Paving the Way Forward for Rural Finance
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Case Study

Risk Management: Islamic Financial Policies

Case Study of Farmers' Commercial Bank

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Contents

Introductory Information

1-1 General:

Farmers' Bank for Investment and Rural Development (FBIRD) was established in 1992 as a common share-holding company. The bank's main shareholders are farmers and their federal unions and organizations. There are more than 9,456 shareholders, who own more than nine million shares. It is one of the largest broad-based and publicly owned companies in the country. The FBIRD, soon after forming, took over the ownership of the Sudan Commercial Bank (SCB), a government owned bank that was declared for sale and privatization. The SCB remained a separate entity for about four years. In 1998 a merger between FBIRD and SCB took place which paved the way for the Farmers' Commercial Bank to continue the mission of the former FBIRD. That mission is to achieve the following:

1-Financing the agricultural, industrial, trade and export sectors.

2-Making production inputs available for both plant and animal production.

3-Developing rural Sudan through financing integrated development projects.

4-Creating a conducive investment atmosphere for the farmer.

5-Providing a comprehensive and distinguished banking service.

6-Operating in the area of foreign exchange.

FCB now covers a wide geographical area through its twenty-eight branches. Also its financing disbursements have advanced direct credits to more than 4,200, 2,479 and 3,243 individuals for the years, 2000, 2001, and 2002 respectively. Moreover, the bank financed a number of rural agricultural projects, based on rent contracting between the government as the land owner and the farmers as cultivators, such as the Geziera Scheme, the Rahad Scheme, the Suki Scheme, and the Blue & White Nile Schemes. The total amount of cash financing allocated to those projects for the farming seasons 98/99, 99/2000, 2000/2001 were more than 7, 3 and 1.7 SDD billion respectively (US $ = SSD 265). It is worth mentioning here that the bank encouraged the importation of farming inputs such as fertilizers, pesticides, etc from abroad through facilities from the exporters. The bank in turn provided commodity loans for these inputs to the farmers, either directly or through their projects' administrations. The Sudan Cotton Company which monopolizes the country's cotton production marketing, provides the bank with needed mortgage, through issuing an order to the central bank to deduct the value of the concerned inputs from the foreign cash returns of exported cotton. The central bank provides the inputs' exporters with needed mortgages concerning the bank (the importer).

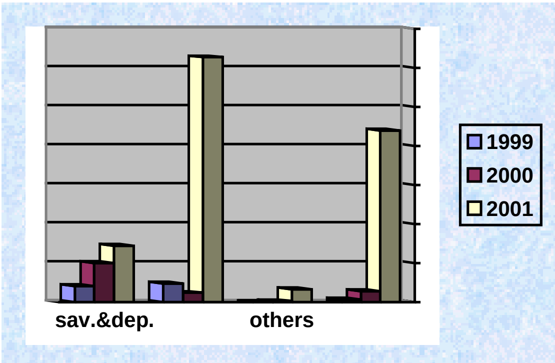
The experience of the Farmers' Commercial Bank is unique and distinguished due to the fact that most of the shareholders are farmers and rural inhabitants, who are able to sit on the board of directors and affect the bank's plans and policies for their own benefit. Moreover, FCB pays more attention to the farmers themselves rather than simply focusing on their economic activities as the case with the other banks. Thus the bank engages in provision of loans for building of classrooms, provision of electricity, provision of water services, etc.

1-2 Finance Distribution & Deposits Attraction

Table (1) shows the bank's total deposits and savings and the total rural and non-rural financing for the period 1998-2001. According to table (1), the average percentage of loans allocated for agriculture and other rural activities for this period was more than 63% of the total amount of financing. This can be attributed to the fact that agriculture is the main rural activity practiced by more than eight percent of Sudan's rural inhabitants. The potential area for cultivation in the country is about eighty million hectares. However, only about 25% of it is actually cultivated due to limited financial resources. The estimated financial needs for full utilization of such available resources is estimated to be US $ 2 billion. The available funds are far less.

