

# Micro Entrepreneurs Experiences with Islamic Banks of Pakistan

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## Abstract

This paper investigates micro entrepreneurs' financing experiences with the Islamic Banks of Pakistan. To accomplish this research objective, a survey of 150 micro-entrepreneurs was conducted in three major cities of Pakistan namely Rawalpindi, Lahore and Peshawar. The result of our survey revealed that majority of the entrepreneurs' income is not sufficient to meet their basic needs. The underlying reasons are large number of dependents, lack of education and lack of access to better sources of income. The results of this study suggest that micro entrepreneurs do not have formal access to micro financing either from the Islamic banks or conventional banks. Further high interest rates in conventional banks are also discouraging micro entrepreneurs. The majority of the respondents also feel that neither Islamic banks nor the government of Pakistan are encouraging lower income micro-entrepreneurs. The results showed that a majority of respondents who applied for financing in Islamic banks were rejected. The results highlight that there is a strong need for Islamic banks to look into their existing business model and diversify their products that can cater needs of micro-entrepreneurs to bring social justice in the society.

**Keywords:** Micro-entrepreneurs, Islamic microfinance, Justice, Perception, Pakistan

## Introduction:

The Islamic finance industry has substantially expended over the past decade and it has achieved a worth of \$2trillion by witnessing an annual growth of 11-12%<sup>1</sup>. It is now present in all corners of the world and is being acknowledged by both Muslims and non-Muslims<sup>2</sup>. Currently, this industry contains 105 Islamic banks operating around the globe<sup>3</sup>. These banks perform functions similar to which are being performed in conventional banks except that they carry out transactions in accordance with the Sharīah rules and regulations<sup>4</sup>. The main Sharīah principles are 1) the prohibition of element of interest on transactions (riba principle), 2) the strong linkage between financing and real assets (materiality principle), 3) the prevention of ethically problematic businesses (e.g.

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<sup>1</sup> The World Bank. "Brief history of Islamic finance." Accessed March 31, 2015.

<http://www.worldbank.org/en/topic/financialsector/brief/islamic-finance>.

<sup>2</sup> Munawar, Iqbal, and Philip Molyneux. *Thirty years of Islamic banking: History, performance and prospects*. New York: Palgrave Macmillan, 2005.

<sup>3</sup> The World Bank. "Islamic banks." Accessed April 04, 2015.

[http://www.wdibf.com/islamic\\_banks.html](http://www.wdibf.com/islamic_banks.html).

<sup>4</sup> Henry, Clement M., and Rodney Wilson, eds. *The politics of Islamic finance*. (Edinburgh: Edinburgh University Press, 2004).

Iqbal, Zamir, and Abbas Mirakhor. *An introduction to Islamic finance: theory and practice*. Vol. 687. United States: John Wiley & Sons, 2011.

alcohol production, arm manufacturing, prostitution), and 4) the real link between returns and risks<sup>5</sup>.

Focusing on the context of the study, The Islamic Banking Industry (IBI) of Pakistan has witnessed substantial growth since the last decade. In 2015, asset base of IBI has grown by 28.14% and now reached to Rs. 1302 billion, while deposits have witnessed a growth of 28.7% and now reached to 1122 billion<sup>6</sup>. At the moment, five Islamic and seventeen conventional banks are operating in Pakistan, having 1597 Islamic branches in total<sup>7</sup>. In addition to this, conventional banks are offering Islamic banking products under 922 Islamic windows<sup>8</sup>. The Islamic banking industry has 10.4% share in assets and 12.2% share in deposits in the financial industry of Pakistan<sup>9</sup>. The growth in Islamic banking industry can also be seen in Figure 1.

**Figure 1: Industry Progress and Market Share**

	(Rupees in billions)								
	Industry Progress			Growth (YoY)			Share in Industry		
	Mar-14	Dec-14	Mar-15	Mar-14	Dec-14	Mar-15	Mar-14	Dec-14	Mar-15
Total Assets	1016	1259	1302	20.0%	24.2%	28.2%	9.4%	10.4%	10.4%
Deposits	872	1070	1122	23.9%	23.3%	28.7%	10.7%	11.6%	12.2%
Net Financing & Investment	662	765	768	-0.7%	7.9%	16.0%	7.6%	7.8%	7.5%
Total Islamic Banking Institutions	20	22	22	-	-	-	-	-	-
Total No. of Branches*	1314	1574	1597	-	-	-	-	-	-

