

An Examination of Challenges and Prospects of Microfinance Sector of Pakistan

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Abstract

The aim of this study refers to highlighting the key challenges and prospects for the microfinance sector of Pakistan. This study has been carried out using the following four steps: present scenario of microfinance in Pakistan, identification of internal and external challenges, prospects in microfinance, and policy recommendations to boost microfinance sector in Pakistan. In this research, microfinance framework has been used to better understand the process of building a sustainable microfinance institution. The findings have been obtained through Primary data, which has been collected through questionnaires. The participants are banks and other financial institutions. This research contributes in three ways: First, microfinance institutions will be facilitated in highlighting the challenges and prospects that are being neglected in the process of analyzing the problems and

opportunities faced by this sector. Second, other financial institutions and banks, realizing the significance of this business, will get encouragement to enter this sector with more innovative products and better standard practices. Thirdly, it will help the country in coming up with new strategies for micro financing. Moreover, microfinance sector may start conducting more training sessions to enhance the skills of the clients, which will affect positively this sector.

Keywords: Challenges in Microfinance, Pakistan, Poverty, MFI's

Introduction

Microfinance is about providing financial services to the poor who are traditionally not served by the conventional financial institutions. Three features distinguish microfinance from other formal financial products. These are: (i) the smallness of loans advanced and or savings collected, (ii) the absence of asset-based collateral, and (iii) simplicity of operations (Microfinance Policy, Regulatory and Supervisory Framework for Nigeria, 2005). Poverty cannot be illustrated, it can be experienced. One knows more about it when he is starving and cannot manage to pay for food. He and his children want new clothes on festivals but cannot buy these, due to low income. He is sick, but he is not able to buy medicine. He wants to send his children to school, but cannot bear the expenses. He wants to be appreciated in society, but is treated poorly by the institutions of the state and society. His voice is less and incapable (Gobind M. et al., 2008). Some people save all the time, although mostly in informal ways. They invest in assets such as gold, jewelry, domestic animals, building materials, and things that can be easily exchanged for cash. They may set aside corn from their harvest to sell later. They bury cash in the garden or stash it under the mattress. They participate in informal savings groups where everyone contributes a small amount of cash each day, week, or month, and is successively awarded the pot on a rotating basis. Some of these groups allow members to borrow from the pot as well. The poor also give their money to neighbors to hold or pay local cash collectors to keep it safe. However, widely used, informal savings mechanisms have serious limitations. It is not possible, for example, to cut a leg off a goat when the family suddenly needs a small amount of cash. In-kind savings are subject to fluctuations in commodity prices, destruction by insects, fire, thieves, or illness (in the case of livestock). Informal rotating savings groups tend to be small and rotate limited amounts of money. Moreover, these groups often require rigid amounts of money at set intervals and do not react to changes in their members' ability to save.

Perhaps most importantly, the poor are more likely to lose their money through fraud or mismanagement in informal savings arrangements than are depositors in formal financial institutions. The concept of microfinance was launched to help the poor population of the world. The significance of microfinance cannot be neglected for the development of any economy. Microfinance encourages poor households to consume their funds in productive activities by providing them small amount of loans. Poor household refers to low-income people who traditionally lack access to banking and other related financial services. The concept tend to empower would-be entrepreneurs to take up a trade for living, allow them to start earning, and thus to provide their families with income stability. The income that generates from such businesses not only helps in expanding those activities but also contributes to the income of the household bringing benefits for the whole family.

In Pakistan, about one-third of the population is "un-banked", or lacking access to finance, which if appropriately tapped can offer tremendous opportunities to both banking institutions and businesses. As a step towards mainstreaming the un-banked, SBP has envisaged increasing the size of micro and small enterprise (MSE) financing from one million borrowers to four million borrowers, and from Rs.1 billion to four billion by the year 2010. In this context, increasing institutional outreach and sinking micro financing into the sector, are considered pivotal strategies. Other areas of interest include

regulatory regimes, product and process innovations, relationship management and monitoring, and market intelligence data (Sohailuddin Alavi, 2007).

According to ILO (2005), cited by Dahri (2007) it is concluded, that the reality for most of the world's poor is that they have to work often for long hours, in poor working conditions and without basic rights and presentation at work that is not productive enough to enable them to themselves and their families out of poverty, it is "*decent and productive*" employment that matters, not employment alone. In developing countries, so many strategies have been put into practice and research has been done but it is felt that it is not enough and research should remain continue in light of latest reports and research to highlight the challenges and opportunities of microfinance. It can bring new strategies into practice. As Pakistan is also a developing country, further suggestions would help to overcome the challenges faced by microfinance and avail the opportunities that exist for this kind of financing. To keep these things in mind, attempt has been made to identify the internal, external challenges and opportunities as special objective of this study.

