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SUDAN ECONOMY RESEARCH GROUP DISCUSSION PAPERS

Universität Bremen
Sudanforschungsgruppe Bremen
Diskussionsbeiträge

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Discussion Paper No. 35

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Poverty Alleviation via Islamic Banking Finance to Micro-Enterprises (MEs) in Sudan: Some lessons for poor countries.

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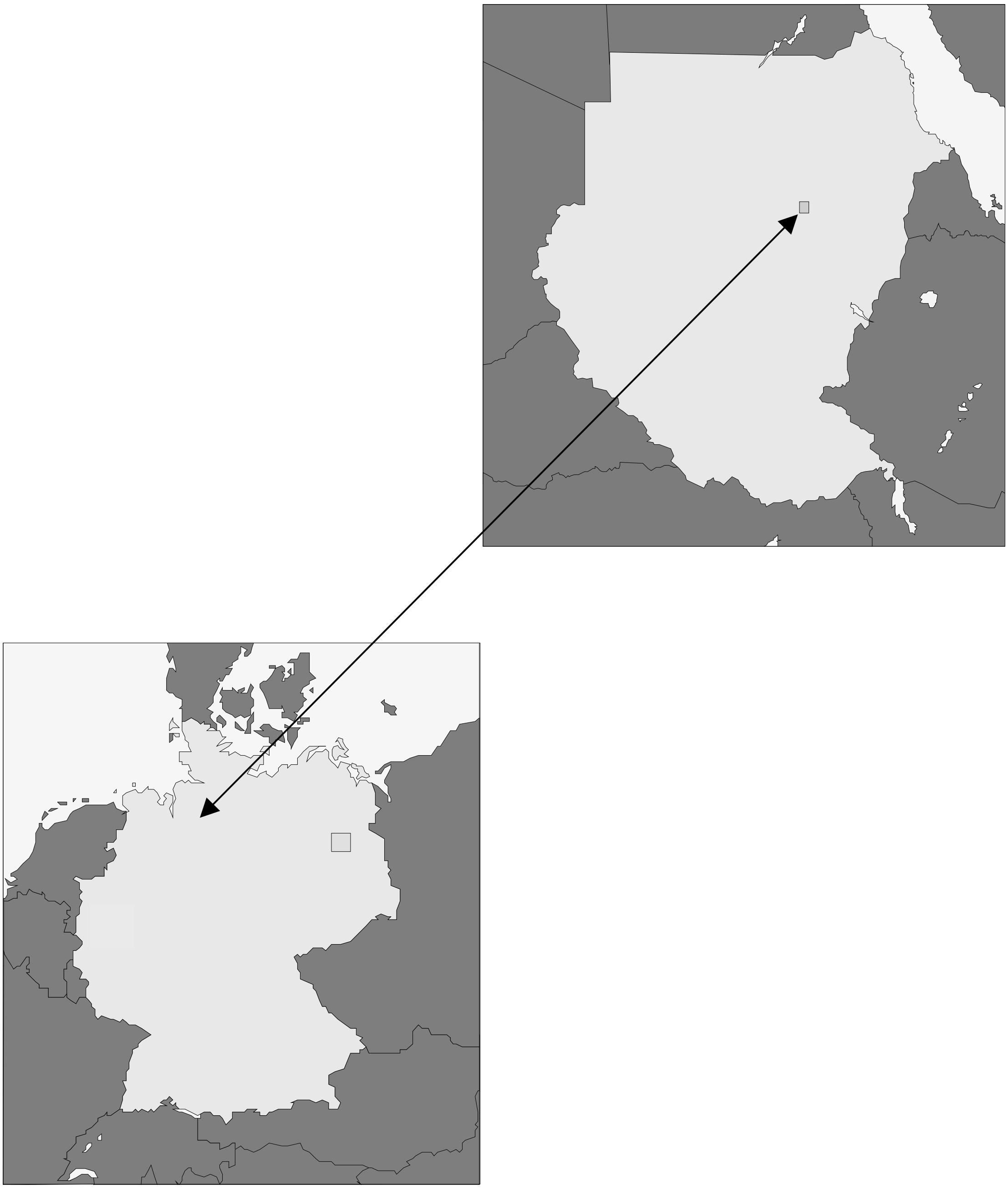
Bremen, March 2003.

Republic Of Sudan



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Poverty Alleviation via Islamic Banking Finance to Micro-Enterprises (MEs) in Sudan: Some lessons for poor countries.

Badr-El-Din A. Ibrahim

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List of Abbreviations:

ABS	Agricultural Bank of Sudan
FB	Farmer's Bank (Sudan)
FES	Friedrich Ebert Stiftung (Foundation)
FIB	Faisal Islamic Bank
GDP	Gross Domestic Product
ICDB	Islamic Co-operative Development Bank (Sudan)
IMSA	Imputed Market Share Approach
LDACs	Least Developed Arab Countries
MEs	Microenterprises
NGOS	Non-Governmental Organizations
NIDBG	Nelein Industrial Development Bank Group
PFBs	Productive Families Branches (of the Sudanese Islamic Bank, Sudan)
PLS	Profit and Loss Sharing
SIB	Sudanese Islamic Bank (Sudan)
SMEs	Small and Micro-Enterprises
SSDB	Saving and Social Development Bank (Sudan).
UNDP	United Nations Development Programme.

Abstract of "Poverty Alleviation via Islamic Banking Finance to Micro-Enterprises (MEs) in Sudan: Some lessons for poor countries"

There is no doubt that poverty in Sudan is wide. The question arises: what the Sudanese Islamic banking can offer to mitigate poverty? The answer requires an investigation of the following hypotheses:

1. First, we hypothesise that efforts were made by commercial banks in Sudan to enhance funding to micro-enterprises (MEs) for poverty alleviation, but national and internal policies of commercial banks have defeated this.

2. Secondly, we hypothesise that the Sudanese Islamic banking finance to MEs cannot be considered effective for poverty mitigation, given its deterrents characteristics such as unstable and high share of resources (demand deposits), weak financial resources, relatively low lending capacity, regional inequality in the distribution of banking branches, sectoral concentration of investment and the bias toward the high profitable institutions in the modern sector at the expense of small sector.

Although we reach the conclusion that the Sudanese experience of financing MEs to be ineffective as a mechanism to alleviate absolute poverty, the experience is postulated to be capable of offering some lessons for MEs financing, and mitigate some of the constraints raised in the literature. Here we are running for some aspects of the Islamic financing system that can be used to overcome some problems of small enterprises financing. There seems to be an advantage that Islamic partnerships can offer to MEs' financing. If profit and loss sharing formulae are taken as one form of venture capital, rather than an ideological concept, it will possibly have a great deal of universal application. Among other advantages, we argue, the use of profit and loss (PLS) financing, extension of financing facilities via specialised geographically scattered branches, innovative approaches of guarantees etc. The Islamic principle, we argue, could be taken by a banking system in the POOR region to help in poverty alleviation. The most important lesson from the Sudanese experience might be that profit and loss sharing (PLS) formulae and mark-up financing techniques are useful in solving outstanding constraints in MEs' financing. One of the features of Islamic PLS experiences that will be analysed is that failed small business, through no fault of their own, under this system of finance, may not end up being worse-off than if they had never borrowed. Owners of failed MEs are not burdened by repayment.

