



INFLUENCE OF ISLAMIC BANKING CONVERSION ON SME'S FINANCING DECISION IN PAKISTAN

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Abstract

The increasing rate of development of Islamic banking within Pakistan creates both opportunities and challenges to the small and medium enterprises (SMEs) in the country in its search of Shariah-compliant financing. Although it has potential, empirical data on the relationship among Islamic banking conversion, small- and medium-enterprise (SME) financing choices is sparse, especially on the interaction between financial and cognitive and normative variables. This paper explores how Cost of Financing, Access to Credit, Perceived Fairness, and Financial Awareness affect SMEs to choose Islamic financing over conventional financing, and the mediating variable of Perceived Risk and the moderation impact of Religious Orientation of Business owner. One thousand three hundred and fifty-five SME owners in key commercial divisions in Punjab, Pakistan, were used as primary data. The hypothesized relationships, i.e. the direct, indirect, and moderated effects are tested using Structural Equation Modelling (SEM). The results can be used by policymakers and financial institutions to develop fair, transparent, and Shariah-compliant financing schemes and improve financial awareness and risk reporting.

Keywords: Islamic Banking; Shariah-Compliant Financing; SMEs; SEM; Financial Awareness; Financing Decisions.

1. INTRODUCTION

The global Islamic financial services market (IFSI) has witnessed a consistent growth throughout the last ten years, driven by the consumer-side tastes and preferences towards Shariah-based products and the supply-side innovation in the Islamic contracts, governance, and capital market instruments (Abdulhamid, 2025). The total assets of the IFSI, comprising the banking, takiful, and Islamic capital market operations, increased significantly in early 2020s; the industry estimates the assets to be in the low trillions of U.S. dollars by 2023 and recent reports show continued strong growth levels into 2024 (Daoud, 2025). This growth has been coupled with product diversification (ex: sukuk, lease-based financing, profit and loss sharing instruments) and a wider geographical spread, not restricted to the Middle East, but extending to the Association of Southeast Asian Nations (ASEAN), South Asia and some of Africa and Europe.

These developments drive academic and policy discussions on the effects of the modalities of Islamic finance on the financing behaviour of firms, especially small and medium enterprises (SMEs), which rely heavily on external financing, especially on working capital, to fund investment. In theory, Islamic banking is differentiated by conventional banking in the following ways: it does not permit Riba (interest), it insists on risk-sharing contracts (e.g., Mudarabah, Musharakah), and it demands financing transactions to be tied to actual economic activity (Abasimel, 2023).

The State Bank of Pakistan (SBP) has established conversion criteria, regulatory frameworks for Islamic banking branches and full-fledged Islamic banks, and strategic objectives to strengthen the presence of Islamic financial intermediation in the national system. Islamic banking penetration has significantly increased, according to the SBP's conversion criteria and Islamic banking bulletins: Due to both natural development and purposeful governmental



facilitation, Islamic banking assets now account for about one-fifth of the nation's banking assets and a comparable share of deposits. With a significant portion of employment, exports, and domestic value-added, SMEs are essential to Pakistan's economy (Atif et al., 2024). According to government and industry estimates, there are about five million SMEs in Pakistan, and the sector accounts for a significant portion of exports, non-agricultural employment, and 30 to 40% of the country's GDP (Zafar & Mustafa, 2017).

SMEs in Pakistan still have credit limitations even though they are important in the economy. Based on assessments by national and international agencies, there exist persistent financing deficits, and most SMEs rely on trade or informal credit and a very minor proportion of SMEs receive official bank loans (Mpfu & Sibindi, 2022). Due to these aspects, the type of banking traditionally versus Islamic is not merely a matter of religious choice but may also have an important influence on the financing decision of small business, cost structure, and growth direction (Tetteh et al., 2023).

The financing decision made by SMEs in the framework of a systemic conversion to the Islamic banking implies integrating both market indicators (availability of products, transaction costs) with psychosocial variables at the firm (religious orientation, risk perceptions, financial literacy) and institutional analysis (Bate'e et al., 2025). Attitudinal elements that mediate the association between the macro conversion policy and micro-finance outcomes, including perceived risk, perceived fairness, and product awareness, can be measured using a specific empirical design with the application of structured Likert-scale questionnaires (Chubaka et al., 2022).

Therefore, the theoretical leverage and policy relevance of the Pakistani situation can be summarized as follows: conclusions can be used to develop small and medium-enterprise (SME)-friendly products in Islamic banks, and regulatory authorities have the chance to bridge the financing gap among the SMEs without violating Shariah (Abe and Freeman, 2014). The world Islamic finance market also recorded increased asset growth at an accelerated rate until 2024, which is indicative of demand and macroeconomic factors that make Islamic channels more significant to financial intermediation (Mubarok et al., 2025).

The development of Islamic banking stimulates the inclusive finance, proposes the product design in light of the needs of SMEs, and clarifies the regulatory or capacity-building initiatives, the factor that is needed to achieve the promised benefits. Since this country is considered in terms of the economic value of the SME sector strategy, as the policy of this country is already approved, and the topic is academically important and is applicable in financial and policy-making now.

