AMERICAN UNIVERSITY OF BEIRUT

SME-CENTERED INSTITUTIONAL INNOVATION IN THE FINANCIAL SECTOR:
ROLE OF KAFALAT IN SHAPING AND TRANSFORMING LENDING PRACTICES

by

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AN ABSTRACT OF THE PROJECT OF

May Ahmad Tehaili for Master of Business Administration
Major: Business Administration

Title: SME-Centered Institutional Innovation in the Financial Sector: Role of Kafalat in Shaping and Transforming Lending Practices

There have been calls for future work by researchers to focus on two key understudied aspects of institutional entrepreneurship process: (1) accounting for the *embeddedness* of institutional entrepreneurs; and (2) accounting for a distributed view of *agency* in institutional processes. First, in the case of embeddedness, the issue is to concretely explain the actual process of how existing actors within the social field who are tangled with the current institutional forces appear to engage in triggering and shepherding change simultaneously. Second, in the case of agency, the challenge is to highlight how agency of several actors (both individual and collective) across the social field of action are involved and implicated in effecting institutional change without appealing to the cult of "heroic" individual. Third, there is a dearth of research on to better understand the underlying processes of institutional maintenance and change through the institutional entrepreneurship lens in the context of a Middle East country (Lebanon) environment. My research in this thesis project has attempted to address these three gaps in the literature. I have done so by assessing institutional innovation process instigated by Kafalat which has subsequently shaped and transformed the SME-oriented lending practices in Lebanon during 1999-2014.

On the one hand, the role of embeddedness was concretely illustrated through the involvement and engagement of initial team of actors who collectively formulated and shepherded the establishment of Kafalat. On the other hand, we showed how subsequently the banks, BDL, donors and SME players collectively exercised agency over different parts of the field in a distributed manner.

My distinctive contribution has been on highlighting how the process of institutional entrepreneurship was enacted within the context of specific dynamics in the focal Middle Eastern country. My research has contributed in addressing the gap in the research on institutional innovation changes focusing on SME lending practices in Lebanon

in terms of who, how and why these changes have come about. My interviews with Kafalat itself, stakeholders and beneficiaries have given me a holistic view of the institutional entrepreneurship process. This 360 view across all parties afforded transparency to the range of actors and their actions to bring about institutional innovation into SME lending practices in particular highlighting the role of influential social actors.

In 1999, Kafalat, a Lebanese financial company at the initiative of the Lebanese government, Association of Banks, BDL and National Guarantee of Deposits was set up to perform loan guarantees for SMEs. Traditionally, SMEs constituted an insignificant share in the financial market activities (~6%) and upon the introduction of Kafalat, giving a wake-up call for banks incentivizing their work in the process of loan feasibility, SME lending has become a permanent fixture of the financial landscape with around 16% share. In other words, Kafalat has helped unleash this institutional change.

Specifically, the findings of this research have demonstrated that the above process model has been employed to analyze the context of Kafalat whereby the actors have exploited the exogenous field characteristics in the ecosystem and become institutional entrepreneurs by changing what is hard to change: the conservative financial system. The findings have extended the literature by not only sustaining with the process model but also by showing that there is a possible triggering of other convergent changes in the institutional environment, i.e., the introduction of Circular 331 by the Central Bank of Lebanon to usher in institutional changes in equity financing market to prompt financial services firms to be actively investing in the knowledge economy to accelerate wealth creation.

However, more importantly, the research has shown that not only has SME lending became a permanent fixture of the financial services landscape; it has also highlighted the fact that Lebanon has again built a reputation for a vibrant entrepreneurial spirit and a strong base of SMEs contributing significantly to its open economy via job creation opportunities - a strategic significance to the economy.

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CHAPTER I

INTRODUCTION

We can now look onto the Small and Medium Enterprises lending scene, especially with the Banque de Liban Accelerate 2014[1] (BDL, 2014) event on 20-21 November at Forum de Beyrouth just behind us: it looks like SME lending is a permanent fixture of the landscape. However, upon closer examination, it becomes clear that the BDL is attempting to change the institutions of finance by ushering in a new institution: equity financing of SMEs. Furthermore, it is even more important to realize that the SMEs have traditionally constituted a relatively insignificant share of the financial market activities of banks in Lebanon (and also Middle East). Indeed, the Lebanese entity called Kafalat, set up in 1999, to perform loan guarantees for SMEs has had a hand in fundamentally changing this picture. However, we know very little about the institutional changes that have been unleashed in terms of shaping and transforming the SME-centered financing which were effected by Kafalat. Furthermore, the processes of these changes in terms of *who, how and why* these changes have come about have not been addressed through formal research. This MBA project is an attempt to address this gap.

My framework for analysis is what is often referred to as organizational institutional theory (Powell and DiMaggio, 1991) and its subsequent development (Lawrence et al

[1] This event was an effort to kick start and push forward the further implementation of BDL Circular 331 which focuses on equity financing of SMEs especially those that are part of the knowledge economy.

2009). According to this theory, institutions are field-level (multi-organizational) logics that govern the behavior of organizations and individuals within that field (Friedland & Alford, 1991). I agree with Fountain that, “the cognitive, cultural, and socio-structural embeddedness of organizational *practices* … helps to explain their surprising *resilience* in the face of new [practices]. The stability of organizational [practices] demonstrates the importance of an institutional perspective.” (2001: 96, *italics added*) That is, it is these *institutions* which contribute to the social construction and maintenance of core practices in the form of “rules, norms, and beliefs that describe reality for the organization, explaining what is and is not, what can be acted upon and what cannot” (Hoffman, 1999: 351). Institutions can be further manifested as action scripts that provide “stable designs for chronically repeated activity sequences” (Jepperson, 1991: 145). More specifically, such scripts govern the conduct of core practices and procedures of work in the form of organizational institutions.

So for example, dominant practice lending of Lebanese commercial banks which focuses on large enterprises is an institutions based on the more than 50-60 years of social forces operating in the field that renders stability and returns to a banking with large enterprises the “right thing to do”. As a result, changing such an institution becomes a monumental task because of the taken for grantedness of the core phenomena (large enterprise bank lending) is resilient to change (DiMaggio, 1988). Furthermore, institutional change requires a set of “sayings and doings” which are similar to performing entrepreneurship. This entrepreneurship is broadly similar to what is considered to have been done by Thomas Edison when he and associates commercialized electricity and its generation as an accepted business enterprise and as a competitor to gas eco-system which dominated the landscape at the time (Hughes, 1993). This notion of entrepreneurially changing an existing institution for a new institution to become accepted and grow is referred to as *institutional entrepreneurship* (Seo & Creed, 2002; Greenwood & Suddaby, 2006; Battilana, 2007; Garud et al, 2007; Battilana & D'Aunno, 2009; Battilana et al 2009).

Thus, "institutional entrepreneurship" refers to the 'activities of actors who have an interest in particular institutional arrangements and who leverage resources to create new institutions or to transform existing ones' (Maguire, Hardy & Lawrence, 2004: 657); while institutional entrepreneurs are those actors to whom the responsibility for new or changed institutions is attributed. These concepts are most closely associated with DiMaggio's (1988: 14) work in which he argued that 'new institutions arise when organized actors with sufficient resources (institutional entrepreneurs) see in them an opportunity to realize interests that they value highly'. Institutional entrepreneur scan also work to maintain or to disrupt and tear down institutions.

I will employ the *institutional entrepreneurship* framework and analyze the process of inception, growth, and transformation of SME-centered financial eco-system via the practices of Kafalat and its stakeholders. I will focus on the application of this framework to provide an enhanced understanding of how institutional practices of lending to SMEs by banks were effectively re-shaped by Kafalat. The lending volume to SMEs prior to Kafalat is said to have been around 6% of total lending. Today this volume stands close to 13-14%. This could not have occurred without an institutional transformation of the multi-organizational field of finance in Lebanon where the banks, BDL and the Association of

Banks have all interacted with Kafalat to effect a new logic of action where SME lending is now considered taken-for-granted. It is the goal of this MBA project to uncover the process of this transformation specifically focusing on who, how and why questions.

The knowledge of this process will help to shed light and provide lessons for the future growth of SME lending. In addition, it may provide insights into how the unfolding process of equity financing development - which is the focus of new BDL Circular 331 - may need to be adapted so that it is institutionalized similarly.

Overall, I plan to carry out a field study on Kafalat s.a.l., a Lebanese financial company with a public concern assisting entrepreneurs of small- and medium enterprises since its inception in 1999 with a collateral-free financial resource at the initiative of the Lebanese government, the Association of Banks, the Central Bank of Lebanon, and the National Institute for the Guarantee of Deposits.

Owned by the National Institute of the Guarantee of Deposits (75%) and 50 Lebanese banks (25%), Kafalat s.a.l. targets SMEs and innovative startups (with less than 40 employees) under Industry, Agriculture, Tourism, Traditional Crafts and High Tech sectors. Loans guaranteed by Kafalat s.a.l. benefit from interest rate subsidies financed by the Lebanese treasury and administered by the Central Bank of Lebanon; they are granted to entrepreneurs based on business plans / feasibility studies that show the viability of the proposed business activity. Guarantee applications are processed by Kafalat s.a.l. to be provided by Lebanese banks to SMEs operating throughout Lebanon under any one of the six different Kafalat programmes.

Operating under Kafalat Basic programme and five other programmes in partnership with EU serving different characteristics (Plus, Startups and Innovation, Agriculture, Innovative and Energy), Kafalat s.a.l. has granted \$109.6 million loan guarantees in 2014, down by 7.3% compared with \$118.2 million in 2013 (L'Orient le Jour – Jan 13, 2014). According to an article published in L'Orient Le Jour (Jan. 13, 2014), the number of granted loans totaled 838 in 2014 against 871 inf 2013 with an average loan amount of \$130,731. This decrease in Kafalat loans is mostly attributed to Lebanon's dire economic situations, yet it is to be noted that not all served sectors have suffered equally – the mostly affected sector was tourism closely followed by the industrial sector; the agriculture and crafts sector remain comparatively constant.

My high level research question is: *How have Kafalat and its stakeholders shaped and transformed the SME-centered lending practices in the financial eco-system?* Since the focus is on *how, why and who*, I will employ a field case study method (Yin, 2014). The field case study is to be employed because it is a more suitable method when one is trying to focus on actual events and also up close study of organizations and their evolution which is exactly the situation of Kafalat. I will obtain data on operations of Kafalat, i.e., its programs and loans through data from Kafalat sources and others. The empirical analysis will be mainly focused on performing interviews with the key persons inside and outside Kafalat including beneficiaries and stakeholders. With this information at hand, my aim is to document the *process* of institutional entrepreneurship enacted by Kafalat and the others in the ecosystem. Especially, I will provide an analysis of *how* Kafalat shaped and transformed SME-centered lending practices—*who* was involved and *why* certain actions were taken. I will also attempt to draw lessons for elaborating the institutional entrepreneurship theory in light of empirical *context* of Lebanon and its distinctive challenges/opportunities.

1.1 Research Objectives

The objectives of this research are summarized below:

1. How institutional entrepreneurship works in the local context of Kafalat?
2. Offer theoretical and policy insights

1.2 Research Questions

1. Extract the *process model* supposed to enable the institutional changes' emergence that is enabled by institutional entrepreneurship via the existing theory
2. What are the specific elements of traditional process of institutional entrepreneurship and are these elements *similarly* important (more or less) in the context of Kafalat?
3. *Why and who* engaged in specific processes of institutional entrepreneurship?
4. What is the role of *context* by collecting and analyzing data on the key aspects of the organizational environment (multi-organizational field) during the inception and evolution of Kafalat; focusing also on challenges and effects of institutional change introduced by Kafalat on the practices of financial sector?

To answer these questions, this paper will commence with the related literature from the major analysts on the study of institutional innovation. By doing so, I would highlight how this field of study "defines novel, useful and legitimate change that disrupts, to varying degrees, the cognitive, normative or regulative mainstays of an organizational field" (Rafaelli & Glynn, 2013). Following this section, I shall discuss details of the research methodology employed offering a justification for the role of institutional entrepreneurs and the notion of institutional innovation in our scope. In the following chapters, I will include a compilation of the interview discussions conducted with the different stakeholders and beneficiaries involved in transforming the lending practices in Lebanon, followed by an assessment of my findings to provide a theoretical approach upon which I will then summarize my contribution to this field of study, discuss its challenges and address the research limitations. Conclusively, I will recapitulate my study offering the opportunity for further research onwards.

CHAPTER II

LITERATURE REVIEW

2.1 Conceptual Framework

In the 1800s, the upsurge of infrastructural developments kindled the next phase of institutional growth. The business world was restructured by innovations such as the railroad, the steamship, electricity and telegraph. As such, companies were granted the capacity for global production, marketing and distribution enabled by new communication and transportation technologies. Hence, we can infer that "driven by a desire to harness the scalable efficiency, [… new institutional forms emerged] (Hagel & Brown, 2013)

In spite of this desire, institutions do change with varying degrees of disruption (Leblebici, Salancik, Copay, & King, 1991). For example, the institution of marriage, varied across the last few decades as legal, normative, and cognitive sensibilities changed. Eventually diverse races, religions, and sexual orientations are now legitimately regarded as marriage partners (Amato, 2007). In a similar context, financial institutions now serving new or underserved populations with different products and services (micro-finance, hybrid…) have undergone considerable innovation (Battilana & Dorado, 2010).

