Sudan: forgotten centre of Islamic finance

When discussing Islamic economics, specialists usually cite Malaysia, Bahrain, the UAE, Iran and, of late, the UK, as evident examples. But such a country as Sudan is either not brought up at all or mentioned in passing. Meanwhile, Sudan is the only country in the world that has a wholly Islamic financial sector, argues Renat Bekkin, PhD in Law, senior researcher at the Institute for African Studies at the Russian Academy of Sciences.

In late 1970s/early 1980s, three countries – Iran, Pakistan and Sudan – embarked on the process of converting their financial systems to Islamic ones. This implied that starting from a predetermined date, all banks and financial institutions in these countries were to use only Shari'ah-compliant methods of financing in their work. In addition, Pakistan and Sudan introduced a new obligatory state tax – zakat (an religious obligation on Muslims to pay a prescribed percentage of their wealth to specified categories in their society, when their wealth exceeds a certain limit). However, the takaful (Islamic insurance) sector was left virtually untouched by the reforms in all three countries.

By the start of the new millennium it became apparent that Sudan was the only country that managed to successfully complete the project of Islamising its entire financial sector. In Iran, despite the official prohibition of interest (riba), interest-based transactions are quite common within the banking sector and the black market. For example, mudarabah (profit-and-loss sharing) comprises an ample portion of financing instruments in Iran, but in a form that does not really comply with Shari'ah – the profit of the bank is specified in advance and does not depend on the outcome of a project. Meanwhile, in Pakistan, after several attempts to eradicate interest-based banking, it was decided to adopt a dual model, thus giving equal ground to conventional and Islamic financial institutions.

In Sudan, following a failed attempt to Islamise the financial sector in the mid-1980s during the rule of president Jaafar Nimeiry, in the early 1990s Sudan's current president, Omar al-Bashir, initiated another series of efforts to make Sudan's financial industry Shari'ah-compliant. These economic reforms were less sporadic and more consistent, yet they were not introduced as rapidly as those during Nimeiry's rule. From the early 1990s, the monistic model of the finance sector introduced by al-Bashir's government has left no alternative to Shari'ah-compliant financing tools.

In 1992, the state established the High Shari'ah Supervisory Board, a supervisory council to oversee the progress of the reforms and their compliance with Shari'ah. The body was comprised of scholars, jurists and economists. Prior to this, some of the functions of the council had been carried out by the department of technical control at the central bank, Bank of Sudan. However, it never dealt with the issues of Shari'ah.

In 1998, a new clause was added to the country's legislation, stating that the state directs the growth of the national economy guided by planning on the basis of work, production and free market to prevent monopoly, usury, fraud, and to ensure national self-sufficiency, abundance, blessings and the aims of justice among states and regions (Article 8).

The status of the High Shari'ah Supervisory Board is subject to the terms of the law regulating the banking activity (ordained in 2003). The council consists of eleven people, the majority of whom are Shari'ah scholars, although it also has economists and bankers (including the central bank's governor) amongst its members. All members are Sudanese citizens and are appointed by the president of the country upon recommendation of the Bank of Sudan's governor and the minister of finance. There is no time restriction on the mandate, so theoretically it can be a life-long post. The members are allowed to combine their membership at the council with the membership of the Shari'ah boards of commercial banks.

The decisions of the council are based on the majority of votes if agreement cannot be reached otherwise, but practice shows that in most cases consensus is achieved without voting.

The High Shari'ah Supervisory Board also acts as an appeal authority for disputes between various Islamic banks, Islamic banks and the Bank of Sudan, and an Islamic bank and its customers. Therefore, the council's functions are not limited to the direct supervision over the country's banking sector.

A bank can also turn to the High Shari'ah Supervisory Board as the ultimate authority if it doesn't agree with a decision of its internal Shari'ah board. The distinguishing trait of Shari'ah boards of some Sudanese banks (e.g. at Tadamon Islamic Bank of Sudan) is that they act as in-house law departments and deal with various legal issues on a daily basis, carrying out the supervisory role at the same time. In the majority of Islamic banks across the world a Shari'ah board is

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just a supervisory body, similar to the board of directors.

Fatwas (rulings) of the High Shari'ah Supervisory Board are not based on views of one particular school of law (for example, the Maliki school, which is dominant in Sudan).

In the period of 1999–2002 the country underwent financial reforms that introduced Basel requirements to the banking sector and aligned them with Shari'ah principles. Sudan learnt from the mistakes of similar reforms in other countries, including Pakistan, where the central bank simply executed orders of the ideological organisations, such as the Council of Islamic Ideology. The High Shari'ah Supervisory Board does not interfere in the issues outside its competence.

Today, all banks in Sudan use only the contracts that are halal (permitted by Shari'ah). Bank of Sudan does not differentiate between Islamic banks and those financial institutions that have conventional roots. The latter must use only the Islamic financial mechanisms approved by the central bank.