It is argued that in the developing countries formal and informal financial sectors have failed to serve the poor at required level. In the formal sector, large loans and bureaucratic and long procedures for getting loans keep away the poor from the financial institutions. Informal sector, on the other hand, is also failed to serve the poor masses. Informal lender's charges are very high and keep the adult laborer as collateral. Exploitation of real valuation of collaterals' high interest rate and monopoly of lenders keep away the majority of the clients from the informal financial sector of providing finance to poor people, from income generating activities to reduce poverty. These results can be verified from Bhaduri (1983); Rao (1980) Bardhan (1980) Ghosh (1986); Ghate et. al., (1992); Herani (2002a&b); Herani (2007); Herani, Rajar and Dhakan (2007); Herani (2008); Sudan (2007); PGE (2009). Due to limitation of financial sector in both formal and informal services, particularly credit has evolved the micro-credit planning and programs.

Literature Review

"The great challenge before us is to address the constraints that exclude people from full participation in the financial sector. Together, we can and must build inclusive financial sectors that help people improve their lives." (Kofi Annan, 2007). However, poverty is a widespread problem found in the rural areas of Pakistan, as almost 28 per cent of the total rural households are categorized as poor. In this regard, the provision of credit, especially micro-credit, has now become an effective tool and a successful strategy for poverty eradication.

The broader definition of *microfinance* includes not only microcredit but also other financial services, which can be offered to the poor. Interested economists found soon that not only small credits but also other services connected with lending could improve economic lives of the poorest (Bauer, Chytilova & Morduch, 2008). Most MFIs connect their credit services also with educational or saving programs or business trainings, retraining scheme or technical trainings. Logically, the investments can turn out to be more profitable when the people have access to training, which can enhance their skills. Historically, the goal of microfinance was the alleviation of poverty. For many years, microfinance had this primary social objective and so traditional MFIs consisted only of non-governmental organizations (NGO), specialized microfinance banks and public sector banks. Although the Microfinance sector has reached a maturity stage over the last three decades, but the capacity of operational level staffs has not enhanced to that extent (Hassan & Islam, 2008).

Varieties of studies have found a few key strengths and positive impacts produced by the implementation of microfinance programs in poor and impoverished areas of the world. First, microfinance programs can be an effective way to provide low-cost financial services to poor individuals and families (Stephens & Tazi, 2006). Second, such programs have been shown to help in the development and growth of the local economy as individuals and families are able to move past subsistence living and increase disposable income levels (Khandker, 2005). MFIs should take

initiatives to upscale their Microenterprise clients to SME level and provide necessary support to link these clients with mainstream financial institutions. The MFIs should take responsibilities of their client's managerial skill development training (Hassan & Islam, 2008).

In addition, many studies (primarily microfinance institution impact studies and academic researcher qualitative or case studies) have shown that microfinance programs were able to reduce poverty through increasing individual and household income levels, as well as improving healthcare, nutrition, education, and helping to empower women. For example, standard of living increases, which help to eradicate extreme poverty and hunger, have occurred at both the individual and household levels because of microfinance programs (Khandker, 2005). Furthermore, it has been demonstrated by some research that microfinance programs increase access to healthcare, making preventative healthcare measures more affordable to the poor (Morduch, 1998). Finally, it has been shown that such programs can help borrowers to develop dignity and self-confidence in conjunction with loan repayment, and self-sufficiency as a means for sustainable income becomes available. The Microfinance Summit Campaign Report (2006) estimates that there are now more than 3,000 microfinance institutions, serving more than 100 million poor people in developing countries.

The total cash turnover of these institutions worldwide is estimated at \$2.5 billion and the potential for new growth is outstanding. One individual who gained worldwide recognition for his work in microfinance is professor Muhammad Yunus who, with Grameen Bank, won the 2006 Nobel Peace Prize. Yunus and Grameen Bank demonstrated that the poor have the ability to pull themselves out of poverty. Yunus also demonstrated that loans made to the working poor, if properly structured, had very high repayment rates. His work caught the attention of both social engineers and profit-seeking investors (Grameen Bank, 2008). Some key strengths and positive impacts of microfinance programs in poor and impoverished areas of the world that; Microfinance programs can be an effective way to provide low-cost financial services to poor individuals and families (Stephens & Tazi, 2006). Such programs help in the development and growth of the local economy allowing individuals and families to move past subsistence living, and therefore increases their disposable income levels (Khandker, 2005).