Poverty Alleviation via Islamic Banking Finance to Micro-Enterprises (MEs) in Sudan: Some lessons for poor countries[1]

1. Introduction:

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 different developing countries. One of the major developments in Muslim (and non-Muslim countries as well) in the last two decades is the emergence of Islamic banks. Sudan is one of the three countries (the others are Iran and Pakistan) where the whole banking system has been converted into Islamic banks. 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 due to the ideological reasoning and belief in Islam.

Islamic banks manage to utilise Islamic financing formulae to provide venture capital to small entrepreneurs. Although a great deal of knowledge is known about the Islamic approach of 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 finance to MEs. This represents a unique, fully-fledged practical experience of the Islamic financing system to small enterprises. This represents 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 Islamisation of the entire banking system.

The purpose of this paper is twofold, mainly to reflect an overview of major instruments of Islamic finance to MEs and poverty alleviation, and to document, with some analysis and examples, the Sudanese institutional application of Islamic finance to MEs — the first in the world supported by full Islamisation of the banking system and banking regulations. This paper, will also, expose international financial institutions, non-governmental organisations, researchers, donors, development agencies, LDCs, governments and other small enterprise financiers to the little-known Islamic financing system to the MEs sector, and show what les-

[1] A modified version of the paper presented to the Workshop on "Poverty and Governance in the Middle East and North Africa Region", Sana'a, Yemen, 2-3 August, 2001, MEAWards Program.

sons we can learn from it. Moreover, it is hoped that analysis here will identify issues on which further research, which is most urgently needed, can be conducted, in order to develop an appropriate universal strategy for MEs financing the world over.

The paper starts with the major concepts of Islamic finance and poverty alleviation. Using real examples from the Sudan, section 3 explains the Islamic modes of finance. Section 4 reviews the Bank of Sudan financing policies related to MEs financing, as well as the national financing policies and regulations. The experiences as well as the application constraints of the Islamic formulae of seven randomly selected Islamic banks to financing MEs are the subject of section 5. Poverty alleviation via Islamic finance to MEs in Sudan is assessed in section 6, and finally the conclusion and recommendations are set in section 7.

2. Islamic Finance, Micro-enterprises and Poverty Alleviation.

Difficult access to credit is singled out in the literature on MEs sectors (informal sector, crafts, productive families, and income generating activities) as one major problem. Studies show that MEs have little access to the resources of the organised financial sector [2]. Most of the difficulties in obtaining finance are related to 'transaction costs' — the cost of administering and delivering of credit and the cost arising from the risk of default. That is why bankers consider MEs as risky clients, do not keep proper records or meet conventional security requirements, and hence they are not bankable. Literature encourages private banks to extend credit through various risks guarantee measures. Others argue that these measures may involve 'moral hazards' as a result of financial institutions passing on the losses to the government, rather than reducing the risk [3]. Others consider the reason for the lack of access to be the shortage of funds brought about by government imposition of credit controls to keep interest rates artificially low. Subsidised credit programmes, it is also argued, encourage MEs to use capital more intensively and less productively[4]. Others, convincingly, showed that the '*benefit to the borrower of a reduction in interest rates, would be relatively insignificant*

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[2] Among others, see Anderson (1982); Schmitz (1982, pp. 429-450).

[3] One example of a guarantee scheme is the 'Double Credit Guarantee Scheme' (DCGS), in Kenya. The Small Enterprises Finance Company provides additional financial security to commercial banks through a fixed deposit reserve (FES, 1990).

[4] Liedholm C. and Mead D. (unpublished).

when compared with the lender's reduction in income'[5]. They argue in favour of relaxing administrative control over interest rate policies to *'reflect the cost of raising resources and lending to low risk borrowers'*[6]. It is now generally acceptable that successful innovative financial schemes to MEs including those of the poor are those, which meet the sustainability, profitability and non-charity criteria. Institutional finance to MEs of the poor has not been a total failure. One well-known success story is that of *Grameen* Bank in Bangladesh, which charges a market rate of interest, without the need for collateral. The crucial factor in the success of the unreplicable *Grameen* model, it is argued, is a cheap system of assessing credit-worthiness, through local knowledge and group pressure [7].

A question is whether or not the lack of access to formal credit facilities by MEs reflects risky repayable defaults or distortions in the practice of credit institutions, or even in the regulations of financial markets via interest rate ceilings, minimum reserve requirements, sectoral credit allocations etc. [8] Findings show that MEs generate higher returns on capital than their large-scale counterparts. Moreover, they also have higher total factor productivity (high output-capital ratios). Despite this it is generally recognised that banks have not extended enough credit to the MEs in poor developing countries. Some schemes have been applied to establish a neutral environment, with respect to enterprise size, to remove discrepancies, and to create incentives to encourage formal financing institutions to extend credit to MEs. The major types of these schemes are:

• The credit insurance or guarantee scheme, in which the government takes over the risk in return for a premium from the micro-enterprise owner. [9]

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[5] Harper (1984, p. 52).

[6] Anderson (1982).

[7] Thomas (1995).

[8] See, for example, Schmitz (1982).

[9] 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).

• 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 MEs.

However, such schemes have very rarely been successful. The guarantee scheme and the link system are slow and partial; whereas the reserved loan portfolio is slow in disbursement and has not reached the intended recipients. It is our observation all over the world that no serious attempt has been made to adapt commercial banks to micro-enterprise clientele. The principle of Islamic profit and loss sharing, PLS, (a sort of short term equity financing) is adopted by the Sudanese Islamic banks and can be seen as one step towards achieving this goal.

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 for the benefit of 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. Another one is the duality of investment in Islamic system, which benefit both the investor and the community at large. These objectives of Islamic investment are the basis for an integrated Islamic financial institution.[10] MEs seem to provide the basic necessities of life and extending finance to them can help in alleviating poverty and achieve the dualistic characteristics of Islamic finance.

Poverty in its broad definition refers to the lack of income and the necessary means of production to attain a "decent" standard of living. Researchers are concerned with the absolute poverty line concept, i.e. the bundle of basic consumer goods required, in addition to other expenditure on health, education, housing etc. Sudanese measurements of the absolute poverty line are 3,947 and 203,818 Sudanese pounds in 1990 and 1996 respectively[11]. The Sudanese *Zakat* (alms-tax) Fund estimated the poverty line of 271,000 Sudanese pounds per

[10] Khalifa and Ibrahim (1993).

[11] Nour (1996).

month in 1996. The Supreme Committee for Wages puts the minimum wage in 1996 in the range of 148,750 Sudanese pounds per month[12]. The official inflation rate in 1995/96 was 130 per cent, whereas the average increase in the minimum wage rate is only 30 per cent. The Head Count Index (the number of poor 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[13].

3. Islamic modes of finance and MEs.

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. Instead of paying a premium by the borrower to the lender along with the principal amount as a condition for a loan, Islamic banks mix capital and skills and share the risk and the resultant profit or loss. Here it is only the profit sharing ratio, not the rate of return itself that is predetermined. More than one major mode of finance has been in operation such as *Murdaraba* — agency joint venture/limited partnership; *Murabaha* —purchase or resale of debt/mark-up/deferred payment sales; and, *Musharaka* — joint partnership, credit/partnership[14].

