HYBRID SUKUK FOR SMES: FINANCING THE REAL ECONOMY THROUGH ETHICAL PRINCIPLES

Anass Patel (PhD candidate from Paris 1 Sorbonne University)
President, 570 Asset Management, Paris, France

Abstract

This paper examines an important question in the context of the lack of financing for SMEs: Can *Sukuk* in the form of hybrid asset-backed securities specifically designed for SMEs be a credible alternative to collateral-based debt? And if yes, what are the economic and legal conditions to set up such a solution that should meet requirements of both the SME borrowing the funds thanks to its real assets, and Investors committing to the capital within the Profit and Loss Sharing (PLS) principle framework?

A real case study from the French economy is utilized in this paper thanks to a hybrid *sukuk* model proposed under the *mudaraba* scheme. However, this model may be applicable to other developing and developed economies across the world depending on the local tax & legal regulations. It is not an academic paper but rather a viewpoint from a practitioner aiming at advancing the reflexion on innovative yet workable solution for the real world economy.

INTRODUCTION

After many years of practice in the capital markets, asset management and structured financing, we came to the conclusion that there are two trends that are misleading our rational economic approach to banking & financing. On the one hand, banks, whether conventional or Islamic ones, tend to request more and more collateral or guarantees on their borrower regardless of the nature of the project to be financed, the quality of the underlying assets and the track record of the entrepreneur-borrower. On the other hand, risk capital investors, more likely to take risks on the potential upside of the project with less focus on the credit history of the client, are getting involved only through more and more complex instruments; their engagement which should supposedly be equity investments are in practice acting more like debt instruments in the form of equity like features such as subordinated or venture loans. This clear evolution of the financial market between “minimum risk taking” (loans with strict guarantees) and “upside only risk sharing” (equity with debt security features) is putting a clear strain on the smaller economic players such as the SMEs, less capable of accessing vanilla types of financing due to their size and risk profile.

Many authors have written on the difference and issues raised by collateral-based debt or profit and loss sharing (PLS) contracts mainly under the asymmetric information analysis framework[1]. But we believe that there has not been enough focus on the SMEs segment, which probably represents the image of the real economy in the modern world. While the debate has been hot on the nature of Islamic financial instruments, especially in their partnership format, their compatibility in the modern markets with the lack of robust risk management systems, alternative solutions especially from project or venture financing have been less so covered.

[1] At least a dozen of papers presented during the last two sessions of the International Conference of Islamic Economics & Finance, source: www.qfis.conference.edu.qa

To best illustrate the disconnect between collateral-based debt and upside-only risk capital, we would like to share our experience in the French economy where we had to find an alternative to riba-based bank financing with an innovative structure that had to overcome this double challenge of "no risk taking loans" or "no risk sharing equity". Tax considerations aside, we think that market participants do not have the right approach when considering the appropriate allocation of equity or debt towards SMEs/ Asset-Backed projects finance.

The assumptions behind this hybrid *sukuk* model is that structuring a *Mudaraba*-based partnership financing instrument specifically for SMEs if used properly and at such a scale, through a programme issuance for example, will make transaction costs incrementally insignificant. As such, it does provide a credible alternative to conventional loans which are increasingly costly and inaccessible to smaller SMEs or entrepreneurs due to the credit crunch. For the importance of developing more equity-based contracts away from simple debt-based contracts, we refer to the numerous works done by eminent scholars *inter alia* Al Suwailem, Haque, Mirakhor, Tag-el-Din, Usmani.

In a nutshell, the model is neither an equity partnership where the capital investors take most if not all power and upside gain nor a pure collateral-based debt with a pre-defined interest rate disconnected to the performance of the project. But it is a true value-sharing instrument between an entrepreneur (*Mudarib*) with its expertise and business idea, and investors (*Rab al maal*) committing to a participative debt funding component (*sak*) completely modelised on the business plan and potential value of the underlying assets making it truly risk sharing. It is not a win-lose situation as for a classical lender to borrower relationship but a participative financing method dependent on the success of the project to generate the necessary cash-flow that gives a chance to the entrepreneur to grow and be successful with a performance shared with its capital partner (*sukuk holder*). Contrary to the proposal of Bacha (1997) to have an alignment of interest through equity-kicker which raises some shari'a issues yet to be resolved, the innovation of this project resides in the contractual framework with a package of partnership instruments (participative loan with no collateral but a waterfall of sharing devices acting as the mudaraba contract) glued together under a sukuk scheme that makes the relationship established on true creation of valuable assets. In this case, the project consisted in the creation of a new restaurant with tangible assets, branding, clientele and track record of the entrepreneurs who were already successful in this business.

With this perspective, we suggest the following three assumptions based on the proposal developed in this paper which is premised on the pilot project at stake:

1. Bank loans are not adapted to SMEs situation
2. Profit and Loss Sharing approach for SMEs financing can work
3. Hybrid structure in the form of participating mudaraba sukuk is a credible alternative

The paper is organized as the following. In the first section, we discuss the SMEs market in light of the 2008 crisis and the new Basel II regulation along with some recent empirical analysis that have shown that they are suffering the most in terms of access to financing due to some intrinsic determinants of their structure. The second section is where we will introduce our analysis to accommodate PLS contracts to SMEs in France before elaborating on the framework prototype developed in section three. We then conclude the paper in the last section with a comparative analysis to the most recent Mudaraba sukuk issued by one of the large investment bank in the gulf region, the Saudi Hollandi Bank.

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