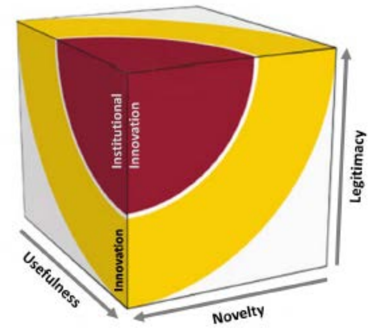
Consistent with Hargrave and Van de Ven (2006), institutional innovation is viewed as embracing the inception of new institutions and/or change in existing institutions. Institutional innovation is challenging and is often met with resistance given the dynamic tension between institutional tenacity and innovative change: "When innovations meet institutions, two social forces collide, one accounting for the stability of social systems and the other for change" (Hargadon & Douglas, 2001: 476). Yet, although consistent with the notion of institutional entrepreneurship, the creation of new institutions still is a more radical form of institutional innovation.

Back to the desire to harness scalable efficiency, Hagel and Brown (2013: 4) argue that institutional innovation is a shift from scalable efficiency to scalable learning. Building on the foundational work of Hargrave and Van de Ven (2006), the organization's ability for innovation was limited by the consistency and predictability created to promote efficiency. In other words, institutional innovation entails "scalable learning" with the ultimate goal of creating smarter institutions in a world of exponential change. (Hagel & Brown, 2013)

In an attempt to fully comprehend the role of change triggering institutional innovation, Scott (1987) identified four variants of institutional theory as (1) normative advocating the notion of institutional innovation emerging as novel, useful and also in alignment with prevailing norms and values; (2) social constructive proposing institutional innovation to be perceived as novel and useful by key social actors consistent with prevailing understandings to reach a more legitimate notion; (3) culturally embedded stressing the role of cultural elements (symbols, cognitive systems, normative beliefs) and their sources; and (4) bundle of logic and practices defining "institutions as distinct social spheres, each with its own particular set of belief systems, logic and substantive content, with high degrees of durability".

Up until now, institutional literature exposed several compatibilities between institutionalism and innovation despite the predictable resistance upon innovation meeting institutions. Hargadon & Douglas, however, suggest a critical dimension of institutional innovation differentiating it from innovation in general. They conceptualize institutional innovations in terms of three key dimensions: novelty, usefulness, and legitimacy.

Graphic Comparison of Innovation to Institutional Innovation



Earlier, we mentioned Van de Ven (1986) who asserts that "as long as the idea is perceived as new to the people involved, it is an 'innovation,' even though it may appear to others to be an 'imitation' of something that exists elsewhere" (Van de Ven, 1986: 592). But, institutional innovation is different. It is less restricted when it comes to novelty; i.e. novelty is perceived in broader terms within the organizational field. (Rafaelli & Glynn, 2013)

Legitimacy, however, is an important factor in institutionalization, as "the creation, transformation, and diffusion of institutions require legitimacy, a condition whereby other alternatives are seen as less appropriate, desirable, or viable" (Dacin, Goodstein, & Scott, 2002:47). This is paired with the endorsement of change from the different institutional actors.

In contrast to other innovations, which may be more technical in terms, institutional innovations are masked with legitimacy, social construction and cultural configurations.

Most importantly, however, is the "pledge" of institutional innovation where it promises to unlock the unlimited potential of ourselves and our organizations." (Hagel & Brown, 2013: 19). A novel, useful, and legitimate aspiration, indeed.

Henceforth, institutional innovation drives us to reassess the entire architecture of relationships both within and across institutions to break the realm of our institutions and move to the ecosystem surrounding it. As Bill Joy famously observed, “No matter how many smart people there are within your firm, remember that there are far more smart people outside your firm.”

Leading from the formerly explained notion of institutional theory, the concept of institutional entrepreneurship seems paradoxical. We are faced, hereof, with the question of how and why organizations or individuals of existing institutions can break the walls within existing institutions. (Holm, 1995; Seo & Creed, 2002). “Specifically, how do managers at small and medium-sized enterprises (SMEs) perceive the formal institutional constraints in their institutional framework that affect their strategic choices to innovate?”

According to an empirical research conducted in China, “creating architectures of relationships reaching beyond the walls of […] institution[s] is one of the most powerful ways to tap into richer and more diverse flows of knowledge and accelerate learning”. Accordingly, there is an ecosystem of third parties each of which contributes to the social construction.

Institutions, hence, are embedded in the cultures, technologies, and infrastructures of their ecosystem, and the emergence of any new social and technological infrastructures often catalyzes fundamental institutional innovations.

Three questions remain to be answered however: (1) Must [organizations and individuals] be willing to change the institutional environment dealing with actors’ intended effects of the initiated changes; (2) How far do [they] have to go in the implementation of change dealing with the effects of their actions; and (3) What is the difference between an entrepreneur and an institutional entrepreneur covering the concept's similarities and differences of entrepreneurs and institutional entrepreneurs.

As such, in answering the above questions, clustering of economic activities and cluster performance have been the subject of growing theoretical (i.e. Amin and Thrift, 1995; Barnes and Gertler, 1999) and empirical scrutiny (i.e. Carlsson, 2002). According to Greif (2001:4), institutions generate a regularity of behavior by enabling, coordinating, and motivating or constraining behavior while being exogenous to each of the individuals whose behavior they influence but endogenous to the society. Hence, institutions are needed to constrain and govern the human action by which Hodgson (1988) refers to as the "restrictive function of institutions". But why is that so?

Based on Scott's interpretations, institutions "construct actors and define their available modes of action; they constrain behavior, but they also empower it…" (Scott, 2001:15). Since culture and experience are time, context and location bound, there is an immense variation in individuals' perceptions of the world and how it works. "Even the formal learning that individuals acquire frequently consists of conflicting models by which we interpret the world around us" (Scott, 2001:4).

Following this however, institutional entrepreneurs must craft a vision for divergent change to appeal to the actors needed to implement it. This is a challenge given that such changes tend to break the "taken-for-granted" practices in the field. Therefore, Markowitz (2007) , Misangyi, Weaver & Elms (2008) tried to translate this divergent change into three dimensions: (1) diagnostic framing exposing problems within the existing institutionalized practices and assigning blame (Suddaby & Greenwood, 2005); (2) prognostic framing promoting a project superior to the existing projects engaging the institutional entrepreneur in de-legitimating existing institutional arrangements (Creed, Scully, & Austin, 2002; Suddaby & Greenwood, 2005), and in legitimating to stakeholders and other potential allies the project at hand (Déjean et al., 2004; Demil & Bensédrine, 2005); and (3) motivational framing providing compelling reasons to support the new vision being promoted (Misangyi et al., 2008). As such, the lower the degrees of institutionalization, the higher the levels of uncertainty in the institutional order (DiMaggio, 1988; Fligstein, 1997; Phillips et al., 2000) influencing the way institutional entrepreneurs affect actor's agency.

The field conditions presented have been considered as taken-for-granted and exogenous to the actions of actors above. Recent research, however, suggests that the actions of other actors can generate field conditions that foster opportunities upon which peers, acting as institutional entrepreneurs, might exploit to precipitate change (Delbridge & Edwards, 2008; Powell & Colyvas, 2008).

To interpret this more, studies assessed the embeddedness of institutional entrepreneurs within more vivid analysis of institutional dynamics and agency building on the research on institutional entrepreneurs that has increasingly promoted a more distributed view of agency.

Accordingly, we have established below some key guidelines serving as process elements to instill institutional innovation smoothly within the existing ecosystem.

One element would be culture being an important determinant in shaping the entrepreneurial society. Hence, with education and training, an entrepreneurial culture can be promoted to shape attitudes to risk-taking and reward. Yet, in spite of this cultural endorsement, there still are “institutional defenders” who benefit from the status quo (DiMaggio, 1988; Levy & Scully, 2007) almost invariably arising to defend existing beliefs and practices. As such, change threatens established organizational privileges and social position within the organizational field.

Implementing change within existing institutions is challenging by which institutional entrepreneurs are challenged to envision the divergent change and mobilize allies in support of its implementation. This entails “loosening” the institutional embeddedness and counter political opposition.

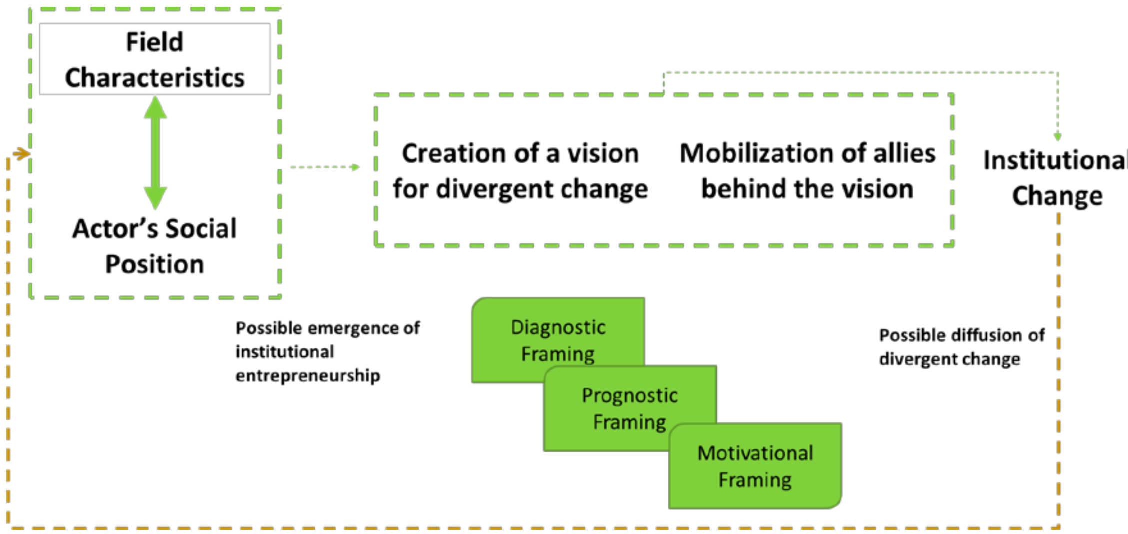
This brings us to another process element, upon which given the differences in business environment, governance structure, and culture, the considerable experience accumulated in innovation policies and their implementation in developed countries may not be applicable in all countries. (Rothwell, 1989)

In other words, a business environment conducive to entrepreneurship and enterprise creation should be ensured by pertinent policies. By doing so, innovative young firms will be granted the capacity to expand given that mutually reinforcing and supportive policies need to be extensively revised across the economy since any lack of attention might adversely impinge on potential entrepreneurs and SMEs. When we talk policies, we are referring to sound fiscal and monetary policies, a basis for a stable macroeconomic environment. These should include structural policies that determine the overall economic framework. Once developed and articulated, institutional entrepreneurs must convince existing institutions of the need for the change and mobilize them behind it. This requires meticulous communication skills delivering a vision in a smart manner.

Apart from the above, research has shown the importance of institutional entrepreneurship's social position not only to initiate, but also to promote divergent change. Social position, hence, can facilitate mobilizing allies for implementing divergent change. According to Maguire et al. (2004), formal authority can help institutional entrepreneurs legitimize divergent ideas, frame stories (Fligstein, 2001), and promote acknowledgment and "consumption" of […] discourse by other actors (Phillips, Lawrence, & Hardy, 2004).

Up until now, we have defined institutional entrepreneurship as one variable, yet Eisenstadt (1980, p. 848) has proposed that institutional entrepreneurs are one variable, among a "constellation" of others, relevant to the process of social change. Building on DiMaggio's (1988) definition and subsequent studies of institutional entrepreneurship, it is argued that institutional entrepreneurs are change agents, but not all change agents are institutional entrepreneurs. Hence, [institutional entrepreneurs] must fulfill two conditions to fulfill their role in divergent change. First by initiating this change and second by actively participating in implementing it. (Battilana, Leca and Boxenbaura (2009)

As we emphasized earlier, some important questions remain to be answered, and our analysis thus far has yielded a contingency model of institutional entrepreneurship created by Battilana, Leca and Boxenbaura (2009) - showcased below – illustrating how field characteristics and actors' social position enable the possible emergence of institutional entrepreneurship, a step into engaging in the implementation of divergent change.



Model of the Process of Institutional Entrepreneurship

In spite of the above created contingency model, research studies have went more in depth beyond provision of the framework conditions influencing the business environment.

Per se, governments need to address policy and market failures that dampen entrepreneurial activity and limit the growth scope for innovative small firms by introducing programmes and support policies systematically designed and implemented at the local level.

If we want to take the Arab region in general and the Lebanese context in specific, according to an article published on the Stanford Innovation Journal, the flourishing of social entrepreneurship (SE) seems to be an epiphenomenon of the Arab uprisings, […] embolden[ing] young creative minds in remote areas. […] [R]evolutions in the MENA region often expanded from provincial areas that were and still are suffering from persistent social and economic grievances. In the aftermath, countries such as Tunisia, Yemen, Libya, Iraq and Lebanon [have gone] through a critical political transition. In this phase, political players home[d] in on political reform and institution building, yet neglect[ed] marginalized populations in rural areas and suburbs. These areas on the periphery [were] left with escalation of socio-economic inequalities (Doumit, 2015).

Hence, [institutional innovation] should be viewed as a way to bridge the destabilizing and gaping chasm between the political elite and marginalized citizens (Doumit, 2015).

Summing up, the last several decades have been marked by an increasing pace of change, disruption, and uncertainty driven primarily by the rapid proliferation of new digital infrastructures and the global shift toward liberal economic policy. The effects of these two trends have amplified the mismatch between scalable efficiency and the business needs of today's companies.

