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# Financing attitude of Islamic vs. conventional banks towards SMES in Pakistan

Mirza Abdul Mateen Baig

# FINANCING ATTITUDE OF ISLAMIC VS. CONVENTIONAL BANKS TOWARDS SMEs IN PAKISTAN

This research report is submitted to the School of Business Studies (SBS) as partial fulfillment of Master of Science in Islamic Banking and Finance degree

by

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# Abstract

This thesis examines the attitude of banks' financing to SMEs in Pakistan. The study further aims to assess if there is any difference between the lending attitude of Islamic and conventional banks. The study conducts a mixed method-based approach. The data is collected from the State Bank of Pakistan and regression analysis is applied to contrast the attitude of Islamic and conventional banks in Pakistan towards SMEs financing. The evidence of the thesis suggests that the Islamic banks are more inclined towards financing SMEs as compared to their conventional counterparts, however, overall, the results are weakly significant at 10% level. The qualitative component of the study is based on interviews of experienced bankers in Pakistan and it aimed to explore the factors that affect financing decisions in banks. The interview discussion shows that there has been a positive change in attitude of banks towards SMEs financing which has been caused primarily by government and Central Bank's policies to support SMEs financing and in turn their development to support economic growth. In addition, it is important to note that during the interview discussions, all the participants agreed that there is not much difference between the lending attitudes of Islamic banks versus conventional banks.

***Keywords:*** Commercial Banks, Decision Making, Islamic Banks**,** Lending Attitude**,** Small and Medium Sized Enterprises

# Chapter 1

# Introduction

SMEs are considered a catalyst in the socio-economic development of any country. They are genuine vehicles for the attainment of economic goals in terms of reducing unemployment at low investment cost and the promotion of entrepreneurial competencies, use of local technology, emanating rural–urban resettlement, domestic resource utilization, and poverty alleviation (Aina & RTP, 2007).

The Small and Medium Enterprises (SMEs) role is important in almost every economy or country, because of their compelling roles for the growth of various sectors of the economies. SMEs have fittingly been mentioned as "the engine of growth" and "catalysts for socio-economic transformation of any country". SMEs represent an indubitable agent for the accomplishment of sovereign economic targets of employment creation and poverty diminution at low investment cost along with evolving entrepreneurial efficiency including technological acquaintance. Other inherent benefits of dynamic SMEs comprise access to the infrastructural services created by the presence of such SMEs in their environs, the provocation of commercial activities such as suppliers of numerous items and distributive trades for things originated and / or needed by the SMEs, deriving from rural urban movement, enriching standard of living of the employees of the SMEs and their dependent relatives as well as of those who are either directly or indirectly affiliated with them (Onuorah, 2010).

## 1.1. How are SMEs defined?

### 1.1.1. International categorization

According to the United Nation's Trade Facilitation and Implementation Guide, definition of Small and Medium-sized Enterprises (SMEs) fluctuate across countries and organizations. The most frequently used categorization is the number of personnel, tracked by turnover and assets.

Globally, the common upper limit for defining an MSME by number of personnel are 250 for medium enterprises, 50 for small enterprises, and 10 for micro enterprises. But different income levels, among other factors, impact some nations, especially low-income countries to employ lower threshold values of 100 and 50 workers (Gonzales et al., 2014).

### 1.1.2. Central Bank of Pakistan categorization

Small firm is an occupational entity which does not employ (including contract employees) more than 50 people and annual sales volume up to Rs.150 million. Medium firm is an occupational entity, which employs (including contract employees) more than 50 people and less than 100 workers in case of trading companies. In case of manufacturing & service establishments, more than 50 and less than 250 people. For all MEs annual sales volume is over Rs.150 million and up to Rs.800 million.

## 1.2. SME’s role globally

According to the World Bank, SMEs play a leading role in most economies, especially in emerging economies. SMEs account for most businesses globally and are key contributors to employment generation and global economic development. In developing countries, most formal jobs are created by SMEs, however, access to finance is a major bottleneck for SMEs prosperity[1].

A survey by Asian Development Bank (Asia SME Finance Monitor - ASM) carried out in 20 countries from 5 ADB regions showed that SMEs accounted for an average of 96% of all enterprises and 62% of the national labor forces across the ASM countries. These countries constitute Central Asia, East Asia, South Asia, Southeast Asia, and the Pacific. Meanwhile, the latest data affirm that SMEs contribute an average of 42% of the Gross Domestic Product (GDP) or manufacturing value added in ASM countries. SMEs have continued to influence trade as per the latest data, the People’s Republic of China (PRC) and India accounted for more than 40% of the total export value, chased by 26% in Thailand, 19% in the Republic of Korea, and 16% in Indonesia. In Australia, approximately 2 million SMEs blend about 70% of all industry employment. In the UK, the SMEs have almost 60% of the private sector labor pool and most of the innovations across all geographies also materialize through the SMEs (Infosys white paper, 2018)[2]. According to Ullah et al. (2016) advanced countries such as the UK and the US, SMEs play a powerful role in their economy, contributing approximately the 1/3rd of employment at the industrial level with the low output percentage.

The findings of Manzoor, Wei and Siraj (2021) shows that SMEs productivity has a positive and substantial effect on the country's economic growth, and SMEs are well-

[1] https://www.worldbank.org/en/topic/smefinance
[2] https://www.infosys.com/industries/financial-services/white-papers/Documents/banks-change-game-SME.pdf

acknowledged globally for their noteworthy position in the economic growth and nurture progress. This resulted in increased SMEs value in developing countries instead of large organizations.

## 1.3. Role of SMEs in Pakistan

Small and medium enterprises (SMEs) tend to play a crucial role to generate employment, create value, and cherish innovation. This, in turn, not only helps to strengthen the profitability of these companies but also raises the standard of living for the people in the country by complementing their capability to enjoy or approach higher quality products and services. Thus, SMEs not only pushes GDP growth but also supports to raise the income of people within the economy by devising more economic openings (Zafar and Mustafa, 2017).

In Pakistan, SMEs constitute around 90% of all the enterprises and provide employment to approximately 80% non-agricultural labor force. The contribution of SMEs has been documented around 40% of GDP, which again imply the importance of SMEs in the growth and development of the country (Hussain, 2018). Despite its contribution to the economy, SMEs in Pakistan are facing problems in access to finance from the formal sources. Currently the SME sector credit is around 8.7% in Pakistan, which is very low and is in turn, compelling many SMEs to fulfill their financial needs by approaching informal sectors. However, the informal networks provide financial support to SMEs at a higher cost in comparison to those obligors who possess the ability to avail financial facilities from formal sources, such as financial institutions (Dar et al., 2017).

According to the study conducted by Zafar and Mustafa (2017), 30 percent of exports from Pakistan depend on the SMEs' overall output. Approximately 3.2 million employees are affiliated with SMEs. This has become a core hub of creating employment opportunities in Pakistan. SME industry in Pakistan has become the paramount aspect of the industrial sector, however, as compared to the neighboring countries such as India and China, this share is smaller in the Country’s GDP as shown in Figure 1.

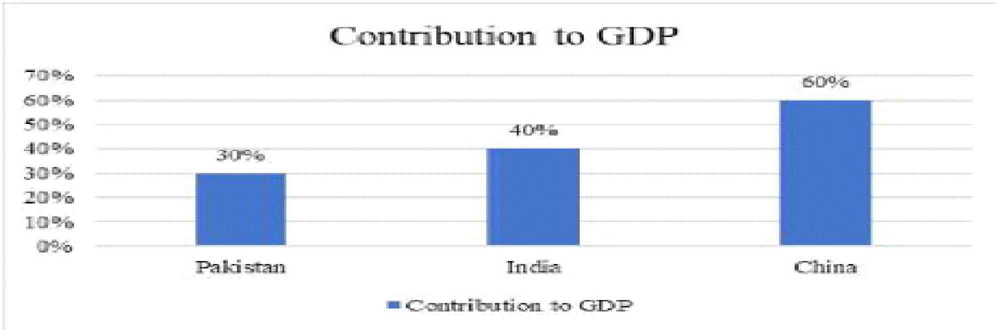


Figure 1

**Figure 1: SMEs Contribution to GDP for Pakistan, India & China[3]**

## 1.4. Role of Government in SMEs Growth

Government of Pakistan has developed various policies for the economic and social development of the country that include the Microfinance Sector Establishment Program, Reforms of Education Sector 2001 to 2005, Paper of Poverty Reduction Strategy, Tax Administration, and Financial Sector Reform. SMEs are also being noted in few such significant documents of socio-economic policies that involve even particular steps for their advertisement (Akhtar and Liu, 2018). On the other hand, Soomro et al. (2019) believe that such measures are not decently prioritized and specified to be capable of implying any meaningful approach or policy for SMEs, though the program for SME sector development looks to upgrade SMEs condition by calling all the stakeholders to design future SME policy of Pakistan**.** Muhmad et al. (2020) opined that lack of understanding about Islamic financing by the SMEs should be encountered by Islamic financial institutions and regulators through training, seminars and education, irrespective of their religious beliefs.

## 1.5. Institutional support and coordination

The role of the governmental institution as a promoter of business development and its close communication with business support bodies is of vital importance for the development of a mutual beneficial relationship especially for SMEs' growth (Zafar and Mustafa, 2017). Seth (2018) mentioned in the article that for the development of the SME sector, policy makers have an important role to play in terms of creating an environment that facilitates commercial lending institutions to tap in the SME market, estimated to be about PKR 1 trillion. The Government of Pakistan through its Finance Supplementary (Second Amendment) Bill, 2019 decided to provide

[3] Zafar and Mustafa (2017)

tax incentive to commercial banks on income accrued on the SME lending portfolio. This particular incentive is being provided to encourage banks to enhance their SME portfolio through creating an enabling environment. Article also suggested that innovative approaches through a broad range of external financing techniques such as asset-based financing, Shariah compliant products, and alternative-debt and equity-financing could offer possible solutions to augment credit off take by the SME.