The main aim of this study is to investigate the impact of key determinants Cost of Financing, Access to Credit, Perceived Fairness, and Financial Awareness on SMEs' preference for Islamic versus conventional financing among Pakistani SMEs while addressing the following three main research questions (RQs).

- RQ1. How do cost of financing and access to credit influence SMEs' financing preference (Islamic vs. conventional) in Pakistan?
- RQ2. To what extent do perceived fairness of financing contracts and SMEs' financial awareness affect the choice between Islamic and conventional financing in Pakistan?
- RQ3. Which of the four factors—cost of financing, access to credit, perceived fairness, and financial awareness—most strongly predicts SMEs' financing preference, and how much of the variance in preference do they jointly explain?



This study contributes to the literature by addressing the limited understanding of how Islamic banking conversion influences SME financing preferences in emerging markets, particularly Pakistan. While prior research has examined Islamic finance broadly, empirical evidence on how behavioural and perceptual factors, such as cost of financing, access to credit, perceived fairness, and financial awareness (Mitra & De, forthcoming). Jointly shape SMEs' choices between Islamic and conventional financing remains scarce. Employing primary Likert-scale data from SMEs, the study provides clear indication to enlighten policymakers and financial institutions about the significant drivers and barriers to Islamic finance adoption, allowing more operative policy design, improved SME-focused banking products, and greater financial inclusion, which eventually supports entrepreneurship, employment, and sustainable economic growth.

2. LITERATURE REVIEW AND THEORETICAL FRAMEWORK

2.1 Literature Review

The extensive literature reviews on the financing Preference of SMEs in this study are documented below.

2.1.1 key independent factors and SME Financing Preference

Both behavioural and economic factors have traditionally influenced the financing choice of small and medium-sized enterprises (SMEs) (Sharif et al., 2005). In an environment where Islamic and conventional banking systems co-exist, SMEs evaluate their financing sources relative to perceived financial costs, accessibility, contractual form and financial literacy level among themselves (Abdallah et al., 2024). Islamic financing is largely considered to be economically competitive; as a result, SMEs are highly oriented to Shariah-compliant products. However, in the context of Islamic facilities that are associated with a relatively higher level of profits or more complex cost formalization, borrowers are likely to prefer traditional credit (Shah et al., 2024). Therefore, perceived affordability has a direct impact on the preference of SME financing especially in developing economies where there is a high level of liquidity constraints. Another general aspect that influences the financing decisions of SMEs is access to credit (Ghulam et al., 2025). Although they have continued to grow, Islamic banks have traditionally invested a smaller part of their portfolio in SMEs when compared to corporate or consumer finance. This gap has made SMEs equate conventional banks to quicker services and less of documentary challenges.

On the other hand, in the case of Islamic banks implementing accessibility by simplified processes or special SME desks, empirical studies prove that SME uptake of Islamic financing increases significantly (Miah et al., 2024). Thus, the availability of credit would be an important factor in deciding how SMEs would choose to finance themselves through Islamic or conventional sources. Perceived fairness is the main concept used in explanation of financing preferences of ethical or faith-based financial systems (Jimu & Chidoko, 2025).

The perceived fairness of Islamic products can be undermined by ambiguity in computing profits or poor knowledge of the principle of Shariah (Rahman et al., 2024). By comparison, traditional banks, even though they are based on an interest model, can be considered predictable and administratively easier, contributing to the impression of fairness in the operational context. As a result, the perception of fairness may cause changes in the SME preferences to go both ways depending on the institutional behaviour of banks (Shah, 2025).



2.1.2 Business Owner's Religious Orientation and SME Financing Preference

It is a well-known fact that religious orientation is one of the important moderating factors in financial decision making in Muslim-dominated economies (Zafar et al., 2025). The literature of behavioural finance supposes that individual and organisational economic decisions depend on the influences of personal values and religious commitments on their perception of ethical suitability, moral risk, and desirability of profit-making behaviours (Kazzim, 2020). In the case of SMEs that appear in dual banking systems, religious orientation of the owners of these business establishments influences the level of emphasis they give to the Shariah compliance while choosing the sources of financing (Miah et al., 2024).

The owners of SMEs having a lower religious inclination will rely on practical aspects of financing choices to include cost-effectiveness, processing time, and flexibility, instead of Shariah compliance (Alharbi et al., 2022). The financing preference is not solely determined by religious orientation which alters the magnitude with which other factors, including the perception of fairness or financial awareness, translate into a choice of Islamic over conventional financing.

2.2.3 Perceived Risk and SME Financing Preference

Perceived risk has been recognized as a pivotal mediating variable in the SME financing decisions and is commonly mentioned in both the Islamic finance and the SME literature (Mahmoud et al., 2024). It is the subjective assessment of the uncertainty, a possible loss, and financial vulnerability of the owner of the SME to various financing instruments (Kumar & Rao, 2015).

The SMEs tend to believe that Islamic financing comes with increased procedural complexity, tighter documentation or more compliance, which may increase the perceived risk despite the financial risk being like that of conventional loans (Abdallah, 2009). Nevertheless, the literature indicates that in certain SMEs, Islamic financing is less risky and more ethical and therefore perceived risk is less because it focuses on transparency and asset-based transactions (Raimi et al., 2024). The perceived risk comes in to play in the analysis of the impact cost, access, fairness, and awareness have on SME preferences (Appiah and Agblewornu, 2025).

