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Islamic Letter of Credit (LC): an Overview on Legal and Shari'ah Issues

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(Paper presented at the *International Conference on Corporate Law 2009* held in 1-3 Jun 2009 at Surabaya, Indonesia)

Perpustakaan Universiti Malaya



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**ISLAMIC LETTER OF CREDIT (LC): AN OVERVIEW ON LEGAL AND SHARĪAH
ISSUES**

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ABSTRACT

Letter of credit serves as an instrument of payment in international trade. Its aim is to facilitate trade between seller and buyer from different countries. The Islamic banking flourishing environment promotes the use of Islamic LC as a method of financing in international trade particularly to Muslims and to the general public as a whole. Nowadays, this facility is offered not only by Islamic bank but also by some conventional banks. Both conventional and Islamic LCs are governed by the same rules of the UCP 600 which is originally western and drafted by western people. Realizing the bizarre in the application of this conventional rule to Islamic LC, this paper focuses on the aim of harmonizing the practice of Islamic LC with the requirement of Sharīah principles where elements such as interest (*ribā*) and uncertainties (*gharār*) are prohibited. It begins by giving a background of Islamic LC in Malaysia. Next, it discusses the definition and types of Islamic LC which consists of *al-murābahah*, *al-wakālah* and *al-mushārahah* as the issuance of Islamic LC is based on these three concepts. In addition, it highlights comparisons between these three concepts. Furthermore, the focal point of discussion is on Sharīah issues in the practice of Islamic LC, such as governing rule, subject-matter, interest, insurance, *aqad*, discrepancy fee, and risk of goods in Islamic LC. Discussion on those issues identified whether they are in compliance with Sharīah principles. In relation to this, various proposals are suggested to harmonize the rules applicable to Islamic LC and Sharīah principles.

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INTRODUCTION

Letters of credit¹ is one of the payment mechanisms in international trade. It is widely used particularly in a sale transaction where the seller and the buyer are not residing in the same country. A long distance in location between both parties always invites worries and uncertainties as it is very difficult to trust each other. Dealing with someone who you do not know or see is very dangerous especially when the sales involve a huge amount of money and expensive goods. Both parties in this situation are reluctant to start giving commitment unless they have been assured that their positions will be protected. A seller will not be willing to part with his goods unless he has been guaranteed that payment will be received. Likewise, the buyer will also not be so generous to advance payment to the goods unless he has been secured that he will receive the goods according to his orders. In this case, LC serves as an important tool to overcome the problems of trustworthiness between buyer and seller. The role and function of LC is to provide an efficient payment by using the bank as a reliable paymaster to advance payment. The seller will be automatically paid once he has presented to the bank documents which strictly comply with the credit requirements whereas the buyer does not have to pay until all the documents has been presented with compliance.

In Malaysia, LC either conventional or Islamic has also been used as a method of payment in international trade. The operational aspects of Islamic LC are very similar with conventional LC.² It is governed by the same UCP which standardizes the operational aspects of various international financial instruments. An Islamic LC can be issued using either the principles of *al-wakālah*, *al-murābahah* or *al-mushārahah*.

Background of Islamic LC in Malaysia

In Malaysia, Islamic LC³ was introduced by Bank Islam Malaysia Berhad in 1983 when the bank started its operation. It followed by Maybank, Bank Bumiputera Malaysia Berhad⁴ and UMBC Bank⁵ in 1993. In 1999, Bank Muamalat was set up and Islamic LC was also one of the products offered. Nowadays, Islamic LC has been offered by almost all major commercial banks in Malaysia, either standalone Islamic banking operations or Islamic windows as part of a conventional commercial bank banking activities.

Currently, it is observed that the number of Islamic LC issued in Malaysia is much lesser compared to the conventional LC.⁶ The fact that the strong application of conventional LC has denied the applicability of Islamic LC which comparatively new and still need some space to gain customers confidence in utilizing this product. In addition, bankers also need to develop their expertise in *Shari'ah* principles in order to functionally operate Islamic LC and other products with a clear understanding on documentation in order to gain customers' confidence.⁷ It is interesting to note that, with the emergence of the Islamic banking system, non-Muslim bank staffs are practically and directly involved in handling Islamic banking products.