Further, according to the SMEDA annual report 2019-20[4], The Government of Pakistan has a clear focus on SMEs and has initiated various programs to strengthen and support the sector through improving technical and business management skills, access to technology and provision of modern business infrastructure. As technology-based SMEs are more likely to access formal finance easily, SME development plan should promote technology adoption for SMEs and simultaneously creditors should devise their financing strategies to provide access to innovative SMEs (Arif et al., 2020).

## 1.6. Challenges faced by SMEs

SMEs in Pakistan are facing difficulties mainly because the formal financial sector is more interested in big-ticket clients. The financial sector of Pakistan, especially commercial banks are reluctant to lend to small firms due to the risk element. They do not lean enough on SMEs that created a great obstacle for SMEs to flourish and expand their businesses. Bonanomi et al. (2019) discussed that according to the report of SMEDA, there is a huge difference between the market share of SMEs and largest companies, the report claims that small enterprises have 19%, while the largest companies especially in manufacturing industries have 54% market share of total financial credits.

Financial institutions in Pakistan are reluctant to rely on SMEs, in this connection, Bonanomi et al., observed that SMEs are not safe because of their inherent challenges and troubles in Pakistan, therefore, financial institutions do not take risk to finance SMEs. On the other hand, SMEs in Pakistan face the challenge of developing infrastructure required to expand their businesses. Lack of infrastructure is not a challenge only for SMEs in Pakistan but other poor countries across the globe. In third world countries, it is extremely difficult to start a small business with acceptable infrastructure because the process of obtaining financing and license acquiring is

[4] SMEDA ANNUAL REPORT 2019 - 2020.pdf

very troublesome and time-consuming. The government of Pakistan does not support small firms practically (Sherazi et al., 2013).

Sherazi et al. (2013) pointed that efficient business planning is a key aspect that plays a very strong role for SMEs growth. Unfortunately, SMEs in Pakistan are also facing the challenge of business planning and strategic vision. Lack of business planning and a low-class strategic vision is a big handicap in the way of SMEs prosperity. Besides all these barriers an informal organizational structure is also a great hurdle in the growth of SMEs. Lack of credit and collateral history is also an obstacle in the way of enhancing small enterprises. In the recent past, the central bank of Pakistan has issued licenses to two private sector credit information bureaus, however, the documentation of credit and collateral history of businesses and individuals might take several years. Many authors argued that training and financial literacy is also a factor that can help grow a small business.

Financing demanded by the SMEs at their initial establishment stage, lack of improper business exposure and collateral, higher costs, inadequate business planning, smaller loan size, depressed sales, revenue, insufficient cash-flows with no credit history are some of the loan rejection causes, on the other contrary, SME owners are not satisfied with the loan approval criteria and procedures of banks particularly banks' inadequate information about SMEs, inadequate advice, stringent collateral demand, high processing costs, interest rate, low repayment period, and cumbersome loan processes. However, Islamic financial institutions should put more attention on partnership and long-term products or contracts to finance the long-term projects for SMEs (Thaker et al., 2020).

If we look at the macro level and according to ADBI's working paper series[5], SMEs encounter increased competition, the inability to speedily change according to market dynamics, technological shift, and lacks of capacity to embrace knowledge, innovation, and creativity. Al Balushi et al. (2019) argued that well informed SME's owners with regard to Islamic financing, make well-structured decisions for adapting Islamic finance for their business.

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[5] https://www.adb.org/sites/default/files /publication/182532/adbi-wp564.pdf

## 1.7. Financial institutions and SMEs in Pakistan

Banks in Pakistan lend to small and medium enterprises (SMEs) selectively and, at times, reluctantly. They have a reason to do so, about 95 percent of SMEs work in the informal sector i.e., they are not properly documented and financing them is far riskier than lending to a tax-paying individual (Aazim, 2019). In Pakistan large industries are the main beneficiaries of either a financial credit system or ease of doing business, while the SME sector is totally neglected in both ways. Banks do not bother much with thousands of enterprises and individuals in need for financial credit by risking too much paperwork and potential default when it comes to lending to a risk-free borrower (Government of Pakistan) securing good profits for the bottom line of their financial statements. Massive government borrowing from commercial banks takes the incentive away from Banks lending to the private sector. Also, financial credit is restricted to collateralized lending in Pakistan, creating a challenge to new startups and SMEs who do not own tangible assets to offer as collateral as most SMEs run their factories and offices on rent (Ihsaan, 2020).

On the other hand, the existence of Islamic banking attracts businesses to satisfy their financial needs according to Islamic laws and values (Lajuni et al., 2017). Most people also use Islamic banking products and services because of their strong attachment with religion (Rizal and Amin, 2017). Al Balushi et al. (2018) emphasized compassion as the more value-added service of the Islamic bank than the conventional bank.

## 1.8. Research objectives

This study has two main objectives: First, to explore the lending attitude of Banking Institutions toward SMEs. Second, to compare Conventional and Islamic banking institutions financing towards SMEs in Pakistan by analyzing the quarterly growth portfolio of the two types of financial institutions starting from the quarter ending December 31, 2013 to quarter ending December 31, 2019, i.e., roughly 6-year of quarterly data available at SBP website.

## 1.9. Problem statement

SMEs form an important constituent of a country's economy. They play substantial part in offering private sector job, enhancing gross domestic product (GDP) growth, and domestic capital investments, however non-availability of access to finance has frustrated the development of this vital segment of the economy resulting in opportunity loss in the form of low job growth, slow poverty alleviation and mediocre economic boost. Hence, this thesis examines which type of the banking system in Pakistan geared more towards SMEs in terms of lending.

## 1.10. Research gap & contribution

There is a wealth of literature available globally and in Pakistan on Banks financing to SMEs as well as Islamic financing for SMEs. Given the importance of SMEs in accelerating economic growth within Pakistan, it is indispensable that SMEs should have access to formal sources of raising capital. To the best of the author's knowledge, no study has discussed and compared financing attitudes of Islamic and conventional banking institutions towards SMEs in Pakistan, however, a study of lending attitude of Islamic versus conventional banks is conducted in another emerging market, i.e., Turkey. Hence this research fills this gap and contributes to the extant literature on financing to SMEs by adding new dimensions and as per the author's knowledge, being the first research conducted on banking-type level in Pakistani context. It improves the understanding of policy makers and practitioners whether Islamic or conventional banking institutions are more geared towards SMEs financing needs.

## 1.11. Significance of the research

The analyses and the evidence presented in this thesis will help in drawing the attention of the financial regulators to facilitate SMEs by enacting supportive policies for them as well as give incentives to industries that prefer SMEs financing and develop rules and regulations so that banking institutions can take leading roles in extending financing facilities to SMEs.

## 1.12. Research limitations

SME sector is a major sector that can play a key role in the national economic development; this thesis examines the attitude of the banks towards SME financing and compares Islamic Financial Institutions with conventional ones by using a secondary quarterly data of six-years (2013 through 2019) available at SBP website. Further, SME data for individual financial institutions is not available at SBP website, which could, if available, help to understand lending attitudes at a bank-level.

Date sample is limited to 2019 while quarterly data for the year 2020 is not included as emergence of Covid-19 has changed the financial spectrum for both the SMEs and financial institutions. Moreover, other control variables are also incorporated in the model to clearly see the difference between two banking types. However, a qualitative approach through few informal unstructured (convenience sampling) interviews is also applied to get more insight and to validate the secondary data and further to ascertain what other factors play an important role in defining that attitude.

# Chapter 2

# Literature Review

## 2.1. Formal and informal sources of finance for SMEs

Across the globe, the most common funding sources available to SMEs can be categorized either as informal or formal. Samawi et al. (2016) mentioned that according to Kaplan and Stromberg (2000) informal finance are the funds provided by the owners themselves, their family and friends, and funds provided by business angels who are investing for sound business reasons, not because of family relations or acquaintanceship; such investors are considered to be potential capital providers. Self-financing is the approach most commonly taken by small enterprises to fund a project (Li et al., 2008). Interestingly, Indarti and Langenberg (2004) documented that in Indonesia, businesses which relied on family and third-party funding enjoyed greater success.

Globally there are various sources of formal finance for SMEs, which include commercial banks, cooperatives, microfinance institutions (MFIs), credit unions, government, suppliers. The major source of formal financing for SMEs in Pakistan includes Asian Development Bank (ADB), Microfinance Banks, and Commercial Banks and non-bank financial institutions. Qamruzzaman and Jianguo (2019) suggested that through indulging formal and informal financiers, the government should drive innovations for SME financing especially drawing policy framework for informal financiers and ensuring low cost of financing for SMEs. Ziyaviddinovna (2021) mentioned in his research with reference to Uzbekistan, that majority of the households and firms borrow informally rather than using formal finance. Religious reasons prevent a household from using formal finance as the majority of them are Muslims, despite only conventional finance availability with intricate financing procedures, rigorous collateral requirements are also the reasons for not using formal finance.

Ndemi et al. (2018) showed a significantly positive relationship between formal lending and financial health of SMEs. Further, the lower operational performance and profits are attributed to availability of finances among SMEs.

Wahid et al. (2014) observed that informal lenders are of two types, i.e., rich and poor lenders in Pakistan. Rich lenders extend loans from their own funds, whereas, poor lenders borrowed from formal sources for their business and lent the same amount informally. SMEs major issue of tilting towards informal sources of finance is the lack of collateral, proper financial statements and documentation (Khan, M.M., 2015). SMEs' owners' beliefs and sentiments affect their opinions about issuing private equity and sharing SME's ownership with private investors, which ultimately influence their financial decisions of trying to access finance by using internal funds to run their businesses (Kijkasiwat, 2021).

## 2.2. SMEs inherent issues

Kouser et al. (2012) documented some constraints faced by SMEs while borrowing funds. SMEs want loans within a short time to meet their cash flow requirements. They are more sensitive for loan turnover time compared to big corporations.According to Cook and Nixson (2000) poor management and accounting practices have minimized the ability of smaller businesses to raise finance. However, on a positive note, Liedholm et al. (1994) mentioned that many small companies fail because of non-financial factors.

