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# BANKING AND FINANCE

TO SMALL AND MICRO-  
ENTERPRISES IN SUDAN

Some Lessons from the Islamic Financing System

**Badr-El-Din A. Ibrahim (Ph.D. Econ.)**

Foreword by Prof Rodney Wilson

Published by

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Published by

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IIBI 2003

ISBN 1 898420 85 8

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## Foreword

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Finance is often the greatest difficulty facing small enterprises, as conventional banks prefer to lend to larger, less risky businesses. Where there is trust between financial institutions and the enterprises they are supporting, the transactions costs of such funding are considerably reduced, not least because moral hazards, and hence risks, are reduced. When both bankers and businessmen share a common religion, and ascribe to the same set of values, less screening is needed of financing applications, yet repayments defaults are less likely. This is a major advantage that Islamic financial institutions enjoy over their conventional competitors, as moral suasion can be used to ensure repayment and full disclosure of all information relevant to the financing. Given these more favourable conditions for Islamic financing, the funding of smaller, and even micro-, businesses becomes viable.

Professor Badr-El-Din Ibrahim demonstrates just how valuable Islamic financing can be in supporting small businesses and in covering the gap that is often left by conventional funding. Large numbers of relatively poor people can benefit from Islamic finance, including recipients of micro-finance, such as those with small manufacturing workshops or single trading establishments. One major advantage of Islamic finance is that risks are shared between the financing institution and the beneficiary, which means that entrepreneurs are better placed to concentrate on what they do best. Entrepreneurship is stifled if those involved in businesses are distracted by excessive worries over risk management. Islamic banks, with a portfolio of funded projects, are better placed to take on greater responsibilities for risk.

The author provides a lucid explanation of those Islamic methods of finance most appropriate for small and micro-enterprises, namely *musharaka*, partnership finance, *murabaha*, mark-

up trade financing and *mudaraba*, profit-sharing financing. Although the author admits his early doubts about the effectiveness of Islamic financing for small-scale businesses, his practical experiences as an advisor with the Sudanese Islamic Bank convinced him of the viability of this type of financing. Indeed, he discovered its much greater suitability, compared with conventional financing methods, for supporting small and micro-enterprises, largely because of its participatory nature, which benefits the recipient and encourages client loyalty. Where there is an ongoing dialogue between the financier and the entrepreneur, business decision-making is improved, as two parties working together produce a better outcome than when each is working in isolation.

Sudan has faced many macro-economic problems and these have created a difficult business environment for small firms and micro-enterprises. Professor Ibrahim shows that these businesses have nevertheless played a major role in generating employment opportunities and increasing the family income of people of modest means. He evaluates the contribution of the informal sector, such as craft workshops and productive families, all of which have benefited from Islamic financing, especially since the 1990s. This has helped significantly with poverty alleviation and there is much potential for this type of small and micro-business support to be extended in the Sudan, as well as elsewhere in Africa and the developing world in general. Indeed, Professor Ibrahim suggests that the profit-and-loss-sharing techniques used for Islamic financing can even be extended to places where interest-based banking is used.

Case studies are often the best means of illustrating how particular ideas and concepts work in practice. One of the major strengths of this work is the discussion of the experiences of particular banks to illustrate how Islamic financing works in reality. The institutions covered include the Sudanese Islamic Bank, the Faisal Islamic Bank, the Islamic Co-operative Development Bank, the Nelein Industrial Development Bank, the Agricultural Bank of Sudan, the Farmer's Bank and the Sudanese Savings Bank. For each

bank, the amount of financing is reported and an assessment made of the financing conditions. This wealth of material provides a very rounded picture of the scope of Islamic financing in Sudan and of how specialised institutions, such as the Industrial Development Bank and the Farmer's Bank, can deploy such funding.

There are undoubtedly important lessons to be learned from Sudan's successful experience with Islamic finance for small businesses and micro-enterprises. Professor Ibrahim's study is a valuable contribution not only to the empirical literature on Islamic finance, but also to development finance literature generally. It will interest all those concerned with economic development at grass-roots level, as it demonstrates the advantages of delivering funding in a manner that is consistent with the beliefs and values of the recipients.

Professor Rodney Wilson,  
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## **ABBREVIATIONS:**

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ABS	Agricultural Bank of Sudan
ACCORD	Agency for Co-operation in Research and Development
ADS	Area Development Scheme (of the UNDP)
CRFs	Crafts
DUGAP	Dutch University Gedaref Assistance Programme
EEC	European Economic Community
FB	The Farmer's Bank
FIBS	Faisal Islamic Bank (Sudan)
FES	Friedrich Ebert Stiftung
GDP	Gross Domestic Product
ICDB	Islamic Co-operative Development Bank
IGAs	Income Generating Activities
ILO	International Labour Organisation
IMF	International Monetary Fund
IMSA	Imputed Market Share Approach
IS	Informal Sector
LDCs	Least Developed Countries
NGOs	Non-Governmental Organisations
NIDGB	Nelein Industrial Development Bank Group
PFs	Productive Families
PFBs	Productive Family Branches (of the SIB)
PLS	Profit-and-Loss-Sharing
PS	Profit-Sharing
RA	Residual Approach
SE	Small Enterprises
SIB	Sudanese Islamic Bank
SIBs	Sudanese Islamic Banks
SSDB	Savings and Social Development Bank
SSIs	Small-Scale Industries
SSPSSEC	Sudanese Society for Promotion of Small-Scale Enterprises and Crafts
SMEs	Small and Medium Enterprises
UNIDO	United Nations Industrial Development Organisation
WASME	World Association For Small and Medium Enterprises

# Introduction

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Small and micro-enterprises are now considered to be one of the major priority areas in development policy in Africa. Recently, the political economy of development has undergone radical change, and there are changing perceptions about the state, the market and society. The role of the public sector has been minimised and solutions to development problems have shifted to the private sector, in which small enterprises are receiving increased attention and new roles. In spite of the concerns about small enterprises, they have not been high on the development agenda of many developing countries. It is clear that small and micro-enterprises (depending on the sub-sector under investigation) have certain economic advantages and the conclusion has been reached that small enterprises have a lot to offer to developing economies. Now, the key question is not whether small enterprises have any potential for development or not, but rather, what kind of assistance we need to offer. One kind of assistance is the provision of institutional financial support.

Funding small and micro-enterprises has been seen as a challenge all over the globe. A multitude of financing schemes has been in operation for many years in various developing countries, but the advances that have been achieved have not been without constraints. Experiences show that financing small and micro-enterprises is hampered by the absence of collateral, the high risk of default on loans and high administrative costs.

One of the major developments in both Muslim and non-Muslim countries in the last two decades has been the emergence of Islamic banks. Their estimated assets are around US\$60 to 100 billion and, today, they share 15 per cent of the total market's assets<sup>3</sup>. Sudan is one of the three countries (the others are Iran and Pakistan) where the whole banking system has been converted to Islamic banks. A variety of methods and investment instruments, based on

risk- and profit-sharing, are employed. The useful lessons which Islamic banking can offer are not easily demonstrated empirically and the success of Islamic banking is taken for granted by its supporters, owing to their ideological reasoning and belief in Islam.

Likewise, in Sudan, the advantages that Islamic modes of financing have are accepted almost as acts of faith, with very little theoretical research carried out and modifications rarely made to the system. It is surprising that, despite more than two decades of the application of Islamic modes of financing in Sudan, there are still substantial modifications and improvements to the system that need to be researched and addressed.

Islamic banks manage to utilise Islamic financing formulae to provide venture capital to small entrepreneurs. Although a great deal is known about the Islamic approach to financing, very little regarding its practical application is known. Sudanese Islamic banks, established in the late 1970s and the early 1980s, are rare examples of formal institutions which are engaged, on a significant scale, in the application of Islamic modes of financing to small and micro-enterprises. This represents a unique, fully-fledged body of practical experience of the Islamic financing system applied to small enterprises. It is one of the rare occasions in the world in which this system has worked in practice and has been heavily supported by specific banking legislation. The experience is associated with central bank financing policies geared towards the Islamisation of the entire banking system.

In Sudan, small and micro-enterprises are trendy. As a result of the deteriorating economic conditions there, every individual dreams of having a small business to mitigate his or her hardships. Moreover, it is generally argued that for sustainability, finance to small and micro-enterprises must pay for itself. The SIB's finance to small and micro-enterprises is designed and managed in a business-like manner and embodies social goals. It is not run as a welfare programme. It is a hybrid of profit-seeking and social objectives on

a continuous basis. Despite this, its cost-effectiveness is maintained. One of the lessons which Islamic profit-and-loss-sharing experiences can teach us is that small businesses that have failed through no fault of their own may not, by using this system, end up being worse-off than if they had never borrowed. One reason for this is that, in the Islamic system, owners of small and micro-enterprises are not burdened by repayments, even if they fail. Thus, the experience of small and micro-enterprise funding in Sudan can provide a lesson to others in the same field world-wide. Yet this success has received little, if any, attention.

The purpose of this book is twofold, mainly to give an overview of major instruments of Islamic financing for small enterprises, but also to document, with some analysis and examples, the Sudanese institutional application of Islamic financing to small and micro-enterprises — the first such system in the world to be supported by the full Islamisation of the banking system and banking regulations.

This book will also, for the first time, introduce international financial institutions, non-governmental organisations, researchers, donors, development agencies, LDCs, governments and other small-enterprise financiers to the little-known Islamic financing system for the small and micro-enterprise sector and show what lessons we can learn from it. Moreover, it is hoped that this analysis will identify issues on which further research, which is most urgently needed, can be conducted, in order to develop an appropriate universal strategy for small and micro-enterprise financing the world over.

The Sudanese experience in Islamic financing of small and micro-enterprises brings new conventions in banking practices to the sector and has some potential for solving the outstanding difficulties of small-enterprise financing. However, some difficulties remain to be addressed.

This book is not intended to put questions to which there are no answers and does not try to compare the Islamic system of

financing small and micro-enterprises with the Western system, much less to promote the former over the latter. Rather, it is intended to raise the issue to the level of debate and discussion among practitioners and academics. I am of the opinion that the lessons learned and the experiences garnered from the Sudanese Islamic banking system, when it comes to funding and promoting small and micro-enterprises, are of global interest. Such enterprises are vital to all of us and we have to ensure that in the future, funding is available to them, whichever system we choose to adopt.

# Chapter One

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## CONSTRAINTS IN FINANCING SMALL AND MICRO-ENTERPRISES

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*This chapter provides theoretical background. Constraints in financing small and micro-enterprises are reviewed. The main features of reforms that have been suggested and applied in order to establish a neutral environment with respect to enterprise size are also shown. It will be seen that no serious attempts to adapt commercial banks to small and micro-enterprise clients have so far been made. The following chapters review this kind of experience.*

## **Financing Constraints of Small and Micro-enterprises**

Easy access to credit is singled out in the literature on small and micro-enterprises as one of the major problems. Most studies highlight the lack of credit facilities as their major obstacle. Additional studies show that small and micro-enterprises have little access to the resources of the organised financial sector, mainly owing to the high risk of default and high administrative costs. Consequently, they resort to moneylenders, who ask for higher interest rates<sup>4</sup>. Small and micro-enterprise capital scarcity is sometimes seen as an illusion. Some small and micro-enterprises cited shortage of capital as a major problem, but it was because their present capital was not economically employed. Others, however, managed to make effective use of their tiny capital.<sup>5</sup>

Most of the difficulties small and micro-entrepreneurs face in obtaining finance are related to ‘transaction costs’ — the cost of administering and delivering credit and the cost arising from the risk of default. It is generally noted that small enterprise loans are relatively small, while the cost of administering credit is fairly constant, irrespective of the size of the loan. Bankers also consider small enterprises to be risky clients because they do not keep the proper records needed by the financial system and hence are not able to meet conventional security requirements.

Having accepted the risk of default and high administrative costs, the literature goes on to suggest the encouragement of private

banks to extend credit through various risk guarantee measures. Others argue that these measures may involve ‘moral hazards’ as a result of financial institutions passing on the losses to the government (through the credit insurance or guarantee scheme, in which the government takes over the risk in return for a premium from a small entrepreneur), rather than attempting to reduce the risk, as intended in the programme.<sup>6</sup> Others consider the reason for the lack of access to be the shortage of funds brought about by government imposition of credit controls that have tended to keep interest rates artificially low. At a low rate of interest, lenders are reluctant to take the risk of default and therefore prefer to lend to establishments which have a guarantee and a good record of repayment. Subsidised credit programmes, it is also argued, encourage small enterprises to use capital more intensively and less productively, replacing the personal savings that typically are the source of investment of small enterprises.<sup>7</sup> Others, convincingly, showed that the “benefit to the borrower of a reduction in interest rates would be relatively insignificant when compared with the lender’s reduction in income.”<sup>8</sup>

The importance of credit is singled out in removing barriers to operations in small enterprises (lack of tools, shortage of raw materials, etc.) to the extent that “a large reduction in the rate of interest is far less important than the fact that the enterprise can operate at all”<sup>9</sup>. As a result, much of the literature on small enterprise financing argues in favour of relaxing administrative control over interest rate policies to “reflect the cost of raising resources and lending to low- risk borrowers”<sup>10</sup>. It is generally acceptable that if finance to small and micro-enterprises is to be sustainable, this should be at the market rates of interest, not concessional rates of interest. Successful innovative financial schemes to small and micro-enterprises are those which meet the sustainability, profitability and non-charity criteria by charging a rate of interest which justifies the transaction cost of lending.

Concessional finance to small and micro-enterprises has not been a total failure. A number of credit schemes are quite successful. One well-known success story is that of the Grameen Bank in Bangladesh, which charges a rate of interest of 16 per cent, without the need for collateral. In cases of personal misfortune, the borrower pays a compulsory insurance charge into an Emergency Fund, which accounts for 25 per cent of the interest payment. The crucial factor in the success of the Grameen Bank, it is argued, is a cheap system of assessing creditworthiness, through local knowledge and group pressure. This system minimises risks and achieves high repayment rates.<sup>11</sup> Attempts have been made to replicate the Grameen model outside of Bangladesh, in rural Africa and urban Asia, by transplantation of most of the basic characteristics. It is argued that this example has exceptional ingredients which are not easily replicable elsewhere. Many argue that the system depends too much on the charisma of the Grameen bank's founder and the special characteristics of Bangladesh's rural poor.<sup>12</sup>

A question that usually arises whenever this topic is discussed is whether or not the lack of access to formal credit facilities by small and micro-enterprises reflects risky repayable defaults or distortions in the practice of credit institutions, or even regulations of financial markets (interest rate ceilings, minimum reserve requirements, exchange rate controls, sectoral credit allocations, etc.).<sup>13</sup> That is, the problem is identified as an external constraint not an internal one. Another question that also arises is whether the lack of access to credit by small producers because of external institutional factors may be a symptom of problems later experienced by the venture, including defaults of repayments. Still another question to be answered is whether or not there is a correlation between interest rates and the supply of credit to small and micro-enterprises. Imposition of concessional rates might exclude small enterprises from the services of formal financiers. Definite views on these issues, based on comprehensive surveys, are far from conclusive.

Findings show that small and micro-enterprises generate higher rates of return on capital than their large-scale counterparts. Moreover, they also have a higher total factor of productivity or economic efficiency, reflected by a high output-to-capital ratio. A high rate of return on small capital, compared with that of large capital investment, poses another argument in favour of small enterprise financing. It is generally recognised that the smaller the finance, the larger the rate of return and vice versa.<sup>14</sup> It is very perplexing that the bankers' reluctance to lend to small enterprises is based on the lack of a suitable guarantee, at a time when the rate of return on capital of small enterprises is higher than that of large-scale enterprises. In fact, the high rate of return from small projects, reflected by a high net monthly profit in relation to capital investment, represents a guarantee that looks better than the unavailable collateral guarantee.

### **Financial Constraints of Small and Micro-enterprises in Sudan**

Recent studies on the financial constraints of small businessmen and women in Sudan are not available. Studies conducted during the 1980s show that a shortage of credit facilities to small and micro-enterprises is evident in the country.<sup>15</sup> Difficulty of access to credit, before the full Islamisation of the banking system, was noted and recorded in many studies. Case studies conducted in different regions during the 1980s in Sudan (covering crafts and small-scale industries and the informal sector, which includes services as well as manufacturing) pointed to the limited ability of the Development Company and the Industrial Bank of Sudan (now Nelein Industrial Development Bank Group) to finance small-scale industries. Some studies also revealed that most of the enterprise owners rely exclusively on self-financing. As is the case in many developing countries, the low level of bank finances is mostly related to the absence of adequate guarantees.

## **Institutional Financing and Small and Micro-enterprises**

It is generally recognised that banks, among other formal financial institutions, have not extended enough credit to the small enterprise sector in developing countries, despite various schemes to minimise the risks involved being put forward. Alternatively, small entrepreneurs often rely on personal savings or profits from other activities, loans from friends and family, advance payments by customers and the less formal lending markets. Some reforms have been suggested and applied to establish a neutral environment, with respect to enterprise size, to remove discrepancies, which currently favour giving credit to large enterprises. In this respect, some schemes have been suggested to redress this bias by creating incentives that encourage formal financing institutions to extend credit to small and micro-enterprises. The major features of these schemes can be summarised as follows:

- The credit insurance or guarantee scheme. In such a scheme, the government takes over the risk in return for a premium from the small enterprise owner.
- A scheme that links formal and non-formal financial institutions. Savings and credit associations, NGOs and self-help promoting institutions link up with the banking system to help provide funds.
- Setting aside a specific portion of a commercial bank's loan portfolio for the exclusive use of small and micro-enterprises.

However, such schemes as the ones highlighted above have very rarely been successful. The guarantee scheme and the link system are slow and partial; whereas the small enterprise reserved loan portfolio is slow in disbursement and has not reached the intended recipients.

It is a general observation that no serious attempt has been made to adapt commercial banks to small and micro-enterprise

clienteles. Generally speaking, there is a lack of provision of administrative capacity and a failure of initiative on the part of commercial banks to handle small credit. The experience of profit-and-loss-sharing (a sort of short-term equity financing) documented in this book can be seen as one step towards achieving this goal.

