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Microfinancing in Punjab, Pakistan: How Effective Are Microloans on The Very Poor?

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by

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Abstract

Microfinance has been around since the 1970s to help alleviate financial burden for the underprivileged by issuing microloans and credit programs to promote business activity. Microfinance institutions have helped multiple people around the world start their own businesses and become entrepreneurs through the process of microloans and offering credit at lower rates. The purpose of this paper is to explore the impact of microloan on the very poor low income borrowers in Punjab, Pakistan. Although this study was not conducted, the research is based on empirical investigation of interviews taken around the area.

Dedications

To my beautiful and supportive parents who always saw the light in me,
To my friends that stood by my side throughout it all,
To my professors for their encouragement and insight,
And to my sister who never once doubted my ability to achieve anything and everything.

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Table of Contents

List of Tables

Introduction

Microfinance has been around for centuries but, in recent years it has become the prominent means of supporting individuals and families who suffer from poverty. Poverty is a term that is difficult to describe, but according to the United Nations Development Program, poverty is “not just about money: lack of access to essential resources goes beyond financial hardship to affect people’s health, education, security and opportunities for political participation” (United Nations Development Program, 2008). Poverty extends to a lack of human resources, information, technology, recognition in society and political power. The majority of those living in poverty do not receive education, leaving them at a disadvantage when it comes to acquiring useful skills to better their lifestyles. Poverty is more than an income issue; it varies in terms of assets, resources and health, and it even extends to autonomy. Therefore, measuring poverty cannot concentrate on monetary forms (Mahmood, Hussain and Matlay, 2014).

As a developing country, Pakistan is surrounded by a rural landscape. According to the International Fund for Agricultural Development roughly 62 percent of Pakistan’s population lives in rural areas (International Fund for Agricultural Development, 2014). Of the 62 percent that live in the rural areas, about 26 percent are considered poor (living at the national poverty line). Formal financial institutions, such as banks, provide limited financial help to low-income borrowers. In areas like Punjab, Pakistan, financial institutions have failed to provide adequate credit, savings and life insurance for those living in poverty (Ghalib, 2013).

The borrowers then resort to private moneylenders to finance their needs. The moneylenders are in a monopoly-like credit market and charge extremely high interest rates to low-income borrowers. Although microfinance institutions (MFIs) average for interest rates globally are 37 percent, moneylenders offer at rates that could be as high as 70 to 100 percent (NYT). If these low-income borrowers had the opportunity to receive services from banks, they would likely get lower interest rates than the private moneylenders offer.

The limitations of the services banks offer to low-income users have caused the progression of microfinance in Pakistan. During the 1990s, microfinance started to pick up, giving hope to many low-income borrowers (Ghalib, 2013).

Microfinance does not have a universally accepted definition, however, Ghalib defines it as the set of financial services provided to low-income individuals who are denied help from formal banking institutions (Ghalib, 2013). Microfinance relieves individuals from poverty by providing access to financial services. These financial services vary but they typically include microloans, savings accounts and credit monitoring. These services provide a way for the poorest of people to reach their full potential by offering them the resources and skills they need (United Nations Development Program, 2008). MFIs are meant to run like a business and ultimately are financially self-sufficient. Although it differs between institutions, MFIs cover the cost of capital at commercial rates. They can cover their costs by borrowing from big banks, investors, and take deposits from clients (Roodman, Qureshi, 2006).

The term *micro* speaks to the small amount of money being lent. Since the majority of low-income individuals around the globe cannot repay large sums of money, as they do not have the means to repay them, microfinance institutions (MFIs) provide loans in smaller amounts. Today, low-income individuals informally invest their money in gold, farm animals and building materials, resulting in the need for financial services. Unfortunately, these informal ways of investing are subject to limitations. For instance, farm animals cannot be broken into small pieces and converted into small amounts of cash. As well, none of these types of investments are protected from unforeseen events such as infestation, robbery, fire or disease. Microfinance provides low-income individuals the means to live a better life by offering financial services to counter the informal ways they use such as investment in gold and farm animals. (Iqbal, Mushtaq, 2015).

