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Author (s):	Saqib Sharif[1], Mirza Abdul Mateen Baig[2]
Affiliation (s):	[1]Institute of Business Administration, Karachi, Pakistan [2]Istanbul Sabahattin Zaim University, Turkey
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Financing Attitude of Islamic and Conventional Banking Institutions towards Small and Medium-Sized Enterprises (SMEs) in Pakistan

Saqib Sharif[1*] and Mirza Abdul Mateen Baig[2]

[1]Institute of Business Administration, Karachi, Pakistan
[2]Istanbul Sabahattin Zaim University, Turkey

Abstract

The current study attempted to investigate the banks' financing attitude towards Small and Medium-Sized Enterprises (SMEs) in Pakistan. The study further aimed to determine the difference in financing attitude between Islamic and conventional banks. The quarterly data was collected from the State Bank of Pakistan's (SBP's) website (the Central Bank of Pakistan). Moreover, regression analysis was applied to contrast the attitude of Islamic and conventional banking institutions in Pakistan towards SMEs financing. The evidence suggested that Islamic banking institutions are more inclined towards financing SMEs as compared to their conventional counterparts. However, overall, the results were weakly significant at 10% level. The current study examined the attitude of the type of banks towards SME financing and compared Islamic financial institutions with conventional ones. However, SMEs outstanding financing data by individual financial institutions was not available, which could, if available, help to understand lending attitudes at a bank level. To the best of authors' knowledge, no study has discussed and compared financing attitudes of Islamic and conventional banking institutions towards SMEs in Pakistan so far. Therefore, the current study attempted to fill this gap by contributing to the extant literature on financing to SMEs. Moreover, it also added new dimensions and as per the authors' knowledge, it was the first research conducted on banking-type level in Pakistani context.

Keywords: commercial banks, financing attitude, Islamic banking institutions**,** Small and Medium-Sized Enterprises (SMEs), State Bank of Pakistan (The Central Bank)

Introduction

Small and Medium-Sized Enterprises (SMEs) are considered as a catalyst in the socioeconomic development of any country. They act as genuine

*Corresponding Author: ssharif@iba.edu.pk

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). There are many inherent benefits of dynamic SMEs, such as access to infrastructural services created by the presence of such SMEs in their environs, the provocation of commercial activities and deriving from rural-urban movement. Further, it has also the benefit of 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).

According to Khalique et al. (2016), in advanced countries, such as the UK and the US, SMEs play a powerful role in their economy, contributing to approximately 1/3rd of employment at industrial level with a low output percentage. The findings of Manzoor et al. (2021) showed that SMEs' productivity has a positive and substantial effect on the country's economic growth. Moreover, SMEs are acknowledged globally for their noteworthy position in the economic growth and for nurturing progress. SMEs not only push gross domestic product (GDP) growth but also support in raising the income of people within the economy by devising more economic openings (Zafar & Mustafa, 2017).

In Pakistan, SMEs constitute about 90% of all the enterprises and provide employment to approximately 80% of non-agricultural labor force. The contribution of SMEs has been documented around 40% of GDP, which again implies 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 regarding access to finance from formal sources. 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 commercial banks (Dar et al., 2017).

A disconnection is also observed between the use of financial statements and decision-making that negatively affects the financial health of SMEs in Pakistan (Akhtar & Liu, 2018). Hence, Soomro et al. (2019) believed that policymakers and planners should invite all the stakeholders to remove inefficiencies and design future SME policy of Pakistan**.** On the other hand, Muhmad et al. (2020) opined that lack of understanding about Islamic

financing by SMEs should be countered by Islamic financial institutions and financial regulators through trainings, seminars, and education, irrespective of their religious beliefs.

The role of government institutions to promote business development and its close communication with business support bodies is of vital importance for the development of a mutually beneficial relationship, especially for SMEs' growth (Zafar & Mustafa, 2017). Seth (2018) opined that for the development of SME sector, policymakers have an important role to play in terms of creating an environment that facilitates commercial lending institutions to tap into the SME market, estimated to be about PKR 1 trillion.