Today, exponential technology advancements are driving deep and fundamental shifts in the business landscape, making organizations struggle to keep up with rapid changes in infrastructure and consumer practices. Institutional innovation—"redefining the rationale for institutions and developing new relationship architectures within and across institutions to break existing performance trade-offs and expand the realm of what is possible" re-architected institutions in such a way to scale learning, to become more adept at generating richer innovations at other levels, including products, services, business models, and management systems. (Hagel & Brown, 2013)

Circular 331

In line with the above mentioned advances and pursuant to Basic Decisions No 6116 and No 6938 and their amendments on March 7, 1996 and March 25, 1998 respectively relating to facilities that may be granted by BDL to banks and financial institutions and capital banks, Circular 331 took effect upon the meeting of the Central Council of BDL in Lebanon on August 21, 2013, upon which:

- Facilities may be granted to a company or companies defined as:
    - Start-up companies
    - Incubators and accelerators whose objects are restricted to support the development, success and growth of startup companies in Lebanon
    - Companies whose objects are restricted to investing venture capital in startup companies in Lebanon […] especially upon the transfer of their participation in such companies
- Banks may benefit from interest-free facilities granted for a maximum period of seven years for their participation at their full responsibility in the capital of companies.

Here then, we have reached an important turning point whereby the traditional model of "punctuated equilibrium" in which companies move from one stable state to another is dead, and companies need to adopt a state of "continually becoming" to keep up with rapid changes in the environment.

In theory, […] not all institutions are economically equally significant or are in fact easily observed even if they lead to Pareto improvements (Elster, 1989) nor persist in the same time length. Further, costs and benefits of institutions are not usually amenable to a clear separation (Oberschall and Leifer, 1986)

Hence, the presence of multiple institutional orders or alternatives constitutes an opportunity for […] institutional entrepreneurship (Clemens & Cook, 1999; Sewell, 1992). The heterogeneity of institutional arrangements in a field, that is, the variance in the characteristics of different institutional arrangements, is thus an enabling condition for institutional entrepreneurship. Formal institutions on the other hand are more susceptible to institutional failures and inefficiencies, not least because of enforcement problems. Yet there is more to the story. (Ozcan, 2004)

In this paper, we pursue to delve into the above depicted notion on institutional innovation with the objective of developing and advancing a process model on who, how and why institutional changes have contributed to the social construction and maintenance of core practices in terms of lending practices in Lebanon.

CHAPTER III

RESEARCH DESIGN AND METHODS

In this chapter, I will discuss the research design and approach employed for my research subjects followed by a detailed portrayal of how and why I chose focused semi-structured interview protocol to collect data.

3.1 Research Design

This paper is an exploratory research study targeting institutional innovation in the Lebanese context undergone on SME lending practices via the role of Kafalat. My research design follows the approach of inductive reasoning. In simple words, we shall focus on institutional innovation and the processes of changes of SME financing in terms of who, how and why these changes have come about in the Lebanese context.

I believe inductive reasoning or a bottom-up approach is suited to an exploratory research study. In the section below, I provide more detail on how I intend to approach my research.

3.2 Research Approach

Because of our focus on SME lending and institutional innovation, I have decided to adopt conversational interview techniques. A face-to-face semi-structured questionnaire was designed for Kafalat, stakeholders and beneficiary SMEs. Also, data on Kafalat operations will be gathered from Kafalat sources and its official website.

The interview output will be examined and analyzed to see what commonalities and differences exist across different players' perspectives in the ecosystem. Furthermore, the data will be examined to understand the role of institutional innovation in the lending context. This analysis shall guide us to set the foundation for future theory building which will hopefully introduce the concept of institutional innovation in the context of the upcoming equity financing.

3.3 Research Subjects

Interviewees chosen for this study had to cover Kafalat as the center of our focus, other stakeholders including banks and beneficiaries covering SMEs.

Furthermore, I had to ensure that my sample is representative enough, by covering the different stages of growth of Kafalat to grasp a somewhat concrete view on Kafalat's role in the industry; otherwise results would have been less relevant.

SME coverage had to pertain to different sectors served by Kafalat (Agriculture, Tourism, Technology and Industry) across different geographical regions given the varying degrees of literacy and awareness in the various cultures in the regions (Beirut, Mount Lebanon, South, etc…)

3.4 Research Instrument

As mentioned previously, I will obtain data on the operations of Kafalat, i.e. its programs and loans through data from Kafalat sources and others.

However, the empirical analysis will be mainly focused on performing interviews. The research instrument is a questionnaire composed of around 20 sequential questions designed to extract the process model of institutional changes, specific elements of traditional process of institutional entrepreneurship, why and who engaged in specific processes of institutional entrepreneurship and the role of context during the inception and evolution of Kafalat.

The questionnaire was conducted via a focused semi-structured interview encouraging two-way communication whilst providing the interviewee the freedom to express one's views. The interviews lasted approximately an hour to acquire deeper understanding of the interviewee's perspectives.

3.5 Data Analysis Protocol

Qualitative data collected from interviews will be analyzed with the aim of better understanding the process model supposed to enable the institutional changes' emergence that is enabled by institutional entrepreneurship via the existing theories. Finally, I would offer a tentative hypothesis for further developing and advancing a framework on institutional innovation.

CHAPTER IV

CASE STUDIES

4.1 Kafalat Interview

In essence, in Lebanon, in the past decades, there were two forms of financing – family owned financing and bank financing.

In an interview with Dr. Khater Abi Habib, Chairman of the Board of Directors at Kafalat s.a.l., we discussed the reasons for introducing Kafalat in Lebanon (inception, mission, vision, evolution) and assessed the ecosystem resulting in transforming the lending practices of SMEs in Lebanon covering the process elements and the role of the Lebanese context in this transformation.

Kafalat Concept Overview

In the late 1990s, banks were already there and were financing the kind of people whom [Kafalat institutional actors] wanted to expand financing to, but they perceived that there was a certain inefficiency in the market which led to weaker financing than was potentially available. Lebanese banks did have the extra resources to expand their portfolio in all directions, yet in fact there were not enough businesses really to absorb the entirely available deposits being legitimate within prudence and normal banking formulas available for financing.

The inefficiencies pointed at earlier were related to cultural settings as well as historical experiences. The war was an important phase in that direction because during the war, credit in Lebanese banks did something brilliant: It survived! It survived by using the kind of prudence emanating from their reading of the risks inherent in the country.

So, upon this, three tendencies were detected in the behavior of banks:

1. Banks tended to concentrate their financing in areas of the country where they thought there were still be a semblance of order –using assets as guarantees which they thought will always have some value. Credit became highly centralized in Beirut and close by Mount Lebanon taking around 90% of the entire volume in 1992. >> Kafalat wanted to partly rectify that.
2. Banks tended to concentrate on people who had very clear guarantees such as real estate guarantees in central areas and if they had pedigree – i.e. well known in the business for a good while or had antecedence in the business. Banks tended to service them much more quickly than if they were a start-up especially if they didn't have pedigree.
3. Banks perceived that risk was related to time which was true because things shifted so quickly from one atmosphere / area to the other. Banks then tended to favor short-term loans even though they will give ongoing line of credit. They favored short-cycle-serviced loans covering mainly commerce and trade and immediate services where the cash cycle was short denying the opportunity to other sectors such as agricultural industry, tourist projects, etc… which were longer term investment and required a much longer cash cycle.

Assessing the ecosystem

The banking atmosphere was feeling this inefficiency. Statistically speaking as of 1998, around 92% of lending was concentrated in the central areas of the country – it was flagrant and this was not intended – the banks would say: how am I going to lend in far areas if the Central Administration of Statistics couldn't access the areas in the first place (south, north and Bekaa mainly)?. All banks genuinely felt the need– some wanted it positively and some were ashamed into it.

As such, a committee was formed to discuss these inefficiencies including Dr. Abi Habib being Head of National Deposit of Guarantees which was to contribute to the core capital at the time alongside representatives of Association of Banks and a deputy governor from the Central Bank of Lebanon.

There was a suggestion, taking into account international models, starting with a study of the status quo taking into consideration the socio economic cultural conditions, sectorial tendencies and geographic and social constraints on which people perceived the business.

Another perspective was taken in the study covering the relationships in the field of financing (at that time, there was no equity funds nor investment banks especially at that level) – it was only commercial banks and their clients and the regulatory process and the comparative advantages and disadvantages of the country.

A third perspective was taking the international models into account (e.g Catalan, Lumbardia, Finnish, Austrians, French, American SBA, etc…) keeping in mind the gaps to adapt to local conditions.

As a result, the study was supported with a deeply governed atmosphere. The moment the program came into place, it had to pass through the Parliament since the National Guarantee of Deposits had no right to invest in financial companies.

Once passed, the Central Bank extended the benefits to subsidized loans so they first gave 60% exemption from statutory reserves (banks could use 60% of the loan from statuary reserved with yield 0%) which reduced the loan cost and then the government passed a rule to give subsidies setting the level at 7% initially with a loan ceiling high enough to make the loan with an interest of 0%; the subsidy level was later reduced to 4.5% to make loans favored but not as massively. The atmosphere was even more rushing than somebody who really favored the matter.

At that time, banks were expanding and Kafalat came alongside the banks without using up their equity to maintain their ratios for the equity resources. Kafalat observed BASEL Accord ratios at the time; BASEL Accord required 8% in equity and one would leverage 12 and a quarter times rather than 12 and a half times. Kafalat decided to leverage only 6.5 times being aware that equity requirements will be raised to 12%. In this way the company was going to operate on the basis of 6.5 times only requiring 16.25% of equity versus risk so that everybody would feel that Kafalat guarantee is a real reliable, irrevocable unquestionable guarantee since once the guarantee is questionable then it would be a weaker motivator.

In effect, Kafalat was helping to expand the market.

Kafalat Mission, Vision & Growth

Kafalat came in with a high order guarantee with a solid background support in the form of substantial equity and with reputable partners (the banks themselves and the Guarantee of Deposits). Together, they shortened the gap between borrowers in the further borders of the country and those centered in the center or suburbs.

Since the guarantee was for a long period, it also tended to reduce the notion of risk perceived between the medium and long run on one hand and on the short on the other hand. This would work for the sectors which were thought to be not efficiently served. This attempt also narrowed the distance; though not entirely between, those who had good personal guarantees or real estate guarantees and / or who had pedigree and reputation in the business versus the new entrants.

This did not close the gap but narrowed it considerably, so all people would have a better chance than before, obviously creating better opportunities for gaining finance for essential geographies, sectors and elements of the population who had been disfavored in a serious way before while now they had a better chance. In effect, it would increase the chances of things happening in the country which would not have happened otherwise; especially it would have attracted talent which was disfavored by lack of financing.

In essence, the banks used Kafalat guarantees to enter further in places where they had reluctance before – they now rectified their direction in the market which remained less efficient.

Kafalat went aggressively in areas where banks had little or no experience about and couldn't gain experience as well and as such Kafalat across time created programme such as Kafalat Innovation which is tailor-made for startups in technology – a relatively new field to finance with loans in the world at large. It is to be noted that some of the best financing doesn't come from banks – it comes from equity which is what the country is moving into now and when Kafalat gave a guarantee of 90% with very small emphasis on personal contribution from the entrepreneurs (many are young and fresh) – it was the best alternative but not the best solution in the absence of seed and early venture capital with Kafalat Innovation and Plus. It was not just Kafalat, but the country as a whole that experienced the absence of very early equity. Kafalat shortened the gap with its programmes, but didn't close it.

Now with Circular 331, the system is converging from the other side and bringing ample equity sources.

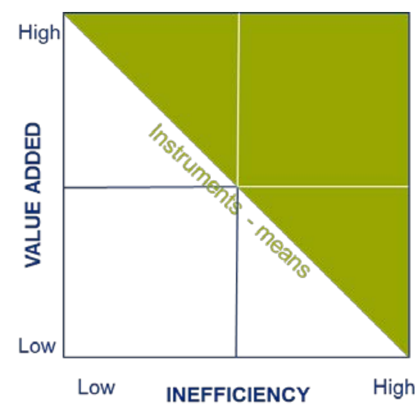
Once Kafalat Innovation started, soon after there was – although not vast - equity financing – loans were still highly needed. Now, with the promise of more seed equity, the market will be perfectly balanced and the better solution will be in place providing the best needed solution.

Kafalat: Mission

Kafalat's mission was and is still to motivate banks to shift more of their resources to sectors, geographies and categories of people for which there is an inefficient market in financing due to lack of interaction, lack of knowledge of circumstances, and lack of administrative presence of a sufficient caliber to cover the necessary supply. So, when the presence of the guarantee is well managed one tends to reduce that inefficiency in the market towards whatever sector or geography one is aiming at.

Kafalat: Vision

Kafalat's vision is to look at the country as a layered matrix – 3d matrix whereby you look at the country as geography and as economic sectors in terms of highest value added prospects (competitive advantage) in a set order and then you look at how inefficient or efficient is the market for different segments in the geography, and for sectors, and in subsectors. Once you spot high inefficiency and the highest competitive advantage – economic value added prospects – you target that quartile (division) of the matrix as your order of attack number one and you scale down.



Kafalat's Efficiency Matrix

Sometimes you will have a segment where you have highest inefficiency and highest comparative advantage and financing but you don't have the ready instruments for it, then you would delay intervention even though it has the conceptually first order of priority and move to the next one. Thus, you move to the first one where you have the means to attack the inefficiency.