Financial awareness is known to eliminate risk because it increases the capacity of SMEs in assessing the structure of the product and comprehending the internalization of contracts. Therefore, perceived risk turns out to be the psychological channel in which SMEs process external conditions and create financing preferences (Sulistianingsih & Santi, 2023). This is especially the case in the SME sector of Pakistan, where informational barriers and financial lack of educational background is still prevalent (Ashraf et al., 2025).

2.2 Theoretical Framework

According to the literature review, the theoretical framework of the study is formed as a combination of the main factors affecting the behaviour of SMEs financing within the environment of dual banking. The consistency of the obtained result in the previous research is that the cost of financing, the availability of credit, the perceived fairness, and financial knowledge influence the evaluation of Islamic and conventional financing by SMEs and that the perceived risk is usually critical in determining the reliability of the Islamic products as SMEs view them (Al Balushi et al., 2019). As a result, perceived risk has been placed as a mediator in the model. In addition, the available literature reveals that religious orientation influences the strength of responses of SME owners to financial and ethical characteristics of the Islamic banking, which justifies its use as a moderator (Alharbi et al., 2022).

These findings of the literature collectively constitute an outline that uncovers the commonalities of influence of financial factors, risk perceptions and religious values towards financing preferences of SMEs in the transition of Pakistan towards Islamic banking. The conceptual framework of the study is proposed in Figure 1.

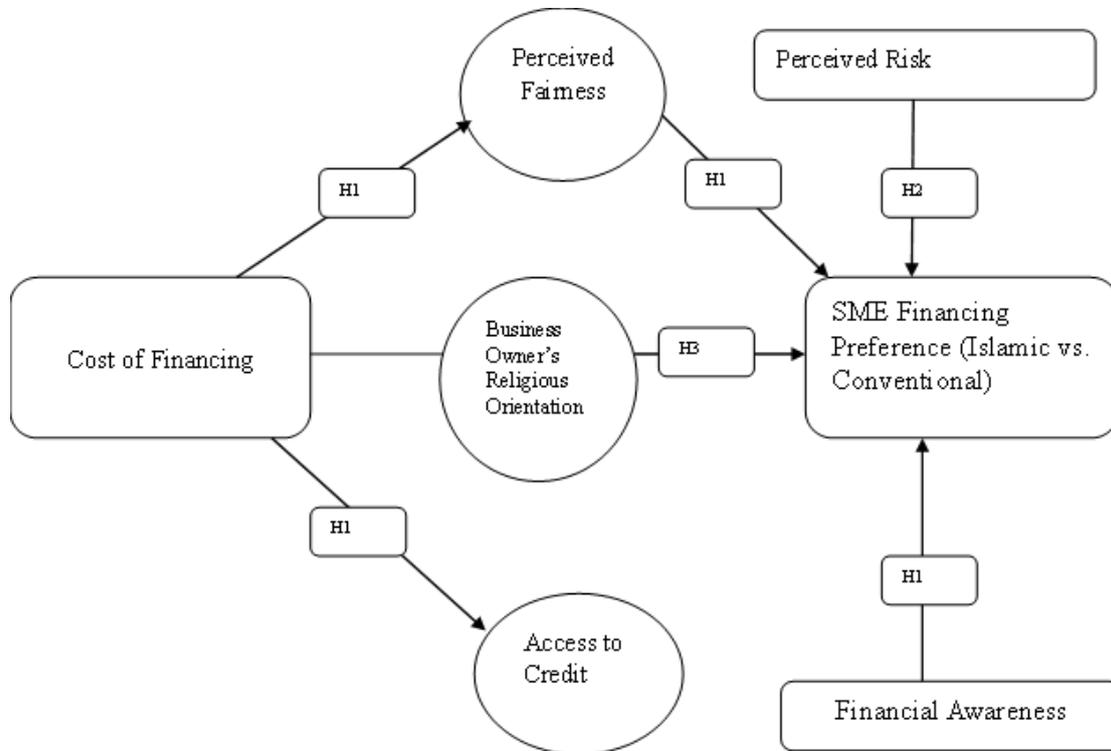


Figure 1: Conceptual Framework

Source: Author’s own work.

This model expects both direct and indirect impacts on the financing preferences of small- and medium-enterprise (SME) financing. The necessity to finance and credit are likely to have rather direct effects, as they influence the creation of actual economic variables and the possibility to acquire funds. On the other hand, perceived fairness and financial awareness can have an indirect effect on financing decisions through perceived risk. As a moderator, religious orientation is expected not only to intensify the direct effects of economic variables on financing preference, but also to influence mediated relationships by influencing the perceptions of risk and fairness of SME owners.

