

# EMPOWERING THE POOR THROUGH ISLAMIC MICROFINANCE



## EXPERIENCE OF THE BANK OF KHARTOUM SUDAN IN VALUE CHAIN PROJECT FINANCING



# ▶ Table of Contents

<b>Acknowledgement</b>	<b>02</b>
<b>Abbreviation</b>	<b>03</b>
<b>Executive Summary</b>	<b>04</b>
<b>Why Islamic Finance for the Poor?</b>	<b>06</b>
Microfinance	07
What is Islamic Microfinance?	09
Islamic Microfinance Preposition: MFIs to take the Leading Role	10
Reality of Islamic Microfinance – Dominance of Debt-based Financing Products	12
<b>IDB's Approach in Assisting the Poor through Inclusive Islamic Finance</b>	<b>13</b>
Developing Microfinance Institutions	14
Methodology of Empowering the Poor by Microfinance Institutions	15
Financial Assistance Products	17
Comparison between Traditional Microfinance Methodology with Empowering the Poor through Value-Chain Project Group Financing Methodology	18
<b>How is IDB Approach of Inclusive Islamic Finance Practiced in the Bank of Khartoum?</b>	<b>19</b>
Background	20
Microfinance Unit and IRADA Microfinance Company	20
Vision and Mission of Bank of Khartoum Microfinance Unit (IRADA)	21
Modus Operandi at Inception– Individual Microfinance using Murabahah	21
<b>Innovative Inclusive Islamic Finance using the Solidarity Group Financing and Value-Chain Project Group Financing Approach</b>	<b>23</b>
Case Study 1: VCP Group Financing – Abu Halima Greenhouses Project	25
Case Study 2: VCP Group Financing – Wad Balal Cattle Fattening Project	28
Case Study 3: VCP Group Financing – Localization of Moringa and Jethropa Project	31
Case Study 4: Solidarity Group Financing – Farmers to Market (F2M)	34
<b>Bank of Khartoum Microfinance Unit/ IRADA Portfolio Analysis</b>	<b>36</b>
Portfolio Status and Achievements	36
Analysis	37
<b>Key Success Factors</b>	<b>38</b>
<b>Conclusion: Opportunities and Recommendations for IDB</b>	<b>41</b>
<b>References</b>	<b>42</b>
<b>Annex 1: Promoting Value Chain Project Group Financing among MFIs</b>	<b>43</b>
<b>Annex 2: Sharia Compliant Modes of Financing which are commonly used</b>	<b>45</b>
<b>Annex 3: IDB and ISFD Portfolio of Micro and MSE Finance Projects</b>	<b>49</b>

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# ► Abbreviation

<b>AFD</b>	Agence Française de Développement
<b>AGFUND</b>	Arab Group Programme for Development
<b>BO</b>	Business Officer
<b>BOK</b>	Bank of Khartoum
<b>CBOS</b>	Central Bank of Sudan
<b>CGAP</b>	Consultative Group to Assist the Poor
<b>COP</b>	Community of Practice
<b>CSR</b>	Corporate Social Responsibility
<b>DIB</b>	Dubai Islamic Bank
<b>F2M</b>	Farmers to Market
<b>FY</b>	Fiscal Year
<b>GCC</b>	Gulf Cooperation Council
<b>GDP</b>	Gross Domestic Product
<b>GNI</b>	Gross National Income
<b>VCP Group Financing</b>	Value Chain Project Group Financing
<b>IATA</b>	International Air Transport Association
<b>ICD</b>	Islamic Corporation for Development of Private Sector
<b>ICIEC</b>	Islamic Corporation for the Insurance of Investment and Export Credit
<b>IDB</b>	Islamic Development Bank
<b>IFC</b>	International Finance Corporation
<b>IRR</b>	Internal Rate of Return
<b>IRTI</b>	Islamic Research and Training Institute
<b>ISFD</b>	Islamic Solidarity Fund for Development
<b>ITFC</b>	International Islamic Trade Finance Corporation
<b>MDB</b>	Multilateral Development Bank
<b>MFI</b>	Microfinance Institution
<b>MFU</b>	Microfinance Unit
<b>MIS</b>	Management Information System
<b>MSE</b>	Micro and Small Enterprise
<b>MSME</b>	Micro, Small, and Medium Enterprise
<b>NBFI</b>	Non-Bank Financial Institution
<b>OSS</b>	Operational Self-Sufficiency
<b>PAR</b>	Portfolio at Risk
<b>ROA</b>	Return on Assets
<b>ROI</b>	Return on Investment
<b>SDG</b>	Sudanese Guinea
<b>SME</b>	Small and Medium Enterprise
<b>TA</b>	Technical Assistance
<b>USD</b>	United States' Dollar

## ▶ Executive Summary

When Professor Muhammad Yunus of Grameen introduced Microfinance, he broke all misconceptions that a bank cannot and should not lend money to the poor because they are not credit-worthy. The Nobel Peace Prize winner was able to demonstrate that by forming groups, provision of collateral was unnecessary as social pressure ensured that the group members repaid their debt on time. Within a short time, Microfinance as a viable business proposition expanded as governments, donors and private institutions attempted to replicate the model. However, various evaluation studies conducted showed that the high interest rates (about 30%) imposed on the poor resulted in mixed results on poverty alleviation. The Microfinance industry matured to various models, some are more developmental and dependent on subsidies, while others focus on efficiency to run on a commercial basis. The development-oriented Microfinance programs supported by governments and donors typically complement the line of financing with Business Development Support. The assumption is that if the business of the beneficiary is successful, he will be able to repay the loan and his livelihood will also improve. On the other spectrum, some banks adopted additional risk mitigation measures to ensure that loans are repaid.

Islamic Microfinance Institutions started similar to how Islamic Financial Institutions began- adapting the conventional model with Shariah compliance. It's no surprise that most Islamic MFIs started with Murabahah financing, and as a result their effectiveness as a means of poverty alleviation remain limited similar to their conventional counterparts. Islamic Finance as an industry require financial institutions to be involved in trade and investment, promotes risk-sharing and fairness in the relationship between financier and entrepreneur; it promotes the financial institutions' involvement in the value-chain (i.e. value adding in the process of getting the product from the supplier to the consumer) and prohibits investment in any industry that may cause harm to the society.

This paper highlights the work done by Bank of Khartoum to embody the spirit of Islamic Finance in its operations. While doing so, they have developed an innovative methodology of conducting Microfinance (Solidarity and Value Chain Project Group Financing). Instead of

providing small loans which defines the Microfinance industry, Bank of Khartoum ventured far in empowering the poor by doing business with them. By sharing risks and profits with the poor, Bank of Khartoum is helping thousands of vulnerable people in Sudan to earn a better living by generating jobs. It currently has a growing portfolio of more than 100,000 business partners/clients. Large projects were developed involving hundreds and in some cases thousands of poor beneficiaries with each investment amounting up to USD 3 million. This methodology was found to be more sustainable (IRR about 20% per annum) and more effective in alleviating poverty (each beneficiary received more income by sharing the venture's profits and being co-owners of the venture). By being a real partner of operating these businesses, Bank of Khartoum has developed its expertise in the area of Agriculture and Livestock development. Like any large professionally run business, the Bank of Khartoum helps poor farmers to run the business, while developing their capacity to assume the ownership of the business over a period of time.

The implications for donors especially IDB are very significant. As a shareholder of the Bank of Khartoum, IDB has been successful in creating a mini-development bank in the process. Bank of Khartoum is currently active in developing and replicating business projects that have a typical profile of: a) IRR of 25% to 30%; b) investment period of 3 to 5 years; c) a pre-determined exit plan after the investment period with the poor taking over the ownership and running of the business.

This paper documents various Investment Projects developed by Bank of Khartoum and highlights the Key Success Factors. It also describes various Lessons Learned and Recommendations for IDB to develop the Islamic Microfinance Industry through this innovative approach. The challenges of developing the industry is great. Similar to Professor Yunus's success in changing the world's perception that the poor are not credit-worthy, IDB needs to take necessary steps to change the world's perception that the poor are not investment-worthy. Professor Yunus have demonstrated that it is possible to replace physical collateral with social group collateral. IDB's experience with Bank of Khartoum has demonstrated that it is possible to reduce the cost of microfinance and mitigate business failure of its beneficiaries by investing in large businesses that benefit

from Economies of Scale and by being an active business operator. By reducing the per capita cost of financing and directly improving the prospect of business continuity, it's feasible to implement profit-sharing instruments promoted by Islamic Finance. If the invested business succeeds, the MFI will be profitable and the income of the poor will increase. The paper also discusses ways how IDB can also play an active role of improving the profitability of these businesses, by improving their access to markets through encouraging trade and exports among Islamic MFIs and private companies in the GCC. The paper also makes several recommendations on how IDB can further develop the Islamic Microfinance industry in general.

IDB is appropriately and uniquely positioned to take the lead in Islamic Microfinance to the world of donors and other global stakeholders. By developing the Islamic Microfinance industry, IDB is able help its Member Countries to generate employment, alleviate poverty and promote economic growth through the creation of mini-development banks invested by IDB or have a line of finance provided by IDB, similar to Bank of Khartoum. By creating these 'multipliers', IDB will be better positioned to create a significant impact to its Member Countries- directly contributing to the achievement of Vision 1440H.

# WHY ISLAMIC FINANCE FOR THE POOR?



# ▶ Why Islamic Finance for the Poor?



## Microfinance

Lacking of access to financial services is considered as one of the key constraints on inclusive economic growth in the developing world. It is the key constraint on the growth of micro, small and medium businesses – often the single source of income for poor households, which hampered employment, economic growth and shared prosperity (IFC, 2013).

Currently there are 2.6 billion people living on less than USD 2 a day, about 600 million of them are small-holder farmers, 180 million are micro-entrepreneurs, and 800 million youth (CGAP, 2014). While it is estimated that 2.5 billion adults lack access to savings or credit, 1.3 billion of it are women, and 200 million micro<sup>1</sup>, small and medium businesses have very limited or no access to credit at all (The World Bank, 2014). Facing this reality, Microfinance surfaced as a key component of development efforts to assist the low-income population. Microfinance is often defined as *"the provision of financial services to low-income poor and very poor self-employed people"* (Otero, 1999). It mainly covers savings and credit services (Schreiner & Colombet, 2001), but can also include other financial services such as insurance and payment services (Oikocredit, 2006; Ledgerwood, 1999). In IDB, *microfinance services (loans, savings, and insurance) are rendered to the active poor to take advantage of economic opportunities, increase their earnings, satisfy basic needs, and protect them against shocks"* (Andaloussi & Hasnaoui, 2010).

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Global Findex

The earliest institutionalization of micro-credit rendering services was recorded in the 14<sup>th</sup> century (1388) in Germany in form of cash endowment (Rahmenstiftung) and 15<sup>th</sup> century in Ottoman empire and non-Arab Islamic world (Balkan, Malay) as cash Awqaf (Cizakca, 1998). It is presumed that in non-Arabic speaking Islamic world, the practice goes even earlier without any trace due to the loss of records between the 8<sup>th</sup> and the 14<sup>th</sup> century. In modern financial landscape history, one of the earliest formal institutions offering savings and credit services to rural small-holder farmers was Mit Ghamr Bank, Egypt in 1963. The bank was later closed in 1973 and its operation was taken over by National Bank of Egypt.

In 2002, the Monterrey Consensus that Governments adopted at the International Conference on Financing for Development explicitly recognized that *"microfinance and credit for micro, small and medium enterprises... as well as national savings schemes are important for enhancing the social and economic impact of the financial sector."* They further recommended that *"development banks, commercial banks and other financial institutions, whether independently or in cooperation, can be effective instruments for facilitating access to finance, including equity financing, for such enterprises..."* Towards achieving the Millennium Development Goals the United Nations General Assembly adopted 2005 as the International Year of Microcredit to *"address the constraints that exclude people from full participation in the financial sector."* At the World Summit at the United Nations in September 2005, Heads of States recognized *"the need for access to financial services, in particular for the poor, including through microfinance and microcredit"* (Obaidullah & Khan, Islamic Microfinance Development, 2008).

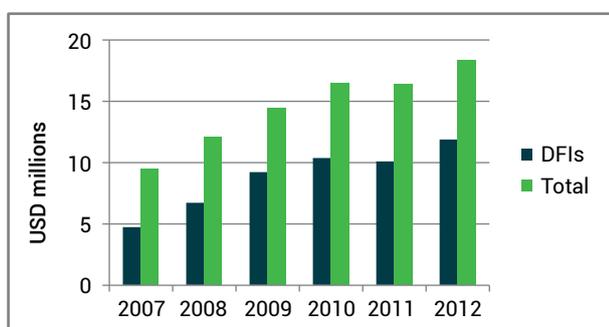
1. Definition of Micro-enterprise varies between countries, but the most commonly used definition is a business that employs less than 10 employees – IFC MSME Indicators.

The commitment of Development Financial Institutions (DFIs) have increased to USD 11.89 billion in 2012 from USD 4.72 billion in 2007. This bring total cross-border commitment to financial inclusion to USD 18.42 billion at the end of 2012.

CGAP

However, it is the celebrated efforts of the Grameen Bank<sup>2</sup> in providing Access to Finance to the un-bankable poor communities in Bangladesh through then-innovative group lending that has spurred many attempts to replicate the model all over the world. Since then both private and public sectors have jumped onto the bandwagon, creating thousands of Microfinance Institutions (MFIs). This is shown by the increase of cross-border commitment of funders in improving access to finance. The commitment of Development Financial Institutions (DFIs) in Microfinance have increased to USD 11.89 billion in 2012 from USD 4.72 billion in 2007. This brings total cross-border commitment in financial inclusion to USD 18.42 billion as per 2012.

**Figure 1 - Trends in Commitments for Financial Inclusion**



Source: CGAP Cross-Border Funder Survey

While Microfinance programs have been successful in challenging the notion that the poor are un-bankable to as far as asserting that “access to financial services is a basic human right”, the jury is still out as to how effective the incumbent Microfinance players has been in achieving its objectives of alleviating poverty and improving people’s welfare. Some Microfinance Institutions (MFIs) have been credited for successfully implementing Microfinance as a sustainable means for poverty alleviation while others have been criticized for exploiting the poor for economic gain.

The success of Microfinance programs to provide services to the poor is measured on various social goals, and they differ from one microfinance institution to another. It is mostly weighted on the basis of clients’ ability to meet their basic needs, acquire assets or even to start small businesses. Another measure is reducing the vulnerability of the poor, to cope with shocks and to finance their emergency needs. Based on several research that have been conducted in various countries, there are still mixed results on the effectiveness of Microfinance in achieving its objectives.

Early studies – mostly employing qualitative or difference of difference methods on cross sectional and panel data suggested positive impacts: a) participation in microfinance does improve potential resistance to vulnerability (Murdoch, 1998; Mustafa, et al., 1996); b) increase perception of women empowerment and material well-being (Mustafa, et al., 1996; Panjaitan-Drioadisuryo & Cloud, 1999); c) increase profit on self-employment (McKernan, 2002); d) improve asset ownership (Shirazi, 2012); and e) benefits the poorest, and has sustained impact on poverty reduction among program participants (Khandker, 2003). Among the criticism raised on the early practice of microfinance were on the dependency of the poor to continuously borrow from the MFIs (Remenyi & Quinones, 2000), observations that the poor also use it for consumption purposes (Shirazi, 2012) as they don’t possess the required mentality for entrepreneurship (Dichter, 2007).

Later studies employing Randomized Control Trials were available in late 2010. A study in India (Banerjee & Duflo, 2011; Buchet, Marshall, Starita, Thomas, & Yalouris, 2011) found that microfinance does increase access to credit, business activities, and shift the expenditure pattern away from wasteful consumption. However there was no evidence found that microfinance improve the clients’ welfare in terms of measurable dimension of healthcare and education. Another study in Morocco (Crepon, Devoto, Duflo, & Parienta, 2011) suggests that microfinance is an opportunity that different clients will take advantage of in different ways. While it is proven that Microfinance benefited mostly those engaging in agricultural activities (livestock), the study failed to find evidence that the clients are more resilient towards income and health shocks. However, a study in South Africa (Karlán & Zinman, 2010) found that consumer credit did increase the borrowers’ well-being in terms of income and food consumption, as well as increasing

2. Prof. Muhammad Yunus and the Grameen Bank received the Noble Peace Prize in 2006 «for their efforts to create economic and social development from below»

probability of future financing. Similarly, access to micro-saving products have found to increase the household income and make the clients less vulnerable to health shocks, as suggested by a study in Kenya (Dupas & Robinson, 2011).

