

## Developing an Innovative Islamic Model for SME Financing through Iran Sukuk market

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### Abstract

Small and medium enterprises (SMEs) are vital for economic development, growth in production, and employment expansion. One of their key challenges is the financing gap. Therefore, offering alternative financing solutions can aid in their growth and development. This study aims to propose an efficient way to finance SMEs through the issuance of sukuk. At first, we identified

challenges in financing SMEs by interviewing experts. Then based on challenges we propose two assumptions in designing a Sukuk model for financing SMEs and based on them, we designed 7 models. We use an intermediary in all models and we propose to finance a portfolio of SMEs instead of financing a single SME and, also we use contracts that originator could use them for any purpose. These models were based on Tawaruq, Ijarah, Musharaka, Manfaat, Salam, Wakalah and Bay' al-dayn. Then we ranked models using the TOPSIS method based on 6 criteria, and the wakalah sukuk model was chosen for SME financing from the capital market. Subsequently, a model based on wakalah sukuk was developed, addressing aspects such as parties involved in Wakalah Sukuk for financing SMEs, profit management in SME Wakalah Sukuk, wakil's fee, construction of SME's portfolio by Wakil, and reporting and monitoring the performance of the originator.

**Keywords:** SME, SME financing, Wakalah sukuk, Capital market.

## Introduction

To improve SME finance in Iran, it is necessary to pay attention to the capacity of the capital market as a complementary solution alongside the banking system. Developing SME finance through the capital market requires an appropriate model based on the needs and requirements of its beneficiaries including SMEs, investors, financial institutions, and the capital market supervisory (Yazdi et al, 2022, p 182).

SMEs are considered the backbone of the economy because they play a prominent role in creating employment, economic growth, innovation, and creativity in developing countries. Generally, SMEs play the most important role in creating new jobs (Kuruwitaarachch et al., 2019). Zafar & Mustafa (2017), stated that in developed economies on average, 55% and 65% of the total gross domestic product and employment (high-income countries) are allocated to SMEs. In developing countries (middle-income countries), this ratio is on average 70% of GDP and 95% of total employment. Similarly, in low-income economies, they contribute 60% to GDP and 70% to total employment. Also, SMEs impact the sustainable development of countries through job creation, innovation, and reducing the income gap (Bartolacci et al, 2020). In Iran, more than 85% of companies are small and medium, which contributes 93% of total employment and creates around 30% of added value (Esmailpoor et al., 2017). Various research has shown that the issue of financing in the fastest time and at the lowest cost is the most important problem for SMEs (Baker et al, 2020; Moscalu et al, 2020). SMEs usually face

restrictions in accessing financial resources and, as a result, have a large financing gap because these businesses have less chance of obtaining financial resources compared to large companies (Abraham and Schmukler, 2017, p 1).

Sukuk can be an alternative solution for financing small and medium businesses and provide access to financial resources in the capital market. Sukuk can also foster economic growth by empowering entrepreneurs and encouraging innovation within the SME sector. By diversifying funding options, sukuk helps mitigate reliance on traditional bank loans, which may not always be accessible for smaller enterprises. This unique financial instrument allows businesses to tap into the capital market, promoting transparency and reducing risk for investors. Furthermore, the adherence to Islamic finance principles ensures that the funds are utilized in ethical projects that benefit society. Ultimately, integrating sukuk into the financing landscape can significantly enhance the resilience and sustainability of small and medium enterprises, driving them toward a more prosperous future.

The current framework of financing instruments in Iran's sukuk market is inadequate for funding small and medium-sized enterprises. This article will address the challenges of financing SMEs and propose a solution to overcome the existing obstacles. In the proposed model, we will discuss various aspects of an appropriate instrument, including the type of sukuk, its underlying assets, and credit risk management.

## Literature Review

Bongini et al. (2019) conducted a study on SMEs' access to market-based financing. They developed an index to illustrate the ease with which potential companies can access financial resources through market-oriented methods. The study revealed that, despite the recognition of capital market financing potential in several Eurozone countries, many SMEs struggle to secure funding through this channel. Furthermore, the research concludes that general business conditions, including GDP growth, the level of domestic financial market development, and the quality of the legal and judicial enforcement system, significantly impact the ability of these firms to obtain financing through the market.

Several studies have examined financing options for SMEs in the capital market. The International Organization of Securities Commissions (2014) introduced innovative tools in equity and debt markets, such as securitization and pooled investment vehicles, to address SMEs' financing challenges. Annas (2014) identified key obstacles like information transparency and adverse

selection, advocating for asset-based sukuk as a potential solution, specifically examining Mudharabah sukuk for financing SMEs in France. The World Bank (2020) evaluated global market-based solutions to improve SME finance, focusing on prerequisites and challenges, including capital market solutions and SME loan securitization. Nassr and Wehinger (2014) discussed alternative banking methods for SMEs. They provided an in-depth analysis of various market-based financing tools, including securitization and covered bonds. The study by Rupika Apoga and Saksonova (2018) explores how companies in EU countries finance their operations. The study notes that despite proposals, SME financing in Europe still heavily relies on banks. However, alternative financing methods are rapidly gaining traction and competing with traditional approaches. The most common non-bank financing options include assistance from friends and acquaintances, government support programs, venture capital investments, and angel investments.