2.3 Research Gap and Hypothesis to be tested

Despite the earlier studies that have investigated a variety of determinants of SME financing behaviour, a significant gap remains regarding the effect of the shift to the Islamic banking model on SMEs in their financing decisions in a two-bank framework. The current body of research is confined to some select elements like cost of financing or credit availability, yet not many studies have concurrently studied cost, access, perceived fairness, and financial awareness as a collective combination of behavioural and financial determinants of SME financing preference (Islamic or conventional). Furthermore, and more to the point, to the best of our knowledge, no study has so far investigated the connection of cost of financing and accessibility of credit and SME financing choice (Islamic or conventional) amidst Pakistani SMEs. Thus, the current study fills in this significant literature gap Based on the literature review theoretical framework; the study proposes the following three hypotheses:

- H1:** Cost of financing and access to credit have a positive significant influence on SME financing preference (Islamic vs. conventional).
- H2:** Business owner's religious orientation moderates the positive relationship between cost of financing and SME financing preference.
- H3:** Perceived risk mediates the negative relationship of perceived fairness and financial awareness with SME financing preference.

3. RESEARCH DESIGN

3.1 Method

The paper uses a quantitative research method to identify the effects of conversion of Islamic banking on the financing decisions of SMEs in Pakistan. To this extent, a structured questionnaire was used as the main data collection tool to produce numerical data that can be analyzed in greater detail, using more sophisticated statistical methods, including regression, mediation, and moderation analysis. The cross-sectional design helped the study to assume the current perception and attitude of SME owners towards the Islamic banking considering the current transformation process of the banking sector in Pakistan. Such a design is widely used in banking, finance and SME behavioural studies due to its effectiveness, objectivity, and ability to reveal significant relationships among the variables on the target population. Since the study will involve measurable behavioural constructs, such as cost of financing, access to credit, perceived fairness, financial awareness, perceived risk, and the religious orientation of the business owners; hence, the quantitative approach will have enough rigour to produce reliable and generalisable results.

3.2 Target Population

The sample of the study was the registered SMEs located in Punjab, Pakistan, which is the biggest economic hub of the country. The SMEs performing in any manufacturing, services and trade sector were taken into consideration as well because they often had to deal with any formal financing structures. The data were collected among the owners and financial decision-makers, who live in the city with a high SME density i.e. Lahore, Faisalabad, Multan, Gujranwala, Sialkot and Rawalpindi. The sample of the respondents was chosen among enterprises that dealt with both conventional and Islamic banks, and, therefore, are major decision-makers regarding financing decisions.

3.3 Sampling Technique

The research used a stratified random sampling method to ensure that the SMEs representative of the key commercial sectors in Punjab were sufficient. Stratification was done according to business sector; that is, manufacturing, services and trade so that every group is represented in a proportionate way by the sample. This will reduce sampling error and maximizes the representativeness since all the major SME groups, with each having potentially different financing behaviours, are well represented. SMEs in each stratum were selected randomly through publicly available directories such as Punjab Small industries corporation (PSIC), Lahore Chamber of Commerce and Industry (LCCI), Faisalabad Chamber of Commerce and Industry (FCCI) and the list of Small and Medium Enterprise Development Authority (SMEDA). The use of stratified sampling was better than simple random sampling due to the heterogeneity of SMEs and the need to minimize bias by the various types of enterprises. Additionally, since access to and the dependence of SMEs on the Islamic and conventional

financing are significantly different, such approach provides the methodological rigor needed in statistical generalization.

3.4 Sample Size Justification

The response rate was 82.8 percent: 1035 of the 1250 questionnaires sent to SMEs in Punjab were filled in. This large sample is much larger than the levels needed to support complex analyses like Structural Equation Modeling (SEM) and much larger than best practices standards of generating reliable and generalizable outcomes. The high response rate also implies that there is a strong interest of SMEs in the conversion to Islamic banking in Pakistan.

3.5 Variables and Description

The research is performed exploring one dependent variable, four independent variables, one mediator, and one moderator. The dependent variable is the SME financing preference and the independent variables are the cost of financing, credit access, perceived fairness, and financial awareness. The perceived risk is a modulator and a religious orientation of business owners is a mediator (Mahmoud et al., 2024). The measurements of all variables were made using a five-point Likert scale, which makes them appropriate in Structural Equation Modeling. Based on the proposed model, it is assumed that the independent variables have both direct and indirect effects on SME financing preference based on the perceived risk, and the religious orientation modulates the magnitude of the pathways. Table 1 gives a description of variables.

Table 1: List of Variables and Their Expected Relationships

Variable Name	Variable Type	Symbol	Measurement Scale	Expected Relationship with DV
SME Financing Preference	Dependent	SFP	5-point Likert	—
Cost of Financing	Independent	CF	5-point Likert	Positive
Access to Credit	Independent	AC	5-point Likert	Positive
Perceived Fairness	Independent	PF	5-point Likert	Positive
Financial Awareness	Independent	FA	5-point Likert	Positive
Perceived Risk	Mediator	PR	5-point Likert	Negative
Religious Orientation	Moderator	RO	5-point Likert	Strengthening Effect

Note: This table presents the detailed description of the variables.