There are currently 30 banks in Sudan. A considerable portion of their business is focused on the foreign trade sector. The agricultural and livestock sectors are serviced by specialised banks, such as Farmers' Commercial Bank, Agricultural Bank of Sudan and Animal Resources Bank. The latter has the Ministry of Finance among its shareholders. The bank's share capital is $35 million and since its establishment in 1993, it has accrued a regional network of 18 branches. Its main activity is financing the export of cattle to Saudi Arabia, based on the murabaha mechanism (the exporter purchases the cattle) and the musharakah mechanism (the actual process of export – mainly services for the cattle drive from the breeding regions in the West Kurdufan province to Port Sudan on the Red Sea shore). Livestock financing comprises up to 80 per cent of the bank's operations. Other banking services for this sector are offered through the subsidiaries and affiliated companies of Animal Resources Bank, namely Livestock Routes Company (provision of water for the cattle) and Animal Resources Services Company (import of the veterinary medicines). The finance models used are murabaha, musharakah and mudarabah. At present, the bank is financing a large-scale project of building of a slaughter-house in Omdurman, worth around $9 million.

Animal Resources Bank also offers standard services such as deposits (current, savings and investment accounts), money transfers and correspondent operations to the public and enterprises.

In the recent years, Sudan has experienced growth of Islamic microfinance. Islamic mi-

Khartoum

crofinance organisations face the same problems as the Sudanese banks: for example, an overwhelming majority of projects (up to 95 per cent) are financed using murabaha and only a tiny portion of ventures is based on musharakah.

Sudan-based financial institutions at present concentrate on the local market and their expansion abroad is unlikely. Moreover, the domestic growth of Islamic banking is being tapered. Thus, in 2007, following the civil war, all banks operating in Southern Sudan were told either to convert to the conventional way of conducting business or to cease their operations there. 15 banks that had branches in the south chose the latter option. By late February 2009, Faisal Islamic Bank, Omdurman National Bank and the Agricultural Bank of Sudan announced the closure of their branches in the region, resulting in the capital outflow of over $45 million. Conventional banks are taking the place of their Islamic counterparts, with around ten institutions now operating in Southern Sudan, including Kenya Commercial Bank, Nile Commercial Bank and Ivory Bank. The Bank of Southern Sudan regulates the activities of the financial sector in the region.

The issue of banning takaful companies in the south of the country was not as pressing as the prohibition of the Islamic banking activity, mainly due to the lack of takaful operators in that region. The majority of the population there is not covered by Islamic insurance. However, it is clear that the ban on Shari'ah-compliant finance in Southern Sudan will affect any takaful operators there, if for no other reason than without Islamic banks, the activity of Islamic insurance companies will be virtually impossible.

The main reason for the emergence of Islamic insurance in Sudan was the banks' need to insure their operations according to Islamic principles.

Everywhere else in Sudan, the insurance sector must comply with Shari'ah, and it is stipulated in state legislation. The world's first takaful company was set up in Sudan.

It is not a coincidence that the country became the birthplace of Islamic insurance. The afore-mentioned three states that started Islamising their financial sectors in the 1970s, sooner or later had to turn their attention to takaful. In 1977, Faisal Islamic Bank of Sudan initiated the idea of establishing an Islamic co-operative insurance company. A group of experts, which included the representatives of the bank's Shari'ah supervisory board, drafted a memorandum and internal rules and regulations of the proposed company. In January 1979, the new venture, Islamic Insurance Company of Sudan, obtained public company status.

The main reason for the emergence of Islamic insurance in Sudan was the banks' need to insure their operations according to Islamic principles. The issue was particularly acute in the sphere of marine insurance. Life insurance appeared later, but did not manage to gain popularity (alongside other savings-oriented products), due to the country's rate of inflation of 50 per cent at the time.

Traditionally, in the conventional commercial insurance company the shareholders are the company's owners. Therefore, all proceeds and profits belong to them. In the case of Islamic Insurance Company of Sudan, the shareholders retained the right to receive profits earned by the company. At the same time, the surplus was to be distributed only among the policy-holders in proportion to their contributions. The policy-holders also obtained the right to a portion of the profit gained as a result of the surplus investment. Furthermore, the insured party could also participate in the decision-making process of the company. The general meeting of the policy-holders takes place once a year, to discuss financial results and to elect a representative to a directors board (practically all boards of directors of takaful companies have a number of representatives of the policy-holders community, usually up to five people). The general meeting of the policy-holders can also provide recommendations to the shareholders of the company.