## **Conclusion**

Difficult access to credit is singled out as a major problem facing small and micro-enterprises. This was certainly the case in Sudan during the 1980s. There is now a general consensus that the difficulties small businessmen and women face in obtaining finance are related to high transaction costs and artificially low interest rates.

Subsidised credit programmes failed, apart from some exceptional cases. Some reforms have been suggested and applied to establish a neutral environment with respect to enterprise size to remove discrepancies, which currently favour providing credit to large enterprises. The features of these schemes are depicted in credit insurance or guarantee schemes, linking informal (credit associations, self-help groups, etc.) to formal financial institutions and setting aside specific loan portfolios for the exclusive use of small and micro-enterprises.

No serious attempt has been made to adapt commercial banks to small and micro-enterprise clients by the provision of administrative capacity and initiatives on the part of commercial banks to handle small credit. The experiences described in this book largely relate to the adaptation of Sudanese Islamic banks to the requirements of small and micro-enterprises.

# Chapter Two

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**THE STRUCTURE AND PERFORMANCE  
OF THE SUDANESE ECONOMY AND THE  
CONTRIBUTION OF THE SMALL  
ENTERPRISE SECTOR TO IT**

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*This chapter is an introductory one. It starts with reviewing the structure and performance of the Sudanese economy and shows the role, the definition, the means of financing and the contribution of the small enterprise sub-sector (small-scale industries, informal sector, crafts, productive families and income generating activities).*

## **The Sudanese Economy: Structure and Performance**

Sudan is the largest country in Africa with an area of 2.5 million square kilometres. The population is approximately 24.9 million (1993) with an annual growth rate of about 2.63 and population density of about 10 persons per kilometre.

Sudan is rich with natural resources and suitable climatic conditions for the production of a wide variety of products and animal-raising. The estimated arable land is 200 million *feddan*.<sup>16</sup> Only 30 per cent of this is currently being used. Natural grazing land is estimated to be 57 million *feddans* and forests cover an area of one million *feddan*. Fishery resources are around 300,000 tonnes per year, but only 60,000 are exploited at the present time. Sudan is rich in mineral resources such as gold, chrome and cement. Oil reserves have been discovered in the south and west of the country, but these have yet to be commercially exploited.

The economy is predominantly agricultural. Agriculture is composed of a large irrigated sub-sector (large-scale, publicly-owned and administered schemes), an expanding mechanised rain-fed sector (large-scale, privately-owned farms) and a neglected, traditional rain-fed agriculture sector (small-scale, privately-owned independent family farming units). Agriculture (crop production and livestock) provides a livelihood for about 80 per cent of the total population and constitutes more than 30 per cent of the GDP and 95 per cent of the country's exports. The key factor in the country's output is cotton, which accounts for almost half of its output. Other crops (gum Arabic, sesame and groundnuts) constitute important

export commodities. Industrial production (mainly foodstuffs and textiles) constitutes about 10 per cent of the GDP. The shares of different sectors in the GDP show a declining share for agriculture and manufacturing as opposed to a rising share for construction and services over the last couple of decades. The services sector now constitutes about 50 per cent, compared with only 27 per cent in 1955 (the year before independence).

One of the most important features of the economy is the existence of weak inter- and intra-sectoral linkages. Intermediate input used by local sectors was only 12.2 per cent in 1955/56. Even up to recent years, the value of the output of intermediate inputs was still low. In 1984, cotton sold for local consumption, as an intermediate input in textile production, was only 3.4 per cent of the total cotton production.<sup>17</sup> This weak inter-sectoral linkage of agriculture and industry indicates a high import dependence. The Sudanese economy is malformed — it lacks internal integration, has weak linkages between sectors, a weak production base, a high dependence on external markets and a distorted industrial sector (biased towards capital and import-intensive production).

The Sudanese economy has been in the grip of a crisis since the 1970s. During the period 1970-72, Sudan attempted a breadbasket strategy to restructure the export sector by producing food, sugar, textiles and meat for export — and to promote import substitution, mainly in sugar and wheat. The strategy is an export-led agro-industrial strategy, based on the belief that Sudan could, given adequate financial support, develop its vast, untapped agricultural resources to provide food security for the Middle East, by changing the dependence of the economy on the EEC and the USA and transforming the economy into a breadbasket strategy for the Middle East, using a combination of Arab funds and Western technology. The motives for this were the perceived threat of a US wheat embargo against Arab countries; cotton marketing difficulties; favourable world prices for breadbasket crops (particularly sugar and

cereal); and the availability of surplus Arab funds after the oil price increase of the early- and mid-1970s.<sup>18</sup> This highly ambitious programme led to huge inflows of cash, mainly from Arab states through bilateral agreements. Up to 1978, roughly US\$3 billion was estimated to have been mobilised for public investment programmes in Sudan.

By the end of the 1970s, however, the economy was in crisis. As a result of an increase in government development expenditure, the budget deficit rose almost 100-fold (from a previously negligible level to about 4 per cent of the GDP). The balance of payments deficit increased from 2 to 5 per cent of the GDP. Exports fell from 15 per cent to 11 per cent of the GDP. The real growth rates started to decline by the end of the 1970s. The inflow of capital from oil-rich Arab countries decreased by the late 1970s, and, as the grace periods of the loans reached their end, a severe economic crisis emerged. After 1978, Arab oil-producing countries started to make fund disbursement to Sudan subject to IMF/World Bank conditions. Since then, the government has entered into a series of IMF stabilisation and World Bank structural adjustment programmes. The deterioration of the economy continued during the 1980s and the 1990s.

The current economic situation within Sudan is not much better than it was in the late-70s and early-80s. The country's current account balance of payments deficit has reached over US\$800 million. The parallel exchange rate deteriorated after 1992, the year when economic liberalisation measures were declared (including measures abolishing official exchange rates, licenses to foreign exchange dealers, abolishing import licenses and liberalisation of imports through the lifting of restrictions). During the period 1992-1995, the exchange rate deteriorated seven times. The current exchange rate is over LS 2600 per dollar, up from only LS 18 in the late 1990s. The budget deficit to the GDP was 0.8 per cent in 1996 and money supply increased by more than 30 per cent annually

during the past decade. Official annual inflation rates exceed 100 per cent, but the actual rates are greater than that figure.

The deteriorating economic conditions necessitate measures to enhance employment and income, especially of the low and middle-income groups. The small and micro-enterprises, of different types and sub-sectors, constitute one important strategy in Sudan to enhance employment and income. To this we now turn.

### **Small and Micro-enterprises in Sudan: Concepts and Definitions**

There are many definitions for small and micro-production in industrial, commercial and service sectors. Terms such as small industries, small and micro-enterprises, crafts, income-generating activities and productive families are some of them. There is no single definition for the small and micro-enterprise sector based on the difference in fixed assets, the type of establishment and the socio-economic characteristics of small producers. The indicators usually used to define small and micro-enterprises are labour employed, volume of investment and type of technology. The definition differs according to the type of establishment and the objective of the definition. The simplest definition for small and micro-enterprises takes into consideration the number of people employed, which is not less than 25 in most cases.

In Sudan, different organisations and institutions used to define small and micro-enterprises in different ways. There is no consensus on how to define small and micro-enterprises and concepts and definitions vary considerably. The criteria for defining small and micro-production in Sudan relate to either employment and/or capital investment. Some definitions are qualitative. For example, in defining crafts, the outdated Handicraft and Industrial Survey of 1970/71, undertaken as part of a comprehensive Industrial Survey, defined crafts to include all industrial activities that produce goods and services "without the use of modern equipment and with

the use of local raw materials”.<sup>19</sup> Definitions offered by researchers are functional, and differ according to the type of research analysis and the kind of small and micro-production the researcher has in mind.<sup>20</sup> Some studies use “productive economic activities that are non-agricultural and non-factory based”, others use the ILO concept of “informal sector”, while yet others use the concept of “unincorporated small-scale sector”, or even “handwork”.<sup>21</sup>

Other organisations, such as the Institute of Industrial Consultancy and Research and the Arab Organisation for Industrial Development, use the number of those employed between 10 and 15, and less than 25 respectively. In addition to the employment of less than 25, UNIDO uses the value of fixed assets. The concept of the “informal sector”, in which the enterprises covered by this concept are generally thought to show similar characteristics, such as ease of entry; labour-intensive; small-scale; reliance on indigenous resources; and “adaptive technology and skills acquired outside the formal school system”<sup>22</sup>, is used by different researchers and organisations which look at tiny, unorganised, small businesses. The ILO first used the concept in Sudan in 1976.<sup>23</sup> In their efforts to support poor families in Sudan, non-governmental organisations (NGOs) used the concept of “income-generating activities” (IGAs). IGAs are part of small-production sub-sectors used to describe kinds of projects aimed at producing self-dependence in capabilities and skills, of the target group of poor people, by increasing incomes through small projects in production and services sectors.<sup>24</sup>

The concept of a “productive family” represents one of the main forms of small enterprise in Sudan. There is no unified definition of this concept, but it generally refers to small-sized (not necessarily home-based) family businesses. A productive family is defined in the by-laws of the Co-ordination Council of Productive Families and Environmental Industries, Ministry of Social Planning, as “a family which has the ability and readiness to provide some of its day-to-day needs by applying means of production to raise its

standard of subsistence.”<sup>25</sup>

For the purpose of this book, whatever definitions and concepts are generally used in Sudan to describe small and micro-production and services, we need to emphasise characteristics of the production or service unit such as smallness and lack of proper book-keeping systems rather than attempting to find a unified definition. Moreover, here we accept a basic distinction between micro-enterprises (household and survival sector; one-person activity) and small enterprises (relatively formalised small-sized activities). Banks in Sudan, which are of interest here, have their own definitions and concepts of small enterprises.

### **The Banking Definition of Small Enterprises in Sudan**

An exact definition of small and micro-enterprises for the purpose of financing them is essential, since there are differences as well as similarities in each section of small producers. Moreover, a precise definition is essential to show the exact amount finance extended to enterprises in each sub-sector of small producers. As a result of the lack of a precise definition by the central bank, most commercial banks in Sudan have numerous definitions and concentrate on certain enterprises in each sub-sector of the broad small-enterprise sector embodied in the financing policy of the Bank of Sudan. For example, in the former Savings Bank (now Savings and Social Development Bank), financing to this sector was mainly extended to social projects, including the efforts of small enterprises in agriculture, small industries and local retail trade. Bonded by its constituent law, the Sudanese Islamic Bank finances small enterprises, especially productive families.

For this purpose, the bank opened specific family business branches in urban residential areas to extend capital to small enterprises. The “productive family”, which the SIB is targeting, is defined in both social and economic terms. The social structure of a

productive family includes the extended family of men and women who have talents, experience and the will to pursue petty economic activity both in production and service (not necessarily home-based), for the purpose of providing goods and services to local inhabitants and increasing incomes to meet the “reasonable” basic requirements of the target group.<sup>26</sup> The definition of the family economic activity mostly follows the concept of the ILO “informal sector”. The Faisal Islamic Bank directs most of its small enterprise financing to craftsmen, mainly through a specialist branch established in 1983. There is no specific definition of craftsmen within the branch. This is why the bank is using the definition of the Handicrafts Industrial Survey, which defines craft as an industrial activity where goods and services are produced without the use of sophisticated modern tools and equipment.<sup>27</sup>

The Farmer’s Bank offers another example of how finance to small enterprises and rural development projects, including productive families, crafts professionals, small industries and small-scale agricultural projects, is carried out. Its definition of small enterprises in general refers to small production and service units which act as sources of income and which exploit local resources and use intermediate technology. The productive families’ projects include the enterprises of individuals, groups and families who have talents and experience in production and are capable of, and willing to, administer small projects, conduct marketing of output and have a good reputation. The craft sub-sector includes craftsmen with a proper workshop. Financing of professionals extends to medical doctors, pharmacists, engineers, agriculturists and veterinarians who provide services and output in rural areas.<sup>28</sup>

There is no unified definition of the target group of small producers within the Nalien Industrial Development Bank Group (NIDBG). Generally speaking, the target group is classified according to the amount of capital invested and the total number of employees. As for the productive families, classification is made

according to the number of family members employed.

The Sudanese Savings Bank (now Savings and Social Development Bank) finances social projects which use local raw materials and is has experience of working with producers in small-scale agriculture, small industries, productive families and petty trade. There is no adequate definition which specifies the social and economic characteristics of this target group.

In summary, it can be said that the banking system of Sudan has no unified and well-defined definition of small and micro-enterprises. The financing policies of the central bank combines craftsmen, professionals and small producers, including the productive families, into one category and defines this sub-sector by the volume of financing from commercial banks. Even though this definition is capable of showing the sub-sector to which financing can be extended, it nevertheless fails to show the units of production in each sub-sector. Sudanese commercial banks, in most cases, extend finance only to some units in this broad definition, but without defining them.

Questions such as the minimum size or scale of the small enterprise, what indicators are to be used for measurement and why we need to measure smallness at all are crucial. There is no point in attempting to provide an acceptable definition unless it is needed for a specific purpose. But for the purpose of financing small and micro-enterprises, the incentives given by financing policies dictate the need for a definition of each target group therein. Otherwise, other, non-targeted, enterprises may be eligible at the expense of enterprises we intend to assist. Moreover, a practical definition is required, whether quantitative or qualitative. The most effective and easiest way is to apply indicators other than the volume of capital finance, as used by financing decision-makers. Indicators that may be used include family labour in productive family enterprise, sales turnover in trading enterprises, specific professional certificates in the case of professionals, levels of income earned and volume of

capital employed in the case of income-generating activities, and indicators of the nature of the enterprise in others.

### **Means of Financing Small and Micro-enterprises in Sudan**

In Sudan, apart from institutional financial support by banks, a plethora of social schemes to provide micro-credit for the poor have historically been in operation. *Khatta* (savers/investors self-administered revolving fund) is the most popular and widespread example of an informal savings and credit scheme. It is a self-managed system into which individuals contribute an agreed sum (*Sarfa*) at regular intervals. The pooled amount is distributed in an agreed order and used mainly (but not wholly) for small businesses (for rent, purchase of equipment/utensils, working capital, etc).<sup>29</sup>

Apart from *Khatta*, village traders have one of the most flexible and traditional financing institutions. They require only personal guarantees, but operate with high profit margins. Another form of small enterprise practice is the traditional partnership in the means of production. In this system, a relatively poor, small entrepreneur receives access to the means of production. Returns are distributed equally between the factors of production. Provision of micro-credit in certain parts of the Sudan is made via tribal kinship. Members of the same clan/tribe or area provide flexible, financial help to each other to start businesses without any additional costs. Another form is the collective help action (*Nafir*), where village inhabitants contribute to poor families in the form of collective work. Over 100 local and foreign NGOs, with direct co-ordination with the authorities, are active in providing micro-credit, emergency loans, medical care and educational services to the poor in Sudan.

Foreign NGOs provide loans for tiny projects such as tea-making, sheep-rearing, water services, petty trade, brick-making, vegetable distribution, shoe-making, women's handicrafts and house restaurants, in addition to providing training services, not only for

migrants but also for the rural and urban poor. Conditions for providing financial support include the degree of poverty, the minority group and unemployment. Other NGOs are based on saving/lending associations and a Grameen Bank-type of group guarantee, together with some use of the Islamic (*Murabaha*) finance system.<sup>30</sup> PLAN SUDAN, the Dutch University Gadaref Assistance Programme (DUGAP) and ACCORD are examples of the groups involved in this kind of practice.<sup>31</sup>

DUGAP has established four credit unions, with a total membership of 146. In addition to small credit, DUGAP provides consumption loans, training in financial matters and technical support. In providing small credits, the *Murabaha* mode of finance is used, with a profit margin of four per cent. Repayment is made monthly and the maximum duration of the loan is six months.<sup>32</sup>

PLAN SUDAN has four associations and a total membership of over 500. They offer the *Murabaha* mode of finance with a profit margin of 4 per cent, a grace period of one to two months and repayment intervals of a month and a quarter.

The objectives of ACCORD's programmes are to assist small enterprises through extended micro-credit for the poor and refugees in Port Sudan and Kassala, Eastern Sudan and. in so doing, raise the level of income and employment. ACCORD uses Islamic modes of finance such as *Murabaha* (capital plus mark-up), *Musharaka* (partnership), *Mudaraba* (speculation) and *Qard Hasan* (benevolent loan). Between 1984 and 1992, more than 26,000 people benefited from the programme in businesses such as fisheries, retailing, welding and sheep-rearing. The duration of the loans ranges between two and five months and the maximum profit margin of *Murabaha* is four per cent per month.<sup>33</sup>

The UNDP, Area Development Scheme (UNDP/ADS) has targeted around 500,000 poor people in rural areas as part of its funding programme. This is a community, participatory rural development programme, which encourages self-reliance to alleviate

rural poverty and raise the standard of living in selected areas. The project targeted poor individuals, including women, in 1,000 villages. The project provides capital through a self-administered, rural, revolving credit financing system (*Sandug*), which is applied through the Islamic *Murabaha* mode of finance to extend credit valued at US\$3.8 millions (about 17 per cent of the total project fund of US\$24.4 million).<sup>34</sup> Payment and collateral are secured through third-party guarantees, social pressure and, sometimes, valuable assets. The actual amount of the loan, loan repayment schedules and the length of the grace period all depend on the type of the project (grain-milling, poultry-keeping, goat-raising, soap-making, crafts and traditional, small-grain stores).

Some of the local social funds and local NGOs (the National Fund for Pensions, the National Fund for Social Insurance, the *Takaful* Fund, the *Zakat* Fund, the Social Solidarity Fund, the *Shariah* Implementation Support Fund, the National Pension Fund, *Ashad*, *Elkifaya* Bank, etc.), have been established to serve specific religious, social and economic goals. Some are financed from the budget, while others are financed through charity or by beneficiaries. Among other activities, they are also engaged in providing small-credit for living-provision kind of projects (such as leatherwork, cloth-making, tailoring, macaroon production and poultry production), especially for poor, widowed, divorced or deserted women.