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"[15]. It is a limited period contractual agreement between the bank and the partner, to use both human and financial resources and distribute whatever profit and loss they make in accordance with capital and human resources invested. In practice labour, skills, management, goodwill and credit-worthiness and contacts can also form the partners' contribution. *Musharaka* is governed by a contract signed by the two parties. The contract shows the financial shares and management obligations, distribution of expected profit or loss. Other conditions include the conduct of the partnership operations through a joint account, in which withdrawals and deposit of sales proceeds are made according to the contractual plan. Moreover,

[12] Ministry of Social Planning and the UNDP (1997).

[13] Ministry of Social Planning and the UNDP (1997).

[14] 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*).

[15] Al Harran (1993, p. 74); Sudanese Islamic Bank (undated).

joint storage of raw materials subject to partnership is also specified, and an insurance cost added to the total cost. In the case of financial loss, the damages incurred shall be borne by the two parties, unless it is otherwise proved to be due to the neglect, abuse or violation of terms agreed upon by the party undertaking the management and operation of the venture.

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 asset 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 will be deducted from the total profit, and the net income is then distributed in accordance with the agreement of the contract.
- Profit allocation must be stated in percentages and according to partners' shares.
- If a partner exerts more effort or has experience, he or she can take an additional percentage of the profits after agreement between the two parties.
- Losses are calculated in proportion of the shares of each partner in 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.[16]

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.

A *Musharaka* contract varies in accordance with the investment project and the contribution of the partner and the bank is subject to mutual agreement, but the main concept can be illustrated as follows, where, B and P are the amount of capital shared by the bank and the partner respectively, R is the expected profit and A is the share of management profits. Thus,

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[16] Abdalla (1997, pp. 1-11).

AR is the value of management profits that could be distributed as follows: P_m AR and B_m AR for the partner and bank respectively, where P_m and B_m are the agreed share of the bank and the partner in management profit respectively. The remaining profit (R-AR) is to be distributed according to the contribution of the two partners in total capital.

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

Table 1: Example of *Musharaka* on a one month investment in a women's shoe manufacturing, Sudanese Islamic Bank, 1993 (in 1000's LS)

	Bank	**Partner**	**Total**
1. Contribution	735	690	1,425
%	(52%)	(48%)	(100%)
2. Expected Net profit (after deduction of all costs of production)			450
3. Profit distribution			
(a) 37% for management			166.5
- 30% partner's % in management		135	
- 7% bank's % in management	31.5		
(b) 63% for shared profit			283.5
- 30% partner's % in the profit		135	
- 33% bank's % in the profit	148.5		
Total profit (a + b)	180.0	170.0	350.0
4. Rate of return on investment			
Partner's rate of return/monthly		24.6 %	
Partner's rate of return/annually		295.6%	
Bank's rate of return/monthly	24.5%		
Bank's rate of return/annually	293.9%		

One advantage of *Musharaka* is that both the monthly and the annual rates of return to the bank are large compared with the rate of return of conventional banks, represented by interest rates. In addition, 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 the bank, the rate of return on investment of the partner's capital is slightly higher than it. This is due to the inclusion of management effort in *Musharaka.*

• The rate of return on capital invested by the bank is very high, reaching three digits per year in some cases, i.e. financing through *Musharaka* is financially profitable to the financing institution.

• If the share in total capital is the same, the bank's percentage share of profit is usually less than that of the partner's. This is because the partner's share in management profit is more than the bank. This is an additional advantage to small entrepreneurs, which is usually unseen.

• It is clear from the table 2 below that, the smaller the finance, the larger rate of return and vice versa. This indicates that (at least from this sample) that small projects have a larger percentage of profit to each partner's finance and to the total finance.

Table 2: Rates of return on investment by sizes enterprise (Sudanese Islamic Bank)

Description	**Project 1**	**Project2**	**Project 3**	**Project 4**
Projects:	**Bread Making**	**Flower nursing**	**Coffee shop**	**Medical lab**
Duration of *Musharaka*	One week	One month	Four months	One month
Date of *Musharaka*	(September, 1995)	(January, 1996)	(December, 1995)	(1996)
Volume of *Musharaka*	29,295	200,000	1,000,000	1,000,000
Bank contribution	75%	50%	50%	14%
Partner contribution	25%	50%	50%	86%
Bank's share in management	0%	0%	1.2%	5%
Partner's share in management	30%	60%	87.7%	25%
Bank's share in total profit	52.5%	20%	6.75%	14.8%
Partner's share in total profit	47.5%	80%	93.25%	85.2%
Monthly rates of return:				
Bank	122%	20%	6% *	5.2%
Partner	325.3%	80%	84% *	6.8%
Average	223.7%	50%	45% *	6%
Annual rates of return:				
Bank	1464%	240%	18%	62.4%
Partner	3904%	960%	252%	81.6%
Average	2684%	600%	135%	72.0%

* Period (four months)

Another form of a joint venture *shariah* credit used in financing MEs in Sudan is *Mudaraba.* It involves two parties - the bank (which owns the money) and the partner/entrepreneur (who uses his/her skills to use it). *Mudaraba* is a profit and loss-sharing contract that implies that one person (called the investor) hands over money to another (*Mudarib*, trustee or agent) for the purpose of investment. The net profits realised are divided between the two parties according to certain ratios agreed upon in advance. In the case of a loss, the owner of the money losses his capital and the trustee losses his effort and the expected profit. *Mudaraba* contracts are considered to be risky and require a great deal of confidence from the two parties, that is why it is usually conducted with a partner who is well trusted, professional and with good track records.

Murabaha involves the resale of a working capital or means of production — after adding a specific profit margin (*Murabaha* margin), the minimum of which is determined by the central bank. *Murabaha* mode of finance is different from the western-type interest finance, as it base its margin to the cost of commodity and finance is not made in cash but in real assets/raw materials. In this mode of finance, and according to Islamic *Shariah* law the financier must first own (or procure) 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[17]. By basing the selling price of the commodity on the original cost, the small entrepreneur is protected against unfair exploitation. Islamic *Murabaha* avoids interest rates by supplying raw materials/assets. In *Murabaha*, the client applies to the bank for financing his purchases of specific raw materials or assets. Invoices usually append the application. The bank buys and resells the raw materials or assets at a price, which covers the expenses and allows the bank a profit margin (called *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. Islamic *Murabaha* avoids interest rates by supplying raw materials/assets. It is not far removed from the concept of hire purchase.

Table 3: Example of *Murabaha* on soap venture (Sudanese Islamic Bank, al-Girsh Productive Family Branch),
amount in thousands Sudanese pounds. (LS).

Description	**Amount**
Total Finance	500
***Murabaha* period**	Three Months
***Murabaha* profit margin (profit)**	12% per month (60)
Bank's selling price	560
Grace period	Two Months
First installment (15%)	84
Other installments	476 (i.e 158.66 per month)*
Bank's profit (for three months)	60
Guarantees	Post dated checks
Method of payments	Equal monthly installments

The exchange rate is US$ 1 = LS 530 (April 1995).