Another factor which discourages the use of Islamic LC and all Islamic products is based on the reason that Islamic banking system in Malaysia is offered as an option rather than primary banking choice (compulsory). Thus, it gives the Muslim customers an option to choose between conventional and Islamic.

Definition of Islamic LC

There is no specific definition for Islamic LC. It is mentioned as "documentary credit" in AAOFI Standard and defined as:

¹ Hereinafter referred to as LC.

² See, Mei Pheng, Lee & Ivan Jeron Detta, (2007) *Islamic Banking & Finance Law*, Pearson Malaysia Sdn. Bhd; at 105.

³ That is LC al-Mudarabah and al-Musharakah.

⁴ now CIMB Bank.

⁵ Formerly known as United Malayan Banking Corporation.

⁶ This fact has been unanimously agreed during the interviews with Encik Zulkifli Illias, Head of Kuala Lumpur Trade Services Centre, Rhb Bank on 21 March, 2008, Encik Wan Nawawi Wan Hassan from Zealot Associates on 13 March, 2008; Puan Norliza Mohd. Zain, Enterprise Sale Support, Islamic Banking, Maybank on 21 February, 2008; and Encik Mokhlis Maizan, General Manager, Sales and Product Management, Bank Islam Malaysia Berhad on 27 September, 2007.

⁷ The same reasons are also shared by other Islamic banking products.

“a written undertaking by a bank (known as the issuer) given to the seller (beneficiary) as per the buyer’s (applicant or orderer’s) instruction or is issued by the bank for its own use, undertaking to pay up to a specified amount (in cash or through acceptance or discounting of a bill of exchange), within certain period of time, on condition that the seller present documents for the goods conforming to the instructions.”⁸

The Standard had summarized the above definition by briefly stated that a documentary credit is an undertaking by a bank to pay subject to conformity of the documents to the contractual instructions.

Apart from the above definition, there are definitions of LC given by a number of commercial banks in Malaysia. For example, Bank Islam Malaysia Berhad has defined Islamic LC as:

“a written undertaking by Bank Islam at the request of the Buyer/Applicant to pay the Seller/Beneficiary a certain sum of money as stipulated in the LC, provided that the Seller/Beneficiary complies with the terms and conditions of the credit.”⁹

A similar definition but a slight different in the wordings is given by Bank Muamalat Malaysia whereby Islamic LC is defined as:

“a written undertaking by the Bank, given to a seller (the beneficiary) at the request and on the instructions of the buyer (the applicant), to pay at sight or at a determinable future date up to a stated sum of money within a prescribed time limit and against stipulated documents which must comply with terms and conditions.”¹⁰

The definitions of Islamic LC have no substantial difference with conventional LC since they carried on the same role and function that is to facilitate trade. The only distinction is the procedure how it is issued and operated. This is so because, the inclusion of *Shari’ah* principles into the application and operations of the LC as a whole, do not change the existing characteristics neither does it change the primary functions of the LC in trade. *Shari’ah* principles only separate the element of *ribā* (interest) and *gharār* (uncertainty) in LC transactions which do not alter the governing rules, UCP and other international rules published by ICC.

Types of Islamic LC

An Islamic bank may issue the LC under three concepts. They are *al-wakālah*, *al-mushārah* and *al-murābahah*. In Malaysia, only LC *al-wakālah* and LC *al-murābahah* concepts are widely used whereas LC *al-mushārah* is not practiced by commercial banks. The reason behind the non-applicability of LC *al-mushārah* is relates to a matter of domestic banking policy, whereby commercial banks, on principle do not jointly take part in any business ventures, hence do not liable to the loss of the goods.¹¹ LC *al-mushārah* is however widely practiced by the Middle East countries.¹²

In LC *al-wakālah*, the customer (al-muwakkil) may ask the bank to issue the LC providing a written instruction. Upon approval, the bank would request the customer to place the deposit of the full amount of the price of the goods to the bank (al-wakil) as a security. The bank accepts the deposit which is placed under lien where the principle of al-wadiah yad dhamanah is applied.¹³ Then, the bank establishes the LC in favour of the exporter and collects its commission and other charges incurred. Upon negotiation of the document, the issuing bank would pay

⁸ Para. 2/1 AAOFI.