Kafalat: Growth

In not a such highly ordered fashion but with the perspective of Kafalat's mission and vision, Kafalat started with Kafalat Basic and then had another programme for small loans (Kafalat Delegation) to make it easier for banks. Afterwards, there was Kafalat Plus which aimed at making companies seeking to have more financing to go more formal and at the same time not requiring a collateral so that more equity in the company is kept in a formal sense hence pushing towards transparency. Therefore, "from a bigger population they started taking targets useful for equity financing…probably one day pushing towards the stock exchange!"

Another attempt was Kafalat Innovation favoring innovation in the absence of seed capital with every early venture capital at any scale to reach the whole country. A guarantee of 90% was given - a must-have when it comes to innovation in a startup.

Kafalat also realized the tree sector was badly damaged during the war (high mountains, cultivation...). This required a different approach with higher loan tenure and grace period. Hence, Kafalat started a programme in collaboration with EU.

Need for Kafalat

Kafalat successes might show in the future that there is no need to operate in the center of the country and shift the focus on high-tech in the peripheries of the country where there is no sufficient level of high-tech penetration. The goal will always be addressing market inefficiencies in a certain sector or quadrangle of the economy.

A guarantee is a very good way of handling these things. It is a very supple instrument and you can use limited resources / human power to move many more resources from the existing financial system because the guarantee gives that extra push.

Equity Financing – an addition - was an area of weakness given that the technique of equity financing started to be used in late 70s and became very fashionable first in California in 80s – mid 90s and then throughout the advanced world. Now, Lebanon is 10-15 years behind but at least it is growing organically. Some Arab countries had many more resources and more funds but they move very slowly while here in Lebanon you can find funds emerging in a fairly organic way because the awareness of the need is there – there are no inhibitions. The presence as Kafalat is going to be in the field - privately run with a public aspect in the hope of supporting the atmosphere that is emerging at quite a scale.

With more equity around, equity will be leveraged with a Kafalat program motivating equity shareholders hence increasing the capacity of the money pushing new participants with new experiences to bring in more intelligent money.

Money in essence is inert. With equity financing, the money is coming with more intelligence.

Without Kafalat around, there would have been some other program and using the concept of guarantee was a very efficient way given the limited resources but it is not the only way – there would have been some other solution – another source of guarantee (not that easy) since at that point in time the relationship between the bank and Guarantee of Deposits was leveraged else it would have been a more difficult task.

If Kafalat were not be incepted then, there would have been a delay denying the Lebanese economy some level of innovations.

Circular 331

Focusing on Circular 331, Kafalat always felt that there was the need for equity, and the Central Bank and government approached them and suggested a co-equity program to seed capital given the shortage in growth capita especially for companies who wanted to go regional or international. Now Kafalat will be redesigning it especially that in the meantime the Central Bank had come up with 331.

Kafalat will be shifting towards seed capital and early venture to push as many of the funds to keep at least one rump of the funds for that, as well as encourage new entrants to the seed capital field especially for companies who have only a couple of millions and therefore when the entries are doubled, they will have twice as many investments hence reducing the risk not by 50% but by substantially more.

Alongside Kafalat there is one more co-equity fund – Berytech – which guarantees seed equity in a moderate way – they will both cooperate on same investments with more intellectual resources for the matter so the resources will be employed for a better effect and later there will be new entrants – addressing issues in the matrix.

Summing up, in 1999, the law was passed and Kafalat started operating in June 2000. In terms of volume, the maximum was reached between 2010 and 2011. The Syrian crisis and its ramifications in Lebanon started biting and since 2011, Kafalat figures have been declining substantially. In the meantime, however, the atmosphere has also changed and now Kafalat is having another wing – an equity wing – which will help in addressing in the best way related to economic activity and the vision that people have of future prospects. However, there were a few months of respite and then the figures started climbing last spring into early summer but then the military prospects became much tougher so the figures started suffering again.

Hence, Kafalat's role is to make people work more and invest more than if there was no guarantee. When times are better Kafalat accelerates and when the circumstances are very tough it decelerates. You have to follow the economic conceptual analytic dimension of ceterus paribus - other things being equal we maintain the decline smartly.

In Kafalat's case, things were extreme – it is circumstantial and related to reality yet all countries are shifting towards cooperatives or repositories for SMEs – a level at which you might not guarantee but support shall be gained in some way because of the excesses of the financial boom.

By the mere existence of SMEs, things are solved yet other things being equal and removing the guarantee, banks might eliminate some loans given. With the presence of the guarantee, banks are more able to give the loans and if absent, banks might go back to shorter lending practices. The exercise is still needed and useful but that doesn't mean it will remain forever.

4.2 Bank Interviews

Kafalat Concept Overview

According to (**Bank A**) **Bechara Nader, Head of SMEs at Bank Audi**, in 1996, there was the emergence of the subsidized loans yet given the war effect and high volume of transactions, SMEs came at a second level of priority. The first move through BDL to give incentives to the economy was to support the reconstruction policy سياسة إعادة الإعمار

Around 2000, Kafalat came into the picture. At that time, the concept was immediately apprehended with a positive impact. Bank guarantees were issued (cash coupled with a subsidy) limited to $200,000. Banks started to lend the customers (not necessarily SMEs) and treat them as SMEs upon eligibility as long as they fall under the criteria of having less than 40 employees. The trend of huge investments augmented and banks started receiving customers and projects.

After 2008, there was money inflow and banks started to be over-liquid while economically speaking, the country was deteriorating due to political issues and the regional turmoil spillover. The only positive effect was the increase in money inflow. However, over-liquidity meant higher costs thus enforcing banks to start looking for smaller projects, i.e. SMEs. New projects at Kafalat with EU collaboration, and projects with innovation were introduced upon which banks were not used to have shifted the focus to SMEs. This was a cyclical flow.

According to (**Bank C**) **Antoine Zarifeh, Head of SMEs at Fransabank**, he believes that what was missing prior to Kafalat inception was the banks' appetite – they were risk averse to certain markets especially with small monetary figures. Kafalat,with its guarantee, encouraged the banks to enter into such disfavored sectors. On the other hand, banks mentality were not that aggressive towards these markets. Kafalat came into the picture to complement the role of banks in the financial sector in general and in the SME sector in specific. Entering new fields that banks were busy from (banks cared about million-dollar projects more) proved that Kafalat came as a right decision to be a backbone for banks to support SMEs.

According to (**Bank B**) **Georgina Dinar, Head of SMEs at Byblos Bank**, 80% of Lebanese market is formed of small individual companies strong in commercial and business but the legal aspect of such companies was weak / cannot grow and don't have access to lending. Banks at that time were resistant to take risk with these companies because there was no future view. Hence, banks needed a company such as Kafalat as a mediator.

Kafalat told banks that this will give them the confidence into the productive sectors. It removed the taboo and shared the risk to encourage these sectors to have access to lending facilities and to grow.

Kafalat being a private company shows however that a country as Lebanon should have taken this initiative but Kafalat was able to (with its partnerships) to succeed. It helped a lot of SMEs to grow and change the mentality of SMEs / family businesses whereby a small "dekkan" turned into a bigger one encouraging the productive sector. In other words, Kafalat was a booster. It gave access to facilities for existing companies and startups and prospects opening the market for new sectors and ideas.

Kafalat SWOT Analysis

According to (**Bank A**) **Bechara Nader, Head of SMEs at Bank Audi**, Kafalat is the typical entity in Middle East that doesn't lose money. Its goal is not making money, nor is it losing or going bankrupt as this might reflect badly on the economy as a whole and on SMEs in specific.

So, up until today, Kafalat has been able to stay intact. However, what helped was that banks have shares in Kafalat (around 25%).

As for (**Bank C**) **Antoine Zarifeh, Head of SMEs at Fransabank**'s perspective, weaknesses were not occurring in Kafalat upon inception, but during evolution two weaknesses emerged:

1. Loan Processing: Time to review the file (from both bank and Kafalat perspective)
2. Banks' Perspective >> increase of default and the claim to be asked from Kafalat takes time

This has affected the approach of banks dealing with Kafalat. Yet, still Kafalat is one of the best ever created concepts in the commercial lending in Lebanon. It fostered the ecosystem in a sense that Kafalat was on top of mind regardless of the eligibility of any applicant.

According to (**Bank B**) **Georgina Dinar, Head of SMEs at Byblos Bank**, there are no weaknesses yet there are lessons learned. Kafalat Basic was the first program and it was a success but it was basic as in limited in its funds. After raising the ceiling with Kafalat Plus in collaboration with EU – the main condition was not to have guarantees. Kafalat didn't go wrong but Kafalat Plus had a high amount and the condition was that the applicant should be a company. Hence, there were new entrants in the market who were not involved in the domain with no correlation between the parties who initiated the company to benefit from Kafalat Plus programme and entering into a big project. Here banks and Kafalat witnessed a failure where they reached a point to recourse with no assets backing it up. Hence, there should be exchange of information and experience between banks and Kafalat.

Another lesson learned is the types of sectors covered such as raising cattle. It is a very hard sector especially in Lebanon as there are no laws / regulations to comfort the banks – i.e. no legal management nor control – low cultural awareness around these sectors. Banks, hence, lowered the focus on such sectors.

Regardless, Kafalat did bring banks closer to the people and sectors. It helped expanding into regions. Kafalat is an excellent product with lots of success stories. Kafalat came with a positive impact since there was thirst in the regions for lending and facilities. Kafalat went to the heart of the gap by targeting needy people all around; it created markets that banks wouldn't have considered. Upon Kafalat's inception, banks changed its structure opening regional offices in attempt to maintain continuous follow-up with the SMEs.

In sum, Kafalat lowered the costs and facilitated lending to startups. Role of the Central Banks being the supporting party has strengthened Kafalat and this proves how much Kafalat is indispensable and successful.

Kafalat Challenges

According to (**Bank A**) **Bechara Nader, Head of SMEs at Bank Audi**, the problem in our country is that it is always seeking to reinvent the wheel and not build upon the previous accomplishments. The process of lending should instead involve investment and financial institutions + government + country policy (Environment / Infrastructure / Regulations). Once this 360 view is complete, banks and Kafalat will adjust to the new equity financing concept.

According to (**Bank C**) **Antoine Zarifeh, Head of SMEs at Fransabank**, he considers that the success lied in banks accepting the proposal and moving the concept into success believing in the sectors. Kafalat needed to prove that its proposed project will do well for the economy. Honesty and transparency are the main challenges per se. Hence, it is a 360 view (trust among all parties). Let’s take now for example, there is recession and people are afraid of investing. Supply is very high compared to demand and the concept can work in any other country but in Lebanon specifically, the banking sector is still more conservative and more stable.

As for (**Bank B**) **Georgina Dinar, Head of SMEs at Byblos Bank**, follow-up is critical and the country is not stable especially projects targeting sectors directly related with the country’s situation and stability. So what if the project didn’t succeed?

Hence, we are faced with three challenges:

1. **Maintaining the continuity of the project**

This is a problem for the lender (bank), project owner and Kafalat (guarantee) >> loss of trust covering the 5C’s around which the bank lends.

2. **Project Profitability**

In essence, the applicant is not risky, yet down payment and loan schedule are.

3. **Fear from “prostituting” the project**

Since the loan is subsidized with no interest, then the role of the banks is to study the file initially considering Kafalat guarantee as a second way out; i.e. the first way out is the project itself i.e. the SME. Many apply for the loan and they are not experts in the field, hence they seek to use the program to their own benefits.

Therefore, the main challenge is the aspect of lending. Once SMEs are affected, the loan defaults and the client is identified as a bad payer hence recourse on Kafalat guarantee. The bank can't always rely on the guarantee else Kafalat will fall.

Kafalat Mission, Vision and Growth

According to (**Bank C**) **Antoine Zarifeh, Head of SMEs at Fransabank**, Kafalat's mission is to tackle everyone in Lebanon with no prejudice nor constraints on any perspective. As for its vision, then Kafalat is viewed to alleviate poverty through financing served on the right track.

According to (**Bank B**) **Georgina Dinar, Head of SMEs at Byblos Bank**, Kafalat's mission was well-served. As for its vision, given equity financing, Kafalat was not found to die – it is a success story and all businesses who started small with Kafalat will surely always stay with Kafalat. There are always opportunities and the market is thirsty for lots of sectors served by Kafalat.

On a side note, the new circular is complimentary. All what Kafalat needs to do is to be re-defined across ministries especially agriculture, tourism and industry who need to enhance their role in the continuity of Kafalat coupled with revision of the laws and regulations and raising awareness.

(**Bank B**) Byblos, for example did workshops and agreements with different sectors with access to financing to bring literacy to such sectors.

Kafalat: Growth

According to (**Bank A**) **Bechara Nader, Head of SMEs at Bank Audi**, growth in Kafalat peaked after 2008. Now with the current situation (economic, political…), once affected everything is affected. Banks are still conservative however. They do create products to fit SME requirements (scoring, financing, way out...) with and without Kafalat (Guarantee + Subsidy)

According to (**Bank C**) **Antoine Zarifeh, Head of SMEs at Fransabank**, Kafalat is not on the downside so there is no peak, yet the sharpness of the slope differs. Only if regulations are easier, then Kafalat would have been more flexible. Kafalat could have been better if it were to serve more sectors – those not subsidized and need high volumes (e.g. hospitalization sectors, clinics…) (e.g. Agriculture was very good) so it should learn from experience. If there were no Kafalat, we would have suffered from ever ongoing limitation of investment in the market.