*The partner also pays 2% of the total finance as Finance Tax, in addition to stamp duties and other finance commissions.

The Islamic financing modes are better suited for meeting the needs of MEs. In most cases financing is granted without an obligation on the part of the partner to pay back whether he or she gains or loses. As Islamic investment arrangements put great emphasis on the trans-

[17] Abdulla (1997, p. 58).

action itself, rather than the creditworthiness of the partner, no strict security should be demanded, [18]. 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.[19] Islamic financing does not require the partner to present securities against possible losses. Any advancement demanded is made to cover the share of the partner in the venture and not as a security against losses. Since the Islamic principle is basically based on profit and loss sharing arrangement then “any security demanded by the Islamic bank is against possible fraud or repayment-evasion, and not against the risk of losses“.[20]

Partnership financing has many advantages to offer to poor small entrepreneurs. *Musharaka* is a flexible, fair (according to Islamic standard) to both parties, easily understandable form of financing. It caters for both production and management, thus leading to increase 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 debts, post-dated cheques or any other kind of obligations. 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 case his/her share might be in kind (inputs), labour, and 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 from small entrepreneurs who have already lost their livelihood in the case of a total failure.

Besides providing finance to the already established MEs, partnership modes of finance are likely to create new economically and technically feasible small-sized investments,

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[18] Ibrahim (1997a, p. 4).

[19] Awad (1994); Khalifa and Al-Shazali (1988).

[20] Awad (1994, p. 3).

through the concentration of feasibility studies rather than the creditworthiness of small entrepreneurs. Wider branch networks and ranges of banking services are a prerequisite for banks in order to reach a large number of small entrepreneurs, through partnership formulae. The partnership arrangements can enhance the ability and incentives of banks to reach small entrepreneurs, thus overcoming the commercial banks' reluctance to lend to small producers. Using partnership arrangements, however, does not mean providing finance to MEs on concessional rates. In contrast, partnership has a better rate of return on capital investment to the bank compared with the conventional interest-based lending.

A *Murabaha* contract is beneficial to MEs. Instead of a small entrepreneur having a loan (which he may use in a different purpose), the *Murabaha* contract will buy the asset or raw material for him at a profit. *Murabaha* profit margin and interest rates could be identical in value, but the process is different. *Murabaha* will make sure that money is used in the intended project for the benefit of small entrepreneurs.

Islamic modes of finance have many advantages compared with interest-based lending when funding MEs. These advantages are as follows:

• In most cases financing is granted without an obligation on the part of the partner to pay back.

• No strict security is demanded.

• 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 financial obligation.

Musharaka, we have seen, has the following advantages to MEs:

• It is a flexible, fair (according to the Islamic standard) to both parties, easily understandable form of financing.

• It caters for management, thus leading to increased incomes for the poor 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.

• In *Musharaka* the client does not have to contribute in case his/her share might be in kind (inputs).

• It avoids repayment from small entrepreneur who have already lost his livelihood in the case of a total failure.

The application of Islamic formulae is not without constraints. The appropriate guarantee for *Murabaha* suitable for small entrepreneurs poses a real problem. Partnerships financing has singled out the high costs of following up and monitoring of projects as a major problem. To reduce the administrative burden, branches have been created to serve limited geographical areas and located around the business. A third party to follow up and share certain percentage in the total profit is also recommended. Group collateral, which can serve a dual function of reducing the administrative costs and acts as a security against fraud and misuse of funds is recommended[21.] A group leader in collaboration with the bank's staff should undertake the monitoring obligations.

Another problem noticed is getting a reasonable management share of the partner. In principle the determination of the management share is made through 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 is a project-specific.

4. Financing Policies and MEs

4.1 The Bank of Sudan Financing Policies and MEs

The Central Bank of Sudan started issuing annual Financing (Credit) Policies since early 1990s.[22] 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 the image of Islamic banks as comprehensive, full service banks. The financing policies also regulate and set conditions for financing small-scale

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[21] Ibrahim (1997a, pp. 3-11).

[22] 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.

sector. In addition, the financing policies set out the percentage of a client's participation of the total financing under the *Musharaka* system of finance to different priority sectors. The policy also sets the minimum percentage of profit margin under the *Murabaha* system. The Financing Policy of the 1990, for the first time, included crafts as one of the priority sectors for financing. In addition, the 1990 Financing Policy stressed the importance of banks' financing to regional and backward areas and small enterprises[23].

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. The successive Financing policies determined the Financing ceiling for priority between 90 to 95% of the total finance, without any breakdown for each sub sector. The 1994/95, July/December 1995, 1996, 1997, 1998, 1999, 2000, 2001 and 2002 Financing Policies included concessions and financing regulations to this sub-sector. These concessions and financing regulations can be summarised herein:

• The Financing Policy 1994/95 specified that finance to this sub-sector might be based on the restricted *Mudaraba* [24] or other financing systems, with the exception of the unrestricted *Mudaraba* system. Financing per transaction may not exceed 1 million Sudanese pounds, raised to 3 million in July/December 1995, in 1996, then reduced to 1 Million Sudanese pound starting June 1996 up to end of 1997. The Central bank condition of the maximum financing per transaction was ignored starting 1997. Banks are free to obtain whatever "sufficient guarantees" they need when financing this sub-sector.

• In the Financing Policy 1994/95 and other Financing Policies, the first instalment of *Murabaha* for MEs was set at less than 15 per cent of the value of the asset. The Financing policy of 1994/95 permitted that the first instalment of *Murabaha* can be delayed and be paid as part of the total instalments. In the Financing Policy of 1995, the first instalment is cancelled and the payments can be arranged between the bank and the client. In 1999 and 2000 the first instalment reinstated at 25 percent, and in 2001 and 2002 it is left for each bank to decide.

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[23] Bank of Sudan (1990, p. 3).

[24] 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, 1997, p. 11).

• 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 to be less than 15 per cent of the bank's total funding. In the case of small producers the participation is left for mutual agreement between the bank and the partner.

• 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 is still 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 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 shall be a maximum of 25 per cent. The partner's participation in 1998 was not less than 30 percent. Since 1999 it is 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 at 30%, 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%, and the bank should charge a 25% of Murabaha selling price from the client with the exception of Productive Families, Small Enterprises and Craftsmen. Professionals sector was separated from Small Producer, Craftsmen and Productive Families.

• The minimum *Murabaha* margin in the 2000 Financing Policy was reduced to 18% and a 25% of *Murabaha* selling price should be charged by the bank from the client with the exception of Productive Families, Small Enterprises and Craftsmen.

• The Comprehensive Banking Policy of 1999/2000 was explicit to advice banks to extend social support for productive families and poor sections of the community. It also called the banks to move gradually from *Murabaha* to *Musharaka* mode of finance. The range for *Murabaha* margin in 2001 and 2002 is 12-15 percent.

Table 4: Bank of Sudan financing policies to craftsmen, professionals and small producers, including productive families (1994 – 2002).