There are advantages and disadvantages to SME financing via capital markets. Gupta and Gregorio (2017) found that listed SMEs are less likely to experience bankruptcy than unlisted ones, concluding that going public reduces financing restrictions and lowers failure risks. The OECD (2015) reported on the pros and cons of market-based SME financing, discussing methods like securitization and public equity listings. Bongi et al. (2019) created an index to measure the accessibility of market-based finance for SMEs in the Eurozone, noting that many SMEs are unable to utilize capital market financing despite recognizing its potential.

Research on challenges related to sukuk issuance for SMEs in Iran highlighted economic and political barriers (Majlis Research Center, 2015). Their 2018 report delved into challenges of debt security issuance, including Sukuk financing costs and the roles of credit ratings.

Sukuk issuance should complement, not replace, bank loans. Expanding capital market financing for SMEs should enhance their connection to the banking system rather than substitute it. Some of the advantages of market-based financing for SMEs are mentioned below;

Increasing the resilience of SMEs against economic shocks: SMEs suffer severely in times of financial crises. Because they face the consequences of the recession, and on the other hand, due to the risky nature of these businesses, banks restrict the allocation of resources to them (Bezmer et al, 2018, p 5). Market-based SME finance can reduce the SME's vulnerability to recession and economic crises by unlocking the available financial resources and reducing the reliance of these enterprises on bank loans (OECD, 2015, p 5).

Market-based financing offers several advantages for SMEs:

1. **Enhancing Resilience to Economic Shocks:** SMEs are particularly vulnerable during financial crises due to their inherent risks and limited access to bank loans. Market-based financing can mitigate this vulnerability by unlocking financial resources and reducing reliance on traditional bank financing (Bezmer et al., 2018; OECD, 2015).
2. **Reducing Dependence on Bank Loans:** SMEs often face challenges due to their reliance on banks. Market-based financing helps bridge the financing gap, particularly for businesses lacking sufficient collateral or turnover records.
3. **Increasing Financing Opportunities:** Directing financial resources toward production is a key goal for economic policymakers. Market-based financing creates efficient investment tools for SMEs, attracting more investors and channeling funds into this vital sector.
4. **Portfolio Diversification:** Market-based financing allows investors to diversify their portfolios through various financial instruments with unique risk and return profiles, such as Sukuks, which offer distinct characteristics advantageous for portfolio management.
5. **Strengthening the Relationship between the Financial and Real Sectors:** The disconnect between these sectors often contributes to economic crises. Utilizing market-based financing can enhance the connection between financial sector development and real economic activity, fostering risk-sharing among SMEs and bolstering macroeconomic stability and financial system performance.

## **Research Methodology**

This research aims to develop a suitable model for issuing Sukuk to finance SMEs. We began by identifying the challenges faced by SMEs in capital market financing through a review of existing studies and expert interviews, followed by a thematic analysis. This analysis, informed by Guest et al. (2012), identified themes reflecting specific experiences or ideas related to our research questions. We categorized themes into three levels: basic themes (codes and key points), organized themes (combinations of basic themes), and comprehensive themes (overarching principles), as outlined by Kamali (2017, p. 192). This process yielded insights into the challenges of SME financing.

Considering the inherent characteristics of SMEs and the identified themes, we established two assumptions: the need for an intermediary between investors and SMEs and the flexibility of contracts for fund usage. Based on

these assumptions, we developed seven models: Bay' al-dayn, Murabaha, Tawarruq, Wakalah, Musharaka, Manfa'a, Salam, and Sale and lease-back. We then applied the TOPSIS technique, a multi-criteria decision-making model introduced by Hwang and Yoon in 1981, to evaluate the models against six criteria derived from our prior analysis. This method involves normalizing the decision matrix and identifying the best positive and negative solutions to rank the options (Çelikbilek and Tüysüz, 2020). Finally, we outlined the key features of the selected model.

## **Results**

### **Challenges of SMEs for issuing Sukuk**

#### **Credit risk management of Islamic securities**

To ensure the supervisory organization understands the risks of Islamic securities, the originator of Sukuk in Iran must provide a guarantor or pledge securities if they lack a proper rating. Banks, which are seen as reliable guarantors, often refuse to support SME Sukuk due to the high risk associated with these businesses and the low income generated from small issuance volumes. Consequently, banks prefer to guarantee larger companies in the Sukuk market. Although SMEs can use various securities, including shares, Sukuk, investment units, and bank deposits, most do not possess significant financial assets.