According to the Small and Medium Enterprises Development Authority annual report (2019-20), the Government of Pakistan clearly focuses on SMEs. Moreover, it has also initiated various programs to strengthen and support the sector through improving technology and 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 plans should promote technology adoption for SMEs, and simultaneously creditors should devise their financing strategies to provide access to innovative SMEs (Arif et al., 2020). Bonanomi et al. (2019) discussed that according to SMEDA's report, there is a huge difference between 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. However, Sherazi et al. (2013) argued that government of Pakistan does not support small firms practically.

Sherazi et al. (2013) pointed out 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. 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, and insufficient cash-flows with no credit history are some of the loan rejection causes. On the contrary, SME owners are not satisfied with loan approval criteria and procedures of banks, particularly banks' inadequate information about SMEs, inadequate

advices, stringent collateral demands, high processing costs, interest rate, low repayment period, and cumbersome loan processes. However, Islamic financial institutions should leverage on partnership and long-term products or contracts to finance the long-term projects for SMEs (Thaker et al., 2020). Al Balushi et al. (2019) argued that well-informed SME owners about Islamic financing make well-structured decisions to adapt Islamic financing for their businesses.

Banks in Pakistan lend to SMEs selectively and, at times, reluctantly. They have a reason to do so. About 95% of SMEs work in the informal sector, that is, they are not properly documented and financing them is far riskier than lending to a tax-paying individual (Aazim, 2019). 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, since most SMEs run their factories and offices on rent. 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 due to their strong attachment with the religion (Rizal & Amin, 2017). Al Balushi et al. (2018) emphasized compassion as a more value-added service of the Islamic bank than the conventional bank.

Objectives of the Study

The current study addressed two main objectives. Firstly, it explored the lending attitude of banking institutions towards SMEs. Secondly, it compared conventional and Islamic banking institutions' financing attitude towards SMEs in Pakistan by analyzing the quarterly growth portfolio of two types of financial institutions starting from the quarter ending December 31st, 2013, to the quarter ending December 31st, 2021, that is, roughly 8-years of quarterly data available at SBP website.

Problem Statement

SMEs are an important constituent of a country's economy. They play a substantial part by offering jobs in private sector, enhancing GDP growth, and domestic capital investments. However, the non-availability of access to finance has frustrated the development of this segment of the economy, resulting in opportunity loss in the form of low job growth, slow poverty alleviation, and mediocre economic boost. On the other hand, due to lack of individual entrepreneurial orientation of SMEs in Pakistan, such as risk-

taking, innovation, and perseverance; SMEs reduce their ability to recognize availability of finance (Bilal et al., 2022). Hence, the current study examined which type of banking system in Pakistan geared more towards SMEs in terms of lending.

Research Gap and Contribution

A wealth of literature is available globally and in Pakistan on bank financing for SMEs as well as Islamic financing for SMEs. Given the importance of SMEs in accelerating the economic growth within Pakistan, it is indispensable that SMEs should have access to formal sources to raise the capital. To the best of authors' knowledge, no study has discussed and compared the financing attitudes of Islamic and conventional banking institutions towards SMEs in Pakistan. However, a study on lending attitudes of Islamic vs. conventional banks was conducted in another emerging market, that is, Turkey (Aysan et al., 2016). Hence this research fills this gap and contributes to the extant literature on financing to SMEs by adding new dimensions and as per the authors' knowledge, being the first research conducted on banking-type level in Pakistani context. It improves the understanding of policy makers and industry practitioners whether Islamic or conventional banking institutions are more geared towards SMEs financing needs.

Significance of the Study

The analyses and the evidences documented in the current study helped to draw the attention of financial regulators to facilitate SMEs by enacting supportive policies for them. Moreover, it also helped to provide incentives to financial institutions that prefer SMEs financing and development of rules and regulations so that banking institutions may take leading role in extending financing facilities to SMEs.

Research limitations

The SME sector is a major sector that can play a key role in boosting the national economic development. The current study examined the attitude of banks towards SME financing and compared Islamic financial institutions with conventional ones by using secondary quarterly data from eight years, that is, (2013-2021) available at the SBP website. However, SMEs' outstanding financing data by individual financial institutions is not available on SBP website, which could, if available, help to understand the lending attitudes at bank level.