Meanwhile, there have been several crises involving microfinance institutions recorded at massive scale, e.g. Nicaragua in 2008, Kolar state of India in 2009, Bosnia and Herzegovina in 2009, Nigeria in 2010, Indian state of Andhra Pradesh in 2010, as well as Pakistan in 2010 (Chen, Rasmussen, & Reille, 2010). These crises were argued to occur due to inadequate governance systems to ensure transparency and prudence, both in credit policy and its social goals. Governance systems were needed to prevent MFIs from becoming legalized loan sharks.

There is still mixed result on how effective microfinance is in achieving its objective, while there have been several crises of microfinance recorded at massive scale. For example Nicaragua in 2008, Kolar state in India in 2009, Bosnia and Herzegovina in 2009, Nigeria in 2010, crisis in the Indian state of Andhra Pradesh in early October 2010, and Pakistan in 2010.



### What is Islamic Microfinance?

Islamic Microfinance is a combination of two disciplines, Microfinance and Islamic Finance. Islamic Finance and Banking can be distinguished from conventional financial services by several features including:

1. Financial transaction must bear no interest on top of a nominal service fee. Profit can only be taken from business/economic transactions.
2. The transactions with clients are based on real economic transactions which adds value to the economy, often backed by hard assets;
3. The financial institution is an active participant of the transaction and shares the risks involved in the transaction of goods and services;
4. The financial institution, as well as the depositors, have the ability to go beyond debt-based relations and enter equity-type or venture capital investments;
5. The transactions and investments made by the Bank should not violate Islamic standards and morals.

The above features distinguish an Islamic Bank as a risk-sharing institution. There is a clear departure from the usual banking culture and mandate, which acts as a simple financial intermediary that does not engage in the actual underlying business transactions. In conventional finance, engaging in business transactions is seen as an unnecessary liability, which deposit taking institutions, such as banks, should stay clear of. Islamic Finance, which denounce this segregation of financier and investor functions (except in social finance – charity or non-interest bearing), mandated Islamic Banks to mediate (take and deploy) funds in the most efficient and prudent manner. The only way that this can be done is by being involved in the business transactions and mitigating risks from the operational side of the transactions i.e. the business.

Similarly, Islamic MFIs are expected to perform the role of investors / fund providers while being fully involved in the business transactions of their clients, sharing the risks with their clients as business partners instead of only being credit providers. **This role is even more critical, since they are sharing the risk with their clients, most of whom are poor and vulnerable.**

Presently more than 300 Islamic Microfinance Institutions in 32 countries including Indonesia, Kenya, Afghanistan, Bangladesh, Sri Lanka, Yemen, Egypt, Sudan, Tanzania, Mauritius, South Africa, Malaysia and Pakistan that are



working for the cause of poverty alleviation (Obaidullah & Khan, Islamic Microfinance Development, 2008). The sector employs more than 1.2 million clients (most in Bangladesh, Sudan, and Indonesia), with portfolio of more than USD 740 million (highest in Indonesia - USD 400 million and Lebanon - USD 135 m), and more than USD 250 million micro deposits (more than 837 thousands depositors). Indonesia have the most number of institutions offering Sharia Microfinance products, while Islami Bank Bangladesh and Agricultural Bank of Sudan are the two institutions with the most clients (Sanabel; CGAP; AFD, 2012).

**More than 300 Islamic Microfinance Institutions in more than 32 countries. The sector employs more than 1.2 million clients, with portfolio of more than USD 740 million, and more than USD 250 million deposits.**

Obaidullah and Khan, Sanabel

Participative Finance: From the risk sharing approach, Islamic Microfinance also receive attention and interest from the non-muslim communities. In such communities, Islamic microfinance are often introduced as participative microfinance, where all of the features mentioned above hold, except that it sometimes involves sectors that may not qualify as Sharia compliant / Islamic investment, e.g. entertainment, tourism and hotels.

safety standards; and d) unattractive due to the poor design or product finishing. Such products are likely to derive low margins due to low demand for the product and low barriers of entry of a fragmented market. Despite this, the poor may not have no option but to take up loans and undertake the high risk involved in starting a microenterprise with the hope of generating some profits to sustain their livelihood. These profits are even likely to be further diminished by the high interest rates of about 20-30% per annum often charged by MFIs, which effective rates that may reach up to 50% in institutions that apply a front load fee and retention policy.

This shows that the poor are not poor solely because they don't have access to credit (Dichter, 2007). Access to credit also doesn't guarantee their resistance in times of shocks. The **poor stays poor and vulnerable because of multi-dimensional factors**. They do not have access to viable business and economic opportunities; they don't have access to financial resource to start the business; they don't have the right environment (access to basic utility – power, clean water etc.) to be able to work efficiently; they don't have safety net in time of shocks (economic or natural disaster) or life events (birth, sickness, death); they don't have networks to acquire inputs or to sell outputs that give them best prices; they don't have networks to share and acquire knowledge of the latest market demand and technology. They are a marginalized group that are unable to compete effectively due to socio-economic factors present in society.

## **Islamic Microfinance Preposition: MFIs to take the Leading Role**

### **Cash follows Business Opportunities and not vice-versa**

Microfinance institutions often make the naked assumption that due to necessity, the poor have access to business opportunities and the only factor preventing them from realizing these opportunities is the availability of cash. This assumption is fundamentally flawed (Dichter, 2007), as suggested by the previously mentioned studies in Hyderabad, and Morocco (Banerjee & Duflo, 2011; Crepon, Devoto, Duflo, & Parienta, 2011; McKernan, 2002).

In fact, most enterprises financed by MFIs are involved in petty trading, small food outlets, agriculture and cottage industry production. Most of the poor are restricted to these industries since many of them are low skilled and the products produced would typically be: a) of low quality; b) small scale production; c) may not meet



**Figure 2: Multidimensional Exclusion faced by the Poor**



Therefore, Microfinance is not the only effort that is needed to democratize business opportunities to the marginalized poor. There are other forms of institutions that attempt to mobilize and empower its poor members - cooperatives, trade-unions, self-help groups, NGOs etc. However, often all these types of organization are working in silos and, alone, they may not have the professionalism and capacity to develop economic opportunities for their members. But, a well-equipped Microfinance entity, can have the network to all of the institutions above, creating

synergic efforts to ensure that the beneficiaries are empowered and have all means necessary to improve their livelihood. By nature, an Islamic Microfinance institution would find greater relevance and interest to have this capability, since they are sharing the risk with the beneficiaries. A list of Sharia compliant Microfinance products and nature of businesses (Andaloussi & Hasnaoui, 2010) can be seen in the table below. A more detailed explanation (Lih, 2011) of some main Sharia compliant products is attached as [Annex 2](#).

**Table 1: Sharia Compliant Financing Products and its Business Nature**

<i>Instrument</i>	<i>Role of MFI</i>	<i>Role of Client</i>	<i>Suitable for</i>	<i>Return Mechanism</i>	<i>Bearer of Asset / Capital Risk</i>	<i>Bearer of Business Risk</i>
Mudarabah	Investor	Executor	Fixed assets, working capital	Profit Sharing	MFI	MFI
Musharakah	Investor	Partner	Fixed assets, working capital	Profit Sharing	Shared	Shared
Muzaraah	Land owner	Cultivator	Agricultural land	Profit Sharing	MFI	Shared
Ijarah (op. leasing)	Lessor	Lessee	Fixed Assets	Floating / fix rate	MFI	Client
Istisna (construction and sale)	Contractor	Buyer	Fixed Assets	Fix rate	MFI then Client	Client
Salam (advance purchase)	Advance buyer	Producer	Working Capital	Fix rate	Client	Client
Murabahah (purchase and sale)	Seller	Buyer	Fixed assets	Fix rate	Client	Client
Istijrar	Stand-by seller	Buyer	Working Capital	Variable rate with a boundary	Client	Client
Qardh (zero interest loan)	Lender	Borrower	All Purpose	None	Client	Client



## Reality of Islamic Microfinance – Dominance of Debt-based Financing Products

A Sanabel-CGAP-AFD survey on Islamic Finance in MSME financing (2012) showed that most Islamic Microfinance institutions provided only Murabahah and Qardh al-Hassan products, while acknowledging that there were institutions that have a wider spectrum of products. Murabahah alone accounts more than 56% of the portfolio of the surveyed MFIs, while Qardh al-Hasan stands second (28%). Although academics have often promoted Islamic Microfinance venture capital modes of financing such as Musharakah and Mudarabah, practitioners have often reasoned that while these modes are theoretically ideal, they are not easy to implement. According to the survey, Mudarabah and Musharakah only accounts to around 7% of the total portfolio.

**Murabahah accounts more than 56% of the portfolio of MFIs, while Qardh al-Hasan stands second (28%). Mudarabah and Musharakah only accounts to around 7% of the total portfolio.**

Sanabel-CGAP-AFD

One reason for this is that without proper mitigation measures, Mudarabah and Musharakah modes of finance can pose Moral Hazard issues relating to business selection, profit declaration, and commitment



of the beneficiary to make repayments. Since the profit of the MFI is directly correlated to the profits made by the beneficiary's business (with the real possibility of making a loss), the MFI may not have the ability to forecast and manage their risks.

Mudarabah and Musharakah should be implemented similar to how other equity or venture capital investments are made. Firstly, the investor needs to conduct a feasibility study to ensure that the business proposition is viable as well as to be aware of the key success factors and risks involved in making the investment. Secondly, there should be a proper understanding between the investor and investee on their rights and obligations, all of which is spelled out in the investment agreement. Thirdly, there should be a proper financial control mechanism to ensure payments are made as intended and the operations of the business is monitored regularly. Last but not least, an exit strategy should be agreed between the investor and investee, with both parties working with the understanding that the investor wants to exit with a target profit margin that is to be achieved in a specific amount of time.

However, if Islamic MFIs operate by giving individual financing only, it is unlikely that they will have the capacity to conduct due diligence and monitoring of their investments made to every individual client. Undertaking the process can only be feasible if the investment size is significantly large and towards a group of beneficiaries (e.g. cooperative, association, company etc.). Wherein lies the issue. Most MFIs, Islamic or conventional, disburse financing to individuals. Even though beneficiaries are often grouped as a means to provide social collateral (like what is practiced by Grameen), the loans made to the beneficiaries are on an individual basis.

For Islamic MFIs to provide equity-oriented financing such as Musharakah and Mudarabah, they will need to: a) change their modus operandi to manage risks like a venture capital institution rather than a loan disbursing bank; and b) change their modus operandi to provide group level financing (to cooperatives, associations, companies, etc.) rather than individual level financing.

**To be able to provide equity-oriented financing such as Musharakah and Mudarabah effectively and efficiently, Islamic MFIs need to: a) shift their approach in managing risks as a venture capital institution; and b) provide group level financing (to cooperatives, associations, companies etc.).**

# IDB'S APPROACH IN ASSISTING THE POOR THROUGH INCLUSIVE ISLAMIC FINANCE



## ► IDB's Approach in Assisting the Poor through Inclusive Islamic Finance



### Developing Microfinance Institutions

Most Islamic Microfinance Institutions started like Islamic Banks - They converted conventional interest bearing debt instruments to Shariah compatible ones (e.g. Murabahah, Salam, and Ijarah). Once the Islamic Microfinance Institution matures, understands its clients and the business opportunities better, it may provide more products to serve its clients.

In earlier years, the conventional way of supporting an access-to-finance effort were often focused only on the sustainability of the MFIs in rendering the financial services, as well as the breadth and depth of the offered services. The success of MFIs are often measured by the sustainability of the MFI, breadth of outreach, depth of outreach, portfolio quality and efficiency. In recent years, the focus is slowly moving towards striking a balance between the social and financial performance of the MFIs, how the social objectives are immersed into the MFIs' goal and strategy, and how true the MFIs are in reflecting the social goals in doing day-to-day business, and monitoring these goals. This is well captured in the newly published Universal Standards for Social Performance Management (CGAP, 2014).

The approach of IDB's intervention in Islamic Microfinance is different from that of other developmental institutions. There are two approaches that IDB takes in promoting Islamic Microfinance: a) setting up new Islamic Microfinance Institutions and b) developing the capacity of existing Microfinance Institutions to introduce Shariah-compliant financial products and services. Depending on several factors including: a) mandate of the available entities; b) target clientele for business development; c) target business sectors to engage and d) capacity to introduce Islamic Finance, IDB will adopt the approach that will best meet the needs of the client. Overall IDB aims to promote risk-sharing products and move away from debt-based services. The List of IDB's intervention in Microfinance is attached as [Annex 3](#).

IDB provides financing (lines or equity) to the Microfinance Institutions. However, the focus is to provide technical assistance to develop the MFI into a business entity

with the capacity to develop and assess viable business opportunities, which the poor can benefit from. This includes identifying and engaging various stakeholders in the value chain to work as business partners.

The MFI's capability to manage risk at the operational level should be improved instead of relying solely on a third party insurance company. They will share the risk of their clients as business partners. Other institutions may also provide vocational trainings and agricultural extension services, leveraging on existing investments that are being made to develop the workforce and generate employment. By developing and operating the financed businesses, MFIs will generate sustainable employment while ensuring a steady income from their investments.

The success indicators may be similar to those measured by conventional MFIs, however, since the financial transactions are tied to the real business transactions, the financial report will be more grounded and closely reflect the success of the financed clients.



**IDB provides financing (lines or equity) to the Microfinance Institutions. However, the focus is to provide technical assistance to develop the MFI into a business entity with the capacity to develop and assess viable business opportunities, which the poor can benefit from.**



## Methodology of Empowering the Poor by Microfinance Institutions

The idea that a commercial bank is able to have the poor as clients, providing them the full suite of financial services is appealing. However, most conventional commercial banks find it difficult to balance the social needs of the poor with profit maximization. Hence, in IDB supported projects, IDB tries to establish a separate entity within the banks to solely serve the microfinance clientele. This entity must observe the social goals of microfinance, as well as sustainability goals of the investment.

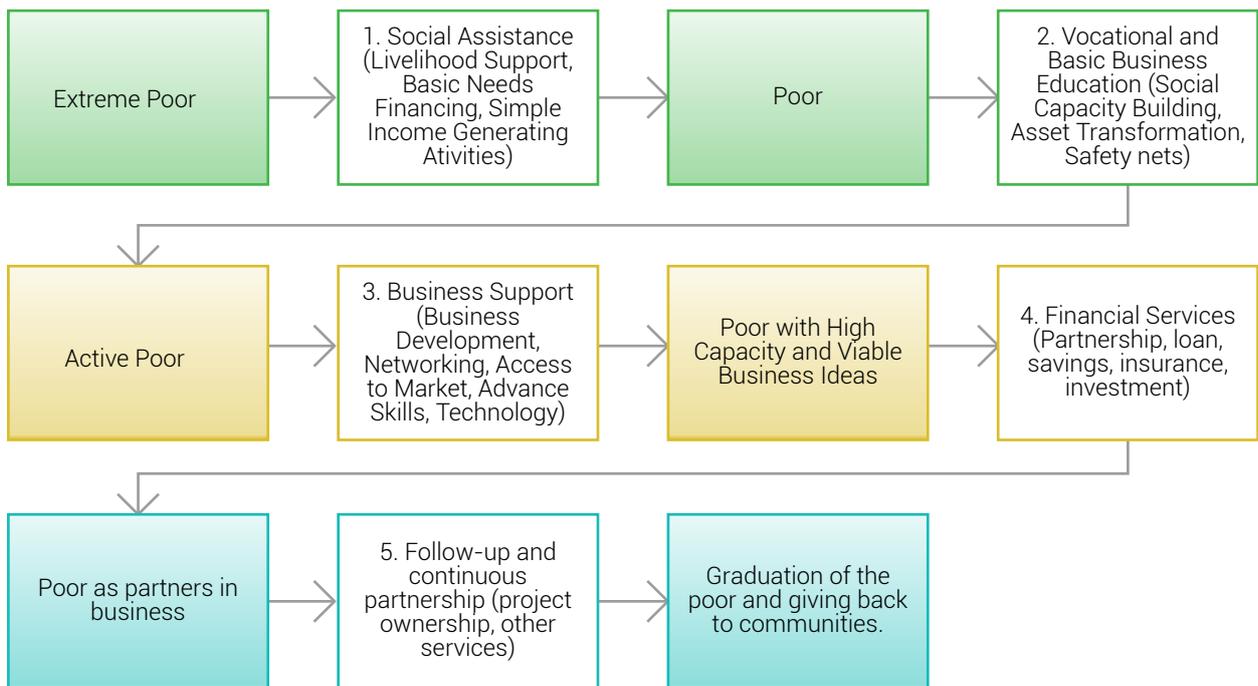
To achieve Microfinance's aim of poverty alleviation through empowering the poor, the Islamic Microfinance entity should do the following:

1. Improve client's wellbeing through:
  - a. Ensuring the clients' basic needs of food, water, shelter and energy as part of the intervention;
  - b. Provision of safety nets to make them more resistant to shocks. Risks related to life and business should be covered by insurance and savings products;
  - c. Transfer the ownership of project assets to the client once their capacity is been developed;

2. Provide business development support including:
  - a. Partner and share business risk with the poor; Tie in the entities' profits with the profits of its clients;
  - b. Assist the client in developing/ refining the business model and provide the necessary capacity building to ensure a better chance of the client's success;
  - c. Facilitate access to markets, skills and technology by engaging various stakeholders in the value chain.