Additionally, obtaining a good credit rating is challenging for SMEs because evaluating their financial statements is complicated by low transparency, insufficient financial records, and the high fixed costs associated with credit rating processes.

#### **SMEs Default risk**

The financing risk for SMEs can be categorized into two types: Moral Hazard and Adverse Selection. Adverse Selection occurs due to information asymmetry before a transaction, where loans may be given to borrowers with a high probability of default, especially when SMEs submit false documents or transactions (Mishkin, 2019).

Moral Hazard arises from information asymmetry after the transaction (Nazarpur and Olad, 2016). The lender struggles to monitor SME performance due to its ambiguity, and the small volume of SME Sukuk makes close supervision economically unfeasible for monitoring institutions.

**Imbalance in risk-return characteristics of SMEs in Iran's Sukuk market**

The tradeoff between risk and return is an important factor in the success of financing securities for small and medium-sized enterprises (SMEs) in Iran. SMEs generally carry higher risk compared to large enterprises, so investors expect a higher rate of return for investing in them. However, Iran's central bank imposes an interest rate ceiling that prevents SMEs from issuing high-yield Sukuk.

**The strictness of Islamic securities issuance resolution**

The issuance of sukuk in Islamic securities is subject to stringent regulations established by the Securities and Exchanges of Iran. These regulations aim to protect investors from various risks, particularly default risk. However, small and medium-sized enterprises (SMEs) often find it difficult to meet these requirements, such as demonstrating positive cash flow and fulfilling information disclosure criteria.

**Internal management problems of SMEs**

The majority of small and medium enterprise (SME) managers are not well-acquainted with the Sukuk market and typically depend on bank financing. Another issue is the time deviations and delays in implementing and developing projects within these companies, which in turn increases the risk of default.

**The high cost of issuing Sukuk**

Issuing Islamic securities will involve heavy costs for the originator, among which we can mention the SPV's fee, the underwriting fee, the market making fee, and the guarantee fee. The increase in the cost of financing from Sukuk compared to bank loans reduces the attractiveness of this type of financing for SMEs.

**Designing SME Sukuk model**

In addressing the challenges of financing SMEs, it is crucial to establish a financial intermediary between investors and SMEs. This intermediary would issue Sukuk on behalf of the SMEs. However, it is important to note that financing through issuing Sukuk carries a high cost, and the amounts required to finance each SME are lower compared to larger companies. As a result, in the current model, the Sukuk is issued to finance a portfolio of businesses. Implementing this model allows for the economy-of-scale feature of funding of

a portfolio of businesses, thereby reducing issuance costs. The use of an intermediary in this Sukuk model addresses some of the aforementioned problems. Next, we will outline the benefits of having an intermediary for issuing Sukuk for a portfolio.

1. Access to a Guarantor: The intermediary can be selected from financial institutions, which typically have relationships with banks, alleviating SMEs' difficulties in securing a guarantor for their Sukuk.
2. Using Intermediary Assets as Collateral: SMEs often struggle with collateral limitations for issuing Sukuk. Financial institutions possess significant assets, such as shares and Islamic securities, which can be utilized as collateral.
3. Simplified Credit Rating Assessment: SMEs face challenges due to limited financial histories and lack of transparency. In this model, the originator is a financial institution with reliable and transparent financial statements, making credit rating assessments more straightforward.
4. Ease of Meeting Sukuk Issuance Requirements: The stringent requirements for Sukuk issuance can be difficult for SMEs to meet due to factors like inadequate management and limited tangible assets. Since the originator in this model is a financial institution, compliance with these requirements becomes much simpler.
5. Cost-Effectiveness for Sukuk Issuance: Issuing Sukuk in small amounts is often not economically viable for financing SMEs. This model allows the intermediary to issue Sukuk to fund a portfolio of SMEs, enhancing cost-efficiency.

### **Choosing the appropriate Sukuk model for financing SMEs**

Considering that businesses have diverse needs (such as paying salaries, settling debts, etc) this model should be able to respond to their diverse needs. Because of that, we left out the Istisna and Murabahah structure. Because in these two types of sukuk, funds should be allocated to specific needs. Other models that will be examined include; Murabahah, Ijarah, Musharaka, Manfaat, Salam, Wakalah, and Bay' al-dayn.

According to the mentioned themes, the following components were selected as the criteria for choosing the best type of SME Sukuk. It should be noted that these criteria were approved by 3 financial experts.