Literature Review

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 in informal financing, 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 potential capital providers. Self-financing is the approach which is mostly adopted 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 and 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 by 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 households and firms borrow informally rather than using formal finance. Certain religious reasons prevent a household from using formal finance since most of them are Muslims. Besides this, conventional finance availability with intricate financing procedures and rigorous collateral requirements are also among the reasons for not using formal finance.

Ndemi et al. (2018) showed a significantly positive relationship between formal lending and financial health of SMEs. Furthermore, the lower operational performance and profits are attributed to the availability of finances among SMEs. Wahid et al. (2014) observed that there are two types of informal lenders in Pakistan, that is, rich and poor. Rich lenders extend loans from their own funds, whereas poor lenders borrow from formal sources for their businesses and lend 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, 2015).

SMEs' owners' beliefs and sentiments affect their opinions about issuing private equity and sharing. SME ownership with private investors ultimately influence their financial decisions of trying to access finance by using internal funds to run their businesses (Kijkasiwat, 2021).

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 on loan turnover time as compared to big corporations. According to Cook & Nixson (2000), poor management and accounting practices have minimized the ability of smaller businesses to raise finance. However, Liedholm et al. (1994) mentioned that many small companies fail due to non-financial factors.

Beck et al. (2006) observed among other things that size and duration persuade financing relationships of lenders to borrowers. Beck (2007) showed that SMEs in emerging economies are more constrained to raise capital due to weak financial and legal infrastructure. 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, legal environment, ethical perception, crime, and corruption constraint new SMEs from availing formal financing.

Alam (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 (Parasie , 2014). Bruns et al. (2008) documented evidence of bank lending officers' credit decision-making concerning SMEs and suggested that banks strongly emphasize tangible accounting figures which SMEs often are unable to present that potentially shift the risk from the bank to the borrower.

Financial Institutions Gauging SMEs for Financing

Broadly the literature focuses on SMEs' accessibility to finance in both advanced and emerging countries. De la Torre et al. (2010) questioned the common wisdom that SMEs are underserved because 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) suggested that different banks apply different lending tools and organizational structures. Foreign banks are more capable 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 to grant credit to SMEs.

The study conducted by Bhalla and Kaur (2012) diagnosed conservative approach of commercial banks towards SMEs. Banks were reluctant in providing loans to SMEs. The findings of Erdogan (2019) showed that the older firms have a better impression about the ease of access to bank financing than younger firms. Moreover, reputational capital gained with age enhances the perception of bank financing accessibility. North et al. (2010) showed that firm's age and longevity are crucial decision-making tools. Shihadeh et al. (2019) concluded that the more access to finance for SMEs blended with higher negotiating ability, the better the business performance and more upgraded production technologies used by SMEs would be. Raza et al. (2017) suggested that the SME sector is considerably underfunded since 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.

SME Financing Outlook in Pakistan

Banks play an important intermediary role in the economic development of any country by channeling the 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 with large inflows of liquidity backed by conducive economic conditions for businesses. SMEs

somehow benefited from increased bank credit extended to the private sector. However, financing to SMEs decreased significantly after 2008, following the economic slowdown experienced in Pakistan and globally, caused by the sub-prime mortgage crisis in the USA. Khan (2022) reiterated that lack of finance and infrastructure along with corruption and management issues affect the entrepreneurial SMEs' performance in Pakistan. Such factors are significantly linked with SMEs' unsustainability. In addition, the economy in Pakistan suffered from growing security concerns, economic barriers, and energy imbalances which harmed the financing portfolio of banks in Pakistan that comprises of lending towards corporates, SMEs, agriculture, micro-entrepreneurs, and consumer segments (Rasool et al., 2013).

Hypotheses

Based on the aforementioned literature, following hypotheses were 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.