Fraser (2004) and Beck et al. (2006) observed among other things that size and duration persuade financing relationships of lenders to borrowers. A study by Beck (2007) showed that SMEs in emerging economies are more constrained to raise capital because of the weak financial and legal systems. Fatoki et al. (2011) observed that in South Africa, internal factors such as managerial competency, collateral, networking and information; and external factors, such as macro-economic, the legal environment, ethical perception, crime and corruption constraint new SMEs to avail formal financing.

Nafis (2015) argued that limited access to finance for SMEs is one of the main obstacles to their growth in most Islamic countries. Additionally, the loan pricing by Islamic banks is relatively higher than conventional banks. On average, around 35% of SMEs in Iraq, Pakistan, Yemen, Saudi Arabia, Jordan, Tunisia, Morocco, Lebanon and Egypt, are not borrowing despite huge demand due to the lack of awareness about Islamic finance[6]. Bruns et al. (2008) provided evidence of bank lending officers' credit decision-making concerning SMEs and suggested that banks place the strongest emphasis on the tangible accounting figures which SMEs often are unable to present, that potentially shift the risk from the bank to the borrower.

## 2.3. How financial institutions gauge SMEs for financing

Broadly, literature focuses on SME accessibility to finance in both advanced and emerging countries. Torre et al. (2010) questions the common wisdom that SMEs are underserved because

[6] Opportunity for Islamic Banks to Finance SME Growth in MENA, IFC Says - WSJ

their chronic opacity makes them substantially (if not entirely) dependent on relationship lending, for which niche banks have a natural comparative advantage. Beck et al. (2011) found that different banks apply different lending tools and organizational structures. Foreign banks are more able to use arms-length lending tools and centralized organizational structures, with powerfully built links between lending tools and organizational structures on the one hand and the extent, type, and pricing of credit to SMEs on the other hand.

Anwar and Asaduzzaman (2018) concluded that commercial banks follow conservative approaches while granting credit to SMEs and are uninterested in granting credit to SMEs as their focus and interest is on collateral and securities. ‘Information Asymmetry’ has been identified as the main reason behind banks to follow a conservative approach. This problem raises the cost of financing for SMEs and thus banks demand collateral and could even refuse granting credit to SMEs. The study also focused on the decision making ability of the bankers regarding financing about SMEs. The study concluded that banks emphasize on the characteristics of loan, financial performance and security offered by the borrower.

The study by Bhalla & Kaur (2012) diagnosed conservative approach of commercial banks towards SMEs. Banks were reluctant in providing loans to SMEs. Erdogan (2019) findings show that older firms have a better impression about the ease of access to bank financing than younger firms do and reputational capital gained with age enhances the perception of bank financing accessibility. North, Baldock and Ekanem (2010) showed that the age of firm and longevity are crucial decision-making tools. Shihadeh et al. (2019) conclude that more access to finance for SMEs blended with higher negotiating ability, the better the business performance and more upgraded production technologies used by SMEs.

Raza et al. (2017) suggest that the SME sector is considerably underfunded as more than 89% of SMEs are either deprived or totally ignored by the banking sector of Pakistan mainly due to the reluctance of Islamic banks towards the SMEs.

## 2.4. SME Financing Outlook in Pakistan

Banks play an important intermediary role in economic development of any country by channeling funds from surplus element (savers/depositors) to the deficient (user/borrowers) element of the country. Banks furnish the crucial input materials as the factors of production which support a country's development. From early 2000, SME sector credit in Pakistan was increasing with the banking sector flush with large inflows of liquidity backed by conducive economic conditions for businesses. The banking sector's absorption of government paper at that time was not significant. SMEs somehow benefited from increased bank credit extended to the private sector. However, the financing to SMEs decreased significantly after 2008, following the economic slowdown experienced in Pakistan and globally, caused by the sub-prime mortgages in USA. In addition, the economy in Pakistan suffered from growing security concerns and energy imbalances, which harmed the business performance of SMEs financing portfolio of the Banks in Pakistan mainly, comprising lending towards corporates, SMEs, agriculture, Microfinance and Consumer segments (Rasool et al., 2013).

## 2.5. Hypotheses

Based on the literature review and previous studies, following hypotheses are developed;

**$H_0$**: Conventional and Islamic Banking Institutions depict similar lending behavior towards SMEs in Pakistan.

**$H_A$**: Conventional and Islamic Banking Institutions depict significantly different lending behavior towards SMEs in Pakistan

Islamic financing transactions are asset based in the form of either a sale, lease, and/or partnership with a flavor of risk sharing, while conventional financing is purely a monetary lending, this basis might affect the lending behavior towards SMEs. The asset-based financial products warrant that transactions are linked to real economic activity with corresponding financial assets and thus contributing to real economic growth as a result of growth of financial assets of Islamic banks or financial institutions (W.B.I.D.B. 2015).

**$H_1$**: Capital ratio significantly influences behavior of banking institutions towards SMEs financing in Pakistan.

Capital to asset ratio effects banks' ability to lend specially to SMEs and particularly lowers lending ability of Islamic banks. Ayub et al. (2016) demonstrated a negative impact of capital adequacy ratio on the willingness to finance of Islamic banks in Pakistan.

**$H_2$**: Liquidity ratio significantly influences lending behavior of banking institutions towards SMEs in Pakistan.

Banks maintain liquidity ratio in order to meet claims on short notices, a minimum cash reserve ratio is also imposed by the central banks. Okahara (2020) concluded that liquidity ratio effect banks' lending behavior.

**$H_3$**: Asset Quality Ratio significantly influences lending behavior of banking institutions towards

SMEs in Pakistan

Loans granted to businesses and households are assets for banks. The earnings on these assets are a key component of their revenues and profitability, and the risk of the loans not being paid back is their major risk. The higher this credit risk, the lower the quality of the loan or "asset quality". When the asset quality decreases, banks must hold more capital to cover the related credit risk and book higher provisions to prepare for the expected losses (European Central Bank)[7]. The empirical evidence showed the effect of the deterioration of bank asset quality (higher levels of non-performing loans) on bank lending behavior, that is persistence and not contemporaneous (Alhassan et al., 2013).

**$H_4$**: Profitability ratio significantly influences lending behavior of banking institutions towards SMEs in Pakistan.

Just looking at the earnings per share is not enough for determining a bank's profitability, but it is important to understand how smartly a financial institution is utilizing its liabilities and equity for profit generation. Evaluating return on asset (ROA) and return of equity (ROE) of the bank will provide a much clearer picture of its profitability. According to Bundesbank (2018) weak profitability which implies a reduced ability on the part of banks to generate capital can lead to more restrictive lending policies.

**$H_5$**: Size of banks significantly influence lending behavior of banking institutions towards SME in Pakistan.

Size is measured as the natural logarithm of the total assets at the end of each quarter. Isa et al. (2019) justifies that large financial intermediaries tend to extend more credit facilities to borrowers compared to small financial institutions, since larger banks have a bigger asset base, extensive branch network and larger pool of liquidity to grant loans.

[7] Asset quality (europa.eu)

# Chapter 3

# Research Methodology

## 3.1. Overview

A research methodology is the procedure test hypotheses following a detailed analysis and examination of the situational factors (Ventresca et al., 2017). The topic of the thesis on which the research study is being conducted indicates the financing attitude of conventional and Islamic banks towards SMEs in Pakistan. The methodology describes the research approach, research design, data collection techniques, and sampling procedure used in this research.

## 3.2. Research Design and Data Collection Techniques

Since this study employed a mixed-method approach, both quantitative data and qualitative information was investigated. The quantitative / secondary quarterly data is taken from the State Bank of Pakistan website where financial data is collected for all financial institutions types with reference to their lending to SMEs. The qualitative / primary data is collected through Unstructured interviews that were conducted with the senior bankers and decision makers across the banking sector, sampling size of six interviewee is selected from Conventional as well as from Islamic Banks and purpose was to examine the challenges which affect the SMEs loan growth in Pakistan and confirm the evidence documented through quantitative data.

## 3.3. Research approach

According to Hennink et al. (2020) the available approaches and techniques for performing the research in the context of SMEs are ingrained in the large companies' mind-frame and more likely to emphasize on survey techniques. The authors further describe that these techniques do not give a clear understanding related to the major problems SMEs are facing related with access to financing. Some scholars support the qualitative research approach for SMEs' research. Ventresca et al. (2017) claimed that the qualitative approach is important in which the research objective is to cover a vast understanding and detailed view of the entire process.

This research aims to evaluate the lending attitude of conventional financial institutions in comparison with the Islamic financial institution towards SMEs. Hence, based on the research objective, the candidate chooses to adopt a mixed-method approach by using both the quantitative and qualitative techniques to analyze the outcomes.

To examine the level to which Islamic banking institutions and conventional ones differ in their eagerness to finance SMEs. This thesis followed the methodology of Aysan et al. (2016) to analyze the data. The baseline empirical model comprising dependent variable: quarterly SMEs portfolio growth of different type of banking institutions; and independent variables are: lag quarterly values of ROA, NPLs to Gross Loans, Advances to Deposit ratio, Capital to Total Assets, Total Assets; to verify the impact of bank type (Islamic or conventional) on SME financing is as follows:

$$Y_{i,\,t} = \alpha_0 + \alpha_1\, IBIs_{i,\,t} + \varepsilon_{i,\,t} \tag{1}$$

Where,

$Y_{i,t}$ = Quarterly SMEs portfolio growth of banking types[8].

IBI = ‘1’ for Islamic Banking Institutions; and ‘0’ otherwise.

The estimation model (1) provides the initial difference between the two types of banks’ lending behavior towards SMEs. In the second estimation model, the bank type controls are incorporated that might affect banks’ SME financing behavior:

$$Y_{i,\,t} = \alpha_0 + \alpha_1\, IBIs_{i,\,t} + \alpha_2\, C_{i,t-1} + \varepsilon_{i,\,t} \tag{2}$$

Where,

$Y_{i,t}$ = Quarterly SMEs portfolio growth.

IBIs = It is a dummy variable that equals one for Islamic Banking Institutions and zero for conventional banks.

$C_{i,t-1}$ = Banking type controls: Return on Assets (ROA – a measure of profitability), Non-performing loans to Gross advances (NPLs – a measure of asset quality), Capital to Asset ratio (CARs – a measure of capital adequacy), Liquid assets to total assets (LATA–a measure of liquidity), and natural logarithm of total assets (i.e., size).