These steps can be explained in the following diagram that was highlighted by Andaloussi<sup>3</sup> (with some adjustment). Not all the beneficiaries should go through all the stages of assistance. Each client will have needs that should be carefully assessed by the Microfinance Institutions. The capacity that will be given to the beneficiaries should also be customized according to the business sector where the beneficiary is engaged or is deemed fit to be involved. Therefore, (i) **a market study** to pin-point good business opportunities for development of MSME is crucial for the MFIs, as well as (ii) a grounded and thorough **needs assessment of the beneficiaries** to identify capacity building requirement of the client.

**Figure 3: Economic Empowerment under Inclusive Islamic Finance Business Model**



3. (Andaloussi & Hasnaoui, 2010)

### **Improving Client's Wellbeing**

This covers the assistance no.1 and no. 2 in Figure 3 above. When having the poor as partners, Microfinance institutions have to recognize the importance of the wellbeing of the clients. Without having their basic needs fulfilled, it is difficult for the poor to exert their best in the business investment or conduct any other productive economic activities. Without food they won't be productive. Without access to electricity or clean water, the poor won't be able to study after dark, or have to spend precious day time to fetch clean water from a far distance. During events of importance (birth, marriage, death), they have to use their resource that should be instead invested in the business. In event of an accident or a natural disaster, they may have to resort to loan sharks. Even though the poor may be active in the economy, they are very vulnerable to become non-active. Therefore, the microfinance institutions who are to partner with the poor, must address all these concerns to ensure they are partnering with Active Poor, either by providing the services itself, or through collaboration with other partners.

In case of Islamic Microfinance, it also has options to tap into Zakah and Waqf (cash) funds, to finance these necessities. It can be channeled to the end-beneficiaries in form of Qardh al-Hassan (interest-free loan) or grant (sadaqah or zakah). Zakah and waqf funds have a huge untapped potential (Obaidullah, Role of Microfinance in Poverty Alleviation: Lessons from Experiences in Selected IDB Member Countries, 2008; Andaloussi & Hasnaoui,

2010), particularly to: (i) cover losses arising from the default of very small microenterprise; (ii) cover part of expenses incurred by MFIs in evaluating and financing microenterprises operated by the very poor; (iii) provide micro-takaful (mutual insurance) to reduce vulnerability of the active-poor due to external shocks; and (iv) build the capacity of households to do income generating activities.

### **Provide Business Development Support**

The Grameen Bank has demonstrated the viability of providing uncollateralized group financing to the poor. Instead of physical collateral, social collateral was pledged with each group member acting as a guarantor of the other group members. This innovation has enabled Microfinance Institutions to do what banks have never dreamed of doing- to provide uncollateralized capital to poor clients that are deemed a high- default risk. However, this risk mitigation measure only assures the bank that there are many guarantors who will be willing to repay on behalf of its group member. It mitigates the risk of repayment but not the risk of business failure.

The most effective way to ensure the beneficiaries' success is to be involved in his business, similar to how venture capital funds are involved in the companies they have invested in. Venture capitalists typically are involved in the business decisions, making payments and seeking customers. Similarly, Islamic MFIs should play the role of an investor instead of a lender, especially when providing Musharakah and Mudarabah financing.





As a committed investor, the MFI will share the business risk with its investees and work with them to improve their business model, helping them with all the elements necessary for the success of the business including: (i) Access to Management (of running the business); (ii) Access to Money (cash); (iii) Access to Market (input and output); and (iv) Access to Know-how (technology and skilled labor).

Notice that cash is only one of the four components needed for a business to succeed. A business also needs customers, skilled management and advanced technology to improve productivity. Besides labor (mostly unskilled), the poor may not have the capacity to fulfill the remaining requirements.

If a Microfinance Institution want to ensure that its investments are profitable, its support (including non-financial) has to be adequate to assist the business venture to succeed. A Microfinance Institution will not be able to provide all these elements in a customized manner for an individual poor client. The cost of doing so will be much too high. **The most viable way a MFI is able to do so is through a large-scale group financing.** The economies of scale generated from large-scale project financing will enable the bank to provide non-financial services needed for the success of the project.

For example, in many Agricultural products, farmers require seeds and fertilizer to grow their crop. They also need appropriate infrastructure including irrigation

**Table 2: Requirement of a typical MFI Client**

Key success factors in business	Requirements of a typical MFI client (e.g. small-scale farmer)
Access to Management	Operating the business effectively and efficiently with the required policies and processes
Access to Money	Financing needs to purchase agricultural inputs, infrastructure, machinery and training
Access to Markets	Ability to sell to a customer that is able to purchase all his products at a high price to maximize profit
Access to Know-how	Acquiring high technology machinery to enhance productivity as well as the necessary training to utilize the technology. Training in latest agricultural methods of production to enhance yields

channels to deliver water to their farms. In addition to that, many farmers use old inefficient methods of farming. They need to receive training from extension workers on the latest farming techniques as well as to know what to plant and when to plant it. They also require high technology equipment that will help them regulate temperature, humidity, water supply etc. Machinery such as tractors, rice thrashers and foot pumps will also enhance their productivity. Even if they had all of this, they will not be able to maximize the benefit generated from their harvest if they are unable to sell their products at a fair price- if they are able to sell them at all.

in tight- jacket definition. It focuses on simple income generating activity financing and relies heavily on Qardh Hasan and low yielding murabahah. Capacity building mainly financed through philanthropic funds, zakah, waqf, or grants. The size of financing are very small, commonly up to USD 1,000 per financing.

2. Solidarity Group Financing - this type have larger size of financing, commonly up to USD 10,000. It focuses on beneficiaries with similar activities and needs, grouping them to benefit from the economies of scale. This type relies on murabahah and salam. Murabahah is used to acquire assets for production activities (sewing machine, cattle, etc.) and Salam is used to provide networking capital.
3. Value Chain Project Group Financing - this type finance large projects run by the poor, where the MFI has majority control of the business, and thus justify heavier investment in the client as well as using profit sharing mechanism. The MFI will identify and invest in potential businesses and will work with the poor as business executors and promoters.



### Financial Assistance Products

Based on the approach above, in many of its project, IDB categorizes the financial assistance products as follows:

1. Survival Income Generating Activities (SIGA) Financing - this is probably the Islamic "Microfinance"





## Comparison between Traditional Microfinance Methodology with Empowering the Poor through Value-Chain Project Group Financing Methodology

The table below shows a comparison of the Empowering the Poor through Value Chain Project Financing Methodology promoted by IDB with the popular Grameen's Microfinance

model. Both attempt to "Do Business with the Poor" but there are differences in the approaches. The traditional model demonstrates the feasibility of ensuring **financial inclusion** with the poor through providing interest- based arm's length financing. IDB's model on the other hand, demonstrates the feasibility of **partnership / venture capital inclusion** of the poor, through venture-capital like financing that requires the bank to be very involved in the business that is being financed.

**Table 3: Differences between Traditional Microfinance and IDB's Methodology**

Features	Traditional Microfinance	IDB Empowering the Poor through Value Chain Project Financing
<b>Loan/ Investment Approval Process</b>		
Target Beneficiary	- Economic Active Poor - Mostly Women - Loans are given to individuals as members of a group	-Economic Active Poor with Relevant skills/ talents - Mostly nuclear families - Investment given to a cooperative/association of many (hundreds or thousands) family beneficiaries
Group or Individual Loan/ Investment	Separate loans given to individual members of a group	Investments made to a group of many individual members
Collateral	Social collateral by other members of the group	No collateral provided- Beneficiaries sign a letter of commitment
Risk evaluation	Based on credit profile of clients, history of default	Based on business risk of proposed investment
Loan/ Investment usage	Various (typically small trading operations) operated by the beneficiary	Specific large investments designed by the bank
<b>Loan/ Investment Product</b>		
Loan/Investment Quantum	Small (less than USD 10,000)	Large (in cases more than USD 1 million)
Loan/Investment Product	Conventional interest based loans	A variety of Islamic Financial instruments
Loan/Investment Return	Interest	Profit –sharing, profits
Loan/Investment Duration	Short (6 to 24 months)	Long (3 to 5 years)
Cost of Financing	Low (One Loan Officer to about 20 clients)	High (One Investment Officer to each cooperative/ association client that is financed)
<b>Support Activities of Loan/Investments</b>		
Bank officer Support	Low (One Loan Officer to about 20 clients)	High (One Investment Officer to each cooperative/ association client that is financed)
Responsibility for business success	Solely on individual beneficiaries, bank provides arm's length loan	Joint responsibility between bank and association of beneficiaries. Bank is required to be an active investor making business decisions
Capacity Building for beneficiaries	Generic (e.g. budgeting, financial planning etc.)- usually supported by grants	Specific (related to operating the business to improve project performance)- usually part of the investment expenses
Non- Financial Support	Not provided most of the time.	Access to Markets (Bank negotiates contracts with customers) Access to Management (Bank helps beneficiaries make business decisions) Access to Know-how (skills development specific to the business and latest technology)
Subsidy Element	Subsidy may be given to reduce operating cost which may reduce interest rates charged to end beneficiary	Subsidy is given in the form of support investments to provide reduce investment costs resulting in a shorter investment period
Insurance/ Takaful	Insurance obtained to mitigate risk of non-repayment	Insurance obtained to mitigate business related risk (eg. crop failure due to draught)
Likelihood of Poverty Alleviation	Dependent on profitability of individual small business which need to be higher than the interest rates charged. In the case of business loss, repayments are still required	Dependent on the profitability of the large business managed by the bank. In the case of business loss, bank will lose its investment

# HOW IS IDB APPROACH OF INCLUSIVE ISLAMIC FINANCE PRACTICED IN THE BANK OF KHARTOUM?



## ▶ How is IDB Approach of Inclusive Islamic Finance Practiced in the Bank of Khartoum?

### Background

Bank of Khartoum is the first bank in Sudan, establishing its operations in 1913. In 1925, it was renamed Barclays Overseas Bank and later Barclays Bank in 1954. The Government took over the ownership of the bank in 1970 and named it State Bank before renaming it Bank of Khartoum in 1975. Between 1983 and 2002, the bank acquired several local and regional banks including the People's Cooperative Bank, Unity Bank and The National Export and Import Bank. In 2002, Bank of Khartoum was registered as a private limited company and subsequently was acquired and managed by Dubai Islamic Bank, the largest Islamic Bank in United Arab Emirates by purchasing 60% of the government shares in 2005.

In February 2008, Bank of Khartoum and Emirates and Sudan Bank merged to form the largest bank in Sudan under the name Bank of Khartoum with SDG 860 million of equity. Bank of Khartoum operates under Islamic Banking Standards and has a comprehensive suite of retail services including a network of 58 branches, 137 ATM and 10 Cash Deposit Machines services, auto finance, home finance, education finance, Takaful, internet banking, SMS alerts, discount and supplementary cards and the first and only call center.

Its major shareholders include Dubai Islamic Bank (DIB), the Islamic Development Bank Jeddah, Abu Dhabi Islamic

Bank, Sharjah Islamic Bank, United Arab Emirates Etisalat and other prominent local and regional Businessmen.

The Bank's business activities are subject to supervision of Shari'a Supervisory Board. The Shari'a Supervisory Board is appointed by the shareholders and has the power to directly review and supervise the activities of the Bank.



### Microfinance Unit and IRADA Microfinance Company

Currently all the microfinance operations of the Bank of Khartoum is under the Microfinance Unit under the Department of Retail, SME and Microfinance. The Unit was established in 2009 with the support and assistance from the Islamic Development Bank. The department was given the trust to implement the SDG 200 million Al-Aman fund for Microfinance. The fund was formed by a strategic partnership of the Zakah Chambers and 32 Sudanese Commercial Banks, following regulation of the Central Bank of Sudan to have all commercial banks invest not less than 12% of their portfolio in Microfinance. The Zakah Chambers contributed SDG 50 million while the remaining SDG 150 million was contributed by commercial banks. As the fund is made up of a mix of



**The Bank's business activities are subject to supervision of Shari'a Supervisory Board. The Shari'a Supervisory Board is appointed by the shareholders and has the power to directly review and supervise the activities of the Bank.**

social and commercial resources, it targets the economic active poor segments in every state of the country.

The success of the Microfinance Unit (MFU) has led to it being spun-off as an independent entity to allow for an even stronger focus on the social dimension of Microfinance aside of the business sustainability. After the spin-off, the Microfinance Unit was named IRADA Microfinance Company, having BOK (75%) and Islamic Development Bank (25%) as main shareholders.



### Vision and Mission of Bank of Khartoum Microfinance Unit (IRADA)

**Vision of IRADA-** To alleviate poverty and hunger by realizing the potential of the poor through development of limited resources and affordable financial facilities.

**Mission of IRADA-** To increase the numbers of poor people involved in entrepreneurial activities through Islamic Finance and expand income generating activities by creating sustainable livelihood and employment.

**Approach Theme-** Today the poor are our clients but tomorrow they will be our business partners.

**Methodology focus-** Empowerment through Group Finance and Partnership

**Values-** Leadership, Excellence, Credibility, Initiative, Partnership and Development-oriented



### Modus Operandi at Inception – Individual Microfinance using Murabahah

The individual micro-finance product started as soon as the Microfinance Unit was formed in the Bank of Khartoum. This product is used mainly to channel the al-Aman Fund for Microfinance. The Bank of Khartoum was selected to utilize the fund under a Mudarabah contract from 2011.

Due to the sheer fund size and pressure to access wide coverage of the poor population of the country, the Murabahah – Bay' Ajil (deferred sale with margin)



## Islamic Finance Product Details

Title	Individual Financing (Murabahah)
<b>Project Objectives</b>	<ul style="list-style-type: none"> <li>• Increase the numbers of entrepreneurs from the low income population in Sudan through affordable Islamic Microfinance</li> <li>• Develop income generating activities in the economy.</li> <li>• Create sustainable livelihoods and employment</li> </ul>
<b>Approved Finance Amount/ Limit</b>	SDG 200.00 million. SDG 10,000 per financing
<b>Financing Tenor</b>	Up to 3 years
<b>Target Return on Investment for BOK</b>	14%
<b>Target Returns for Beneficiaries (During Implementation Period)</b>	N/A
<b>Target Returns for Beneficiaries (After Implementation Period)</b>	N/A
<b>Actual Return on Investment to Date</b>	14% (defaulters are backed by Zakah fund)
<b>Target Groups and Beneficiary</b>	Economically active poor (Zakat category) segment of Sudan population
<b>Islamic Financing Modes</b>	Murabahah
<b>Non-Financing Intervention/Services</b>	<ul style="list-style-type: none"> <li>• Savings</li> <li>• Insurance</li> <li>• Zakat guarantee</li> </ul>
<b>Stakeholders and Partners</b>	Central Bank of Sudan, Zakat Chamber
<b>Guarantees and Collaterals</b>	No Collaterals Personal bank cheque Third party guarantee Zakat fund
<b>Identified Risks and Mitigation Measures</b>	As a national program, the fact that Zakat fund is available as cushion creating moral hazard and delinquency among the clients – A personal cheque guarantee is mandatory. If clients defaulted due to negligence, the case would be brought to authorities

mode of financing was chosen. As the most basic Sharia compliant contract, it was easy to develop, and it only requires minimum due diligence. It also requires no collateral and mainly guaranteed by individual bank cheques and third party guarantees. On top of it, the BoK runs the fund under Mudarabah agreement, which won't affect BOK balance sheet, and the Fund itself has a cushion of 25% Zakah contribution.