Data and Methodology

A research methodology refers to the procedure of testing the hypotheses following a detailed analysis and examination of situational factors (Ventresca & Mohr, 2017). The topic of the study on which the research is being conducted is about the difference in financing attitude between Islamic vs. conventional banks towards SMEs in Pakistan. The methodology describes the research approach, research design, data collection techniques, and sampling procedure.

Research Design and Data Collection Techniques

The quarterly data was obtained from the State Bank of Pakistan's website and financial data was collected for all types of financial institutions with reference to their lending portfolio to SMEs. 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 survey techniques, which do not give a

clear understanding related to the major problems SMEs are facing related with access to financing.

To investigate the level at which Islamic banking institutions and conventional ones differ in their eagerness to finance SMEs; this study followed the methodology of Aysan et al. (2016) to analyze the data. The baseline empirical model comprising dependent variable, i.e., quarterly SMEs portfolio growth of different type of banking institutions; our focus independent variable is a dummy variable by type of bank, and control variables are lag quarterly values of Return on Assets (ROA), Non-performing loans to Gross Loans (NPLs), Liquid Assets to Total Asset ratio, Capital to Total Assets ratio, and Total Assets (i.e., size); to assess which bank type (Islamic or conventional) has an effect on SMEs' financing decisions:

$$Y_{i,t} = \alpha_0 + \alpha_1 IBIs_{i,t} + \varepsilon_{i,t} \quad (1)$$

where, 'i' refers to the bank type in quarter 't' and '$Y_{i,t}$' captures quarterly outstanding SMEs' portfolio growth by banking type[1]; '*IBIs'* is a dummy variable '1' for Islamic banking institutions; and '0' for conventional banks.

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 control variables are incorporated that might potentially influence the banks' SMEs financing behavior:

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

Here, '$Y_{i,t}$' is quarterly outstanding SMEs' portfolio growth and '$IBIs_{i,t}$' is a dummy variable that equals one for Islamic banking institutions and zero for conventional banks. '$C_{i,t-1}$' represents a matrix of banking type controls: that is, 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 (that is, size of bank type).

[1]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 windows / divisions of conventional banks.

Lastly, in the third and final specification, quarterly time dummy variables 'T_t' are included to account for time variation (since the sample period also includes two years of global COVID-19 pandemic);

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

where, '$Y_{i,t}$' is outstanding SMEs' portfolio growth of banking type 'i' at time/quarter 't'; '*IBIs*' is a dummy variable equals to one for Islamic banking institutions and zero otherwise, '$C_{i,t-1}$' is a matrix of lag quarterly values of bank type controls (that is, ROA, NPLs, CARs, LATA, and Size), and 'T_t' is quarterly time dummy variables for each year (D1, D2, D3, D4, D5, D6, and D7; i.e., *n-1*).

Discussion of Control variables

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 (The World Bank Group, 2015).

Capital to asset ratio effects banks' lending ability, especially to SMEs and particularly lowers the lending ability of Islamic banking institutions. Ayub et al. (2016) demonstrated a negative impact of capital adequacy ratio on the willingness to get finance from Islamic banks in Pakistan. Banks maintain liquidity ratio to meet claims on short notices, a minimum cash reserve ratio is also imposed by the central banks. Okahara (2020) concluded that liquidity ratio effects the banks' lending behavior. Loans granted to businesses and households are assets for banks. The earnings on these assets are key components of their revenues and profitability, and the probability 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" would be. 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, n.d.). The empirical evidence showed the effect of 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).

Earnings per share is not enough to determine a bank's profitability, however, 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 would provide a much clearer picture of its profitability. According to Bundesbank (2018), weak profitability, which implies that a reduced ability on the part of banks to generate capital, can lead to more restricted lending policies. Size is measured as the natural logarithm of the total assets at the end of each quarter. Isa et al. (2019) justified that large financial intermediaries tend to extend more credit facilities to borrowers as compared to small financial institutions, since larger banks have a bigger asset base, extensive branch network, and larger pool of liquidity to grant loans.

Comparative Analysis of Financial Institutions' Financing to SMEs

Table 1 shows 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 observed an increase of 111% from 2013-2021, whereas SMEs loans booked an increase of 85% 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 agricultural country, agriculture financing was observed to be just 44% increased.