Negative impacts of microfinance and microcredit programs are that; microfinance programs benefit the moderately poor more than the destitute, and thus impact can vary by income group (better-off benefit more from microcredit) (Jonathan & Barbara 2002; Morduch, 1998; Dugger, 2004). Both formal and semi-formal financial institutions cover a very small share of MFI's markets as compared to informal market (Aleem, 1990). Hassan and Islam (2008) in a study conclude that, uplifting of client, managerial skill development programs for both client and staff of MFI and governmental policies can uplift the MFI growth, which in turn has positive impact on overall macroeconomic growth of country. Moreover, the studies conducted on micro-credit were mainly based on the impact assessment of the programmed. Realizing the situation, there is a need for an empirical study to analyze the factors that determine challenges faced by MFI's and future prospects in microfinance program.

The History of Micro-Finance in Asia

The history of micro-finance in Asia has started with the ideas of Dr. Yunus founder of Grameen Bank Bangladesh since 1976. It became bank in 1983. It has completed 26 years. In Pakistan, micro financing shows an increasing trend. Government is also playing positive role in establishing micro-finance system yet could not achieved the desired goal.

Indian microfinance is dominated by two operational approaches: self-help groups (SHGs), and microfinance institutions (MFIs), in addition to a few cooperative forms. The SHG model was initiated by the National Bank for Agriculture and Rural Development (NABARD) through the SHG-Bank Linkage Programme in the early 1990s. Today the SHG model, which links informal groups of women to the mainstream banking system, has the largest outreach to microfinance clients in the world. MFIs

emerged in the late 1990s to harness social and commercial funds available for on lending to clients. Today there are over 1,000 Indian MFIs. Microfinance actually started in Pakistan in the 1980s with Non Governmental Organizations (NGOs) through Rural Support Programs (RSPs) began making small loans to farmers on an informal basis. Microfinance Banks (MFBs) did not become well established until the late 1990s and are now growing rapidly.

Microfinance Sector in Pakistan

Microfinance is still relatively new to Pakistan, both in concept and practice. Until 2000, the main providers of microfinance were NGOs and government-sponsored rural support networks or, in at least one case, a traditional commercial bank with a specialized microfinance window. To reach these unserved households, in 2001 the government of Pakistan established a regulatory framework to promote the rapid expansion of microfinance throughout the country. Learning from international experiences, in promoting the expansion of access to financial services, policymakers emphasized the importance of sustainable microfinance and encouraged private sector participation from the start (State Bank of Pakistan (2004), p.19). Legislation established a specialized microfinance-banking license to provide micro financial services on the district, region or nationwide level.

Prudential regulation of the licensed microfinance banks is carried out by the State Bank of Pakistan, the central bank, as it is for other commercial banks operating in the country. As with other banks, microfinance banks are required to submit to an external audit and to publish an annual report. The first step of licensing has been to allow lending. The microfinance banks are allowed to offer voluntary savings services only after being in operation for some time and having an appropriate MIS system in place. In addition to regulating the amount of lending, the legislation regulates the opening of new branches and provisioning, rescheduling and write-off of loans, and to some extent interest rates since microfinance banks are required to implement “appropriate pricing policies which ensure access of affordable financial services to the poor as well as operational and financial self-sustainability of MFIs” (State Bank of Pakistan, 2004). As in many Asian countries, there are not yet any compelling examples of microfinance institutions (MFIs), be they nongovernment organization (NGO) or bank, that have developed a product and methodology that has proven to be fully financially sustainable and capable of reaching significant numbers of micro entrepreneurs. However, there is nonetheless an interesting range of models and products, and the industry is young and still experimenting; the future of the sector in Pakistan will be keenly observed.

Objectives of the Study

The objectives of the study include:

- To explore the present situation of Microfinance in Pakistan
- To identify the challenges faced by Microfinance Institutions in Pakistan
- To identify the internal and external constraints of MFIs in Pakistan.
- To provide policy recommendations to boost MFIs sector in Pakistan

Research Methodology

Conceptual Frame Work

Conceptual framework for the study has been adopted from the study “Microfinance in Pakistan: Challenges and Prospects” by Sohailuddin Alavi (2007).

Intervening Indicators	Enabling Indicators	Performance Indicators
<p><u>Internal:</u> Strategic focus Systems approach Process management Technology Structures People skills</p> <p><u>External:</u> Regulatory and policy alignment Alliances and linkages Institutional technical support/assistance Social mobilization</p>	<p>MFBs should be able to develop their institutional capacity:</p> <ul style="list-style-type: none"> To identify viable micro and small enterprises and to evaluate their potentials and risks, such as <ul style="list-style-type: none"> Ability to make effective use of the money (credit) in the enterprise, Ability at present and/or in due course of time to meet its financial obligations in a befitting fashion, Requisite competence of the trade, and Passion, commitment and discipline in enterprise. To reach to the door step of micro and small enterprises To develop and deliver financial services at competitive prices To develop and sustain essentially profitable relationships with all MSE customers To manage their profit function efficacy at all times To mobilize and deploy resources at optimal efficacy 	<p>Should be able to offer full range of financial services to the micro enterprises by precisely satisfying their financial needs and exceeding their expectations in a profitable and sustainable manner</p> <p>Should be able to adhere to its CSR towards poorest of the poor in a generally acceptable manner</p>

Sample Size and Data Collection

The data was collected through questionnaire that was distributed to 80 executives in four different MFIs. These executives have the responsibility of key customers' identification, analysis and operational activities involved in the management process. Out of the 80 respondents 54 (67.50%) have responded. The author has done the convenience sampling due to the limitations.