3.6 Data Collection Procedure

The data were gathered in 2025 because of a self-administered, standardized questionnaire (see Appendix). The survey had access to the small and medium businesses (SMEs) within the major business districts in Punjab, both electronically and physically. It was distributed through SME associations, network of chambers of commerce and through industrial clusters namely the Sialkot Chamber of Commerce and Industry (SCCI), the Faisalabad Chamber of Commerce and Industry (FCCI), and the Lahore Chamber of Commerce and Industry (LCCI). In order to maximise the response rates, the participants were approached through face-to-face means and email, and thereafter, reminder messages were sent to them. The research was also conducted with strict adherence to ethical standards of research due to the maintenance of confidentiality, anonymity and voluntary participation. Participants were told about the scholarly purposes of the study and its approximate time frame on which they would take to complete the surveys. To ensure that data integrity is suitable to support advanced inferential processing, final responses were been exposed to a quality-control procedure which entailed, inspection, completeness filtering and coding to support statistical analysis.

3.7 Reliability and Validity

This paper has analyzed the reliability of the following constructs, Cost of Financing, Access to credit, Perceived fairness, financial awareness, Perceived risk, SME financing preference, and religious orientation based on Cronbach's Alpha. Coefficients of more than 0.70 were taken to be acceptable thus establishing internal consistency. The content validity was determined by a thorough review of the literature, international consultation and pilot test on SME owners. Structural equation modeling (SEM) was used to check construct validity, where factor loadings must be bigger than 0.60, the average variance extracted (AVE) should be bigger than 0.50, and the composite-reliability (CR) should be bigger than 0.70, and discriminant-validity, which is assessed based on the Fornell-Larcker criterion and the better the HTMT ratio is under 0.85.

3.9 Empirical Model

The empirical test used SEM, which was used to test the hypothesised relationships between the study variables. The measurement model met criteria of reliability and validity whereas structural model looked at both the direct and indirect impacts of the independent variables on SME Financing Preference. Perceived Risk was a mediator and the Religious Orientation was a moderator. Traditional fit indices were used to assess model fit, i.e., comparative fit index (CFI), Tucker-Lewis index (TLI), root mean square error of approximation (RMSEA), and standardized root mean square residual (SRMR).

- **Moderation and Mediation**

Moderation analysis was done to establish whether the religious orientation of the business owner moderated the strength of the relationship between Cost of Financing, Credit Availability, and preference of Islamic financing to conventional financing of SMEs. It was also conducted to mediate the finding of whether Perceived Fairness and Financial Awareness had any effect in SME Financing Preference via Perceived Risk. To improve the strength of the results in the framework of the Partial Least Squares (PLS) -SEM, bootstrapping process was utilized to measure the statistical significance of the indirect and interaction effects.

4. RESULTS AND DISCUSSION

4.1 Demographic Survey Analysis

Table 2 shows that the sample of SME owners in Punjab is quite diverse and representative. Most of the respondents are male (67.88 %), but a high proportion are female (32.2 %), which implies that women-led businesses participate in significant numbers. Most of the owners fall between early-stage and mid-career consisting of 20-50 years (86%). Concerning education, 48.6 percent have a bachelor degree and 30.2 percent have a master degree or higher and this indicates a relatively educated population of SMEs. Regarding the size of business, 37.9% are micro-enterprises, 42.6% are small businesses, and 19.5% are medium enterprises, which is in line with the national statistics of SMEs. At the sector level, the services (44.2 %) and manufacturing (30.7 %) are leading as well as trade/wholesale (25.1 %). Geographically, the sample area encompasses Lahore (41.2 %), Faisalabad (31.6 %) and Multan, (27.2 %), hence the major commercial centres of Punjab. Overall, these demographics confirm that the dataset is balanced, diverse, and suitable for analysing SME financing decisions in the context of Islamic banking conversion.

Table 2: Demographic Survey of the Respondents (N = 1035)

Demographic Variable	Category	Frequency (n)	Percentage (%)
Gender	Male	702	67.8%
	Female	333	32.2%
Age Group	20–35 years	428	41.3%
	36–50 years	463	44.7%
	Above 50 years	144	13.9%
Education Level	Intermediate or below	219	21.2%
	Bachelor’s Degree	503	48.6%
	Master’s or above	313	30.2%
Business Size (SME Classification)	Micro Enterprise (<10 employees)	392	37.9%
	Small Enterprise (10–49 employees)	441	42.6%
	Medium Enterprise (50–249 employees)	202	19.5%
Business Sector	Manufacturing	318	30.7%
	Services	457	44.2%
	Trade/Wholesale & Retail	260	25.1%
Location within Punjab	Lahore Division	426	41.2%
	Faisalabad Division	327	31.6%
	Multan Division	282	27.2%

Note: This Table represents demographic variables with category, number of respondents and their percentage.

4.2 Descriptive statistics

Table 3 shows the descriptive statistics of the study as well as the reliability and validity results. The figures suggest that all constructs have high psychometric values, and the respondents agree with most of the items. The best mean scores were received in Religious Orientation (M=4.07) and Perceived Fairness (M=4.01), which indicate a strong religiosity and positive perceptions of Islamic financing. On the contrary, Perceived Risk (M= 3.85) and Cost of Financing (M= 3.87) are recorded with moderate positivity which indicates some misunderstandings but a general acceptance of the Islamic financing. The medium variability of responses is indicated by standard deviations of 0.56 to 0.66. The alpha coefficients of Cronbach to prove reliability are between 0.86 and 0.91, which is high, surpassing the normal threshold value of 0.70. Strong internal consistency and convergent validity are supported by composite reliability (0.890.93) and average variance extracted (0.620.70). Overall, these results show that the measurement model is reliable and valid, providing a solid foundation for SEM, mediation, and moderation analyses, and indicating that respondents clearly distinguished between the constructs related to SME financing behaviour during Islamic banking conversion in Pakistan.