Lastly, in the third and final specification, quarterly time dummy variables $T_t$ are included to account for time variation;

$$Y_{i,\,t} = \alpha_0 + \alpha_1\, IBIs_{i,\,t} + \alpha_2\, C_{\,i,\,t-1} + \alpha_3\, T_t + \varepsilon_{i,\,t} \tag{3}$$

[8] Five banking types are considered in this research; three categorized under conventional banking institutions, i.e., 1) Domestic private banks, 2) Public sector banks; and 3) Specialized banks. Whereas Islamic banking institutions include: 1) Full-fledged Islamic banks, and 2) Islamic banking divisions of conventional banks.

Where,

Yi,t = Quarterly SMEs portfolio growth of banking type 'i' at time 't'

IBIs = dummy variable equals to one for Islamic Banking Institutions and zero otherwise.

Ci,t-1 = lag quarterly values of bank type Controls (i.e., ROA, NPLs, CARs, LATA, and Size.

Tt = Quarterly time dummy variables for each year (D1, D2, D3, D4, and D5)

## 3.4. Comparative analysis of FIs financing to SMEs

From Table 1, we can see that in 2013 the share of Corporate financing was 70% of the total financing, whereas the share of SMEs financing was just 7% of total financing for the same year. Corporate financing noted an increase of 111% from 2013 to 2019, whereas SMEs loans booked an increase of 69% for the same period in absolute terms. During the period under review commodity financing and consumer financing increased by 67% and 110% respectively; however, despite Pakistan being an agriculture country, agriculture financing noted just 44% increase.

It is important to note that percentage share of total advances have increased for corporate and consumer by 4% & 1% respectively (i.e. increased from 70% to 74% and 6% to 7% respectively), hence both these sectors accounted for 5% increase, whereby, percentage share of commodity, SME and agriculture finance has fallen by 2%, 1% and 2% respectively (i.e., percentage share of commodity financing in total advances have fallen from 11% in year 2013 to 9% in year 2019, similarly, percentage share of SME and agriculture loans moved down from 7% to 6% and 6% to 4% respectively) and documented a total fall of 5%. Hence, we can say that the overall increase in the corporate and consumer sector during the period of study was at the cost of SME, commodity & agriculture financing.

| Financial growth / decline over the period 2013 – 2019 | | | | | Rs: In Million |
|---|---|---|---|---|---|
| **Sectors** | **Advances Dec. 2013** | **Advances Dec. 2019** | **% age Change From 2013 to 2019** | **% age Share of Total Advances for 2013** | **% age Share of Total Advances for 2019** |
| Corporate Financing | 3,013,732 | 6,356,658 | 111% | 70% | 74% |
| Commodity Financing | 478,874 | 799,126 | 67% | 11% | 9% |
| SME Financing | 283,962 | 480,009 | 69% | 7% | 6% |
| Consumer Sector | 273,162 | 572,563 | 110% | 6% | 7% |
| Agriculture Finance | 239,748 | 344,611 | 44% | 6% | 4% |
| **Total*** | **4,289,478** | **8,552,967** | **99%** | **-** | **74%** |

Source: Financial Soundness Indicators and Quarterly Compendium of the Banking System, SBP.

* Excluding Staff loans.

http://www.sbp.org.pk/ecodata/fsi/qc/2013/Dec.pdf

http://www.sbp.org.pk/ecodata/fsi/qc/2019/Dec.pdf

**Table 1 : Financial growth / decline over the period 2013 – 2019**

Figure 2 shows that in terms of volume all five sectors noted an increase, but however, the case is different if we analyze each sector financing as a percentage of year's total advances portfolio.

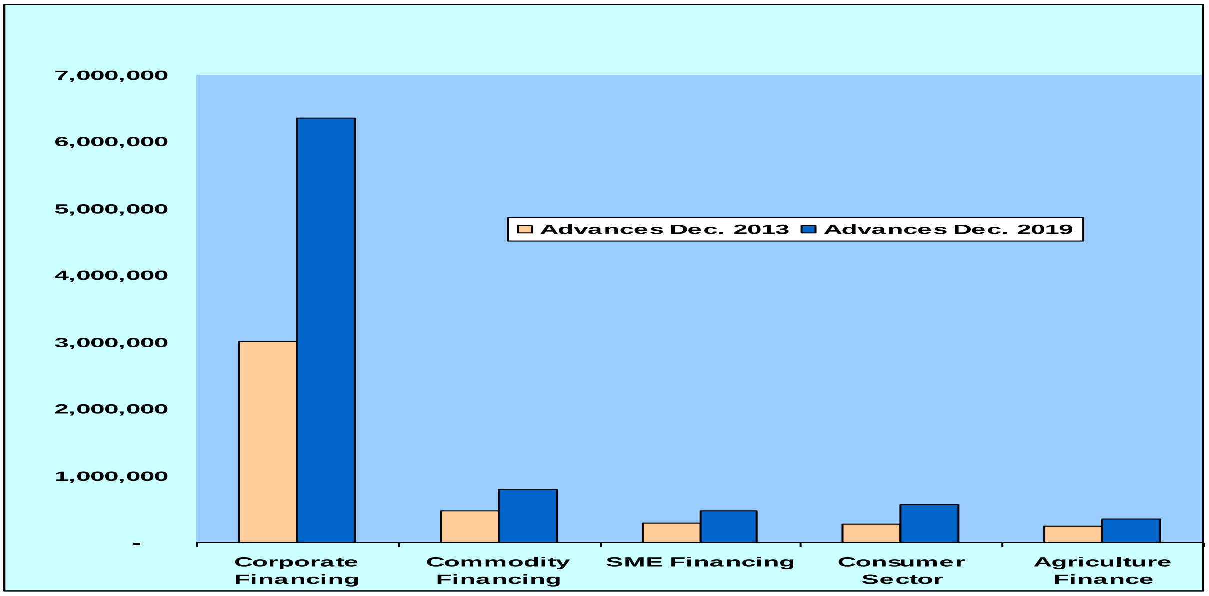


**Figure 2: Financial Institution Category-Share of Advances 2013 to 2019**

Figure 3 pertains to year 2013, we can see that the share of Corporate finance was 70%, followed by Commodity financing 11%, SME financing at 7%; while both Consumer and Agriculture financing stood at 6% of the total financing for the stated year. For the year 2019 in Figure 4, Corporate / Commercial financing and Consumer financing noted an increase and stood at 74% and 7% respectively, while Commodity, SME & Agriculture financing noted a decrease and stood at 9%, 6% & 4% respectively.

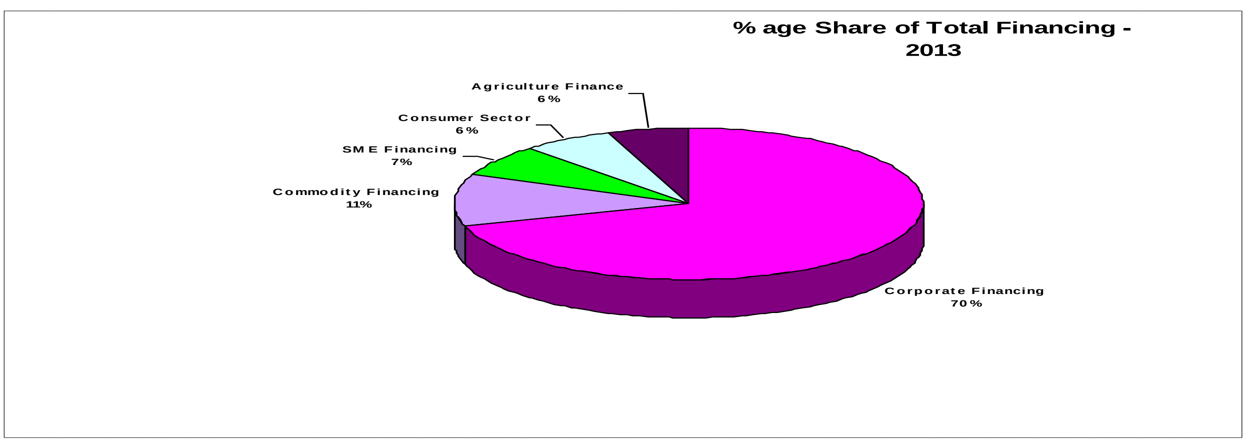


**Figure 3: Financial Institution Category-Percentage share of advances in Year 2013**

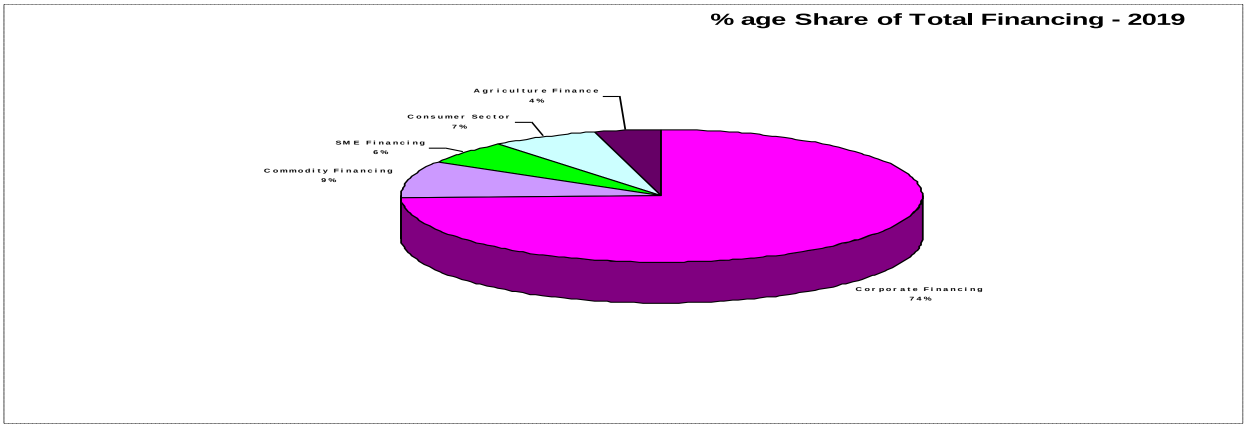


**Figure 4: Percentage share of advances in Year 2019**

## 3.5. SME Financing Profile of Banks

Since this research is focusing to SMEs loans only, we can see from Table 2 that SME financing is in the range of 8%-9% of total private sector financing and depicts an average quarterly growth rate of 19% to 20% for the period 2013 to 2019. However, first three quarters of year 2019 noted a fall while last quarter i.e., Oct-Dec, 2019 noted an increase in SME financing. The fall is mainly related to high borrowing cost as the discount rate is the major driver of borrowing cost, which was in the range of 13% to 14% in the year 2019.