According to (**Bank B**) **Georgina Dinar, Head of SMEs at Byblos Bank**, each product has a lifecycle and same goes for Kafalat, it is now at its peak going down – not because it's weaker or it failed – yet it is the trend. However, it is not an extreme downward slope, as in it is still early for maturity and death – it shouldn't be before 10 years unless it does a breakthrough change through its lessons learned probably via serving new sectors such as energy. There will always be something new for Kafalat. Constant innovation is essential serving the new to tap sectors in the market. However, this doesn't cancel the thought that with or without Kafalat we would lend SMEs in different sectors yet with varying degrees of risk.

Kafalat in the Lebanese Context

According to (**Bank A**) **Bechara Nader, Head of SMEs at Bank Audi**, if the process is fit in collaboration with those overseeing the funds (similar to banks), then it will succeed anywhere. But, if banks are not involved in this process with it overseeing the investments combined with the relevant regulations then it won't succeed.

According to (**Bank B**) **Georgina Dinar, Head of SMEs at Byblos Bank**, Kafalat would have worked easier outside Lebanon yet the banks' strengths made it stronger in Lebanon and the supporting policies of Central Bank of Lebanon and the supervision along with the continuous follow-up on SMEs from Kafalat, and banks (financials, site visits, etc...) also boosted its role.

Outside Lebanon, it would have been harder if there were no support given the infrastructure of the banks and experiences. In other words, we can shift Kafalat as a second success story to regional countries.

Need for Kafalat

According to (**Bank A**) **Bechara Nader, Head of SMEs at Bank Audi**, Lebanon does have negative things in the country, yet it does have positive aspects as well. The Lebanese person is innovative by nature and with involvement of private and financial sectors, then definitely something would have come up and because Lebanon is open because of languages, geographies and contacts, programmes would have occurred sooner or later. But, definitely given Kafalat, it facilitated a lot – especially that it is 100% in-house.

According to (**Bank B**) **Georgina Dinar, Head of SMEs at Byblos Bank**, if there were no Kafalat, there would have been lack in lending to individuals especially in the sectors covered by Kafalat. If it were to be covered, it would be at a slower pace. An alternative would have been that many sectors would have gone extinct and mentality wouldn't have expanded much given the risk level. Therefore, lower SME lending volumes would be faced with higher risk sectors. Banks cannot take the role of Kafalat and neither can Kafalat take the role of banks.

Circular 331

According to (**Bank A**) **Bechara Nader, Head of SMEs at Bank Audi**, the new circular 331 is a positive start. For an economy generating 50 billion in loans, this circular should not be limited to the knowledge sector since the country is in need of equity.

However, how will it be formulated vis-à-vis the commercial banks is an issue that remains to be tackled. There are some prospects, however, that can be beneficial especially that Lebanon is saturated with loans.

Although, Kafalat initially created a fund so that it can indulge with this circular, yet equity financing should go in parallel with Kafalat. If we talk equity, then we are talking about investors whose goal is profits. An investor doesn't care about the economy as much as he focuses on increasing profits.

So, Circular 331 is good for taking decisions yet this doesn’t persuade startups or innovative entrepreneurs to seek investment especially if the investor doesn’t know about the business.

Therefore, Kafalat should take part in this because the investor would be rest assured that any financial institution (equity taking part) coupled with the country policies (monetary and fiscal) would fit the current procedure.

According to (**Bank C**) **Antoine Zarifeh, Head of SMEs at Fransabank**, Circular 331 will not affect Kafalat nor compete. He is not sure if banks will be that interested in the projects especially if they are small projects. Circular 331 serves different target segments and different approaches from bank’s perspective.

A few projects were seen under Circular 331, but they didn’t have the same outburst as Kafalat. The exit strategy is after 7 years but how? Kafalat Innovative is a better loan than $100,000 equity. Hence, we can say that 331 does complement with Kafalat only on small scales.

Before inception, banks acknowledged the need to operate similarly to lend to retail. SMEs had a small portfolio but not to be categorized. Now after 2000, SMEs have been identified and Kafalat boosted it up due to diversification of risk. In essence, banks don’t care which product is being granted– they all roll around the same spread versus Kafalat and subsidy loans.

According to (**Bank B**) **Georgina Dinar, Head of SMEs at Byblos Bank**, under this circular, companies are the target. It has a positive impact on SMEs since banks will be partners with them. However, it only compliments to Kafalat. Banks will only get involved if projects have a solid background and minimal risk, i.e. not someone new!! Experience is essential. In this case, in a nutshell, Kafalat moved the economic cycle. Banks couldn't stay with merchants and big businesses. Kafalat has broken the chains and hovered across regions.

4.3 SME Interviews

Kafalat Concept Overview

According to (**Tourism SME**) **Sami Hochar, CEO of Catertainment**, banks are very tough in Lebanon especially when it comes to SME lending. In Lebanon, one has to beg to take a loan and it takes a lot of time – it is tough especially if the applicant is young and doesn't have any collaterals. Before Kafalat, it was a real hassle to establish a startup especially if one didn't belong to a certain social level. Parents' mentality and culture at that time wouldn't believe in an avant-garde idea. So, Kafalat came to break this – it gave a push to proactive people with a vision to be able to start their own business. "Shops, restaurants, resorts, touristic logistics – all are a result of Kafalat – it boosted the economy".

According to (**Industry / Agriculture SME**) **Imad Safieddine, Owner of Safieddine Group**, the importance of Kafalat lies in small loans for the young and startups (farmers and industrialists). To them, the problem lies in banks – no control of Kafalat over the banks dealing with SME clients - it is very complicated process. An SME client would go through the same procedures as any other commercial loan however the processing time with Kafalat is faster / easier.

As for (**Advanced Technology SME**) **Spiro Azkoul, EO and Founder at MyTV**, banks are in it for the money. The beauty of Kafalat lies in the low interest rates and opportunity for small injection of capital. There is no stake with Kafalat as the owner of the idea is king!

For (**Agriculture / Traditional SME**) **Youmna Ghrayeb, Founder of Maymouneh**, upon the beginning of Kafalat, there was a need for guarantees and banks needed collateral – Kafalat was there as the support. "Maymouneh" is a new entrant – homemade and healthy foods. In their case, they needed to prepare a long-term feasibility study which Kafalat helped them with and upon realizing profits, they started paying back. It gave them a big opportunity – after 7 years they closed the loan and took another one.

Kafalat SWOT Analysis

When asked to assess Kafalat's strengths and weaknesses, (**Tourism SME**) **Sami Hochar, CEO of Catertainment,** declared that Kafalat's <u>strengths</u> lie in boosting the economy and diversifying the industry (e.g. restaurants) which used to be more of a monopoly. Now, even young people (still at college) lead successful businesses. **It drove the whole economic cycle.** However, Kafalat's <u>weaknesses</u> prevail in guarantees being given to those who are not professionals in the business – technically those who spoiled the system.

As for, (**Industry / Agriculture SME**) **Imad Safieddine, Owner of Safieddine Group**, Kafalat's <u>weaknesses</u> lie in lack of media promotions especially upon inception which gave room for the banks to work out the system to their own benefit. However, without Kafalat, SMEs couldn't have done it and reached this full economic cycle. The positive attribute is that there is no need for balance sheets and financials to be presented given the low literacy within some sectors that are new to the concept of lending in general and Kafalat in specific. Threats, however, lie in banks not being transparent enough and the <u>strengths</u> lie in the guarantees and the subsidy.

(**Advanced Technology SME**) **Spiro Azkoul, EO and Founder at MyTV** claims that Kafalat's <u>weaknesses</u> lie in being very traditional and very non-tech savvy and its challenge reclines on bridging the gap. Despite the above, Kafalat is OK! It is the banks who are old and not fit with innovation.

According to (**Agriculture / Traditional SME**) **Youmna Ghrayeb, Founder of Maymouneh**, banks wouldn't have given them a loan without the guarantee. Kafalat is better because of the low interests. Without Kafalat, projects wouldn't have continued nor grown. The strength lies in the guarantee. To them, there are no <u>weaknesses.</u> On the contrary, Kafalat now is getting bigger because of higher loan ceilings.

Kafalat / SME Challenges

(**Tourism SME**) **Sami Hochar, CEO of Catertainment** perceives that at time of inception, Kafalat couldn't fail **–** it is a very well-structured business plan offering good rates which encouraged SMEs to seek Kafalat even if they have the money. It is easy and especially in Lebanon with all its ups and downs. Nowadays, however, Kafalat is facing some challenges because there are lots of businesses, economic marasm and people not being able to continue in the business. On the other hand, SMEs face more challenges given the economic ups and downs – SMEs cannot grow substantially given the load of overhead management in case of no sales.

According to (**Advanced Technology SME**) **Spiro Azkoul, EO and Founder at MyTV**, Kafalat's challenges lie in that lending companies resemble more "a date" yet investing in them is "marriage" and you will be stuck. Hence, Kafalat is a better option yet it needs to raise the bar for tech support and simplify its processes. However, we need both in the economy.

Kafalat Mission, Vision & Growth

Based on (**Tourism SME**) **Sami Hochar, CEO of Catertainment**, Kafalat under the current situations, doesn't deal with big established companies despite Kafalat Plus and Cash Flow programmes – yet the support is still needed but not found in the full essence – it has a few obstacles. Kafalat should deal more on the professional basis yet should not punish the young startups. It has to encompass more follow-up and more technical overview. Kafalat should go into bigger projects and bigger companies especially with the companies who grew with Kafalat.

As for (**Industry / Agriculture SME**) **Imad Safieddine, Owner of Safieddine Group**, he believes that culture plays a role in growth – awareness, literacy, trust and transparency. Kafalat cannot work on its own – banks should be transparent as they are the ones who need clients. There should be a supervisory committee from Kafalat towards banks. Amend the policies!! However, despite all of this, SMEs do attribute their success to Kafalat.

According to (**Agriculture / Traditional SME**) **Youmna Ghrayeb, Founder of Maymouneh**, Kafalat's Mission was in it being a big help for underserved sectors. As for its vision, Kafalat is indispensable for small projects to grow. It was able to foster the economic cycle. There were no opportunities in remote areas and with Kafalat they were able to give chances to all people especially women in remote areas – in other words Kafalat had a role in women empowerment in those areas.

Kafalat Growth

Based on (**Tourism SME**) **Sami Hochar, CEO of Catertainment**, Kafalat growth will be maintained – Kafalat system is good and it is in a safe economy and growth is safe and healthy. Kafalat is only boosting this and giving the support. There is always room for SMEs yet Kafalat only needs to diversify into more sectors not programs to boost the economy.

Kafalat would work in any ecosystem – its supporting backbone in Lebanon was the need especially after the war. At that time, people were economically weak (there was the rich, small medium class and the poor who wouldn't even think to grown unless they are very proactive). Kafalat came to lessen the gap by giving opportunities. **Imagine Kafalat in Dubai, it would kill!!**

At the end of the day, if there's no Kafalat SMEs would have sought the banking sector and paid high interest rates yet would have been much more cautious and grown at a lower scale. On the other hand, the poor / young guy not trusting the bank would have lost the opportunity. - It is a 360 view!

Kafalat was and is a must for Lebanon! So, a big YES for Kafalat **–** it restarted the economy after the war (downtown didn't exist, Hamra didn't exist… all these hubs didn't exist) **–** it created clusters.

However, as an advice, (**Advanced Technology SME**) **Spiro Azkoul, EO and Founder at MyTV**, believed that Kafalat should be training banks through seminars, conferences, etc…

Given the geopolitical exposure in the ecosystem, (**Agriculture / Traditional SME**) **Youmna Ghrayeb, Founder of Maymouneh** believes that people are less inclined to travel and instead grow SMEs. To encourage them, more information is needed and more awareness should be materialized especially in remote areas. Banks should be encouraged if not forced with new programmes to deal with Kafalat.

Need for Kafalat

According to (**Tourism SME**) **Sami Hochar, CEO of Catertainment,** Kafalat should grow new opportunities. SMEs, avoiding high interests, wouldn't deal with banks so without Kafalat there would have been some obstacles. Also, banks wouldn't have supported SMEs due to the fact that tomorrow's industry is risky!

(**Advanced Technology SME**) **Spiro Azkoul, EO and Founder at MyTV**, on the other hand believes that if there were no Kafalat, the SME would have needed to raise money by losing on its own equity capital. A better solution would be for banks to get rid of the obstacles as they are too traditional and cannot handle the "loud music".

Any country's big economies are defined by its multitude of SMEs, so if there were no Kafalat, the economy wouldn't have been healthy. That was what (**Agriculture / Traditional SME**) **Youmna Ghrayeb, Founder of Maymouneh,** perceives. In other words, there would have been no diversification of power and less vitality. SMEs would have gone extinct!

Circular 331

With the introduction of Circular 331, (**Tourism SME**) **Sami Hochar, CEO of Catertainment** believes that it plays a role similar to Kafalat but cannot be Kafalat. It is a boost for the second phase of the career but it wouldn't replace Kafalat – it is only complimentary. Circular 331 serves those "anti-Kafalat" seeking for profits only.