⁹ [on-line]: <[http://www.bankislam.com.my/Letter Of Credit-\(LC-i\).aspx](http://www.bankislam.com.my/Letter Of Credit-(LC-i).aspx)>

¹⁰ Through the publication of “A Quick guide on products and services, Bank Muamalat Malaysia Berhad, Kuala Lumpur” (2002), also available [on-line]:

<http://www.muamalat.com.my/index.php?pg=tfinance_general&ac=112>

¹¹ Interview with Encik Zulkifli Md. Iiyas, Head of Kuala Lumpur Trade Services, Rhb Bank on 21 March, 2008; Encik Mokhlis Maizan, General Manager, Sales and Product Management, Bank Islam Malaysia Berhad on 27 September, 2007.

¹² Ibid.

¹³ That is a guaranteed custody whereby bank has the authority to use the deposits and gives a guarantee to return it to customer when he need it; the meaning provided by Standard Chartered, [on-line]:

<<http://www.standardchartered.com.my/ib/info/concept.html>> viewed on 17 March, 2008.

the negotiating bank utilizing the customer's deposit. Subsequently, the bank releases the documents to the customers and charges the fees for its services under the principles of *al-Ujrah* (fee).¹⁴

With reference to situation mentioned above, in LC *al-wakālah*, there is an agency relationship exists between bank and customer, whereby the bank acts as an agent to the customer (the importer). Delegation of agency is where the customer or the applicant will hand over the instruction in writing to the bank by completing a standard form indicating details in trade. The bank or the agent will act on the written instruction or request by the customer to issue the said LC. This written instruction acts as an *aqad* (offer and acceptance) which binds both parties into a binding agreement. From this point onwards, the bank or the agent will ensure that the LC reaches the exporter. The bank then undertakes to examine the documents as required by the UCP and to effect payment accordingly. Acting as an agent, the issuing bank is only relaying the guarantee of payment to the exporter. The bank is not a purchaser but only an agent to make a payment on behalf of the importer. The goods are in actual fact, is fully paid by the applicant from the deposit placed with the bank. Being an agent, the bank entitles to receive commissions apart from service charge obtained on issuance of the LC. It is customarily and expressly stated that the LC issuance fee in Malaysia is charged at 0.1% per month or part thereof based on the Malaysian amount equivalent until expiry.¹⁵ Currently, LC *al-wakālah* is practiced by all full-fledged Islamic banks in Malaysia.

Under *al-mushārah*, the bank issues the LC and both the bank and the customer contribute to the purchase price under LC. They later share the profits of the business venture based on the pre-agreed profit-sharing ratio. Losses are borne proportionate with capital contribution (in paying the purchase price). For instance, where a customer of the Islamic bank has been awarded a contract for supply of certain merchandise to a particular organization, he may propose for a joint-venture scheme whereby the bank grants him a credit facility in order for him to import and supply the merchandise. This joint venture proposal is known as *al-mushārah* which will be operated on the basis of profit-sharing.¹⁶

Similar to LC *al-wakālah*, the first step in establishing LC *al-mushārah* begins with the customer issuing an instruction or request in writing to the issuing bank. The customer places with the bank a deposit for his share of the cost of goods to be purchased or imported as per the *al-mushārah* agreement which the bank accepts under the principle of *al-wadiah yad dhamanah*.¹⁷ The bank issues the LC and pays the proceeds to the negotiating bank, utilizing the customer's deposit as well as its own shares of financing, and subsequently releases the documents to the customer. Finally, the customer takes possession of the goods and disposes these off in the manner agreed in the agreement.