1. **Compatibility with the medium-term to long-term time horizon of the applicants:** Considering that SMEs may need long-term investment for some activities, it is desirable to issue Sukuk with long-term maturities.
2. **Uncomplicated Sukuk structure:** The structure of Sukuk and relations between stakeholders should not be complicated. To minimize the cost of transactions, and implement the processes easily.
3. **Flexibility in using the proceeds:** SMEs have different financing needs. SMEs needs to finance their working capital and fixed capital. So the model should have the possibility to be used in different needs.
4. **No need for underlying assets:** SMEs have few assets. In the appropriate model the originator should not need to have a significant fixed assets.
5. **Possibility of extending Sukuk maturity:** Due to the economic turmoil, SMEs frequently encounter time delays when implementing projects. As a result, the bond structure needs to be flexible and easily restructure to accommodate these potential delays.
6. **Possibility to use the model in different types of companies:** Considering that each of the economic enterprises in the portfolio has different needs according to the type of industry and the company's conditions, the appropriate model should have high flexibility in the way of repayment and the way of allocating funds.

Based on these criteria, we asked the experts to give points from 1 to 10 regarding the methods of financing SMEs. The job positions of the respondents are described in the table below.

**Table 1. Characteristics of the interviewees**

Secretary of the Jurisprudential Committee of the Stock Exchange Organization	Head of the Financial Instruments and Markets of the Stock Exchange Organization
Halal Fund development deputy	Expert of the Finance Department of the Majlis Research Center
The secretary of the jurisprudential sub-committee of the stock exchange organization	Financing expert of Mellat Investment Bank Company
Financial expert of Noavar investment fund	Member of the Faculty of Imam Sadiq University (AS)
Co-founder and Chairman of the Board of Rosha Innovation Development Company	Experts of Islamic Studies and Development Research Center of Stock Exchange Organization

Source 1: Research findings

### Implementation of TOPSIS to rank methods

Based on the steps outlined in the research method section, the decision-making matrix needs to be scaled according to positive and negative criteria. Then, the balanced decision-making matrix should be calculated. The table below presents the results of these calculations. The average answers of the experts are presented in the table below.

**Table 2. Balanced scale-free decision matrix**

Type of Sukuk	Compatibility with the medium-term to long-term time horizon of the applicants	Uncomplicated sukuk structure	Flexibility in using the proceeds	No need for underlying assets	Inclusion in use for different types of companies	The possibility of extending sukuk
Tawaruq	6.9	4.6	6.9	6.4	6.6	3.3
Ijarah	6.9	6.2	7.2	4.6	2.6	6.4
Musharaka	7.2	6.1	4.7	5.4	6.2	7
Manfaat	6.6	6.1	6.6	5	4.1	6.3
Salam	4	6.1	6.9	4.8	3.7	2.8
Wakalah	7.8	7.4	7.9	8	7.4	7.3
Bay' al-dayn	4.3	6.5	7.2	5.5	5.7	2.4

Source 2: Research findings

The following table shows the values related to ideal and non-ideal options, which can be used to calculate the distance of each financing tool from these options. The results of the calculations are reported in the table below.

**Table 3. Determining the ideal and Non-ideal options in the TOPSIS method**

Type of Sukuk	Compatibility with the medium-term to long-term time horizon of the applicants	Uncomplicated sukuk structure	Flexibility in using the proceeds	No need for underlying assets	Inclusion in use for different types of companies	The possibility of extending sukuk
The ideal option	0.061895	0.019436	0.022627	0.04866	0.133559	0.212284
Non-ideal option	0.031799	0.011961	0.013454	0.027805	0.047516	0.070761

Source 3: Research findings

**Table 4. The distance of sukuk types from the ideal option and calculating its sum**

Type of Sukuk	The distance to the ideal option	Distance to the Non-ideal option
Tawaruq	0.118418	0.079512
Ijarah	0.092903	0.117107
Musharaka	0.03036	0.150187
Manfaat	0.069131	0.1177
Salam	0.151521	0.023193
Wakalah	0	0.170038
Bay' al-dayn	0.148304	0.056239

Source 4: Research findings

In the last step, the similarity index is calculated and financing instruments are ranked.

**Table 4. Final ranking of credit risk management tools with TOPSIS method**

Type of Sukuk	similarity index	rank
Tawaruq	0.401719	5
Ijarah	0.557626	4
Musharaka	0.831844	2
Manfaat	0.629983	3
Salam	0.132747	7
Wakalah	1	1
Bay' al-dayn	0.27495	6

Source 5: Research findings

The results of this questionnaire show that wakalah sukuk is the most suitable type of sukuk for financing small and medium businesses. Therefore, the wakalah sukuk model for financing SMEs will be discussed in the following.

### Designing Wakalah sukuk to finance SMEs

In Iran's Civil law (Article 656), Wakalah is described as a contract in which one party appoints the other as a representative to carry out a specific task. According to AAOIFI's Sharia Standard No. 23, Wakalah is defined as an act in which one party assigns another to act on their behalf and delegates the authority to perform a specific task.