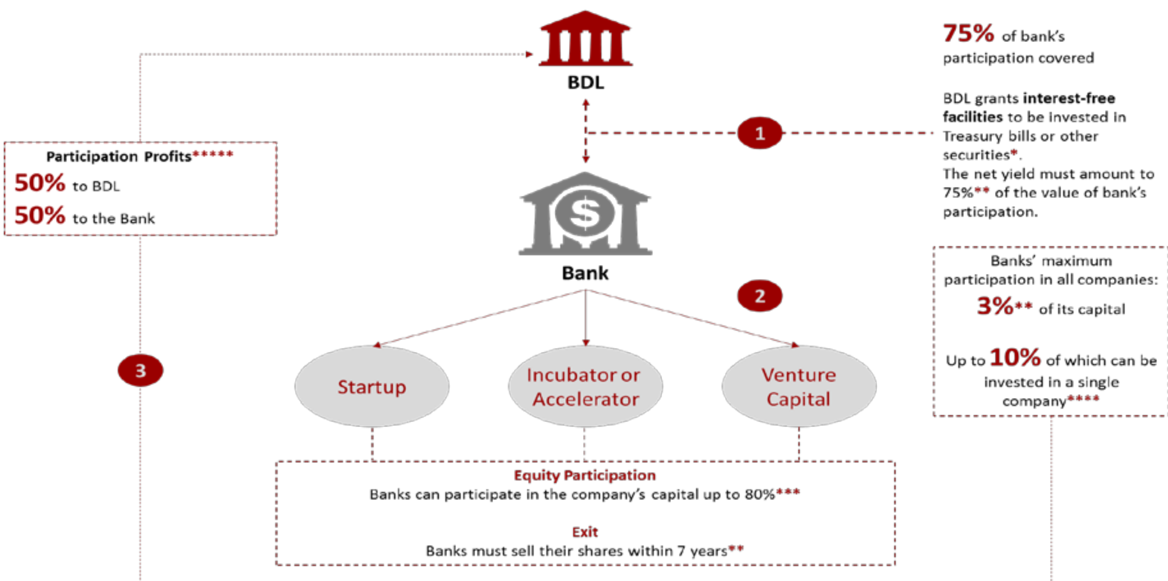
According to (**Industry / Agriculture SME**) **Imad Safieddine, Owner of Safieddine Group**, however, SMEs will continue its growth with or without 331. In his opinion, with Circular 331, banks will ruin it given the innovation and technology introduction. To him, innovation is bigger than banks.

As for, (**Advanced Technology SME**) **Spiro Azkoul, EO and Founder at MyTV,** 331 would be picked by SMEs depending on the amount needed. Kafalat is pertinent for small injection of capital. As a lending tool, it will continue to be successful. According to

Spiro, Lebanon needs both lending and investing. However, to his acuity, lending is more of what companies need because investing strategies in Lebanon are still rudimentary and old-schooled.

4.4 Other Interviews

According to Riad Salame, BDL Governor, a knowledge economy is an economy in which information is invested to create new and improved products and services with a high added value that constitutes a main component of the production process and generation of wealth.



In other words, knowledge economy plays a key role in driving economic growth, creating job opportunities, increasing GDP per capita and ensuing sustainable development.

2As such, as mentioned earlier, BDL issued on August 22, 2013 the Intermediate

[2] *In case no Treasury Bills were issued, investment is then made in other accounts, operations, or securities approved by the BDL Central Council.

Circular 331 with the aim of prompting banks to invest in companies that would enrich the Lebanese national wealth.

The above flow chart showcases the process and conditions for banks' participation in startups, incubators / accelerators, and venture capital companies. It also outlines the facilities that BDL grants to participating banks.

According to Dr. Khater Abi Habib in Lebanon does need more and better venture capitalists and seed capitalists. However, more funds need to be more intelligent in the institutions and in a structured context.

In the past few years, Kafalat was trying to fill the matrix, while other parties also took the initiatives of incubators, namely Berytech, and other associations such as Bader. Now, we have accelerators, incubators, equity funds, etc... in a hope to fill the matrix wholly. If played right, with mutual support, Lebanon will get the right entrepreneurial support for a balanced innovation in the SME sector. "It is not a rushed job and it shouldn't be".

** These limits may be exceeded with the approval of BDL Central Council.
*** This percentage may be exceeded if stock options are granted to the founders of the company.
**** Several banks may participate in the capital of a single company with the approval of BDL Central Council.
***** Intermediate Circular 331 was amended y Intermediate Circular 367 dated August 11, 2014 which provides, inter alia, that the participating bank should receive the profits generated by its own participation before sharing the participation profits equally with BDL.

CHAPTER V

FINDINGS

In order to attend to the research questions presented in the introduction chapter, this section shall cover the (a) process model assessing the strengths and weaknesses of the institutional change tackling the who and why questions; (b) the process elements covering the cognitive / socio-cultural factors contributing to the social construction and maintenance of core practices and (c) the role of context in addressing the divergent change in the institution of SME lending.

5.1 Process Model

By reaching a turning point, presented earlier with the contingency model showcasing the enabling conditions of institutional entrepreneurship (illustrated below), we will build on it to shed light on the notion of institutional innovation within Kafalat and SME lending landscape.

Early studies of institutional entrepreneurship focused on single actor's contribution. Recent studies, however, have attempted to account for […] collective dimension of institutional entrepreneurship (Canales, 2008; Lounsbury & Crumley, 2007; Rao et al., 2000).

Based on Kafalat's perspective, if it were not for the support of the financial centers in Lebanon (Central Bank of Lebanon, National Guarantee of Deposits and banks), it wouldn't have been able to deliver its mission of divergent change and implement it in such a smooth approach with a positive apprehension from all parties.

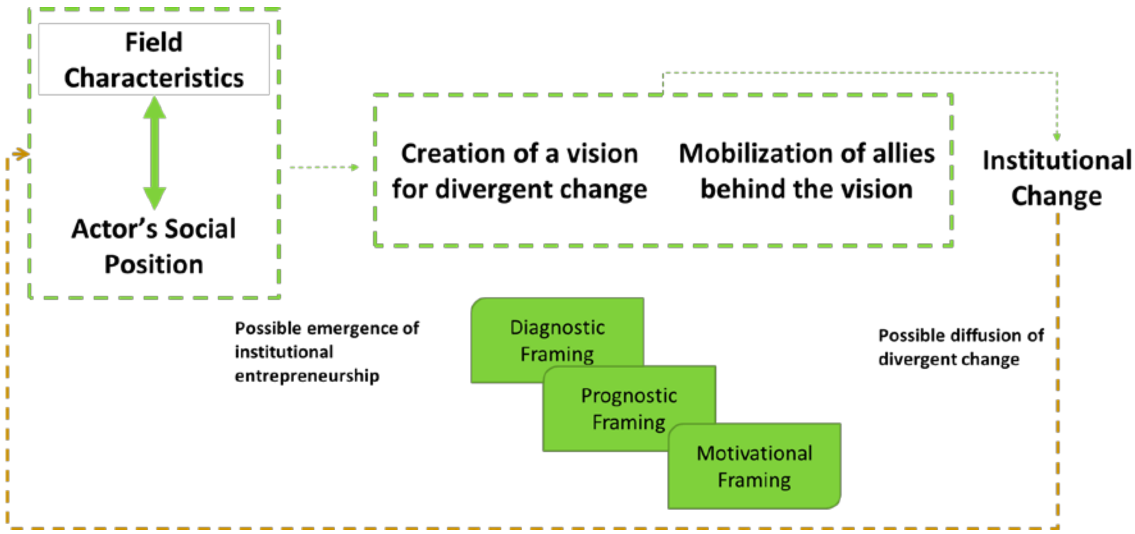
Had it not been for the trust between banks and Kafalat, SMEs would not have had the same opportunity to borrow, grow and expand. SMEs in general experience difficulties in acquiring external resources – "We have to beg to get financing".

Cost and risk of innovation were impeding factors that Kafalat addressed to augment the banks' risk appetite. Considering agency to be distributed affords a more realistic view of institutional processes as political and non-deterministic, and of the outcomes, being dependent on the actions and reactions of multiple actors, as being by definition uncertain (Delbridge & Edwards, 2008; Garud et al., 2007; Meyer, 2006; Reay & Hinings, 2005). When agency is considered to be distributed, politics and collective mobilization become central to understanding how diverse actors can coalesce.

In all the case studies, interviewees have agreed on the fact that if it weren't for the mutual support, Kafalat wouldn't have been able to serve its mission on its own.

5.2 Process Elements

Starting with the **Field Characteristics**, social upheaval, technological disruption, or regulatory changes all can lead to the possible emergence of introducing new ideas into the ecosystem. Inferred from the case studies, lack of SME financing, emergence of marginalized areas due to war and the cost and risk of innovation facing the conservatism in the financial sector all have encouraged specific actors to exploit the opportunity to become institutional entrepreneurs.



Had it not been for the war, however, Lebanon might not have witnessed this huge gap which resulted in the emergence of marginalized areas not even knowing that their innovative proactive members would have a chance to grow their idea to expand locally, if not regionally and globally.

If economic globalization offers opportunities to improve living conditions, it also implies substantial and continuous restructuring and change – most especially in a time of economic crisis – and a renewed or new approach, not only to the new social challenges but also to the old ones that have not yet been met successfully. Competition keeps increasing and as a consequence, all territories have to engage more strongly in innovation, both technological and social, and in entrepreneurship, both "commercial" (for-profit businesses pursuing as a primary objective economic value and its appropriation) and social (primarily aiming at addressing and satisfying unmet social needs, and therefore creating social value).

The most urgent challenge for national governments, local authorities, policy makers and economic stakeholders is therefore to help the less well-off adapt to new and changing situations and – more importantly and more generally – to promote sustainable economic and social development so that once the economy has recovered the benefits can be widely diffused.

Whether exogenous or created by the actors, the above depicted characteristics entice the possible emergence of institutional entrepreneurship. And, in Kafalat context, it has enticed the need to diverge the focus on SMEs and highlight their role in the economy.

Institutional innovation, hence, is part of the solution, as it explicitly aims to provide innovative solutions to unsolved social problems, putting social value creation at the heart of their mission in order to improve individuals' and communities' lives and increase their well-being.

In addition to the above, the **actors' social position** with their different statuses have different impacts on the divergent change initiated by the actors. In the context of Kafalat, the forces of the Lebanese government, National Guarantee of Deposits, Central Bank of Lebanon, Association of Banks and the banks themselves (50 of them) all have contributed in managing the process of divergent change. Reputable partners, solid background support and high order guarantee all have helped boost the concept of Kafalat.

Up until then, institutional entrepreneurs are faced with a challenge in changing the conservative financial sector which is doubly hard and hereby must craft a vision in terms appealing to the actors needed to implement it and this was translated into three dimensions via Kafalat change. By exposing the weaknesses within the existing practices highlighting the bank tendencies and by promoting the change and providing compelling reasons to support SME financing, Kafalat institutional actors were able to reach the second stage of institutional innovation – Mobilization of Allies.

Because divergent change can seldom be implemented without support, Kafalat institutional actors had to **mobilize allies** by convincing the need for change alongside the informal network position across the different actors – all of which provided access to information and support providing safe investment and low default rates. By doing so, they had to define the identity of the change, reduce inherent contradictions, build sustainable coalition all while emphasizing the failures in the existing institution.

Once all of these forces have been witnessed, **institutional change** has occurred moving SME financing from less than 6% share to around 16% upon the introduction of Kafalat into the market unleashing the institutional change. The result was a resourced based institutional change within the SME lending ecosystem. In typical cases, divergent change might then diffuse throughout the field. In our research, however, it is inferred that Circular 331, introduction of incubators, accelerators, equity funding (introduced by Kafalat as well), all has proven that there has been diffusion of **convergent change** which will ultimately affect the field characteristics.

Moving on the above, all the case studies covering SMEs have acknowledged the need for raising awareness across the regions given the cultural differences in the varying regions.

Authors such as Neck, Brush and Allen (2009, p. 15) suggest that “a lack of agreement on what defines social entrepreneurship or a social entrepreneur may not be important”, arguing that what really matters is understanding the landscape of the sector.

In order to do so, some have revisited their previous assumptions (Light, 2008) or have instead focused on the landscape of social entrepreneurship to suggest a typology of entrepreneurial ventures in order to identify those that could be included in the social entrepreneurship field (Neck et al., 2009), 4 or have identified sets of primary and secondary characteristics of social entrepreneurship (Brouard and Larivet, 2009).

Inspired from the case studies in chapter 4 and based on research studies I hereby shed light and provide lessons learned and insights for any institutional innovation attempt in the future to reshape an industry in general which can also be related to Circular 331 amendments in Lebanon.

By <u>building enabling environments (legal, monetary and fiscal policies, regulatory) and implementing supporting policies,</u> we foster the ecosystem to encourage initiatives from institutional entrepreneurs to fulfill their socio-economic goals while pursuing sustainability in the market.

By providing sustainable finance, a social capital marketplace shall be fostered whereby policy measures offerings fiscal incentives and innovative institutional arrangements between civil society, governments and financial institutions.

Taking circular 331 into account, seed funding is critical in the early phases of a project as it covers the costs linked to a startup and also the costs of capital investments. This could be provided through small loans or grants which can be complimentary to Kafalat programmes. Once a new circular is introduced it shouldn't cancel the existence of previous practices. They all come to complete each other to fill a full matrix making it alluring to the SMEs and banks as well.

By providing training opportunities and raising awareness across the sectors in both central areas, suburbs and rural areas, entrepreneurs will be helped to hone and develop their entrepreneurial and creative skills. As such, a culture of inclusive entrepreneurship will be nurtured.