### **The Contribution of the Small Enterprise Sub-Sector in Sudan**

Economic analysis in developing countries is dualistic in nature, there being two sectors, the official (formal) and non-official (informal). This means that there is differentiation between large enterprises and small enterprises in different sectors. The philosophy, the policy and the pattern of development finance reflect disagreement. The traditional school calls for the development of

large-scale enterprises for their economy-of-scale advantage, whereas the other school favours small enterprises as a tool of development. The general trend of investment laws in developing countries gives more concessions for large-scale public sector enterprises, both local and foreign. This leads to the growth of large-scale enterprises, though many doubts are raised over their feasibility. On the other hand, small and micro-enterprises have proved to be successful in generating revenue and employment. Small and micro-enterprises are potential tools for economic integration, with inter- and intra-linkages (mainly forward and backward linkages). Small and micro-enterprises are characterised by small capital investment and can be considered as one of the most important strategies for developing and energising the private sector. The following is a brief summary of the contributions of various small sub-sectors to the Sudanese economy.

### **Small-Scale Industries**

In Sudan the contribution of the industrial sector to the GDP is about 8 per cent. Sudan's industrial sector employees constitute not less than 5 per cent of the total labour force and industry contributes less than 1 per cent of the total exports — mainly semi-processed goods. Among the industrial sub-sectors in Sudan are small-scale industries (defined by their employment of less than 25 workers). According to the outdated Industrial Survey, small enterprises make a major contribution to Sudan's industrial sector, sharing 95 per cent of the total industrial establishment. Small-scale industries accounted for less than 10 per cent of investment in the industrial sector, but more than 35 per cent of gross manufacturing output and constituted nearly 50 per cent of the industrial revenue. Small-scale industries in Sudan need less capital measured by the average investment per enterprise, yield an annual output of three times the level of investment and need about half the investment of large-scale industries to create one job. Small industries also appear

to produce larger ratios of value added to gross output and value added to employment.<sup>35</sup> Although the contribution of small industries in Sudan is overwhelming, when we investigate the contribution of each branch (or sub-sector), the results are mixed. It is worth mentioning that, using a research methodology based on “sub-sector” or “branch”, as opposed to “cross-section” (which includes supporting inter- and intra-linkages), the author investigated the potential contribution of small industries in Darfur State to structural adjustment in Sudan.

The results show that capital-intensity is low, but variations between branches and within branches are pronounced and not explained by the size of the enterprise (plant size). Moreover, small-scale industries are not homogenous. Different sub-branches have different characteristics related to capital-intensity, import-intensity and dynamic potential. With some exceptions, linkages are not highly prevalent.<sup>36</sup>

### **Informal Sector**

Another of the sub-sectors of small and micro-enterprise in Sudan is the “informal sector”, which first appeared in the 1970s, following a huge migration from rural to urban areas as the result of unequal development, wars and drought. There is no up-to-date information on the volume and role of the informal sector in Sudan. The ILO study of 1976<sup>37</sup> showed that self-employment in this sub-sector of small production comprised between 25 and 30 per cent of employment in urban areas and the annual growth rate was shown to be 45 per cent compared with the figure for the period of independence in 1956. Moreover, the contribution in the industrial sector was about 60 per cent. In 1996, another ILO report re-emphasised the importance of the informal sector and estimated its contribution to be 60 per cent of the total urban employment in Sudan.<sup>38</sup> In a study conducted by the Ministry of Planning, it was shown that over 100,000 people employed in the informal sector of

Khartoum, in almost all production and services sectors, migrated annually. Moreover, the number of informal sector establishments has multiplied within the past five years, and there is a move towards commerce and services at the expense of industry. The role of women in the informal sector was estimated to be 12 per cent in 1990, up from 2.9 per cent in 1983.<sup>39</sup>

### **Crafts**

There is no data on craftsmen covering their distribution, ages, number or types of activities. Also, there are no statistics on their contribution to the country’s GDP. Unsystematic data only is available, from scattered statistics, official reports and personal research, in addition to general observations. The number of registered craftsmen’s co-operative associations has increased tremendously in recent years. The major objectives of these co-operative associations are finding workshop facilities for members, training school leavers, maintaining relationships with local authorities and creating good relations with similar international associations. This is an indication of the increased number of organised craftsmen.

### **Productive Families**

As a result of the difficult economic situation in recent years, many families have moved towards micro-enterprises. The number of those engaged in micro-enterprises as productive families constitutes a huge proportion of the small enterprises in Sudan and this number is increasing all the time. This phenomenon has led the banking system to issue preferential financing treatment to such enterprises through policies directed by the central bank.<sup>40</sup> The Ministry of Social Planning has also recognised this by establishing the Council of Co-ordination of Productive Families and Environmental Industries, which is composed of academics, NGOs, government officials and banks, to determine policies, programmes

and mechanisms for financing productive families. Despite these efforts, and because of the lack of statistical data, it is difficult to determine exactly the contribution of productive families to the national economy.

### **Income-Generating Activities**

Since the late 1970s, Sudan has played host to refugees from neighbouring countries, in addition to the rural-urban migration resulting from famine, drought and civil war. The number of refugees has now reached more than one million. As a result, NGOs started programmes for refugees and migrants, specifically income-generating schemes for women, with the aim of creating employment opportunities through tiny investment projects. This has been achieved by revolving funds and by charging very low interest and administrative costs, without requiring noticeable guarantees. More than 100 local and foreign NGOs are presently active in providing income-generating credit, counselling and training programmes.

There is no data on the employment or production role of income-generating activities in Sudan. It is difficult to estimate the contribution of income-generating activities, but, as is clear from the number of the target group and the volume of finance from both local and foreign NGOs, the contribution is undoubtedly huge.

### **Conclusion**

As a result of increased government development expenditure, budget deficits and the end of the huge monetary assistance from oil-rich Arab countries, Sudan's economy has faltered.

Despite measures taken by the IMF and World Bank to alleviate funding problems to the country, the situation continues to deteriorate.

As the economy has worsened, the emergence of small enterprises has become a means by which to secure income and

employment. The depression of the economy has been reflected in the shift towards small and micro-enterprises by those seek specifically to increase employment and income, especially within the low and middle-income groups.

In Sudan, there are many terms for small and micro-production in the industrial, commercial and service sectors – terms such as small industries, small and micro-enterprises, crafts, income-generating activities and productive families. There is no unified definition of the small and micro-enterprise sector relating to the difference in fixed assets, type of establishment and socio-economic characteristics of small producers.

In the banking system of Sudan there is no unified definition of small and micro-enterprises. The financing policies of the central bank combine craftsmen, professionals and small producers, including productive families, in one category and define this sub-sector by the volume of financing from commercial banks. The Sudanese commercial banks, in most cases, extend finance to only some units in this broad sub-sector, without actually defining them.

In Sudan, apart from institutional financial support by banks, there is a plethora of social schemes to provide micro-credit for the poor. Foreign NGOs, as well as local social funds and local NGOs, have been established to serve specific religious, social and economic goals and to provide small credit to micro-enterprises through Islamic modes of finance.

A summary of the contribution of the various small sub-sectors to the Sudanese economy shows that small and micro-enterprises have proved successful in generating revenue and employment. Small and micro-enterprises can be considered to be one of the most important strategies for enhancing income and employment. Despite what we have mentioned here, there is no data on the employment or production role of income-generating activities in Sudan to show this contribution. It is difficult to estimate the contribution of income-generating activities, but it is

clear from the number of the target group and volume of finance that this contribution is huge.

## Chapter Three

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### ISLAMIC MODES OF FINANCE AND SMALL AND MICRO-ENTERPRISES

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*The conventional bank usually gets back the amount it has lent along with the interest payments. It does not matter whether the entrepreneur made a profit or incurred a loss. But in the Islamic banking system, the prohibition of interest necessitates banking investment operations being conducted on the basis of profit-and-loss-sharing arrangements. Here it is only the profit-sharing ratio, not the rate of return itself, that is predetermined. More than one major mode of finance have been in operation such as: Mudaraba — agency joint venture/limited partnership, where the bank supplies the capital and the entrepreneur the labour; Murabaha — purchase and resale of an asset to an entrepreneur at a mark-up (profit) on the basis of deferred payment; and Musharaka — joint partnership, with capital supplied by both parties.<sup>41</sup> The following sections illustrate these modes in greater detail.*

### **The Musharaka (Partnership) Mode of Finance**

*Musharaka* can be defined as a “form of partnership where two or more persons combine either their capital or labour together, to share the profits, enjoying similar rights and liabilities”<sup>42</sup>. It is a limited period contractual agreement between the bank (represented by the branch) and the partner to use both human and financial resources and distribute whatever profit or loss they make in accordance with capital and human resources invested. Islamic *Musharaka* is of two types: contractual and non-contractual. Here we are concerned with the contractual type (not necessarily formal or written), in which profit or loss is shared in any equitably agreed proportions, and in which there is only restricted authority and obligation. In such an Islamic partnership, the partners need not have equal shares or equal responsibility for the management. Losses would be divided in accordance with capital contribution. It is not only capital shares that govern *Musharaka* in Islam. In practice, labour, skills, management, goodwill, credit-worthiness and contacts may also form the partners’ contributions.

*Musharaka* is governed by a contract signed by the two parties

which is wide in coverage, accurate and flexible. It extends to include financing as well as the management of the project. The contract shows the financial shares and management obligations, distribution of expected profit or loss and any other conditions which may govern the partnership relations. These conditions include the conduct of the partnership operations through a joint account opened in the name of the partnership, allowing withdrawals and deposit of sales proceeds according to the contractual plan. Joint storage of raw materials, subject to partnership, is also specified in the contract and an insurance cost is added to the total cost. In the case of financial loss, it is borne by the two parties, unless it is proved to be due to neglect, abuse or violation of terms agreed upon by the party undertaking the management and operation of the venture, in which case the latter bears the cost of all damages.

A *Musharaka* contract varies in accordance with the investment project and the contribution of the partner and the bank. It is subject to mutual agreement, but the main concept can be illustrated as follows: If we denote the amount of capital shared by the bank and the partner respectively by  $K_b$  and  $K_p$  ( $K_b + K_p = K$ , total venture capital). If  $\pi_e$  denotes expected profit, and  $\pi_m$  denotes management profits ( $\pi_m < \pi_e$ ).  $\pi_m$  could be distributed as follows:  $(P_m) \cdot (\pi_m)$  and  $(B_m) \cdot (\pi_m)$  for the partner and bank respectively, where  $(P_m)$  and  $(B_m)$  are the agreed share of the partner and the bank in management profit respectively ( $P_m + B_m = 1$ ). The remaining profit  $\pi_s$  (equivalent to  $\pi_e - \pi_m$ ) is to be distributed according to the contribution of the two partners in total capital. Thus total profit of the partner and the bank is the addition of management profit and shared profit as follows:  $(P_m) \cdot (\pi_m) + (K_p/K) \cdot (\pi_s)$  and  $(B_m) \cdot (\pi_m) + (K_b/K) \cdot (\pi_s)$  respectively. Losses also are distributed according to the investment shares. Profits distributed

between the two partners can be shown as follows: Table No. (1)

Description	Bank	Partner	Expected profit
Contribution	$K_b$	$K_p$	$K$
Management	$(m_b) \cdot (\%_b)$	$(m_p) \cdot (\%_p)$	$\%_0$
Shared profits	$(K_b/K) \cdot (\%_b)$	$(K_p/K) \cdot (\%_p)$	$\%_0$
Total profit of each partner	$(m_b) \cdot (\%_b) + (K_b/K) \cdot (\%_b)$	$(m_p) \cdot (\%_p) + (K_p/K) \cdot (\%_p)$	$\%_0$

$(m_b) + (m_p) = 1$

In any *Musharaka* contract, the following rules are applied:

The capital is generally paid in cash. Payments in kind (non-monetary assets) are also acceptable. In the case of financing working capital, working capital ought to be associated with the assets of the business. The assets will be hired for a suitable period, i.e., the depreciation of the asset for the whole *Musharaka* period will be calculated to enable *Musharaka* of working capital to be performed. The cost of hiring the asset will be deducted from the total profit, and the net income is then distributed in accordance with the agreement in the contract.

Each partner enjoys a legal capacity to act both for himself and on behalf of other partner(s) in dealing with partnership matters.

Profit allocation must be stated in percentages and according to the partners' shares.

It is possible that if a partner exerts more effort, or has more experience, he or she can take an agreed additional percentage of the profits in lieu of his labour/expertise.

Losses are calculated in proportion to the shares of each partner in the capital.

A *Musharaka* contract is non-binding — each partner has a right to withdraw under certain conditions if it causes no injury to other parties, if communicated to the other parties.<sup>43</sup>

*Musharaka* can take another form, in which the bank can enter into partnership with the client on the basis of diminishing

*Musharaka*, through which the full ownership of the business assets passes to the partner after a certain period. Under this type of agreement, the client is given the right to gradually buy as much as he can from the bank's shares until he/she becomes the sole owner of the asset, providing the following rules apply. Suppose the total cost of the project is 1,000 Sudanese pounds and the client's share is 50 per cent and the project is divided into 10 shares each equal to 100 pounds. At the end of each financial period, if the partner buys some of the bank's shares, and if at the end of the first year he/she buys shares, then his/her ownership in the second financial period will be 60 per cent, while the bank's ownership will be 40 per cent. This will continue until the client becomes the sole owner of the project.

The following is an example of *Musharaka* from the Sudanese Islamic Bank.

	Bank	Partner	Total
<b>1. Contribution</b>	735	690	1,425
%	(52%)	(48%)	(100%)
<b>2. Net profit</b>	-	-	450
<b>3. Profit distribution (as per agreement)</b>			
a) 37% for management	-	-	166.5
30% partner's % in management	-	138	-
7% bank's % in management	81.5	-	-
b) 63% for shared profit	-	-	283.5
30% partner's % in the profit	-	156	-
33% bank's % in the profit	147.5	-	-
<b>Total Profits</b>	<b>179</b>	<b>271</b>	<b>450</b>
<b>4. Rate of return on investment</b>			
Partner's rate of return/monthly	-	39%	-
Partner's rate of return/annually	-	471%	-
Bank's rate of return/monthly	24%	-	-
Bank's rate of return/annually	288%	-	-

Both the monthly and the annual rates of return to the bank and the partner are large. The table below, which compares the rate of returns of different project sizes, shows additional advantages of *Musharaka* namely:

- Even when the partner's financial contribution to the project is less than that of the bank, the rate of return on the partner's capital is higher than the bank's. This is due to the inclusion of management effort in *Musharaka*.
- The rate of return on capital invested by the bank or the partner is unexpectedly very high, reaching three digits per year in some cases. This gives a clear indication that financing through *Musharaka* is financially profitable to both parties. It also indicates that financing through *Musharaka* does not expose the financial institution to any risk by lending to small and micro-enterprises.

**Table 3: Rates of return on investment by sizes enterprise (Sudanese Islamic Bank)**

Description	Project 1	Project 2	Project 3	Project 4
<b>Project:</b>	<b>Bread Making</b>	<b>Flower mashing</b>	<b>Coffee shop</b>	<b>Medical lab</b>
<b>Duration of Musharaka</b>	One week	One month	Four months	One month
<b>Date of Musharaka</b>	(September, 1995)	(January, 1995)	(December, 1995)	(1996)
<b>Volume of Musharaka</b>	29,595	200,000	1,000,000	30,000,000
<b>Bank contribution</b>	75%	50%	50%	34%
<b>Partner contribution</b>	25%	50%	50%	66%
<b>Bank's share in management</b>	0%	0%	1.2%	5%
<b>Partner's share in management</b>	90%	60%	89.7%	25%
<b>Bank's share in total profit</b>	52.5%	20%	6.75%	14.8%
<b>Partner's share in total profit</b>	47.5%	80%	93.25%	85.2%
<b>Monthly rates of return:</b>				
<b>Bank</b>	122%	20%	6%*	5.2%
<b>Partner</b>	525.3%	80%	84%*	6.9%
<b>Total</b>	223.6%	50%	45%*	6.6%
<b>Annual rates of return:</b>				
<b>Bank</b>	1464%	240%	18%	62.4%
<b>Partner</b>	3904%	960%	252%	81.6%
<b>Total</b>	2803.2%	600%	185%	79.9%

\* Period (four months)

- The bank's profit share, although high, is not proportional to its capital contribution. The bank's percentage share of profit is usually less than that of the partner's. This is an additional advantage to small entrepreneurs, which is usually unseen.

- It is clear from the table above that the smaller the finance, the larger the rate of return and vice versa. This indicates that small projects have a larger percentage of profit to each partner's finance and to the total finance.

### The Mudaraba Mode of Finance

Another form of joint venture used in financing small enterprises in Sudan is *Mudaraba*. It involves two parties —the bank (which owns the money) and the entrepreneur, who uses his/her skills to run the business (*mudarib*). *Mudaraba* is a profit-and-loss-sharing contract. The net profits realised are divided between the two parties according to the ratio agreed upon in advance. In the case of a loss, the owner of the money loses his capital and the trustee loses his time and effort and the expected profit. *Mudaraba* contracts are considered to be risky and require a great deal of confidence from the two parties, so is usually conducted with a partner who is well-trusted, professional and with a good track record.

In a *Mudaraba*, the entrepreneur presents an application in which he mentions the type of project and the duration for its implementation. The bank arranges the necessary finance and the entrepreneur sets to work.

### The Murabaha Mode of Finance

*Murabaha* involves the purchase and resale of a piece of equipment or other means of production to the client after adding a specific profit margin or mark-up, the minimum for which is determined by the central bank's financing policy for each sector. In this mode of finance, according to the *Shariah*, the financier must

first own (or buy) the commodity and then resell it. The commodity must be a tangible one and the buyer must know and agree to the purchase and resale prices.<sup>45</sup> By basing the selling price of the commodity on the original cost, the small entrepreneur is protected against unfair exploitation. Expenses not directly related to the commodity are not allowed to be included.

The abolition of the interest rate in Islamic banking practice has led to partnerships between banks and clients in which there is no credit. *Murabaha* avoids interest rates by supplying raw materials/assets at a profit instead. It is not far removed from the concept of hire purchase.

