



The implication of using profit and loss sharing modes of finance in the banking system, with a particular reference to equity participation (partnership) method in Sudan

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Abstract

Purpose – The purpose of this paper is to evaluate the performance of *musharakah* (equity participation) in terms of profitability and risk; to investigate *musharakah* management to recognise the obstacles and factors influencing decision-making and to investigate the implications of using *musharakah* mode of finance.

Design/methodology/approach – Data from Sudan, which fully adhere to interest-free principles of finance, will be used. Part of the data source is the Sudanese banks' balance sheets and annual reports, which provide bank level data for all Sudanese banks for the period 1990-2004. Initially, some descriptive analysis is provided. The concentration of *musharakah* in the Sudanese Islamic banks each year is provided so as to give an indication of the influence of *musharakah*. The second part of the data is survey data collected from nine banks. The survey has been distributed and collected from staff members of investment departments at the Sudanese banks.

Findings – The results show the high preference of *musharakah* among banks' staff compared with other modes of finance. The results indicate that the lack of knowledgeable bankers in selecting, evaluating and managing profitable projects is a significant cause for the lack of profit and loss (PLS) projects. The results show the high profitability and risk performance. The paper has exposed the key issues involved in bad debt and general risk degree for *musharakah*.

Originality/value – The advantages and disadvantages of using *musharakah* have been discussed, obstacles for the scheme have identified, and the performance of *musharakah* has been evaluated. The paper should contribute to a better understanding of the implications of using PLS modes of finance, particularly *musharakah*.

Keywords Sudan, Islam, Banking, Profit, Loss, Partnership

Paper type Research paper

Introduction

In recent years there has been significant growth in academic interest on Islamic banking and finance. However, most of the academic writings on this topic concentrate on comparing conventional banking with Islamic banking, without giving more practical examples of the interest-free banking techniques. Whilst acceptable perhaps for the earlier studies, the expansion of Islamic banking methods across the world means that these studies now need to be conducted in greater depth.

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It is well known from the literature on Islamic economics that raising and mobilising of financial resources in an Islamic economy must be guided by interest-free instruments. Accordingly, banks may perform all their functions provided that they avoid the payment and receipt of interest. This practice already exists and is being constantly refined and modified to meet the rapidly changing needs of ever more sophisticated businesses. Almost all theoretical models of Islamic banking are based on profit and loss (PLS) contracts, whether *mudarabah* or *musharakah* or both. By this means, both the supplier of the capital and the entrepreneur share in the risks: both prosper when returns are favourable and suffer together when returns are poor. This is the basis for what became known as “interest-free Islamic banks”. In addition to PLS contracts, there are non-PLS contracts such as *salam* and *mudarabah*. Without a doubt, the aforementioned contracts are generally accepted amongst most Islamic scholars as long as both parties adhere to the conditions of each contract.

These methods of finance are considered economic choices; therefore there are a number of economic choices for both the Islamic bank and the customer when making business contracts between them. Then, it is possible to conclude that the range of contracts available to customers is widened. This is an example of the efficiency-enhancing characteristics of spectrum filling (Iqbal and Llewellyn, 2000).

The assumption is made that both parties will be rational in order to choose a contract that will favour both the bank and the customer. A customer’s decision to invest according to which method used, or whether to continue to invest with a particular Islamic bank would mainly depend on the risk of the method and the projects in which their funds are invested, the returns which they expect to receive from those projects using this method, compared with returns from other similar risk class projects, and the bank’s ability to achieve those returns (Pastor, 1999). Other factors include the time in which they can return the capital, and whether they have the ability, which the project demands, such as the managerial efficiency and so forth (Ahmed, 2005). Generally speaking, the profitability and risk factors are the ones that play a dominant role, as both parties are fundamentally geared towards maximising their profit and minimising their losses. Just as one cannot deny that the other factors sometimes play a greater role, he can also not negate the fact that these other factors, directly or indirectly, affect the profitability and risk margins.

This paper will attempt to answer three main questions, the first of which is to investigate whether the PLS contracts are dominating the Islamic banking system in Sudan in terms of using the largest percentage of the funds available. The second is to evaluate the performance of *musharakah* in terms of profitability and risk. The evaluation of Islamic finance methods’ performance is important for all parties: depositors, bank managers and regulators. In a competitive financial market, this performance provides signals to depositor–investors whether to invest in or withdraw funds from the bank. Similarly, it highlights whether the bank managers should improve their deposit service, loan service or both to improve its finance. The regulator is also interested to know this for its regulation purposes. The third to investigate the obstacles facing management of *musharakah* projects through the banking system to recognise factors influencing decision-making. We will answer these questions by referring to the practise of the Sudanese banks.

The rest of this paper is organized as follows: section two will provide a brief theoretical framework of *musharakah* finance scheme through the banking system. The evolution of Islamic banking in Sudan will be reviewed briefly in section three. While section four explains the methodology and data collection, section five will

discuss the sample characteristics. In the main section, section six will examine the results of the empirical study. The conclusion will be presented in section seven.

Theoretical framework of *musharakah* (partnership) financing scheme through the banking system

Definition

Musharakah is a word of Arabic origin which literally means sharing. In the context of business and trade it means a joint enterprise in which all the partners share the profit or loss of the joint venture (Usmani, 1999). *Musharakah* (or *Sharaka*)[1] can be defined as a “form of partnership where two or more persons combine their capital or labour together, to share the profits, enjoying similar rights and liabilities” (Al-Harran, 1993). This form of business can be registered as a partnership with unlimited liability or as a company with a limited liability. In practice, the customer will apply for finance to share the capital, management and return of a project. If the project sounds feasible, the bank might consider sharing the finance of the project after reviewing the entire requirements requested by the bank.

Types of equity participation musharakah

The partnership we will be studying is the capital-capital partnership in which all parties contribute cash or goods and other property to the capital but not labour or credit solely. Therefore the partnerships as a result of combining capital with labour (*mudarabah*) or labour with labour (*shirkat al-a'mal*) are outside the scope of this study.

Partnership financing (equity participation) can be categorized according to the duration of the project (El-Bhasri and Adam, 1997), it can be for either an indefinite period, as it is in the case of the stock of the joint stock companies, or a definite (short, medium or long) period as it is in the case of participation finance through *musharakah* when it is for specific period or shares in partnerships when profit only not the capital gain targeted (Al-Harran, 1993). A short-term financing is usually for financing of working capital for one production period, season, fiscal year, or even a certain operation which involves production period ranging between three and 12 months' duration (Al-Harran, 1995a, b). The long-term financing covers financing of capital assets extending over a period of more than one.

Long-term partnership can be continuous or diminishing: a diminishing partnership is one wherein the bank's share in the partnership diminishes gradually through repayment, leaving the venture to be wholly owned by the client. In diminishing partnership, the share of the bank diminishes through repayment leaving the project to be wholly owned by the client at the time of the liquidation of the financing contract.

Short-term and impermanent *musharakah* agreement is normally for one short-term and specific purpose, such as the purchase and sale of a machine or a commodity. Both the bank and its partner contribute to the capital but it is the partner who undertakes the management of the buying, selling, marketing and account-keeping related to the transaction. The bank's function is to finance its share of the transaction, provide necessary banking services like the opening of letters of credit where necessary, and to monitor the progress of the *musharakah* through the current account and other periodic progress reports from the partner (Usmani, 2002). Most of the impermanent normal *musharakah* unusually used for commercial purpose. A commercial *musharakah* contract is useful for an Islamic Bank as it is liquidated quickly, turnover of the capital is higher, and therefore, the return will also be generally higher. The bank's activities in

advancing finance on the basis of commercial *musharakah* to a large number of ventures; serve to diversify and minimise risk in its investment operations.