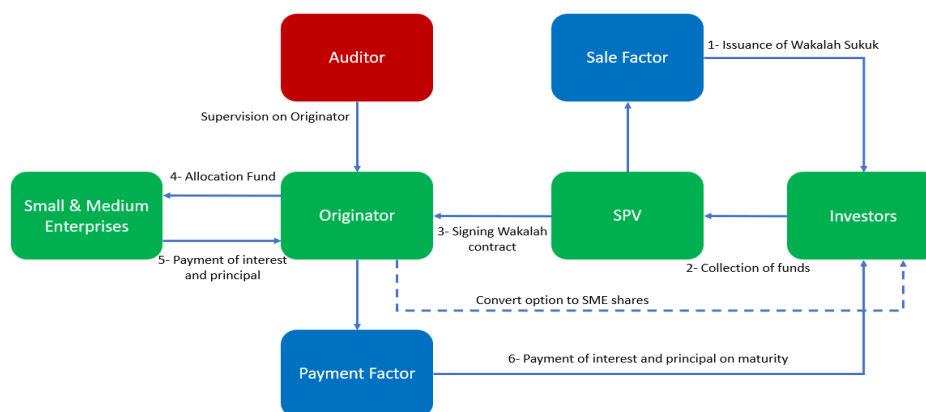
According to the SEO resolution, wakalah sukuk is a transferable security signifying joint ownership of assets, goods, services, specific projects, or the rights and benefits arising from specific economic activities. It is issued based on the Wakalah (Board of SEO, 2018). The IIFM report in 2022 reveals that

short-term wakalah sukuk (with maturity of less than 12 months) accounted for approximately 30% of the total volume of sukuk issuance from 2010 to 2021 (IIFM, 2022, p 46). Additionally, in 2022, the volume of Wakalah sukuk issuance constituted 41% of the total international sukuk issuance volume (IIFM, 2022, p 66). The flexible structure, ability to utilize resources in various fields, and the lack of significant differences among Islamic religions in the Wakalah contract have attracted companies and governments to increasingly issue Wakalah sukuk. In fact, in 2021, the majority of new sukuk issuance at both domestic and global levels was wakalah sukuk (IIFM, 2022, p 41-73).

The issuance of wakalah sukuk offers significant advantages, as outlined in the following scenarios:

1. The originator enjoys greater control over the funds, leading to improved operational efficiency and effectiveness in investment and returns;
2. Flexibility in selecting the underlying assets for issuing wakalah sukuk allows for the creation of a diversified pool of assets, including tangible, debt, and cash;
3. Wakalah sukuk investments are well-suited for individuals with surplus income but who lack a clear investment strategy or face investment limitations (Abdullah and Sairally, 2017, p 397-398).

Additionally, the diagram below depicts the model of wakalah sukuk for SME financing.



**Figure 1. The model of issuance of wakalah sukuk for SME financing**

Source 6: Research findings

The convertible sukuk is a type of sukuk that includes the option to exchange a specified number of sukuk for the common shares of the company at a predetermined conversion rate (Bodie et al, 2021). Converting the wakalah sukuk into shares is contingent upon the conditions outlined in the contract. It is essential to adhere to the regulations regarding the conversion of sukuk into shares as stipulated in the contract to prevent any fraudulent activities (IFSB, 2021, p 9). For wakalah sukuk, SMEs offer investors the opportunity to exchange their sukuk for shares in one of the companies that has received financing, at a fixed exchange rate. This feature not only enhances the appeal of sukuk but also provides investors with the option to purchase shares in SMEs if it proves advantageous and leads to greater profits. Establishing the conversion rate at the outset of the sukuk issuance is critical to averting any potential fraudulent practices (Tohidi, 2019, p 40).

The success or failure of issuing sukuk to finance SMEs is greatly influenced by the attractiveness of the rate of return in comparison to the associated risks (Altman et al, 2020). One of the key challenges in financing SMEs is the mismatch between risk and return of sukuk, particularly due to the mandatory determination of sukuk coupons in Iran. Enabling the conversion of sukuk to SME shares provides a way to align returns with risk to the greatest extent possible for financing SMEs.

### **The parties involved in Wakalah Sukuk for financing SMEs**

According to the guidelines for issuing Wakalah sukuk in the capital market of Iran, the involved parties are the originator, guarantor, SPV, sales agent, paying agent, and trustee. As per Article 2 of the Wakalah Sukuk resolution, holding companies, investment firms, investment banks, non-governmental public institutions, ministries, government institutions or companies, and municipalities can participate in the issuance of Wakalah sukuk. Therefore, potential originators of Wakalah SME Sukuk may include investment banks, innovation and prosperity fund firms, provincial investment companies, and other investment entities.