In *Murabaha*, the client applies to the bank to finance his purchases of specific raw materials or assets. The application is usually accompanied by invoices. The bank buys and resells the raw materials or assets at a price which covers its expenses and allows the bank a profit margin (called a *Murabaha* profit margin) upon which the two parties agree. The price compensates the bank for the loss of the use of the money and the risk of non-repayment. The partner usually pays the bank back in agreed instalments. The concept of

Table 4 Example of <i>Murabaha</i> on soap venture (Sudanese Islamic Bank, al-Ghish Productive Family Branch), amount in 000 <sup>1</sup> Sudanese pounds <sup>47</sup>	
Description	Amount
Total Finance	500
<i>Murabaha</i> period	Three Months
<i>Murabaha</i> profit margin (profit)	12% per month (60)
Bank's selling price	560
Grace period	Two Months
First instalment (15%)	84
Other instalments	476 (i.e. 158.66 per month) <sup>48</sup>
Bank's profit (for three months)	60
Guarantees	Post dated cheques
Method of payments	Equal monthly instalments

The exchange rate is US\$ 1 = LS 500 (April 1995)

<sup>48</sup>The partner also pays 2% of the total finance as Finance Tax, in addition to stamp duties and other finance commissions.

*Murabaha* can be illustrated as follows.

If we assume that the total cost of a project is C and the margin of *Murabaha* is r per cent, then the value of the asset resold to the partner is C+rC (the value to the partner). If X is the percentage of the first instalment, then the value of the first instalment is X(C+rC). The next instalment can be calculated using the formula: C+rC - X(C+rC). The instalments have to be paid in equal amounts, with each instalment equal to C+rC - X(C+rC)/N, where N is the instalment period.<sup>46</sup>

### Advantages of Islamic Modes of Finance for Small Enterprises

The Islamic financing modes are better suited than conventional modes for meeting the needs of small enterprises. In most cases, financing is granted without an obligation on the part of the partner to repay whether he or she gains or loses. Moreover, no strict security is demanded, as Islamic investment arrangements put great emphasis on the transaction itself, rather than the creditworthiness of the partner.<sup>47</sup> If the operation ends in a loss, the partner does not bear this loss alone. If he or she is unable to settle his or her bills, a grace period is given without any additional fees.<sup>49</sup> Islamic financing does not require the partner to present securities against possible losses. Any advance demanded is made to cover the share of the partner in the venture and not as a security against losses. Since the Islamic concept is based on profit-and-loss-sharing, then "any security demanded by the Islamic bank is against possible fraud or repayment-evasion, and not against the risk of losses".<sup>50</sup>

Partnership financing has many advantages to offer to small entrepreneurs. *Musharaka* is a flexible, fair, easily understandable form of financing. It caters for both production and management, thus leading to increased incomes for income groups who do not own capital. It is a suitable mode of financing for both working and fixed capital. In countries with high inflation, *Musharaka* preserves

the real value of capital invested — that is, at the time of selling the two partners may decide to wait in anticipation of higher prices. *Musharaka* does not require strict collateral guarantees and does not leave the partner with a heavy burden of debt, post-dated cheques or any other kind of obligation. Personal acquaintance with the client and his behaviour, in addition to continual supervision and follow-up by the bank's management, are necessary requirements in the absence of conventional guarantees. Sudanese Islamic banks usually use personal guarantees, storage of raw materials subject to partnership, and regular field visits, which limit the chances of dishonesty such as unrecorded sales of the product under partnership or tampering with records. Another important advantage of *Musharaka* is that the client does not have to contribute in the case where his/her share is in kind (input), labour, or machine depreciation. In *Musharaka*, the bank may take an active role in marketing the product, thus reducing the marketing burden on small entrepreneurs. *Musharaka* also avoids repayments being necessary from small entrepreneurs who have already lost their livelihood in the case of a total failure.

Beside providing finance to already established small and micro-enterprises, partnership modes of finance are likely to create new economically and technically worthwhile small-sized investments chosen by feasibility studies rather than the creditworthiness of small entrepreneurs. Wider branch networks and ranges of banking services are a prerequisite for banks if they are to reach a large number of small entrepreneurs and offer them partnership facilities, thus relieving them of the problem of commercial banks' reluctance to lend to them. Using partnership arrangements, however, does not mean providing finance to small and micro-enterprises on concessional rates. On the contrary, it will provide a high rate of return on capital investment to both the bank and the partner.

A *Murabaha* contract is beneficial to small and micro-enterprises. Instead of a small entrepreneur having a loan (which he may use for a different purpose than the ostensible one), the *Murabaha* contract will buy him the asset or raw material needed for his business for a certain period and at a profit for the bank. *Murabaha* profit margins may be identical in value to interest rates, but the principle and process is different. *Murabaha* makes sure that the money is used in the intended project for the benefit of the small entrepreneur.

## Conclusion

Islamic banks conduct investment by different modes of financing from those of conventional banks. Three modes are used to finance small and micro-enterprises by the Sudanese Banking system. This chapter has illustrated these modes in some detail and it can be seen from the above that Islamic modes of finance have many advantages when funding small and micro-enterprises, given the constraints of financing outlined in Chapter one. These advantages are as follows:

- In most cases, financing is granted without an obligation on the part of the partner to pay it back irrespective of whether he or she gains or loses.
- No strict security is demanded, as the Islamic investment arrangements put great emphasis on the feasibility of the transaction itself rather than the creditworthiness of the partner.
- If the operation ends in a loss, the entrepreneur does not bear this loss alone. If he or she is unable to settle his or her bills, a grace period is given without any additional fees.

*Musharaka*, we have seen, has the following advantages to small and micro-enterprises:

- It is a flexible, fair, easily understandable form of financing.
- It caters for both production and management, thus leading

to increased incomes for income groups who do not own capital.

- It is a suitable mode of financing for both working and fixed capital.
- It preserves the real value of capital invested.
- It does not require strict collateral guarantees and does not leave the partner with a heavy burden of debts, post-dated cheques or any other kind of obligation.
- In *Musharaka*, the client does not have to contribute if his/her share is in kind (inputs) such as labour and machine depreciation.
- It avoids repayments from small entrepreneurs who have already lost their livelihood in the case of a total failure.
- It provides a high rate of return on capital investment to both the bank and the partner.

## Chapter Four

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### THE BANK OF SUDAN FINANCING POLICIES AND THE SMALL ENTERPRISE SECTOR

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*This chapter is about the Bank of Sudan's financing policies and their effects upon the small and micro-enterprise sector. The composition of the Sudanese banking system is first shown, then the Bank of Sudan's financing policies for the period 1994-1997. The financing policies and small enterprises sub-sectors are elaborated. Besides the Bank of Sudan's financing policies towards small enterprises, banks and national policies of finance are also shown. Finally, financing policies for small enterprises run by women are briefly outlined.*

## **The Sudanese Banking System**

The Sudanese banking system consists of the Central Bank of Sudan, 17 commercial banks (Khartoum Bank, Commercial Bank of Sudan, al-Bank al-Ahli, al-Tadamon Islamic Bank, Faisal Islamic bank, al-Baraka Bank, Sudanese Islamic Bank, al-Garb al-Islami, Ivory Bank, National Bank of Omdurman, al-Shamal al-Islami, etc.), including four government-owned commercial banks, some branches of foreign banks, (Habib Bank, Sudanese French Bank, Middle East Bank, Oman Bank, City Bank, etc.); four specialised banks (Nelien Industrial Development Bank Group, Agricultural Bank of Sudan, Animal Resource Bank and Real Estate Bank); and investment and sectoral banks (Workers' bank, Farmer's Bank and Islamic Co-operative Development Bank).

The Islamic banking system in Sudan was initiated by Faisal Islamic Bank in 1978. A number of other Islamic banks followed suit (Islamic Co-operative Bank, al-Baraka Islamic Bank, al-Tadamon Islamic Bank, al-Garb Islamic Bank, al-Shamal Islamic Bank and the Sudanese Islamic Bank). The Islamic system of finance was gradually shaped and, in 1984, all financing institutions were directed by the central bank to adopt the Islamic mode of finance.

## **The Bank of Sudan's Financing Policies**

In accordance with the Organisation of the Banking Industry Law 1991,<sup>51</sup> especially Article 1-20 (determination of profit margins, fees and duties), Article 1-36 (maximum and minimum volume of financing), Article 1-36 (total volume of financing), Article 1-36-C (volume of financing to individuals), Article 1-36-E (3) (guarantees), Article 1-36-C (5) (profit margin and other conditions for credit), and in accordance with the Islamisation of the entire banking system, the Central Bank of Sudan started issuing annual Financing (Credit) Policies.<sup>52</sup> The policy is designed to support government plans, the objectives of which are, usually, achieving self-sufficiency, increasing production, reducing inflation and stabilising exchange rates, thereby promoting an image of Islamic banks as comprehensive, full-service banks. The financing policy has mainly depended on setting quantitative limits on commercial banks' lending.

In order to achieve the desired objectives, the financing facilities of commercial banks are usually limited to priority sectors. Banks are not permitted to provide finance to activities such as purchase of foreign currencies and shares in the Khartoum Securities Exchange, trade in foreign exchange, construction or purchase of property or land, or importation of goods (with the exception of drugs and raw materials for medicine, medical equipment and industrial inputs).<sup>53</sup>

The financing policies also regulate credit and set conditions for export credits and financing to the small-scale sector. In addition, the financing policies set out the percentage of a client's participation in the total financing, under the *Musharaka* system, of different priority sectors. The policy also sets the minimum percentage of profit margin under the *Murabaha* system. The Bank of Sudan also sets the domestic monetary reserve policy (minimum legal reserve requirements, internal liquidity ratio, inter-bank lending rates and the regulations on commercial banks' requests for credit from the central bank).

## The Financing Policies and Small Enterprises

In Sudan, a partial recognition of the small enterprise sub-sector started at the beginning of the 1990s. The financing policy of the Central Bank of Sudan in 1990, for the first time, included crafts as one of the priority sectors for financing. In addition, the 1990 financing policy mentioned the importance of banks financing regional and backward areas and small enterprises.<sup>54</sup>

The full recognition of the small enterprise sub-sector started with the 1994/95 financing policy. “Craftsmen, Professionals and Small Producers, including Productive Families” is considered one of the priority sectors for banking finance, together with the agricultural sector, industrial sector, export sector, mining and energy production sector, low-cost housing sector and transport and storage sector. The 1994/95, July/December 1995, 1996, 1997, 1998, 1999, 2000, 2001 and 2002 financing policies included concessions and financing regulations for this sub-sector. These concessions and financing regulations can be summarised as:

- Article (3) of the Financing Policy 1994/95, specified that finance to this sub-sector should be based on the restricted *Mudaraba*<sup>55</sup> or other financing systems, with the exception of the unrestricted *Mudaraba* system. Financing per transaction should not exceed 1 million Sudanese pounds. This was raised to 3 million pounds in July/December 1995 and in 1996, then reduced to 1 million Sudanese pounds from June 1996 up to the end of 1997. The Central Bank’s condition of the maximum financing per transaction was ignored starting in 1997. Banks are free to obtain whatever “sufficient guarantees” they need when financing this sub-sector. The Financing Policies since 1994 do not include or exclude any of the guarantees currently used in the banking system of Sudan. This exactly matches the Law of Banking regulation of 1991, Article 36/H and Article (8) of the Financing Regulations, which read: “Banks should make sure to impose reasonable and sufficient guarantees for financing clients, since it represents the last resort in

case of a client’s failure for repayment on the specified date”.<sup>56</sup>

- In Article 6/1/B, Financing Policy 1994/95, and other Financing Policies, the first instalment of *Murabaha* for small enterprises was determined to be not less than 15 per cent of the value of the asset. In Article 65/1/C, the Financing policy of 1994/95 permitted the first instalment of *Murabaha* to be delayed and paid as part of the total instalments. Starting from the 1995 Financing Policy, the first instalment was cancelled and the payments could be arranged between the bank and the client. In 1999 and 2000, the first instalment was reinstated at 25 per cent, and in 2001 and 2002, it was left for each bank to decide.

- In the financing policies of 1994/95 and July-December 1995, the percentage of participation in *Musharaka* of finance granted to craftsmen or professionals must not be less than 15 per cent of the bank’s total funding. In the case of small producers (including productive families), the percentage of participation was left for mutual agreement between the bank and the partner (Article 6/2/C, Financing Policy 1994/95, Article 6H, Financing Policy July-December 1995).

- In the Financing Policy of 1996, the small entrepreneur’s percentage of participation in *Musharaka* must be 10 per cent. For craftsmen and professionals, the percentage of participation remained at 15 per cent. In the 1996 Financing Policy, the percentage of participation for professionals and craftsmen was raised to 25 per cent and that for small producers (including productive families) was raised to 20 per cent. In 1997, both participation percentages were raised. The percentage of participation for professionals and craftsmen was raised to 30 per cent. As for small producers (including productive families), the partner’s participation was a maximum of 25 per cent. The partner’s participation in 1998 was not less than 30 per cent. Since 1999, the participation has been left for each bank to decide.

- The minimum *Murabaha* margin (minimum percentage of

profits from *Murabaha* credit) in 1994/95 and 1995 was 15 per cent per annum, raised to 30 per cent for professionals, craftsmen and small producers and 20 per cent for productive families. In 1997, the two margins were 35 and 30 per cent respectively. The Financing Policy of 1998 unifies the minimum percentage of profit margin under the *Murabaha* system for all priority sectors (including small producers) at 30 per cent, while leaving the minimum percentage margin under the *Murabaha* system for non-priority sectors undetermined.

- The minimum *Murabaha* margin in the 1999 Financing Policy was 20 per cent and the client had to be charged 25 per cent of the *Murabaha* selling price by the bank, with the exception of productive families, small enterprises and craftsmen. The professionals sector was separated from the small producer, craftsmen and productive families sector.

- The minimum *Murabaha* margin in the 2000 Financing Policy was reduced to 17 per cent and the client had to be charged 25 per cent of the *Murabaha* selling price by the bank, with the exception of productive families, small enterprises and craftsmen. The range of the *Murabaha* margin in 2001 and 2002 was 12–15 per cent.

- The Comprehensive Banking Policy of 1999 was explicit in advising banks to extend social support to productive families and poor sections of the community. It also called on banks to move gradually from the *Murabaha* to the *Musharaka* mode of finance.

Exemptions were made for craftsmen, professionals and small producers (including productive families) from registration certificates, audited statements and profit and loss accounts in the case of financings of less than five million Sudanese pounds.

Successive financing policies determined the financing ceiling for priority and other, non-priority, sectors. For example, the 1996 financing policy determined that not less than 90 per cent of the bank's financing should be granted to the priority sectors. The

**Table 5: Bank of Sudan financing policies to craftsmen, professionals and small producers, including productive families (1994–2000).**

Financing Policy Description	1994/1995	July-December 1995	1996	Amendment of June 1996	1997	1998	1999	2000
<b>The maximum financing</b>	Not exceed 1 million Sudanese Pounds per transaction.	Not exceed 3 million Sudanese Pounds per transaction.	Not exceed 3 million Sudanese Pounds per transaction.	Not exceed 1 million Sudanese Pounds per transaction.	Not exceed 1 million Sudanese Pounds per transaction.	Not mentioned.	Not mentioned. 5% minimum financing of Productive Families, Small Producers and Crafts.	Not mentioned. 7% minimum financing of the sub/sector.
<b>Mode of finance</b>	Restricted <i>Murabaha</i> or other financing modes.	Restricted <i>Murabaha</i> or other financing modes.	Restricted <i>Murabaha</i> or other financing modes.	Restricted <i>Murabaha</i> or other financing modes.	Restricted <i>Murabaha</i> or other financing modes.	Restricted <i>Murabaha</i> or other financing modes.	Restricted <i>Murabaha</i> or other financing modes.	
<b>Participation</b>	Not less than 15% of total financing (craftsmen and professional s).	Not less than 15% of total financing ( Craftsmen and professional s) In accordance with the agreement between the partner and the bank. (small producer including productive families)	Not less than 15% of total financing (craftsmen and professional s).	Not less than 25% of total financing (craftsmen and professional s).	30% (craftsmen and professional s)	Not less than 20%	Left for each bank.	Left for each bank.
<b>The first installment in <i>Murabaha</i></b>	Not less than 15% (professionals and craftsmen). First installment in <i>Murabaha</i> can be delayed and be paid as part of the total installment.	The first installment is cancelled and the repayment can be arranged between the partner and the bank.					25% first installment.	25% first installment.
<b>Minimum <i>Murabaha</i> margin</b>	15% per annum.	15% per annum.	20% (professionals and craftsmen). 15% (small producer including productive families)	30% (professionals and small producer). 20% (productive families)	35% (professionals and craftsmen). 30% (small producer including productive families)	36% for all priority sectors.	20% for all priority sectors.	18% for all priority sectors reduced to 15% in May 2000.

specification for the other priority sectors, including craftsmen, professionals, small producers and productive families, was given.

## **Banks and National Financing Policies and Regulations**

In accordance with the financing policy of the Bank of Sudan outlined above, and the national financing policies, the Sudanese banks determined their internal financing policies for financing small producers. In addition to the financing regulations set by the Central Bank, the banks set internal regulations to ensure successful projects, consolidate the application of the Central Bank regulations and make sure of the success of the marketing of the output and so on. These conditions included socio-economic surveys of applicants to check their reputation and skill, checks for debts and a review of the marketing experience of loan applicants. In addition to other fees, the national policies that banks must comply with are tax and *zakat* clearance certificates and other government fees and duties, namely:

- Finance tax of investment operations based on the bank's participation in the case of finance through *Musharaka*, and on the volume of investment, excluding the *Murabaha* profit margin, in the case of *Murabaha*.
- 0.001 per cent management fees on investment operations (called investment execution fees) deducted from the client's account. This fee is based on the volume of investment in *Murabaha* and the participation of the bank in *Musharaka*.
- 0.005 per cent fees out of the total finance, or a percentage of the money due in *Murabaha* (including the *Murabaha* margin).
- 0.025 per cent charge in stamp duties on the *Musharaka* or *Murabaha* contracts, deducted from the client, and based on the volume of the investment project, which includes the shares of the bank and the partner. In the case of *Murabaha*, it is deducted from the volume of the *Murabaha* excluding the *Murabaha* profit margin.