Islamic Insurance Company of Sudan was given a range of incentives, including tax exemption on all of its assets and profits. Also, the firm's assets could not be confiscated or nationalised. The regulatory framework for conventional insurance companies did not apply to the Islamic Insurance Company of Sudan. At the time, Sudanese lawmakers saw Islamic insurance as an alternative to conventional, and therefore takaful companies were not to be regulated by the conventional legislation, still present at that time in Sudan.

It took a while for the legislation dealing specifically with the takaful sector to be devised and implemented. The first reference to Islamic insurance in the country's regulatory documents appeared in the civil code of 1983. By 1985, Sudan had four takaful operators.

In 1992, the state passed a decree on the control and supervision of the insurance sector, which stated that all insurance operators in Sudan must comply with Shari'ah principles. In 2001, more detailed legislation was adopted, and in 2003 the government expanded it further and passed the Law of Insurance and Takaful. Thus, Sudan is the only country today that has a completely Islamised insurance sector de jure.

Despite some deviation from the course along the way, Sudan became the only country that introduced reforms in the set direction more or less consecutively. The development strategy encompassed the transformation of the banking and insurance markets, as well as government bonds (the first Islamic bond was issued in 1999). However, none of the legislation covers Southern Sudan, where, as mentioned above, Shari'ah-compliant finance is banned.

Of course, creating an Islamic economy in Sudan would be much more difficult if it hadn't received foreign assistance. The International Monetary Fund (IMF) played a significant role in supporting Sudan's endeavours. Amongst other things, the IMF specialists helped to devise government bonds, based on the mechanism of musharakah.

In 1994, Khartoum Stock Exchange (KSE) was set up. Today, the exchange trades shares of 54 Sudanese companies, nine investment funds and twelve issues of government sukuk (Islamic bonds). KSE requires full information disclosure, which ensures a high level of transparency. The stock exchange has its own Shari'ah board, which screens and approves the products prior to their trading. Such a conservative approach prevents speculation. It is also worth noting that the banks in Sudan do not lend money for any speculative operations and finance only certain projects. Shari'ah prohibits short-selling, as one cannot sell what one does not own.

In 2003, KSE launched the Khartoum Index, developed with the assistance of the IMF. In five years it grew from 1000 to 2500 points. Today, KSE is one of the top five African exchanges – it ranks fifth, with the volume of trading around $5 billion (not including sukuk trading). Due to the prohibition of speculation, the price of the listed stock usually equals its nominal book value. For that reason, the problems of the world stock markets hardly affected KSE.

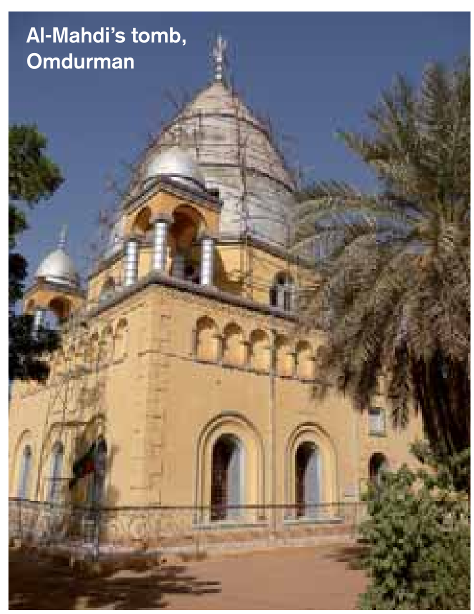
The listing rules of the exchange are stipulated in the Law of Khartoum Stock Exchange of 1994. The trading process is still manual, but a move towards automation is scheduled for the first half of 2009.

Like in many other countries, sukuk have been one of the most popular financial instruments in recent years in Sudan. Sukuk trading accounts for a major segment of KSE's activity, with the choice of musharakah, ijara and government investment certificates.

Government musharakah certificates (GMCs) are also known as shahama bonds, and their existence in Sudan dates back to 1999. These are short-term securities. Through shahama bonds the state borrows money in the domestic market instead of printing more banknotes. After one year, holders of GMCs can either cash or extend them. These bonds are backed by the stocks and shares portfolio of various companies owned by the Ministry of Finance and therefore are asset-backed. The profitability of GMCs can reach 33 per cent per annum and depends on the financial results of the companies involved. Hence, the profit of a GMC is variable rather than fixed. The government issues these bonds on a quarterly basis and their placement is done very quickly – in just six days. The major problem is that the revenue from these securities is mainly used by the Sudanese government to cover the costs of civil service, defence and so on, rather than for development purposes.

Government investment certificates (GICs) are medium-term securities, based on various contracts financed by the Ministry of Finance of Sudan via the istisna, murabaha and ijara tools. Issuance of these sukuk is similar to the conventional securitisation, where the Ministry of Finance acts as the originator. GICs are based on a limited mudarabah, which means that the raised money is invested solely in the projects stipulated in the original contract.