As previously discussed, one of the significant challenges for these businesses is the requirement to provide a guarantor for sukuk issuance. According to the regulations, the guarantor must be chosen by the originator and approved by the organization from a specified list of financial institutions, including banks, credit institutions supervised by the central bank, insurance companies under central insurance supervision, retirement funds, investment companies, holding companies, non-governmental public institutions, as well as government companies and institutions.

In the prevailing model, organizations such as the parent company of the Small Industries and Industrial Towns Organization of Iran, the Innovation and Prosperity Fund, and development banks (including Tose'e Saderat Bank, Tose'e Ta'avon Bank, San'at ma'dan Bank, Keshavarzi Bank, Maskan Bank) are identified as potential guarantors for the Sukuk. This instrument is issued by another institution to bolster the ecosystem for small and medium-sized enterprises.

In wakalah sukuk, the originator has significant discretion in using the funds obtained from the issuance of Wakalah sukuk. Shariah risk is a concern associated with Sukuk. In this type of sukuk, once the funds are collected, the agent enters into separate contracts with the beneficiaries and then allocates the funds to those parties based on the specific contracts. It's crucial to closely monitor the process of finalizing contracts with SMEs to ensure compliance with Shariah and legal aspects of the contracts, as well as to assess the risk by calculating the company's funding requirements in relation to the requested amount and conducting an economic and financial evaluation of the development plan and its internal rate of return.

### **Profit management in SME Wakalah Sukuk**

As per the resolution of the shari'ah committee of the SEO, the calculation and payment of interest in wakalah sukuk must be clearly outlined in the prospectus. Interest in wakalah sukuk can be calculated and paid in the following ways:

1. Payment of fixed and definite interest if the contracts with SMEs have a fixed and definite interest and the Wakil's fee is also fixed.
2. Payment of interest amounts on the payment dates in the form of accruals and fixed interest (if any) at the final due date.
3. Payment of actual profit (if any) at maturity (Board of SEO, 2018).

If the wakil's performance in wakalah sukuk is weak, and is accompanied by negligence or deficiency, it is possible that the Wakalah sukukholders, in addition to not earning any profit, may lose all or part of their capital.

It is not allowed for a representative (wakil) to guarantee anticipated profits or losses, but a third party may be used to voluntarily make such a commitment. In this case, the committed third party must have a better credit rating than the wakil, and this commitment is irrevocable and payable (IFSB, 2021, p. 189).

It is impermissible to simultaneously combine Wakalah and personal guarantees within the same contract, as this contradicts the essence of Wakalah contracts. When a party acts as both a Wakil and a guarantor, the guarantee provided transforms the transaction into an interest-based loan (AAOIFI, 2017, p 617). However, there are two mechanisms available to mitigate this risk.

### **Compensation for the Profit Deficit**

The Shariah Council of the Securities Commission of Malaysia has suggested the early payment of interest to the Sukuk holders as a loan on behalf of the originator, in connection with the reimbursement of the interest paid to the Sukuk holders. It's important to clarify that the amount paid by the originator is considered an advance payment to the sukukholders and should be distinguished from the price of the sale and purchase contract of the asset that the originator is obligated to pay by the sukuk's maturity (Sharia Council of the Securities Commission of Malaysia, 2022, p 131).

### **Donation of the profit deficit by the originator to the sukukholders**

The relationship between the originator and the wakalah sukukholders is akin to the relationship between the bank (as a wakil) and the depositor (as a muwakil) in the Iranian banking system. Therefore, the existing jurisprudential rules concerning guaranteeing the expected profit of depositors (as muwakil) in the Islamic banking system in Iran can be expanded to cover the guarantee of profit for Sukuk holders (as muwakil) in the capital market. In this context, the originator agrees to cover the profit deficit from their resources if the profit from the asset pool is less than the expected profit. The bank (as a wakil) acts as an agent in the proper and correct investment of depositors' resources (as a muwakil). Therefore, by determining the guaranteed profit, it has given a kind of assurance for the good performance of its work, and if the actual profit is less than the guaranteed profit, the wakil will be required to compensate the difference from its resources. This guarantee can be stated in the form of a "covenant in the contract" (Bariklu, 2007, p 103).

### **Profit guarantee by a third party:**

To ensure the expected profit of the sukukholders, it is feasible to engage a third-party entity as a guarantor of the minimum profit. In other words, an external party, such as an insurance company, is tasked with ensuring profits for muwakils. In this scenario, the third party's guarantee does not impede the role of the bank's wakalah and is fully lawful and sound from a jurisprudential perspective (Qelich and Mosavian, 2020, p 646). The provision of a guarantee does not imply a contractual or enforced guarantee; rather, it entails the

guarantor's commitment to achieve the profit stipulated by the originator. Therefore, it is evident that the provision refers to an obligation to act, not a commitment to a specific outcome. Thus, this provision is valid (Bariklu, 2010, p 103).