**SME Financing Profile of Banks – Quarterly (Rs. in Billion)**

| Category | Outstanding SME Financing | Quarterly Growth of SME financing | Domestic private sector financing | SME finance as a %age of Pvt. sector Financing | SME NPL Ratio |
|---|---|---|---|---|---|
| Dec-13 | 273 | - | 4182 | 7% | 33% |
| Dec-14 | 288 | 20% | 4599 | 6% | 30% |
| Dec-15 | 305 | 17% | 4976 | 6% | 25% |
| Dec-16 | 401 | 23% | 4350 | 9% | 20% |
| Dec-17 | 443 | 20% | 5067 | 9% | 17% |
| Dec-18 | 513 | 25% | 6071 | 8% | 15% |
| Dec-19 | 477 | 13% | 6281 | 8% | 17% |

**Table 2: SME Financing Profile-Year end Quarter 2013-2019**

Figure 5 also demonstrates the comparison of SME financing share with that of domestic private sector financing. Over the period from 2013 to 2019 the share of SME financing shows a nominal growth.

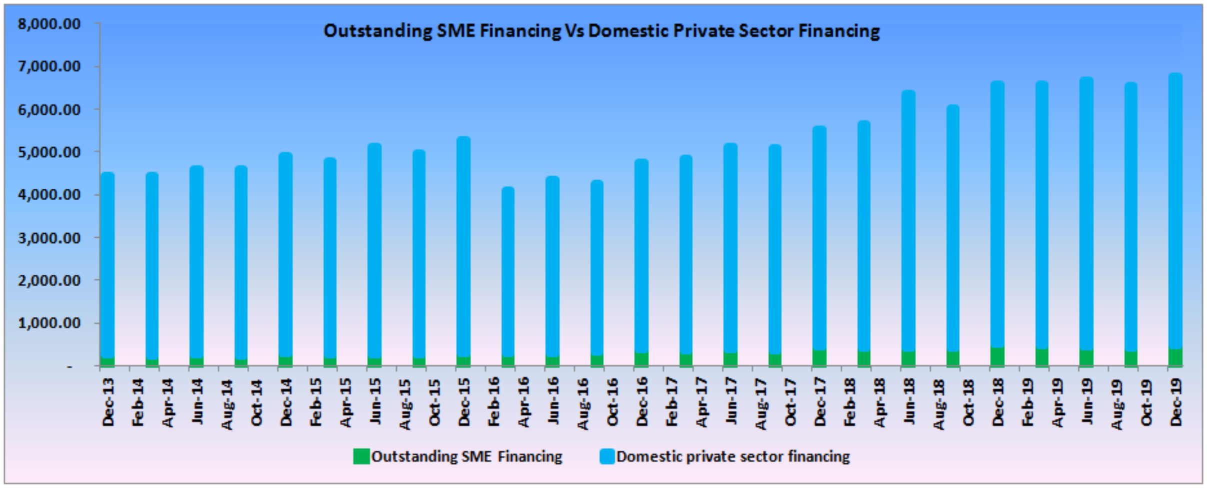


**Figure 5: Outstanding Financing Vs Domestic Private Sector for year 2013 to year 2019**

### 3.5.1. Facility-wise Composition of SME Financing

Composition of SME financing is given in the Figure 6 extracted from the values provided in Table 3, where SMEs were mostly financed by the Banks under working capital category, followed by fixed investment and trade finance. Working capital finance gives ease to SMEs and they can utilize funds when and where they think most beneficial for their business operations.

**Facility-wise Composition of SME Financing (Rs. Billion)**

| Year | Fixed Investment | Working Capital | Trade Finance |
|---|---|---|---|
| Dec-13 | 33 | 214 | 26 |
| Dec-14 | 38 | 213 | 38 |
| Dec-15 | 71 | 206 | 28 |
| Dec-16 | 89 | 263 | 43 |
| Dec-17 | 99 | 304 | 40 |
| Dec-18 | 123 | 341 | 49 |
| Dec-19 | 109 | 326 | 42 |

**Table 3: Facility-wise Composition of SME Financing**

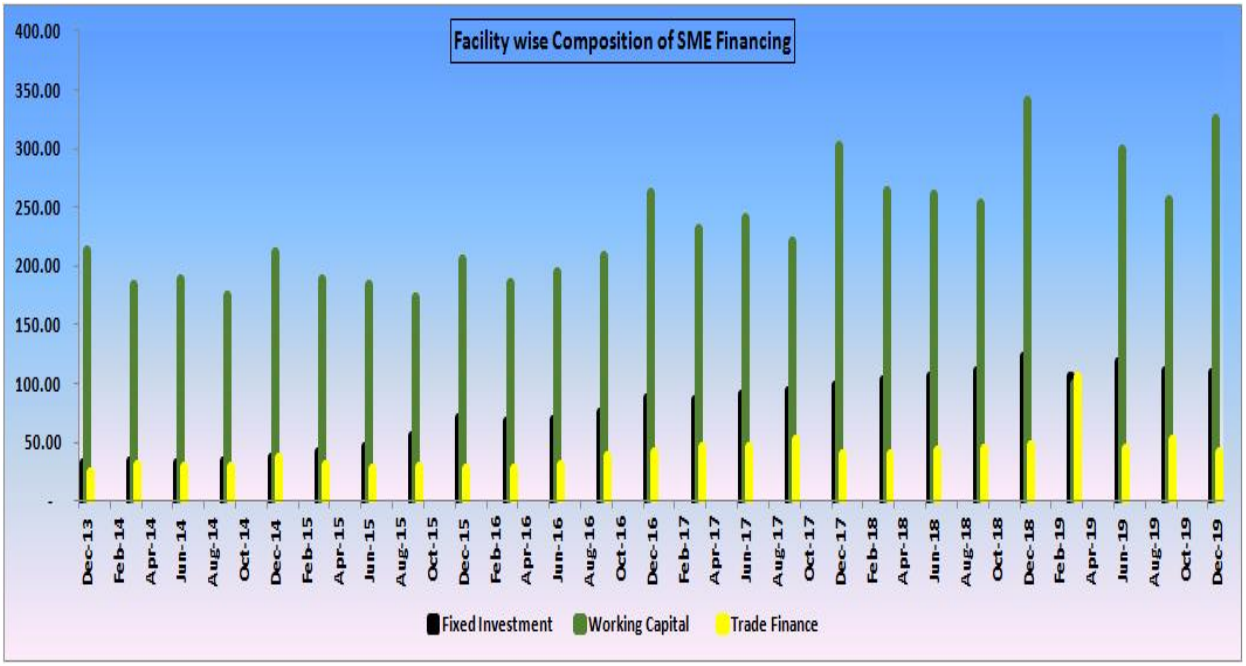


**Figure 6: Facility wise composition of SME financing**

### 3.5.2. Sector-wise Composition of SME Financing

If we look at sector wise composition of SME financing in Table 4, manufacturing SMEs have taken the lead followed by Trading and Service SMEs. Manufacturing SMEs utilize financing for manufacturing of various products not only for domestic sale but also for export purposes, hence they also utilize import and export related facilities of financial institutions and are the major contributor of earning foreign exchange for the country as well as generating employment.

**Sector-wise Composition of SME Financing (Rs. Billion)**

| Year | Trading SMEs | Manufacturing SMEs | Service SMEs |
|---|---|---|---|
| Dec-13 | 117 | 110 | 46 |
| Dec-14 | 116 | 123 | 49 |
| Dec-15 | 113 | 107 | 85 |
| Dec-16 | 132 | 174 | 89 |
| Dec-17 | 156 | 186 | 100 |
| Dec-18 | 161 | 213 | 140 |
| Dec-19 | 159 | 198 | 120 |

**Table 4: Sector-wise Composition of SME Financing**

## 3.6. Banking Cluster Composition

Further, by studying SBP's quarterly data for SMEs as shown in Table 5, one can see that portfolio of Public Sector Commercial Banks stood at Rs: 57 Billion in quarter end of 2013 and reached at Rs: 110 Billion in the quarter ending Dec.2019, booking an increase of 93% from Dec 13 to Dec 19, whereas average growth comes out to be 4% between 2013 and 2019. Domestic commercial banks portfolio stood at Rs: 194 Billion for the quarter ended on Dec. 2013 and reached at Rs: 307 Billion in the quarter ending Dec.2019, booking an increase of 58% from Dec 13 to Dec 19, whereas average growth comes out to be 3% between 2013 and 2019. Similarly, by looking at the portfolio of Islamic Banks (Including Islamic Windows) who were infant in the early 2000 and made presentable financial footing after 2012, their portfolio stood at Rs: 16 Billion for the quarter ended on Dec. 2013 and reached at Rs: 58 Billion in the quarter ending Dec.2019, booking an increase of 262% from Dec 13 to Dec 19, whereas average growth comes out to a 7% between 2013 and 2019.