It is important to note that the percentage share of total advances have increased for corporate and consumer by 4% and 1%, respectively (that is, increased from 70% to 74% and 6% to 7%, respectively). Hence, both these sectors accounted for 5% increase, whereas, percentage share of commodity, SME, and agriculture finance has fallen by 2%, 1%, and 2%, respectively (that is, percentage share of commodity financing in total advances have fallen from 11% in the year 2013 to 9% in year 2021, similarly, percentage share of SME and agriculture loans moved down from 7% to 6.51% and 6% to 4%, respectively) and documented a total fall of 5%. Hence, it can be said that the overall increase in the corporate and consumer sector during the period of study was at the cost of SMEs, commodity and agriculture financing.

Table 1

Financing Growth over the Period (2013–2021)

Financing Growth Over the Period 2013–2021					(Rs in Million)
Sectors	Advances Dec. 2013	Advances Dec. 2021	% age Change From 2013 to 2021	% age Share of Total Advances for 2013	% age Share of Total Advances for 2021
Corporate Financing	3,013,732	6,356,658	111%	70%	74%
Commodity Financing	478,874	799,126	67%	11%	9%
SME Financing	283,962	524,090	85%	7%	7%
Consumer	273,162	572,563	110%	6%	7%
Sector Agriculture Finance	239,748	344,611	44%	6%	4%
Total*	4,289,478	8,552,967	99%		

Note. 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/2021/Dec.pdf

SME Financing Profile of Banks

Since, the current research was focused on SMEs loans only, it can be seen from Table 2 that SMEs' financing is in the range of 6% to 9% of total private sector financing and depicts an average annual growth rate of 17.25% for the period 2013-2021.

Table 2

SME Financing Portfolio-Year End Quarter 2013-2021

Category	Outstanding SMEs Financing	Quarterly Growth of SMEs financing	Domestic private sector financing	SMEs finance as a %age of Pvt. Sector Financing	SMEs 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%

Category	Outstanding SMEs Financing	Quarterly Growth of SMEs financing	Domestic private sector financing	SMEs finance as a %age of Pvt. Sector Financing	SMEs NPL Ratio
Dec-18	513	25%	6071	8%	15%
Dec-19	477	13%	6281	8%	17%
Dec-20	482	9%	6625	7.27%	15.62%
Dec-21	524	11%	8051	6.51%	15.85%

The last column of Table 2 shows SMEs non-performing loans (NPLs) that stood at 33% in the quarter ending Dec. 2013, whereas it was at 16% in the quarter ending Dec. 2021. This considerable fall (or improvement) is mostly due to the 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 and financial needs. It is also due the financing exposure undertaken by the Islamic banking institutions 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.

Banking Type/Cluster Composition

SBP's yearend quarterly data of SMEs outstanding portfolio is shown in Table 3. The portfolio of Public Sector Commercial Banks (PSCBs) stood at Rs. 57 billion in quarter end of 2013 and reached at Rs. 128 billion in the quarter ending Dec. 2021, booking an average growth of 4% between 2013 and 2021. Domestic private banks' (DPBs') portfolio stood at Rs. 194 billion for the quarter ended in Dec. 2013 and reached at Rs: 345 billion in the quarter ending Dec. 2021, booking an average growth of 3% between 2013 and 2021. Similarly, by looking at the portfolio of Islamic banks (including Islamic banking divisions of conventional banks) which were at the embryonic stage in the early 2000 and made presentable financial footing after 2012, their portfolio stood at Rs. 16 billion for the quarter ended in Dec. 2013 and reached Rs: 61 billion in the quarter ending Dec. 2021, booking an average growth of 7% between 2013 and 2021. Moreover, despite low volumetric exposure of Islamic banking institutions as compared to conventional banking, overall, their financing to SMEs show impressive upward trend. While, domestic private banks noted lower growth trend followed by the falling trend of public sector commercial

banks. Lastly, Specialized Banks (SBs) remain stagnant through 2013 and 2021.