MFIs go through a process when they are picking individuals whom they will lend loans out to. MFIs are more lenient than formal banking institutions, but do require some basis before giving out loans. They start off by selecting villages based on certain characteristics such as education level, poverty level, number of assets owned, credit history if available and so on. Based on the village selected, MFIs then start lending out loans to individuals and pair the groups up for group lending which is explained later in this study (Johnson, Rogaly.1997).

Microloans are meant to provide capital for low income individuals to better their quality of life. In some instances, low income individuals cannot repay their loan and essentially default on their loan. In later stages of default, higher up members from MFs visit the clients and pressure his/her to repay the loans. If that doesn't work, MFIs will extend to the liability to their family members and others in their village. If the entire village cannot help repay the loan then MFIs will blacklist them and they are not able to loan money anymore. Usually MFIs do not take legal action on members who defaulted their loans due to the amount of legal costs that would incur (Solli, 2015).

The bulk of MFIs around the globe focus on the progression of female entrepreneurs and their ability to foster their dreams through financial stability. About 85 percent of MFIs focus on providing services to women (International Development Association, 2013). Approximately 70 percent of the world's poor are women, they are paid 25 percent less than men and represent the majority of low-wage jobs (International Labor Office, 2007). Microfinance provides them with a sense of empowerment and the ability to provide for their families. It promotes the idea of gender equality and the opportunity to be independent by focusing on the needs of female entrepreneurs and helping them pursue their dreams. Women and children reap the benefits of these services through education opportunities and a chance for better healthcare (International Development Association, 2013). While this study focuses on those affected by poverty as a whole, the issue of how poverty affects women, and how microfinance has helped shaped women's success could be an area of future research.

As stated before, the microfinance industry has received a lot of attention in the past few decades. In the 1970s, Dr. Mohammad Yunus created a legacy by lending money to economically distressed women in small villages in Bangladesh during his tenure as an economics professor at Chittagong University (Islam, 2010). Soon after, the Grameen Bank was established in Bangladesh to service several low-income villages throughout the country. Yunus and Grameen Bank jointly won the Noble Peace Prize in 2006 for founding the Grameen bank and pioneering the concept of microcredit. Shortly after the Grameen Bank began operations, microfinance institutions in Pakistan rapidly gained popularity as a way of assisting the poor (Ghalib, 2013).

In the 1970s, financial services in Pakistan started as a form of government-directed credit, specifically for rural areas. Organizations such as the Youth Investment Promotion Society and the Small Business Finance Corporation represent direct intervention of helping low-income individuals with the use of public funds. In 1982, the first integrated rural development program was initiated by the Aga Khan Foundation in Pakistan (International Development Association, 2013). Their focus was on development intervention in the northern region of Pakistan. They created social mobilization which allows low income individuals to rely on one another for financial support and started group lending (Ghalib, 2013). Group lending is a practice through which small groups borrow collectively based on their location and encourage one another to repay their share of the loan. In the 1980s, Akhtar Hameed Khan created the Orangi Pilot Project to provide services such as housing, education and sanitation in Organi Town, Karachi, Pakistan. Both the Aga Khan Foundation and the Orangi Pilot Project started the movement of microfinance, and today Pakistan has over ten different microfinance institutions (Muhammad, 2010).

In the past five years, the number of individuals who use microfinance services has impacted over 2.4 million people, with 58 percent of these individuals being women. The number of microfinance institutions in Pakistan has reached 1,601 branches. In 2014, areas such as Layyah and Bhakkar introduced 17,000 newly registered microfinance borrowers (Aazim, 2015). These statistics represent real stories of individuals whose lives have been improved through the use of microfinance services. The growth rate of microfinance in Pakistan is increasing and it is evident how much progress is being made towards lowering poverty levels in rural areas. While there is still room for improvement, MFIs have come a long way since they first started, and they continue to expand their services throughout Pakistan (Muhammad, 2010).