Ijara certificates of the Bank of Sudan (CICs) are backed by the buildings owned by the central bank. According to the law, Sudanese banks must invest up to 30 per cent of deposits in CICs. These bonds use ijara as the method of financing. At the end of each term, an independent surveyor evaluates the buildings.


Al-Mahdi's tomb, Omdurman

All of the afore-mentioned sukuk can be invested in only by banks, and only banks are permitted to resell them.

In October 2003, the Ministry of Finance set up a special committee to deal with sukuk, with the main task to research the ways of effective use of the attracted funds. The advantage of issuing government sukuk is that they are based on actual, tangible assets. Such instruments help to contain the inflation level (additional banknotes are not printed, and therefore, the money supply is not increased). In five years, Sudan's Ministry of Finance raised around $3.5 billion via sukuk (about $600 million annually).

Although sukuk is still issued as a hard copy in Sudan, a depository has recently been set up and there are plans to automate the clearing process in the near future.

The reforms have also addressed the country's fiscal policy. However, the government has not achieved the same results as in the banking sector. In 1984, it passed a law on zakat and taxation. Unlike the preceding legislation of 1980, where zakat was a voluntary act, the new regulation made it obligatory for all Muslim citizens of Sudan residing in the country and outside it.

A decree in 1984 made void 19 laws that regulated various taxes and levies, including the excise duty on alcohol, which made a substantial regular contribution to the budget. Instead, the government introduced three new taxes: stamp duty, social solidarity tax for local non-Muslims and foreigners residing in Sudan, and development tax. The latter does not quite fit in the strategy of creating an Islamic financial system, as Shari'ah, whilst not having anything against capital investment, strongly opposes hoarding.

Unfortunately, these reforms were ill-timed – in 1984 Sudan experienced one of the worst droughts in history. It transpired very quickly that the results of the undertaken reforms did not meet the expectations of the government. By the end of the first fiscal year since the introduction of zakat, the budget received a considerably lower sum than the anticipated $51.7 million. A few weeks after the budget announcement, the government was forced to introduce a value added tax (VAT) and social fairness tax.

The new government that came to power a year later, restored the previous tax policy, but zakat retained the status of a state financial levy. Today, the zakat system exists independently from the rest of the fiscal system in Sudan. Zakat is paid prior to paying taxes and from a fiscal point of view it is calculated as costs, i.e. the taxed sum is reduced by the amount of zakat payment.

Sudan tried to avoid the serious mistakes that were made during tax reforms in Pakistan and attempted to couple the zakat collection with the ease of the tax burden rather than its increase. But the financial levies left after the reform of 1984 were not sufficient for replenishing the budget and fulfilling a vital task of bridging the gap between the rich and the poor through fair redistribution of the resources within the society.

Creating an Islamic economy in Sudan would be much more difficult if it hadn't been for foreign assistance. The International Monetary Fund (IMF) played a significant role in supporting Sudan's endeavours.

Many Muslim economists and jurists see zakat as the main tax in the fiscal system of a Muslim country. The rest of the taxes, both direct and indirect, should be just additional payments, delivering on targets not dealt with by zakat funds. The entire financial levy structure of a Muslim country should be built around zakat. Meanwhile, in Sudan it turned out to be the exact opposite – zakat is de-facto taken outside the tax system, thus depriving it of the opportunity to function as the core. Furthermore, the zakat collection and distribution scheme is far from transparent, making it easy to abuse the system. At present, the government is working on a new model of zakat allocation, according to which the funds will be issued directly to the needy.

As for another important Islamic charity institution, waqf, it has not yet found any application in the Islamic economic infrastructure of Sudan. The majority of waqf endowments are circulated in the religion-related sector. Waqf is well established in the form of shops that sell gold items and other articles on the territory of the mosques.

Overall, Sudan's Islamic economic system has proved to be effective. It has been developing continuously since the establishment of the country's first Shari'ah-compliant bank in 1977. However, whilst acknowledging Sudan's progress in creating an Islamic financial sector, many specialists point out that the undertaken reforms brought the country political, rather than economic dividends. Its Islamic financial institutions in reality do not fulfil the role they should in a poor agricultural country. The overwhelming majority of Islamic banks tend to invest in short-term commercial projects using murabaha, rather than in the industrial or agricultural sectors. 90 per cent of investments of Sudanese banks are made in the export and import operations, whilst the agricultural sector gets no more than four per cent.

Without doubt, the consistent approach of Muslim scholars and practitioners in Sudan has helped the market to avoid a number of problems related to applying some questionable mechanisms, like reverse murabaha or tawaruq (a sale of a commodity to the customer by a bank on deferred payment at cost-plus profit). On the other hand, Sudanese banks drastically lack creativity, which would enable them to expand the product range. In addition, the deficiency of competition from conventional counterparts adversely affects the process of introducing innovations to the marketplace.