As part of capacity building, every beneficiary is required to open a savings account, against which the cheques were issued. Through this they learned about banking and other services offered by the financial sector.

To date, SDG 128.00 million have been paid to and disbursed from the fund. It has been channeled to around 95,000 beneficiaries, of whom around 85,000 are active customers. The margin from the operation is 14% on local currency basis, with default rate of around 12%. The default rate was high because clients learned that the fund is backed by Zakah funds.

Learning from these lessons, the second phase of al-Aman fund is currently proposed to gradually invest more in the Group and Project financing and less in the individual Murabahah financing. It is envisaged that in the future, the portfolio of this product will be reduced to only 25% of the total portfolio.

# INNOVATIVE INCLUSIVE ISLAMIC FINANCE USING THE SOLIDARITY GROUP FINANCING AND VALUE-CHAIN PROJECT GROUP FINANCING APPROACH



## ► Innovative Inclusive Islamic Finance using the Solidarity Group Financing and Value-Chain Project Group Financing Approach

While providing Islamic Microfinance through individual Murabahah products similar to other Islamic MFIs, Bank of Khartoum hired a consultant to provide the required MIS system. IBF Group was appointed to develop the MIS for the bank and to provide capacity building in the area of Inclusive Islamic Finance through Solidarity Group Financing and Value Chain Project (VCP) Group Financing Approach. Based on the recommendation of the consultant, Bank of Khartoum embarked on a needs assessment survey and Market study to better understand the business opportunities available in the country and the existing stakeholders in the value chain. Some of the project proposals were developed by bank headquarter staff while others were developed in coordination with community groups (e.g. cooperatives, associations etc.). The consultant helped the client develop their business ideas into plans with the various Islamic Finance instruments that may be provided to targeted clients. Feasibility studies would subsequently be carried out on these business plans. The following four case studies are examples of some of the Solidarity Group Financing and Value Chain Project Group Financing that have been successfully implemented by Bank of Khartoum.



## ▶ CASE STUDY 1:

### VCP Group Financing – Abu Halima Greenhouses Project



The Abu Halima Greenhouses Project was initially conceived by the Agricultural Graduates. Many of the graduates were unemployed or were working in other farms with very low pay and wanted to be given the opportunity to work and reap the fruits of their labor. They formulated a business proposal and approached the Bank of Khartoum for investment. The graduates had an innovative idea of producing winter crops (e.g. tomatoes) during summer, producing them through a controlled greenhouse environment. During summer, imported tomatoes cost five times the locally produced tomatoes sold in winter. In addition, the greenhouse will be able to produce high value crops that are usually imported during winter (e.g. pepper). BOK refined the business proposal in consultation with the graduates and submitted the proposal to Al-Aman investment board for approval to commission a detailed feasibility study.

Based on the feasibility study, the board approved SDG 10.90 million (USD 3.27 million) with the possibility of increasing up to SDG 15 million (USD 4.50 million) in the form of Mudarabah. This investment will be for constructing 25 productive greenhouses, each 1,710 square meters of 5 tunnels of 342 square meters each.

The project is expected to achieve an ROA of 18% and IRR of 22%. Interested graduates applied to be part of the

project and undertook a thorough interview that tested their capacity and commitment to the project. During the five year production period, it is expected that the graduates will receive about to SDG 2,700 (USD 810) a month, receiving 40% of profits generated from the project. During this period, the graduates will form a registered cooperative and be trained on how to manage the greenhouses and the business with the expectation that BOK will cede control of the project after the 5 year

implementation period. Since the key to success of the project is being able to sell all the high value crops to customers, BOK negotiated master contracts with large supermarket customers such as Home Centre and Sanaa. The government agreed to provide the diesel engines. These engines will be owned and maintained by the beneficiaries.

One interesting feature of this project is that there is no requirement for collaterals or third party guarantees. Each graduate signs a personal guarantee to remain committed to the project throughout the 5 years. BOK reserves the right to remove any graduate and replace it with another if the graduate is not serious or committed to the project. At the end of the 5<sup>th</sup> year, all

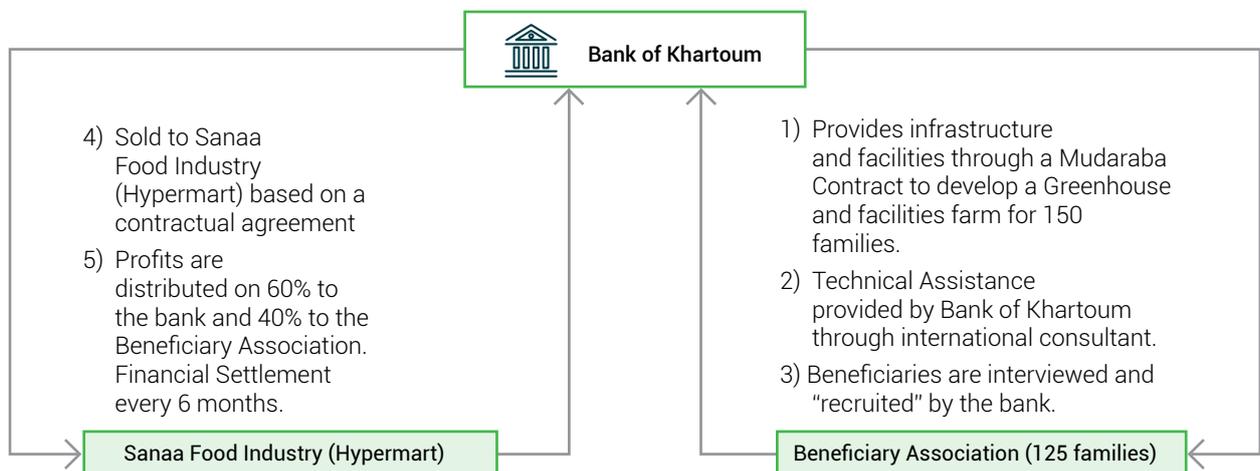
of the project assets (estimated at SDG 10.00 million) will be transferred to the Graduates Association (made up of the 125 selected graduates) after which they are expected to receive at least SDG 6,750 a month from the produce. Another interesting feature is that as Rabul-Maal (investor), BOK has the right to extend the Mudarabah for another year due to crop failure or other unforeseen circumstances, the bank has a buffer of one year to ensure its target returns for the investment are met. Despite being motivated by profit, the bank ensures the welfare of the graduates. The target returns during project implementation is more than what farmers will earn if they were to work on their own or if they were to work on another farm.

### Islamic Finance Product Details

Title	Abu Halima Greenhouses Project
<b>Project Objectives</b>	<ul style="list-style-type: none"> <li>• Provide business opportunities for graduates</li> <li>• Increase the income of project beneficiaries</li> <li>• Provide training and technical support for beneficiaries</li> <li>• Grow high value crops during winter season</li> <li>• Grow winter season crops during summer season</li> </ul>
<b>Approved Finance Amount/ Limit</b>	<ul style="list-style-type: none"> <li>• SDG 10.90 million with a possibility of increasing up to SDG 15 million (estimated about USD 4.50 million)</li> <li>• Estimated investment SDG 17,445 per beneficiary for 625 beneficiaries from 125 families</li> <li>• The project consists of 25 productive Greenhouses, each greenhouse space of 1,710 square meters. Each greenhouse contains 5 tunnels each 342 square meters</li> </ul>
<b>Financing Tenor</b>	5 years
<b>Products Produced</b>	<ul style="list-style-type: none"> <li>• Hot Charliston Pepper</li> <li>• Sweet Charliston Pepper</li> <li>• Tomato</li> <li>• Cucumber</li> <li>• Yellow pepper</li> <li>• Red pepper</li> </ul>
<b>Target Return on Investment for BOK per annum</b>	<ul style="list-style-type: none"> <li>• 60% of profit of 1200 ton of high value vegetables and fruits annually</li> <li>• ROA-18%</li> <li>• IRR-22%</li> </ul>
<b>Target Returns for Beneficiaries (During Implementation Period)</b>	Monthly- SDG 2,700 per family (SDG 5400 per beneficiary) including Living Allowance (SDG 300 to 600)
<b>Target Returns for Beneficiaries (After Implementation Period)</b>	Monthly- SDG 6,750 per family + ownership of Abu Halima Greenhouses Project Assets
<b>Actual Return on Investment to Date</b>	ROA-10%
<b>Target Groups and Beneficiary</b>	125 Agricultural Graduates (with families) representing total 600 beneficiaries
<b>Islamic Financing Modes</b>	Restricted Mudarabah- As working capital to purchase greenhouses, supporting infrastructure, technical feasibility, technical capacity building, agricultural inputs and living allowances

Title	Abu Halima Greenhouses Project
<b>Non-Financing Intervention/ Services</b>	<ul style="list-style-type: none"> <li>• Detailed feasibility study</li> <li>• Helped to source Turkish firm to construct greenhouses and related infrastructure</li> <li>• Helped to hire Turkish consultant to provide technical support throughout project lifetime.</li> <li>• Pre-production support- Provided Greenhouses, seeds, fertilizers, pesticides, machineries, electric and water sources</li> <li>• At production support- Living expenses allowance, operational expenses, harvest expenses, technical support.</li> <li>• After production support- Cooling storage and Grading room</li> <li>• Helped to Source large customers such as DAL and Home Centre to purchase produce</li> <li>• Helped to manage the project accounts</li> <li>• Formed and Registered Cooperative of farmers</li> <li>• Ownership will be transferred to the cooperative Cooperative will be trained to manage the business upon the bank's exit</li> </ul>
<b>Stakeholders and Partners</b>	<ul style="list-style-type: none"> <li>• State Ministry of Agriculture- help to get fertilizers and assist in technical capacity building</li> <li>• Ministry of Social Affairs- Nominate beneficiaries through graduate fund</li> <li>• Major Supermarket Chain- Sanaa food hypermart and Home centre to purchase vegetables</li> </ul>
<b>Guarantees and Collaterals</b>	<p>No financial/physical collaterals requested. Personal guarantees given by beneficiaries against mis-management and negligence</p>
<b>Identified Risks and Mitigation Measures</b>	<ul style="list-style-type: none"> <li>• Inability to sell produce- Contracted major customer to purchase products at market price</li> <li>• Crop Failure due to disease- Provide fertilizers and the capacity building for farmers to use appropriate amounts</li> <li>• Crop Failure due to heat- Greenhouses have automatic temperature control</li> <li>• Crop Failure due to lack of humidity – Greenhouses have automatic humidity control</li> <li>• Crop Failure due to lack of water- Drip Irrigation system is developed to provide water. A well is constructed to provide sufficient water</li> <li>• Electricity blackouts- Generators provided that run on diesel to run as backup electricity</li> <li>• Inability for families to live a suitable life that will lead to a lack of commitment- Families provided SDG 300 to SDG 600 as living allowance a month</li> <li>• Lack of Commitment by beneficiaries- Ability for BOK to remove beneficiary and replace them with another worker. Beneficiaries have to sign into work and their performance is monitored. Bank has the prerogative to distribute a larger proportion of profits based on performance and commitment</li> <li>• Conflict during distribution of profits due to different yields- Profits of the farmers and bank is based on the total production of all the Greenhouses and not on an individual greenhouse basis</li> </ul>

**Product Diagram- Abu Halima Greenhouses Project**



## ▶ CASE STUDY 2:

### VCP Group Financing – Wad Balal Cattle Fattening Project



The Wad Balal Cattle Fattening Project was initially conceived by a group of established Sudanese businessmen living and working abroad. Instead of just providing aid through cash transfers, the businessmen wanted to contribute to the improvement of their village which was mainly in the livestock industry. The businessmen wanted to use their connections to supply the Middle East with livestock from Wad Balal. However, to successfully meet the export market standards, they needed to help their suppliers (livestock herders) with the necessary infrastructure. With this idea, they developed a business plan and approached BOK for assistance. BOK refined the business plan and submitted the proposal to the Al-Aman board for approval of the feasibility study.

The board subsequently approved SDG 9.30 million (including SDG 4.27 million for purchasing calves) for the project based on the feasibility study's recommendation. The group of businessmen registered the Wad Balal Company with the mandate of investing in livestock production assets for the community as well as to purchase the livestock from the community for export to

the Middle East. In addition, they also helped the herders to register the Wad Balal Association with the aim of supplying livestock to their company.

In this project, BOK has two main contracts: a) Murabaha Financing to purchase calves for the Wad Balal Association; and b) Diminishing Musharakah Financing to

purchase livestock production assets for the Wad Balal Company. Due to the low education and capacity of the members of the Wad Balal Association, the Wad Balal Company is expected to help the association maintain production standards for export.

In the first contract, BOK will provide the financing to purchase of calves for Wad Balal Association. By purchasing in bulk, the bank will be able to help the association to acquire calves at a lower price. The mark-up of the Murabahah is 15% per annum. No collateral is provided in the transaction but the Wad Balal Company agreed to provide 55% guarantee for the repayment of the cattle.

In the second contract, the businessmen invested about SDG 321,000 amounting to 6% of the capital while BOK invested SDG 5.03 million (94% of the capital). The capital

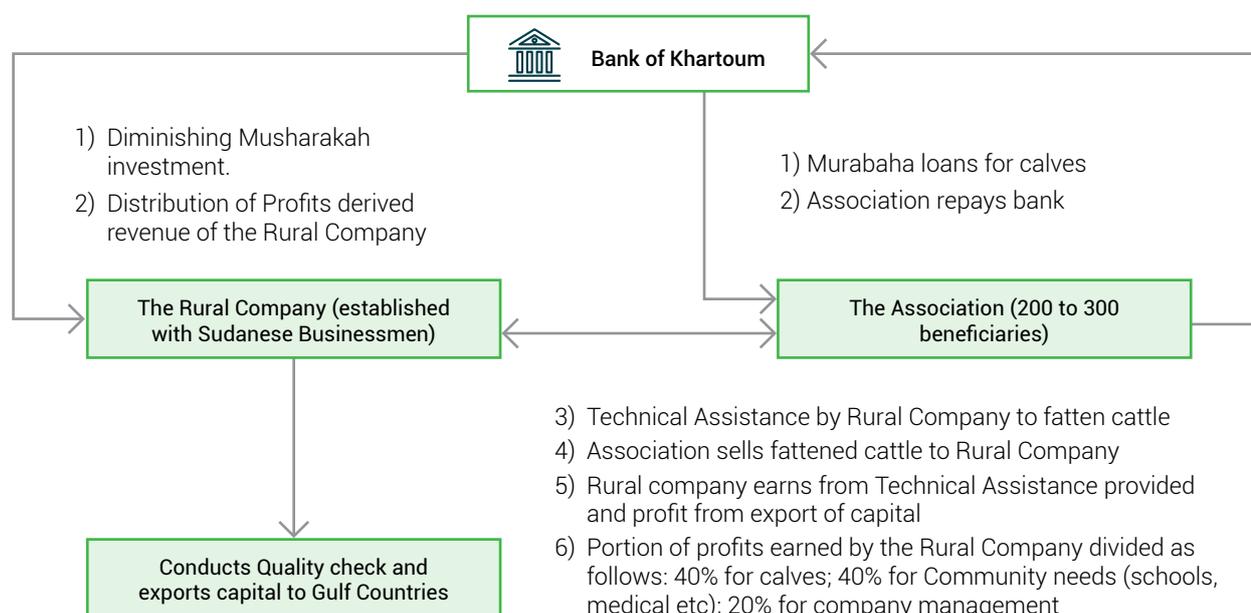
is used to purchase fixed assets and Alfalfa as well as for other operating expenses. These assets and services will be leased to the Wad Balal Association at 18% leasing profit which is also estimated at 21% of the export sales and 19% of local sales. This leasing profit will be used to purchase the shares of BOK over a period of 5 years including a 2- year grace period. When the Wad Balal Company's share increases over time, their share of profits will also increase. True to its social objectives, the Wad Balal Company has given an irrevocable guarantee to utilize their gained profits in the following manner: a) 40% to purchase more calves for the poor to enable more poor to join the association; b) 40% for social development projects (e.g. education, medical etc.); and c) 20% for the management of the company. Under the Diminishing Musharakah Agreement, the businessmen agreed to mortgage their land as collateral against negligence and mismanagement.

