credit, savings, and increasingly additional financial services such as insurance and money transfer. The evidence showed that for the very poor, saving is as important as borrowing. This is indicative of the importance of microfinance as a combination of different financial services.

Figure 1.2 Microenterprise development, microfinance and microcredit



The recent shift in terminology from microcredit to microfinance reflects the acknowledgment that savings services, and not just loans, improve the well-being of the poor and, together with insurance, help poor people stabilize their income and protect against risks. Money transfer is another critical service: according to the World Bank, the business of remittances, i.e., the money that emigrants send home to their relatives, is growing strongly and is often managed through informal arrangements with high charges and risks.

Clients' training, provided by some MFIs, is classified as a non-financial service and is a tool of the broader category of microenterprise development. The correct definition of microfinance includes only financial services, and this is why, even if it is often provided by MFIs, training is not classified under the term microfinance as in Figure 1.2.



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Historical Dilemma



The current practice of using the terms microcredit and microfinance synonymously needs to be discontinued to better understand their different roles in the industry. The source of confusion is likely to be historical and can be traced back to the late 1990s when the term microfinance was first introduced as an extension of the already well-known idea of microcredit. The introduction of the term microfinance followed the success of many microcredit programmes around the world, and in 1997, during the first Microcredit Summit, 2,900 delegates from 137 countries representing around 1,500 organisations gathered in Washington, D.C. During that occasion, the birth of the global industry of microfinance was officially recognized. Since then, the focus started to change and move from the predominant welfarist idea, where only the provision of credit was considered to be important, to the need to become financially sustainable through the provision of a complete range of financial products and to reach more people.

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The “first generation” of institutions, predominantly NGOs, delivered only credit in almost thirty years, starting from the seventies. This added confusion to the use of the terms, and even today, serious difficulties still exist in looking at microfinance as a set of financial products that can be delivered on a sustainable basis. But why did these institutions provide only credit? They assumed that poor people were unable to save and that they only needed loans. However, it was proved to be untrue; in 1984 when Bank Rakyat Indonesia (BRI), the biggest MFI in the world (see box below), offered savings accounts to poor people with no minimum deposit, it achieved extraordinary success. In December 2003, the micro banking division of BRI recorded 3.1 million loan accounts and 29.9 million savings accounts with an average loan disbursed of US\$542 and average savings balance per account of US\$118.



Bank Rakyat Indonesia (BRI)

Bank Rakyat Indonesia is the world's largest microfinance institution. It is a state owned commercial bank, and it only implements individual lending. Despite its success and the size of its operations, BRI is not well known as other MFIs around the world.

The approach used by BRI allowed the bank to successfully provide credit products, savings services, and become self-sufficient. The bank also learned that interest rate is not the principal concern for borrowers and savers. They primarily need safe, convenient, and flexible financial products provided on an ongoing basis. For low-income people, access to financial services is often the main constraint. The annual effective interest rate charged by the bank was slightly higher than 30% in 2003 and was in line with other sustainable microfinance institutions around the world.

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Besides its successful loan product, called Kupedes, since 1986, BRI has also provided Simpedes, a savings instrument designed to meet the needs of its clients. It does not require a minimum account balance, and using the account numbers, clients are entitled to participate in a lottery (There are prizes every six months).

Thanks to effective features and good marketing efforts, BRI succeeded in mobilizing savings from its clients and achieved the extraordinary results of mobilizing almost ten times the number of savings accounts compared to loan accounts, and more than double the amount of savings compared to loans outstanding (see session on Methodologies for more details about Bank Rakyat Indonesia).





conclusion

The poor need a different range of financial instruments to be able to build assets, stabilize consumption, and protect themselves against risks. The broadening of the concept of microfinance comes from this basic assumption.

This generates great hope for the future and to quote the words of Muhammad Yunus, founder of the Grameen Bank “One can reasonably state that people are poor today because of the failure of the financial institutions to support them in the past”: it is of primary importance to give access to financial services to people that otherwise would be excluded from the formal financial system and in particular is important to provide microfinance, i.e. a complete set of financial products, and not just credit



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