Financing Policy Description	1994/1995	July–December 1995	1996	Amendments June 1996	1997	1998	1999	2000	2001	2002
The maximum financing	Not exceed 1 millions Sudanese Pounds per transaction.	Not exceed 3 millions Sudanese Pounds per transaction.	Not exceed 3 millions Sudanese Pounds per transaction.	Not exceed 1 millions Sudanese Pounds per transaction.	Not exceed 1 millions 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.	Not mentioned	Not mentioned Minimum financing is 10%
Mode of finance	Restricted *Mudaraba* or other financing modes.	Restricted *Mudaraba* or other financing modes	Restricted *Mudaraba* or other financing modes	Restricted *Mudaraba* or other financing modes	Restricted *Mudaraba* or other financing modes	Restricted *Mudaraba* or other financing modes	Restricted *Mudaraba* or other financing modes	Restricted *Mudaraba* or other financing mode	Restricted *Mudaraba* or other financing mode	Restricted *Mudaraba* or other financing mode
Participation	Not less than 15% of total financing (craftsmen and professionals) In accordance with the agreement between the partner and the bank (small producers including productive families)	Not less than 15% of total financing (Craftsmen and professionals) In accordance with the agreement between the partner and the bank (small producers including productive families)	Not less than 15% of total financing (craftsmen and professionals) 10% (small producers including productive families)	Not less than 25% of total financing (craftsmen and professionals) 20% as maximum (small producers including productive families).	30% (craftsmen and professionals) 25% as maximum (small producers including productive families)	Not less than 30%	Left for each bank	Left for each bank.	Left for each bank.	Left for each bank.
The first instalment in *Murabaha*	Not less than 15% (professionals and craftsmen). First instalment in Murabaha can be delayed and be paid as part of the total instalments	The first instalment is cancelled and the repayment can be arranged between the partner and the bank					25% first instalment	25% first instalment	Left for each bank	Left for each bank
Minimum *Murabaha* margin	15% per annum	15% per annum	20% (professionals and craftsmen) 15% (small producers including productive families)	30% (professionals and small producers) 20% (productive families)	35% (professional and craftsmen) 30% (small producers including productive families)	30% for all priority sectors.	20% for all priority sectors.	18% for all priority sectors reduced to 15% in May 2000.	Minimum 12%, Maximum 15%	Minimum 12%, Maximum 15%

It is clear that the recognition of small enterprise sector as one of the priority sectors for banking finance in Sudan has started mid- 1990s. The financing regulations of the Bank of

Sudan are still under modification, and lacks proper identification of the share of banking finance to this sector, despite more than seven years passed since mid-1990s. Finally, the lack of recognition of female managed small enterprises relates to the understanding of the Sudanese financial institutions that these are only income generating activities rather than commercial, business-like activities. It may also be related to the lack of recognition female business acumen. This understanding ignores the recent growing phenomenon of female managed small enterprises in Sudan and the role of women as a proactive entrepreneur.

4.2 National Financing Policies and Regulations

In addition to the central bank regulations banks should comply with the national policies such as Tax and *Zakat* clearance certificate and other government fees and duties namely:[25]

• Finance tax of investment operations based on the bank's participation in the case of finance through *Musharaka*, and on the volume of investment in the case of *Murabaha*, excluding the *Murabaha* profit margin.

• 0.001 per cent management fees on investment operations (also called investment execution fee). 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 of *Murabaha* (including *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 share of the bank and the partner. In the case of *Murabaha* it is deducted from the volume of *Murabaha* excluding *Murabaha* profit margin.

In the following project financed through *Musaharak*, 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: Finance Tax 10,300, Stamp duties 2,500, Bank commissions 1,935, Administrative fees 500, Total 14,935.

We are hastening to show the following observations.

- Government fees (finance tax and stamp duty) constitute 86 per cent.

[25] Ibrahim (1996).

- The total fees paid equals to 3%t and 24% of the contribution of the bank and the partner respectively.
- In addition small producers are required to present tax and Z*akat* clearance certificate.

5. The experience of Sudanese Islamic banks in financing MEs

5.1 The Sudanese Islamic Bank

In its move to finance MEs, the privately owned Sudanese Islamic Bank (SIB) is the first bank in Sudan that initiated and opened family specific branches in urban residential areas to extend capital to MEs. The first specialised branch was opened in Omdurman in May 1992 with 12 professional (mostly graduate) staff, of who eight are women. The branch was opened in a normal house without counters. A second branch of the same kind was also opened in Wad Medani, with 13 professional staff, of who eight are women. Because of the success of the initial branches, the bank opened a model branch in March 1994 to cater for Mulazmin and Bail-al-mal districts of Omdurman with eight professional staff of who six are 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. [57]

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.

• The use of the largest portion of the fund, that is available for investments, in income-generating activities.[26]

In the case of *Musharaka*, a contract has to be signed by the bank and the partner and a partnership account is opened showing the specification of the share of each partner. Guarantees usually include personal guarantees, field visits, and storage of raw materials, the *Musharaka* contract, and regular deposit of sales proceeds. 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. 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 the showrooms, which are opened in each branch for this purpose.

Before granting a loan on account of *Murabaha*, the bank checks and roughly estimates the assets of the applicant to see whether they match the amount of loan required or not. The bank then buys these assets or raw materials and delivers them to the client with a margin of profit (called *Murabaha* profit margin), which ranges from 3 to 4 per cent per month. The time of the operation of the project usually ranges between one and six months. Types of guarantee in *Murabaha* financing include post-dated cheques from the client or other third party. Credit information concerning the third party is generated 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 after which he starts paying the instalments.

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. Around 73 per cent of the volumes of deposits are in the form of current accounts, and 27 per cent is family saving accounts[27]. Up to December 1994 over 500 projects (mainly women's projects) were financed in the three branches. 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 productive families branches (PFBs) of the Sudanese Islamic Bank (SIB), comprising about 74 per cent of the total finance.

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 geographical location of the productive families' branches, with the concentration of foodstuffs at al-Thawra branch; sewing at al-Girsh model branch; poultry, cows, and goat keeping at Wad Medani branch.

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[26] Ibrahim (1997a).
[27] Ibrahim (1995a).

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. None of the partners who are financed could have previously 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 with no formalities in withdrawals.

The SIB experience in financing productive families illustrates the way Islamic principles of banking (namely the social role of money and the dual nature of Islamic investment) could be applied to micro businesses to achieve both social objectives and profit. The PFB is working in such a way to mobilise deposits from a specific geographical location, and lend that money to the same dwellers[28]. This is contrary to the traditional way the banking system usually works whereby it mobilises deposits from rural savers to be invested in urban areas[29].

On the whole, the PFBs have managed to set up institutional micro-financial savings and lending service. By opening institutionally convenient saving outlets, by creating credit culture among small businessmen, and by acting as a partner in business, SIB shows clearly that the poor are indeed a bankable commodity. 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 are known by name and so on). Thanks to the nature of the *Musharaka* operations, bank-partner relations are much closer and more cordial than is possible under the conventional banking system. Moreover, in *Musharaka*,[30] the partner gains some advantages to his/her business such as obtaining good quality raw materials at reasonable (sometimes official prices); and also acquainting him/her with how to operate a business, dealing with a bank account, and maintain-

[28] 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, "Usury – The Lender's long lament", pp. 103 - 105.

[29] Among others, Harper (1998, p. 20).