The short-term *musharakah* can be divided to four categories (Usmani, 2002): financing of a single transaction, financing of working capital, sharing in the gross profit only, running *musharakah* accounts on the basis of daily products.

Distribution of PLS

If a favourable return occurred the net return will be distributed to both parties according to the contract, this will mean that the proportion of the distributed profit between the partners must be predetermined and agreed upon at the time of signing the contract. It is worth mentioning that it is allowed to agree upon distribution proportion different than the proportion of the capital contribution. The ratio of profit for each partner must be determined in proportion to the actual profit occurred to the business, and not in proportion to the capital invested by him. It is not allowed to fix an amount in a lump sum for any one of the partners, or any rate of profit tied up with his investment (Usmani, 1999).

Profit-sharing ratios are determined on the basis of many factors. One of which is a customer or firm's past and expected performance. Banks do not claim a share in the profits on an equal footing, which otherwise would mean sharing profits in strict proportion to the bank's financing of the capital of a customer. In *musharakah* practice, the bank's role is limited in the most of the cases to the provision of capital, whereas the customer, besides providing his share of the capital, also uses their labour, skill, enterprise and expertise. Therefore, the contract rules evaluate the contribution of the management, labour and skills by devoting and specifying a portion of profit for it. This portion is called the management fee. The management bonus is payable to the customer under one of two basis whether on the base of the whole profit regardless its quantity or on the basis of achieving the projected profits. If profits fall below the projection, banks may allow a management fee at a lower rate rather than cancelling it altogether. Consequently the customer who achieves a higher rate of profits can earn a higher percentage of bonuses, which, as mentioned, shall be specified in the agreement (Akhtar, 1997).

The contract then, if a favourable return occurred, will specify the percentage of distributed profit as an exchange of management and the percentage of distributed profit as a capital price. To illustrate, If we refer to the total net profit by P , and the capital of both the bank and the partner by L_b and L_c , respectively, which if combined together will give the total capital of *musharakah* projects (L_{bc}). Then we will have $P = P_m + P_c$, as P_m will represents the profits as exchange of capital management and P_c represents the profits as exchange of capital (Ibrahim, 1997).

The contract, as mentioned, will specify the percentages of the distribution denoted to the capital share, supposedly it is R_{bt} for the bank which equals to L_b/L_{bc} then the customer will have to have $(1 - R_{bt})$ which represents the customer's profit (R_{ct}) which itself brought of from dividing the share capital of the customer over the total capital L_c/L_{bc} . Likewise the distribution denoted to the management will be R_{bm} for the bank and $1 - R_{bm}$ which represents the customer share of profits denoted for management (R_{cm}). This distribution some times been done in another way when the agreement refer the profit devoted to management for both parties been referred to the total net profit. In such case we will have the total net profit 100 per cent distributed to four collections as a per cent of the 100 per cent as follows:

$$R_{ct} + R_{cm} + R_{bt} + R_{bm} = 100$$

Therefore, the total net profit distributed to the customer (partner) will equal to the combination of his/her profit denoted for the management and the capital share.

However, it is possible that if a partner put into effect more effort, or has more experience, he or she can take an additional percentage of the profits in lieu of his labour/expertise as well as the capital not only the capital share.

The losses from another hand, however, have to be distributed according to the capital contribution. In another words, losses are distributed according to the investment shares even if it is different that the profit distribution (Ibrahim, 1997).

Broadly, *musharakah* contract determines the management share of the profit for parties, the bank and the customer, through mutual agreement. However, getting a fair proportion of the profit is a problem as the customer will try to overvalue his management effort and then accordingly he will ask for high percent of the profit. By contrast the bank will try to underestimate his effort. Thus, a proper and fair methodology and calculation needed and the estimation of the management share of the profit should not be left entirely to negotiations.

Ibrahim (2004) suggested two approaches for that which are; the residual approach (RA) and the imputed market share approach (IMSA). The RA requires knowledge of the rate of return on each unit of the capital invested in previous similar. Subsequently, we have to deduct the share profits from the total expected profits and then divide the result by the total expected profit.

The first one is the RA in which he to deduct share profits from total expected profits and then divide the result by the total expected profit. To have the management profit as a residual requires knowledge of rate of return on each unit of the capital invested in previous similar projects. If we denote management profit by PM, the expected profit by EP, capital investment by CI and lastly rate of return Rc. Thus in this approach, an estimation of the share profit can be calculated from the product of the volume of capital invested multiplied by the rate of return on each unit of capital (Ibrahim, 2004). Thus, the subsequent equation to estimate the management share of the profit can be obtained from the following:

$$PM = (EP) - (CI) \cdot (Rc)/EP$$

where, PM is the management profit, EP is the expected profit, CI denotes capital investment and Rc denotes the rate of returns on capital. Alternatively he suggested:

$$PM = 1 - (CI) \cdot (Rc)/EP$$

In, the second approach, the IMSA the evaluation will be through using the current local market price divided by the total expected profit and, therefore, we can calculate it according to the following equation:

$$PM = MV_m/EP$$

where, PM is the management profit, EP is the expected profit, MV_m denotes the current local market price. A weighing system can be used for factors such as qualifications, experience, and volume of capital, sensitivity of the project and additional incentives for the management (Ibrahim, 2004).

If the project is wholly managed by the client, the management fees go to him, in addition to his profit share. If the bank is involved in management, part of the fees is paid to the bank. Management fees usually depend on the client's bargaining power and on the nature of the project (for example, if the activity requires special skills the share of the client is greater).

Intangible guarantee concept

Profits produced in *musharakah* is not guaranteed, as a result, the entrepreneur does not assure, secure or guarantee profits. Fundamentally, no collateral is needed. Therefore, it is possible to conclude that *musharakah* does not require strict collateral guarantees and does not leave the partner (entrepreneur) with a heavy burden of debts, post-dated cheques or any other kind of obligations compared with debt finance in the conventional system. For this reason, concentration should be on factors like the feasibility of the project, skills of the customer and his history and lastly the objective situation of the market and its risks. Taking the personal features of the customer as a part of the factors can be considered as an intangible guarantee. No doubts, such thing is increasing risks from a hand and promoting a new service from another hand. To illustrate, by taking intangible assets, such as education, skills, and experience, as collateral as tangible assets, Islamic banking breaks this discriminative barrier and offers an equal opportunity to all potential producers to improve their well-being and that of the society. Simultaneously, these banks will have to share any unfavourable return, if any, with its customers.

It has been observed that the existing banking institutions prefer to grant credit facilities to those clients who apart from enjoying a good business reputation are also able to offer sufficient collateral security mainly valuable assets. This practice seems quite reasonable from the risk point of view, however, the non-tangible collaterals holders are unjustifiably deprived of obtaining the necessary financial accommodation. The existing practice of demanding collaterals for the purpose of granting financial accommodation stems from the fact that Western banking institutions are primarily concerned with the profitability rather than the social imperatives. The imposition of tangible collaterals as a necessary condition left small businessmen and farmers trapped in a vicious circle: they cannot get access to finance unless they offer sufficient collaterals, they cannot possess tangible collaterals unless they build a strong productive base, they cannot improve their productive base unless they get access to finance, they cannot get access to finance unless they offer sufficient collaterals, so no solution for the endless, vicious and evil circle. Besides this, since you can get the credit as long as the risks is low and the capital with its interests is well guaranteed, there is no real consideration for their management skills or the feasibility of their project (Hamid, 1991).

However, the bank (the financier) who usually does not perform full management capacity, normally asks for guarantee against any losses caused by the partner as a result of his mismanagement or negligence.