Further, we can see from Table 5 that over the period of this study i.e., from quarter end Dec 2013 to Dec 2019, average growth of SME financing by Public Sector Commercial Banks was 4%, while average growth of SME financing by Islamic Banks stood at 7%. Despite low volumetric exposure of Islamic Banks as compared to Commercial Banks, their financing to SMEs have increased percentage wise over the stated period, this phenomenon can be seen in the Figure 7, where Islamic banking institutions show constant upward trend while domestic private banks noted less net growth trend followed by falling trend of public sector commercial banks.

| Share of Financial Institution (By Types) in SME Financing (Rs. Billion) | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Banking Cluster** | **PSCBs** | **Quarterly Growth of PSCBs** | **SBs** | **Quarterly Growth of SBs** | **DPBs** | **Quarterly Growth of DPBs** | **IBIs** | **Quarterly Growth of IBIs** |
| Dec-13 | 57 | - | 10 | - | 194 | - | 16 | - |
| Dec-14 | 64 | 42% | 10 | 0% | 201 | 16% | 15 | 7% |
| Dec-15 | 89 | 22% | 9 | 17% | 187 | 25% | 27 | 90% |
| Dec-16 | 98 | 29% | 10 | 4% | 257 | 19% | 29 | 24% |
| Dec-17 | 100 | 26% | 9 | 1% | 291 | 19% | 41 | 23% |
| Dec-18 | 113 | 34% | 9 | 0% | 332 | 22% | 57 | 32% |
| Dec-19 | 101 | 27% | 9 | -2% | 307 | 10% | 58 | 14% |
| **Avg. Growth Rate** | **-** | **4%** | **-** | **0%** | **-** | **3%** | **-** | **7%** |

**Table 5: Banking Cluster – Quarterly Financing**

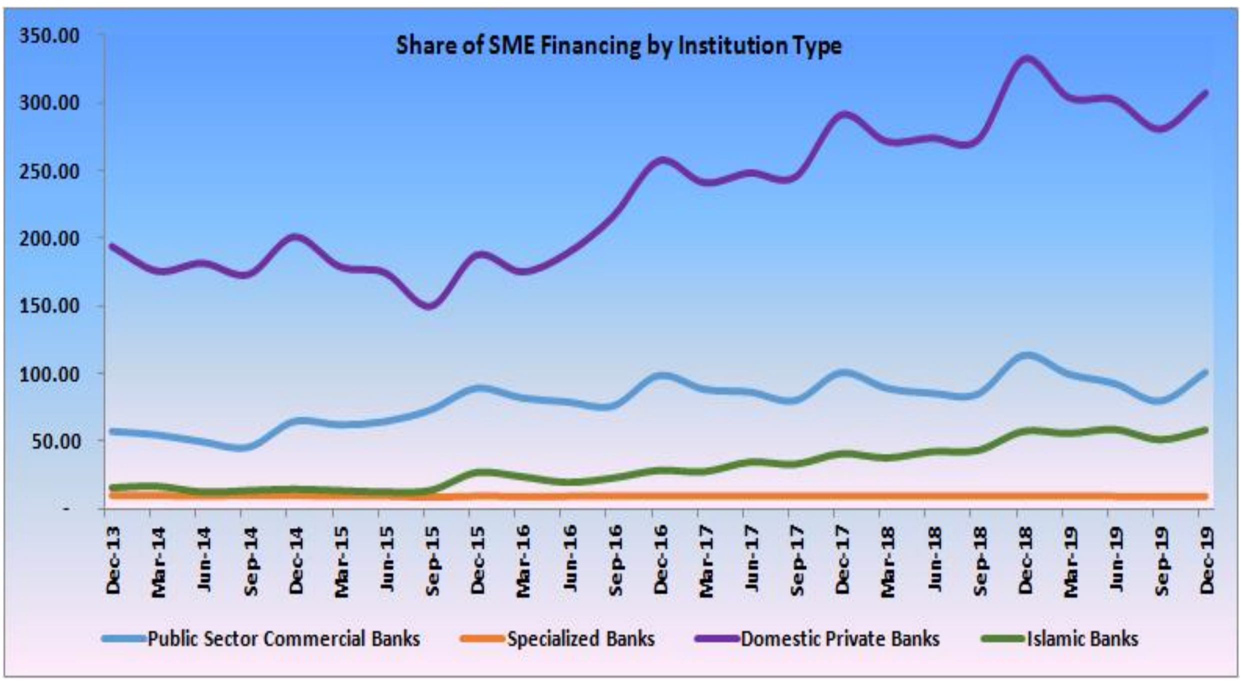


**Figure 7: Share of SME Financing – Institution wise category**

With reference to NPLs, Figure 8 shows SME NPLs stood at 33% in the quarter ending Dec 2013, whereas it was at 17% in the quarter ending Dec 2019. This considerable fall (or improvement) is mostly due to development of better risk mitigating tools, availability of updated data checks, better understanding of bank’s requirement by SME entrepreneurs, increased knowledge of financial institutions about SMEs working dynamics & financial needs and financing exposure undertaken by the Islamic institution financing with the aim of generating real economic activity in the country which required strict follow ups and continuous monitoring about the proper utilization of funds by the SMEs.

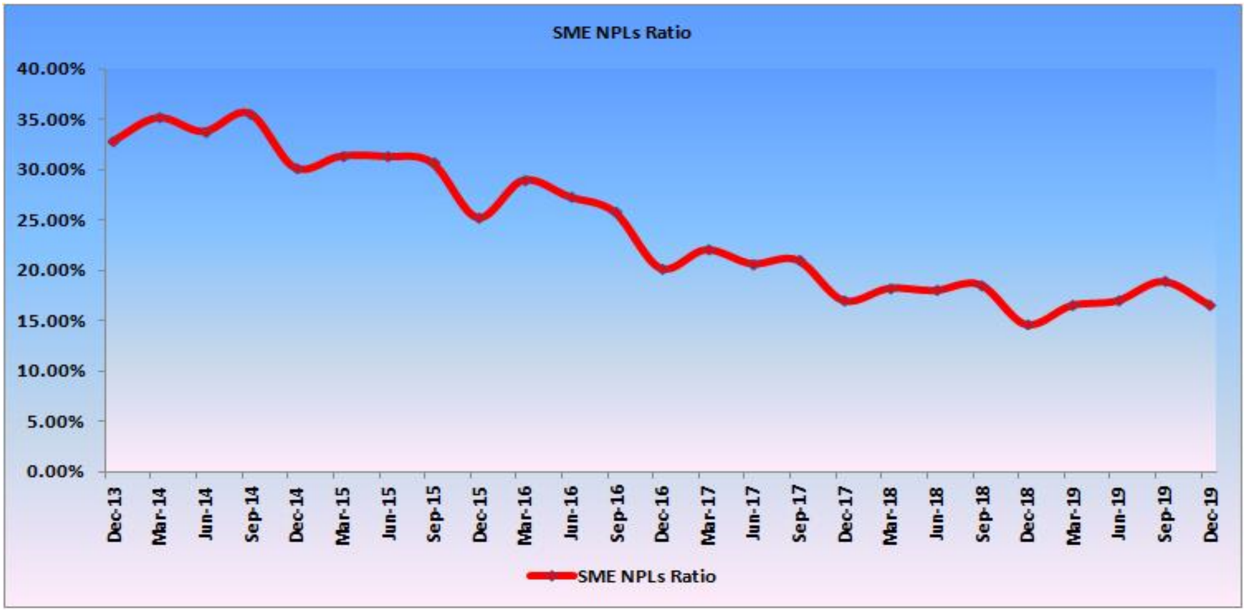


**Figure 8: SME NPL Ratio from 2013 to 2019**

## 3.7. Descriptive Statistics

Summary statistics in Table 6 compare financial performance / indicators of Conventional and Islamic financial institutions under Panel A and Panel B respectively. SMEs portfolio mean quarterly exposure stood at Rs107B for conventional banks, whereas, it is Rs31B for Islamic financial institutions. On the conventional side, Public sector and Domestic banks have taken higher exposure as compared to Specialized banks; on the other hand, Islamic banking institutions showed much lower mean exposure in terms of volume. Maximum quarterly exposure of Rs: 331B is taken by a Domestic bank in Dec 2018, while maximum quarterly exposure of Rs 58.14B is booked in June 2019 by an Islamic bank. Variation in the values which is represented through standard deviation is high for conventional as compared to Islamic financial institutions.

Mean ROA of Islamic banks is marginally higher as compared to Conventional Banks, both types of financial systems show almost the same level of asset utilization for their revenue generation, however, Islamic bank’s ROE is higher as compared to Conventional Banks thereby depicting higher return for their shareholders. NPLs ratio are much higher for conventional as compared to Islamic institutions, the higher mean is mainly attributable to Specialized banks which booked 43% NPLs only in June quarter of 2019.

Mean advance to deposit ratio for Islamic banks stood at 52.27% while for conventional banks stood at 138.45% this is mainly due to specialized banks where highest ratio of 570.50% is noted in the quarter ending March 2015. Capital to total assets ratio is an important measure for the financial institutions' stability and efficiency and is emphasized through Basel implementation globally. Mean Capital to assets ratio is maintained by conventional banks at 14.93 while mean stood at 6.58 for Islamic banks, main reason for lower CAR is the significant growth of risk weighted assets as Islamic banks increased their financing portfolio. Mean Liquidity ratio for conventional banks is higher as compared to Islamic banks and indicate that conventional banks are in a better position to weather economic or political shifts. Banking type size is the natural logarithm of total assets that is obviously higher for conventional financial institutions.

| Variable | Panel A | | | N=75 | Panel B | | | N=25 |
|---|---|---|---|---|---|---|---|---|
| | Conventional Banks | | | | Islamic Banks | | | |
| | Mean | Std. dev. | Min | Max | Mean | Std.dev. | Min | Max |
| Quarterly Growth | 107.32 | 99.27 | 7.98 | 331.99 | 31.04 | 15.76 | 13.00 | 58.14 |
| ROA (Before Tax) | 1.32 | 2.48 | (8.90) | 7.20 | 1.37 | 0.39 | 1.00 | 2.30 |
| ROE (Before Tax) | 13.60 | 13.87 | (36.10) | 32.70 | 20.92 | 6.16 | 14.40 | 35.30 |
| NPL To Loan | 17.09 | 8.57 | 6.10 | 43.20 | 4.12 | 1.18 | 2.30 | 5.80 |
| Adv. to Deposit Ratio | 138.45 | 144.10 | 43.10 | 570.50 | 52.27 | 12.49 | 34.80 | 69.30 |
| Capital to Total Asset | 14.93 | 13.82 | 5.60 | 60.00 | 6.58 | 0.33 | 6.00 | 7.40 |
| Total Assets (Million) | 4,549,846 | 4,829,682 | 170,079 | 14,226,975 | 1,947,080 | 670,518 | 1,014,000 | 3,284,000 |
| LATA | 40.76 | 13.74 | 13.20 | 57.10 | 30.28 | 6.61 | 19.50 | 41.90 |