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

ing proper business accounting records.[31] The system also allows for flexibility in dealing with small investors, since the objective credibility of the applicant, well known through the field survey, is more important than the ability of the client to repay his debt. Thus, no court cases have been incurred through this method up to now. The failure cases are not related to the repayments of debts, but to other social and marketing/follow-up factors.[32] Instead of going to court for repayment of loans, the bank only 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).

5.2 Faisal Islamic Bank of Sudan (FIBS)

Within small enterprises the private FIBS 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”.[33] The branch services two objectives: the establishment of the first specialised branch as stated in the basic policy of FIB and, to support the craftsmen subsector[34]. The amount of money lent to craftsmen by the branch in 1993 was 2.4 million Sudanese pounds in 1993, and rose to 168 million a year later. Total financing up to 1997, is 567 million Sudanese pounds, which comprises around 5 per cent of the total finance of the FIB. According to FIB internal files, the total number of projects financed during the same period (1993-1994) is 1,400, or 12 projects per month on average. These include machinery, spare parts, and various means of transport, agricultural implements and electric bakeries. The only formula used by FIB in financing craftsmen is *Murabaha,* with the margin ranging from 3 to 4 per cent per month. There are two sets of conditions in financing craftsmen: basic conditions and conditions required putting the investment operation into effect. The first sets of basic conditions are:

[31] al-Bhasri and Adam (1997, p 18).

[32] According to al-Bhasri and Adam (1997), 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.

[33] Miro et al. (1986).

[34] Miro et al. (1986, p. 57).

• Opening of an applicant's account with the bank.

• Application, invoices and feasibility study.

• Identification of the applicant (membership of the craftsmen union, or vocational training certificate).

• The feasibility of the project, the availability of a suitable workshop or a license from the authority concerned.

The second set of conditions below represents the guarantees required by the bank.

• 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.

• A bank ownership guarantee.[35]

5.3 Islamic Co-operative Development Bank (ICDB)

The only formula for financing small producers (including productive families) under the private 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 two months. 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. 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, including funding for blacksmiths, carpentry, fishing boats and oil mills. Financing productive families was estimated to cost 41 million Sudanese pounds, mainly poultry, cows and manual looms. Small-scale projects include oil mills, tailoring, needlework, soap making, grain-mills and sweets. The bank's finance to craftsmen, productive families and small producers reached 10 per cent of total finance between 1991 and 1993.[36] 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

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[35] 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 instalments. 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 instalments.

[36] Friedrich Ebert Stiftung (1995, p. 71).

ICDB, information is generated from the other banks with which he or she deals with. 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 and the bank may jointly stores raw materials or storage of final products, or even secures real estate guarantee. In all cases the bank requires tax and *Zakat* (alms tax) exemption certificates.

5.4 Nelein Industrial Development Bank Group (NIDBG)

The basic formula for financing small enterprises, including productive families, in the privately owned NIDBG is *Murabaha.* The range for the loans is from 500,000 to million-and-a-half 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 as small producers. The bank makes the feasibility study and the small producer pays the cost.

The bank accepts personal guarantees by third parties and social funds (*Zakat* and *Takaful* - solidarity-funds), collateral guarantees or a certificate from a residence committee. The application form is simple, and so are the procedures for funding. NIDBG financing of small enterprises in 1992 represents 4.4 per cent of the bank's total finance, raised to 7 per cent in 1993. NIDGB has financed projects in the field of productive families, small enterprises and crafts. Projects financed included food processing (cheese, yoghurt, *Kisra* (flat brad), biscuits, sweets and rural oil mills); tailoring and needlework, leatherwork, soap-making, building materials and engineering workshops, building and packing services, and other services such as tyre repair workshops.

5.5 The Agricultural Bank of Sudan (ABS)

The publicly owned 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, reduced to 283,000 in 1994. The number of beneficiaries was 1,066 and 881 for the two years respectively.

5.6 Farmer's Bank (FB)

In 1994, the privately owned Farmer's Bank financed 159 small enterprises. Finance of 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 business in the capital region. This illustrates the geographical distribution of finance by the bank.[37]

5.7 The Savings and Social Development Bank, SSDB

The publicly owned SSDB 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, while the *Musharaka* system accounted for 15% of the SSDB total finance.

[37] Tigani et al. (1995, p 24).

5.8 Evaluation of the Sudanese Banking Experience in Financing MEs

The following table (table 5) summarises the target groups, modes and percentage of finance and the types of projects of the Sudanese Islamic banks.

Table 5: Sudanese Islamic Banks: 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	*Murabaha :* 20% *Musharaka:* 74% *Mudaraba:* 6% (1993)	6%	Tailoring, shoes soap-making, informal sector activities.
FIB	Craftsmen, small producers and productive families	*Murabaha*: 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	*Murabaha and musharaka*	10% (annual average 1991-1993)	Oilmills, needlework, tailoring, soap-making, grainmills and sweets.
NIDBG	Productive families, small enterprises and crafts	*Murabaha*	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	*Murabaha, Musharaka and Mudaraba*	1,9% - 6%	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	*Musharaka* 15.6% *Murabaha* 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

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

Table 6: *Murabaha* mode of finance for micro enterprises (Sudanese Islamic Banks)						
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 *Murabaha* margin. Up to 6 months *Murabbaha* 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 *Murabaha*. Up to one-year *Murabaha* 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 *Murabaha*. Up to one-year *Murabaha* 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.
NIDBG	100%	Between 500 and 1500 thousands and up to 2000 thousands.	15 % *Murabaha* margin for amount up to 1500 thousands. 25% *Murabaha* 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% *Murabaha* margin, with grace period up to five months.			Small industries, productive families, and retail trade.

From Table 6 above, it is clear that:

• *Murabaha* is the most dominant mode of finance for small and medium enterprises used within the Sudanese banking system. It has used up to 90 per cent of the time in some banks. *Musharaka*, on the other hand, constitutes about 20 per cent in the SIB. Other banks, however, rarely use it.[38]

• *Murabaha* margin for small producers in general ranges between 3 to 4 per cent per month (36 to 48 per cent per annum), above the minimum margin of 15 per cent per annum stated in the financing policies. The current *Murabaha* margin is three to four times the mini-

[38] 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 Yousef (1996) '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'.

mum margin stated in the financing policy of the central bank. The repayment methods are also different than those stipulated.

• The financing policies stated that banks are free to obtain whatever "sufficient guarantees" they require when financing this sub-sector. Banks resort to traditional guarantees such as personal guarantees, post dated cheques, and third party guarantees. This happens inspite of the fact that Article (8/2/A) of the Financing Regulations[39] 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 hinder the application of this kind of guarantee.[40]

• Apart from NIDBG, all the other banks require loans repaid in equal instalments,[41] but a grace period of one to three months is granted. The repayment method of NIDBG is easier than other banks because the repayment period can be extended for up to 12 months.

• There are variations in the total finance to MEs, and similarities in the volume of finance per project.

• Although the target group is small producers, banks separate it into different categories, without a clear definition of each category. Each bank specialises in one or two subsectors.