Research Instrument

We have divided this Questionnaire into three segments;

- External Challenges
- Internal Challenges
- Prospects

First and second section measure challenges, both internal and external faced by MFI and third section addresses the future prospects for MFI. Each section is based on separate research objectives. Only closed-ended questions are included in the questionnaire. In closed-ended questions, Likert-scale method (Proctor, T. 2005) is used for response. Seven different scaling options are included in Likert-scale method to minimize the response biasness.

Sampling

As we have limited MFIs, in the country so author has distributed 80 questionnaires and 54 responses are received (67.50%) from Karachi, Islamabad and Lahore cities.

Total Number of Questionnaire	Response Received	% of Response
80	54	67.50%

Methods for Submission of Questionnaire

The questionnaire is distributed to the respondents through the way of e-mail and assisted with telephone call contact with them. The author has continuous telephonic contacts and communication with them for accurate and efficient results as well as to run it efficiently for reclaiming.

Data Analysis Method

The software SPSS and MS Excel are used to analyze the data. We have used Descriptive Statistics for interpretation purpose. We have used Frequency distributions.

Result Discussion and Interpretation

The questionnaire delivered to respondents contains multiple-choice questions for maximum response. There were also left comments options in each section of the questionnaire. Moreover, information has also been gathered by discussing the topic with Micro Finance sector related people telephonically. So, the comments and discussions are summarized as a feedback.

Analysis of Results and Interpretation

The questionnaire results are divided into three sections:

- External Challenges
- Internal Challenges
- Prospects

Section 1 (a) External Challenges

Questions	1 Strongly Agree	2 Slightly Agree	3 Agree	4 Slightly Disagree	5 Disagree	6 Strongly Disagree	7 Do not Know	Total no of Response
Govt giving importance To Micro finance	1	11	30	8	4	0	0	54
MFI staff Well trained	0	3	24	6	21	0	0	54
Loans used in Consumption not invested	0	0	16	14	24	0	0	54
MFI Skill Devl of client	0	2	12	35	5	0	0	54
MFI and Banks Forbidden	2	16	25	11	0	0	0	54
Norms about Loan	0	1	30	3	20	0	0	54