Obligation for the originator to purchase the underlying assets at a certain price

It is feasible to stipulate that the originator repurchases a portion of the underlying assets at a predetermined price, which encompasses the profit and principal (ISRA, 2016, P 412). Nonetheless, this approach contradicts the essence of wakalah sukuk. According to AAOIFI, the use of buyback in Wakalah Sukuk is permissible only if the originator and buyer are not the same.

### **Creating a profit reserve account**

The excess profit, which is the difference between the actual profit and the expected profit of sukukholders, is kept in the profit reserve account. This account is held and managed by the SPV until the sukuk reaches maturity. At maturity, if the originator (wakil) has managed investments well and reported regularly to supervisory bodies, including the trustee, Sharia supervisor, and risk supervisor, the excess reserve transfers to the originator. However, if the originator's performance does not meet these criteria, the profit reserve will be transferred to the sukuk holders. In Iranian capital markets, the mechanism for allocating excess profit to the wakil is not specified. It is also mentioned in standard number 46 that; "The representative (wakil) is allowed, with the muwakil's consent, to set aside a portion of the profits to create a reserve account that benefits the muwakil" (AAOIFI, 2017, p 1122). The purpose of creating a profit reserve account is as follows:

### **Motivating Wakil to earn profit**

Wakil plays a significant role in the structure of wakalah sukuk. It is responsible for investments, and its performance directly affects the profit of the asset pool. This mechanism is used in Islamic countries and is approved by international standards to motivate Wakil.

### **Ensuring and smoothing the periodic payment**

The profit reserve account ensures the payment of periodic profit when Wakil has not been able to pay the expected profit to the Sukuk holders. If Wakil fails to provide the expected profit, the profit will be paid from the profit reserve account. The figure below illustrates the operation of the profit reserve account.

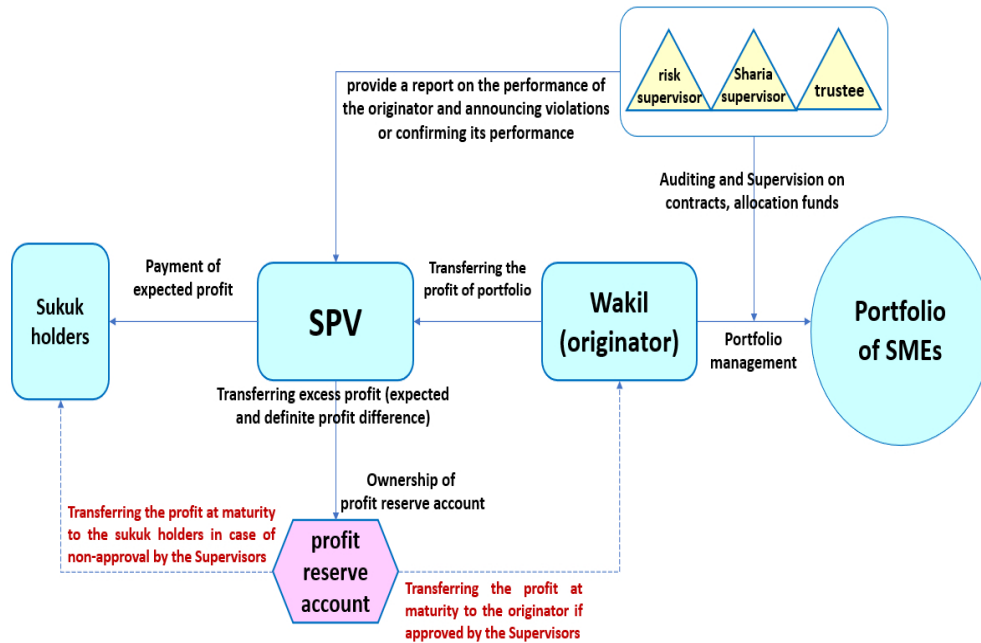


Figure 2. Mechanism and function of the profit reserve account and its allocation

Source 7: Research findings

### Wakil's fee

As per the Sharia Council and the Securities Commission of Malaysia, Wakalah sukuk holders waive their excess profit in favor of the wakil, considering it an incentive fee as per the "Tanazul rule." Waiving rights entails relinquishing legal rights in favor of another person (Sharia Council of the Securities Commission of Malaysia, 2022, pp 132-133; SC, 2015). Additionally, as per the AAOIFI standards, it is permissible to waive the excess profit based on the suspended donation rule (AAOIFI, 2017). However, based on the opinion and approval of the Shari'ah Committee of the Iran's Securities and Exchange Organization (SEO), the wakil's fee can be either fixed or variable (Shari'ah Committee of SEO, 1400, p 325). According to the conventional model in Islamic countries and international standards, the excess profit is considered a reward and incentive fee for the wakil. Therefore, the wakil owns the excess profit.