By supporting market development and providing training for public officials, public procurement measures would bee further exploited such that social enterprises can expand their growth. Now that BDL Accelerate is behind us and also the direction of the Lebanese government of supporting CSR-oriented SMEs, involving social enterprises in public service delivery can bring many community benefits. However, public officials are often not well acquainted with those benefits, while some small social enterprises are not familiar with public tenders and need skills and networks to successfully compete in public bids. Therefore, training both for public officials working on procurement and for social enterprises should be provided and encouraged.

By evaluating the impact of institutional innovation in selected areas lacking awareness will require the identification of quantitative and qualitative measurement tools, including the social return on investment measures and the balanced scorecard. This will help prove the vision of institutional actors and implement change at a faster pace.

By establishing innovation funds for social innovation, innovation development is supported. This can be directed to underserved sectors same as Kafalat did by shedding light on the inefficiencies in the market and bringing banks closer to the people and supporting their experimental ideas at central and rural levels.

By creating incubators and accelerators, Kafalat and Berytech – with the “we spirit” are fostering the emergence of intermediaries connecting SMEs with innovation supply. Incubators play a critical role in spreading social innovations, as they bring together the skills and expertise necessary to help sustain and develop a social enterprise. They also provide a space to experiment and assess new ideas in practice; allow fast learning across a community of innovators; and, establish clear pathways for scaling up the most promising models. The absence of intermediaries in the social field is a key reason why too few innovations succeed. For intermediaries to be effective, they must be embedded across diverse sectors.

In all cases, whether for beneficiaries or stakeholders, they have all agreed that if it weren’t for the full 360 support, Kafalat wouldn’t have succeeded. Moreover, given the Lebanese context and the thirst of innovation, we would have lost many of these opportunities in Lebanon as the destination of tourism…

CHAPTER VI

DISCUSSION

6.1 Research Contribution

In their comprehensive review of extant research Battilana et al (2009) call for future work by scholars to focus on two key understudied aspects of institutional entrepreneurship process: (1) accounting for the *embeddedness* of institutional entrepreneurs; and (2) accounting for a distributed view of *agency* in institutional processes. First, in the case of embeddedness, the issue is to concretely explain the actual process of how existing actors within the social field who are tangled with the current institutional forces appear to engage in triggering and shepherding change simultaneously. Second, in the case of agency, the challenge is to highlight how agency of several actors (both individual and collective) across the social field of action are involved and implicated in effecting institutional change without appealing to the cult of “heroic” individual. Third, there is a dearth of research on to better understand the underlying processes of institutional maintenance and change through the institutional entrepreneurship lens in the context of a Middle East country (Lebanon) environment. My research in this thesis project has attempted to address these three gaps in the literature. I have done so by assessing institutional innovation process instigated by Kafalat which has subsequently shaped and transformed the SME-oriented lending practices in Lebanon during 1999-2014.

On the one hand, the role of embeddedness was concretely illustrated through the involvement and engagement of initial team of actors who collectively formulated and shepherded the establishment of Kafalat (Abi Habib, Sader, etc.). On the other hand, we showed how subsequently the banks, BDL, donors and SME players collectively exercised agency over different parts of the field in a distributed manner.

However, my concrete contribution has been on highlighting how the process of institutional entrepreneurship was enacted with the context of specific dynamics in the focal Middle Eastern country. My research has contributed in addressing the gap in the research on institutional innovation changes focusing on SME lending practices in Lebanon in terms of who, how and why these changes have come about. My interviews with Kafalat itself, stakeholders and beneficiaries have given me a holistic view of the institutional entrepreneurship process. This 360 view across all parties afforded transparency to the range of actors and their actions to bring about institutional innovation into SME lending practices in particular highlighting the role of influential social actors.

Ultimately, the findings of this project has demonstrated that the validity process model of enabling conditions for institutional entrepreneurship in the context of Kafalat whereby the actors have exploited the exogenous field characteristics in the ecosystem and engaged in institutional entrepreneurship action thereby changing what was a resilient institution and thus hard to change: the conservative financial system. The findings have extended the literature by demonstrating the validity of the process model. But also they have shown that there has been a possible unleashing subsequent institutional convergent change upon via the introduction of Circular 331 by the Central Bank of Lebanon. This is expected to usher in a new institutional change by promoting equity financing practices to prompt financial services firms and organization to invest in the knowledge economy to accelerate wealth creation.

However, more importantly, the research has shown that not only has SME lending became a permanent fixture of the landscape—i.e., institutionalized itself as a new but embedded practice; it has also highlighted the fact that Lebanon has built a reputation for a vibrant entrepreneurial landscape and a strong base of SMEs contributing significantly to its open economy via job creation opportunities - a strategic significance for growth.

In summary, this research, has enhanced our understanding of the process of institutional entrepreneurship by studying changes to SME lending practice within the financial services arena of the focal economy.

6.2 Limitations of the Study

Applying qualitative comparative analysis (Fiss, 2007; Ragin, 2000) seems to be well-suited to examining in broader terms in the future starting from emergence of institutional entrepreneurs, the process of implementing divergent change and contributing to this process. In future work both quantitative and further qualitative research can be undertaken to rectify potential past shortcomings.

Due to confidentiality terms and time limitations, we were not able to interview a more comprehensive list of stakeholders varying from banks to political institutions who were involved in assessing the ecosystem prior to the inception of Kafalat and during its evolution to cover all possible perspectives. This can be rectified in further research.

As for SMEs, in the case studies covered, we have focused on single, in-depth, longitudinal case studies (De Holan & Phillips, 2002; Garud et al., 2002; Munir & Phillips, 2005) yielding valuable insights, but within limits. In other words, due to time requirements there were geographical limits on travel for data collection. This somewhat limited the scope of our analysis on the beneficiary perspectives. In future research SMEs across additional sectors/sizes can be included to further analyze the effect of Kafalat on the SME growth especially across underserved sectors in rural areas.

To the extent that institutional entrepreneurship evokes a complex social, organizational, political, and field (multi-organizational) process, it is useful cast a wider net and thus to focus on the actions of institutional entrepreneurs and their collaborators as well as the actions of those who oppose them (DiMaggio, 1988; Lawrence & Suddaby, 2006). Therefore, it is expected that future work will tackle a broader range of institutional actors in the model to construct a more complete picture of institutional entrepreneurship process of SME financing.

CHAPTER VII

CONCLUSION

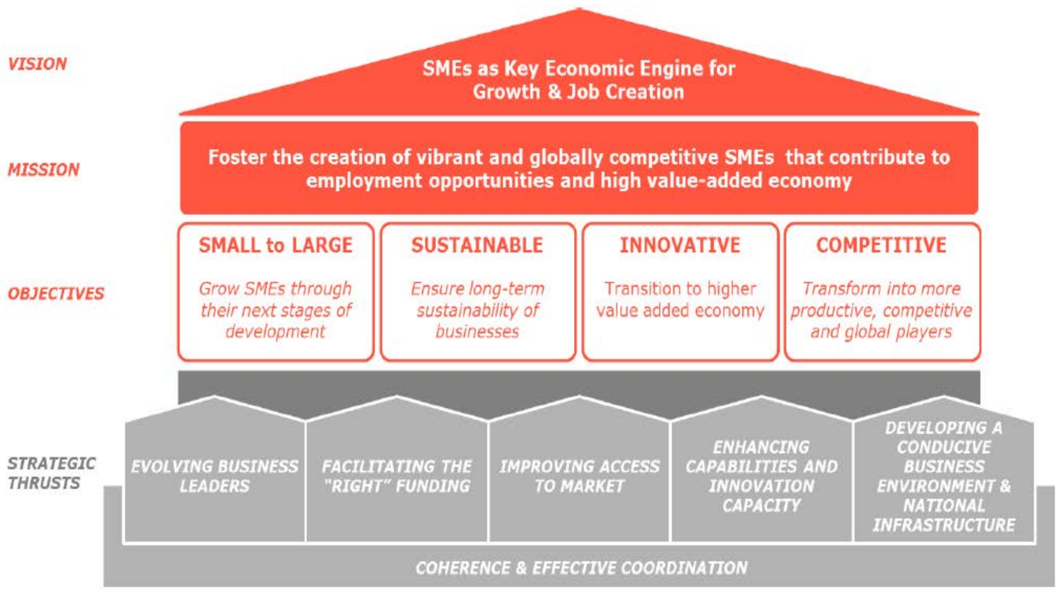
It is common knowledge among academics that SMEs are the engine of economic growth in most economies including Lebanon because of the job creation role that SMEs play is greater than their larger counterparts. However, it is also true that SMEs suffer from premature failure usually within the first 5 years of their existence. The critical role of financial resources especially loan funding to sustaining the growth of SMEs in the first five years is akin to oxygen needed for the growing fetus within mother's womb. Anecdotally, it has been known that Kafalat has played a critical in making the practices of SME lending acceptable and part of the financial services landscape over last 15 years. However, this was usually known among a handful people. This research has sought to document this role. But more importantly the research has theoretically analyzed the institutional entrepreneurship process through which Kafalat has managed to change these institutional lending practices and thus bring about an institutional innovation in the conservative environment of financial services.

Specifically, this research on Kafalat establishment and growth has presented an extraordinary resource for entrepreneurs since its inception in 1999. Its value of institutional innovation in a world of mounting performance pressure is compelling, yet it has ultimately provided an opportunity to break the traditional practices and shift from a business environment of focusing only on existing winners to one where there is opportunity is given to the rising stars (Hagel & Brown, 2013)

Prior to 1999, there is limited volume of SME financing loans (less than % 6 of total loan portfolios) and the consensus was that SME lending was not enough has depicted the launching of Kafalat and related initiatives which gave a wake-up call for banks. This has resulted in the financial lubrication in the SME economy upon which SME lending has become a "taken-for-granted" practice—now more than 16% of total lending volume. The 10% increase in total volume of lending combined with the approximately 14,000 projects financed is testimony to the success in the SME sector that Kafalat has been able to bring about. In the language of unlocking value creation as formulated by Baker and xxxx (2005), Kafalat has served as a broker among many actors to "create something out of nothing". The subsequent initiatives whether caused or merely nudged by Kafalat's presence can only help the SME growth prospects. These include the issuance of BDL C-331, introduction of incubators, accelerators, equity financing facility (introduced by Kafalat with the help of the World Bank). These initiatives show that there has been diffusion of convergent change which will ultimately facilitate the lending process to SMEs within the ecosystem.

If we hope for a robust democratic future in the Middle East, we have to find new ways to promote the budding examples of social entrepreneurship as a bridge to a more secure and stable future. In this context, social entrepreneurship in other words, "institutional innovation" fostering entrepreneurship reintegrates communities on the periphery – often hotbeds for violence – and gives them a stake within the ecosystem. "[It] not only paints a new coat on a system that is stonewashed and cracked, but also changes the foundation, giving sidelined communities a chance to prosper" (Doumit, 2014)

However, more importantly, the research has shown that not only has SME lending became a permanent fixture of the landscape; it has also highlighted the fact that Lebanon has "built a reputation for a vibrant entrepreneurial landscape and a strong base of SMEs contributing significantly to its open economy via job creation opportunities - a strategic significance to the economy to focus on" (Inventis, 2015)



We end by pointing out that domain of research at the intersection of institutional entrepreneurship and change agency is ripe for scholarly attention within the Middle Eastern environment, specifically Lebanon and especially focusing on the startup and SME growth. Because institutional change is a highly complex and uncertain process, the outcome of which is difficult to predict, we should devote additional effort to trying to understand better how actors can initiate and implement institutional change through the institutional entrepreneurship lens. By doing so, research can inform our understanding intuitional component of the changes we are engaging in vis-à-vis startups and SME growth.