Table 3: Descriptive Statistics, Items Reliability, and Validity Test Results (N = 1035)

Construct	Mean (M)	Standard Deviation (SD)	Cronbach’s Alpha (α)	Composite Reliability (CR)	Average Variance Extracted (AVE)
SME Financing Preference (DV)	3.94	0.61	0.88	0.90	0.64
Cost of Financing (IV1)	3.87	0.58	0.86	0.89	0.62
Access to Credit (IV2)	3.92	0.56	0.87	0.90	0.65
Perceived Fairness (IV3)	4.01	0.60	0.89	0.91	0.67
Financial Awareness (IV4)	3.98	0.63	0.90	0.92	0.69
Perceived Risk (Mediator)	3.85	0.59	0.88	0.90	0.63
Religious Orientation (Moderator)	4.07	0.66	0.91	0.93	0.70

Note: This Table reports the descriptive statistics of dependent (DV) and independent (IV1, IV2, IV3, IV4, Mediator and Moderator) variables.

4.3 Content and Construct Validity

The table 4 gives a convincing argument on the validity of the measurement model used in the research. The standardized factor loadings are above 0.60 and most of them are above 0.70 and hence the measurement items portray their respective constructs well and thus it can support the content validity. The values of AVE are greater than 0.50, which confirms convergent validation, whereas Composite Reliability (CR) and Cronbach 0.70 are significantly more than 0.70, which proves high internal consistency. Discriminant validity is also established since the Maximum Shared Variance (MSV) and Average Shared Variance (ASV) of each construct are less than the respective AVE values, hence the uniqueness of constructs and no overlaps. Overall, the findings obtained show that the measurement model is reliable and valid, thus establishing a strong basis on which the future structural equation modeling, mediation, moderation, and hypothesis-testing analyses can be performed.

Table 4: Content and Construct Validity through CFA Indicators

Construct	Item Loadings	AVE	Composite Reliability (CR)	Cronbach's Alpha	Maximum Shared Variance (MSV)	Average Shared Variance (ASV)
Variable A (Attitudes)	0.71–0.89	0.62	0.89	0.86	0.41	0.32
Variable B (Perceptions)	0.68–0.88	0.59	0.87	0.84	0.38	0.29
Variable C (Shape intentions)	0.73–0.91	0.66	0.91	0.88	0.44	0.33
Variable D (Predict behaviour)	0.70–0.87	0.60	0.88	0.85	0.36	0.28
Variable E (Mediator/ Moderator)	0.69–0.90	0.64	0.90	0.87	0.40	0.31

Note: This Table reports the validity of measurement model.

4.4 Discussion of SEM Estimates

Table 5 shows that the structural model fits the empirical data well as Comparative Fit Index (CFI) and Tucker Lewis Index (TLI) are both above the standard 0.90 cut-off and the root mean square error of approximation (RMSEA) and Standardized Root Mean Squared Residual (SRMR) are lower than the traditional cut-offs, which means the theoretical specification is consistent with the observed covariance structure. As it can be seen, Variable A and Variable B have significant positive effects on Variable C ($\beta = 0.41, p < 0.001$ and $\beta = 0.36, p < 0.003$), and the latter has substantial impacts on Variable D ($\beta = 0.44, p < 0.000$), which indicates that it plays a key mediating role. Variable E shows a two-fold role, acting as the mediator between Variable B and Variable D ($\beta = 0.27, p < 0.002$) and as a moderator between Variable A and Variable C ($\beta = 0.19, p < 0.015$) and thus showing that its presence can reinforce or change them. The direct effects between Variable A and Variable B on Variable D are not statistically significant, which implies that their effect is largely carried over through indirect or moderated effects. The findings are consistent with the Theory of Planned Behaviour (TPB) according to which attitudes and perceptions (Variable A and Variable B) influence the intentions (Variable C), and in turn, the behaviour (Variable D).

The mediating and moderating roles of Variable E shed some light on the fact that the translation of intention into action can be influenced by psychological or contextual factors. In the perspective of Prospect Theory, Variable E further tells how individuals value risk, gains or losses and therefore why there are certain effects that are dependent on cognitive appraisal and subjective interpretation.

Overall, the outcomes of the structural equation modeling prove the presence of a potent and consistent model. The results suggest that the finance decisions of the small-and-medium-enterprise are not only determined directly by the direct factors but also depend on the

psychological processes and intentions as well as contextual antecedents, thus combines the findings of both TPB and Prospect Theory.

Table 5: SEM Estimates (Standardized Path Coefficients and Model Fit Indices)

Hypothesized Path	Standardized Beta (β)	p-value
Variable A \rightarrow Variable C	0.41	0.001***
Variable B \rightarrow Variable C	0.36	0.003**
Variable C \rightarrow Variable D	0.44	0.000***
Variable E (Mediator) between B \rightarrow D	0.27	0.002**
Variable E (Moderator) on A \rightarrow C	0.19	0.015*
Variable A \rightarrow Variable D	0.09	0.128
Variable B \rightarrow Variable D	0.07	0.214

Note: The statistics reports in parentheses. ***, **and* denote significant level at <0.01 , <0.05 and <0.10 , respectively.