### Islamic Finance Product Details

Title	Wad Balal Cattle-Fattening Project
<b>Project Objectives</b>	Produce 7,000 cattle annually under export standards Link poor livestock herders with international markets Increase incomes of 250-300 poor families
<b>Approved Finance Amount/ Limit</b>	SDG 9.30 million (estimated about USD 1.68 million) for 250 to 300 families with the possibility of up to SDG 10.00 million. Direct investments include Hangers, Electric Source, Water Source, Fattening Supportive investment include Cooling storage, Services Facilities, Securities facilities, living allowance of beneficiaries and technical support. Equipment, Alfalfa mixture. (Total Assets SDG 2.78 million) Feasibility and startup expenses (SDG 0.33 million) Calves expenses – SDG 4.27 million Alfalfa expenses- SDG 1.16 million Other operating expenses- SDG 0.771 million
<b>Financing Tenor</b>	5 years
<b>Products Produced and expected revenue</b>	Target Production of 7,000 Fattened Cattle annually
<b>Target Return on Investment for BOK per annum</b>	15% per annum on Murabahah Fund 18% per annum on Ijarah of assets used for cattle fattening to the association. The leasing price is also estimated at 19% of local sales and 21% of export sales. The Ijarah profits is shared based on the share between Wad Balal Company and BOK based on Diminishing Musharakah after a 2 year grace period. Wad Balal Company will have an initial share of 5% with BOK contributing 95%. The Wad Balal Company will utilize the profits earned in the following manner: 40% for purchasing calves for Wad Balal Association 40% for conducting social development (i.e. CSR activities) in the area. 20% for the management expenses
<b>Target Returns for Beneficiaries (During Implementation Period)</b>	Monthly- SDG 2,100 per family (SDG 420 per beneficiary) including Living Allowance (SDG 300 to 600)
<b>Target Returns for Beneficiaries (After Implementation Period)</b>	Monthly- SDG 2,470 per family + 80% of profits earned by Wad Balal Company in the form of calves and social development activities
<b>Actual Return on Investment to Date</b>	NA (About to begin)

Title	Wad Balal Cattle-Fattening Project
<b>Target Groups and Beneficiary</b>	250 to 300 Poor Cattle Herds Families forming Wad Balal Association
<b>Islamic Financing Modes</b>	SDG 4.26 million using Murabahah to purchase Cattle for Wad Balal Association at 15% profit margin based on the following schedule: SDG 5.04 million using Diminishing Musharakah for Assets and other non-asset operating expenses. Profits will be generated from an Ijarah (leasing) profit of 18%
<b>Non-Financing Intervention/ Services</b>	Detailed feasibility study Conduct Tender to construct infrastructure Engage an expert to provide technical support throughout project lifetime to ensure production quality and cattle vet services Help to link with Wad Balal Company (eminent businessmen with customers in the Middle East) Helped to manage the project accounts Formed and Registered Wad Balal Association of Farmers
<b>Stakeholders and Partners</b>	Wad Balal Company established by businessmen in the diaspora with the aim of developing the area (Diminishing Musharakah for expenses and assets). This company will lease the assets to Wad Balal Association. They will also purchase the cattle from Wad Balal Association and sell it to their customers Wad Balal Association formed by poor livestock families
<b>Guarantees and Collaterals</b>	Livestock production assets- 45% Wad Balal Company Guarantee – 55%
<b>Identified Risks and Mitigation Measures</b>	Inability to sell calves- Wad Balal Company which has strong export links with the Middle East have committed to purchase the cattle at a fair price. Cattle infected with disease- On site veterinarian services to treat and prevent cattle diseases. Cattle does not meet the required specifications (e.g. health, weight) for export market- On site technical services provided to teach farmers how to improve the value of their cattle. Inability for families to live a suitable life that will lead to a lack of commitment- Families provided living allowance a month. Lack of Commitment by beneficiaries- Ability for BOK to remove beneficiary and replace them with another worker. Beneficiaries have to sign into work and their performance is monitored. Bank has the prerogative to distribute a larger proportion of profits based on performance and commitment. Wad Balal Association also monitors performance. Other third party risks – Insurance purchased by the project

### Product Diagram - Wad Balal Cattle Fattening Project



## ► CASE STUDY 3:

### Localization of Moringa and Jethropa Project



The concept of this project was originated as part of the partnership between the Bank of Khartoum, Islamic Development Bank and the International Business Finance Group (Consultant). After conducting market study and needs assessment covering majority of the region, it is found that there is a potential in growing the two crops to enhance income generation of small farmers.

The idea is to efficiently utilize the 3 acre land availed to each small farmer family by the Ministry of Agriculture in Sudan, not only in planting subsistence crops, but also cash crops. Following up this opportunity, the BOK partnered with a local company dealing with Moringa products, Ishraqa Khadra Co., and conducted a detailed feasibility study of a project to empower farmers to produce Moringa as cash crop.

The project targets 150 families, mostly graduates in agriculture, in village communities. The families will be grouped in 10, with 30 acres of land. Each family will utilize 2 acres by cultivating 8 type of subsistence

The Bank of Khartoum will finance the infrastructure for the groups of farmers in form of electricity, water source and network, cultivation equipment and implements, service facilities, inputs , and living cows, livestock feed, and inputs for horticulture planting. The payment of the total infrastructure will be in a specific amount of Moringa seeds and Alfalfa, and Jatropha seeds which will be delivered each time they are harvested. The farmers will get the excess of Moringa and Jatropha harvest as their additional income.

horticulture crops, while the 1 acre will be planted with Moringa and Jatropha trees. Moringa is a tree with a wide range of medical use and there is a high demand from local and international markets. The Jatropha trees will mainly be planted for their oil and exported as bio-fuel (one of approved bio-fuels by IATA). The families then will plant 1,800 Moringa trees and 520 Jatropha trees with the 3 acres of land provided by the government.

The Bank of Khartoum will finance the infrastructure for groups of 10 farmers in the form of electricity (source and grids), water source and network, cultivation equipment, service facilities, inputs (seeds, fertilizers, pesticides), and living allowance in form of 2 cows, livestock feed, and inputs for horticulture planting. The payment of

the total infrastructure will be in a specific amount of Moringa seeds and Alfalfa, and Jatropha seeds which will be delivered each time they are harvested. Any excess of Moringa and Jatropha will be harvested for additional income.

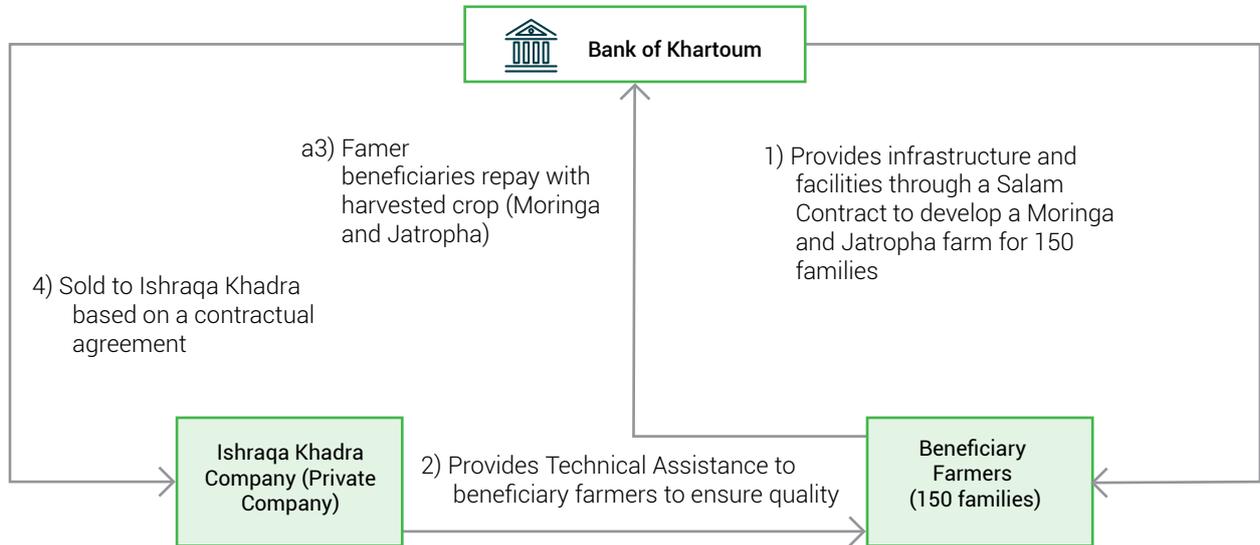
The Bank of Khartoum also assisted the farmers by linking them to the private sector buyers. The Ishraqa Khadra Co. signed a pledge to buy all the produce of the Moringa plant, from both the Bank of Khartoum and the farmers. The company also provides technical expertise through assisting the farmers in cultivating and harvesting the crops, so that the product quality is according to the required standard.

### Islamic Microfinance Product Details

Title	Localization of Moringa and Jatropha
<b>Project Objectives</b>	<ul style="list-style-type: none"> <li>To empower families and graduates in producing cash crop to increase their livelihood</li> <li>To boost the production of cash crop Moringa and Jatropha for domestic consumption and export</li> </ul>
<b>Approved Finance Amount/ Limit</b>	SDG 11.00 million (USD 3.50 million)
<b>Financing Tenor</b>	3 years framework, 9 month grace period for Alfalfa, and 18 month grace period for Moringa and Jetropha. Salam delivery each 6 month for Alfalfa, and 12 month for Moringa and Jetropha.
<b>Target Return on Investment for BOK</b>	20%
<b>Target Returns for Beneficiaries (During Implementation Period)</b>	Monthly- SDG 2,100 per family (SDG 420 per beneficiary)
<b>Target Returns for Beneficiaries (After Implementation Period)</b>	Monthly- SDG 2,625 per family + ownership of Moringa & Jetropha Farm Project assets
<b>Actual Return on Investment to Date</b>	18%
<b>Target Groups and Beneficiary</b>	Rural poor villagers. 150 families (approx. 600 beneficiaries), grouped in 10 families per financing
<b>Islamic Financing Modes</b>	Salam (shiraa) with the farmers for Moringa and Jatropha, Salam (bay') with buyers – Ishraqa Khadra Co., Murabahah with farmers for buying cows/livestock
<b>Non-Financing Intervention/Services</b>	<ul style="list-style-type: none"> <li>Feasibility study – Ishraqa Khadra Co. and Bank of Khartoum</li> <li>Technical expertise to ensure production quality – Ishraqa Khadra Co.</li> <li>Support facilities (electricity, water, equipment and implements) is included in Salam price</li> <li>Agriculture inputs (seeds, fertilizers, pesticides etc.) is included in Salam price</li> <li>Living expense (vegetable cultivation and livestock breeding) is included in Salam price</li> <li>Marketing of products. Beneficiary pays in commodities to Bank of Khartoum, which will sell the products to Ishraqa Khadra Co.</li> </ul>

Title	Localization of Moringa and Jatropha
<b>Stakeholders and Partners</b>	Ishraqa Khadra Co.
<b>Guarantees and Collaterals</b>	<ul style="list-style-type: none"> <li>• No Collaterals</li> <li>• Ishraqa Khadra Co. provides a technical expertise to ensure quality of the products.</li> <li>• Ishraqa Khadra Co. provides a unilateral promise to buy the products of the farmers</li> <li>• Ishraqa Khadra Co. provides guarantee of delivery of products by farmers</li> </ul>
<b>Identified Risks and Mitigation Measures</b>	<p>Ishraqa Khadra Co. dishonor the promise to buy – the Products chosen has been through a feasibility study and qualified as globally traded</p> <p>Farmers' negligence – the Salam contract was used, not Mudarabah. In case of non-delivery, the guarantee from Ishraqa Khadhra Co. can be exercised</p>

**Product Diagram - Moringa and Jetropha Project**



## ► CASE STUDY 4:

### Solidarity Group Financing – Farmers to Market (F2M)



The F2M program is another collaboration between the MFU of Bank of Khartoum and the Central Bank of Sudan, Ministry of Agriculture, Ministry of Social Welfare, Zakat Chamber, World Food Program and Government of Sudan's Strategic Food Security Reserve. The concept of this project was also originated by the partnership between the Bank of Khartoum, Islamic Development Bank and the International Business Finance Group (Consultant).

The idea is to improve the productivity of small farmer families in producing staple crops for food security. The Department of Agriculture Extension of the Ministry of Agriculture will provide training and demonstrations to the farmers on good practices in cultivating the land to plant sesame, millet, sorghum, corn and Sudanese bean.

The project targets 73,000 farmers, in 878 farmer groups. The Bank of Khartoum will provide microfinance for buying inputs, equipment for land development and harvesting and working capital. The repayment will be in form of a specific amount of staple crops which will be delivered each time they are harvested. The Bank of Khartoum will sell the yield to the Strategic Food Security Reserve and the World Food Program

The project targets 73,000 farmers, in 878 farmer groups spread across the country. Each group cultivates land of between 5-10 acres. The Bank of Khartoum will provide microfinance for buying inputs, equipment for land development and harvesting as well as working capital. Each farmer will receive not more than SDG 500 for all stages (land development, planting, and harvesting). The repayment will be in form of a specific amount of staple crops which will be delivered each time they are harvested (maximum 8 month). The Bank of Khartoum will sell the yield to the Strategic Food Security Reserve and the World Food Program.

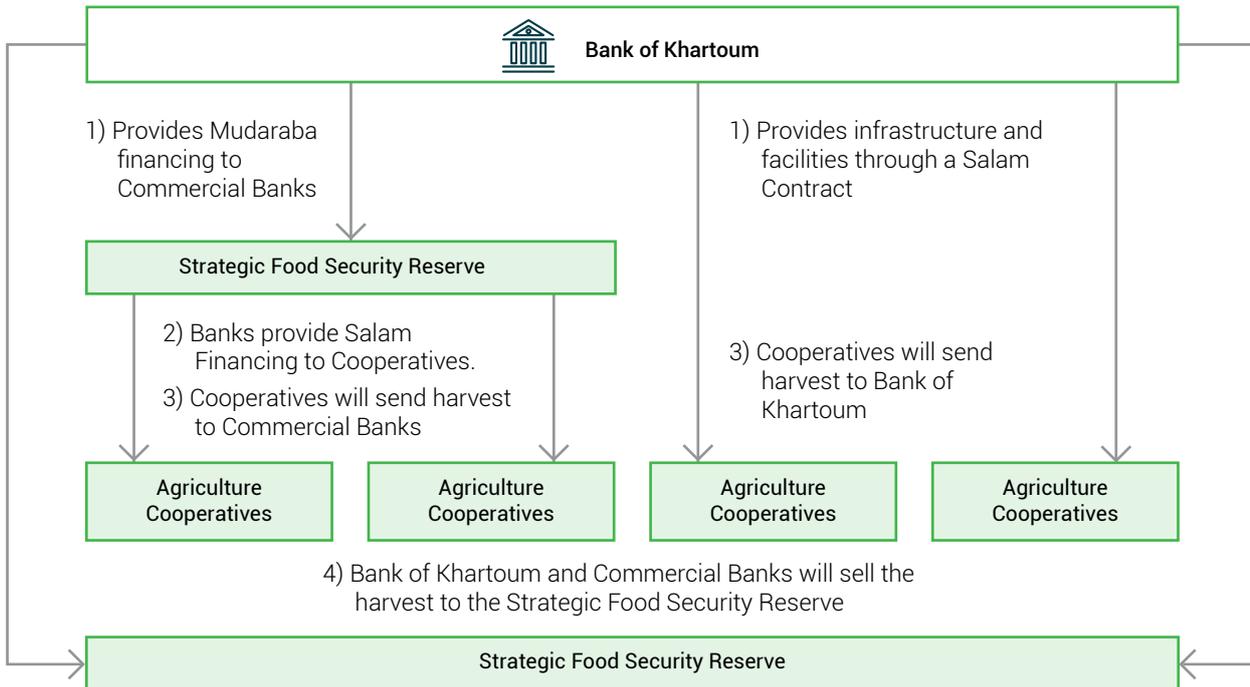
In collaboration with the Department of Agriculture Extension, Bank of Khartoum also assists the farmers by providing continuous follow-up and capacity building in managing and governing the farmers' association. The Department of Agriculture Extension also provides

technical expertise assisting the farmers in cultivating and harvesting the crops, so that the product quality is according to the required standard. During the planting period, the World Food Program will provide farmers with subsistence food for work.