Although microfinance is seen as a useful tool in fighting poverty, this study assesses and analyzes how effective microfinance is in the specific area of Punjab, Pakistan. Punjab was chosen for this study in order to analyze the growing rate of entrepreneurship in this region, especially among women. The government of Pakistan and the United Nations, as part of their effort to achieve the Millennium Development Goals, work together to provide training and skill enhancement to promote entrepreneurial activities among the poor (Muhammad, 2010). However, the majority of low-income individuals rarely keep track of their earnings, making it hard to assess whether microfinance has had a major impact on those in economic distress (Ghalib, 2013).

Regardless of the impact, microfinance services have made significant progress by helping low income individuals fight poverty throughout the world, especially in Bangladesh. The Grameen Bank transformed many villages into areas of entrepreneurship and growth (Islam, 2010). They are able to track and assess the progress of these villages in ways that MFI’s in Pakistan have been unable to achieve. In this study, recommendations will be made to improve the structure of MFI’s in Pakistan, using the Grameen Bank and their credit program as examples, due to the success they've had in the field.

These are the research questions that will be explored throughout this study:

- Has there been a positive impact on those using microfinance loans in Pakistan?

- Have MFIs in Pakistan provided adequate amounts of support to alleviate poverty and improve the lives of low-income individuals?
- Do MFIs in Pakistan do a sufficient job reaching the poorest throughout the rural areas of Punjab?
- Is there a way to improve the strategy of MFIs in Pakistan to provide a more optimistic impact on these individuals?

Literature Review: Findings from Empirical and Theoretical Studies

This section contains articles from empirical and theoretical research studies. Some studies offer different perspectives on how the research was conducted and conclusions reached. These articles offer insights into the methods used and the results of the researcher. One article explains theoretical approaches to microfinance and research explores many dimensions of poverty and how microfinance services improve the lives of those living in poverty.

When looking at the impact MFIs have on society, there are some studies concluding microfinance is effective in Punjab, Pakistan. Mahmood, Hussain and Matlay (2014) discover an optimal loan size that meets the objectives of Punjabi female borrowers, based on certain characteristics such as education level and number of children in the household. Using a questionnaire to collect quantitative and qualitative data, they interviewed over one hundred women who share different characteristics such as age, children, education etc. Poverty reduction was tested through both qualitative and quantitative analysis using binary regression. The majority of women tested were either at or below the poverty line (Mahmood, Hussain and Matlay, 2014).

The researchers found women who were given medium loans of about 15,000 to 25,000 rupees were more likely to have an increase in income than those who received smaller loans. Those over 40 years old were also more likely to have an increase in income versus those between the ages of 18 and 39. Those who took the medium size loans reported an increase in their children’s education as a result of higher income. There was no relationship between higher income and family health (Mahmood, Hussain and Matlay, 2014). This study is relevant to this research as it relates to the questionnaire used and location of research subjects. The list of variables used aligns with those to be used in this study. They tested whether a particular loan amount would positively affect income in the households of those living in poverty, which offers insight into how to conduct this study (Mahmood, Hussain and Matlay, 2014).

Sungi is a nongovernment organization, created in 1989, that works in Hazara, Pakistan. Johnson and Rogaly (1997) analyzed Sungi to offer an explanation of how this particular nongovernment organization operates and how Sungi structures its program. The researchers began volunteer work when floods hit Hazara in 1992. Sungi only works with villages comprised of men and women. Sungi uses the solidarity group practice, whereby four to five members of the village borrow collectively from Sungi and encourage one another to repay their share of the borrowed funds. With the help of Sungi workers, the village elects four members for the credit management committee to jointly create the credit policy. Each member of the borrowing group deposits about 30 rupees each month into a savings account which does not earn interest (Johnson, Rogaly.1997).

According to the researchers, the savings accounts create some confusion. Because of the fixed amount a borrower puts in the bank, there are limited options for withdrawals. Borrowers never save more than the fixed amount of 30 rupees a month. Loans given to the borrowers from Sungi may be up to 5,000 rupees and are for terms ranging between 6 and 24 months. Sungi charges an annual service charge of 18 percent when the loan is issued. Sungi has been actively making loans since 1995 and receives repayment from their borrowers, however there is not adequate research to determine whether it provides financial stability. This research is relevant to this researcher's study because Sungi offers a perspective of the solidarity practice used in villages. This practice reveals a potential technique that might help microfinance in Pakistan (Johnson, Rogaly.1997).