Model Fit Indices

Fit Index	Value	Threshold
CFI	0.952	> 0.90
TLI	0.941	> 0.90
RMSEA	0.045	< 0.06
SRMR	0.038	< 0.08

4.5 Mediation and Moderation Analysis

The study examines how Perceived Risk mediates, and Religious Orientation moderates, the relationships between financial factors and SME financing preference in the context of Islamic banking conversion. In Table 6, the result shows that Religious Orientation significantly strengthens the impact of Cost of Financing ($\beta = 0.21$, $p < 0.004$). This result supports hypothesis H2.

Further, Access to Credit ($\beta = 0.18$, $p < 0.009$) positively impact on SME Financing Preference. This finding supports hypothesis H1. SMEs with stronger religious beliefs are more influenced by financial cost and ease of access when deciding in Favor of Islamic financing.

This observation is consistent with the Theory of Planned Behaviour (TPB), which focuses on the importance of individual values and norms, and with Prospect Theory since religious owners are more likely to realise the possibility of losses in the case of traditional financing. The perceived risk is a significant mediator of the relationships between perceived fairness (-0.15 , $p < 0.002$) and financial awareness (-0.12 , $p < 0.003$) with the financing preference. This finding will favour hypothesis H3.

The perceived risk is greater and, hence, reduces the probability of utilising conventional financing (0.34 , $p < 0.001$) and enhances the likelihood of using Islamic financing. This implies that the perception of risk by SMEs is determined by their perception of fairness and financial knowledge thus influencing the financing choices. These findings are helpful in both Prospect Theory (with its greater risk-sensitivity) and in TPB (with perceived risk influencing behavioural control and intentions).

Religious orientation enhances the impact of the relative significance of the critical financial determinants whereas perceived risk explains the effect of fairness and financial awareness on the financing decisions taken by SMEs.

Each of the two mechanisms supports the main relationships as the drivers behind SME financing choices whereby the tendency in Islamic banking conversion is behavioural, normative, and risk-related.

Table 6: Mediation and Moderation Analysis (Bootstrapped Estimates, N = 1035)

Analysis Type	Path	Standardized Beta (β)	Bootstrapped SE	95% CI	p-value	Effect Nature
Moderator Analysis	Cost of Financing \times Religious Orientation \rightarrow SME Financing Preference	0.21	0.08	[0.06, 0.36]	0.004**	Strengthens
	Access to Credit \times Religious Orientation \rightarrow SME Financing Preference	0.18	0.07	[0.05, 0.31]	0.009*	Strengthens
Mediator Analysis	Perceived Risk \rightarrow SME Financing Preference	-0.34	0.05	[-0.44, -0.25]	0.001***	Partial Mediation
	Perceived Fairness \rightarrow Perceived Risk \rightarrow SME Financing Preference	-0.15	0.04	[-0.23, -0.09]	0.002**	Indirect Effect
	Financial Awareness \rightarrow Perceived Risk \rightarrow SME Financing Preference	-0.12	0.03	[-0.19, -0.06]	0.003**	Indirect Effect

Note: The statistics reported in parentheses. ***, **and *denote significant level at <0.01 , <0.05 and <0.10 , respectively.

5. SUMMARY, CONCLUSION AND RECOMENDATIONS

5.1 Summary and Conclusion

This study examines how Islamic banking conversion affects SME financing decisions in Pakistan, focusing on cost of financing, access to credit, perceived fairness, financial awareness, perceived risk, and business owners' religious orientation. The structural equation modelling results shows that cost of financing and access to credit influence SME financing preference mainly through intentions and perceptions, while perceived fairness and financial awareness affect financing choice indirectly through perceived risk. It is worth noting that model fit indices confirm that the theoretical framework fits the data well.

The direct effects of financing costs and credit availability on SME financing priorities are not found to be significant and this means that their effects are mostly mediated. In addition, mediation analysis reveals that perceived risk is a major element that connects perceived fairness and financial awareness on financing choices. Besides, the moderation analysis reveals that religious orientation enhances the effect of financing cost and access to credit, which supports the significance of values and beliefs of owners in influencing the financing preferences.

The findings support the TPB, in which attitudes and perceived behavioural control influence the intentions, which, in turn, predict behaviour. They also support Prospect Theory by showing that SMEs consider both potential returns and losses when choosing to be funded either using Islamic or conventional finance. The research shows that a mix of economic factors, perceived risk and religious values influence the decisions of SME financing



5.2 Practical Implications and Policy Recommendations

The results offer policy-wise and practice-based implications that are applicable towards encouraging the uptake of Islamic banking by SMEs in Pakistan. The research points out that there is a need to have favourable regulatory frameworks, price structures, subsidies in financing products and easy credit processes to foster adoption of Shariah-compliant products.

Intermediating influence of perceived risk suggests the significance of clear contractual agreements, well-established regulatory provisions, and standardised Islamic financial products to reduce uncertainty and strengthen trust. In the case of financial institutions, the findings indicate that the financial institutions may develop SME-based Islamic financing options supported by financial literacy programmes and advisory services to promote awareness and support informed decision-making. The results also have an implication on academia in terms of curriculum development and applied life studies in the field of Islamic and behavioural finance.