On the hand, under LC *al-murābahah*, the bank will provide a financing facility to the customer or applicant where the customer is given a certain period of time to make a full settlement of the purchase. The bank issues the LC and pays the purchase price to the exporter. Then, the bank through the documents of title to the goods buys the said goods and resells them at a different price agreeable to the customer. The new selling price constitutes a mark-up of certain profit above the original cost price. In this case, the customer is further assisted with a certain grace period in order to enable him to sell the goods to the final buyer. It is also permit him to collect the sales proceeds before he is required to make full settlement to the bank. For instance, a customer engaging either in trading or manufacturing, may need to purchase merchandise or raw materials in the course of his business. The customer therefore requires the LC together with financing over a certain period of time. The Islamic bank can then offer him an LC *al-murābahah* facility.¹⁸

¹⁴ See, Bank Negara website, [on-line]: <http://www.bnm.gov.my/index.php?ch=174&pg=469&ac=384>; See also,

Eon Bank website, [on-line]: http://www.eoncap-islamicbank.com.my/financing/financing_trade_financing.asp

¹⁵ Association of Bank in Malaysia (ABM) Rules, H5 Commercial Letters of Credit or Authority and/or Guarantee. However, the rules were regulated since 1984 and were not revised since then. It has no enforcement on the banks and most of the banks have applied their own specified charges.

¹⁶ See, Kamar Khir, Gupta, L, Shanmugam, B (2008) *Islamic Banking, A Practical Perspective*, 1st edition: Longman,, at 224-225; Mei Pheng, Lee & Ivan Jeron Detta (2007), at 118; See also Bank Negara Malaysia website, [on-line]: <http://www.bnm.gov.my/index.php>

¹⁷ n.31, at 13.

¹⁸ Example illustrated by Mei Pheng, Lee & Ivan Jeron Detta (2007), at 109. See also, Kamal Khir, B (2008), at 126.

In brief, the procedure begins when the customer informs the bank of his LC requirements and requests the bank to purchase goods by executing an *aqad* in writing. The customer indicates that he would be willing to purchase the goods from the bank upon negotiation of the LC on the principle of *al-murābahah*. The bank appoints the customer as its agent to purchase the required goods on its behalf. The bank establishes the LC and pays the proceeds to the negotiating bank, utilizing its own funds. The bank sells the goods to the customer at a sale price comprising its cost and a profit margin under the principle of *al-murābahah* for settlement on a deferred term.¹⁹

Differences of LC *Al-Murābahah* And LC *Al-Mushārahah* Operations

Trade transaction generally can be carried out either by applying *al-murābahah* concept or *al-musharakah* concept. The role or involvement of a bank in a particular business venture would determine whether the concept of *al-murābahah* or *al-musharakah* is applied. If for instance, the bank is also contributing the capital investment jointly with the buyer, it is said that the concept of *al-musharakah* exists. On the other hand, if the bank is not one of the parties in a particular trade carried out by the buyer, the concept of *al-murābahah* is applied.

As discussed above, *al-murābahah* is a doctrine of credit business transaction where the amount of purchases or 'debt' is paid after the goods are sold to the final buyer. The bank would acquire the goods for its customer from the exporter, either from abroad or domestically. This is done by issuing a guarantee for payment instrument to the exporter, which is an LC. In this trade cycle, the bank has no management rights of whatsoever to determine how the goods should be disposed off but only relying on its customer. The bank only benefits from the total capital invested in the said business venture where it earns some profit margin. The customer on the other hand, could purchase the inventories without having paid for them upfront. The bank however, is not liable and responsible on the loss should the business venture failed. In other words, in those events, failure and success, the customer is liable to honor the selling price to the bank on the agreed date.²⁰

Unlike *al-murābahah*, *al-musharakah* witnesses the involvement of the bank in a particular business venture carried out by the buyer both, capital investment and roles played by the bank. The bank is directly involved in the business venture where capital will be invested in an agreed proportion. By virtue of the investment, the bank jointly owns the business with its customer. The bank is therefore partly liable and responsible to the business venture. In practice, the bank provides consultation and advices on the fund management and the customer will run the day to day business operations.²¹ The bank will acquire the inventories or assets at the request of its customer to enhance the running of the said business venture by issuing an LC to the seller. Both parties would benefit from this business venture by sharing the profit margin in accordance to the ratio of the invested capital.