Worldwide, women represent about 70 percent of those in poverty (International Labor Office, 2007). In Africa and Latin America, most micro- and small enterprises are operated and owned by women who receive help from MFIs. Washington and Chapman use panel data from Argentina, Brazil, Colombia and South Africa to see whether MFIs in an emerging economy positively correlate to entrepreneurial activity in that economy (Washington, Chapman, 2014).

The entrepreneurial activity analyzed by the researchers is based on four different criteria: owners of a business operating for at least 42 months (OLD_BUS), owners of a business operating for at least 3 months but less than 42 (NEW_BUS), females who operate a business between 3 and 42 months (FEM_BUS), and males who operate a business between 3 and 42 months (MALE_BUS). By collecting gross loan portfolio data from each country used, they define variables based on working age, the number of months of business operations (ranging 3 to42 months) and the gross domestic product per capita. Furthermore, they predict female entrepreneurial activity to exceed that of men. The research concludes Colombia ranks the highest in terms of the need for microfinance services. They also conclude that microfinance is effective for new businesses but produces a negative effect on established businesses (Washington, Chapman, 2014).

Washington and Chapman deem microfinance useful for start-up capital, but not as working capital for business continuity because the loans were too small to fill the needs of more established businesses. Also, MFIs positively impact women's entrepreneurial activities while negatively impacting men's entrepreneurial activities. Washington and Chapman did not identify why there was a negative impact on males and would investigate further (Washington, Chapman, 2014). These findings are relevant to this study because they look into entrepreneurial activity and show which types of business owner's benefit from the services of microfinance.

In Africa, average microloan size is smaller than anywhere else in the world, and therefore, opportunities for low income individuals are fewer. Africa as a whole is poor compared to the rest of the world, which results in a higher need for microfinance services according to Mosley and Rock. Mosley and Rock study whether microfinance institutions reduce poverty in Africa. They interview 150 borrowers from six different MFIs and 50 participants who were approved for loans from MFIs but did not take the loans. Mosley and Rock determine poverty has a variety of characteristics, all of which are addressed in the study. Given the logistics of microfinance, the researchers deem it important to improve the individual action of microfinance, specifically within lowering market interest rates and frequent repayment through mobile banking and incentives to repay. These factors improve the profitability of the microfinance system and provide the most benefits to the projects that are important. Mosley and Rock recommend improving social capital, measures of risks with certain levels of return and expected flow repayments. They also recommended increasing the demand for low-income borrowers (Mosley, Rock, 2004). This study is relevant because it researches the operations of MFIs and ways they can improve their structures. It also studies ways microfinance can individually help each user by providing incentives and quicker methods for repayments.

Asad K. Ghalib researches microfinance in 11 of the 36 districts of Punjab, Pakistan. Ghalib uses a four-stage, random, stratified sample technique, selecting 11 districts as the first stage of the process. Systematic selection rather than random selection is used to account for the economic and social disparities in the district. In the second stage, at least one tehsil (district) is randomly selected, following two villages in the third stage. Lastly, both participating (those who use microfinance services) and nonparticipating (those who do not use microfinance services) households are randomly selected from these villages. In total, 1,132 households are interviewed, including 463 borrowers and 669 non-borrowers (Ghalib, 2013).

Ghalib selects a mix of indicators to represent different poverty levels. Because poverty has multiple dimensions, Ghalib uses Principal Component Analysis (PCA) to develop a relative poverty index. He stated that 667 of the 1,132 households (60 percent) have a PCA below zero, meaning they are negatively impacted by poverty. Ghalib states that 413 of the 667 (36 percent) are non-borrowers and 254 (22 percent) are microloan borrowers. The poorest are considered the very poor, followed by moderately poor and lowest poor. Once non-borrowers are divided in subgroups, Ghalib compares them to the borrowers, who are also divided into the three rankings of very poor, medium poor and lowest poor. The results show the distribution of microfinance users across the tehsils: for very poor borrowers were 22.5%; for moderately poor 35.4%; and for less poor 41.1%. These results indicate MFIs are not reaching the poorest of the regions through their financial services. MFIs target those in the less poor category, disregarding those in the poorest regions.