Table 3

Banking Type/Cluster – Year End Quarterly Financing

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%
Dec-20	105	05%	9	0%	325	8%	57	0%
Dec-21	128	26%	9	0%	345	9%	61	3%
Avg. Growth Rate	-	4%	-	0%	-	3%	-	7%

Empirical Analysis/Results and Discussion

Descriptive Statistics

Summary statistics in Table 4 compares the financial performance/indicators of conventional and Islamic financial institutions under Panel A and Panel B, respectively. SMEs' portfolio mean quarterly exposure stood at Rs. 107 billion for conventional banks, whereas it was Rs. 31 billion for Islamic financial institutions. On the conventional side, public sector and domestic private banks have taken higher exposure as compared to specialized banks. On the other hand, Islamic banking institutions have lower mean exposure in terms of volume. Maximum quarterly exposure of Rs: 331 billion was taken by a domestic private bank in Dec 2018, while maximum quarterly exposure of Rs. 58.14 billion was booked in June 2019 by Islamic banks. 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 is 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 the highest ratio of 570.50% is noted in the quarter ending March 2015. Capital to 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. The 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 indicates that conventional banks are in a better position to economic or political shifts. Banking type size is the natural logarithm of total assets that is obviously higher for conventional financial institutions with bigger market share.

Correlation Analysis

Table 5 presents the results of correlation analysis, showing the direction and strength of correlation between variables. As per the results, the correlation between capital adequacy ratio (CARs) and asset quality ratio (NPLs) is 0.5676 which depicts that these variables have a positive correlation. The correlation between profitability ratio (ROA) and capital ratio is 0.1233 which is positive, however, weak. In contrast to asset quality and profitability, capital ratio shows a negative correlation with liquidity ratio and size reflected by -0.0200 and -0.6686, respectively. Overall, none of the variables show correlation of more than + or – 0.70. Hence, regression analysis can be safely conducted as the problem of multi-collinearity does not exist.

Table 4
Descriptive Statistics

Variable	Panel A (*N*=96)				Panel B (*N*=32)			
	Conventional Banks				Islamic Banks			
	Mean	Std. dev.	Min	Max	Mean	Std. dev.	Min	Max
SMEs Loan	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 5
Correlation Analysis

	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 5 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.

Regression Analysis

A regression model is applied to overcome the inherent limitations in correlation results. Table 6 provides the results of regression model. In these regression models, this study compared the two broad banking institution types, 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, this 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 in financing facility/growth of loans to different sectors of the economy. After controlling the other explanatory variables, the two types of banking institutions are not different from zero (that is, 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, evidence similar to the second model, was observed. Hence, overall, Table 6 suggests a weak higher growth in SMEs' financing portfolio of Islamic banks relative to conventional counterparts. Overall, the hypothesis of significant difference was not rejected in two types of banking institutions' lending behavior towards SMEs. However, low level of formal financing in Pakistan is attributable to lack of entrepreneurial orientation and documentation by SMEs and banks' focus on big ticket clients (Bilal et al., 2022).

Table 6

Regression Analyses I

	1	2	3
IBIs	0.0412**(0.0087)	0.0789(0.0554)	0.0698(0.0460)
Capital ratio (CAR)		-0.0003(0.0003)	-0.0007(0.0006)
Asset Quality ratio (NPL)		0.0033(0.0044)	0.0029(0.0034)
Liquidity ratio (LATA)		0.0012(0.0024)	0.0011(0.0023)
Profitability ratio (ROA)		0.0042(0.0052)	0.0001(0.0035)
Size (ln TA)		0.0204(0.0207)	0.0178(0.0191)
Time fixed effects	No	No	Yes
No. of Observations	128	128	128
R^2	0.0179	0.0420	0.0716

Note. Banks' SMEs Financing Portfolio – Islamic vs. Conventional Banking Institutions. Dependent Variable: Quarterly Growth by Banking Type * Shows significance level at 10%; ** Shows significance level at 5%.; and *** Shows significance level at 1%.