Therefore, the customer might have to provide acceptable collateral, such as:

- (1) A real estate guarantee of the value equal to or more than the volume of financing.
- (2) A bank ownership guarantee which used when the bank finances a means of transport through diminishing *musharakah*, in which case the vehicle is

registered as a property of the bank until the time when the partner has paid all the instalments.

- (3) Two reputable guarantors (personal guarantee of a third), and he or she should sign promissory bank notes.
- (4) In the case of raw materials financing, the bank usually supplies only part of the raw materials to the partner, depending on his or her payment of instalments (Ibrahim, 1997).

In all cases, being a partner of the customer, the bank will be liable to bear any loss which may be caused due to any reason other than the negligence or misconduct of the customer (Usmani, 1999).

Follow-up procedures and obligations of clients

Investment departments' staff should regularly visits *musharakah* projects and checks bookkeeping, marketing of products, account receivable and collection procedure. These arrangements tend to ensure the safety as well as the profitability of the bank's investment. The bank constantly should watch its interest by focusing on the overall performance of the project.

Follow-up and close supervision is one of most important factors contributing to the solution of problems and the elimination of obstacles that face the partner client in the running of operations and the marketing of the finished product. Follow-up also limits the chance for any possible dishonesty on the part of the partner (e.g. unrecorded sale of the product or materials, or tampering with the records, etc.) (El-Bhasri and Adam, 1997).

One of the main problems facing *musharakah* financing is the increasing burden of monitoring and follow-up, especially at the expansion of bank operations. Another important aspect is the ability of the bank to recruit the right type of personnel, those who are dedicated, qualified, competent, patient and business-minded. This remains to be the biggest challenge; *musharakah* success depends, to a great extent on building trust between the bank and its partner to avoid fraud and dishonesty. How a bank could build such trust remains another challenge (Abdalla, 1999).

One way to solve the moral hazard problem with *musharakah* is to increase project monitoring and enforce restrictive covenants. Sudanese banks have paid little attention to developing their project appraisal capabilities (Ahmed, 2005). The moral hazard problem makes it desirable for the banks to monitor the performance of the projects they finance. No doubt, this entails additional costs but the benefits in terms of final declared profits more than offset those. In spite of this, the banks have been reluctant to do that because the entrepreneurs tend to resist it. They have instead chosen the easier way out, i.e. fixed return modes (Ahmed, 2003).

The bank requires the client to observe following conditions:

- (1) A proper bookkeeping system should be followed which reflects bookkeeping and accounting records, administrative activities, marketing policies, accounts receivable as well as collection procedures.
- (2) There should be a separate bank account for the joint venture (Ibrahim, 1999).
- (3) Project materials should be properly stored with withdrawals made as agreed by both parties. Materials purchases should be supported by invoices and should be limited to the quantities and types specified in the partnership contract.

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- (4) Sales revenues should be deposited in the venture account regularly.
 - (5) The partner is required to submit periodic reports showing the details of the operations.
 - (6) The client should adhere to the dates set for the commencement and liquidation of the venture project.
 - (7) And above all, both field follow-up and office follow-up should be used. To illustrate visits to the projects should be made to check materials, documents, performance and management. In addition to that checking office follow-up should be carried out which include checking documents and reports, meeting with clients, clients training to improve management skills.

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The primary reasons for monitoring, therefore, are:

- to keep track of project progress;
- to provide feedback on the project management;
- to serve as a warning mechanism for project management; and
- to help prevent or solve problems encountered during project implementation.

In financing small businesses, the close proximity of the business location to the banks branch has also been found to be helpful when financing small business. This enables close supervision by the bank representatives, and easier contact on the part of the partner. It also facilitates the regular deposit of sales proceeds.

Brief history of the banking sector in Sudan

The evolution of Islamic banking in Sudan can be divided into four stages. The first stage commenced in 1977, when the first Islamic Bank, Faisal Islamic Bank, Sudan (FIBS), which was similar to its Egyptian counterpart, was established in Khartoum (Wilson, 1984). By 1983, three more banks had opened: Tadamon Islamic Bank, Sudan (TIBS), Sudanese Islamic Bank (SIBS), and Islamic Co-operative Bank. However, Islamic banks were operating in an environment dominated by traditional banking systems during this period.

The second stage started in September 1983, when the whole financial system began to be converted to the Islamic model. That year saw the establishment of the Al-Barakah Islamic Bank of Sudan and the Islamic Bank of Western Sudan (Wilson, 1997). This period was characterised by political and environment crises, which led to structural changes in the country.

The third stage started after the downfall of *Nimairi's* government in 1985, and ended with the military coup of 1989. During this period, many of the traditional banks reverted back to their conventional practices. Islamic banks were forced to operate in an extremely hostile environment characterised by negative media coverage, lawsuits and heavy regulations. However, Islamic banking expanded rapidly in the mid-1980s, accounting for up to one-third of bank deposits, which gave scope for all the rival institutions to win business. At that time, the economy was experiencing modest growth, and the competition between the providers of Islamic finance meant that bank depositors enjoyed reasonable returns and good services by Sudanese standards, while borrowers faced less risk than those funded by conventional banks. Since the late 1980s, the Sudanese economy has deteriorated, partly due to natural disasters such as drought and floods, but also because of incompetent government and financial

mismanagement. This resulted in high external debt, and a structural adjustment programme imposed by the IMF that was unsuccessful. In this difficult situation, the Islamic banks have done well to survive (Wilson, 1997).

The fourth and the final stage started in 1989, when the whole economy was transformed in order to conform to Islamic law (Bashir, 1999). The single market, coming from the Islamisation of the banking system programme, has substantially increased the level of competition in the Sudanese banking system. This greater competition though driving firms to improve their efficiency may also encourage them to orient their businesses towards activities, sectors, and/or clients of higher risk.

Methodology and data collection

The main objective of this study is to investigate the implications of using *musharakah* mode of finance by the Islamic banks in Sudan and to provide an empirical assessment of the *musharakah* projects performance and its obstacles.

The significance of this study stems from the fact that despite the apparent success of Islamic financial institutions in many corners of the world, many governments are reluctant to endorse a wide scale shift towards Islamic finance mainly because of the implications of using PLS sharing PLS modes of finance. Moral hazard and limited knowledge about the wider economic effects of PLS method of the Islamic finance is one of the reasons behind such reluctance. The study hopes to contribute to a better understanding among researchers and policy-makers as to the likely the implications of *musharakah* mode of Islamic finance.

Data from Sudan, which fully adhere to interest-free principles of finance, will be used to answer our questions. Part of the data source used in this paper is the Sudanese banks balance sheets and annual reports, which provides bank level data for all Sudanese banks for the period 1990-2004. Initially, some descriptive analysis is provided. The concentration of *musharakah* in the SIBSs each year is provided so as to give an indication of the influence of *musharakah*. The second part of the data is a survey data collected from nine banks[2]. The survey questions are of nominal and ordinal data. Therefore non-parametric procedures are best suited to these data. A total of 250 of staff (investment departments' employees only) were randomly being sampled out of a figure between 1,000 and 2,000 represents the whole population. The methods of investigation are analytical and descriptive[3].

The sample characteristics

Table I provides the frequencies and per cents of personal characteristics of investment departments' employees in the Sudanese banking industry in Sudan.

This section provides information on the personal characteristics of investment department employees in the Sudanese banking industry including sex, age, education and managerial experience.

The following patterns can be noticed for each characteristic.