•There are no separate rules and procedures of financing female-owned enterprises, despite the growing phenomenon of women entrepreneurs.[42]

5.9 Applications Constraints and Suggested Modifications

First, let us ascertain the fact that Islamic banking formulae originated from ideas and judgements of ancient Islamic jurists hundreds of years ago, and are not written in the holly *Qu'ran* or *Hadith (sayings of prophet Mohammed, peace upon him).* The latter give general

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[39] Bank of Sudan (1995).

[40] NIDBG attempted to establish a 'Small Enterprise guarantee Fund' to be financed by banks and other financiers of small enterprises and donations (NIDBG, 1996).

[41] Islamic banks have not tried progressive or regressive repayment of the *Murabaha* instalments. We feel that progressive instalments 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.

[42] 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 (1995).

guidelines about how the system of Islamic financing should work. The development of the formulae represents a judgement according to the times and circumstances prevailing when they were originally made. The Muslim schools of thought differ, on details related to application, but not the basic principle. Islamic banks of today have taken the ancient views as a base to build the system of financing that we now see today. That is why there are some constraints in the application. Here I suggest some modifications.

The application of Islamic partnerships has singled out the high costs of following up and monitoring of projects as a major problem.[43] To reduce the administrative burden, branches have been created to serve limited geographical areas and located around the business.[44] A third party to follow up and share certain percentage in the total profit is also recommended[45] Group collateral, which can serve a dual function of reducing the administrative costs, and acts as a security against fraud and misuse of funds is recommended [46.] A group leader in collaboration with the bank's staff should undertake the monitoring obligations.

Another problem noticed is getting a reasonable management share of the partner. In principle the determination of the management share is made through 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 is project-specific. Here a more operational and reasonable methodology is required. The Residual Approach (RA) to calculate the management share in total profit is suggested by deducting share profits from total expected profits and then dividing them by the total expected profit[47]. To have the management profit as a residual requires knowledge of the rate of return on the capital invested in previous similar finished projects (the rate of return on each unit of capital). The shared profit can be calculated by multiplying the volume of capital invested in the project by the rate of return on capital. Additional incentive to the partner can be granted; thereby the bank can determine a maximum rate of return of total capital used in the project, above which the bank will be ready to sacrifice additional profit for the partner. In

[43] Ibrahim (1997b).

[44] See Ibrahim (1997b).

[45] See, for example, Ibrahim (1997b, p. 10).

[46] Abdullah (1997, p. 60).

[47] Ibrahim (1995b, pp. 29-31).

the current situation the partner sometimes gets this incentive through increased management share, over and above the limit determined by the contract. The modification outlined here 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. 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. To illustrate the approach, if M is the market value of the management effort, and R is expected profit, then IMSA is (M/R) 100%.

Evaluating the fixed assets in diminishing (self-liquidating) *Musharaka* also needs a modification. Banks do not usually re-evaluate the asset at different times when part of the repayment is made. Inflation is not taken into account, and hence diminishing *Musharaka* is at the disadvantage of the bank. Re-evaluation 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 to unity. If r1, r2, r3, r4 etc are payments in periods 1, 2, 3, 4, respectively, and v1, v2, v3, v4, and so on are values of the asset in each payment period respectively, then at the time of full payment $r1/v1 + r2/v2 + r3/v3 + r4/v4 = 1$. Adjustment of the partners' shares has to be modified each period in accordance with the changes that may have happened 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 in 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.

A *Mudaraba* contract requires a great deal of confidence in the two parties that is why it is very rarely used, despite the central bank determination of a restricted *Mudaraba* as one means of finance for MEs.

6. Islamic Finance and 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 the relatively low incomes or the inequality of its 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.[48] The question arises as to what the Sudanese Islamic banking system of finance to small enterprises can offer to mitigate poverty? 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 the basic needs, subsistence needs, in the prevailing socio-economic circumstances) can be a result of sickness, old age, or a continuous increase of prices. Relative poverty, on the other hand, is related to income inequality or as a result of a malfunctioning supply and demand mechanism[49].

The combined lending to combined deposits of the Sudanese banking system is 40 per cent. The combined deposits are 400 billion Sudanese pounds, so the total lending is 160 billion. At maximum, the banking system allocated 6 per cent of this to craftsmen, professionals and small producers including productive families i.e. 9.6 billion Sudanese pounds. A per capita loan is calculated at 600 Sudanese pounds and total operations are 3,200 per year. That is to say, the beneficiary is 3,200 small enterprises per year out of a total population of 16 million classified under the poverty line. By this process, we need 50 years to cover the current total number under poverty line. The Sudanese banking finance to MEs cannot be considered effective for poverty mitigation, if we take into consideration the following characteristics:

• Demand deposits ratio is over 70 per cent of the total deposits. Demand deposits in Sudan are characterised by a high degree of instability.

• Regional inequality in the distribution of branches. Concentration of branches in commercial towns and urban areas.[50] Rich Khartoum and central states share almost 55 per cent of the total number of banks in the country.[51]

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[48] Nour (1996).

[49] 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 (1997b).

[50] For more details on the Sudanese banking concentration, see Ibrahim, (1992, pp. 216 – 28).

• Sectoral concentration of investment and the bias toward the organised sections with high profitability in the modern sector. In 1999 about 60 per cent of the total lending of commercial banks was directed towards modern agriculture, industry and exports[52]. Small producers shared only 6 per cent of the total lending.[53]

• Weak financial resources of the banking system, and relatively low lending capacity. The actual lending capacity in 1999 was only 32 per cent of the total lending. This figure compares badly to the 1980 figure of 88 per cent.[54] The ratio of financial resources to GDP did not exceed 12 per cent and total banking assets to GDP is about 20 per cent, while total deposits to money supply was 20 per cent at the very best. The adaptation of the Sudanese banking system to the requirements of the Basle Commission's capital sufficiency standard requires the banking system to look at internal problems rather than external, including their role in alleviating poverty.

• In Sudan the mitigation of poverty through microenterprise finance targeted only the level of income, although the 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 [55] — the minimum cost of living increased eight times each year during the above period.

Despite the subtle differences in the application of financing formulae, Sudanese banks have managed to employ Islamic modes of finance to fund poor small entrepreneurs. So far, some expectations have been fulfilled, though some difficult questions need to be answered. The major constraint is the national policies specially designed towards MEs financing. Moreover, tax and *Zakat* clearance certificates pose problems to this target group.

Although the financing (credit) policies of the Bank of Sudan aimed at alleviating poverty and achieving a reasonably fair distribution of income and wealth, it is clear that these objectives cannot wholly be achieved through the banking system. In spite of the concessions granted to MEs, and as a result of internal policies of the banking system and other

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[51] Bank of Sudan (1999).

[52] Bank of Sudan (1999).

[53] Al-Tigani Said et al (1995, p. 18).

[54] Al-Tigani Said et al. (1995, p. 15).

[55] Nour (1996, p. 16).

internal and external constraints, the banking and finance to MEs did not act as a mechanism to mitigate poverty in Sudan. The Sudanese experience was and is still capable of offering some lessons for MEs financing in the poor countries, and mitigate some of the constraints raised in the literature of MEs financing, namely:[56]

• The extension of financing via geographically scattered branches designed to extend credit to MEs has helped a great deal in reducing the cost of administering credit.