Table (1) shows deposits, savings and the rural finance

		rural finance			total finance	
year	deposits &savings	agri	others	non ruralfin.	amount	%
1999	4104	85.70%	1.60%	12.70%	5542	100.00%
2000	9968	43.30%	4.80%	51.90%	5498.5	100.00%
2001	14486	57.10%	3%	40%	10977.7	100.10%



1-3- The other rural activities, include the following**:**

1- Social service activities such as loans for drilling water wells, inputs for electricity and water services, building of classrooms and clinics.

2-Handicrafts such as leather working, carpentry, metal working, and vehicle maintenance workshops.

3-Small-scale industrial projects such as oil extracting, soap- making, and seeds milling.

4-Small-scale productive family projects such as milking goats, small-scale poultry projects, charcoal making, animal drawn equipment, and tailoring.

5-Professional activities such as private clinics and health centers for doctors, agricultural service centers, and engineering service centers.

When comparing the volume of deposits and savings with that of the financing for each year we find that savings and deposits exceeded that of financing for most years included in table (1). This happens because the local banks are not allowed, according to the central bank regulations, to deliver an amount of cash financing that exceeds sixty percent of each bank's total savings and deposits at any time. Also the deposits and savings attracted from the urban branches, mainly the ten branches in the capital, Khartoum, are always over seventy-five percent of the bank's total deposits and savings. Since more than sixty percent of the bank financing is rural credit and the source of it is seventy-five percent urban, it can be argued that the FCB is a net rural credit supplier.

Most of the loans are short-term loans. However, the bank has long term investment in the form of equity participation, the total of which is equivalent to SSD 226 million, (US$00.9 million). The bank's policy is to encourage business fields and establishment of corporations relevant to its objectives. The bank is now providing capital for the following companies: Kenana Sugar Company (industrial), Sudan Cotton Company (Marketing), National Co-operative Insurance Company, Rural Development Company, Kagbar Electricity Company, Sudanese Potato Seed Company, Deposits Guarantee Fund Company, Sudanese National Reinsurance Company, Elnaeim Investment Company, Nile Cement Company, and Elmuhagir Investment Company.

1-4 –**Islamic Banking**

The finance is delivered in accordance with the rules and conditions of the Islamic banking system. There are fundamental differences between the Islamic banking and the interest charging banking system. In Islamic banking all the interest bearing methods of lending are prohibited and the predetermined interest prices against cash lending is regarded as usurious and exploitive. Therefore, other means or methods of lending and finance are practiced such as Al-Murabaha, Al-Musharkah , Al-Mudarabah Al-Salam, Al-Mugawalah, and Al-Istisna. The definitive descriptions for each of them follow.

1-4-1 Al-Murabaha

Al-Murabaha is a finance method and contracting type that mainly includes thesale of goods for profit. It is practiced when the bank owns a commodity, such as farming inputs, and there is a client aiming to obtain it through facilitative means of postdated payments. In this case the bank provides the client with a commodity-loan, the value of which will be the sum of the basic commodity cost plus the bank's profit. The conditions for a correct contract are:

a-Real ownership of the commodity by the bank (the seller) by the time of negotiation and through the end of the contract.

b- Disclosure of the exact cost of the commodity to the client and the desired profit.

c-All transactions must , in particular, be free from usury.

d- The bank (the seller) must disclose any defect in the goods sold.

Another type of Al-Murabaha known as Al-Murabaha Lil Amir Bil-shira exists. In this type the seller does not own the commodity at the time of negotiation but will obtain it later in response to his client's application. However, the seller is willing to obtain the commodity through facilitative means. When the bank obtains the ownership in response to the application (Al-Amir Bil-Shira) and the client reconfirms his desire to obtain the commodity, after viewing it under the bank ownership, then the contract will be conducted. It bears the same conditions of Al-Murabaha except for condition (a). Thus the main difference between a Murabaha sale and Al- Murabaha Lil Amir Bil-Shira sale lies with ownership of the commodity at the time of negotiation.