### Islamic Finance Product Details

Title	Linking Farmers to Market Project (F2M)
<b>Project Objectives</b>	<ul style="list-style-type: none"> <li>To support and empower small farmers and link them to markets</li> <li>To strengthen the food security of farmers and uplift the farmers from the vicious cycle of poverty</li> <li>To achieve self-sufficiency for farmers and surplus in production for markets</li> </ul>
<b>Approved Finance Amount/ Limit</b>	USD 8.22 million, each SDG 500 (30% for seeds purchase, 30% for land development, 30% for harvest)
<b>Financing Tenor</b>	Maximum 8 month
<b>Target Return on Investment for BOK</b>	20%
<b>Target Returns for Beneficiaries (During Implementation Period)</b>	Monthly- SDG 2,100 per family (SDG 420 per beneficiary)
<b>Target Returns for Beneficiaries (After Impl. Period)</b>	Monthly- SDG 2,625 per family
<b>Actual Return on Investment to Date</b>	18%
<b>Target Groups and Beneficiary</b>	73,000 smallholders under 878 Farmers Association in 7 states (23,677 through direct contract, and 48,396 through Mudarabah with other commercial bank)
<b>Islamic Financing Modes</b>	Salam (shiraa) with the farmers, Salam (bay') with Govt. of Sudan's Strategic Reserve, Mudarabah with commercial banks
<b>Non-Financing Intervention/Services</b>	<ul style="list-style-type: none"> <li>Technical feasibility study and linking the farmers with other partners (Bank of Khartoum)</li> <li>Technical assistance for product quality (Min. of Agriculture extension service)</li> <li>Food for farmers during the planting period (World Food Program)</li> <li>Grouping the farmers to associations (Farmers Union, Bank of Khartoum)</li> <li>Coordination and monitoring of partners activities (Bank of Khartoum)</li> <li>Building the capacity of farmers group in management and follow up (Min of Agriculture extension, Bank of Khartoum)</li> <li>Link farmers to local, regional, and global market (Bank of Khartoum)</li> </ul>
<b>Stakeholders and Partners</b>	Bank of Sudan, 3 commercial banks, World Food Program, Insurance / Takaful Companies, Federal Ministry of Agriculture Farmers Union, Ministry of Social Welfare, Zakat Chamber, Strategic Inventory Department
<b>Guarantees and Collaterals</b>	<ul style="list-style-type: none"> <li>Group reference</li> <li>Crop Insurance (takaful companies)</li> <li>Guarantee (Zakat Chamber)</li> </ul>
<b>Identified Risks and Mitigation Measures</b>	<ul style="list-style-type: none"> <li>Bloated operational expense due to extensive numbers of beneficiaries – Salam is conducted with associations of 50 – 100 farmers.</li> <li>Delinquency / non-performance of farmers – Group mechanism will create a social push for farmers to conduct their promise</li> <li>Crop failure – Takaful</li> <li>Business failure – Zakat chamber</li> <li>Unfavorable market price – the crops produced are staple and substantial crops (sesame/millet/corn/beans), which price is determined by the Govt. of Sudan.</li> </ul>

**Product Diagram - Linking Farmers to Markets**



## Bank of Khartoum Microfinance Unit/ IRADA Portfolio Analysis

### Portfolio Status and Achievements

At the end of its establishment year, 2009, the Microfinance Unit (MFU) of Bank of Khartoum was still mainly focusing on individual Murabahah financing. The investment of large size projects incorporating risk sharing mechanism such as Abu Halimah greenhouses started in May 2011.

**Outreach** – The total outstanding portfolio of the Microfinance Unit (2013) is around SDG 87 million or 2.15%, going down from 2.29% in 2012 (SDG 88 million). This is due to the repayment to the al-Aman fund. In terms of outreach, the MFU has reached more than 159,000 active clients (financing) since 2009. The average financing size was SDG 553, which is 11.77% of the Gross National Income of USD 1,500 per capita, highlighting the deep penetration of its operation as compared to the regional average of 12.87% in Africa<sup>4</sup>.

As a rule of thumb 20% level of average outstanding balance over GNI per capita is considered as adequate depth of penetration (Rosenberg, 2009). However, deep-diving into project level, it is found that on average the Value Chain Project Group Financing have much higher average financing size, which is around SDG 78,000 per household, or USD 15,000 per head. This constitute around 3 times GNI per capita, which in CGAP definition falls under SME Financing criteria.

**Portfolio Quality** – Innovation of the Value Chain Project Group Financing improved the Microfinance portfolio quality of the BOK. At the end of 2013, the default rate (Financing at Risk) was around 12% for individual Murabahah financing, while in the project financing the figure was 3% (actual yield lower than target ROI)<sup>5</sup>. This rate is much better than the country PAR>90 average of 22.94% or PAR>30 average of 28.63%, but is relatively

4. MixMarket Cross Market Analysis (Sept. 2014)

5. For Projects which focus in Mudarabah / Musharakah this should be measured by amount financing with daily / weekly yield lower than minimum required ROI, including negative yields. However since this information is not available, we use the proxy: "the amount of financing with weekly yield lower than target ROI"

high compared to the average in the African region (2.34% and 1.71%). According to the BOK, this is mostly due to the deteriorating economy after the South Sudan separation. However, the overall default rate / PAR of 6% is still within generally acceptable level in Microfinance practices (Rosenberg, 2009).

**Financial Sustainability** – Similarly, Project Financing's weighted average Return on Investment was 18%, above the ROI of individual Murabahah financing of 14% in local

currency. The profitability is at competitive level with median market benchmark, which is 1.8% in hard currency. Sudan as a whole is currently experiencing extra ordinary inflation regime after the South Sudan separation (more than 30%), and a mere 18% ROI may be considered thin to cover the inflation abrasion. However, the profit should be benchmarked with the normal inflation rate (11-12%) when the project was conceived, and therefore 18% local currency profit is a very promising and fair rate for businesses with the poor.

	OVERALL	Individual Murabahah	Solidarity Group	Value Chain Projects
<b>Total Clients</b>	≈167,400	≈95,000	72,000	400
<b>Active Clients</b>	≈157,400	≈85,000	72,000	400
<b>Total Financing (SDG mil.)</b>	185.20	128.00	26.00	31.20
<b>Outstanding Financing (SDG mil.)</b>	87.00	29.80	26.00	31.20
<b>Average Financing Size (SDG)</b>	553	351	361	78,000
<b>Average ROI</b>	16%	14%	20%	16%
<b>Default Rate / PAR</b>	6%	12%	2%	2%
<b>OSS FY</b>	1.15			

In terms of sustainability, Bank of Khartoum has a reasonable Self Sufficiency policy. Operational Self Sufficiency stood at 1.30 above the country average of 1.11 even though slightly below the regional average of 1.35 for Africa<sup>6</sup>. As the figure for the Microfinance Unit was not attainable, we consider that the Microfinance Unit Self-Sufficiency policy will be at the same level as Bank of Khartoum.

**Efficiency** – The project financing also provide easier client monitoring and risk mitigation measures. In individual Murabahah financing, each Business Officer (BO – equivalent of credit officer) on average is servicing around 20 clients<sup>7</sup>, while in the project financing, the average Clients per Officer is 60. The nature of group financing in a localized project area enables the BO to operate more efficiently and monitor the business more closely. The BO involves deeply in the financed business, contributing his technical expertise and building the capacity of beneficiary at the same time. With the help of the technical partner, the BO can also identify the business associated risk together with the beneficiaries, and discuss risk mitigation measures as solutions.

## Analysis

From the facts above, there are several key takeaways from the case studies. Firstly, it is evident in the case of IRADA, that **Value Chain Project (VCP) group financing requires more commitment in terms of resources, as well as financing size**. Secondly, the **VCP group financing's risk mitigating mechanism has been observed to yield in a lower default risk** compared to individual financing. Thirdly, the **VCP Group Financing enables the MFIs to engage in risk sharing with very poor beneficiaries, departing from debt-based financing**.

Value Chain Project (VCP) group financing requires more commitment in terms of resources, yield in a lower the default risk compared to individual financing, enables the MFIs to engage in risk sharing with very poor beneficiaries, therefore it may play greater role in developing sustainable business model in financing the poor.

6. MixMarket Cross Market Analysis (Sept. 2014)

7. From interview with MFU

These findings suggest that **Value Chain Project Group Financing may play greater role in developing sustainable business models in financing the poor.**

The Bank is mitigating the business risk by providing all the required assistance including business network and environment to its business partner (the poor). This of course requires dedication of resources from the Bank of Khartoum, and the high overhead can only be compensated in projects with larger scale.

The above analysis underline the importance to pilot test and upscale the Value Chain Project group financing model in other regions and setting, which may provide complementarity to the existing microfinance model. The models can answer to the challenge of existing financing

demand and add into the potential of supporting the Micro and SME sector in addressing poverty alleviation, financial inclusion, and equitable economic growth.

In Sudan, despite the high devaluation regime following the separation with oil-rich South Sudan and financial embargo, the Micro and SME sector had prevailed and may serve as the future backbone of the National economic growth. With tripartite partnership model between financial institution, established market/business enterprises, and the local micro, small and medium entrepreneurs, the country could improve its productivity, self-dependency, and shock resistance with development of sustainable economy based on grass root businesses.

## ▶ Key Success Factors

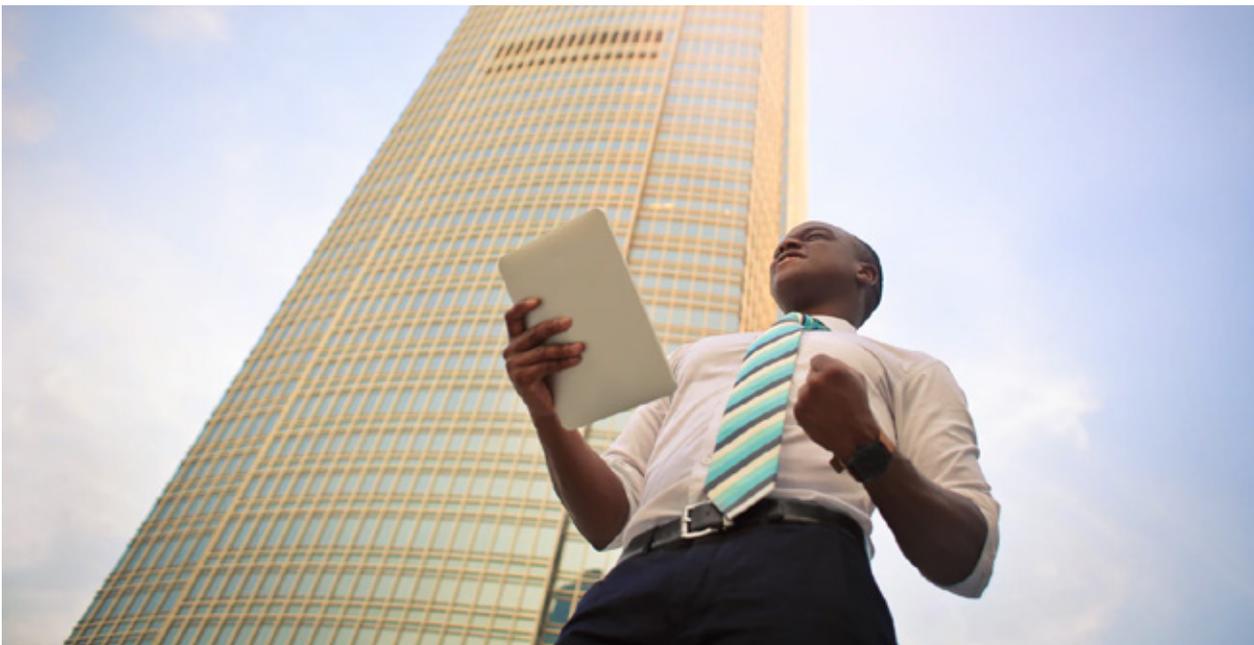
The experience of Bank of Khartoum shed light on several Key Success Factors that enabled the bank to effectively empower the Poor through the Innovative Financing Methodology. Some of the Key Success Factors are described as follows:

### Strategy

**Large project financing that benefit from economies of scale:** Bank of Khartoum realized that making and monitoring small investments would incur significant cost to the bank. Typically MFIs charge 25% to 30% per annum interest rates due to the high cost involved in

operationalizing the businesses. The high interest was not due to the high risk associated with lending with the poor. A bank employee monitoring 10 to 15 clients at one time that borrow an average of USD 1,000 will have about USD 15,000 to monitor at any one time. This amounts to managing a maximum of USD 300,000 per bank officer over 5 years. In comparison, bank officers that manage just one venture capital financing may manage about USD 4.00 million over the five year period.

**Engaged bank that is willing to manage the success of the project instead of relying to beneficiaries:** With only one project officer needed to only monitor one investment,



the project officer will be able to better manage and monitor the investment. The end beneficiaries will have better access to the bank officer who will ultimately work closely with the community to ensure that the project is a success. By being exposed to the risk of business failure, the bank will learn about every business issue and work with the community to find solutions. All decisions made will be made collectively with the goal of making fair profit for both the bank and the community of beneficiaries.

**Selecting sub-projects with possibility of replication:**

Bank of Khartoum develops investment opportunities similar to how business lines are developed. Whether it is the Salam product that has been rolled out for Moringa and Jetropha investments or Abu Halima Mudarabah project or the Wad Balal Diminishing Musharakah, feasibility studies were conducted to refine the business model and mitigate implementation risks involved. A pilot is then launched for each product and the model is improved during implementation. Once it is a proven success, the bank can easily replicate its experience in other locations in the country. By just replicating these three projects, Bank of Khartoum will gain the expertise in developing businesses in the area of Horticulture, Moringa, Jethropha and Livestock. As each business grows within the bank, so will the expertise, experience and knowledge in the field. The Return on Investments for replicated projects are expected to be higher due to the reduced cost of reviewing the feasibility study and the reduced learning curve of implementing the projects.

**Arrangement – Collaboration**

**Synchronization with National Development Plan** - the Bank of Khartoum has developed a close relationship with the government. It shares with them their investment plans and proposes assets where the government might consider in supporting. For example, diesel engines in the Abu Halima project were provided by the government. These engines will also be owned and maintained by the beneficiaries.

**Supportive national regulatory framework:** Sudan has a proactive regulator that encourages Islamic Banks to undertake equity startup investments like those conducted by Bank of Khartoum. Some regulators might shirk at the idea of a bank investing in a risky endeavor and prohibit exposing depositors' funds to any form of risk. While some of the external risks may be mitigated through takaful insurance operators, the main business risk would still need to be managed effectively by the bank.

**Government investment on basic infrastructure-** Basic infrastructure such as roads, bridges, electrical and

water supply etc. are necessary to support any economic activities. Government investment in infrastructure is a key consideration for private sector to invest in downstream activities. The lack of infrastructure in rural areas is a major hurdle preventing private sector investment.

**Leveraging on Waqf social investments for community benefit-**

Waqf can play two key roles in providing support financing. Firstly, similar to government financing, Waqf investment can help subsidize investments related to project assets or capacity building activities. Secondly, the project may involve the setting up of a Waqf business similar to the Wad Balal Company.

**Planning – Preparation**

**Conducting a thorough, consultative feasibility study:**

In each project, after a basic business plan was developed, a thorough feasibility study was commissioned by Bank of Khartoum to analyze the risks involved and develop the profitability scenarios. The study was developed in a consultative manner together with future clients, government, end beneficiaries, technical experts and many other stakeholders involved. It was important to seek the input of all stakeholders, not only to ensure that all stakeholders will support the project but also to ensure that the bank reflects on all risks and issues related to project implementation.