Source: Quarterly Unaudited Accounts  
\*number includes sub-branches

Adopted from SBP<sup>10</sup>

As witnessed above, Islamic banking industry has accomplished a substantial growth and its growth momentum depends upon the strategic positioning of Islamic banking players to sustain the competitive advantage and the products and services offered to meet the need of their customers. Microfinance is considered as one of the important economic development tools that addresses issues such as poverty, illiteracy, inequality, gender and socio-political imbalance<sup>11</sup>. According to a survey conducted in 54 countries by The World Bank (2009, p.54) points out that a large number of entrepreneurs belong to low-income countries. This study further point out that nearly a half of the urban poor in Indonesia, Nicaragua, and Pakistan run their own business and are engaged in multiple businesses. For instance 51 percent of very poor rural households in Pakistan are engaged in agriculture business and also earn some income by selling

<sup>5</sup> Awan, Hayat M., and Khuram Shahzad Bukhari. "Customer's criteria for selecting an Islamic bank: evidence from Pakistan." *Journal of Islamic Marketing* 2, no. 1 (2011), 14-27.

<sup>6</sup> State Bank of Pakistan. "Islamic Banking Bulletin." (Accessed December 15, 2015). <http://www.sbp.org.pk/ibd/bulletin/2015/IBB-Sep-2015.pdf>.

<sup>7</sup> State Bank of Pakistan, "Islamic Banking Bulletin.", 28.

<sup>8</sup> Ibid.

<sup>9</sup> Ibid., 6.

<sup>10</sup> Ibid.

<sup>11</sup> Mahmood, Hafiz Zahid, Kausar Abbas, Mehreen Fatima, and Shumaila Asghar. "Does Islamic Microfinance Go beyond the Self-employability? An Appraisal from Lahore, Pakistan." *Journal of Creating Value* 2, no. 2 (2016), 268-286.

labour to non-agricultural firms<sup>12</sup>. Studies have pointed out that the formal sector of financing (i.e. banks and financial institutions) is reluctant to finance to those people who are poor and do not have any collateral<sup>13</sup>. Further the same study states that, the Islamic banking sector is perceived as reluctant to finance the poor due to high cost associated with the maintenance of SMEs and microfinance accounts. Contrary to this, The Government of Pakistan and The State Bank of Pakistan appear to encourage the Islamic banks not only to finance the small and medium enterprises (SMEs) but also to participate in the microfinance sector (Microfinance Institutions Ordinance, 2001). Islamic banks of Pakistan appear to include Islamic microfinance in their products binder<sup>14</sup>. They are supposed to not only cater the needs of high net worth clients but also to take care of the poor segment of society<sup>15</sup>. Keeping in view findings of previous scholarship in general and the growth in the Islamic Banking of Pakistan in particular, this research is aimed to understand the experiences of micro entrepreneurs with Islamic banks of Pakistan regarding access to micro finance. The previous literature has also pointed out to conduct a research exploring the experiences of micro entrepreneurs with Islamic Banks<sup>16</sup>.

The paper is organized as follows. The next section presents the literature review. The section three describes research methodology used in this research. The penultimate section describes data analysis results. The final section presents discussion of the results, limitations and future research suggestions.

#### **Literature Review:**

In the last decade, the literature on microfinance focused on examining the issues of conventional microfinance institutions (MFIs) sustainability and their products and services, management practices, clientele targeting, regulations and policy matters, and their impact assessment<sup>17</sup>. Despite the transformation of Islamic microfinance as a widely available and valid alternative to conventional microfinance, there is no considerable development in Islamic microfinance research examining perceptions and patronage factors in recent years<sup>18</sup>. Researchers have provided information on global outreach of Islamic Microfinance Institutions (IMFIs) by making comparison of Islamic countries and point out those IMFIs in Indonesia predominates in terms of their services

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<sup>12</sup> Abbas, Kausar, and Nasim Shirazi. "The key players' perception on the role of Islamic microfinance in poverty alleviation: The case of Pakistan." *Journal of Islamic Accounting and Business Research* 6, no. 2 (2015), 244-267.

<sup>13</sup> Abbas, Kausar, and Nasim Shirazi, "The key players' perception," 244-267.

<sup>14</sup> Ibid., 244.

<sup>15</sup> Ibid.

<sup>16</sup> El-Komi, Mohamed, and Rachel Croson. "Experiments in Islamic microfinance." *Journal of Economic Behavior & Organization* 95 (2013), 252-269.