Biographical details

Gender. One can observe that the distribution of males and females is uneven. The representation of females is only 10 per cent of the total sample and 90 per cent for the male representation. Notably, it is close to the representations of both genders in the banking industry as a whole in which we can also find that the percentage of males and females equals 70 and 30 per cent, respectively (SBA The Sudanese Banks Association, 2004)[4]. This may be due the nature of Muslim society where males are expected to

	Valid	Frequency	Percent
Sex	Male	224	89.6
	Female	26	10.4
	Total	250	100.0
Age (years)	20-30	28	11.2
	31-40	146	58.4
	41-50	71	28.4
	Above 50	5	2.0
	Total	250	100.0
Educational qualification	Sudan Senior School Certificate	29	11.6
	Diploma	35	14.0
	Bachelor	129	51.6
	Postgraduate	55	22.0
	Other	2	.8
Total	250	100.0	
Managerial experience (years)	1-5	27	10.8
	6-10	34	13.6
	11-15	112	44.8
	16-20	40	16.0
	21 years and above	37	14.8
	Total	250	100.0
Investment management experience	Less than three years	72	28.8
	3-5	65	26.0
	6-8	56	22.4
	Nine and above	57	22.8
	Total	250	100.0
Investment training undertaken	Yes	216	86.4
	No	34	13.6
	Total	250	100.0
Name of the bank	Shamal Islamic Bank	39	15.6
	Saving Bank	39	15.6
	SIBS	35	14.0
	TIBS	32	12.8
	FIBS	31	12.4
	Bank of Khartoum	29	11.6
	Omedrman National Bank	24	9.6
	Saudi Sudanese Bank	21	8.4
	Total	250	100.0

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Table I.
The personal characteristics of the respondents

carry out the responsibilities of their families and therefore they are expected to work more than the females.

Age. The majority of the respondents belong to the age group ranging between 31 and 40 years old.

Education and qualification level. In general the respondents as a whole were well educated. Almost three quarters 73 per cent had finished a university degree, at which 51 per cent held a bachelor degree and 22 per cent held a postgraduate degree. The high level of education found in this level indicates the high degree to which employees are informed about finance and banking. This evidence, considered in the light of overall illiteracy rate of about 60 per cent for the Sudanese population over 15 years old, illustrates that those involved in taking financial decisions are well educated. By

contrast, approximately 10 per cent of the employees hold higher secondary school certificates, which is the lowest education level needed to be currently appointed to a position in any Sudanese bank currently. Therefore, it is possible to conclude that the dominant types of employees are very well educated.

Managerial experience. One can notice that a substantial majority (74 per cent) of the respondents have had over ten years of banking experience which means that they almost witnessed the whole process of the Islamisation of the banking system in Sudan from the beginning on 1992. As 44 per cent of the respondents have had between 11 and 15 years of banking experience combined with 16 and 14 per cent of them have between 16 to 20 and over 20 years, respectively. We may conclude that most of the respondents have relatively long experiences.

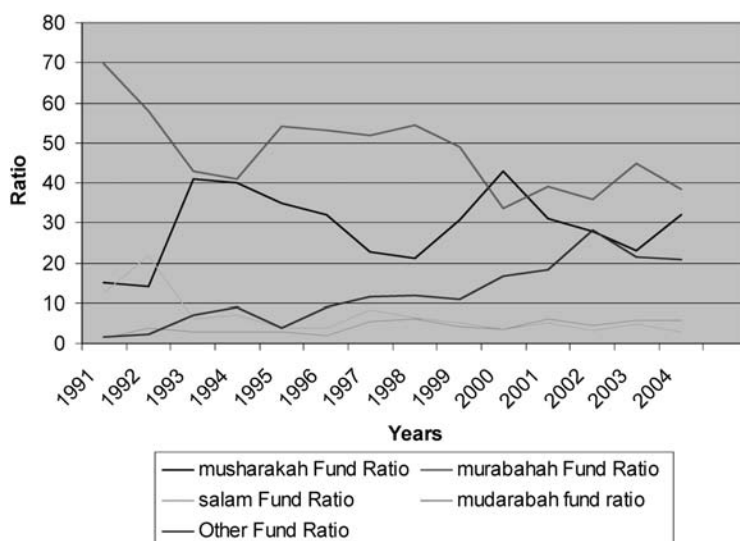
Investment training undertaken. Of the respondents, 86 per cent have had the chance to be trained to work for an investment department which is responsible for studying, accepting, financing and follow up projects financed by the banks using various Islamic finance methods including *musharakah* (partnership). This, together with the results brought out about the respondents experience and education, point out that the respondents are fairly qualified to manage finance operations including *musharakah* projects.

The banks which the respondents working for. The respondents sampled represent all Sudanese banks, both governmental and non-governmental (private), large and small scale, old and new, and specialized and non-specialized (commercial) banks. The percentages revealed which banks the respondents work for and belong to. Three of these banks are governmental banks, notably Omderman National Banks, Savings Bank and Bank of Khartoum. These three banks are represented by 36 per cent of the sample while the 64 per cent representing the five private banks are Shamal Islamic Bank, SIBS, TIBS, FIBS and Saudi Sudanese Bank. Additionally, 15 per cent of those respondents are working for a specialized bank, the Savings Bank, in contrast to the other seven banks which are commercial banks. The table, in addition, shows that for each of the following, Shamal Islamic Bank (a private relatively new and small scale bank), the Savings Bank (a relatively old and large scale bank) and the SIBS (a private old and large scale bank) the respondents range from 14 to 15.6 per cent working in each bank. Whereas for TIBS (an old, private and large scale bank), FIBS (an old, private and large scale bank) and Khartoum Bank (an old governmental and large scale bank) the respondents range from 11.6 to 12.8 per cent working in each bank, the rest of the respondents 20 per cent are working for Omderman National Bank (a relatively new and small scale governmental bank) and the Saudi Sudanese Bank (a relatively old and small scale bank) as the percentage for each is nearly 10 per cent.

We may conclude here, that the sample represents the entire population of the Sudanese banking industry and its component governmental and non-governmental (private) banks, specialized and commercial banks, as well as large and small scale banks and older and relatively new banks[5].

Distribution of fund per method of finance

Figure 1 shows the total fund distribution among Islamic finance methods namely, *musharakah*, *murabahah*, *salam* and other methods between 1990 and 2004. According to this figure *murabahah* had the biggest share of the fund with an average of 47 per cent from the overall funds. On the other hand, the *musharakah*, *salam*, *mudarabah* and other methods achieved 29, 6, 4 and 12 per cent, respectively. In general, we can notice that there is a gradual increase for *musharakah* fund as it started with 15 per cent in



Source: Bank of Sudan reports for the period 1990-2004

Figure 1. The distribution of fund per method of finance in Sudanese banking industry 1990-2004

1990 and increased to 32 per cent in 2004 compared with a gradual decrease for *murabahah* which started with 70 per cent in 1990 and ended by 38 per cent in 2004. As the figure also shows, that in two years (2000-2001), *musharakah* held the largest amount of funds, it must be noted that whilst all of Islamic finance banks and banking operations, all over the world, have been dominated by the non-PLS modes and the share of *musharakah* and *mudarabah* is very low, in Sudan, the story is different, as a great increase happened to the PLS share. From another hand there are many reasons why *mudarabah* does not play as large part as *musharakah*. One of them is because *mudarabah* in Sudan works mainly on trade.

The relative proportions of these different types of Islamic assets will, of course, have implications for a bank's medium and longer-term liquidity. The asset structure also has implications for income, with higher income associated with *musharakah* than *murabahah*. The asset structure and composition will also have consequences for bank risk. If problems arise with *mudarabah* these will have to be sorted out in a relatively short period or else the asset will be written off. Non-performing assets based on *musharakah* may cause problems for years, and there will be much less pressure to make provisions until the date of maturity of the assets approaches. This, however, means that problems may accumulate ultimately threatening the financial viability of the Islamic Bank itself unless appropriate action is taken.