1-4-2 Musharakah(Partnership)

In this method of financing two or more partners agree through a Musharkah contract to carry out a specified joint-venture economic activity. The contract specifies the kind, the amount to be contributed by each of the partners, the partnership period, and the basis for profit distribution. The conditions for Al-Musharakah are the following:

a- Specification of the capital amount of Al-Musharkah.

b- Determination of the value of paid up shares for each partner particularly if they are commodity shares.

c- Specification of the ways and means of profit distribution among partners. It is usually a percentage proportional to the value of shares paid by each partner.

d- The partners might delegate one of them to act on behalf of the others for the sake of the group as a whole.

e- It is acceptable for a partner who works more than the others and/or who enjoys more experience to stipulate to take a percentage in lieu of his extra labor and expertise.

Types of Al-Musharakah

The following are the types of Al-Musharakah:

a- Continued Musharkah- a farmer, for example may contribute the land and other capital goods, while the bank may provide inputs and working capital. Rights and obligations are confined to the terms of the specific contract.

b- Diminishing Musharakah- in this type the client is given the right to gradually buy the shares of the bank until he becomes the sole owner of the project.

1-4-3 Al-Salam

This is a method of financing and a type of contract usually between a farmer, the borrower, and the bank, the cash lender. In this type of contract a cash loan is immediately delivered to the borrower after he completes the conditions and terms of the financing and the repayment will be in commodity form and not in cash.

The followings are the conditions governing the conduct of an Al-Salam contract:

a- The price for the commodity that will be delivered as a repayment must be identified and known.

b- The sold commodity must be known by detailed specifications of quantity and quality.

c- Repayments must be in commodity and not in cash. The cash repayment is prohibited except for the exact original loan without any added profit.

d- The repayment must be postponed to a specified future date and a known place of delivery.

e- The borrower is free with regard to the source of the commodity for repayment, whether from his own farm production or bought from the market as long as it is typical to the specified descriptions.

This method of financing is found to be more flexible and preferred by the farmers because it enables them to get cash lending and be free to do what they like with regard to the finance allocation. It is also observed that the commodity repayments are usually done from the harvest of the crops financed.

<u>1-4-4 Al-Mudarabah:</u>

In this type of contracted agreement the bank, which is the creditor, provides cash to the borrower who contributes to the project only by labor and expertise in respect of investing the capital. The followings are the conditions of contract validity:

a- The capital ought to be identified, known to the partners and delivered to the borrower.

b- The duty of the borrower is to do his best to investing the capital and at the same time take all the precautionary measures to protect the assets of the Mudarabah.

c- The borrower is under no obligation to pay for any damage to the capital, if the damage happens for reasons that are not under his control and there is no misadministration.

d- Each of the two parties have the right to terminate the contract whenever they choose.

e- The other party must accept the termination unless he will be subject to a loss. In this case the termination should be postponed until a suitable date.

f- The distribution of the profit must be explicitly agreed upon as a specified percentage for each partner.

g- In case of loss, nothing is paid to the borrower for his labor and expertise.

There are two types for Mudaraba, restricted and unrestricted. In the restricted case the field of activity is determined for the borrower. In the unrestricted case the borrower is left free to decide the field of activity.

<u>1-4-5 Al-Mugawla and Al-Istisna</u>

Mugawla is a method of financing and type contract between a contractor, who performs some work, and the owner of the project (the borrower), who provides the material for the work. In the Istisna method the contractor provides both the work and material for the borrower.

Conditions of validity:

a- Clear specification and definitions for the work under contract to the extent that there are no items or terms in doubt.

The price of the work under contract and the terms of payment must be specified. The price or part of it may be paid in advance, after completing the work, or in installments through as the work progresses.

Table (2) shows the financing distribution according to method. The most practiced method for both rural and non-rural financing is Al-Murabaha. It is also the main method for providing industrial factories with commodity loans of inputs and practiced for provision of farming inputs. The next most commonly practiced method is Al-Salam, which is primarily used for financing the agricultural sector. According to the current central bank regulations local banks are not allowed, until recently, to finance other sectors using the Al-Salam mode of finance. This policy is intended to control the cash money supply.

The methods of Al-Musharakah and Al-Mugawla are less practiced, but tends to increase from one year to the next. The other modes include sale through installments, Al-Mudaraba and Istisna.