Khaleequzzaman, Muhammad, and Nasim Shah Shirazi. "Islamic Microfinance - an Inclusive Approach with Special Reference to Poverty Eradication in Pakistan." *International Journal of Economics, Management and Accounting* 20, no. 1 (2012), 19.

Rhule, Karice. "Islamic Microfinance: a Vehicle for Promoting Financial Inclusion." *Law School International Immersion Program Papers* 1, no. 21 (2016), 1-31.

<sup>17</sup> Mohammed Obaidullah, "Role of Microfinance in Poverty Alleviation: lessons from experiences in selected IDB member countries." Islamic Research Training Institute, (Jeddah: Islamic Development Bank, 2007), 1-92.

Ahmed, Habib. "Waqf-based microfinance: Realizing the social role of Islamic finance." *World Bank* (2007), 1-22

<sup>18</sup> Rhule, Karice. "Islamic Microfinance," 1-31.

over other IMFIs in other thirteen countries<sup>19</sup>. Another study has pointed out that the practices IMFIs in Pakistan are very low as compared to other neighbouring countries such as India, Afghanistan and Bangladesh<sup>20</sup>.

Islamic Republic of Pakistan is the sixth most populous nation with a population exceeding 180 million people who are predominantly Muslims. Over the past few years, several institutions have launched Islamic microfinance products in Pakistan. It has been acknowledged that microfinance is an important tool which contributes to the economic development in general and to the development of poor in particular<sup>21</sup>. They collected data from 168 clients of three major IMFIs functioning in Lahore, Pakistan. They found that the Islamic microfinance played a significant role in starting new businesses and uplifting the existing businesses of the respondents. Furthermore, a study investigated the impact of Islamic microfinance on health, education, income, expenditures and assets of the poor who took financing from IMFIs using pre and post project approach<sup>22</sup>. The results of that study revealed significant improvement in the health, education, income and assets of the respondents.

Another study conducted a research on an Islamic microfinance organization i.e. Akhuwat operating in Pakistan and found that it provides interest free loans (i.e. Qard-Hassan) to individuals living below the poverty line<sup>23</sup>. The Akhuwat does not provide Sharī'ah-compliance products and offer Qard-e-Hasan in which profit margins are not charged by the institution. It has been argued that IMFIs can be turned into profitable entities by incorporating Islamic banking practices<sup>24</sup>. A study has highlighted that the interest based and collateral based financing is not welcomed by the low income people<sup>25</sup>. Practically, Islamic Banks are not incorporating Islamic microfinance principles at the time of dispensing loans to the poor<sup>26</sup>.

A study has highlighted that the Islamic banks have a great potentials for Islamic microfinance which could gratify the risk sharing needs of the micro entrepreneurs<sup>27</sup>. A notable example in this regard can be seen from the case of Islami Bank Bangladesh Limited (IBBL) which launched its Rural Development Scheme (RDS) in 1995. In the meantime, 207 Branches of this Bank are operating in different areas of Bangladesh. These Branches are offering services to the poor in 15,748 villages of 61 districts of

<sup>19</sup> Nimrah, K., T. Michael, and R. Xavier. "Islamic microfinance: An emerging market niche." *Focus Note* 49 (2008), 1-16.

<sup>20</sup> IRTI, "Framework And Strategies For Development Of Islamic Microfinance Services.", Working paper for IFSD forum 2007 Islamic Microfinance Development: Challenges and Initiatives, Meridian President Hotel, Dakar; Senegal, May 27 (2007).

<sup>21</sup> Mahmood Hafiz Zahid et al., "Does Islamic Microfinance Go beyond," pp.268-286

<sup>22</sup> Zahid, Mahmood, Hafiz, Kausar Abbas, and Mehreen Fatima. "Islamic microfinance and household welfare nexus: empirical investigation from Pakistan." *Journal of Global Entrepreneurship Research* 7, no. 1 (2017), 18.

<sup>23</sup> Akhter, Waheed, Nadeem Akhtar, and Syed Khurram Ali Jaffri. "Islamic microfinance and poverty alleviation: A case of Pakistan." *Proceeding 2nd CBRC* (2009), 1-8.

<sup>24</sup> Akhter et al., "Islamic micro-finance and poverty alleviation," 1-8.

<sup>25</sup> Choudhury, Masudul Alam. *Islamic economics and finance: An epistemological inquiry*. (United Kingdom: Emerald Group Publishing, 2011).