In the following laundry soap project, financed through *Musharaka* at the al-Girsh branch of the Sudanese Islamic Bank, with a contribution of the bank and the partner of 500,000 and 62,000 Sudanese pounds respectively, we calculated the following banking and government fees.

Business profit tax	10,300
Stamp duties	2,500
Bank commissions	1,935
Administrative fees	500
Total	14,935

We hasten to show the following observations:

Government fees (finance tax and stamp duty) constitute 76 per cent and 86 per cent in the case of *Murabaha* and *Musharaka* respectively.

In the case of *Musharaka*, the total fees paid equal 3 per cent of the contribution of the bank and 24 per cent of the contribution of the partner. In *Murabaha* finance, the total fees equal 3 per cent of the contribution of the bank.

In addition to the above, small producers are burdened with the presentation of a tax and *zakat* (alms tax) clearance certificate.

## **Financing Policies and Small Enterprises run by Women**

Several factors have influenced women in Sudan to take up small businesses, especially home-based productive family businesses. While many women take small business as a means to enhance income and to be self-dependent, a significant number become entrepreneurs owing to economic compulsion resulting from the death of the spouse, desertion, divorce, or separation from the spouse. Another category establish small businesses after having fulfilled their roles as wife and mother, while others view the setting up of a small business as a challenging economic venture.

The move towards small and micro-enterprises by women in

Sudan is encouraged by the extension of the banking system to small enterprises, especially productive families. Changes in culture, customs and traditions have prepared the society fully to accept the new roles that are being assigned to women. The process of change has been gradual. Self-employment through small business by a vast majority of women in poor rural and urban households has not been given the necessary support due to it, either by governmental policy or by banking legislation. Their contribution, although great, remains outside the purview of the mainstream of productive activities. In the Sudanese banking system, the issue of finance is common to all small entrepreneurs, irrespective of their sex. In some cases, women are preferable to the banking system as customers, owing to their positive attitude towards money matters, and the Islamic banking system suits women because it does not link the creditworthiness of partners to their ability to provide collateral, which women lack. That is, the viability of the project is more important to the Islamic bank than the collateral needed to start it. Sudanese banks, thanks to the financing policies of the Central Bank, are not fully guided by conventional banking norms in that they do not consider security-linked loans better than a sound business proposal.

Banking policies within the small-scale sector are a way to understand the environment in which women operate. The many reasons that compel women to operate at low investment levels put the majority of them in the category of micro-producers. Although the entry of Sudanese women as first generation entrepreneurs is more than a decade old, and their role in small enterprises is increasing, up to now banking policies have not given preference to female entrepreneurs as a special category. Although the concept of women entrepreneurs in Sudan is now well recognised, banking policies still cover female enterprises with the same regulations and

policies as are applied to other small enterprises. Though the small sector is now part of the priority sector for banking finance, small-scale projects set up and run by women are just one part of many small projects under different names. Moreover, the lack of a database on female-owned enterprises and the lack of a clear definition of a female entrepreneur are a hindrance when identifying policies and facilities specific for small, female-run enterprises.

The lack of recognition of this type of enterprise is due to the view of Sudanese financial institutions that female-managed enterprises are simply income-generating activities rather than commercial, business-like activities. It may also be related to the lack of recognition of female business acumen. This viewpoint patently ignores the recent growing phenomenon of female-run small enterprises in Sudan and the role of a woman as a proactive entrepreneur.

## Conclusion

The full recognition of the small enterprise sub-sector started with the 1994/95 Financing Policy, in which the sub-sector “Craftsmen, Professionals and Small Producers, including Productive Families” is considered one of the priority sectors for banking finance. Financing policies included concessions among the financing regulations for this sub-sector. In addition to the financing regulations set by the Central Bank, the banks set their own internal regulations to ensure successful projects, consolidate the application of the Central Bank regulations and ensure the success of the marketing of the output. These conditions included socio-economic surveys of applicants to check their reputations and skills, whether they had any outstanding debts and their marketing experience. In addition to other fees, the national policies that banks must comply with are: tax and *zakat* clearance certificates and a number of other, incidental government fees and duties.

The lack of recognition of female-managed small enterprises is due to the view of Sudanese financial institutions that these are only income-generating activities rather than commercial, business-like activities. It may also relate to a lack of recognition female business acumen. This attitude ignores the recent growing phenomenon of female-managed small enterprises in Sudan and the role of women as proactive entrepreneurs.

## Chapter Five

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**FINANCING CHALLENGES OF SMALL  
ENTERPRISES: THE EXPERIENCE OF  
SUDANESE ISLAMIC BANKS**

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*The Sudanese experience in Islamic financing has brought new conventions to the funding of the small enterprise sector and has some potential for solving its outstanding difficulties. However, before this potential can be realised, some difficulties have to be addressed. In this chapter, the experience of six selected Islamic banks in Sudan will be reviewed and modifications to the existing applications will be suggested.*

### **The Sudanese Islamic Bank**

The Sudanese Islamic Bank (SIB) is one of a set of Islamic banks established in the early 1980s. It had a nominal capital of US\$20 million. The bank now has more than 40 branches spread all over the country, including three productive family branches (PFBs), which have been established to extend finance to small and micro-enterprises. While financing small and medium enterprises is a feature of all Sudanese banks, the SIB is the only bank which has established special branches catering for productive families.

### **The Productive Families Branches (PFBs)**

In its move to finance small and micro-enterprises, the SIB was the first bank in Sudan to initiate and open family-specific branches in urban residential areas to extend capital to small enterprises. The first specialised branch was opened in Omdurman in May 1992 with 12 professional (mostly graduate) staff, of whom eight were women. The organisational structure of the branch is composed of the branch manager, the executive manager, the project and family affairs section (which deals with investment, feasibility studies and project follow-up), an accounts section (to deal with current accounts and family savings deposits, in addition to computing and auditing) and the treasury section. The branch was opened in an ordinary house, without counters. A second branch of the same kind was opened in Wad Medani, a small town about 180km south of Khartoum, with 13 professional staff, of whom

eight were women. Because of the success of the initial branches, the bank opened a model branch in March 1994, to cater for the Mulazmin and Bail-al-mal districts of Omdurman, with eight professional staff, of whom six were women (including, for the first time in the history of Sudanese Islamic banking, a female manager). Although the structure and the general features of the branch have not changed, the new model branch was meant to address the major outstanding constraints on small businesses. Encouraged by its success, the bank has now decided to open four other, similar branches in other parts of the capital and rural areas.<sup>57</sup>

In financing productive families, the SIB has the following aims:

- The consolidation of the sense of social justice and solidarity (*takaful*) among the members of the society.
- Participation in investment in ways that benefit the local community.
- Promotion of banking awareness, giving help in developing the sense of saving money and encouraging citizens to operate through banking channels.
- The use of the largest possible portion of investment funds in income-generating activities.<sup>58</sup>

### **Procedures for Investment**

The procedures for investment in productive family businesses are initiated by an application from the partner giving some information about his or her project or about the intention to enter into a lending relationship with the branch, together with a specification of the financing formula. The branch begins by receiving information about the client and his experience within the field of work he wishes to borrow money for. After visiting the family, the investment and family affairs section then prepares a socio-economic survey. The most suitable mode of finance for the project is then suggested and the primary report, which usually

includes the following, is submitted to the manager:

- The basic information about the family, including the dates of birth of household members, social status, number of children, place of residence, annual income for all members of the family, and so on.
- The applicant's past transactions with the bank (if any) and his or her reputation and experience in the proposed project (if any).
- The extent to which the application matches the credit (financing) policy of the Bank of Sudan and the investment policy of the SIB.
- The technical, economic and social feasibility of the project.
- The significance of the project as far as the branch's investment priorities are concerned.

In the case of *Musharaka*, a contract has to be signed by the bank and the partner and a partnership account is opened, showing a specification of the share of each partner. The bank makes sure that the partner's contribution is not less than the ratio specified by the central bank's financing policy to this small-scale sector (see Table 5). Guarantees usually include personal guarantees, field visits and storage of raw materials, the *Musharaka* contract and the regular deposit of sales proceeds. Drawings from the deposited fund are made in accordance with the plan agreed in the contract. Material purchases are supported by invoices and limited to the quantities and types specified in the contract. Materials purchased, according to the contract, are stored under the care of both partners and withdrawals agreed by both parties. The bank starts general supervision and follow-up of the project's operation, using its own staff. This includes both field and office-based follow-up. In the field follow-up, the staff of the investment and family affairs section maintain regular contacts with the partner to ensure that the bank is kept aware of the current operations so as to be able to take any necessary measures if things start to go seriously wrong. The partner is required to submit periodic reports showing details of the operation and should adhere

to the dates of the announcement and liquidation of the project as agreed in the contract. Sales revenue is deposited in the joint account. By the end of the period of the partnership (which is project-specific), the bank buys any remaining unsold products and sells them in showrooms which are opened in each branch for this purpose.

Before granting a *Murabaha* loan, the bank estimates the value of the assets required by the applicant to see whether or not it matches the amount of the loan required. The bank then buys these assets or raw materials and delivers them to the client, charging a margin of profit which ranges from 3 to 4 per cent per month. The contract period for the project usually ranges between one and six months. Types of guarantee in *Murabaha* financing include post-dated cheques from the client or a third party. Credit information concerning the third party is obtained secretly from the bank in which he or she deals. For projects in which the client has not enough experience, a one to two months' grace period is given. At the end of the operation, the investment and family affairs section evaluates the project.

## **Deposits and Financing of Productive Families Branches**

Deposits at the three branches are in the form of current accounts and family savings accounts. Total deposits in the three branches reached 84 million Sudanese pounds by the end of December 1994. About 73 per cent of the volume of deposits is in the form of current accounts and 27 per cent is family savings accounts. There are 440 current accounts and 72 family savings accounts.<sup>59</sup>

Up to December 1994, over 500 projects (mainly women's projects) were financed by the three branches, with normal project-financing not exceeding 500,000 Sudanese pounds. Since their inception, the branches have invested over 40 million Sudanese

pounds in family-based projects. About 17 per cent of these projects were financed through *Musharaka*, in which the bank's share is 20 per cent of the total money invested. *Mudaraba* constitutes only 6 per cent of the total finance. *Murabaha* is the most dominant financing mode in the PFBs of the SIB, comprising about 74 per cent of the total finance. At present, the bank's policy is to expand the *Musharaka* financing to a minimum 50 per cent. Most of the partners are depositors, but not all depositors are using the bank as a source of finance.

### **Projects Financed and Business Specialisation**

Projects financed cover a wide range of small urban enterprises, such as tailoring, food processing, shoe- and soap-making, chalk, cheese-making, goat- and poultry-keeping, petty retail trade and some informal sector activities, such as *Kisra* (flat local bread)-making. Business specialisation varies according to the geographical location of the productive families' branches, with the concentration of foodstuffs at the al-Thawra branch, sewing at the al-Girsh model branch and poultry- cow- and goat-keeping at the Wad Medani branch.

### **Establishing a Base for Non-Traditional Banking Practices**

Working with PFBs has had a special significance, because of the unique experiment in Sudan to help productive families learn to save and to diffuse banking awareness among small producers. The experience of PFBs has revealed some of the advantages of such non-traditional transactions. PFBs have had great success in reaching small producers by selecting the most suitable Islamic financing tools from *Musharaka*, *Murabaha* and *Mudaraba*. None of the partners who have been financed could have gained access to such funding had not the PFBs been available. Ordinary people in urban residential areas, especially women, can now get access to conveniently located

branches. They can open family saving accounts at a very low minimum amount, without paying interest, and with no formalities for withdrawals. The staff is able to help any customer who has had no previous contacts with a formal financial institution. The bank has well-qualified staff, who are prepared to administer and run small savings and lending operations.

The SIB experience in financing productive families illustrates the way in which Islamic principles of banking (namely the social role of money and the dual nature of Islamic investment) can be applied to small businesses. The basic philosophy behind the PFBs follows Islamic principles, which guide the circulation of money in the economy. In Islam, money is not the property of individuals, but belongs to the community at large. The bank interprets the word "community" to mean people in the same geographical location as the PFB bank. The PFB system is working in such a way as to mobilise deposits from a specific geographical location and lend that money to dwellers in the same district.<sup>60</sup> This is contrary to the traditional way the banking system works, whereby it mobilises deposits from rural savers to be invested in urban areas.<sup>61</sup> This new formal banking behaviour also encourages small savings. The SIB is not forced, either by the government or by the central bank, to collect money from small savers and lend to them, even though small investments are not always guaranteed to bring healthy profits to the bank.

On the whole, the PFBs have managed to set up an institutional micro-financial savings and lending service. By opening institutionally convenient savings outlets, by creating a credit culture among small businessmen and by acting as a partner in business, the SIB shows clearly that the poor are indeed "bankable".

The SIB experience in financing productive families has also brought with it some innovations in banking on both a local and international level. This new banking convention has reformulated the bank-client relationship with regard to regulatory control

(represented by the absence of counters, clients being known by name, and so on). Thanks to the nature of *Musharaka* operations, bank/partner relations are much closer and more cordial than is possible under the conventional banking system. Moreover, in *Musharaka*,<sup>62</sup> the partner gains advantages to his/her business, such as access to good quality raw materials at reasonable (sometimes official) prices and an acquaintance with how to operate a business, deal with a bank account and maintain proper business records.<sup>63</sup> The system also allows for flexibility in dealing with small investors, since the objective credibility of the applicant, known through the field survey, is more important than the ability of the client to repay his debt. Thus, no court cases have so far been incurred by using this method. The cases of failure have not been related to the non-repayment of debts, but to social and marketing/follow-up factors.<sup>64</sup> Instead of going to court for repayment of loans, the bank merely keeps court procedures in mind as a warning. The PFB experiment also widens the use of the branch buildings to marketing the products there and sometimes using them for production (manual looms, soap, oil mills, and so on).

### **Faisal Islamic Bank of Sudan (FIBS)**

Within small enterprises, the FIB specialises in financing craftsmen. A specialist bank for craftsmen was established at Omdurman in 1983. The aim of the branch is to “develop human capabilities and to extend financing to the financially incapable and productive section of the society”.<sup>65</sup> The branch services two objectives: the establishment of the first specialised branch, as stated in the basic policy of the FIB, and to support the craftsmen sub-sector.<sup>66</sup>

### **The Volume and Conditions of Financing**

The amount of money lent to craftsmen by the branch was

2.4 million Sudanese pounds in 1993 and rose to 168 million a year later. Total financing for the whole period since the bank’s inception (1983-1994), is 567 million Sudanese pounds, which comprises about 5 per cent of the total finance of the FIB. The total number of projects financed during the same period (1983-1994) is 1,400, or 12 projects per month on average.<sup>67</sup>

The only formula used by the FIB in financing craftsmen is *Murabaha*, with the margin ranging from 3 to 4 per cent per month. There are two sets of conditions specified by the bank in financing craftsmen: the basic conditions required for any kind of financing and the conditions required to put the investment operation into effect. The first set of basic conditions is:

- Opening of an applicant’s account with the bank.
  - Application, invoices and feasibility study.
  - Identification of the applicant as a craftsman (membership of the Craftsmen and Small Enterprises Union or a vocational training certificate).
  - The feasibility of the potential project and the availability of a suitable workshop or a licence from the authority concerned.
- The second set of conditions represents the guarantees required by the bank. Various alternatives are acceptable, namely:
- The personal guarantee of a third, financially capable, party.
  - A real estate guarantee of the value of capital equal to, or more than, the volume of financing.
  - Output/raw materials storage guarantee (the client is allowed to withdraw part of his raw materials as long as he can manage to repay some of the instalments).
  - A bank ownership guarantee.<sup>68</sup>

The partner is also required to insure the commodity and open an account with the bank.

### **Projects Financed**

On average, more than 200 projects have been financed annually between 1983-1996 by the bank. These include machinery, spare parts, various means of transport, agricultural implements and electric bakeries.<sup>69</sup>

### **Islamic Co-operative Development Bank (ICDB)**

The only formula for financing small producers (including productive families) under ICDB is *Murabaha*. *Murabaha* is used for loans not exceeding 400,000 Sudanese pounds and it has a duration of up to one year, with a maximum grace period of two months. Repayment is made in equal instalments, every month or every other month. The margin of *Murabaha* is 3 to 4 per cent monthly, above the minimum range identified in the financing policy of the Bank of Sudan.

### **Volume and Conditions of Finance and Types of Projects**

The ICDB finances urban craftsmen through a special fund called the “Craftsmen Support Fund”, which was valued at 88 million Sudanese pounds in 1992-93 and included funding for blacksmiths, carpentry, fishing boats and oil mills. Financing productive families was estimated to cost 41 million Sudanese pounds, mainly for poultry, cows and manual looms. Small-scale projects include oil mills, tailoring, needlework, soap-making, grain-mills and sweets. The bank’s financing of craftsmen, productive families and small producers reached 10 per cent of total financing between 1991 and 1993.<sup>70</sup>

The guarantee policies of the bank are flexible. The bank accepts a personal guarantee from a third party through cheques, depending on the number of instalments. If the third party is not a client of the ICDB, information is obtained from the other banks with which he or she deals. Sometimes a collateral guarantee in the form of an estate mortgage is required. Other guarantees include storage of raw materials and assets. In the case of craftsmen, personal

guarantees are taken if the volume of finance is about 300,000 Sudanese pounds. For higher volumes of finance the bank jointly stores raw materials or final products or may even secure a real estate guarantee. In all cases, the bank also requires tax and zakat (alms tax) exemption certificates.

### **Nelein Industrial Development Bank Group (NIDBG)**

The basic formula for financing small enterprises, including productive families, in the NIDBG is *Murabaha*. The range for the loans is from 500,000 to 1.5 million Sudanese pounds. *Murabaha* can be extended up to 21 months, with a grace period of three months. Repayment is made by equal instalments, either monthly or quarterly. The *Murabaha* margin ranges from 3 to 4 per cent per month for the small enterprise sector, though it is higher when the amount of finance is 1.5 to 2 million Sudanese pounds. According to the bank’s investment criteria, those who require advances of up to 2 million Sudanese pounds are considered classed as small producers. The bank makes a feasibility study and the small producer pays the cost.