• The small enterprises financed are characterised by a high rate of return on the investment.

• Those who are characterised by relative poverty are capable of meeting their banking requirements.

• The innovative approach of guarantees proved effective and traditional guarantees do not lead to enhanced rate of repayments.

In his prominent work on Islamic partnership financing for MEs, 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".[57] Although these methodologies, he added, managed to avoid most of the outstanding problems of micro-enterprise finance, they are not free from other constraints. One, if the enterprise fails, loss of livelihood occurs and small poor 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.[58] The conclusion is that profit and loss sharing formulae are known to avoid these two constraints. On another occasion, Harper asked a 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?"[59] There seems to be an advantage that Islamic partnerships can offer to MEs' financing.

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[56] Ibrahim, (1996).

[57] Harper (1997, p. 1), *emphasis added*.

[58] Harper (1997, p.1).

[59] Harper (1998, p. 68).

It has already been established that Islamic partnership finance has indeed some potential for MEs, but some outstanding problems have to be solved if it is to be widely adopted.[60] If profit and loss sharing formulae are taken as one form of venture capital, rather than an ideological concept, it will possibly have a great deal of universal application, especially as a supplement to interest credit financing to MEs. 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 profit and loss sharing formula*.[61] This recommendation envisages that profit and loss sharing formula, of any sort, can be applied to interest banking, without the need to change the structure of the bank. Before showing that, let us first concentrate on the main features of the conventional partnership and show the differences (if any) between the conventional and *Musharaka* partnership.[62]

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

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[60] See different contributions in Harper (1997).

[61] Awad (1975), *emphasis added*.

[62] For more detail analysis about the difference between *Musharaka* and conventional partnership see Ibrahim (1999).

Table 7: Major characteristics between conventional partnership and the *Musharaka*					
Type of partnership	**Type of Agreement**	**Form and characteristics of contributions**	**Profit allocation**	**Commencement and liquidation**	**Other constraints**
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 commissions.	1. Commencement is known, but liquidation is unknown and not recorded in the contract.	1. Conventional partnership is usually undertaken between equals. 2. Restricted authority and obligations.
Musharaka	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. Withdrawals 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. 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 ratios of the assets (Diminishing *Musharaka* only).

It is clear from the Table above that the unfamiliar Islamic partnership mode of finance is just a simplified, short-term, fixed contribution conventional partnership. If the Islamic system, guided by its principle of profit and loss sharing as opposed to fixed interest, managed to modify the conventional partnership for financing small enterprises, why can't the interest-based banking system apply whatever sort of partnership, based on its conventional one to extend finance for small enterprises? This applies to a system of both *Musharaka*. As a result, interest avoidance is not an issue here, and *Musharaka* or any kind of partnership cannot easily be rejected on economic grounds. The basic difference between interest and interest- free banking systems makes no difference in the application of any sort of partnership arrangement as a supplement to interest financing to extend credit to small and medium enterprises.

Unlike *Musharaka* and *Mudaraba*, Islamic *Murabaha* does not appear as a share of profit and loss mechanism, but rather assumes the capacity of the classical financial intermediary. The use of Islamic *Murabaha* as a credit vehicle is not to be confused with interest lending. The sale for profit requires that the commodity to be sold for money and the operation is not a mere exchange of money for money. There is a risk involved in *Murabaha* in terms of the risk of time spent and the execution of plan, and the risk between purchase and resale. For example, a sudden drop in price could result in the customer refusing to accept the goods, since he is free not to accept commodities under *Murabaha*. In this way it can be a form of risk sharing and justifies profit. It avoids lending money but it is close to the Western concept and it is easy to adopt. It is not far removed from the general rule when a commodity offered for sale on credit fetches a higher price than when it was originally offered for cash.

In order to incorporate the profit and loss sharing formula and mark-up techniques in the conventional banks, 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. As for the first part, we need to mention that using profit and loss sharing arrangements will provide an inclination to fund medium and small-sized projects. There remains a suitable structure. First, we must mention that there is no need to restructure the banking system in order to provide finance on profit and loss sharing or mark-up techniques. With the same banking structure, we suggest either separate branches to be opened for financing MEs through profit and loss sharing formulae and mark-up techniques or, if this is not practical, a separate section, or “counters” or “windows” in existing branches that can be used as a pilot project. If this suggestion is acceptable, there is no initial investment costs. If the pilot project is successful, then a separate specialised branch or branches can be established on a profit and loss basis or on a mark-up system.

In sum, the central question here is not whether Islamic finance is *halal,* but the advantages that a profit and loss sharing arrangement can offer, under whatever name, and what interest-based methods fail to provide. Islamic modes of finance have fulfilled some expectations in MEs financing, though some difficulties, which have faced the practical application, should be addressed. In this paper we concluded, amongst other things, that the Islamic system of finance to MEs has some potential in overcoming the outstanding difficulties with regard to micro-financing world-wide. Although the application of the Sudanese Islamic system to MEs is not without application constraints, it seems clear that the way in which it operates can be modified and used as a supplement to POOR financial methods.

7. Conclusion and policy recommendations

When comparing the Western medieval economy and the Islamic system of banking, Taylor and Evans concluded that both systems prohibit usury and permit any return from partnership, provided that the partner making the investment genuinely shares the risk. They wrote, "the closeness of the two systems [*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"[63]. Moreover, Harper concluded, "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".[64] 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 suggested is the elimination of a guaranteed fixed interest rate.[65]

Islamic banks and western style interest-based banks should not view each other as competitors. They can learn from each other, for the mutual benefit of their clients, including poor small entrepreneurs. The gap between the 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 will not cause concern if we attempted to use a sharing formula as a supplement to interest in the conventional banking system. Here I have argued that the Islamic system of finance, based on profit and loss sharing, cannot only be understood and applied in the context of Islamic banking only, and is thus irrelevant to interest banking. Even if profit and loss sharing formulae are taken as one form of venture capital it will possibly

[63] Taylor and Evans (1987, p. 26), *emphasis added*.

[64] Harper (1997, p.64), *emphasis added*.

[65] Quoted in Darrat and Suliman (1990).

have a great deal of universal application, especially as a supplement to interest credit financing to MEs in the POOR countries. These approaches to banking, although matching the Islamic financing system, are not traditionally associated with Islam. Conventional banking systems in the poor countries can adopt any form of partnership finance to MEs, as a form of a genuine business-based relationship.[66] The removal of the build-in bias towards big secure businesses in the western-kind interest-based financial system, and the move towards institutional financing of the poor, can largely be made by profit and loss sharing rather than provisions of 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 MEs, or even the provision of concessional credit for MEs.

The application of Islamic financing formulae to MEs, 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 in the application of the Islamic formulae if it is to become more widespread and successful. The application of profit and loss sharing formulae in the conventional banking of the POOR region to help in poverty alleviation can be made through “counters” or “windows”. Perhaps it does not sound too odd to suggest that specialised branches be run on a profit and loss basis or on a mark-up financial basis. Some conventional banks in the USA, Europe and Southeast Asia have already set up units dealing with Islamic instruments within their organisations. This is an experience, which should be learned from.

[66] 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 Harper (1994, p. 35).

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