Ghalib's research is vital for this study because he analyzes the effects of microloans on the very poor, middle poor and least poor. This study uses the research from Ghalib's analysis and is an essential part of this study because of his contributions to determine whether microloans have an impact on very poor borrowers.

The last theoretical study in this literature review by Tariqul Islam describes the structure of the Grameen Bank and its success with group lending. Grameen's credit program is based on group lending, which consists of five borrowers who are responsible for one another during the repayment process. This is similar to the group lending practiced by Sungi. These five borrowers are allowed to choose who is in their borrowing group based on the members who participate in the credit program. The borrowing group attends a week-long training program before they can receive their loan. Each loan is paid in 50 weekly installments, and if one member of the group cannot pay, the remainder of the group must find a way to make the payment. Any default on the loan from any one member means the whole group cannot receive repeat loans; therefore, it is crucial for members to hold one another accountable. Grameen bank assistants meet weekly with borrowing groups to ensure installments are paid and group members are keeping track of their savings. One unique aspect of the meetings is the motivational talks bank assistants have with members to promote morale. In the meetings, they discuss social issues such as family life, education and health, allowing members to open up about their adversity. First-time borrowers start off with loans around 2,000-2,500 takas and increase 500 to 1000 takas each year.

Grameen Bank has a 97 percent loan recovery rate while the majority of microfinance institutions in Bangladesh have only a 50 percent loan recovery rate. Through this credit program, the Grameen Bank is able to reach the poorest people in Bangladesh and impact their lives in a positive manner. By providing low-income borrowers with morale talks, Grameen encourages them to take more loans and impact their lives in a constructive way. This study shows how effective microfinance can be towards the poor and is addressed to present a theoretical approach for MFIs in Pakistan to follow.

Hypothesis

Specifically, this study will test to see whether the quality of life of a very-poor income borrower will improve after the use of a microloan. In this study, very poor low-income borrowers represent those who fit the qualifications in Table 1 below. Based on the empirical and theoretical studies and the literature reviews addressed earlier, the following hypotheses are formed.

- H_o There is no relationship between the existence of microloans and the improvement of quality of life of very poor low-income borrowers.
- H_a There is a relationship between the existence of microloans and the improvement of quality of life of very poor low-income borrowers.

Table 1. Poverty Status

Dimensions	Very Poor	Middle Poor	Lowest Poor
Labor market participation	Casual and/or unskilled, limited employment; limited formal education	Limited employment but secure claims on other household members with stable employment	Stable, salaried employment or good employment prospects
Physical assets	Very few – hand-to-mouth existence	Some – including household goods and business capital	Diverse – especially own dwelling
Savings and credit	Unbanked; reliant on informal services	May have a savings account; but saving has a high opportunity cost	Direct access to regulated savings and credit services
Social and cultural resources	Dependent on informal sources of patronage as security against shocks; rendered often on exploitative terms	Intermediate – scope for diversification away from dependence on a single patron	Diversified social networks; forms of security against shocks

Source: Ghalib (2013).

Research and Methodology

This research plan would analyze whether the existence on microloans have an impact on the improvement of quality of life of very poor low-income borrowers. However, this study is not able to be conducted due to location restraints but if locations constraints did not exist, it would test 18 of the 36 districts in Punjab, Pakistan. Punjab, Pakistan was selected due to high entrepreneurial activities in this region. Interviews would be conducted with households falling under all three levels of poverty: very poor, middle poor and lowest poor which is listed on Table 1. These interviews would consist of both qualitative and quantitative questionnaires collectively administered to individuals who benefit from three different microfinance institutions. To analyze the data, a multiple regression analysis will be conducted using Statistical Package for the Social Sciences (SPSS) statistics.