### **Volume and Conditions of Finance**

The bank accepts personal guarantees by third parties and social funds (*zakat* and *takaful* – solidarity funds) for any amount not exceeding 1.5 million Sudanese pounds and third party guarantees for finance less than 2 million. Otherwise, the bank requires collateral guarantees, in addition to a certificate from a residence committee. Exemption from tax and *zakat* certificates is granted in the case of finance deals for less than 500,000 Sudanese pounds. The application form is simple and so are the procedures for funding. NIDBG financing of small enterprises amounted to 442 million Sudanese pounds in 1992, representing 4.4 per cent of the bank’s total expenditure. In 1993, the amount reached 839 million, representing about 7 per cent of total financing.

## Types of Small-Scale Projects

NIDGB financed more than 465 projects of productive families, small enterprises and craftsmen during the period 1989 to 1992. Projects financed included food processing (cheese, yoghurt and *Kisra* (flat bread), biscuits and sweets), rural oil mills, tailoring and needlework, leatherwork, soap-making, building materials and engineering workshops, building and packing services, tyre repair workshops, etc.

## The Agricultural Bank of Sudan (ABS)

The ABS started to finance productive families in 1990 in agriculture and livestock, as well as providing funds for small industrial and service enterprises. The available statistics indicate that about 286,000 Sudanese pounds were used to finance productive families in 1993 and 283,000 in 1994. The number of beneficiaries for the two years was 1,066 and 881 respectively.

## The Farmer's Bank (FB)

In 1994, the Farmer's Bank financed 159 small enterprises. Finance to craftsmen reached 11.1 million Sudanese pounds with small enterprises accounting for 9 million. Only 27 per cent of the total finance made available was given to businesses in the capital region. This illustrates the geographical distribution of finance by the bank.<sup>71</sup>

## The Sudanese Savings Bank (Savings and Social Development Bank, SSDB)

The bank gives the lowest *Murabaha* profit margin of 15 per cent per annum and a grace period of up to five months. The percentage of finance to small producers out of the total finance reached 29% in 1995 (about LS 708 millions), while the *Musharaka* system accounted for 15% of the SSDB total financing.

## Evaluation of the Sudanese Banking Experience in

## Financing Small Enterprises

Among the Sudanese banks described above, the SIB is the only one that has established special small enterprise branches. The spectrum of projects financed is limited in the NIDBG, ICDB, FB, ABS, SSDB and FIB, compared with the heterogeneity of projects under the SIB. SIB has a relatively large target group covering different specialisations. Although the Sudanese banks use all modes of Islamic financing, *Murabaha* is the most commonly used method.

Table 1: Sudanese Islamic Bank: Some indicators and modes of finance to small and microenterprises.

Bank	Target group	Major modes of finance	% of finance (out of total finance)	Types of projects
SIB	Productive families, small enterprises, crafts and informal sector activities	<i>Murabaha</i> : 20% <i>Musharaka</i> : 74% <i>Mudharaba</i> : 6% (1993)	6%	Tailoring, shoes soap-making, informal sector activities.
FB	Craftsmen, small producers and productive families	<i>Murabaha</i> : over 90%	5% (average 1993-1994)	Engineering workshops, machinery and equipment transport vehicles and bakeries and spare parts.
ICDB	Small producers including productive families, crafts	<i>Murabaha</i> and <i>musharaka</i>	10% (annual average 1991-1993)	Oil mills, needlework, tailoring, soap-making, grainmills and sweets.
NIDBG	Productive families, small enterprises and crafts	<i>Murabaha</i>	4.4% (1992)	Food products, tailoring, needlework, leatherwork, soap-making, building materials, engineering workshops, typing and other services.
ABS	Productive families, small farming and other small enterprises	<i>Murabaha</i> , <i>Musharaka</i> and <i>Mudharaba</i>	NA	Animal raising and poultry, small flower nursing, small-scale industries and productive families (foodstuff, soap-making and tailoring).
FB	Productive families, small producers, crafts, and small farming	-	5.4% (1994) 6.5% (up to June 1996)	Poultry, animal raising, coal production, professional activities, agricultural activities and crafts.
SSDB	Small producers	<i>Mudharaba</i> : 15.6% <i>Murabaha</i> : 60.8% Others: 23.6% (1995)	11.7% (1993) 18.8% (1994) 29.3% (up to August 1995)	Poultry, cows, sewing machines, oil production and other services activities.

Banks prefer *Murabaha* because it guarantees a given return on capital invested and the bank does not have to bother about the supervision and management of the project. In the bank's view, *Murabaha* is safe both for profit and for repayment. On the other hand, the SIB uses *Musharaka* as one of its major financing formulae, based on the belief that the Islamic system is principally one of partnership and that, in addition, *Musharaka* has the elements of convenience mentioned earlier. The following table summarises the target groups, modes, percentage of finance and types of projects of the Sudanese Islamic banks.

Although *Murabaha* is used by all banks for financing small businesses in varying degrees, its application in each bank is slightly different. The following table summarises the amount of finance, conditions, guarantees and target groups.

From Table 7 opposite, it is clear that:

- *Murabaha* is the dominant mode of finance for small and medium enterprises used within the Sudanese banking system. It has been used up to 90 per cent of the time in some banks. It is the major mode of finance for craftsmen used by the FIB. *Musharaka*, on the other hand, constitutes about 20 per cent of financing in the SIB. Other banks, however, rarely use it.<sup>72</sup>

- The *Murabaha* margin for small producers in general ranges from 3 to 4 per cent per month (36 to 48 per cent per annum), which is above the minimum margin of 15 per cent per annum required by the financing policies of the Central Bank. The repayment methods are also different from those stipulated.

- The financing policies, as we have previously mentioned, state that banks are free to obtain whatever "sufficient guarantees" they require when financing this sub-sector. They do not include or exclude any of the guarantees currently used in the banking system of Sudan. Banks resort to traditional guarantees such as personal guarantees, post-dated cheques and third-party guarantees. This happens in spite of the fact that Article 8/2/A of the Financing

The Bank	Percentage of total finance	Amount of finance	Conditions	Guarantee	Repayment methods	Target group
SIB	74%	Less or equal to 500 thousands Sudanese pounds	3-4 percent monthly <i>Murabaha</i> margin. Up to 6 months <i>Murabaha</i> period	Post dated checks from the client or other third party.	Equal instalments, sometimes with grace period. Repayment every month.	Productive families, small enterprises, crafts and informal sector activities.
FIB	100%	Not defined	3-4 percent monthly <i>Murabaha</i> . Up to one-year <i>Murabaha</i> period.	Personal guarantee, bank ownership guarantee or real estate guarantee.	Equal instalments every month, without grace period.	Craftsmen.
ICDB	100%	Less or equal to 400 thousands Sudanese pounds.	3-4 percent monthly <i>Murabaha</i> . Up to one-year <i>Murabaha</i> period.	Personal guarantee. Post-dated checks. Social fund guarantee.	Equal instalments, with 1-2 month's grace period, and repayment every month or two months.	Small producers and craftsmen.
NIDBO	100%	Between 500 and 1500 thousands and up to 2000 thousands.	15 % <i>Murabaha</i> margin for amount up to 1500 thousands. 25% <i>Murabaha</i> margin for amount more than 1500, but less than 2000.	Personal and social fund guarantee for amount less than 1500 thousands. Collateral guarantee for amount exceeding 1500 thousands.	Equal instalments, with 3 months grace period, and repayment every three months.	Small enterprises and productive families.
ABS	Not available	321 thousands (average finance 1994)				Small enterprises, productive families and crafts.
FB	Not available	400 thousands				Productive families, crafts, professionals, and small industries.
SSDB	Not available	-	15% <i>Murabaha</i> margin, with grace period up to five months.			Small industries, productive families, and retail trade.

Regulations<sup>72</sup> refers to the possibility of evaluation of machinery and equipment as a way of ensuring a guarantee. The lack of specialised institutions to evaluate machinery and equipment in Sudan may be hindering the application of this kind of guarantee.<sup>74</sup>

- Apart from the NIDBG, all the other banks require loans repaid in equal instalments,<sup>75</sup> but a grace period of one to three months is granted. The repayment method of the NIDBG is easier than that of other banks because the repayment period can be extended for up to 12 months.

- There are variations in the total volume of finance made to small and micro-enterprises by Sudanese banks, but similarities in the volume of finance per project.

- The target group “small producers” is separated by banks into different categories, such as productive families, craftsmen, the informal sector and so on, without there being a clear definition for each category. Each bank specialises in one or two sub-sectors.

There are no separate rules and procedures for financing female-owned enterprises, despite the growing phenomenon of women entrepreneurs.<sup>76</sup>

We now move on to look at the major constraints in the application of Islamic finances and how to overcome them.

## **Applications Constraints and Suggested Modifications**

First, let us note the fact that the details of Islamic banking formulae we use today are not written in the *Qu’ran* or *Hadith*, but originated in the ideas and judgements of the Islamic jurists in the Middle Ages, who based their conclusions on general principles indicated in the *Qur’an* and *Hadith*. These scholars worked out general guidelines as to how Islamic economic principles should work in practice. The development of these guidelines depended on successive judgements made according to the times and circumstances prevailing when they were originally made. Muslim

schools of thought arose which differed on the details related to applications, but agreed on the Quranic principles. Islamic banks of today have taken these views as a basis on which to build the system of financing that we use today, for Islamic banks have to be built on solid intellectual foundations. For the Islamic system to gain more ground and acceptability internationally, economists and other experts are confronted with devising techniques of financing which are not only practical to operate, but in accordance with strict Islamic principles. Here I suggest some possible modifications of applications, based on my experience with the operations of Sudanese Islamic banks.

The application of Islamic partnerships has singled out the high costs of the following up, and the monitoring, of projects as a major problem.<sup>77</sup> To reduce the administrative burden, branches have been created to serve limited geographical areas located around the businesses they service.<sup>78</sup> A third party to follow up and share a certain percentage in the total profit is also recommended.<sup>79</sup> Group collateral, which can serve the dual function of reducing the administrative costs and act as a security against fraud and misuse of funds, is recommended<sup>80</sup>. A group leader, in collaboration with the bank’s staff, should undertake the monitoring obligations.

Another problem, which has been noticed, is deciding on a fair management share for the partner. In principle, the determination of the management share is made by a mutual agreement between the bank and the partner. In practice, it is usually in the range of 20 to 30 per cent of the total expected profit. This flat rate may be unfair either to the bank or to the partner, as the management effort required varies between different projects. Here a more operational and fair method of calculating profit shares is required. One suggested method is the Residual Approach (RA) to calculating the management share of the total profit by deducting share profits from total expected profits and then dividing them by the total expected profit.<sup>81</sup> To have the management profit as a

residual requires knowledge of the rate of return on the capital invested in previous similar projects, i.e., the rate of return on each unit of capital. By multiplying the volume of capital invested by the rate of return on each unit of capital, we get a share profit.<sup>82</sup> Additional incentives to the partner can be granted, thereby allowing the bank to determine the maximum rate of return on the total capital used in the project, above which the bank will be ready to sacrifice any additional profit to the partner. In the current situation, the partner sometimes gets this incentive through an increased management share over and above the limit determined by the contract. The modification outlined above is more operational and easier to calculate.

Alternatively, we can use the "Imputed Market Share Approach" (IMSA). Here the value of the management efforts can be evaluated at the prevailing local market price and then divided by the total expected profit. To illustrate the approach, if  $V_m$  is the market value of the management effort, and  $\pi_e$  is expected profit, then IMSA gives a management share in profit of  $(V_m/\pi_e)$  100%. A weighing system can be used for factors such as qualifications, experience, and volume of capital, sensitivity of the project and additional incentives for the management.

Evaluating the fixed assets in diminishing (self-liquidating) *Musharaka* also needs a modification. Banks do not usually revalue the asset at different times during the repayment period. Inflation is not taken into account, and hence, diminishing *Musharaka* is to the disadvantage of the bank. Revaluation of the assets should be undertaken and the volume of payment can be considered as a ratio of the value at the time of payment. For full payment of the value of the asset, the addition of these ratios must equal unity. If  $r_1, r_2, r_3, r_4, \dots$ , are payments in periods 1, 2, 3, 4, etc., respectively, and  $v_1, v_2, v_3, v_4, \dots$  and so on are values of the asset in each payment period respectively, then, at the time of full payment,  $r_1/v_1 + r_2/v_2 + r_3/v_3 + r_4/v_4 + \dots = 1$ . Adjustment of the partners' shares has

to be modified each period in accordance with the changes that may have occurred after each part-payment.

Compared to *Musharaka*, *Murabaha* has few constraints — that is one reason why bankers favour it. One of the major problems in *Murabaha* is when the client, with the help of the staff, does not use the money for the intended purchase of raw materials or fixed assets. This is called "fictitious *Murabaha*". Although the Bank of Sudan has strict laws against the use of fictitious *Murabaha*, it still sometimes happens.<sup>83</sup>

A *Mudaraba* contract requires a great deal of confidence between the two parties and that is why it is very rarely used. Despite the determination of a form of restricted *Mudaraba*, as one means of finance for small enterprises, having been made by the Bank of Sudan, it is not frequently used.

## Conclusion

Despite the subtle differences in the application and use of financing formulae, many Sudanese banks have managed to employ Islamic modes of finance to fund small enterprises. Here we have illustrated these approaches to financing small and micro-enterprises with reference to the SIB, ICDB, FIB, ABS, FB, SSDB and NIDBG banks. The most interesting of these is the experience of the SIB, which has established a basis for financing small and micro-enterprises from specialised branches, mainly using profit-and-loss-financing formulae, without the need for collateral guarantees and with no cases of default.

So far, some expectations in small enterprise financing have been fulfilled, though some difficult questions still need to be answered. One of the major constraints is the lack of a unified definition of small and micro-enterprises with specified socio-economic characteristics. The lack of national policies specially designed and intended for small and micro-enterprises has created

other constraints. Although the financing policies specify the small enterprise sector as being one of the priority sectors for banking and finance, other constraints, such as tax and *zakat* clearance certificates pose problems to this target group.

## Chapter Six

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**BANKING FINANCE TO SMALL AND  
MICRO-ENTERPRISES IN THE SUDAN  
AND POVERTY ALLEVATION**

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## Poverty Alleviation and the Islamic Principle of Financing

Poverty alleviation through grassroots productive families (small family businesses) in Sudan is currently receiving considerable attention from banks, the government and NGOs alike.

The principle of Islamic finance is based on the belief that all wealth belongs to *Allah* (God) and individual owners are trustees of that money. Moreover, private investment in Islam is dualistic in nature, i.e., is for the benefit of the investor and the community at the same time. There are many principles which tend to guide investment in the Islamic world. One of these principles is the use of money and investment to provide basic necessities to society as a whole. Also, these principles determine some rules concerning priorities and avenues for investment and its mechanisms. These principles for the Islamic circulation of money and investment determine the basic objectives of an integrated Islamic financial institution.<sup>84</sup> Small enterprises usually provide the basic necessities of life and so extending finance to them can help to alleviate poverty and achieve the dualistic characteristics of Islamic finance mentioned above.

## The Concept of Poverty and the Volume of Poverty in Sudan

Poverty, in its broad definition, refers to a lack of income and the necessary means of production to attain a “decent” standard of living. But researchers are concerned with the “absolute poverty” concept, i.e., the amount of basic consumer goods required, in addition to other expenditure on health, education, housing, etc., to survive. Sudanese measurements of the absolute poverty line are 3,947 and 203,818 Sudanese pounds in 1990 and 1996 respectively.<sup>85</sup> The “relative poverty” concept, on the other hand, measures the poverty of individuals, families and other groups, who have no access to the minimum acceptable requirements in their

society. The Sudanese *Zakat* Fund estimated the relative poverty line to be 271,000 Sudanese pounds per month in 1996. The Supreme Committee for Wages puts the minimum wage in 1996 in the range of 148,750 Sudanese pounds per month. The official inflation rate in 1995/96 was 130 per cent, whereas the average increase in the minimum wage rate was only 30 per cent. The Head Count Index (the number of poor people living under the poverty line) showed that poverty exceeds 90 per cent and between 1990 and 1996, the number of poor increased by 2.5 per cent annually.<sup>86</sup> If this is the case, then it will be impractical, if not completely impossible, to target poor income groups. It is more practical to seek to improve the performance of the economy through a change in macroeconomic policies.

In order to see the effects of bank-lending to small enterprises upon poverty alleviation, let us concentrate for a moment on the distinction between absolute poverty and relative poverty. Absolute poverty (the inability to meet basic needs, subsistence needs, in the prevailing socio-economic circumstances) can be a result of sickness, old age or a continuous increase in prices. Relative poverty, on the other hand, is related to income inequality or is a result of a malfunctioning supply-and-demand mechanism.<sup>87</sup> Relative poverty increases as a result of increases in the cost of living and the reduction of real income as a result of negative economic policies.

## Banking Finance and Relative Poverty Alleviation

There is no doubt that poverty in Sudan is wide, to the extent that incomes cover only a fraction of the cost of living as a result of relatively low incomes or the inequality of income distribution and the continuous rise in the prices of goods and services. The degree of poverty in Sudan has been measured to be 82.7 per cent and 83.1 per cent for rural and urban populations respectively.<sup>88</sup> The question arises as to what the Sudanese Islamic banking system of finance to small enterprises can offer to mitigate this poverty.

According to available statistics, the combined lending to combined deposits of the banking system is 40 per cent. The combined deposits are 400 billion Sudanese pounds, so the total lending is 160 billion. At a maximum, the banking system allocated only 6 per cent of this to craftsmen, professionals and small producers, including productive families, i.e., 9.6 billion Sudanese pounds. The per capita loan is calculated at 600 Sudanese pounds and the total operations are 3,200 per year. That is to say, the beneficiaries are 3,200 small enterprises per year out of a total population of 16 million classified as being below the poverty line. At this rate, we would need 50 years to relieve the current total number of people under the poverty line.