<sup>26</sup> Abdul-Rahman, Abdul\_Rahim. "Islamic microfinance: A missing component in Islamic banking." *Kyoto Bulletin of Islamic Area Studies* 1, no. 2 (2007), 38-53.

<sup>27</sup> Abdul-Rahman, Abdul\_Rahim, "Islamic microfinance: A missing component," 38-53.

Bangladesh and 765,011 individuals have become its member. The bank has disbursed loans of Taka 62,063.64 million and witnessing a recovery rate of 99.59%.

Ahmed argues that the social aspect of Islamic banks can be accomplished by financing the poor micro-entrepreneurs<sup>28</sup>. Islamic banks can offer microfinance programs using profit and loss sharing to improve the economic conditions of the poor as the low income people have no collateral to offer to the banks. According to Abdouli, Islamic banking institutions could lose their importance if they keep the tangibility of assets, as a requisite to access to finance<sup>29</sup>. He further refined that granting of credit to an educated and financially poor person can be beneficial for creating social justice in the society.

#### **Methodology:**

This research used a survey research method to solicit the opinions / experiences of micro-entrepreneurs and petty traders. In this research method, we used a questionnaire to gather relevant information from the respondents. The questionnaire was first developed based on the existing studies and was later updated based on the opinions of the top level executives of Micro Islamic banks. The final version of the questionnaire was distributed to 270 micro-entrepreneurs and petty traders operating in three major cities of Pakistan including Rawalpindi, Lahore and Peshawar. These three cities have become hubs of multiple businesses. Further, the respondents operating in these cities are engaged in long standing small and bigger business set-ups. Before handing over the questionnaire to the respondents, their consent, regarding participation in the research, was sought. After explaining the purpose of this study, the respondents were requested to fill the entire questionnaire and provide the correct information. The respondents took, on average, 20 to 30 minutes to fill the questionnaire. For the purpose of data collection, we approached five to ten micro-entrepreneurs and petty traders in a day. Out of 270 distributed questionnaires, we managed to collect data from 210 respondents, thus resulted a response rate of 78%. Out of 210 collected questionnaires, only 150 questionnaires were usable for further analysis, consequently, resulted a response rate of 72%. The profile of the respondents is explained in the following section.

#### **Sample Description:**

Table 1, summarizes the demographic information about the respondents. The sample shows that 81% of the respondents are male. This indicates that a small and medium sized business industry of Pakistan is dominated by male entrepreneurs. The sample also shows that around 66% of the respondents are married, 33% are single and around 1% respondents are either widowed or divorced. 76% of the respondents have age below 40 years. This indicates that a relatively young people are involved in managing their businesses. In other words, entrepreneurs are young individuals. The sample shows that 98.6% of the respondents are Muslim and around 33% of the respondents have education above matriculation. This indicates that majority of the entrepreneurs have education below matriculation. Table 1 shows that 40.4% of the respondents have less the 5 years of experience. The respondents are engaged in several businesses such as poultry, fruits and vegetables, tea shop, tailoring, beauty salons, tuition centres, day care centres, ice cream parlours, fresh juice corner, ladies boutiques, small-auto workshops,

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<sup>28</sup> Habib Ahmed, "Frontiers of Islamic Banking: A synthesis of social role and micro finance," Islamic Research and Training Institute. (Jeddah, Saudi Arabia: Islamic Development Bank, 2003).

<sup>29</sup> Abdouli, Abdelhamid. "Access to finance and collaterals: Islamic versus western banking." *Islamic Economics* 3, no. 1 (1991).

fast food joints, pastries, traditional catering, electrical wiring, masonry, and barbers shops etc (see Table 1).