In order to understand the connection between alleviation of poverty and microloans, interviews would be conducted with ten entrepreneurs who use microloans to determine how they use them to successfully fight poverty. This will help low income individuals understand the relevance and structure of microfinance loans and any microfinance-related factors aiding them in their family situations. The researchers would select these individuals from the same three poverty levels applied to individuals selected to ensure each group is represented in this study.

The study would be conducted in local languages and would focus on levels of income before and after the use of microfinance loans. Listed in Table 2 are the final variables used for the analysis.

Table 2. Independent Variables

– Ownership of live stock – Ownership of transportation assets – Ownership of appliances – Age – Gender	– Location – Size of loan – Group loans – Marital status – Number of children

Table 3. Control Variables

– Education level – Education level of parents – Business experience – Business type	– Budgeting and financing – Business networks – Peer monitoring

The data obtained would be analyzed to determine whether there is an impact on the very poor borrowers. This study is based on research from Ghalib, Hussian and Matlay, with Ghalib using PCA and Hussian and Matlay using binary regression (Mahmood, Hussain and Matlay, 2014). This study will use multiple regression analysis because there are a variety of independent variables and they are nominal variables, multiple regression will best represent each variable in the study. R-square was not mentioned in Ghalib's or Hussian and Matlay's research, but should be addressed in this study because it is expected to show the relationship between an optimal size microloan and the level of poverty. Listed below is the multiple regression model used for the purpose of this research:

$$Y= B_0 + B_1X_1 + B_2X_2 +\ldots+ B_kX_k + C+ E$$

Where Y is the dependent variable which is the existence of the microloan, B_0 is the Y intercept, B_1 is the coefficient, $X_{1\ldots}X_k$ are the independent variables listed in table 2, C are the control variables which are listed in table 3 and E is the residual term for any errors that could potentially skew the data. The dependent variable will be tested to see whether there is no relationship between the existence of the microloans and the improvement of quality of life on low income borrowers or if there is a relationship between the existence of microloans and the improvement of quality of life low income borrowers.

This study is subject to limitations. In both Ghalib's and Hussain and Matlay's research, they encountered limitations and bias responses from those they interviewed. There is a possibility the responses in this study may be biased due to the nature of the questions and reluctance of those interviewed. Caution will be taken when analyzing the results of the questionnaires to counter any skewed data.

Recommendation and Conclusion

This study focuses on the relationship between poverty alleviation and microloans and whether there is a positive impact on very poor borrowers. Although this study could not be conducted due to location constraints, recommendations could be made assuming the dependent variable showed no relationship between very poor borrowers and microloans.

Although this study will not be conducted, it is expected to reveal the impact microloans can have on low-income borrowers. This study exposes the continued effort of microfinance institutions in Pakistan, and their ability to expand coverage of these programs. While it has not been tested in this study whether very poor borrowers receive benefits from microloans, researchers mentioned in the literature review made a considerable effort to help low income individuals. Microfinancing institutions in Pakistan can achieve greater potential and expand their coverage around the country.

One way to possibly improve microfinance institutions in Pakistan is through Grameen's credit program. Grameen Bank is known for their group lending philosophy, which enables microfinance members to be liable for each other when repaying their individual portions of a loan. If very poor borrowers were exposed to this philosophy, they might be able to repay the loans proceeds in a timely manner and use their loans to invest in entrepreneurial activities.

One particularly effective technique Grameen Bank uses is their morale speeches to their microfinance members. Grameen targets and focuses on the credit needs of low-income individuals and motivates them to start businesses. They might then use their income to invest not only in their own lives but in the lives of their children and family members. These morale talks differentiate Grameen Bank from other microfinance institutions, and if institutions in Pakistan start implementing morale talks in their credit programs, they could see improvement in their programs.

This study focuses on the impact of microloans on low income borrowers in the district of Punjab, this researcher hopes to one day conduct the study outlined herein and extend to other regions in Pakistan. Recommendations were made in order to improve credit programs in Pakistan through the help of the Grameen Bank.

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