From the analysis above, it can be seen that a considerable effort is needed from the financing agencies to increase funding to small enterprises enough to alleviate poverty. But national policies and the internal policies of commercial banks are defeating this. There must be an environment more conducive to the application of the central bank's policies through specialised branches or through the creation of a suitable mechanism to reduce the cost of lending, increase profitability and enhance the volume of lending.

Sudanese banking finance to small enterprises cannot be considered effective for poverty mitigation if we take into consideration the following characteristics of the Sudanese banking system:

- Demand deposits constitute over 70 per cent of total deposits. Demand deposits in Sudan are characterised by a high degree of instability.
- Branches are unequally distributed between urban and rural districts, being concentrated in commercial towns and urban areas.<sup>89</sup> Khartoum and the central states share almost 50 per cent of the total number of banks in the country.<sup>90</sup>
- There is a concentration of investment in the most organised sections, with high profitability being in the modern sector. An

analysis of sectoral lending in 1993 shows that about 74 per cent of the combined total lending of commercial banks was directed towards modern agriculture, industry and exports. Small producers shared only 6 per cent of the total lending.<sup>91</sup>

- The financial resources of the banking system are weak, giving banks a relatively low lending capacity. The actual lending capacity in 1993 was only 46 per cent of the total lending. This figure compares badly with the 1980 figure of 88 per cent.<sup>92</sup> The ratio of financial resources to the GDP did not exceed 12 per cent and total banking assets to the GDP were only 17 per cent in 1992, while total deposits to the money supply were 20 per cent at the very most.

The adaptation of the Sudanese banking system to the requirements of the Basil Committee require the banking system to look at internal problems rather than external ones, including their role in alleviating poverty.

In Sudan, the mitigation of poverty through small enterprise finance targeted only the level of income, although real income experienced a continuous decline as a result of the increased cost of living. The minimum cost of living per day increased from 71 Sudanese pounds in 1992 to 2,440 in 1996<sup>93</sup> — the minimum cost of living increased eight times each year during the above period. As a result, it is essential to look at policies to mitigate the impact of the liberalisation of prices, rather than to seek strategies to increase incomes through small enterprise finance.

The Sudanese experience of financing small enterprises has proved to be ineffective as a mechanism to alleviate absolute poverty. The small number of failed projects are those whose owners are unable to meet their basic needs. We argue that if there is a role to be played by the Sudanese banking system, it should be among those who are characterised as being in the relative poverty region — those who work in the private and public sectors.

The Sudanese experience was, and is still, capable of offering

some lessons for small enterprise financing, and to mitigate some of the constraints raised in the literature of small enterprises financing, namely:<sup>94</sup>

- The extension of financing via geographically scattered branches designed to extend credit to small enterprises has helped a great deal to reduce the cost of administering credit to small enterprises.

- The small enterprises financed were characterised by a high rate of return on the investment.

- Those who are characterised by relative poverty are capable of meeting their banking financial and repayment requirements.

- The innovative approach to guarantees proved effective and traditional guarantees do not lead to an enhanced rate of repayment.

### **Conclusion**

Although the financing policies of the Bank of Sudan have been aimed at achieving a fair distribution of income and wealth, it is clear that this cannot be achieved through the banking system. In spite of the concessions granted to small producers, and as a result of the internal policies of the banking system and internal and external constraints, the banking and finance extended to small enterprises did not act as a mechanism to mitigate poverty in Sudan. Yet the Sudanese experience was, and still is, capable of offering some lessons for small enterprise financing. What lessons we can learn from this experience is the subject of the following chapter.

## Chapter Seven

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### **ISLAMIC FINANCING TO SMALL AND MICRO-ENTERPRISES: LESSONS FROM THE EXPERIENCE**

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In his prominent work on Islamic partnership financing for small and micro-enterprises, Malcolm Harper (1997) argued that “there is a wide range of methodologies through which [*institutional*] finance can be delivered to the owners of [*small businesses and micro-*] enterprises, and recovered in a way that is profitable for the financing institution”.<sup>95</sup> Although these methodologies, he added, managed to avoid most of the outstanding problems of micro-enterprise finance, they were not free from other constraints. One, if the enterprise fails, loss of livelihood occurs and small businessmen are burdened with debt. Moreover, when inflation is high, loans are inevitably decapitalised in real terms, even if there are high recovery rates and coverage of operating costs.<sup>96</sup> The conclusion is that profit-and-loss-sharing formulae are known to avoid these two constraints. On another occasion, Harper asked the logical question that “even if the whole system of partnership financing, with or without its religious implications, cannot be applied, are there some aspects of the system which can be used to overcome one or other of the problems of inflation and the ‘double burden’ of loss?”<sup>97</sup> There seems to be an advantage that Islamic partnerships can offer to small enterprise financing. Despite this partnership potential, no formula has yet received wide acceptance.

It has already been established that Islamic partnership finance has indeed some potential for micro-enterprises, but some outstanding problems have to be solved if it is to be widely adopted.<sup>98</sup> Here we argue that only these modifications of the Islamic mode of finance are required for the formulae to suit the fixed-interest financial institutions. Thus it cannot be said that profit-and-loss-sharing arrangements and mark-up techniques can only be understood and applied in the context of Islamic banking and are thus irrelevant to interest banking. More specifically, if profit-and-loss-sharing is taken as one form of venture capital, rather than as an ideological concept, it will possibly have a great deal of universal

application, especially as a supplement to interest-based financing to small enterprises.

### **Can Profit-and-Loss-Sharing Formulae be Extended to an Interest-Based Banking System?**

In Sudan, the call for Islamic partnership financing for small producers was made more than 15 years before the Islamisation of the banking system. In his study of craftsmen, Mohammed Hashim Awad (1975) offered many recommendations for the development of this sector, among which is a fund (to be developed into a bank) to extend soft credit to craftsmen based *on a profit-and-loss-sharing formula*.<sup>99</sup> This recommendation is vital to the analysis here, as it envisages that profit-and-loss-sharing formulae, of any sort, can be applied to interest-based banking without the need to change the structure of the bank. Before showing that this is true, let us concentrate for a moment on the main features of the conventional partnership and show the differences (if any) between the conventional and *Musharaka* partnership.<sup>100</sup>

Traditional partnerships can be defined as “two or more persons who join together with a view to gaining profit”.<sup>101</sup> Partnership contracts include how profits and losses are to be shared; how much capital each partner is to contribute to the business; whether any interest is to be given on the capital contributed and, if so, at what rate; whether any partner is entitled to a salary or a commission; and the restrictions on drawings and procedures to be followed in the case of the death or retirement of a partner. The main features of conventional partnership are:

- Contributions may be in the form of cash or other property or goodwill. The capital account includes the amount of each partner’s original contribution and any additional amounts subsequently contributed to the business.
- Profits and losses are allocated through either a fixed percentage allocation or according to the partners’ contributions of

services and capital to the business or in proportion to capital balances (at the beginning or the end of the accounting period or average capital balance).<sup>102</sup>

- In conventional partnerships, the net income for the period is allocated amongst the partners, leaving the project in operation. Withdrawals (for personal use) and additions to capital are allowed.

- Except in special circumstances, the dates of commencement and liquidation of the venture are unknown in advance and hence not recorded in the contract.

Given these characteristics of conventional partnerships, we now go on to see the difference between them and a *Musharaka*.

- Conventional partnerships are not always specified for a limited period; *Musharaka* ends with the end of the business cycle. The dissolution of the Islamic partnership is on the expiration of the time fixed in the agreement for the length of the partnership. The commencement and liquidation dates of the *Musharaka* venture are known in advance and recorded in the contract.

- Although the profit and loss of conventional partnerships can be distributed in two ways, *Musharaka* profit and loss allocation is only made in accordance with the partners' contributions of capital and services.

- Although withdrawals from a partnership fund are possible, since it is a long-term agreement, withdrawals from a *Musharaka* are not common, since it is a short-term agreement.

- Unlike conventional partnerships, *Musharaka* contributions are fixed by the contract and no additional amount is subsequently contributed to the business. This fixed original contribution makes a *Musharaka* a limited partnership for a limited duration.

- In a *Musharaka*, the distribution of profit is made once, at the time of liquidation, whereas in conventional partnerships, the net income is distributed periodically among the partners while the project is still in operation.

- Conventional partnerships are made between equal partners,

Type of partnership	Type of Agreement	Form and characteristics of contributions	Profit allocation	Liquidation (Length of the life of the agreement)	Financial equivalence of the partners, authority and obligations, and ownership of assets
Conventional partnership	Long-term contractual agreement	1. Capital, financial property and/or goodwill. 2. Withdrawal and additions to capital contribution is allowed.	1. Either fixed percentage allocation or according to partner's contribution of capital and services or in proportion to capital balance. 2. Net income of the business is allocated periodically leaving the project in operation. 3. Partners may be entitled to salary or commission.	1. Unknown and not recorded in the contract (will stop when one of the partners dies or when the partners agree to discontinue).	1. Conventional partnership is usually undertaken between equals. 2. Restricted authority and obligations.
<i>Musharaka</i>	1. Limited contractual agreement with similar rights and liabilities.	1. Financial capital, labour and financial value of asset depreciation. 2. Contributions are in varying proportions and one partner may not contribute financial capital. 3. Withdrawal and additional to capital is not allowed during the lifetime of the contract, except by mutual consent. The contract will be changed accordingly.	1. Profit allocation according to partners' contribution, with profit or loss sharing ratio agreed in advance and cannot be altered during the life of the contract. 2. Profit allocation is made when the project finishes. No partner is entitled to a salary or commission. 3. Allocation is made for financial contribution and management efforts.	1. For specific length of time known in advance and recorded in the contract.	1. Partnership is undertaken between financially unequal parties. 2. Restricted authority and obligations. 3. Ownership of the assets can be passed to a partner after systematically paying ratio of the assets (Distributing <i>Musharaka</i> only).

whereas a *Musharaka* can be between a small businessman and a big bank; hence it is a simplified form of venture capital.

The following table illustrates the major characteristics of conventional partnerships and the *Musharaka*.

Modern partnerships can be classified into three groups, partnerships, limited companies and co-operative societies, all influenced by business practice and controlled by statutory government rules. They resemble *Musharaka*, with restricted authority and obligations, in which there is a limited liability — this means that the shareholders cannot be held liable for more than the amount of capital they have invested.

In fact, the Islamic partnership mode of finance is just a simplified, short-term, fixed contribution conventional partnership. Since the Islamic system, guided by its principle of profit-and-loss-sharing as opposed to fixed interest, has managed to modify the conventional partnership for financing small enterprises, why can't the interest-based banking system design some sort of partnership, based on its conventional one, to extend finance to small enterprises? *Musharaka*, or any kind of partnership, cannot easily be rejected on economic grounds. The principal difference between interest and non-interest financial institutions is that a fixed or predetermined return on financial transactions (interest rate), instead of an uncertain rate of return (profit share), is forbidden in Islamic banking. Instead of paying a fixed return and bearing the full risk of investing the borrowed money, small entrepreneurs would naturally prefer to share the risk with the bank. This basic difference between interest-based and interest-free banking systems makes no other difference to the application of any sort of partnership arrangement. So, as a supplement to interest-based financing, conventional banks should be able find a way to extend credit to small and medium-size enterprises.

## **The Murabaha Mode of Financing and the Interest-Based Banking System**

Unlike *Musharaka* and *Mudaraba*, Islamic *Murabaha* does not work on a profit-and-loss mechanism, but rather the bank assumes the capacity of the classical financial intermediary. The use of Islamic *Murabaha* as a credit vehicle is not to be confused with interest-based lending. It requires that the bank buy, and then sell, to the client for money, a commodity that he has asked for in connection with his business, so that the operation is not a mere exchange of money for money. There is a risk for the bank in terms of time spent on the execution of the plan, and the risk between purchase and resale, since the customer is free to change his mind and not to accept the commodities bought for him under *Murabaha*. This risk taken by the bank justifies a profit. It avoids lending money but it is close to the Western concept and would be easy to adopt. It is not far removed from the case where a commodity offered for sale on credit fetches a higher price than when it was originally offered for cash.

*Murabaha* enables small and micro-enterprises to finance purchases of raw materials and/or fixed assets with deferred payments.

## **Incorporation of Profit-and-Loss-Sharing Arrangements and Mark-Up Techniques in the Interest-Based Banking System**

In order to incorporate the profit-and-loss-sharing formula and mark-up technique into the existing banking framework, two issues need to be looked at:

- The way to incorporate partnership and mark-up systems into the existing banking framework.
- *Musharaka*, *Murabaha* and *Murabaha* should be free from application constraints.

The second issue was dealt with in Chapter Four. As for the first part, using profit-and-loss-sharing arrangements will provide an inclination to conventional banks to fund medium and small-sized projects. There remains the need to find a suitable structure. First,

there is no need to restructure existing banks. They could open separate branches for financing small and micro-enterprises through profit-and-loss-sharing formulae and mark-up techniques or, if this is not practical at first, separate sections, called “counters” or “windows” could be set up in existing branches and be used as pilot projects. In this way, there would be no initial costs. If the pilot project were successful, then a separate specialised branch or branches could be established to use profit-and-loss or mark-up systems.

## Conclusion

The central question in this chapter is not whether Islamic finance is *halal*, but the advantages that profit-and-loss-sharing arrangements, under whatever name, can provide which interest-based methods cannot.

Islamic modes of finance have fulfilled some expectations in small and micro-enterprise financing, though some difficulties which have faced the practical application of the profit-and-loss-sharing system remain to be addressed. In this chapter, we concluded, among other things, that the Islamic system of finance for small and micro-enterprises has shown some potential in overcoming the outstanding difficulties with regard to micro-financing world-wide. Although the application of the Sudanese Islamic system to small and micro-enterprises is not without application constraints, it is clear that the way in which it operates can be modified and used as a supplement to Western financial methods.

## CONCLUSION AND POLICY RECOMMENDATIONS

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Comparing the Western medieval economy and the Islamic system of banking, Taylor and Evans concluded that both systems prohibit usury, but permit a return from partnership, provided that the partner making the investment genuinely shares the risk. They wrote, “the closeness of the two systems [the Western medieval economy and the Islamic system] is great and there is some evidence of common origins. Contemporary Western thought, however, has apparently removed itself far from its own tradition — hence the gap between Western and Islamic banking systems”<sup>103</sup>. Harper concluded that “the Islamic prohibition of fixed- interest lending, *which is also reflected in the Jewish and Christian traditions*, has led to the evolution of a number of financial innovations from which everyone can learn”<sup>104</sup>. In addition, Kindleberger has recently proposed reforms to reduce banking risks. One of the causes of many bank failures, he observes, is the payment of interest, irrespective of whether the bank is doing well or not. One of the reforms he suggests is the elimination of a guaranteed fixed-interest rate.<sup>105</sup>

Two important observations need to be stressed here:

- Practice, sometimes, deviates from principles and if this happens, it might not always be rational, and it does not affect the validity and usefulness of the original principles.
- Islamic banks and interest-based banks should not view each other as competitors. They can learn from each other, within religious boundaries, for the mutual benefit of their clients, including small entrepreneurs. The profit-and-loss-sharing formulae constitute good opportunities for co-operation between Western interest-based banking systems and Islamic financial institutions.

The gap between Islamic and non-Islamic financial institutions is not as wide as many people tend to think. The very roots of the fundamental principles are not different. In this context,

it should not cause concern if we attempt to use a profit-sharing formula as a supplement to interest-based lending in the conventional banking system. In this book, I have argued that the Islamic system of finance, based on profit-and-loss-sharing, cannot be understood to apply to Islamic banking only, and thus irrelevant to interest-based banking. Even if profit-and-loss-sharing formulae are taken as a form of venture capital, rather than an ideological concept, they will possibly have a great deal of universal application, especially as a supplement to interest-based financing of small enterprises. Instead of paying a fixed return and thus bearing the full risk of investing the borrowed money, small entrepreneurs would have peace of mind from being able to share the risks with the bank. From the point of view of the bank, the rate of return on profit-and-loss-sharing has usually proved to be higher than the rate of interest. Even the technique which requires that goods be sold to the entrepreneur for money, instead of a mere exchange of money for money, as in conventional lending, has some advantages to small entrepreneurs that could be investigated.

These approaches to banking, although matching the Islamic financing system, are not traditionally associated with Islam. Conventional banking systems can adopt any form of partnership finance to small and micro-enterprises, as a form of a genuine business-based relationship rather than a relationship based on security, as long as bank-client mistrust is removed.<sup>106</sup> In contrast, the Western interest-based financial system has an in-built bias towards lending only to big, secure businesses, which pose less risk, as opposed to providing venture capital to small businesses. This bias can be largely overcome by using profit-and-loss-sharing formulae instead of providing credit insurance or guarantee schemes, linking formal and non-formal financial institutions, setting aside a specific portion of commercial bank loan portfolios for the exclusive use of small and micro-enterprises, or even providing concessional credit for small and micro-enterprises.

What we suggest here is a system for financing small and micro-enterprises with readily available collateral and for banks to participate in the risk as long as the project is viable and operational profitability a likelihood. Where this is the case, good and profitable projects might not need to be turned down because of a lack of collateral at inception, provided that they are financed on a profit-and-loss-sharing basis. In this procedure, both sides are keen on making the operation a success and so the profits are likely to prove to be much higher than normal commercial profits. It is also a suitable method of funding for small entrepreneurs who own little and have only their skills and efforts to share.

The application of Islamic financing formulae to small and micro-enterprises, as we have discovered, has not been without its problems. One reason for this is that Islamic banks have been created from scratch, with no past relevant experience in profit-and-loss-sharing to learn from. As we have shown, many problems remain to be resolved. A great deal of research is needed into the application of Islamic formulae if it is to become more widespread and successful.

The application of profit-and-loss-sharing formulae within the conventional banking system can be made through “counters” or “windows”. Perhaps it does not sound too odd to suggest that specialised branches be set up to run on a profit-and-loss-basis or on a mark-up basis. Some conventional banks in the USA, Europe and Southeast Asia have already set up units dealing with Islamic instruments within their organisations. Theirs is an experience which conventional banks can learn from.