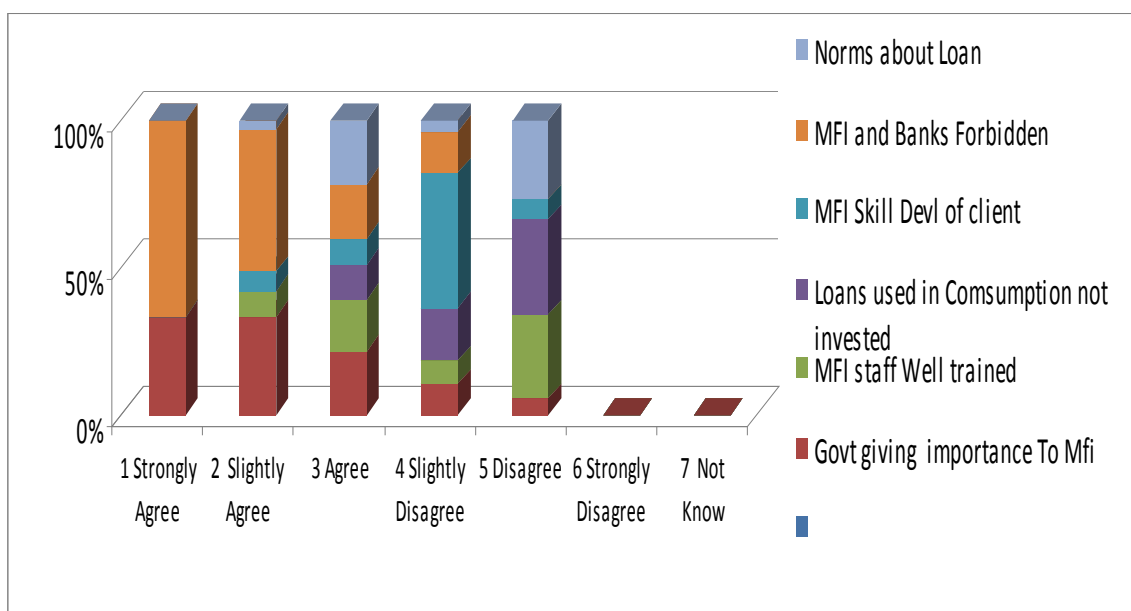
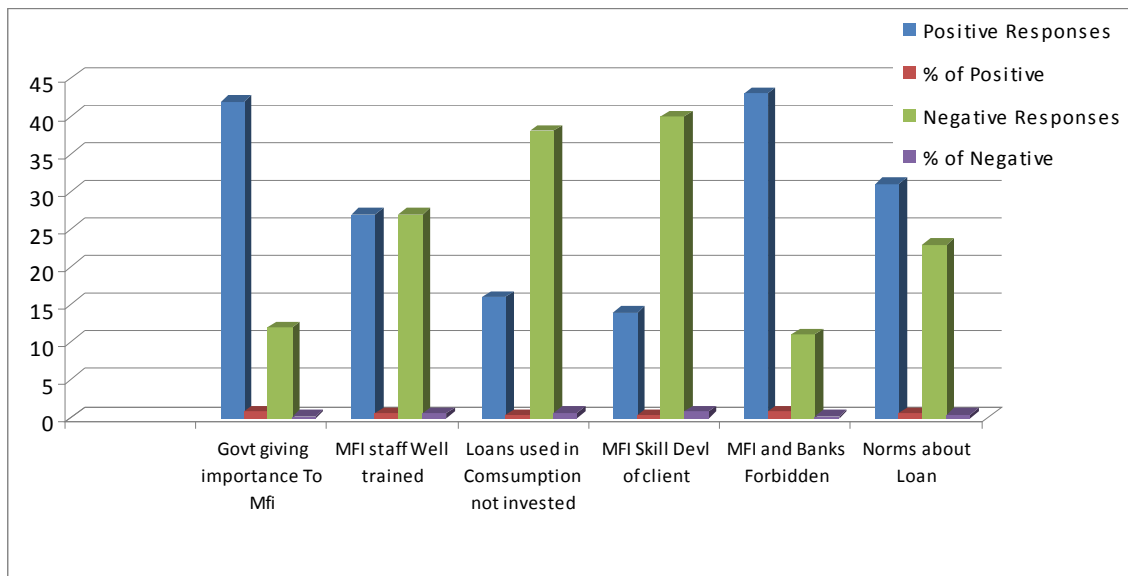


Table 1(b): Comparison of Frequencies

Questions	Positive Responses	% of Positive	Negative Responses	% of Negative
Govt giving importance To MFI	42	78%	12	22%
MFI staff Well trained	27	50%	27	50%
Loans used in Consumption not invested	16	30%	38	70%
MFI Skill Devl of client	14	26%	40	74%
MFI and Banks Forbidden	43	80%	11	20%
Norms about Loan	31	57%	23	43%



In the above section, the six factors highlighted addresses the external challenges of MFI's in the market of Pakistan.

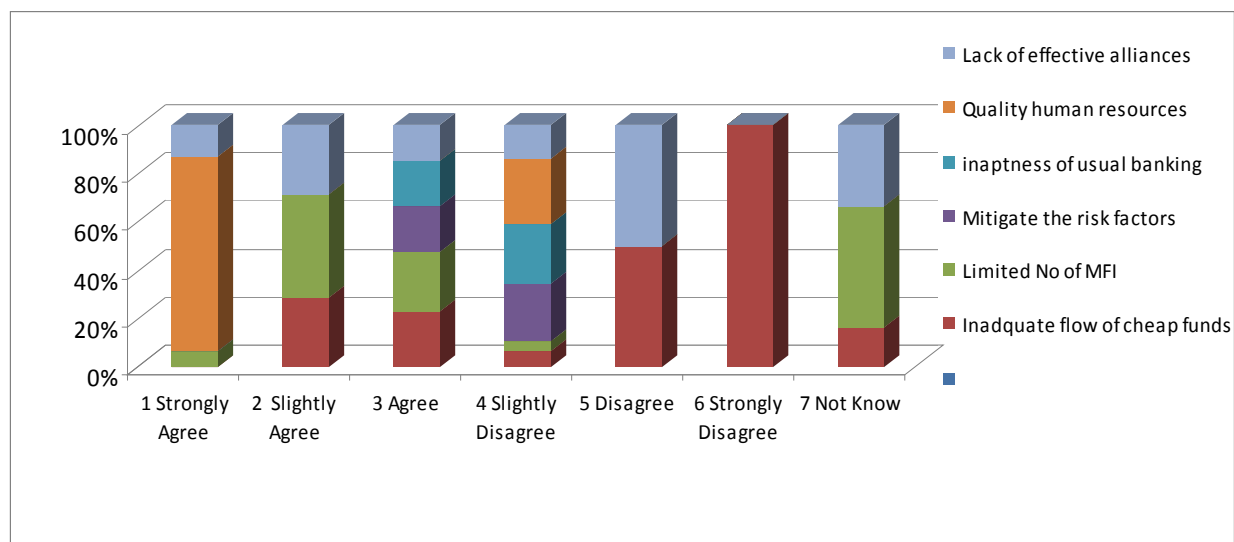
- Govt.'s due importance to the sector
- Staff trainings by the MFIs
- Utilizations of the loans
- Importance of clients' skills development by the MFIs
- Islamic point of view
- Local norms