**Table 1:** Demographic profile of the respondents

	Demographic variables	Categories	Frequency	Percentage
1	Gender	Male Female	122 28	81.3 18.7
2	Marital Status	Single Married Divorced Widow	49 99 1 1	32.7 66.0 0.7 0.7
3	Age	Below 20 20 – 30 31 – 40 41 – 50 More than 50	7 39 68 30 6	4.7 26.0 45.3 20.0 4.0
4	Religion	Islam Others	148 2	98.6 1.4
5	Current qualification	Master Bachelor Matriculation Primary Certificate/Diploma Others	1 48 58 14 14 15	1.0 31.6 38.8 9.2 9.2 10.2
6	Working experience	Less than 1 year 1- 5 years 6 - 10 years 11 - 20 years Above 20 years	6 55 67 13 9	4.0 36.4 44.4 9.1 6.1
7	Nature of business	Poultry shop Fruit and vegetable Tea shop Tailoring Others	7 5 6 9 123	5.0 3.0 4.0 6.0 82.0
8	Usual working hours	less than 8 hours 8 to 10 hours More than 10 hours	23 55 72	15.0 37.0 48.0
9	Working spouse	Yes No	20 130	13.0 87.0
10	Number of dependent (children below 18 year old)	0 1 2 3 4 or more	50 5 27 30 38	33.0 3.4 18.0 20.0 25.6
11	Number of dependent (adults)	1 2 3 or more	7 67 76	4.8 44.4 50.8
12	Monthly income (Rs)	9000 - 20000 20001 - 40000 40001 – 60000 60001 and above	90 38 13 9	60.0 25.0 9.0 6.0

Table 1 show that 37% of the respondents work 8-10 hours in a day and nearly half of the respondents work more than 10 hours in a day. The spouses of 13% of the respondents were also engaged in the same business and rests of them were staying at home. Table 1 shows that 33% of respondents do not have children, 41.4% respondents have 1-3 children, and 25.6% have four or above. Table also shows that 49.2% respondents have 1-2 adult dependents, while 50.8% respondents have three or more adult dependants. 60% of the respondents are earning between Rs.9000 to Rs.20000, 25% are earning between Rs.20000 to Rs.40000, and 15% of them are earning above Rs.40000.

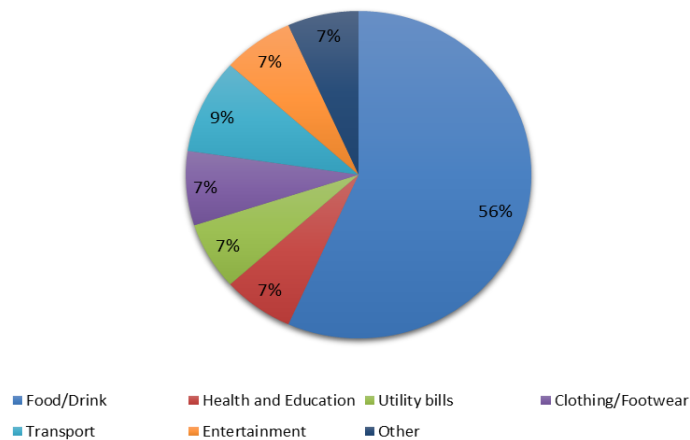
### Results:

Table 2 shows respondents' spending on different items. The result shows that respondents spend major portion of their income on food items (84.67%), health care and education (74.67%), clothing and footwear (64.67%), transport (60%), and utility bills (54.67%). The respondents have little left over to meet others needs such as: better housing, health, education, and entertainment. The results have revealed that respondents spent on average 56% of their income on food related items and they face difficulty in meeting other needs (see Figure 1)..

**Table 2: Respondents' spending on different items**

Categories	Frequency	Percentage
Food/Drink	127	84.67%
Transport	90	60.00%
Clothing/Footwear	97	64.67%
Health care and Education	112	74.67%
Entertainment	36	24.00%
Utility bills	82	54.67%
Others	49	32.67%
Total	150	100.00%

**Figure 1: Distribution of Income with respect to different items**



**Respondents' Experiences with Islamic Banks:**

Table 3 presents experiences of respondents with Islamic Banks. The results show that that 85% of the respondents have applied to Islamic banks for small financing. The respondents who applied to Islamic banks for the microloan were not succeeded and even they did not get any satisfactory response for the rejection of their loan applications. The results show that 15% of the respondents have not applied for the loans due to their perceptions that these banks might not be considering their applications due to absence of guarantee. They also believe that these banks do not give loan to small enterprises or less financially sound individuals. We also asked the respondents about the resubmission of their applications about Islamic financing, 79% of them have showed their disappointment and did not apply for the second time. Underlying reason about this disappointment is that overwhelming majority of the respondents was not satisfied with the present services provided by Islamic banks to the micro-entrepreneurs.