## NOTES

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1 Yousif Tarik, 1996, 'Islamic banking financial development and growth', Forum, Vol. 3, No. 3, September (*emphasis added*).

2 Helmsing A.H.J. and Kolstee, T. 1993, Small enterprises and the changing policies, structural adjustment, financial policy and assistance programs in Africa (eds.), Intermediate Technology Publications, p. 6, (*emphasis added*).

3 Yousif, Tarik, 1996, *op. cit.*

4 Among others, see Anderson, 1992 'Small industry in developing countries: A discussion of issues', World Development, Vol. 10, No. 11, Schmitz, 1982, 'Growth constraints on small-scale manufacturing in developing countries: A Critical review', World Development, Vol. 10, No. 6, pp. 429-450.

5 Harper, Malcolm, 1984, Small business in the third world: Guidelines for practical assistance, IT publication, p. 45.

6 One example of a guarantee scheme is the Double Credit Guarantee Scheme (DCGS) assisted by Friedrich Ebert Foundation (FES) and the Small Enterprises Finance Company (SEFCO) in Kenya, which is meant to introduce craftsmen to the banking system. SEFCO, in collaboration with FES, provides additional financial security to commercial banks through a fixed deposit reserve held at the commercial bank (for more details see, FES, 1990, Handbook for Credit Guarantee Associations in Kenya, FES, Nairobi, Kenya.

7 Liedholm C. and Mead D. 'Small-scale industries in Sub-Saharan Africa: Empirical evidence and strategic implications', (unpublished).

8 Harper, Malcolm, 1984, *op. cit.* p. 52.

9 Harper, Malcolm, 1984, *ibid.* p. 50.

10 Anderson, 1982, *op. cit.*,

11 Thomas, J.J, 1995, 'Replicating the Grameen Bank– the Latin American Experience', Small Enterprise Development, Vol. 6,

No. 2.

12 See, for example, Thomas, J.J, 1995, *ibid.* p. 17.

13 See, for example, Schmitz, Herbert, 1982, *op. cit.*

14 This statement is also true for Sudanese Islamic banks (See Chapter Three, Section 3.2).

15 Ibrahim, Badr-El-Din, 1992, 'An investigation into the operation of the World Bank structural adjustment programs in Sub-Saharan African, with special reference to Sudan', Unpublished Ph.D. thesis, University of Manchester, UK, Chapter 4 'Crafts and small-scale industries in the context of structural adjustment', p. 198.

16 *Feddan* is an area measurement which equals to 1.038 acres or 0.42 hectares.

17 Bank of Sudan, Annual Report, 1988, p. 119.

18 Ibrahim, Badr-El-Din, *op. cit.* 1992.

19 Department of Statistics, 1994, 'Handicrafts Industrial Survey', 1970-71, Khartoum, Sudan.

20 Ibrahim, Badr-El-Din, 1988, 'An evaluation of empirical studies on handicrafts and small-scale industrial activities in Sudan', Sudan Economy Research Group, (SERG), Discussion Papers, No. 17, University of Bremen, Germany, 1988.

21 For more details see Ibrahim, Badr-El-Din, *ibid.* 1988, p. 13.

22 International Labor Organization, ILO, 1976, 'Employment, incomes and equity: A comprehensive strategy of increasing productive employment in Kenya', ILO Geneva.

23 ILO, 'Employment and Equity: A comprehensive strategy for Sudan, 1976, ILO, Geneva. More detailed documentation about the use of the concept of 'informal sector' in Sudan is illustrated in Ibrahim, Badr-El-Din, 1996, 'The informal sector in Sudan: Concept, historical background, and reasons for promotion', a paper presented to the workshop on 'Women in the informal sector', Women co-ordination Unit, Ministry of Social Planning,

Khartoum, Sudan, April.

24 Ibrahim, Badr-El-Din, 1996, 'Traditional Saving/Lending Practices and the Experience of some Non-Governmental Organizations in Sudan', (in Arabic), al-Mugtasid, No. 17, September 1996, Tadamon Islamic Bank, Khartoum, Sudan.

25 Ibrahim, Badr-El-Din, 1994, 'Financing constraints of productive families' projects and the new financing policy of 1994/95' al-Sudan al-Hadeith, daily newspaper, 11 August, Khartoum, Sudan.

26 Ibrahim, Badr-El-Din, 1995, 'A socio-economic survey of families: Mulazmin and Bait al-Mal, Omdurman', Sudanese Islamic Bank, Khartoum, Sudan, in Arabic; Badr-El-Din Ibrahim, 'Constraints in financing productive families projects and the financing policy of 1994/95', al-Sudan al-Hadieth, daily newspaper, 11 August 1994.

27 Faisal Islamic Bank adds the number of employment of not more than 25 workers to this definition.

28 Al-Tigani Said, Sayed Abbas and Ibrahim, Badr-El-Din, 1995, "Financing small and medium enterprises: The Sudanese Experience", Presented to the workshop on 'Financing Small and Medium Enterprises in the Arab World', Union of Arab Banks and Nelien Industrial Development Bank Group (NIDBG), 19 –21 December.

29 Safa, El-Agib, 1995, 'The Experience of traditional saving groups and *El Kifaya* Bank in financing poor women', in Harper, Malcolm, 1997, Partnership financing for small enterprises: Some lessons from Islamic credit systems, IT publication, pp. 24–29.

30 For more description of Islamic modes of finance see Chapter Three.

31 Ibrahim, Badr-El-Din, 1996, 'Traditional Saving/lending programs..', op. cit.

32 Janssen, Resi, 1995, 'The experience with women's credit unions in Gedaref', DUGAP, (unpublished).

33 Nourain, Asim, 1997, 'ACCORD *Musharaka* credit in Sudan', in Harper, Malcolm, 1997, op. cit., pp. 30–34, op. cit.

34 Ibrahim, Badr-El-Din, 1996, 'Micro-credit and small producers, with emphasis on Area Development Scheme (ADS)', a paper presented to FES Khartoum, Sudan.

35 UNIDO, 1986, 'Technical report, Industrial Survey of the Sudan', UNIDO, Vienna.

36 Ibrahim, Badr-El-Din, 1994, 'A branch analysis to small and medium enterprises development and research in LDCs, with special emphasis on Darfur State (Sudan)', 'World Associations for Small and Medium Enterprises (WASME), 7th international conference on small and Medium Enterprises (SMEs), Addis Ababa, Ethiopia, March.

37 ILO, 1976, op. cit.

38 ILO, 1986, 'Employment and economic reform: Towards a strategy for the Sudan', a report to the ILO/JASPA Mission to the Sudan, ILO, Geneva.

39 Faiza, Idris and al-Amin al-Faki, 1993, 'The contribution of women in the informal sector to GDP', in Arabic, (unpublished).

40 For more analysis of the banking policies and financing towards productive families see Chapter Four and Five.

41 Islamic banks also resort to other modes of finance on a deferred payment base (*Bai'muajjal*), leasing (*Ijara*), and pre-paid purchase of goods (*Bai'Salam*) to name a few. These and other modes of finance are not used in the Sudanese banking system, or when used, are not applied to small and microenterprises.

42 Al Harran, Saad, 1993, Islamic Finance: Partnership Financing, Pelanduck Publications, and Malaysia. p. 74; Sudanese Islamic Bank, undated, "Partnership in Islamic Financing – Theory and practice", Sudanese Islamic Bank Publications, Khartoum, Sudan.

43 Abdalla, Ahmed Ali, 1997, Islamic modes of finance: Origins, principles, and legal rules, al-Musrafi, No. 13, Bank of

Sudan, December, pp. 1-11.

44 Source: Ibrahim, Badr-El-Din, 1997, p. 4, 'Financing challenges for small enterprises – The experience of Sudanese Islamic Banks', pp. 3-11 in Harper, Malcolm, 1997, op cit. 1997.

45 Abdulla, Mustafa Gamal-El-Din, 1997, "Partnership financing for small enterprises – problems and suggested improvements", in Harper, 1997, (ed.), p. 58.

46 Ibrahim, Badr-El-Din, 1997, op. cit.

47 Ibrahim, Badr-El-Din, 1997, Ibid.

48 Mohsin Khan and Abbas Mirakhor, 1986, 'The framework and practice of Islamic banking', Finance and Development, September, p. 34.

49 Awad, Mohammed Hashim, 1994, 'Islamic financing for small-scale enterprises', Industry and Development, No. 1, Nelien Industrial development Bank Group (NIDBG), Khartoum; Khalifa, Mohammed Osman and Al-Shazali, Salah Eddin, 1988, "The experience of Sudanese Islamic Bank in the *Musharka* financing", Sudanese Islamic Bank, Khartoum, Sudan.

50 Awad, Mohammed Hashim, ibid., 1994, p. 3.

51 Bank of Sudan, Financing Policy, 1991, Bank of Sudan, Khartoum.

52 To suit the purpose of the Islamic profit and loss sharing system, the credit policy was changed to a financing policy. The Islamic system does not provide credit, but finance production. Moreover, the basic functioning of the central bank in which there is full Islamization of the banking system is the same as a conventional bank, but the mechanism is different.

53 See, for example, Bank of Sudan Financing policy, 1997, Bank of Sudan, Khartoum.

54 Bank of Sudan, Financing Policy, 1990, p. 3, Bank of Sudan, Khartoum.

55 The *Mudaraba* is said to be restricted where the owner of the capital restricts the freedom of the *Mudarib* in the ways in which

he or she invests the capital (e.g. carrying out business in a specific geographical area, or dealing with a specific commodity or commodities). The restricted *Mudaraba* is useful for closer monitoring and supervising by the capital owner (Abdalla, Ahmed Ali, 1997, op. cit. p. 11).

56 Order No. 20/95, Bank of Sudan, Khartoum.

57 Ibrahim, Badr-El-Din, 1997, op. cit.

58 Ibrahim, Badr-El-Din, Khalifa Mohammed Osman and al-Khalifa, Mahmoud, 1994, 'The role of the Sudanese Islamic Bank in rural development', presented to the seminar on the role of finance in the creation of suitable development, Arab Organization of Agricultural Development and the Union of Arab Banks, Khartoum, (in Arabic).

59 Ibrahim, Badr-El-Din, 1995, 'A report on the performance of Productive Family Branches', SIB, Khartoum, Sudan (in Arabic).

60 The idea behind Productive Families' Branches is similar to the idea of a social or ethical bank, which viewed that at least 'some financial institutions need to be kept small and should be designed to serve particular communities and investment policies', The Economists, Dec. 25th 1993, January 7th , 1994, p. 105).

61 Among others, Harper, Malcolm, 1998, Profit for the poor: Cases in Micro-Finance, Oxford & IBH publishing Co., New Delhi, observed that commercial banks have 'traditionally mobilized low-cost deposits from poorer people, and particularly from rural areas, and have lent the money to urban dwellers who are better off and have more access to investment opportunities', p. 20.

62 In *Murabaha* the client also gets the advantage of obtaining good quality raw materials at reasonable prices, through the bank's review of invoices.

63 al-Bhasri, M. and Adam, Nawal, 1997, 'Examples of partnership financing for microenterprises – the case of Sudanese Islamic Bank', p 18, in Harper, Malcolm, 1979, op. cit.

64 According to al-Bhasri, M and Adam Nawal, 1997, ibid.,

the failure cases examined in Wad Medani Productive Family branch are related more to factors beyond the control of the bank and the partner, such as social factors (divorce, movement of the wife with her husband away from the work place), and in some cases factors such as lack of marketing, inadequate follow-up and supervision by the bank.

65 Miro, Abdel Radi et al, 1986, 'The economics of craftsmen and the role of the craftsmen branch of Faisal Islamic Bank', The Center for Research and Statistics, FIB, Khartoum, in Arabic.

66 Miro, Abdel Radi et al, 1996, *ibid.* p. 57.

67 FIB, internal files.

68 This guarantee is used when the bank finances a means of transport, in which case the vehicle is registered as a property of the bank until the time when the partner has paid all the installments. In the case of financing raw materials, the bank usually supplies only part of the raw materials to the partner, depending on the partner payment of installments.

69 Miro, Abdel Radi et al, 1996, *op. cit.*, p. 60.

70 Friedrich Ebert Stiftung, 1995, 'Craftsmen: Current situation and future prospects', p. 71, FES, Khartoum, Sudan.

71 Tigani Said et al, 1995, *op. cit.*, p. 24.

72 This result is not only confined to the Sudanese Islamic banking system. Islamic banks have shown strong preference for modes of finance, which are less risky, namely the 'mark-up' device. According to Yousif, Tarik, 1996, *op. cit.* 'The evidence indicates that the majority of Islamic banks do not uphold the fundamental principles of profit-and-loss sharing; instead, the bulk of their financing takes on a debt-like character similar to that in conventional financing'.

73 Order No. 20/95, Bank of Sudan, Khartoum.

74 NIDBG attempted to establish a 'Small Enterprise guarantee Fund' to be financed by banks and other financiers of small enterprises and donations (NIDBG, Small Enterprises

Guarantee Fund, NIDGB, Khartoum).

75 Islamic banks have not tried progressive or regressive repayment of the *Murabaha* installments. We feel that progressive installments are the most suitable of small producers, owing to their weak financial capabilities at the starting of the project, and, in most cases, due to marketing difficulties it takes time before they can realize proceeds from sales.

76 Although the banking system in Sudan is not directly concerned with women small and microenterprises, but the percentage of finance is estimated to be 0.9 – 2.7 per cent of the total finance of the banking system, almost 50 per cent of finance to small and microenterprises is allocated to women enterprises (Mahmoud, Mohammed al-Tayeb, 1995, 'Experience of the banking system in financing women small enterprises' a paper presented to the Workshop on 'Women Small Enterprises: Management, Finance and Marketing, Sudan Academy of Management Science, 1995 (in Arabic).

77 Ibrahim, Badr-El-Din, 1997, *op. cit.*, Harper, Malcolm, 1997, *op. cit.*; Harper, Malcolm, 1994, '*Musharaka* (partnership) financing: an approach to venture capital for microenterprises', Small Enterprise Development, Vol. 5, No. 4, December.

78 See Ibrahim, Badr-El-Din, 1997, *op. cit.*

79 See, for example, Ibrahim, 1997, *op. cit.*, p. 10.

80 Abdullah, Mustafa Gamal El-Din, 1997, *op. cit.*, p. 60.

81 Ibrahim, Badr-El-Din, 1995, "Methods in determining the share of management in the Islamic *Musharaka* mode of financing", Industry and Development, Nielien Industrial Development Bank Group (NIDB), Khartoum, Sudan, No. 3, pp. 29-31.

82 To illustrate the RA in calculating the management share let us denote management profit by  $\pi_p$ , and expected profit by  $\pi_e$ . Let  $K$  denotes capital investment, and  $r_k$  denotes the rate of returns on capital, then  $\pi_m = [(\pi_e) - (K) \cdot (r_k)] / \pi_e$ . Alternatively,  $\pi_m = 1 - [(K) \cdot (r_k) / \pi_e]$ .

83 See Chapter Four.

84 Mohammed Osman Khalifa and Ibrahim, Badr-El-Din, 1993, 'Islamic Banks in Sudan: Interest- Free Banking or Integrated Financial Establishments', Presented to the Conference on Islamization of Knowledge, February 1993, Khartoum, Sudan.

85 Nour, Tahir, Mohammed (1996), 'Poverty in Sudan and the role of Saving and Social Development Bank', unpublished paper.

86 Seminar on poverty study, June 1997, Ministry of Social Planning and the UNDP.

87 Absolute poverty in Islam is the concern of *Zakat*. But the possibility of using the banking system as an avenue for Zakat is possible, Ibrahim, Badr-El-Din, 1997, 'A view on how to Exploit *Zakat* Fund in the Saving and Social Development Bank to Finance Small Enterprises' (in Arabic), *al-Masrafi Magazine*, No. 11, June, Bank of Sudan, Khartoum.

88 Nour, Tahir Mohammed (1996), op. cit., (Unpublished).

89 For more details on the Sudanese banking concentration, see, Ibrahim, Badr-El-Din, 1992, 'Some aspects of Islamic banking in least developed Arab countries (LDACs): Reflections on the Faisal Islamic Bank, Sudan', pp. 216 – 28, in Kunibert Raffer and M.A. Mohammed Salih (ed.), *The least developed and the oil-rich Arab countries: dependence, interdependence or patronage?* Macmillan Press, London.

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95 Harper, Malcolm (ed.), 1997, op. cit., p. 1 (*emphasis added*).

96 Harper, Malcolm, 1997, (ed.), *ibid.* p.1.

97 Harper, Malcolm, op. cit., 1998, p. 68.

98 See different contributions in Harper, Malcolm, (ed.) op. cit., 1997.

99 Awad, Mohammed Hashim, op. cit., 1975, 'Craftsmen: An economic study', Socialist Union Publication, Khartoum, Sudan (*emphasis added*).

100 For more detail analysis about the difference between Musharka and conventional partnership see Ibrahim, Badr-El-Din 1999 Can Musharaka financing of SMEs be applied to the interest-based banking system?, *Small Enterprise Development Journal*, Intermediate Technology Publications, London, United Kingdom, Vol. 10, No. 3, September, pp. 38-43.

101 Castle, E. and Owens, N. 1994, *Principles of accounting*, 9th edition, Pitman Publisher, England, p. 236.

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103 Taylor, T and Evans, J, 1987, 'Islamic banking and the prohibition of usury in western economic thought', *National Westminster Bank Quarterly Review*, November, p. 26, (*emphasis added*).

104 Harper, Malcolm, op. cit. 1997, p.64, (*emphasis added*).

105 Quoted in Darrat A. and Suliman M. 1990, 'Islamic banking: An outline of some conceptual and empirical aspects', *Saving and Development*, No. 2, xiv.

106 It is perhaps not out of imagination that locally-based NGOs which provide community-based financial services to small enterprise in Sudan, have shifted to the *Musharaka* and *Murabaha* modes of finance, because they feel that it is the only way to sustain their programs in the face of continued inflation in Sudan. See Chapter Two and Harper, Malcolm, 1994, op. cit., p. 35.

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