It is worth explaining the main reasons mentioned by Dar and Presley (2000), for the lack of PLS contracts, mainly *mudarabah* in this case. They believe that the reason behind the lack of PLS modes in Islamic banking practice is because of the fact that PLS contracts are inherently vulnerable to agency problems, because entrepreneurs have disincentives to put in effort and have incentives to report less profit compared to the self-financing owner-manager. But if this is the case in Sudan, it should apply to both *musharakah* and *mudarabah*. However, in Sudanese banks as we have seen, this is not case. Sudanese banks rely on the use of *musharakah* but not *mudarabah*. The second reason is that the PLS is not feasible for funding short-term projects due to the

ensuing high degree of risk (i.e. the time diversification effect of equity). This makes Islamic banks and other financial institutions rely on some other debt-like modes, especially mark-up, to ensure a certain degree of liquidity. This is again not the case of Sudan as most of *musharakah* finance is a short-term finance.

The findings

Musharakah management

In this section we intend to discuss the different characteristics of *musharakah* projects including the average age of the *musharakah* projects, interference in management decisions, sharing the pricing decision, the awareness of the accurate product costs of partnership projects, and improvement programs conducted to improve finance management especially in the management of *musharakah* projects. The χ^2 goodness-of-fit test[6] has been used to differ between these characteristics as shown in Table II.

The following may be observed.

Preference of Islamic finance methods. The result of the χ^2 goodness-of-fit test indicates that there is reasonable very low like-hood that the differences in the Islamic finance methods preference in the sample data can be attributed to chance. In spite of the high risk of *musharakah* mode of finance and the high management skills needed, most of the respondents prefer *musharakah* as their mode of finance in dealing with their customers. Therefore, almost 60 per cent of the sample respondents preferred *musharakah* and by contrast only about 35 per cent of them selected *murabahah*, whilst less than 3 per cent chose the *salam* mode of finance and less than 3 per cent of the respondents including *mudarabah*, *istisnaa*, *muzarahah* and *mosagah*. This may show the support of the banks' employees to *musharakah*.

The managers as well as customers are guided by a pecking order when choosing among financing opportunities. The most popular reason for this behavior, as mentioned by Read (1998), is due to control, which is the desire to avoid external interference and maintain independence. The amount of debt or equity sought is determined, to a large extent, by the enterprises owner's and managers' goals of protecting the control of enterprise. Nasr (2005) argues that if the pecking order hypothesis holds, then, owners are reluctant to use *musharakah* mode of finance mainly due to absent of control factor from the demand side and high risk embedded in the instrument from the supply factor. According to Nasr small business owners prefer to be financed using *murabahah* then *Ejarah Wa iqtinaa*, followed by *mudarabah* and lastly *musharakah*. The results shown above, by contrast, do not agree with him. The reason we can put forward is that, as the researcher himself (Nasr) mentioned that there were several factors that potentially may restricted his conclusions to be drawn from his study. This is due to the small number of distributed and collected survey (45 respondents from which only few of them have been financed using *musharakah*) and the low of education level of the respondents. In addition the sample contains a high percentage of Christians[7].

Average age of musharakah projects. The result of the χ^2 goodness-of-fit test indicates that there are differences between the averages of *musharakah* projects' age. The dominant type of *musharakah* is that which lasts for three to six months as reflected by 72 per cent as of the respondents. Therefore as we mentioned earlier, the reason mention by Dar and Presley (2000) is no longer valid for the Sudanese case. One might stop here to keep in mind that almost all the literature state that the PLS supports long-term economic and financial development, especially *musharakah* by financing long-term productive projects. In reality, nearly all Islamic banks offer trade and project

		Frequency	Percent
Preference of Islamic financial methods χ^2 225.936 Asymp. Sig. 0.000	<i>Musharakah</i>	148	59.2
	<i>Murabahah</i>	88	35.2
	Salalm	7	2.8
	Other	7	2.8
	Total	250	100.0
Average age of the <i>musharakah</i> projects χ^2 458.200 Asymp. Sig. 0.000	Less than three months	9	3.6
	3-6 months	181	72.4
	7-12 months	50	20.0
	1-2 years	8	3.2
	Above two years	2	0.8
	Total	250	100.0
Respondents awareness of the accurate product cost of the partnership projects χ^2 129.992 Asymp. Sig. 0.000	Yes	159	63.6
	No	12	4.8
	To some extent	79	31.6
	Total	250	100.0
The respondents share pricing decisions with their partners χ^2 3.848 Asymp. Sig. 0.146	Yes	97	38.8
	No	81	32.4
	To some extent	72	28.8
	Total	250	100.0
The high risk of <i>musharakah</i> contracts causes great institutional influence on management decisions χ^2 106.240 Asymp. Sig. 0.000	Strongly agree	76	30.4
	Agree	92	36.8
	Uncertain	20	8.0
	Disagree	56	22.4
	Strongly disagree	6	2.4
	Total	250	100.0
The respondents' banks are committed to a quality improvement program χ^2 20.384 Asymp. Sig. 0.000	Yes	116	46.4
	No	60	24.0
	To some extent	74	29.6
	Total	250	100.0
Management actively supports the quality program χ^2 68.744 Asymp. Sig. 0.000	Yes	145	58.0
	No	49	19.6
	To some extent	56	22.4
	Total	250	100.0
Respondents satisfaction with their bank methodology for measuring the credit worthiness of customers and project-related risks χ^2 13.592 Asymp. Sig. 0.000	Yes	79	31.6
	No	62	24.8
	To some extent	109	43.6
	Total	250	100.0
Quality-related training is provided for all employees χ^2 20.216 Asymp. Sig. 0.000	Yes	97	38.8
	No	50	20.0
	To some extent	103	41.2
	Total	250	100.0

Table II.
Musharakah
management

finance *murabahah*, commissioned manufacturing, or on leasing bases and thus PLS features marginally in the practice of Islamic banking and finance. Whatever the degree of success of individual Islamic banks, the majority have so far failed to adopt PLS-based modes of financing in their businesses. However, the Sudanese banking experience is different, having seen that they succeeded in offering PLS modes, namely here *musharakah*. Yet, these offers are mainly for a short-term period of three to six months.

We argue here that one of the major dilemmas facing the present Islamic banks nowadays in Sudan is the fact that Islamic banks have to involve in long-term finance according to its theory where these banks mobilise funds on the basis of short-term deposits. Facing all the economical and political barriers fronting the country, e.g. high inflation rate as external factors, as well as internal factors, e.g. small size of the capital and lack of managerial efficiency, yet SIBS have to involve in long-term finance.

The Islamic banks in many Muslim countries have occasionally used this partnership financing scheme for financing of the working capital of the enterprises. These banks have mostly relied on the mark-up mode (Akhtar, 1997). However, SIBSs are an exception. They have mostly used the partnership financing mode in a variety of cases with considerable success. SIBs play a great role in assisting poor families. For increasing family income, it finances small enterprises usually located in the house-premises. For this purpose, SIBs operates productive families' branches in the residential areas.

We may divide *musharakah* projects in Sudanese banking industry to the following categories:

- (1) *Musharakah* sharing of certain financial transactions. In this type of *musharakah* the bank pays up to 40 per cent of the capital of a given project, which is most likely to be an internal trade type project. This type of *musharakah* is characterised by short-term projects.
- (2) *Musharakah* through sharing the operational capital. This type of *musharakah* takes place when the customer has in his possession an asset, be it a company or factory of some kind, but does not have sufficient funds for the day-to-day expenses. The bank provides the customer with financial support for the day-to-day running of the business, and in return earns a share of the company's profit.
- (3) Declining *musharakah*. The bank collaborates with a customer who invests a lesser amount than that of the bank for a certain project. Once this business is up and running the bank takes a larger amount of the profits and as a result gradually gives up its share in the company to its customer. This process continues until the customer becomes the sole proprietor of the business.
- (4) Continuous *musharakah*: where both parties, the bank and the customer (whose share in the company is usually not below 25 per cent), collaborate specifically for long-term projects. The amounts of their capital invested in the projects are reflected by share values, whether in a public or private limited company.