It is clear from the table 1(b) that "Government is giving due importance to MFI", out of 54 respondents' 78% response positively and 22% in negative. It means Government considers MFI as a very important sector in the country development process. Second question is about Microfinance Institutions' staff's training level; there is 50% response in positive and 50% in negative. This indicates that MFI staff working in market needs adequate training. Ultimately, their training may draw some positive impact on MFI sector in specific, and at large, it may benefit the country's economy. Third and the most important factor about the utilization of loan money by client, surprisingly 70% of respondents say that loans are used for investment purpose by client and not for personal consumption. However, 30% of respondents believe that loan taken by client is used for their private consumption. The fourth question is about MFI attitude towards client's skills development shows; only 26% of responses are positive and 74% responded negatively. This result indicates a gap for policy makers of MFI's concluding that they are not putting due efforts in their business because their client is usually not only poor but also lacking management and other skills. Further research can be done on the level of skill of client and the growth of their business and relationship with MFI. The second last question in the first section addresses the perception of the client about financial institute in religious

perspective; 80% of respondents are positive that financial intuitions are largely perceived as non-Islamic. This issue can be resolved by focusing on the establishment of Islamic MFI's or marketing the concept of microfinance more aggressively. Final question is about the norms restrictions on the financial sector, again 53% of responses are positive about the existence of such norms and 43% are negative. We may say that in future these norms may go to decline.

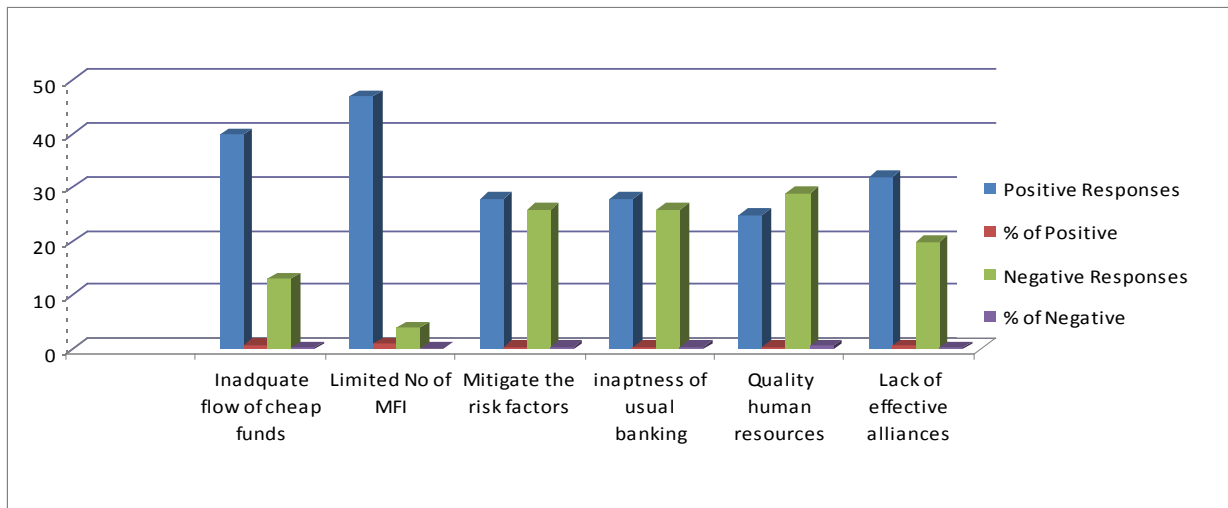
Section 2 Internal Challenges

Questions	1 Strongly Agree	2 Slightly Agree	3 Agree	4 Slightly Disagree	5 Disagree	6 Strongly Disagree	7 Not Know	Total no of Response
Inadequate flow of cheap funds	0	6	34	7	5	1	1	54
Limited No of MFI	2	9	36	4	0	0	3	54
Mitigate the risk factors	0	0	28	26	0	0	0	54
Inaptness of usual banking	0	0	28	26	0	0	0	54
Quality human resources	25	0	0	29	0	0	0	54
Lack of effective alliances	4	6	22	15	5	0	2	54