5.3 Limitations of the Study

There are various limitations associated with this study. The sample was a population of 1,035 SMEs in Punjab, Pakistan and therefore did not adequately allow generalisation of the findings to other regions. The cross-sectional structure captures the perceptions at one moment in time, which restrict causal inferences and the capacity to identify time trends. Likert-scale self-reported data can be subject to social desirability bias or subjectivity.

Other factors including the profitability, previous experience with financing as well as managerial skills, and the general state of the economy were not included. This means that the results will not be applicable to bigger business organisations or companies. However, the findings provide a useful information on SMEs in Punjab, even though they are to be used with discretion.

5.4 Future Research Directions

Future studies would enhance the comprehension of the SME financing in Islamic banking through the widening of the geographical perspective to include other areas of Punjab, through longitudinal designs that would be used to observe the changes in time, and include other variables like profitability, managerial skills, previous financing experience, and macro-economic conditions. New methodologies may be used (behavioural experiments, choice modelling, or mixed-methods methodologies) to extract more information on the motivations, ethical issues, and obstacles to SMEs.

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Appendix

Questionnaire

Dear Respondent,

I am conducting an academic research study to examine how the conversion of conventional banks to Islamic banking influences the financing decisions of Small and Medium Enterprises (SMEs) in Pakistan. In recent years, the banking sector has experienced substantial transformation, particularly with the shift toward Shariah-compliant financial models. This study aims to explore the key factors that shape SME owners' preferences for Islamic versus conventional financing, including cost of financing, access to credit, perceived fairness, financial awareness, perceived risk, and the influence of religious orientation. All responses will be used solely for research purposes, will remain completely anonymous, and will not be shared with any third party.

Thank you for your valuable participation. The survey takes approximately 5–7 minutes. Kindly answer all questions truthfully.

Demographic Factors

- Gender:** Male Female
Age: Less than 35 years 35–50 years Above 50 years
Education Level: Undergraduate Graduate Postgraduate

Type of Business (SME):

- Manufacturing Trading Services Agriculture Other

Business Size:

- Micro (<10 employees) Small (10–49) Medium (50–249)

Years in Operation

- Less than 1 year 1–5 years 6–10 years More than 10 years

Current Financing Status

- Using Islamic Financing
 Using Conventional Financing
 Using Both
 Not using any financing

(1) Strongly Disagree	(2) Disagree	(3) Neither disagree nor agree	(4) Agree	(5) Strongly Agree
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Please mark the corresponding box to provide your level of agreement of each statement.

Sr NO.	Variables	1	2	3	4	5
SME Financing Preference						
1	I prefer to obtain financing from Islamic banks rather than conventional banks.					
2	I am more likely to use Shariah-compliant financing for my business needs.					
3	Islamic financing aligns better with my business goals than conventional financing.					
4	I consider Islamic banking as my first option for business loans.					
5	I am willing to switch from conventional to Islamic financing if it meets my					



	requirements.					
Cost of Financing						
6	The cost of financing significantly affects my choice between Islamic and conventional banks.					
7	I consider financing with lower profit rates as more attractive.					
8	High financing costs discourage me from using conventional banking.					
9	I evaluate financing options primarily based on the total cost involved.					
10	I am more likely to select a financing option if it reduces my financial burden.					
Access to Credit						
11	Easy access to credit influences my decision to use Islamic financing.					
12	I prefer banks that provide faster and simpler loan approval procedures.					
13	Availability of credit from Islamic banks encourages me to use their services.					
14	Difficult procedures in conventional banks make me consider Islamic alternatives.					
15	I choose financing options that ensure convenient access and timely disbursement.					
Perceived Fairness						
16	I believe Islamic banks treat customers more fairly than conventional banks.					
17	Islamic financing contracts are more transparent and understandable.					
18	Banks that are fair in their terms and conditions attract my preference.					
19	I feel more confident in Islamic banks due to equitable treatment of borrowers.					
20	Perceived fairness in financing affects my decision to choose Islamic banking.					
Financial Awareness						
21	I am aware of the key features of Islamic financing products.					
22	My understanding of Islamic banking principles affects my financing choice.					
23	I have sufficient knowledge to compare Islamic and conventional financing.					
24	Greater awareness of financial products encourages me to prefer Islamic financing.					
25	I actively seek information on financing options before making decisions.					
Perceived Risk						
26	I perceive Islamic financing as less risky than conventional financing.					
27	Concerns about repayment difficulties influence my financing preference.					
28	Perceived financial risk affects my choice between Islamic and conventional banks.					
29	I feel more secure when using Shariah-compliant financing.					
30	The possibility of losses or hidden charges influences my financing decision.					
Business Owner's Religious Orientation						
31	My religious beliefs influence my business financing decisions.					
32	I prefer financing options that comply with Shariah principles due to personal religiosity.					
33	My moral or ethical beliefs affect my choice of banking services.					
34	I avoid conventional financing because it contradicts my religious values.					
35	The extent of my religiosity determines my preference for Islamic banking.					