The above table shows regression analysis. Dependent variable: Quarterly growth in SME loans by type of banking institution 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 Shariah guidelines, and 0 for conventional banking. 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, however, their

coefficient estimates are not reported. Cluster-robust standard errors (to account for both heteroscedasticity and autocorrelation) are in parentheses.

Afterwards, the regression models are run by further bifurcating the conventional banking institution types. In Table 7, the reference variable is domestic private sector banks. In the first model, the coefficient of determination is 0.0250 or 2.50%. As compared 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, Islamic banking institutions show positive, however, weakly significant results (that is, at 10% significance level). Moreover, the control variable of size also shows weakly significant positive coefficient. Thus, it can be said that banks with huge branch networks have the potential to increase the outreach to SMEs. Lastly, the study concluded that Islamic banks have slightly more inclination to meet the financing requirements of SMEs by extending credit to this very important sector in a developing country, such as Pakistan. Lastly, the study also suggested that lack of finance to SMEs has to do with management issues and corruption in Pakistan (Khan, 2022). Hence, the country has consistently low exposure towards SMEs sector as compared to peer South Asian economies, such as Bangladesh, India, and Sri Lanka.

Table 7

Regression Analyses II

	1	2	3
IBIs	0.0343***(0.0006)	0.1546*(0.0687)	0.6256*(0.2495)
PSBs	0.0043***(0.0008)	0.0626(0.0352)	0.4891(0.2227)
Specialized	-0.0253***(0.0008)	0.1473*(0.0617)	12.126(0.5503)
Capital Ratio		-0.0004(0.0003)	0.0001(0.0011)
Asset Quality Ratio		0.0038(0.0049)	0.0016(0.0026)
Liquidity Ratio		0.0011(0.0024)	0.0008(0.0019)
Profitability Ratio		0.0056(0.0058)	-0.0119(0.0108)
Size		0.0590*(0.0267)	0.3345*(0.1460)
Time fixed effects	No	No	Yes
No. of Observations	128	128	128
R^2	0.0250	0.0467	0.1248

Note. Banks' SME Financing Portfolio - Islamic vs. Conventional Banking Institutions. Dependent Variable: Quarterly Growth of SME Loans by Banking Type. * Significance level at 10%; ** Significance level at 5%; and *** Significance level at 1%.

The above table 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 is a dummy variable that equals to 1 when a bank operates according to the Shariah guidelines and 0 otherwise. Public sector banks 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, for instance, agricultural loans. Private domestic banks serve 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, however, their coefficient estimates are not reported. Cluster-robust standard errors (to account for both heteroscedasticity and autocorrelation) are in parentheses.

Conclusion and Recommendations

The current study explored the financing attitude of Islamic vs. conventional banks and which type of financial intermediary is more inclined towards SMEs 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, however, consistent with Aysan et al. (2016). It is important to note that Islamic financial institutions, despite being new players in the financial horizon of Pakistan as compared to conventional banking institutions, have taken SMEs sector as a serious part of their financing portfolio.

Recommendations and Future Research Agenda

Based on the findings and importance of SMEs in the economic growth of Pakistan, the current study suggested that SMEs should be given equal opportunity to avail financing facilities from formal banking channels.

Financial literacy trainings and workshops should be conducted for owners of SMEs across the country by the central bank and financial institutions, whereby comprehensive information about the loan obtaining

criteria, documentation, as well as up-to-date knowledge about tax system and trade regulations should be provided.

Banking institutions in general, and Islamic financial institutions should concentrate on processes to pave an easier system of financing to SMEs through their various business models, such as participation (Musharaka), lease (Ijarah), and sale and purchase (Murabaha, Istisan, Salam) which promotes the real economic activity. Lastly, the study also utilized quarter-end SMEs' outstanding financing data by banking type, available on SBP website. However, it would be interesting in future to analyze month-end /monthly data for a longer sample period in order to get more insightful evidences. Monthly data is submitted by banks to SBP but is not publicly available. Moreover, the study also utilized bank type (that is, cluster of banks) data to explore the association of lending behavior by banking institutions to SMEs. Therefore, access to proprietary individual bank-wise data from State Bank, facilitates better understanding of lending attitudes at a bank level.

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