Comparison of Frequencies

Questions	Positive Responses	% of Positive	Negative Responses	% of Negative
Inadequate flow of cheap funds	40	74%	13	24%
Limited No of MFI	47	87%	4	7%
Mitigate the risk factors	28	52%	26	48%
Inaptness of usual banking	28	52%	26	48%
Quality human resources	25	46%	29	54%
Lack of effective alliances	32	59%	20	37%



Internal Challenges

The section 2 of the challenges is about the key internal challenges faced by MFI. We have discussed six different internal challenges; the first and probably the most important challenge are about the availability of other cheaper financial resources. 74% of the respondents agree that the availability of other cheaper source of finance is a great challenge for them and 36% responded in opposite. This indicates the fact that the cost of borrowing is high for small borrowers. Effort should be done to make small loans available at some competitive cost in comparison to other financial products. About the limited physical presence of MFI, 87% response is positive and only 13% is negative, which again reveals the gap for policy makers that the limited presence may be the major cause of low performance and growth of MFI sector. The third question is about the general inability of MFIs about risks and standard practices; 52% responded positively about the situation but 48% do not agree. We may say that there is a great need for MFIs to mitigate the risk factors and adopt the standard practices. The fourth question is about the incompatibility of conventional banking with the need of microfinance product; 52% of respondents are positive about the inaptness of conventional banking with microfinance product need while 48% do not agree that there is incompatibility of microfinance need and traditional banking. Therefore, we may say that a second majority of MFI believes that conventional banking system can also cater to the need of microfinance product. The second last question of this section is about the availability of quality human resource in comparison to other financial institutions; 48% of the respondents are positive about the availability of quality human resource due to scare funds while 52% do not agree. This shows that availability of quality human resource is not much of an issue in MFIs. Final question is about the lacking in value chain and delivery process of microfinance product; a majority of 59% is positive that there are lacking in value chain and delivery process, but 37% are of opposite view and 4% are uncertain about the answer to this question.

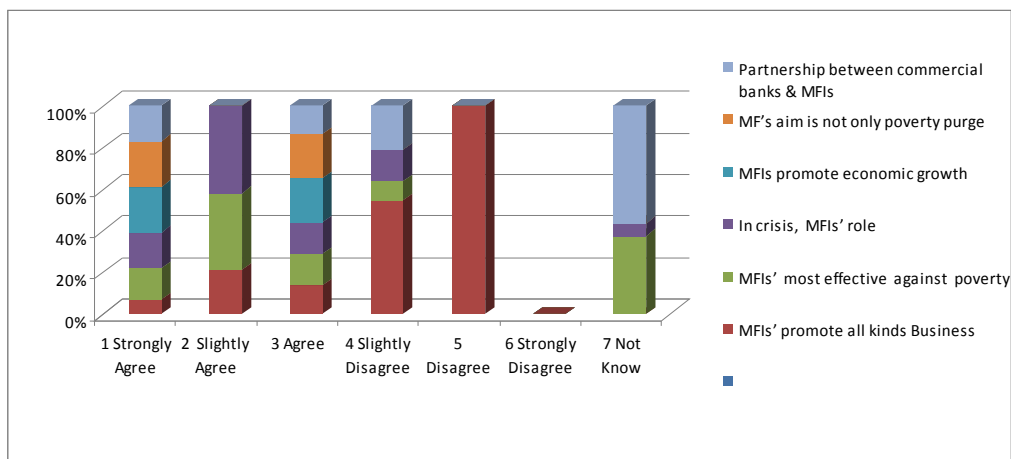
Section 3 Prospect/Opportunities

Summarized table of Prospect of MFIs:

Questions	1 Strongly Agree	2 Slightly Agree	3 Agree	4 Slightly Disagree	5 Disagree	6 Strongly Disagree	7 Not Know	Total no of Response
MFIs' promote all kinds Business	8	4	18	18	6	0	0	54
MFIs' most effective against poverty	18	7	20	3	0	0	6	54