**Thorough selection of beneficiaries:**

Business angel investors often cite that the key success factor of any startup is the commitment of the entrepreneur. Same is true here and the bank should not arbitrarily select and partner people located in the same village. In fact, Bank of Khartoum undertakes a thorough selection process. In the Abu Halima project for example, Agricultural graduates are encouraged to apply to join the project. They are then interviewed where their technical skills, commitment and personal attitude are assessed. Unlike conventional banking, beneficiaries are not required to provide collateral. Once they have been selected through a competitive process, beneficiaries are required to sign a letter of commitment. If they do not meet up to the expectations spelled out in the letter of commitment, the bank has the unilateral right to exclude and replace the beneficiary.

**Assessment and Building the Capacity of beneficiaries:**

In every project, a technical consultant is hired to thoroughly assess the capacity building requirement of the beneficiaries as well as to develop the capacity of the beneficiaries in achieving maximum productivity for the

project. For the project to be successful, the productivity of the project would need to be higher than that was forecasted in the feasibility study. Beneficiaries should be open to accept new ways of farming, be disciplined, and work cohesively with the bank and the appointed consultant for the common goal of deriving maximum profit.

**Providing the necessary support investment:** The feasibility of the project will not only be determined by the commercial viability of production but also the commercial viability of bringing the product to market. It also includes measures of risk mitigation and its associated costs. An investor will only be willing to participate in a project where the risk involved is acceptable to the expected returns generated when the product is brought to market. Government grants or Waqf investments may be utilized to provide the upstream infrastructure needed to support the investment in downstream economic activities.

### Implementation Arrangement

**Decentralization of decision making:** Having dedicated bank investment officers to every project would not have been effective if they are not empowered themselves. These project officers are given the authority to decide payments, collect receipts and have the ability to run the day to day business of the project with little interference from bank management. Bank management are updated daily on the project progress and leave it to the officers to work for maximum profitability. Besides being empowered, bank investment officers also receive bonus payments if the project they are in charge of does well (i.e. achieves or exceeds financial and social targets.)

**Established project governance:** Decentralized decision making may be abused if there was not proper governance structure. Even though project officers need not approach bank management for most decisions, decisions of payments are made with the end beneficiaries. Every payment is also counter signed by bank managers found in the branches. In addition, every project is audited.

**Constant monitoring and improvement while mitigating risks throughout project cycle:** Each investment project has a dedicated bank officer who is tasked at monitoring the implementation of the project on a daily basis, record the expenses and revenues generated and raise any issues or risks faced by the project to the management. The end beneficiaries will have in the bank a true partner who will work with them to improve profitability. Since all expenses incurred by the business will erode the profits

of both the bank and the end beneficiaries, such decisions are taken in a collective manner. Bank management will also be able to compare the target and actual profits generated by the project and suggest corrective measures if needed.

**Effectively negotiating and managing customers:** Bank of Khartoum has been able to mitigate the risk of business failure by linking the projects to reputable and stable customers. Abu Halima has two major supermarkets as their clients, willing to purchase the company's produce. Wad Balal also has ready overseas customers keen on purchasing the supply from the company. These large companies are willing to: a) purchase large quantities on a regular basis; and b) pay a fair price for the produce. This is because Bank of Khartoum is seen as a reliable partner which will ensure a steady supply of the produce. By eliminating the middleman, Bank of Khartoum is able to share the profits with its clients.

### Client Orientation

**Ensuring fair and equitable distribution of profit throughout project life cycle:** In every feasibility study, the focus are not just the returns that will be obtained by the bank but also the returns to the client. The amount of returns need to be sufficient for supporting a family with up to four children. This amount in Sudan is calculated to be about SDG 2,100 per month. It is imperative for the bank to prioritize the income of its poor partners first. The bank must be ready to be flexible in its repayment plans and defer payment where required. If clients perceive the bank is taking advantage of its superior bargaining power, the relationship will collapse and the bank's overall investment will be in jeopardy.

**Bank exits project with assets transferred to the end beneficiaries in an institutional manner:** The goal is to ensure that the end beneficiaries will be sufficiently compensated during the project implementation so that they will remain committed. Although the bank will be the main partner driving growth, its beneficiary partners should not remain dependent of the bank after that period. Beneficiaries are partners in this relationship and are not working for the bank. By limiting the bank's involvement to a maximum of 5 years, the bank not only is able to recover its investments in a reasonable period of time but it also leaves sufficient time to develop the capacity of its end beneficiaries to take over the project assets. The beneficiaries will look forward to fully owning their project and larger profits when the bank exits its investment.

## ► Conclusion: Opportunities and Recommendations for IDB

Many of the Key Success Factors experienced by Bank of Khartoum are also relevant for IDB as an Islamic Financial Institution. In order to enhance its role as a catalyst for employment creation, IDB needs to develop its expertise in investing and developing the capacity of Islamic Banks that are mandated to do so. As an Islamic Financial Institution in its own right, it should also look at ways how it can enhance its value addition to its MFI partners. Some of the opportunities for IDB include the following:

- 1) Promote Inclusive Islamic Finance to Champion 'Smart' Financing solutions including conducting Solidarity Group and Value Chain Project (VCP) Group Financing. Other Case Studies of projects financed/ invested by IDB (eg. Benin, Palestine, Guinea etc.) should be undertaken. Once documented, IDB should promote this methodology to its investees and other Microfinance Associations and organizations such as Sanabel, AgFund, CGAP etc. These Case Studies should be shared with other MFIs during reverse-linkage workshops/conferences that are organized regularly to share best practices.
- 2) IDB can take the lead in developing the capacity of MFIs keen on Islamic Microfinance by providing templates for collecting data as well as a repository of manuals, tools and strategies on how a MFI can introduce Islamic Financial Products used in individual, Solidarity Group, or VCP Group Financing. IDB will also have a repository on previous Market Studies, Beneficiary Needs Assessment Studies and Feasibility studies that were conducted by MFIs. To do this, IDB may engage Bank of Khartoum and other partners/ consultants to develop the toolkits, templates and manuals. The details of these and other activities can be found in [Annex-1](#).
- 3) IDB and ICD has substantial equity investments in Islamic Financial Institutions. Similar to how the Central Bank of Khartoum has developed a policy for all banks in Sudan to allocate 12% of its lending portfolio to beneficiaries that have been identified as poor (i.e. Microfinance), IDB Group should take the lead in advocating that every financial institution should allocate a similar proportion of their lending portfolio to the poor as part of their efforts of contributing to IDB Vision 1440H pillar of Alleviating Poverty. Each Islamic Financial Institution should advocate or operate Inclusive Islamic Finance through a specialized subsidiary.

IDB is appropriately and uniquely positioned to take the lead in Inclusive Islamic Finance to the world of donors and other global stakeholders. By developing the Inclusive Islamic Finance industry, IDB is able help its Member Countries to generate employment, alleviate poverty and promote economic growth through the creation of mini-development banks invested by IDB or have a line of finance provided by IDB, similar to Bank of Khartoum. By creating these 'multipliers', IDB will be better positioned to create a significant impact to its Member Countries- directly contributing to the achievement of Vision 1440H.



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# ▶ Annex 1: Promoting Value Chain Project Group Financing among MFIs

## Regulatory

**Assist MFIs in obtaining regulatory acceptance for Islamic Microfinance activities from Central Bank/regulator:** The unconventional manner in which Bank of Khartoum is operating may not be possible under many banking regulations which prohibit banks from owning assets or conducting any form of trade. IDB would need to help the banks obtain freedom in conducting such investments on the basis that these are developmental investments that are being made which will generate jobs for the poor. Based on its experience in other countries, IDB should help countries draft Islamic Finance policy exceptions, bylaws or acts depending on the need of the country.

**Develop a central Shariah Advisory Committee service for Islamic Microfinance Institutions:** One of the key constraints of a small Islamic Microfinance Institution is that they are not able to finance individual Shariah Advisory Committees to provide guidance on the financial products are being developed in the bank. The secretariat for the Shariah Advisory Committee can be a repository of all documents, legal contracts, financial products based on transaction methods such as those mentioned above and serve as a knowledge centre for developing Shariah compliant financial products. IDB's current financial product development centre may evolve to play this function.

## Capacity Building- Toolkits, Manuals, Studies and MIS system

**Develop Islamic Microfinance capacity development toolkit:** One of the key value add that IDB can provide in addition to funding is the internally generated Islamic Microfinance Capacity Development toolkit which will include Standard Operating Procedures, Governance processes, Audit requirements, Legal Documentation, Technical Best Practices, Feasibility Study Templates, Investment procedures, Monitoring & Evaluation Procedures etc. These toolkit will be improved internally and updated annually to incorporate IDB's experiences in this field.

**Capture Market Studies, Beneficiary Needs Assessment and Feasibility Studies developed by MFIs:** Developing quality feasibility studies is a key success factor for MFI investments. IDB should take stock of all feasibility studies conducted by MFIs so that it is able to benchmark one study from another. In addition, it is also possible

to replicate feasibility studies by customizing a study to another country. It would also be cheaper and more efficient to hire a consultant to validate the feasibility study instead of starting from scratch. There should also be internal capacity of IDB staff to help train and guide its partners to conduct feasibility studies of VCP Group Financing opportunities.

**Develop an Information System to monitor investments made by partner MFIs:** Recently, IDB has taken the lead in providing a Restricted Mudarabah investment under the Youth Employment Support Program. This is the first time any MDB is investing and sharing the risk with Microfinance Institutions. As the Rabbul Maal (investor), IDB is exposed to investments made by its Mudarib (fund manager) MFIs. In the Bank of Khartoum, all investments are closely monitored via an Islamic Microfinance Information System. Each project will be rated whether it has met its target revenues and profits on a monthly basis and a cumulative basis. Projects achieving the optimistic profits scenario will be rated green while those meeting the expected scenario as yellow and those falling below the expected scenario will be rated as red. This information will provide management with timely information on either addressing certain challenges faced by a project by either putting additional resources to overcome the challenge or to scale down the investment. IDB requires a similar system to monitor the investments made by its Mudarib MFIs.

## Developing Business Opportunities and Market Access

**Map out economic activity/ businesses of Islamic MFIs:** IDB should take stock of the production capabilities of the investments made by Islamic MFIs. It should be aware of the businesses these MFIs are involved in so that it can help boost trade and investment in its member countries. By mapping out the economic activity taking place in its member countries, IDB is able to identify and better comprehend the comparative advantage of their member countries in the specific industries and advise these countries to promote these industries to further enhance employment creation and cooperation between IDB member countries.

**Develop trading/investment opportunities between Islamic Microfinance Institutions:** This paper documents the sectors that Bank of Khartoum is involved in. It produces various horticulture fruits and vegetables including tomatoes, charlston peppers, livestock and

Moringa and Jetropha. As the equity shareholder, IDB should look at ways how it is able to open markets for these products through either: a) possible trade with other Islamic Financial Institutions; b) Introducing major clients in the GCC; c) Introduce clients by providing financing from ITFC; and d) Provide Export Insurance with ICIEC. When IDB is able to map out the economic activities invested by its MFIs, it is able to further assist these banks by developing export links. By promoting products of the MFIs, IDB can help to develop export markets and hence enhance demand for such products. Higher demand will translate into higher profits for the Islamic MFIs and its end beneficiaries.

**Promote 'smart money' investment opportunities through vertical expansion:** By having a steady business in livestock, it gives rise to other complementary businesses that Bank of Khartoum may consider to invest in. They may open a chain of restaurants or a chain of meat shops that can purchase from these projects. Similar to the franchising model, IDB may support the expansion of such activities by inviting a franchisor to invest or to help the bank to begin a similar franchise.

**Enhancing Advocacy of IDB's Methodology of Islamic Microfinance**

**Becoming a More Active Investment Partner:** As the Rabul Maal (investor), IDB should not restrict itself to merely providing the funds and receiving progress reports. It should also regularly monitor its investments by communicating with the Executing Agency and understanding what works and what does not work. IDB should be an active partner in advising the Mudarib (fund manager) to generate more profits.

**Introduce Islamic Microfinance in every Islamic Bank**

**invested by IDB:** IDB has been credited with promoting Islamic Finance by creating Islamic Banks or investing in existing financial institutions. Bank of Khartoum is a good example of a bank where IDB is a shareholder. Although the Microfinance Unit within the bank was triggered by the Central Bank of Sudan's policy for banks to allocate about 12% of loans made to the poor (ie through Microfinance programs). By embarking on the methodology described in this paper, Bank of Khartoum has been successful in conducting Inclusive Finance in a profitable manner enabling their Microfinance operations to expand even further. IDB should replicate this experience in other banks invested by IDB. In this way, IDB is able to effectively create multipliers or (mini-IDBs) which develops and invests in opportunities that creates jobs and improves the livelihoods of the poor.

**Develop a Rating system to encourage 'smart money' for Islamic products:** To encourage Islamic Microfinance to conduct their operations in the innovative manner done by Bank of Khartoum, IDB can develop a Rating system to encourage 'smart money' Islamic Financial products instead of the typical Murabahah financing carried out by many Islamic Microfinance Institutions. For example, the main value add of Murabahah financing is that the Islamic MFI is able to source effectively for the lowest price and transfer the benefits to its clients. Such transactions are conducted in the full spirit of the Islamic Finance which promotes banks as traders that value-adds in the value chain compared to mere fund providers. Such Islamic Financial products may be rated with 5 points. At the other end of the scale, MFIs which meet the minimum Shariah requirement of not absorbing late 'fine' payments as part of their income may receive a rating of zero points. An illustration of the rating scale can be found below. Similar rating scales can be developed for Istisna', Ijara, Salam etc.

▶ **Murabaha vs Fixed Term Loan**

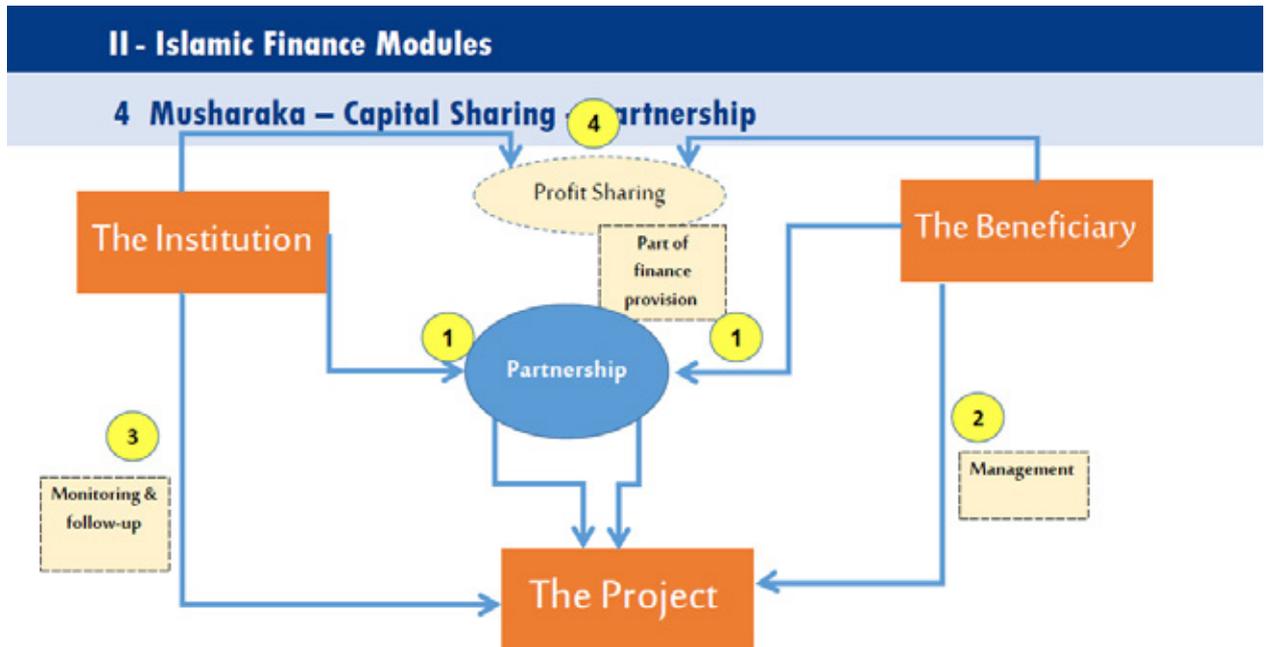
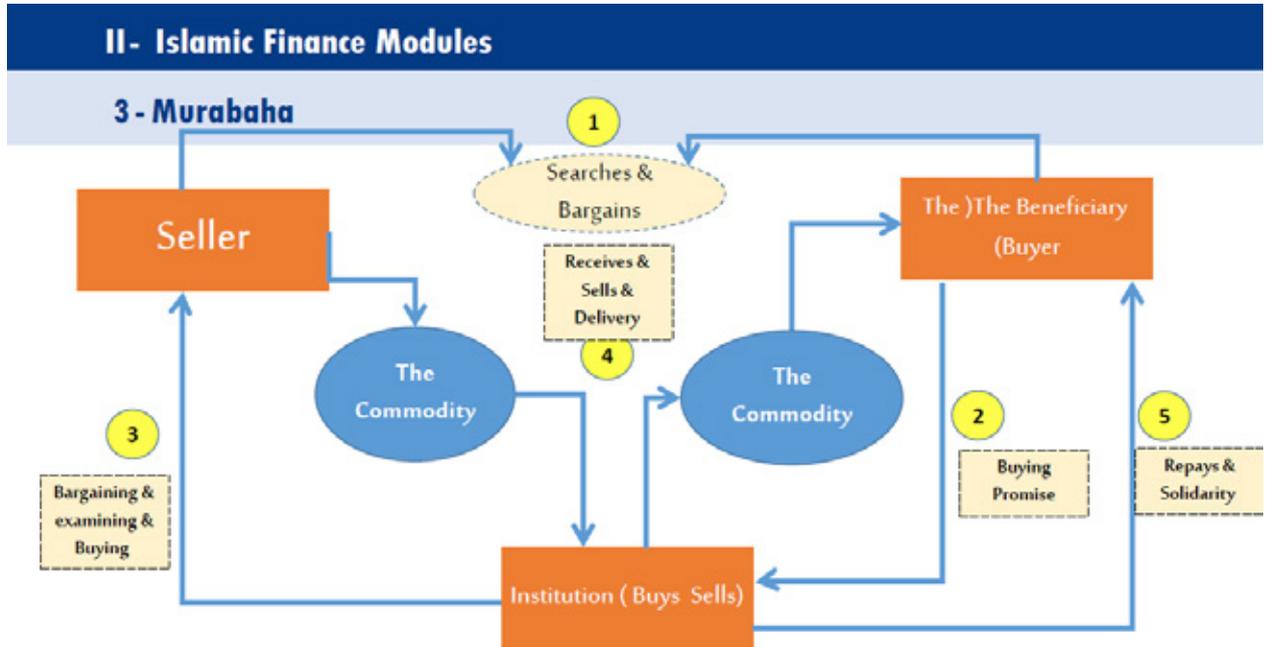
- ▶ MFI by product on behalf of client and sells it to client at a profit
- ▶ **Differentiating Factor:** FMI should be able to source effectively for the lowest price