Awareness of accurate product cost and sharing pricing decision with the customers in partnership projects

The staff must regularly visit the projects and check the bookkeeping, marketing of products, account receivable and collection procedures. These arrangements tend to ensure the safety as well as the profitability of the bank's investment. The bank must constantly watch its interests by focusing on the overall performance of the project, through which a good knowledge of the products cost and pricing strategy will be gained-investigating for example where losses are made. In such a case the business being supported will be required to provide a satisfactory explanation (Wilson, 1984).

Since the χ^2 level is bigger than 0.05 then the null hypothesis will be accepted. There for any differences in the respondents views can be attributed to chance. In our sample, the employees' awareness of the accurate product cost of the partnership

projects is high at 63 per cent of them are aware of it because their customers provide them with the necessary information, as well as updating them about market price changes. Only a few of them (less than 5 per cent) are not aware of this, while 38 per cent are to some extent aware of it. Conversely and unexpectedly, 38 per cent of them share the pricing decision with their partner while 32 per cent of them do not and 28 per cent to some extent do. However, all the appeared differences can be attributed to chance.

In general, the bank is taking an equity share in the business being supported; it has no interest in sitting on the board of the company or exercising its voting rights at the company annual general meetings or at any other shareholders' meetings if registered as a separate entity and has no interests in any capital gains if registered as a partnership. Islamic banks maintain low profiles, and are, thus, best regarded as sleeping partners. Referring to most of the *musharakah* cases, we might say that in a substantial amount of these projects we may consider the banks to be indeed sleeping partners. The bank shares in a partnership's profits and is liable for any financial losses. There is no serious problem with this arrangement if the bank is able, and is allowed, to monitor the business operations of the firm. However, proper monitoring mechanisms are yet to be devised for *musharakah* (Ahmed, 2004; Dar and Presley, 2000). Reducing the moral hazard will need a proper follow-up for PLS projects and co-operations between banks and its entrepreneur. Where there is an ongoing dialogue between the financier and the entrepreneur, business decision-making can be improved, as two parties will be working together to produce a better outcome than when each is working in isolation.

The high risk of musharakah contracts causes great institutional influence on management decisions

As we mentioned before, consideration of customer wishes of no interference is essential, even though it may times cause weak monitoring. By contrast the high risk of *musharakah* contracts causes great institutional influence on management decisions. So the sense of balance is indeed needed in these cases. The majority of respondents agreed that it may cause an influence on management decisions, 30 and 36 per cent of them agreed and strongly agreed with this respectively. By contrast, 22 per cent disagreed and only less than 3 per cent of them strongly disagreed with this assertion. Along with that, only 8 per cent of the respondents were uncertain. These differences are attributed to the chance since the χ^2 level of significance is below 0.05.

It is most important to recognise the impact of PLS modes of financing on Islamic banks, especially the fact that when Islamic banks provide funds through their PLS facilities, there is a recognisable default on the part of the agent-entrepreneur until PLS contracts expire, barring proved negligence or mismanagement on the part of the agent-entrepreneur. In fact, a default of PLS contracts means that the investment project has failed to deliver what was expected, that is a lower or no profit, or loss. In this case, the lower profit or loss is shared between or among parties according to the stipulated PLS ratios (Errico and Farahbaksh, 1998).

Therefore, Islamic banks have a lower degree of control of the management of the enterprise they finance through the PLS contract. By contrast, credit risk related to financing through non-PLS modes are lessened by the possibility of collateralization, including mortgaging. The assessment of an appropriate level of the capital adequacy ratio for Islamic banks should be primarily based on systematic analysis of the underlining asset portfolio between PLS and non-PLS transactions (Errico and

Farahbaksh, 1998). Although the PLS contracts perhaps present significant risks to Islamic banks, it is also presents profitable opportunity. Accordingly, the assessment and management of investment risk becomes more difficult in an Islamic environment than in conventional banking because of the following factors (Errico and Farahbaksh, 1998):

- (1) PLS modes cannot be systematically made dependant on collateral or other guarantees.
- (2) Administration of the PLS modes is more complex compared conventional financing.
- (3) The relatively weak legal framework supporting bank lending operation.

Another point to be added here is that the single market Islamisation of the banking system programme, as happened in Sudan, may increase the level of competition. This greater competition, though driving firms to improve their efficiency, may also encourage them to orient their businesses towards activities, sectors, and/or clients of higher risk. In order to safeguard invested funds and realise profits, Islamic banks will need to rely more than conventional banks on a set of appropriate policies and adequate infrastructure for portfolio diversification, monitoring and control. They would also need to rely on the existence of an adequate supply of trained banking staff skilled in investment and Islamic banking practices to implement these policies.

To conclude, there is a need for risk analysis and risk management tools to provide agents with hedging instruments, especially with Islamic banks. In conventional banks, interest rates play a key role in managing liquidity, pricing risk and allocating credit. In the absence of the interest rates, the risk manager in an Islamic bank faces a greater challenge than the risk manager of a similar size conventional bank. In addition to this burden, Islamic banks are unlikely to benefit from a critical mass of similar institutions with which the Islamic bank can be developed, thus requiring Islamic banks to hold higher levels of liquidity than conventional banks, with a consequent negative impact on their ability to compete.

The respondents' banks are committed to a quality improvement program and their management actively supports the quality program

Since the χ^2 test shows a level of significance lower than 0.05 then any differences appear on the percentages of the options given to the respondents is likely true. We can observe that nearly half of the respondents believe that their bank is committed to a quality improvement programme whereas 29 per cent of them believe that to some extent they are committed and 24 per cent do not believe they are committed at all. Therefore, it is simple to conclude that the majority consider their banks to be committed to a quality improvement programme regarding their performance.

Almost 60 per cent of respondents believe that their management support their quality programme and in contrast 19 per cent of them believe their management does not, and in the middle, 22 per cent to some extent do. Thus it may seem, when put side by side with previous results concerning commitment to a quality programme, that the respondents believe that there are quality programmes carried out by their banks to improve performance and that their management does commit themselves and support these programmes with a significance level of 0.0.

Respondents' satisfaction with their bank methodology for measuring the credit worthiness of customers and project related risk

Conversely, 43 per cent of respondents are to some extent satisfied with their banks' methodology for measuring the credit worthiness of customers and project related risk, which seems likely be the main risk facing *musharakah*, and 24 per cent on the other hand are not satisfied. This may lead to strong advice to review their bank's methodology for measuring the credit worthiness of customers and project related risks. (Asymp. Sig. 0.000)

Quality-related training is provided for all employees. A total of 41 per cent of the respondents assume that quality-related training is provided for all employees, whilst less than 25 per cent of them do not believe so while the majority of them (43 per cent) consider that all employees have been provided with quality-related training. It is worthwhile to restate that most of the respondents (86 per cent) have attended investment training courses as mentioned before. (Asymp. Sig. 0.000)

Financial performance of musharakah projects. To get a clear picture of the *musharakah* performance, we investigate the respondents' assessment of its profitability, risk and performance management system for their banks. This section provides information on the financial performance of *musharakah* projects.

Table III presents the frequencies and percents of the respondents' opinions concerning the profitability, risk and satisfaction with their banks performance measurement systems for *musharakah* projects.