**Table 6: Descriptive Statistics**

# Chapter 4

# Empirical Analysis

## 4.1. Correlation analysis

Table 7 presents results of correlation analysis showing the nature of correlation and strength of correlation between variables. As per the results the correlation between capital adequacy ratio and asset quality ratio (NPLs) is 0.5676 (56.76%) which depicts that these variables have positive correlation. The correlation between profitability ratio and capital ratio is 0.1233 or 12.33% which is considered to be positive but weak correlation. In contrast to asset quality and profitability, capital ratio shows negative correlation with liquidity ratio and size reflected by -0.0200 and -0.6686 or -2.0% and -66.86% respectively. Overall, none of the variables show correlation of + or – 0.70. Hence, regression analysis can be safely conducted as the problem of multicollinearity does not exist.

| | **Capital Ratio** | **Asset Quality Ratio** | **Liquidity Ratio** | **Profitability Ratio** | **Size** |
|---|---|---|---|---|---|
| Capital Ratio | 1.000 | | | | |
| Asset Quality Ratio | 0.5676 | 1.000 | | | |
| Liquidity Ratio | -0.0200 | -0.0087 | 1.000 | | |
| Profitability Ratio | 0.1233 | -0.3729 | -0.0889 | 1.000 | |
| Size | -0.6686 | -0.6986 | -0.0199 | 0.0681 | 1.000 |

**Table 7: Correlation Analysis**

This Table shows Pearson's correlation analysis among independent variables. Capital ratio is measured as the book value of equity to total assets. Asset Quality ratio is measured as the Non-Performing Loans to Gross Loans. Liquidity ratio is measured as liquid assets (cash and central bank reserves) to total assets. Profitability ratio is measured as net income to total assets (before tax). Size variable is computed as the natural logarithm of total assets.

## 4.2. Regression Analysis

A regression model is used to overcome inherent limitations in correlation results. Table 8 provides regression model results. In these regression models, this thesis compared the two broad banking institutions type, viz. Conventional and Islamic banking institutions. The coefficient of determination in the first model is 0.0179 or 1.79% which explains that the type of banking institution in this model only explains 1.79% of variability in quarterly growth of SME portfolio. However, the Islamic banking institutions coefficient is significantly positive at 5% level. It can be concluded that Islamic banks tend to extend more financing facilities to SMEs as compared to conventional banks. However, these secular result needs to be interpreted with caution, as the first model is run without considering bank type controls and time fixed effects. In the Second regression model, explanatory bank type controls are incorporated, since the extant literature suggests that these variables affect the changes / growth of loans to different sectors of the economy. After, controlling for other explanatory variables, the two types of banking institutions are not different from zero (i.e., the coefficient on dummy indicator of IBIs is positive, but insignificant). Surprisingly, none of the control variables are significantly affecting the growth rate of quarterly SME loans in Pakistan.

Finally, in the third regression model with time fixed effects, we observe evidence similar to the second model. Hence, overall, Table 8 results suggest a weak positive growth in the SME financing portfolio of Islamic banks relative to conventional counterparts; thus null hypothesis cannot be rejected. Likewise, other Hypotheses can be rejected, as none of the bank type specific control variables are significantly affecting the growth rate of SMEs loans.

**Banks' SME financing portfolio – Islamic versus conventional banking Institutions**

**Dependent Variable: Quarterly Growth by Banking Type**

| | **1** | **2** | **3** |
|---|---|---|---|
| IBIs | 0.0412** | 0.0789 | 0.0698 |
| | (0.0087) | (0.0554) | (0.0460) |
| Capital ratio (CAR) | | -0.0003 | -0.0007 |
| | | (0.0003) | (0.0006) |
| Asset Quality ratio (NPL) | | 0.0033 | 0.0029 |
| | | (0.0044) | (0.0034) |
| Liquidity ratio (LATA) | | 0.0012 | 0.0011 |
| | | (0.0024) | (0.0023) |
| Profitability ratio (ROA) | | 0.0042 | 0.0001 |
| | | (0.0052) | (0.0035) |
| Size (ln TA) | | 0.0204 | 0.0178 |
| | | (0.0207) | (0.0191) |
| Time fixed effects | No | No | Yes |
| No. of Observations | 96 | 96 | 96 |
| R-Square | 0.0179 | 0.0420 | 0.0716 |

**Table 8: Regression Analyses 1**

Capital ratio is calculated as the book value of equity to total assets (lagged). Asset Quality ratio is calculated as the Non-Performing Loans to Gross Loans (lagged). Liquidity ratio is calculated as liquid assets (cash and central bank reserves) to total assets (lagged). Profitability ratio is calculated as net income to total assets (lagged). Size variable is computed as the natural logarithm of total assets (lagged). For time fixed effects, quarter-year dummy variables are included in all specifications but their coefficient estimates are not reported. Cluster-robust standard errors (to account for both heteroscedasticity and autocorrelation) are in parentheses.

*** Shows significance level at 1%.

** Shows significance level at 5%.

* Shows significance level at 10%

Next, we run the regression models by further bifurcating the conventional banking institution types. In Table 9, the reference variable is domestic private sector banks. In the first model the coefficient of determination is 0.0250 or 2.50%. In comparison to domestic private banks, both Shari'ah compliant and Public sector banks show significant positive growth in their SMEs portfolio, whereas Specialized banks show a negatively significant growth, that is, the growth rate is relatively lower than domestic private banks. In model 2 and 3 of regression analysis, the Islamic banking institutions show positive but weakly significant results (i.e., at the 10% significance level). Moreover, the size control variable also show weakly significant positive coefficient. Thus, it can be said that banks with large branch network has the potential to increase and outreach the small and medium sized businesses. Lastly, documented findings of this thesis conclude that Islamic banks have slightly more inclination to meet the financing requirements of SMEs by extending to this very important sector for a developing country like Pakistan.

**Banks' SME financing portfolio - Islamic versus Conventional banking Institutions**

**Dependent variable: Quarterly Growth of SME loans by Banking Type**

| | 1 | 2 | 3 |
|---|---|---|---|
| IBIs | 0.0343*** | 0.1546* | 0.6256* |
| | (0.0006) | (0.0687) | (0.2495) |
| PSBs | 0.0043*** | 0.0626 | 0.4891 |
| | (0.0008) | (0.0352) | (0.2227) |
| Specialized | -0.0253*** | 0.1473* | 12.126 |
| | (0.0008) | (0.0617) | (0.5503) |
| Capital Ratio | | -0.0004 | 0.0001 |
| | | (0.0003) | (0.0011) |
| Asset Quality Ratio | | 0.0038 | 0.0016 |
| | | (0.0049) | (0.0026) |
| Liquidity Ratio | | 0.0011 | 0.0008 |
| | | (0.0024) | (0.0019) |
| Profitability Ratio | | 0.0056 | -0.0119 |
| | | (0.0058) | (0.0108) |
| Size | | 0.0590* | 0.3345* |
| | | (0.0267) | (0.1460) |
| Time fixed effects | No | No | Yes |
| No. of Observations | 96 | 96 | 96 |
| R-Square | 0.0250 | 0.0467 | 0.1248 |

**Table 9: Regression Analyses 2**

Table 9 shows regression analysis. Dependent variable: Quarterly growth in SME loans of each type of banking institutions by taking the first difference of the log of SME loans. Independent variables: Islamic Banking Institutions (IBIs) is a dummy variable that equals to 1 when a bank operates according to the Shariah guidelines, and 0 otherwise. Public Sector Banks (PSBs) is equal to 1 when the bank is owned by the government, and 0 otherwise. Specialized Banks is equal to 1 when the bank is operating in one core area; e.g., Agriculture loans. Private Domestic Banks serves as the reference group. Capital ratio is calculated as the book value of equity to total assets (lagged). Asset Quality ratio is calculated as the Non-Performing Loans to Gross Loans (lagged). Liquidity ratio is calculated as liquid assets (cash and central bank reserves) to total assets (lagged). Profitability ratio is calculated as net income to total assets (lagged). Size variable is computed as the natural logarithm of total assets (lagged). For time fixed effects, quarter-year dummy variables are included in all specifications, but their coefficient estimates are not reported. Cluster-robust standard errors (to account for both heteroscedasticity and autocorrelation) are in parentheses.

*** Significance level at 1%.

** Significance level at 5%.

* Significance level at 10%.

## 4.3. Qualitative Results – Interviews

In this section the findings of unstructured interviews have been presented documenting general attitude of Pakistani banks towards financing of SMEs. The research presents two broad themes obtained through literature survey as sub-headings as well as quotations from participants as supplementary evidence. In addition, the researcher compares the findings with this thesis and previous studies to demonstrate their consistency. A list of broad questions that were posed to potential respondents are mentioned in the Appendix at the end of thesis.

Brief profiles of the respondents are as follows;

| Respondent | Designation | Institution Type | Exp. (Y) |
|---|---|---|---|
| $R_1$ | Regional Head Commercial & SME | Islamic Banking Division | 22 |
| $R_2$ | Senior Risk Officer | Islamic Banking Division | 21 |
| $R_3$ | Regional Head-Commercial & SME | Conventional Bank | 17 |
| $R_4$ | Unit Head-SME | Islamic Banking Division | 13 |
| $R_5$ | Unit Head-SME & Commercial Banking | Conventional Bank | 14 |
| $R_6$ | Senior Relationship Manager-SME Banking | Islamic Bank | 10 |
| $R_7$ | Relationship Manager-SME & Middle Markets | Conventional Bank | 7 |
| $R_8$ | Unit Head-SME Department | Islamic Bank | 11 |

### 4.3.1. Attitude of Banks towards SMEs

Many participants agreed that there has been a change in the attitude of banks towards SMEs in recent past. Consider the following statement from $R_1$,

> *"There has been a change in attitude of banks towards SMEs, mainly because of change in policies but there are also other factors such as competition and other factors"*

Similar observations were presented by Kouser et al. (2012) from which it can be inferred that there has been a change in the bank's lending policies towards SMEs to enhance flexibility and facilitate SMEs to gain better access to financial instruments and services. The study also acknowledged that since SMEs are high risk therefore there are more constraints to facilitate loan applications.