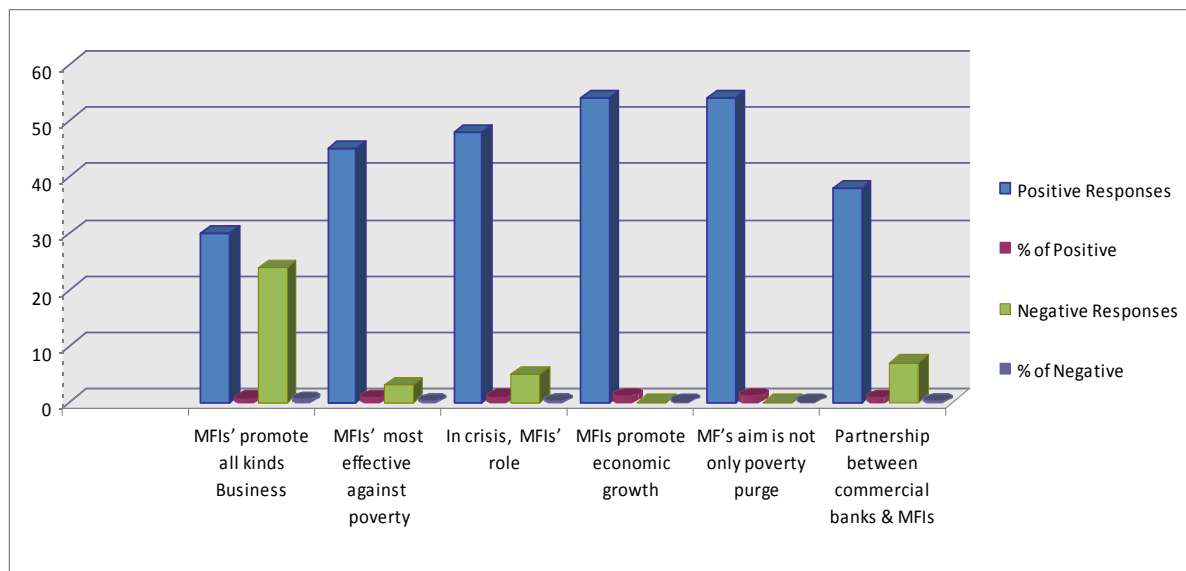
Summarized table of Prospect of MFIs: - continued

In crisis, MFIs' role	20	8	20	5	0	0	1	54
MFIs promote economic growth	26	0	28	0	0	0	0	54
MF's aim is not only poverty purge	26	0	28	0	0	0	0	54
Partnership between commercial banks & MFIs	20	0	18	7	0	0	9	54



Comparison of Frequencies

Questions	Positive Responses	% of Positive	Negative Responses	% of Negative
MFIs' promote all kinds Business	30	56%	24	44%
MFIs' most effective against poverty	45	83%	3	6%
In crisis, MFIs' role	48	89%	5	9%
MFIs promote economic growth	54	100%	0	0%
MF's aim is not only poverty purge	54	100%	0	0%
Partnership between commercial banks & MFIs	38	70%	7	13%



Prospects/Opportunities

The third and the last section is about the opportunities for MFIs, first question is about the promotion of different kinds of business through MFIs; 56% of respondents are positive that MFIs are promoting all kinds of business and 44% do not agree. The second majority of respondents believe that MFIs are not addressing all kinds of business. Hence, there is a need to look at the different kinds of businesses served by MFIs. In the question about the role of MFIs in reduction of poverty, 83% are positive about the role of MFI in poverty reduction, while a minority of 17% does not agree. The fourth question about the role of MFI in economic growth of country; 100% respondents advocate that MFIs are working for the economic development. 100% respondents are positive that MFIs are not only working against poverty but also playing some other roles too in economy. Finally, a 70% of respondents are positive about the alliance of commercial banks and MFIs, 13% do not agree about the alliance and 17% are uncertain.

Conclusions

From this study, we conclude that:

- Government is providing due importance to MF sector.
- MFI's staff needs training which can affect positively on MF Sector.
- A majority of 70% believe that loan is utilized in investments activities rather than personal consumption.
- MFIs have very low attention toward its clients' skill development.
- A majority of population perceive MFIs and other financial services against their religious beliefs.
- Lastly, norms and culture poses threats to MFIs and Banks.
- Cost of microfinance is relatively high in comparison to other financial products.
- Standards of practices and processes need improvement in MFIs.
- Alliance of commercial banking and microfinance is viewed as positive.

Recommendations

MFIs' staff working in market needs adequate training. Ultimately, their training will draw some positive impacts on MFI sector in specific and may benefit the economy of the country at large. MFIs are not putting due efforts in their business because their client is usually not only poor but also lacking management and other skills. Further research can be done on the level of skills of the client and growth of his/her business to elaborate the different skill levels. There may be a need of Islamic MFIs or marketing the concept of microfinance more aggressively to avoid the potential biasness in financial organizations. Effort should be done to make small loans available at some competitive cost in comparison to other financial products. There is a great need for MFIs to mitigate the risk factor and adopt the standard practices.

Limitation of Research

This study had the following limitations

- The author was not able to distribute the questionnaire to company executives all over the country.
- Time period to conduct the study was very limited.
- Some of the respondents did not answer the questions seriously
- Sample size was limited to 3 cities only, which cannot be easily applicable to all population of Pakistan.

- Not all respondents can maintain same level of accuracy in answering the questions due to lack of time and interest. It may create little discrepancy to some extent in formulating the conclusions.

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