It is notable that the *P*-value (significance or Asymp. Sig.) is equal to 0.0 in all questions. The non-parametric test, therefore, confirm that the performance is not on the same level on all options according to the respondents views. The following can be observed in these differences:

	Valid	Frequency	Percent
<i>Musharakah</i> profitability χ^2 190.520 Asymp. Sig. 0.000	Very high	57	22.8
	High	114	45.6
	Acceptable	76	30.4
	Low or none	2	.8
	Not sure	1	0.4
	Total	250	100.0
<i>Musharakah</i> risk χ^2 67.240 Asymp. Sig. 0.000	Very high	72	28.8
	High	75	30.0
	Acceptable	61	24.4
	Low or none	36	14.4
	Not sure	6	2.4
	Total	250	100.0
The right to interfere into management decisions results in <i>musharakah</i> not being attractive χ^2 109.240 Asymp. Sig. 0.000	Strongly agree	51	20.4
	Agree	96	38.4
	Uncertain	22	8.8
	Disagree	75	30.0
	Strongly disagree	6	2.4
	Total	250	100.0
Respondents' satisfaction with their banks' performance measurement systems for <i>musharakah</i> projects χ^2 37.544 Asymp. Sig. 0.000	Yes	115	46.0
	No	39	15.6
	To some extent	96	38.4
	Total	250	100.0

Table III.
Financial performance of *musharakah* projects

Musharakah profitability. The profitability of *musharakah* projects is high. As a result, on a whole 45 per cent of the respondents consider the profitability of *musharakah* projects to be high, alongside 22 per cent of them who believe it is very high, while only 8 per cent believe it is low and 33 per cent consider it to have acceptable profits compared with other projects financed used other methods. Accordingly, we may sum up that the majority of the respondents believe that the projects financed using *musharakah* have a high profitability compared to their banks standards.

Musharakah risk.. Almost one-third (30 per cent) of the sample respondents believe that the *musharakah* risk is high with additional of 28 per cent believe it is very high. In regards of those who consider *musharakah* risk to be is acceptable or low they were simply 24 and 14 per cent, respectively.

In regard to the performance of the risk compared with the profit of the methods, it is generally clear, from Figure 2 that there is a harmony between the risk and profitability of *musharakah*: whenever one of the increases the other also increases and *vice versa*. This financial activity is consistent with the economics principle which states that there should be proportionality between profit and risk. Hence, we might say that the profitability is quite high and the risk is to some extent also high. However, *musharakah* profitability is higher than its risk.

Managerial efficiency is necessary for improving performance, especially for those projects which depend on following-up, management and control such as *musharakah* projects. Management is defined as the initiation of projects (demand and feasibility studies, project proposals and so on) and the implementation of these proposals by an active involvement in the production process. Control on the other hand is defined as the right to ratify the initial proposals and supervise the projects either through internal monitoring or external mechanisms (Dar and Presley, 2000). Accordingly, we may advise to strengthen the managerial efficiency of these banks.

We may observe that one of the main problems of *musharakah* is the non-performing debts[8] affair that has delayed simply the process of pay back both to the investor and to the bank. The problems faced by *musharakah* are mainly risk; the report proves that the problem of delay is the biggest problem that *musharakah* faces because if these loans are not paid off in time, they accumulate.

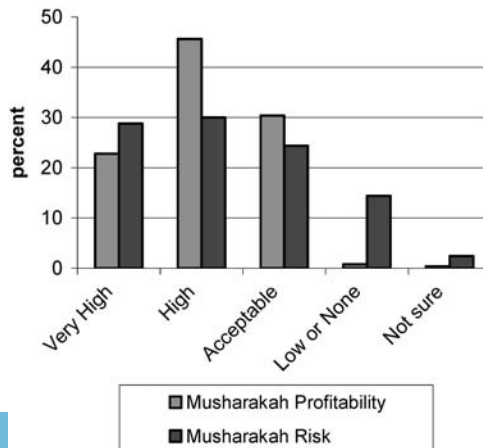


Figure 2.
Musharakah performance

Concerning risk there are three points that can be considered:

- (1) The moral commitment by the bank to facilitate and to finance the small producers and poor families as we have seen before. This leads to the bank not asking for sufficient guarantees and they ignore the credibility of the customer. As an alternative, they should ask for personal guarantors.
- (2) The nature of government in the system of *musharakah* in Sudan does not allow any one of the partners to take any kind of guarantee against the other partner. The only situation that allows a form of guarantee to be taken is that of mismanagement and fraud.
- (3) The partnerships do not have a great amount of control for some operations, such as animal export, which may lead to the delegating of responsibility by the bank to the other partner and allowing the other partner to do whatever he or she wishes.

The presence of the moral hazard problem in PLS modes makes it desirable for the banks to monitor the performance of the projects financed by them. Without doubt, it will involve additional costs but the benefits in terms of final declared profits will more than compensate for the costs of monitoring. In spite of this, the banks have been reluctant to do this because the entrepreneurs tend to resist it. Due to this, the banks may choose the easier way out, i.e. use fixed returns modes.

For the investment department of FIBS (FIBS, 1989) the recommendations to improve the management and performance of *musharakah* is first to improve the contract conditions which can minimise risk and give more authority to following-up these projects, secondly, it is to carry out as many short-term operations and projects as possible which we will come to comment on later. According to the report, there are two advantages of using this strategy:

- (1) a broader portfolio diversification which can reduce risk for a given return or increase return for a given risk; and
- (2) the ability to participate in new risks, including new projects.

These help money circulation as well as the constant re-appraisal of projects.

Interference into management decisions. Since the *musharakah* mode of finance contains moral hazard that represents the two possibilities of PLS which may occur, Islamic banks when using PLS sharing contracts try to carefully study the feasibility of this kind of finance. Then, if approved, they manage and follow-up these projects as they contain high risk which will lead to more interference in management decisions than other projects and transactions financed using other methods (such as non-PLS sharing contracts). Consequently, one assumption, which enforces itself effectively here, states that the right to interfere into management decisions results in *musharakah* not being attractive to customers or even to their banks. The majority of respondents, almost 60 per cent, show their support of the assumption with different kinds of agreements, that is 20 per cent of them strongly agreed and 38 per cent agreed with it. By contrast, 30 per cent of the respondents disagreed with the assumption and only less than 3 per cent strongly disagreed while about 8 per cent of them were uncertain. We may conclude that on the whole most of the respondents suppose the right to interfere into management decisions results in *musharakah* not being attractive to customers or their banks.

Satisfaction with performance measurement systems for musharakah projects. A total of 46 per cent of the respondents are satisfied with their banks' measurement systems for the performance of *musharakah* projects; whilst 38 per cent of them are to some extent satisfied and only about 15 per cent of them are not satisfied. As a result of this, it may be possible to conclude that a relatively simple majority of the respondents believe that the measurements of *musharakah* performance are quite satisfying and therefore there is no need to proceed further for substantial changes or improvement.

The relation between the lack of risk management knowledge and the weak of the budgets for finance methods

As shown in Figure 3, one can notice, in general, that the percent of the respondents decrease whenever goes from strongly agree to strongly disagree. It is noticed as well that the majority of respondents agreed that lack of risk management knowledge is behind the weak of the budgets for finance methods 45 per cent and 37 per cent of them strongly agreed and agreed with this respectively. By contrast, less than 9 per cent disagreed and only less than 1 per cent of them strongly disagreed with this assertion. Along with that, only less than 9 per cent of the respondents were uncertain.

Table IV shows the relevant importance of several factors affecting decision when choose to fund a customer using *musharakah* method of finance. These factors are customer credit worthiness, the customer choice of financing method, expected risk, credit policies set by the central Bank, expected profitability and the activity type whether it is agricultural or industrial and so on.