Similar opinion was presented by another participant $R_2$, which is reflected in following statement,

> *"The bank's policies towards SME loan application and relevant processes have seen a change in the past decade or so. I think that now banks consider small firms as profitable sector, but as risks are huge so do the markup"*

The statement above relates to Janjua, Hayat and Aslam (2018) who found that one of the main factors that affect the attitude of banks towards lending is the risk factor. Naturally, there is high mark-up for high risk loans and therefore there are also more formal requirements such as collateral. However, the main impact of risk factor is the disinclination of banks to extend loans to SMEs, which requires special attention to fully utilize the potential of SMEs as a driving force to promote growth and development.

### 4.3.2. Factors affecting Lending Decisions

One of the main factors identified by participants $R_3$ is the size of the firm. Consider the following excerpt,

> *"Firm size is the main factor. First we assess whether the assets of the firm are valued according to market value and then we conduct our risk assessment"*

Similar perspectives have been found in Ilyas (2019) who argued that for Banks, the size and age of the borrowing entity are the main determinants of loaning decisions. The size of the firm is typically calculated in terms of the value of its assets. The banks evaluate the size of the firm based on documents provided by the applicants and the loan amount of the granting decision affected by the assessment of firm size. It was also found in the study that number of employees has also been considered as a determinant of firm size. The ease to get loan for a firm increases provided that the value of its assets and number of employees is high.

Another commonly cited factor that affects banks' lending decision is the availability of collateral as shown in following statement of $R_4$,

> *"Collateral is the main obstacle for SMEs to obtain loans in my experience."*

Karamat et al. (2016) also noted this tendency and opined that Pakistani banks were rather obsessed with collateralized lending due to which potentially innovative borrowers were often discouraged. The study reported that 97% of lending in Pakistan to the private sector was based on collateral. It was observed and critiqued that banks preferred to lend large sums to large corporations instead of small firms and entrepreneurs. Large corporations can easily meet the collateral requirements.

One of the factors that have positively affected the attitude of banks towards SME loaning is the rise in competition. Consider the following statement of $R_5$,

> *"Banking sector in Pakistan is resilient but with growth in the banking sector, we are facing competitive pressures. I think this is a factor that will motivate banks to focus on SME lending currently and in future"*

Similar opinion was presented by Alam (2016) who posited that banks have increased their financing towards SMEs because of increase in competition. Competitive factors put pressure to increase their flexibility towards SMEs. The study also opined that if the financial structure of Pakistan improves and SMEs are facilitated by the Central Bank then, banks will relax some of the loan conditions and enhance access to financing for SMEs.

One of the factors that was highlighted by all participants was the credit scoring. Consider the following statement of $R_6$,

> *"Well credit score is the main factor. We use data from applications and from e-CIB (Electronic Credit Information Bureau) and we model the financial health of applicants and if appropriate, we approve the loan. Otherwise, than that it is very difficult"*

According to Nadeem and Rasool (2018) credit scoring is typically based on hard information about the applicant (SME) and its owner. This includes personal data of owner and banking history that can be obtained from consumer credit bureaus (such as e-CIB in Pakistan).

The data obtained from credit bureaus is analyzed to assign a credit rating for the applicant. Overall, the bank can generate a loan performance model to predict the future cash flows of SMEs and assign a final score reflecting overall risk. In the recent past SBP has issued licenses to two private sector credit information bureaus; hopefully, with the passage of time, the presence of private sector bureaus might facilitate financial intermediaries to extend funds to SME clients.

Another important factor that affects the lending decision of banks is the documentation, as indicated by following excerpt of $R_7$:

> *"We have to do a lot of work to process applications, especially if there is lack of documentation required. Small business owners do not even keep accounting record, which makes it difficult to assess risk and increase workload and time of application processing"*

Similar concerns have been reported by Khan et al. (2020) who emphasized that lack of proper documentation increases the cost of lending for banks. As per the State Bank of Pakistan, if SMEs cannot provide adequate documentation, then banks may perform a cash flow analysis of SMEs to undertake loan decisions. This in turn increases cost of lending decisions for banks due to which the banks are reluctant to process the SME loan applications.

Participant $R_7$ also highlighted the use of relationship lending model in following words;

> *"The policies are now changing and we now consider how well we know the client and how well the company is performing. The relationship with the bank is now important besides other formal requirements"*

The statement above can be related to the relationship banking strategy. According to Waheed and Siddiqui (2019) relationship banking is a potential solution to risk assessment and opacity issues of SMEs. The opacity issues faced by SMEs can be overcome through the relationship lending model. A financial institution heavily relies on information that accumulates over time via the relationship between the bank and SMEs (as clients). The bank gradually gathers information about the owner, local community and the industry in which the applicant is operating.

Participant $R_8$ also highlighted important aspects which are necessary for Islamic banks to better catering to SMEs needs;

> *"Islamic banks should focus on technology based lending approach and educate SMEs owner about it. Regulators and other stakeholders must focus on trainings at all levels. It*

*is required now that Islamic banks should come forward and table their offering to SMEs, while regulators should develop an equal opportunity environment for Islamic banks".*

It is important to note that during the interview discussion, all of the participants agreed that there is not much difference between the lending attitudes of Islamic banks versus conventional banks. The researcher also could not find any previous study that highlighted any difference in attitude of the Islamic banks and conventional banks towards SME financing. Hence, there are no factors that indicate differentiation between lending decisions and attitude of Islamic banks and conventional banks in Pakistan. However, due to low risk profile and large volume borrowing capability of large firms, banks mostly take more financing exposure on them.

# Chapter 5

# Conclusion and Recommendations

## 5.1. Conclusion

The purpose of the research is to identify which type of financial is more inclined towards SME financing. The evidence suggests that Shari'ah-compliant Banking Institutions are more inclined to extend financing facilities to SMEs, relative to conventional counterparts. However, the results are weakly significant but consistent with Aysan et al., (2016).

Based on unstructured interviews with senior bankers, factors that affect decision making of banks towards SME financing, this study concludes that the primary factor is risk. SMEs present high risk and therefore banks have traditionally been reluctant to finance SMEs. In addition, collateral is also an important factor. The SMEs that are able to provide collateral have better chances to get their loans approved. Lack of documentation has also been found as an important factor because it affects the cost and loan application processing time for banks.

Further, the responses showed that falling NPL ratio of SMEs, continuous financial regulators' direction and competition are other factors that have prompted positive attitude of banks towards SME financing. Finally, the credit rating has also been found as an important factor. Typical credit rating is achieved by collecting personal data, credibility of the owner of the SME, size and age as well as the relationship and previous banking history of the SME. However despite low volume of SME financing, Islamic financial institutions are more inclined towards SMEs than Conventional financial institutions during the period under review. Hence it can be concluded that there is significant potential for SMEs to grow and the banks as well as the government needs to put in efforts to facilitate SME financing and enhance their inclusion in the financial system. A number of recommendations have been presented in the following section.

## 5.2. Recommendations

Based on the findings of the study and importance of the SMEs in the economic growth of Pakistan, this research recommends that SMEs should be given financing priority. In the era of information technology, simple financing software applications should be developed by banks so that cumbersome documentation and application processing time can be reduced. Collateral requirements can be relaxed in case of promising SMEs. Financial institutions should develop different risk rating mechanism and parameters for evaluating SMEs.

Proper financial literacy trainings by the central bank as well as financial institutions should be conducted for SMEs all across the country, where comprehensive information about the loan obtaining criteria, documentation, as well as up-to-date knowledge about tax system and trade regulations should be provided. Small and Medium Enterprise Development Authority (SMEDA) should frame strategies that encourage infrastructure development of SME business specially that matches current & future global trade competition, draw policies to reduce communication gap between SME's owners and government, bridge a way for an easy access to finance from financial institutions and provide a platform for technical trainings in order to develop skilled labor force for SMEs.

Islamic financial institution should concentrate to pave a more easy system for financing to SMEs through their various business models, such as participation (Musharaka), lease (Ijarah) sale and purchase (Murabaha, Istisan, Salam) which promotes the real economic activity. However, Islamic banks should market themselves to SMEs by branding various factors such as product awareness, Islamic bank corporate image, ideology, obligation, relative advantage and behavioral attitude.

GOP and SBP are fully supporting Islamic financial institutions and providing level playing field for their expansion. Particularly for SMEs, Central bank issued various refinance schemes under Islamic modes. Islamic banks being more inclined towards SMEs need continuous regulatory support particularly in establishing Islamic Discount window and addressing to their excess liquidity placement issues.

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# Appendix

## Informal Questionnaire – Areas of Discussion

| | |
|---|---|
| **Respondent Name** | : ______________________________ |
| **Respondent Title** | : ______________________________ |
| **Respondent Experience** | : ______________________________ |
| **Conventional Banker / Islamic Banker** | : ______________________________ |

1) **Role** of SME in Pakistan?
2) **Problems/Challenges faced by SMEs** in Pakistan?
3) **Problems faced by IFIs /banks** in dealing with SMEs?
4) How do bankers perceive **SMEs with respect to business risk**?
5) Does SMEs have **acceptable collaterals** to offer to Banks?
6) How important is **SME's cash flow** for banks?
7) How well SMEs are **organized**?
8) What **financing products** are more feasible for SMEs?
9) Does the **age and size of SMEs** important for banks' lending decisions?
10) What **additional factors** are considered must be present in SMEs for qualifying for financing from banks?
11) What **role regulators** are playing in supporting both SMEs and IFIs?
12) How do banks perceive **future competition** in SMEs financing business?
13) How **financial inclusion** can be applied to SMEs?
14) What are the main responsibilities of banks to **promote SMEs** and give quick financial access to this sector?
15) Does **credit history and relationship** with banks matter for SMEs?
16) Are **IFIs more inclined to finance SMEs** or conventional banks still taking the lead?
17) What are the **important factors for such inclination**?