Table (2), the distribution of total finance according to methods

Method of finance	year of finance		
	1999	2000	2001
Al-Murabaha	30%	32.60%	33.10%
Al-Musharkah	0.00%	10.70%	13.40%
Al-Salam	68.60%	27.80%	17.50%
AL-MUGAWLA	0.10%	0.60%	2.70%
others	1.30%	28.30%	33.30%
total	100%	100.00%	100.00%

1-5-The sources of funds

There are internal and external sources of funds. The internal sources include paid up capital, reserves, issuing fees, and retained earnings.

The external sources of funding includedeposits &savings, borrowing from the central bank, and deferred payment facilities both inside and outside the country.

2-Results &Impacts

2-1 Financial and ratio analysis

Table (4) indicates some aspects of performance during the period from 1999-2001. These performance measures include the following:

1- An increase in total assets estimated to be more than sixty-two percent.

2- An increase in total financing, estimated to be more than ninety-eight percent.

3- An increase in total net profit, estimated to be more than 104%.

4- The increase in the total owners' equity was found to be more than 187%.

The financial and ratio analysis resulted in the following findings:

With respect to the savings and deposits in relation to capital, the ratios are 23%, 11.1%, and 18% for the years 1999, 2000 and 2001 respectively. In general these ratios show a decreasing trend. Considering capital in relation to the loans, it shows an improving trend. The ratios are 17%, 20%, and 25% for the three years respectively. In relation to total assets, the average capital adequacy ratio for the three years is 8.2%.

The operational cost to average assets ratios are 8.1, 7.1 and 4.1% for the years 1999, 2000, and 2001 respectively. This is an indication of a decreasing trend of assets utilization cost. The net income to average assets ratios are 3.8, 2.7, and 8.1% for the concerned three years respectively which indicate an improvement in the income generated per unit asset at the end of the concerned period.

The ratios for leverage (loans/assets) were found to be 38%, 62%, and 47% for the three years respectively. The loans in relation to the owners' equity (total/owners' equity) showed a decreasing trend from 1,224%, to 497%, and finally to 403%. This is an indication of increasing dependency on owners' equity for financing.

Table (3) shows some aspects of the FCB performance during the mentioned period.

Values in SSD millions (SSD= US $ .0037)

TOTAL ASSETS	14533	18763	23559.9
AVERAGE ASSETS	12330.6	16648.2	21171
TOTALFINANCE	5542	5498.5	10977.7
GROSS INCOME	1186	1674	1621
TOTAL EXPENDITURE	1109	1401	1431
NET INCOME	77	273	190
PAID UP CAPITAL	666	666	971
RESERVES & RETAINED PROFITS	279.9	438.8	1752.9
TOTAL OWNERS' EQUITY	945.9	1104.8	2723.9

3-Challenges and Management

3-1 Challenges

Financing of agriculture is very risky in Sudan particularly in the absence of modern means of production to help combat frequent droughts and annual rainfall fluctuations.

Under these this difficult conditions it is important to consider the main challenges and risks that face the FCB and the measures that can be used to alleviate the problem..

3-1-1-credit risk

1- Credit is risky because of bad farming seasons that render most farmers unable to repay their loans. This is complicated by problems of poor guarantees, an occasional decline in the value of mortgages because of economic recession or an initial incorrect evaluation preformed by the concerned evaluation entities at the time preceding the loan provision. Generally, the bank adopted some measures to tackle the challenges of credit risks. These include:

a- Adopting measures such as time deposits based on the Mudrabah contract in which the bank acts as the borrower and the clients as lenders.

b- Delivery of farm financing in installments according to the actual needs of the crops' growth stage accompanied with frequent visits to the projects receiving financing.

c- Contributing to the establishment of the national insurance company to encourage the establishment of insurance services for farming activities.

d- Participating in the establishment of crop marketing companies such as Sudan Cotton Company to organize collective crop marketing.

e- More financial training the staff, especially with regard to proper delivery and collection procedures.

g- Introduction of electronic banking aimed at competent banking services to the clients so as to attract more of them and increase the revenues from such facilities.