### Construction of SME's portfolio by Wakil and its reporting

In wakalah sukuk, the investment agent (originator) must inform the sukuk holders (Muwakils) about all the details related to the SMEs in the portfolio. This includes providing a technical and economic evaluation report of the

SMEs being financed, outlining the liquidation characteristics, specifying the geographic region and economic sector, and presenting the expected profit and the wakil's ability to liquidate the assets at maturity. Throughout the tenure of the sukuk, the wakil is responsible for establishing the necessary technical infrastructure to effectively monitor the investments (ISRA, 2017, P 417).

Wakil is required to invest the funds in compliance with Sharia principles (IFSB, 2021, p 189). The asset pool may consist of various Shariah-compliant assets selected by the investment agent for a specified period, including stocks, real estate, and cars obtained through contracts such as Murabaha and Istisnaa (IFSB, 2021, p212). According to Sunni jurisprudence, the majority of the assets should be tangible, with the preferable ratio of tangible assets in the asset pool falling between 33% and 51% (AAOIFI, Shariah Standard No 21). Adhering to this ratio ensures that tangible assets remain in the majority.

In relation to the proposed model for issuing wakalah sukuk for financing SMEs, it is recommended to avoid using profit-loss sharing contracts in allocating resources. The lack of transparency in the financial statements of these businesses presents significant challenges in accurately calculating real and actual profits when employing partnership contracts. Consequently, the issuance of such sukuk will encounter substantial obstacles. Furthermore, the use of partnership contracts poses a risk of transferring the businesses' risks to the sukuk holders, thereby increasing the sukuk's risk profile and diminishing its appeal to risk-averse investors. Conversely, such a model may be favorable for SMEs, as it allows the founders to retain control of the company.

The financing requirements of SMEs can be broadly categorized into two groups: the need for capital assets and the need for working capital (Ross et al, 2015). Therefore, in the current model, capital assets can be financed through options such as sales and leaseback, Murabaha, and Istisna, while working capital can be financed using Salam and Bay-aldayn contracts.

### **Monitoring the performance of the originator**

In the context of the originate-to-distribute model, the incentive for the originator to allocate funds responsibly may be diminished, as the originator does not bear the risk of the portfolio (Purnanandam, 2011). Research by Purnanandam has indicated that banks' lending to their own portfolios experience lower default rates compared to those offering loans to third parties about whom they have little knowledge. Therefore, for this model, we propose several oversight solutions for the originator:

- Involvement of a trustee in the budgeting process;

- Conducting audits of the originator by independent entities;
- Increasing the originator's stake in the investment portfolio to align their interests with those of the investors;
- Mandating the originator to replace defaulted SMEs with new ones.

## Discussion and Conclusion

SMEs are often seen as the driving force behind economic growth, playing dual roles in the economy. Firstly, these enterprises significantly contribute to economic expansion by boosting GDP participation. Secondly, SMEs can have a substantial impact on poverty reduction through job creation. Timely and low-cost financing is key to the growth and development of SMEs. The issue of financing for these companies has been a focal point for researchers and policymakers, resulting in various proposed solutions. This research introduces an innovative model for SME financing using Sukuk. To determine the optimal Sukuk model for financing SMEs, the study initially identified the most crucial challenges associated with financing SMEs through Sukuk issuance in Iran through literature review and expert interviews. These challenges include credit risk management of Islamic securities, SME default risk, mismatches in risk-return profiles within Iran's Sukuk market, the stringency of Islamic securities issuance regulations, internal management issues within SMEs, and the high costs associated with Sukuk issuance.

Considering the challenges associated with SME financing through Sukuk issuance, it has been determined that an intermediary is necessary between investors and SMEs in the Sukuk model. This model should be designed to allow SMEs to utilize funds for various needs. Based on these considerations, seven Sukuk models, including Tawaruq, Ijarah, Musharaka, Manfa'ah, Salam, Wakalah, and Bay' al-dayn, have been proposed. Six criteria were then established for ranking models, including medium to long-term compatibility, uncomplicated Sukuk structure, flexible use of proceeds, no requirement for underlying assets, and potential for Sukuk maturity extension, and adaptability to different company types. Following this, seven financing methods were ranked by experts using the TOPSIS technique, with the results indicating that the Wakalah Sukuk model is the optimal choice for financing SMEs in the capital market. Accordingly, the Wakalah Sukuk model was tailored to meet the financing needs of SMEs, taking into consideration various aspects such as profit management, Wakil's fee, construction of SMEs' portfolio by Wakil, and reporting and monitoring of the originator's performance.

Despite having guidelines for issuing Wakalah Sukuk, this type of Sukuk has not been used to finance companies. Future studies should investigate the reasons behind the reluctance of originators to use this type of Sukuk.

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