The figure suggests that customer credit worthiness is the most important factors. That 38 per cent of the respondents ranked it first which can be compared with 28, 17 and 13 per cent who ranked it second, third and fourth. Concerning the second important factor the respondents believe that the activity type is the second important factor affecting decision when choose to fund a customer using *musharakah* method of finance since 28 per cent of the respondent believe it is. In addition, the respondents believe the expected risk and expected is the third and fourth important factor with percent of 27 and 23 per cent of the respondents, respectively, voted for. Then lastly

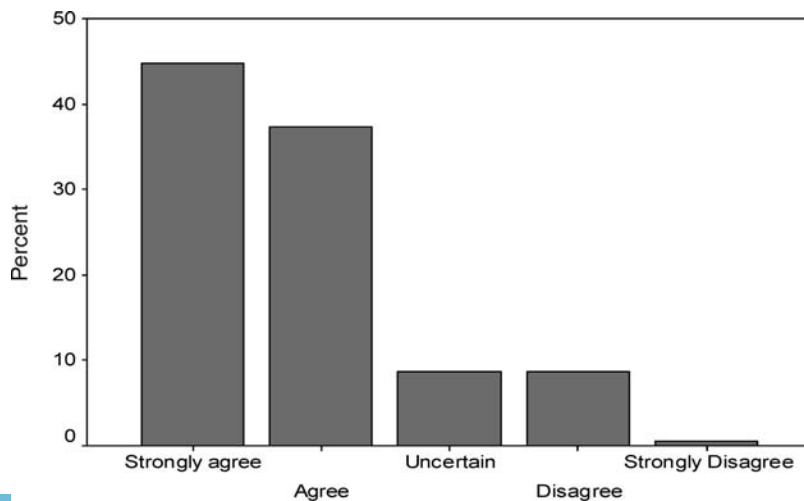


Figure 3. Ranking the importance of factors which affecting the decision of choosing *musharakah* as a method of finance

Lack of risk management knowledge behind the weak of budgets

Factors	Significance ^a						Total scores	Weighted significance points	
	Ranked 1st	Ranked 2nd	Ranked 3rd	Ranked 4th	Ranked 5th	Ranked 6th			Total ^b
Customer credit worthiness	Frequency Percent	31 38.3	19 23.5	14 17.3	11 13.6	4 4.9	2 2.5	81 100.0	187 380
The activity type whether it is agricultural or industrial, etc	Frequency Percent	13 16.0	23 28.4	14 17.3	12 14.8	11 13.6	8 9.9	81 100.0	215 315
Expected risk	Frequency Percent	4 4.9	11 13.6	22 27.2	18 22.2	13 16.0	13 16.0	81 100.0	252 307
Expected profitability	Frequency Percent	4 4.9	12 14.8	13 16.0	19 23.5	16 19.8	17 21.0	81 100.0	260 289
Credit policies set by the Central Bank	Frequency Percent	23 28.4	4 4.9	8 9.9	13 16.0	27 33.3	6 7.4	81 100.0	278 325
The customer choice of financing method	Frequency Percent	6 7.4	12 14.8	10 12.3	8 9.9	10 12.3	35 43.2	81 100.0	242

Notes: ^aNumbers weighted significance (points) column in the table are the number of votes that each factor received, ranked from one to six. To estimate each factors' significance, we have weighted each vote by points from six to one, first rank has six points, second rank has five points third rank has four points fourth rank has three points fifth rank has two points and sixth rank has one point. e.g. $132 \times 6 + 17 \times 5 + 11 \times 4 + 10 \times 3 + 1 \times 2 + 3 \times 1 = 956$. Total scores have been counted by combining and adding all scores in all ranks for each factor, e.g. $132 \times 1 + 17 \times 2 + 11 \times 3 + 10 \times 4 + 1 \times 5 + 3 \times 6 = 262$. The greater of the weighted significance points the more important is the factor and the smaller the total scores the more important the factor; ^bthe question was not applicable for 169 of the respondents

Table IV. Factors affecting the decision of choosing *musharakah* as a method of finance

credit policies set by the central bank and the customer choice of financing method come on the fifth sixth rank. The weighted significance points and the total scores, which are our chosen scheme to know the overall importance, prove the same results.

This raises the fundamental question of whether intangible assets such as education, experience, and skills can be as equal collateral as less than tangible assets in reality. Would it be possible to consider the intangible assets? Can Islamic banks balance the priority to the needs of society and the common interest with the individual profit and private interest?

Having had more than ten years using *musharakah* we should have had that balance. At least they have had to start concentrating in granting credit to educated talented customers with no collateral. The price, might be paid when adopting the wide range of no collateral finance through *musharakah*, is high cost and high risks, as financing on the (un-granted) PLS sharing base will increase the risks and following-up many financed projects will increase the costs. Unless a developed risk management, efficient managerial staff trained and a proper follow-up has taken place.

Conclusions

Profits produced in *musharakah* is not guaranteed, as a result, the entrepreneur dose not assure or secure profits. Fundamentally, no collateral is needed. *Musharakah* does not require strict collateral guarantees and does not leave the partner (entrepreneur) with a heavy burden of debts, post-dated cheques or any other kind of obligations compared with debt finance in the conventional system. While concentration should be on factors like the feasibility of the project, skills of the customer and his history and lastly the objective situation of the market and its risks, yet the most important factors affecting choosing *musharakah* as a mode of finance is customer credit worthiness. A system which accepts taking the personal features of the customer as a part of the factors should be developed.

A great increase happened to share of the PLS in the Sudanese banking industry as almost one-third of the total fund have been financed using *musharakah*. In spite of the high risk of *musharakah* mode of finance and the high management skills needed, most of the respondents prefer *musharakah* as their mode of finance in dealing with their customers. The dominant type of *musharakah* is that which lasts for three to six months as reflected by the majority the respondents. Managerial efficiency is needed for improving performance. Efficient following-up and close supervision is one of most important factors contributing to the solution of problems and the elimination of obstacles that face banks. Great attention should be drawn to the central bank policy as it is the most important factor affecting the distribution of banks fund according to the different methods of finance in the banks' budgets.

The advantages and disadvantages of using *musharakah* have been discussed, obstacles for the scheme have identified, and the performance of *musharakah* has been evaluated. The results indicate that the lack of knowledgeable bankers in selecting, evaluating and managing profitable projects is a significant cause for the lack of PLS projects. The paper has exposed the key issues involved in bad debt and general risk degree for *musharakah*. Quality improvement programme is needed to improve *musharakah* performance.

Notes

1. The word *shirkah* is used with same meaning or with connections to *musharakah*.
2. A breakdown of the participating banks will be shown.

3. It is worth mentioning here that the use of these methods may not completely alleviate the measurement problem. For instance, it might have been meaningful had it been possible to measure the competitiveness of the individual banks and analysis for all methods of finance used compared with *musharakah* in Sudan as another indicator of its readiness as well as the possible impact of the PLS modes in macro level. However, this approach is a wider to be included in one paper. Such approach is an undergoing research for the author who reads for PhD in Islamic finance at Durham University in the UK.
4. The area of male gender domination needs further study, but this is outside the scope of this study.
5. In addition to that the majority of these banks are using an average of 47 per cent of their funds to finance customers using *musharakah* for the period between 1993 and 1999 (Ahmed, 2005).
6. The χ^2 goodness-of-fit test, also referred to as the χ^2 test for a single sample, is a non-parametric test employed in a hypothesis testing situation involving a single with nominal and categorical data (Sheskin, 1997).
7. The study has been conducted on the customer demand side on *musharakah* in the urban area of Cairo.
8. The term bad debts is well known but not quite valid for the *musharakah* case as no debts should occurred between partners, therefore it should be called non-performing *musharakah* investment.

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Further reading

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