3-1-2- Capital risks

The failure in repayments collections at the proper time leads to the reduction of earnings, thus both the core and supplementary capital are affected.The bank is now preparing to increase the capital through provision of new shares by selling them on the stock exchange market. The intended capital is SSD 3 billion (US $11.3 million). Furthermore, the bank has liquidated some of its fixed assets.The merger between FBIR and SCB was a measure of capital consolidation.

3-1-3-Operational risks

The bank adopted regular measures of financial statement sheets, statistical data analysis forms, and the internal and external audit measures. After the merger, administrative reform was conducted which resulted in the reduction of the staff, and the merger and reduction of branches and departments to control operational expenses. The bank is also gradually implementing the BAZL Committee measures for the control of various risk aspects.

3-2-**Management**

The organizational structure of the bank includes the following:

1- The board of directors is composed of ten members and is the top level of authority. They are elected by the general assembly for a specified period. Consequently, most of them are farmers. The board is responsible of appointing the general manager and gives him the authority to delegate. Also it is responsible for approving the annual or strategic plans and supervising the implementation of these plans.

2- An administrative committee from within the board members assists it, and is usually composed of three to four members who make decisions about urgent matters that need a level of authorization greater than that of the general manager.

3- The general manager is responsible for the implementation of the plans and achieving the determined goals. Thus he chooses, co-ordinates, manages and directs the human and material resources to reach the target.

4- The deputy general manager, about eight department managers, twenty-eight branch managers, and the various rank levels of staff members assist the general manager. The total number of the staff is 878. Administrative leadership accounts for about nine percent of all staff. About half of the staff members are originally staff members of the former SCB, which was established since 1962. Therefore, these staff members have a long experience with regard to traditional banking methods. The bank chose to blend of experience and qualification by introducing appointment policies based on high qualifications (university degree as minimum level to be appointed) since 1999. Comprehensive training courses are adopted to improve the level of know-how among the existing staff.

4-Recommendations

1- Credit suppliers should be more concerned with the people targeted for rural credit not just their economic activities. So rural credit needs to be accompanied with educational and training programs that are directed to the targeted people and not only to the staff.

2- Training programs targeted to rural people must implement training on issues of financial management such as regular recording of daily expenses and revenues, calculation of profit and losses, and keeping track of the dates and amounts of loans and repayment date.

3- Commodity loans restrict the borrower to a specific activity and such restriction and concentration leads to success.

4- Commodity loans and commodity repayments activate the market of inputs and the market of harvested or manufactured products.

5- Suppliers of credit need to properly diagnose of the causes of repayment failures so as to learn and not repeat the same mistakes.

6- Provision of credit to the agricultural sector must be bound to the adoption of specific recommendations by the borrowers. Borrows must also provide documents certifying each stage of a farm progress, before the loan is provided for that particular stage.

5-Conclusion

The Farmers Commercial bank, which was established in 1992 under the name of Farmers Bank for Investment and Rural Development, is an example of how to pave the way for sustainable financing of rural activities. Mobilization of the scattered rural financial resources was achieved through shares and participation in the capital of the well-constructed financial institution. Participation was sustained by a growing number of deposits and savings as one of the main sources for credit supply. Relatively new banking methods for credit supply were adopted that were based on Islamic rules. The rules, in general, encourage the productive activities of legal trade, farming, and manufacturing so that the profit gained from such activities is recycled as cash money within the productive sector. The Islamic finance methods are characterized by tendencies that include exchange of cash versus commodity. For example, in an Al-Salam contract requires cash delivery versus commodity repayment and an AL-Murabaha contract requires commodity delivery versus cash repayment. Cash is not allowed to generate cash to the owner unless there is a known legal economic activity. Profit from predetermined interest rates, over cash loans, without sharing the risk of losses are prohibited, because it concentrates the wealth among a few cash owners and impoverishes the rest of the community members who are exposed to the exploitation of cash owners.

The experience of the FCB is not without risks, but it seems that there is a strong desire to maintain sustainability and achieve development. As a result, the bank intends to increase the core capital and improve the working environment for both the clients and the staff with awareness and full regard to the international measures and means for modern banking services.