APPENDIX

1. Kafalat Statistics over years 2013 and 2014

1.1 Kafalat sal, Basic and Plus

	Kafalat sal				Kafalat Basic				Kafalat Plus			
Regions	2014 H1	2014 H2	2013 H1	2013 H2	2014 H1	2014 H2	2013 H1	2013 H2	2014 H1	2014 H2	2013 H1	2013 H2
Bekaa	21.0%	19.1%	23.0%	20.0%	22.2%	19.4%	26.5%	22.9%	3.6%	11.3%	10.5%	4.8%
South Lebanon	9.4%	14.6%	11.0%	14.9%	10.4%	14.7%	8.3%	16.3%	5.4%	9.4%	9.3%	6.5%
North Lebanon	11.2%	11.6%	10.1%	12.2%	12.1%	12.5%	11.7%	12.6%	7.1%	9.4%	7.0%	8.1%
Nabatieh	11.0%	9.9%	7.9%	6.5%	10.4%	10.3%	10.2%	7.7%	3.6%	1.9%	2.3%	1.6%
Beirut	4.6%	3.0%	8.9%	5.1%	2.4%	2.2%	6.1%	3.2%	19.6%	11.3%	19.8%	17.7%
Mount Lebanon	42.9%	41.8%	39.1%	41.3%	42.6%	41.0%	37.1%	37.3%	60.7%	56.6%	51.2%	61.3%
Sectors												
Agriculture	49.5%	45.5%	38.9%	45.0%	48.8%	42.5%	44.3%	45.3%	7.1%	3.8%	16.3%	8.1%
Industry	34.3%	36.1%	33.8%	33.6%	37.4%	38.8%	35.2%	36.4%	53.6%	58.5%	37.2%	45.2%
Advanced Technology	3.2%	1.2%	3.4%	1.4%	2.1%	0.7%	1.5%	0.6%	10.7%	3.8%	7.0%	6.5%
Tourism	9.8%	13.9%	19.2%	15.3%	8.0%	14.3%	12.5%	13.2%	26.8%	30.2%	39.5%	37.1%
Craft	3.2%	3.2%	4.8%	4.7%	3.8%	3.7%	6.4%	4.6%	1.8%	3.8%		3.2%
Total Number of Issued Guarantees	438	404	417	491	289	273	264	349	56	53	86	62
Total Volume of Issued Guarantees (in mn)	85,212	80,804	81,376	97,606	49,918	49,439	49,623	61,790	24,013	22,716	25,672	25,543

1.2 Kafalat Innovation and Startup & Innovation

	Kafalat Innovation				Kafalat Startup & Innovation			
Regions	**2014 H1**	**2014 H2**	**2013 H1**	**2013 H2**	**2014 H1**	**2014 H2**	**2013 H1**	**2013 H2**
Bekaa								
South Lebanon						100.0%		33.3%
North Lebanon								
Nabatieh								
Beirut	100.0%		33.3%	100.0%			33.3%	
Mount Lebanon			66.7%				66.7%	66.7%
Sectors								
Agriculture								
Industry			33.3%					66.7%
Advanced Technology	100.0%		66.7%	100.0%		100.0%	33.3%	
Tourism							66.7%	33.3%
Craft								
Total Number of Issued Guarantees	**2**		**3**	**1**		**1**	**6**	**3**
Total Volume of Issued Guarantees (in mn)	**450**		**443**	**200**		**600**	**2,025**	**1,772**

1.3 Kafalat Trees and Small Agriculture

	Kafalat Trees				Kafalat Small Agriculture			
Regions	**2014 H1**	**2014 H2**	**2013 H1**	**2013 H2**	**2014 H1**	**2014 H2**	**2013 H1**	**2013 H2**
Bekaa	56.8%	36.1%	66.7%	30.4%				
South Lebanon	2.3%	13.9%	33.3%	17.4%	10.0%	21.4%		15.4%
North Lebanon	11.4%	19.4%		17.4%	10.0%			7.7%
Nabatieh	6.8%	8.3%			30.0%	7.1%		
Beirut								
Mount Lebanon	22.7%	22.2%		34.8%	50.0%	71.4%		76.9%
Sectors								
Agriculture	100.0%	100.0%			100.0%	100.0%		100.0%
Industry								
Advanced Technology								
Tourism								
Craft								
Total Number of Issued Guarantees		**36**	**3**	**23**	**10**	**14**		**13**
Total Volume of Issued Guarantees (in mn)		**5,650**	**153**	**4,803**	**469**	**586**		**578**

1.4 Kafalat Energy A and Energy B

	Kafalat Energy A				Kafalat Energy B			
Regions	**2014 H1**	**2014 H2**	**2013 H1**	**2013 H2**	**2014 H1**	**2014 H2**	**2013 H1**	**2013 H2**
Bekaa						100.0%		
South Lebanon								
North Lebanon								
Nabatieh								
Beirut								
Mount Lebanon				100.0%	100.0%			
Sectors								
Agriculture								
Industry					50.0%	100.0%		
Advanced Technology								
Tourism				100.0%	50.0%			
Craft								
Total Number of Issued Guarantees				**1**	**2**	**1**		
Total Volume of Issued Guarantees (in mn)				**600**	**353**	**489**		

2. Kafalat Programmes

2.1 Kafalat Basic

The Kafalat Basic programme offers loan guarantees for investments in fixed assets and working capital needs of eligible SMEs.

Characteristics of Kafalat Basic	
Maximum Loan Amount	LBP 300 M or its counter value in foreign currencies (EUR or USD)
Eligible Applicants	◆ Individual ◆ Sole proprietorship ◆ Simple partnership ◆ Limited Liability Company (SARL) ◆ Joint Stock Company (SAL) ◆ Cooperative ◆ NGO
Applicant's Development	Existing or Start-up
Investment Type	To finance Fixed Assets and Working Capital Needs
Loan Duration	Up to 7 years
Guarantee Ratio	75 %
Grace Period	Between 6 months and 1 year
Interest rate in LBP	40% of the Lebanese Treasury Bills Yield (TBY's) of 1 year + 3%
Interest rate in FCY	Libor (1 year) + 5.5%
Subsidy	Up to 4.5%
Special Conditions	Bank may ask for a collateral, but it cannot exceed 50% of the loan value

2.2 Kafalat Plus

The Kafalat PLUS programme is the result of a partnership between the European Union and the Ministry of Economy and Trade of Lebanon (MoET) to help finance new production capacity or to sustain current production and employment. The programme offers loan guarantees for investments in fixed assets and working capital needs of eligible SMEs.

Characteristics of Kafalat Plus	
Maximum Loan Amount	LBP 600 M or its counter value in foreign currencies (EUR or USD)
Eligible Applicants	◆ Limited Liability Company (SARL) ◆ Joint Stock Company (SAL) ◆ Cooperative
Applicant's Development	Existing or Start-up
Investment Type	To finance Fixed Assets and Working Capital Needs
Loan Duration	Up to 7 years
Guarantee Ratio	85 %
Grace Period	Between 6 months and 1 year
Interest rate in LBP	40% of the Lebanese Treasury Bills Yield (TBY's) of 1 year + 3%
Interest rate in FCY	Libor (1 year) + 5.5%
Subsidy	Up to 4.5%
Special Conditions	1- Bank cannot ask for an additional collateral 2- Minimum 20% contribution (in kind or in cash) of the borrower in the project 3- Private equity should not be less than 30% of total outstanding liabilities

2.3 Kafalat Start-ups and Innovation

The Kafalat Start-ups and Innovation programme is the result of a partnership with the European Union and the Presidency of Council of Ministers to primarily serve the needs of innovative enterprises and start-ups in Lebanon. The fund will enable to guarantee loans granted to highly innovative investments and/or conventional start-ups.

Characteristics of Kafalat Start-ups and Innovation		
Maximum Loan Amount	LBP 650 M or its counter value in foreign currencies (EUR or USD)	
Eligible Applicants	◆ Joint Stock Company (SAL) only	
Applicant's Development	Start-up or existing for less than 2 years	
Investment Type	To finance Fixed Assets and Working Capital Needs	
Loan Duration	Up to 7 years	
Guarantee Ratio	Innovation	Start-ups
	90%	85%
Grace Period	Between 6 months and 1 year	
Interest rate in LBP	40% of the Lebanese Treasury Bills Yield (TBY's) of 1 year + 3%	
Interest rate in FCY	Libor (1 year) + 5.5%	
Subsidy	Up to 4.5%	
Special Conditions	1- Bank cannot ask for an additional collateral 2- Minimum 50% contribution (in kind or in cash) of the borrower in the project	

2.4 Kafalat Agriculture

The Kafalat Agriculture Programme is implemented in the framework of the ARDP (Agricultural and Rural Development Programme) funded by the European Union and executed by the Lebanese Ministry of Agriculture, and is co-financed by the European Union and Kafalat SAL. It responds to special needs raised by activities of Small Agricultural and Tree Plantation.

Characteristics of Kafalat Agriculture

	Small Agriculture	Trees
Maximum Loan Amount	LBP 65 M or its counter value in foreign currencies (EUR or USD)	LBP 480 M or its counter value in foreign currencies (EUR or USD)
Eligible Applicants	◆ Individual ◆ Sole proprietorship ◆ Simple partnership ◆ Limited Liability Company (SARL) ◆ Joint Stock Company (SAL) ◆ Cooperative ◆ NGO	
Applicant's Development	Existing or Start-up	
Investment Type	To finance Fixed Assets and Working Capital Needs	
Financed Activities	◆ Farming ◆ Machinery ◆ Livestock/poultry/fish farms ◆ Small fishing boats ◆ Irrigation systems ◆ Greenhouses, terraces, reservoirs, storage rooms ◆ Working capital ◆ Conditioning and packaging	◆ Trees ◆ Machinery for trees ◆ Irrigation systems ◆ Reconstruction of terrace, reservoirs, and storage rooms ◆ Working capital ◆ Conditioning and packaging of fruits
Loan Duration	Up to 7 years	Up to 10 years
Guarantee Ratio	85 %	75 %
Grace Period	Between 6 and 12 months	Between 6 and 36 months
Interest rate in LBP	40% of TBY of 1 year + 3%	First 7 years: 40% of TBY of 1 year + 3% Last 3 years: 3%
Subsidy	Up to 4.5% for 7 years only	
Special Conditions	Bank cannot ask for an additional collateral	Bank may ask for a collateral, but it cannot exceed 50% of the loan value

2.5 Kafalat Innovative

The Kafalat Innovative programme is the result of a partnership between the European Union and the Ministry of Economy and Trade (MoET) to help finance innovative ideas and businesses. The programme is co-financed by the EU and Kafalat SAL, and offers loan guarantees for investments in fixed assets and working capital needs.

Characteristics of Kafalat Innovative	
Maximum Loan Amount	LBP 300 M in LBP only
Eligible Applicants	◆ Limited Liability Company (SARL) ◆ Joint Stock Company (SAL) ◆ Cooperative
Applicant's Development	Start-up or existing for less than 2 years
Investment Type	To finance Fixed Assets and Working Capital Needs
Loan Duration	Up to 5 years
Guarantee Ratio	90%
Grace Period	Between 6 months and 1 year
Interest rate in LBP	40% of the Lebanese Treasury Bills Yield (TBY's) of 1 year + 3%
Subsidy	Up to 4.5%
Special Conditions	1- Bank cannot ask for an additional collateral 2- Minimum 10% contribution (in kind or in cash) of the borrower in the project

2.6 Kafalat Energy

The Kafalat Energy programme is a result of a partnership between the European Union and Kafalat SAL to address the energy constraints faced by SMEs, and at the same time ensure a reduction of negative environmental impact. This programme will provide eligible SMEs with loan guarantees for investments in Energy Efficiency and Renewable Energy to finance the Purchase of equipment and Design and Installation costs. Applicants who benefit from Kafalat Energy are automatically eligible to benefit from a grant 5% of the project value, made available by the European Union through the Central Bank.

Characteristics of Kafalat Energy

	Programme A Energy Efficiency	**Programme B** Renewable Energy generation for internal use	**Programme C** Renewable Energy generation for sale to third parties
Maximum Loan Amount	600 M LBP, in LBP only	600 M LBP, in LBP only	1,320 M LBP, in LBP only
Eligible Applicants	◆ Individual ◆ Sole proprietorship ◆ Simple partnership ◆ Limited Liability Company (SARL) ◆ Joint Stock Company (SAL) ◆ Cooperative ◆ NGO		
Applicant's Development	Existing or Start-up		
Investment Type	To finance Fixed Assets and Working Capital Needs		
Financed Activities	To finance the adoption of or conversion to sustainable energy consumption, i.e. to optimize an energy system to consume less energy	To install a renewable power generation system, and consume the produced electricity for internal use, to replace fossil fuel based electricity	To install a renewable power generation system, with the goal of selling all or part of the produced electricity to others, including the public grid
Loan Duration	Up to 10 years	Up to 15 years	Up to 15 years
Guarantee Ratio	75 %	75 %	75 %
Grace Period	Up to 1 year	Up to 2 year	Up to 3 year
Interest rate	3%		
Subsidy	Up to 4.5% for 7 years only		
Special Conditions	1- Bank may ask for a collateral, but it cannot exceed 50% of the loan value 2- Companies which currently benefit or have already benefited from a Kafalat guarantee in other programmes are eligible to benefit from Kafalat Energy 3- Borrower must provide Engineering Design Report and Financial Study for the energy project		

3. Interview Questions

- What was missing from the entrepreneurial ecosystem that led the focus on establishing a company that assists SMEs, Kafalat?
- Who was involved in assessing the ecosystem? Why?
    - Parties
    - Roles of each party
- What were the risks taken to set this initiative?
    - Risks?
    - Challenges?
- How was the topic addressed to encourage the involvement of more than one party?
    - Reasons?
    - Opportunities?
- Was there resistance upon inception? How was it acted upon?
    - Strengths?
    - Weaknesses?
- If we want to define Kafalat in a couple of words, what would you reflect on its:
    - Mission?
    - Vision?

From the above, we can conclude the theory of institutional innovation:

- To what level, do you believe Kafalat had a hand in reshaping and transforming the SME-Centered financial sector in Lebanon?

- Kafalat's different programs and roles
- Stages of Kafalat history (growth and pitfalls)

- Previously, SME lending has constituted an insignificant share of the financial market activities of banks in Lebanon. Nowadays, the share has increased substantially.
    - Do you think the increase will prevail in the upcoming future? Why?
    - Have you ever faced shortage in cash / funds in supporting SMEs?
    - Has this impacted the success of SMEs in any way?
- What do you think can or cannot be done to maintain growth in this sector?
    - Financial Lending Sector [Challenges? / Opportunities?]
    - SME Lending Sector [Challenges? / Opportunities?]
- To what level do you believe the context of the Lebanese ecosystem has had an impact on the organizational environment of Kafalat?
    - Upon Inception?
    - During Evolution?
- How do you think Kafalat is applicable in different contexts?
    - In the Lebanese context only?
    - On SME-Centered activities context only?
- Based on BDL Accelerate and recent activities, investment in equity financing is an opportunity.
    - How do you believe it will affect the financial sector, in general?
    - How do you believe it will affect the SME lending sector, in specific?
- If we were to shift a few years back, what would have happened without Kafalat?

- Reasons?
- Alternatives?

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