Changes interest to profit, proper management of late 'fine' payments (0 points)	Pays directly to supplier and takes ownership of the products (1 point)	Pays, conducts quality check and transports products to client (2 point)	Sources product- price similar to conventional (3 point)	Sources product and sells at higher than spot price but lower than conventional rate (4 point)	Sources product at a lower than spot price to the client (5 point)
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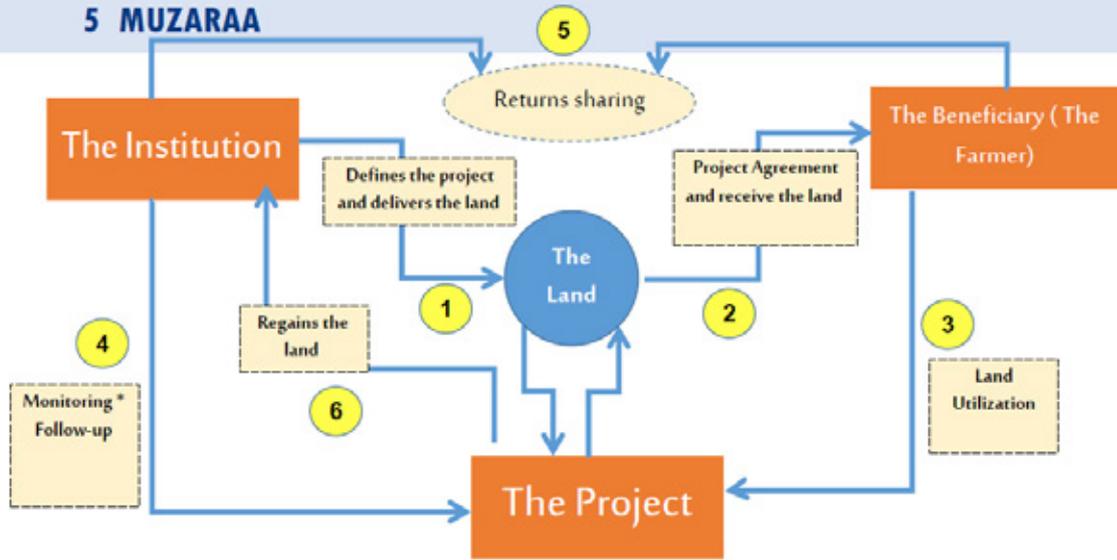
# Annex 2: Sharia Compliant Modes of Financing which are commonly used

(Lih, 2011)



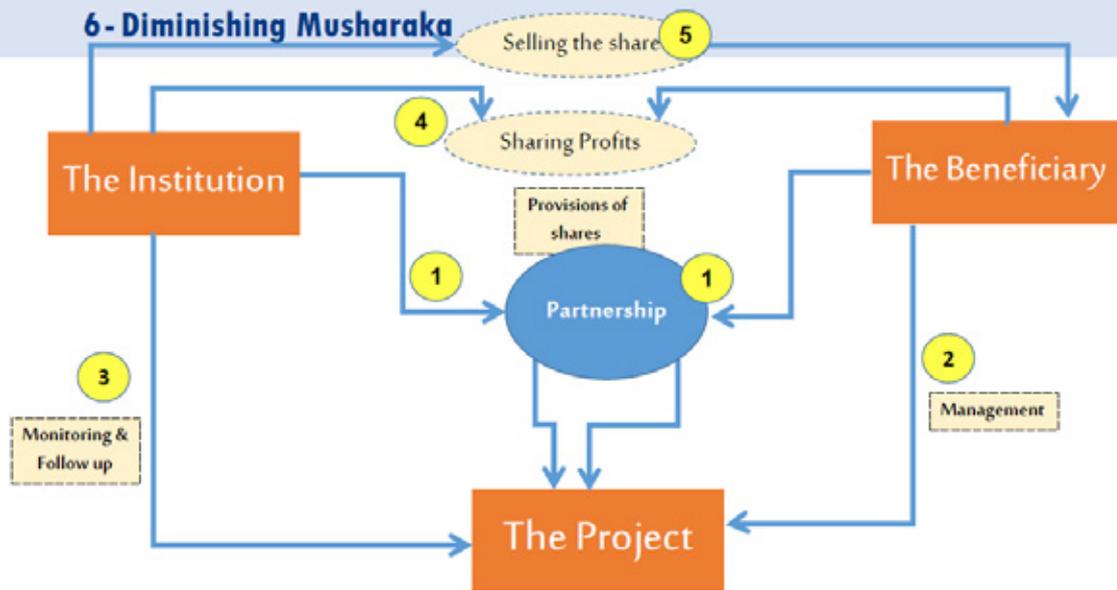
## II - Islamic Finance Modules

### 5 MUZARAA



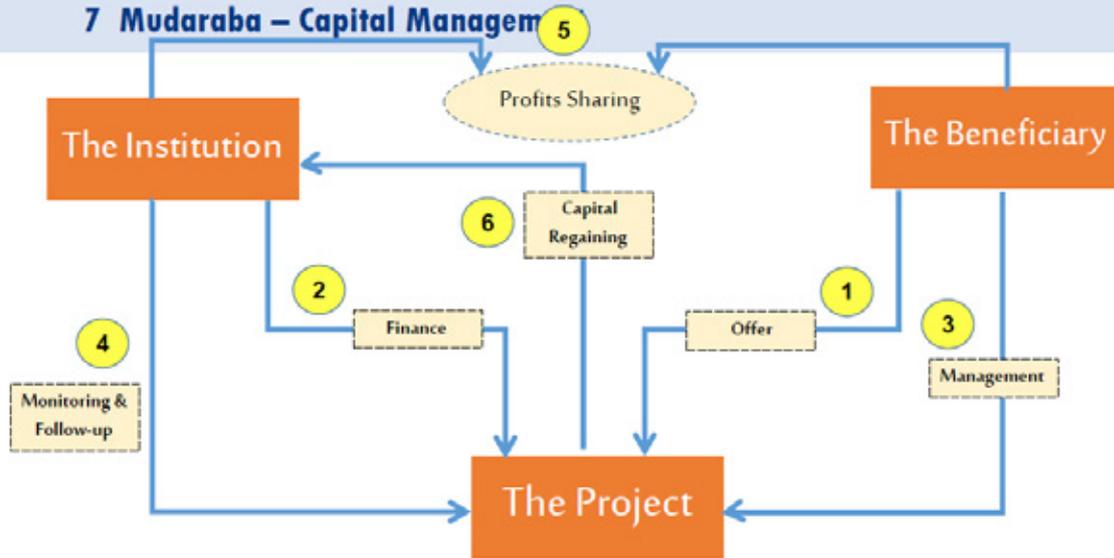
## II - Islamic Finance Modules

### 6- Diminishing Musharaka



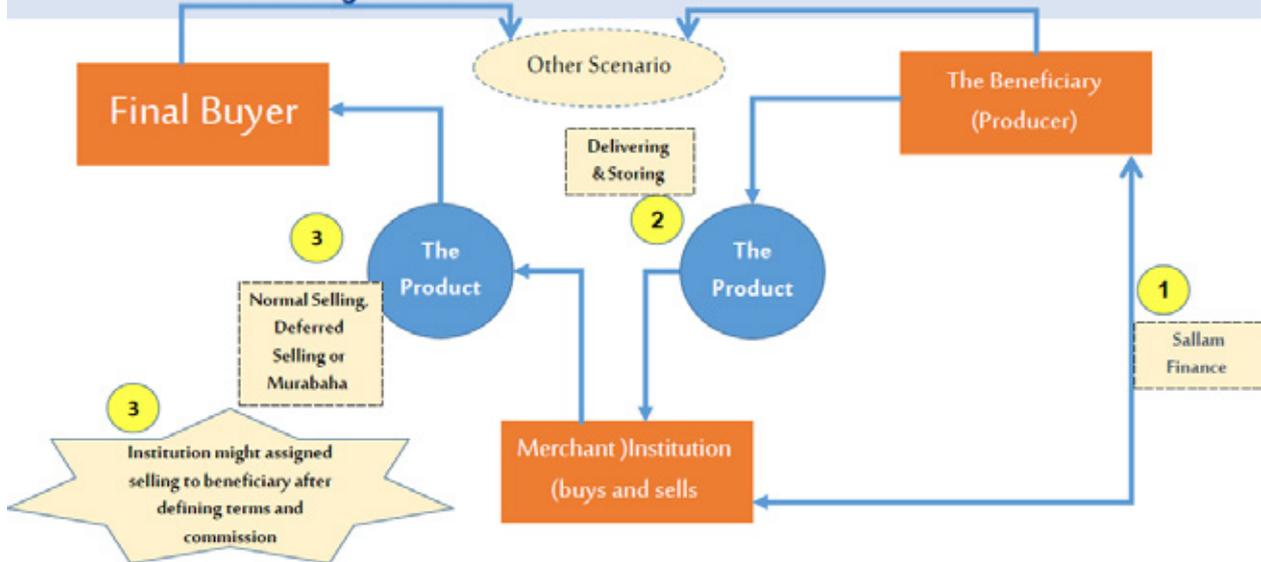
## II - Islamic Finance Modules

### 7 Mudaraba – Capital Management



## II - Islamic Finance Modules

### 8 Sallam- Selling In Advance



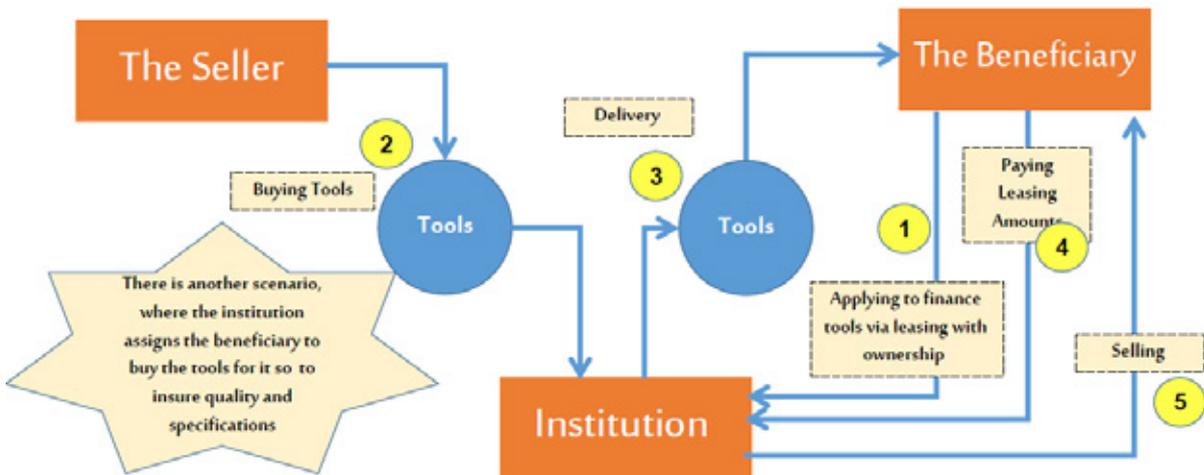
## II- Islamic Finance Modules

### 9- Manufacturing



## II- Islamic Finance Modules

### 11 - Leasing with Ownership



## ► Annex 3: IDB and ISFD Portfolio of Micro and MSE Finance Projects

### **Line of Financing (Agriculture and Rural Development Department)**

Microfinance Support Program (in collaboration with ISFD):

- *Guinea (USD 1.03 million disbursed)*
- *Bangladesh (USD 15.40 million disbursed)*
- *Maldives (USD 3.00 million disbursed)*
- *Cameron (USD 1.034 million)*
- *Senegal (USD 3.44 million)*
- *Senegal (USD 3.0 million disbursed)*
- *Tunisia (USD 5.10 million disbursed)*
- *Jordan (USD 10.45 million committed)*
- *Mali (USD 1.3 million committed)*
- *Kyrgyz Republic (USD 5.3 million disbursed)*
- *Tajikistan (USD 10.32 million committed)*
- *Chad (USD 6.5 million committed)*
- *Egypt (USD 10.18 million committed)*
- *Sudan (USD 17.33 million committed)*
- *Benin (USD 10.45 million committed)*
- *Kazakhstan (USD 10.32 million disbursed)*
- *Albania (USD 5.30 million committed)*
- *Cote d'Ivoire (USD 11.00 committed)*
- *Iran (USD 5.00 million in the pipeline)*

Youth Employment Support Program:

- *Tunisia (USD 50.32 million committed)*
- *Egypt (USD 50.32 million committed)*
- *Libya (USD 50.32 million committed)*
- *Morocco (USD 50.00 million in the pipeline)*

Stand-alone project – MSME Finance

- *Maldives (USD 10.30 million committed)*

### **TA, Equity, and Funds (Islamic Financial Services Industry Department)**

Microfinance Development Program

#### **Sudan:**

- *Bank Al-Usra – US\$300k TA for capacity building in Islamic microfinance completed.*
- *Bank Al-Khartoum - US\$ 3.5 million equity in IRADA MFI*
- *Al-Ebdaa Bank - US\$ 1.25 million equity under process (Sponsor: AGFUND)*

#### **Bangladesh:**

- *Islamic Microfinance NBF1\_- Equity to set up Bangladesh's first specialized Islamic microfinance institution under process*

#### **Senegal:**

- *Phase I - US\$300k capacity building TA for enabling environment completed.*
- *Phase II - Investment in MFI. Under process.*

#### **Indonesia:**

- *Proposed US\$50m Islamic Microfinance Fund - under process.*

Phase II countries for which feasibility studies are being conducted for Egypt, Tunisia, Pakistan and Tajikistan.



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