**Table 3:** Distribution of the Respondents based on their experiences with Islamic Bank

Experience with Islamic Bank	Col 1	Frequency Col 2	Percentage Col 3
1-Recently, have you applied to Islamic banks for the microfinance?	Yes	128	85.0
	No	22	15.0
	Total	150	100.0
2-Were the applications for the credit accepted?	Yes	--	--
	No	128	85.0
	Total		
3-Have you applied again after sometimes in case of rejected the prior application?	Yes	27	21.0
	No	101	79.0
	Total	128	100.0

Table 4 shows respondents' perceptions / observations to support Islamic microfinance by Government and Islamic Banks. The results show that 80 percent of the respondents state that Islamic banks are not encouraging low income micro-entrepreneurs in terms of providing financing facility. They also have the opinion that the Government does not support the establishment of Islamic microfinance to lower income people (83%). Most of the respondents believe that banks consider them as less trustworthy and unbankable. Contrary to this finding, many other studies suggest that the poor are considered as creditworthy (Oke et al., 2007)<sup>30</sup>.

<sup>30</sup> Oke, Joel TO, R. Adeyemo, and Mure U. Agbonlahor. "An empirical analysis of microcredit repayment in southwestern Nigeria." *Journal of Human Behavior in the Social Environment* 16, no. 4 (2007), 37-55.



**Table 4:** Distribution of the Respondents based on their observation / perceptions to support Islamic microfinance by Govt & Islamic Banks

Perception	Disagree (%) Col 1	Uncertain (%) Col 2	Agree (%) Col 3	Mean Col 4	Std. Dev Col 5
1-Islamic banks encourage lower income micro-entrepreneurs by offering Islamic microfinance without collateral such as witness/guarantor	80.4	13.3	6.3	2.56	0.918
2-Govt of Pakistan supports the establishment of Islamic microfinance to lower income micro-entrepreneurs	83.1	16.9	-----	1.72	0.641

**Respondents' experiences with conventional banks:**

Table 5 presents respondents' experiences with the conventional banks. The respondents were asked about their financing experiences with the conventional microfinance institutions or banks. Majority of the respondents were not attracted by these services as a few of them applied for it but their applications were rejected. Further they are fully acquainted that the interest rates charged by these institutions are very high.

**Table 5:** Distribution of the Respondents based on their experiences with conventional microfinance

Willingness	Yes Frequency Col 1	No Frequency Col 2
1-Are you interested in microfinance?	20	130
2-Have you applied for conventional financing?	10	140
2.1- In case of Yes, applications have been approved.	1	9
3-Do you know that conventional microfinance institutions/banks charge the interest ( سود ) rates on principle amount?	150	0
4- The average interest rate charged on micro-loans is very high.	145	5

**Conclusion and Discussion:**

The result of our survey revealed that majority of the entrepreneurs' income is not sufficient to meet their basic needs. The underlying reasons are large number of dependents, lack of education and lack of access to better sources of income. Unfortunately, the results of this study suggest that micro entrepreneurs do not have formal access to micro financing either from the Islamic banks or conventional banks. Further high interest rates in conventional banks are also discouraging micro entrepreneurs. The results require that the Islamic banks need to offer short-term Shari'ah-compliance loans for lower-income groups without collaterals to fulfill the essence of microfinance. The fundamental principle of Islamic microfinance is to comply with Islamic values to promote social justice in the society. This objective can be accomplished by paying more attention to the lower / disadvantaged segments of the society. This aspect increases the responsibility of Islamic micro financing institutions / banks regarding provision of finances to micro entrepreneurs. The current structure / nature of products are not sufficient to satisfy the needs of small entrepreneurs thus requires Islamic banks to look into their existing business models and diversify their products that can cater the needs of micro-entrepreneurs, who have business experiences, good attitude towards work and high moral principles. In addition to this, conventional banks also need to offer products and lower the interest rates to facilities the agenda to uplift the lower income groups of the society.

The majority of the respondents also feel that Islamic banks are not found to be encouraging lower income micro-entrepreneurs. Likewise, the majority of micro-entrepreneurs and petty traders also believe that the government of Pakistan does not fully encourage the establishment of Islamic microfinance to serve the interest of people belonging to the low income class. These findings suggest that specific guidelines on Islamic microfinance issued by the State Bank of Pakistan should be strictly monitored to ensure that Shari'ah rules are followed by Islamic banks. With the introduction of comprehensive internal and external controls, it is hoped that subsequently, unequal distribution of wealth will be reduced and poverty be eliminated.

This study is not free from limitations. Firstly the findings of this research rely on a small sample of observations and, thus, the results of this research cannot be generalized to all the entrepreneurs of Pakistan. Therefore the future research needs to collect information from a large sample having representation of major cities of Pakistan. Secondly, the results of this research can only be applied to micro financing institutions and cannot be generalized to other banks.