In both cases above, the LC is used as the payment mechanism where bank is acted as an agent or *al-wakālah* for the buyer to convey the message to the seller that the payment is guaranteed provided that the terms and conditions of the LC is complied with. In practice, under *al-murābahah* trade transaction, where bank does not have any control over the business venture, the type of goods involved are restricted to only inventories and stocks for example, sugar, flour, spare parts and commodities. This is to ensure that the buyer will dispose them off within the shortest time period.

On the other hand, under *al-musharakah* concept, where bank has some control over the business venture, goods purchased will also cover assets such as machinery, transport and logistics. This concept requires the bank to look into a wider picture of the business venture whereas, under *al-murābahah* the bank only concern with the small sub-activity of the business venture.

¹⁹ Ibid, See also Bank Negara Website, [on-line]:

<http://www.bnm.gov.my/index.php?ch=174&pg=469&ac=384>

²⁰ Encik Wan Nawawi Hassan, Zealot Associates (Personal Communication, on 7 April, 2008); Interveiw with Encik Mokhlis Maizan, General Manager, Sales and Product Management, Bank Islam Malaysia Berhad on 27 September, 2007.

²¹ Encik Wan Nawawi Hassan, Zealot Associates (Personal Communication, on 7 April, 2008); Encik Zulkifli Bidin, Head, Trade Sales, Hong Leong Bank (Personal communication on 9 April, 2008).

Shari'ah Issues in Islamic LC

Eventhough both conventional and Islamic LCs carry out the same role and function, it may differ in certain aspects. The following discussion highlights certain differences between conventional and Islamic LC and considers issues and practices in Islamic LC transactions from *Shari'ah* points of view.

(1) Governing Rule

The application and operations of LC is primarily though not solely, governed by the standard international rules known as Uniform Custom and Practice for Documentary Credits or UCP in short, issued by the International Chamber of Commerce. This set of rule has been adopted by all countries worldwide as a standard trade practice pertaining to applications and operations of LC. The latest version of UCP is the UCP 600.

An interesting question here is does the current UCP that is UCP 600 complies and can as well govern the application and operations of Islamic LC? It is important to note that the emergence of Islamic Banking system that produces Islamic LC technically speaking does not produce a 'new' LC product. Based on the definitions above, the objective and function of the LC whether conventional or Islamic do not explain the technical differences. Therefore, Islamic LC is governed by the same conventional UCP which "remains a product of the Western practitioners and experts."²² It is strongly recommended that:

"The existing UCP be studied, reviewed, amended, supplemented and in the process a new set of rules and regulations that are founded on our understanding of Islamic law practice."²³

(2) Subject-matter or goods traded

Obviously, under Islamic LC, goods traded must be of *halal* goods which is one of the Islamic principles. Allah said:

"Eat of that which Allah hath bestowed on you as *halal* and good and keep your duty to Allah Whom you are believers."²⁴

Thus, all parties, bank, importer and exporter must be fully aware that they are dealing with *halal* goods. This requirement however is not relevant in conventional LC as long as the goods has value and not unillegal.

However, there is one question arose relating to the issue of *halal* goods in LC *al-wakālah*, that is how to determine whether the goods are really *halal* before the LC *al-wakālah* is issued. This practice differs from one country to another. Some banks in foreign countries require a certification from the exporting country to certify the goods are *halal*. In Malaysia, Bank Negara Malaysia has established a listing of all the goods which entitle to be financed under Islamic financing facilities.²⁵

(3) Interest (*ribā*)

Generally speaking, the UCP 600 does not contain any express articles which associate to *ribā* or *gharar*. However, in article 13(b)(iii) provides that:

"An issuing bank will be responsible for any loss of interest, together with any expenses incurred, if reimbursement is not provided on first demand by a reimbursing bank in accordance with the terms and conditions of the credit."

The 'interest' expressed in this article refers to the 'penalty' amount that is to be paid by the LC issuing bank to the reimbursing bank in the event of failure to provide reimbursement without delay. In practice, this 'penalty' amount is not pre-determined at the point of the issuance of the LC but only disclosed by the reimbursing bank upon claiming reimbursement from the issuing bank in the case where the documents are negotiated.²⁶ The 'penalty'

²² Ahcene Lahsasna, *Implementation of the Islamic Letter of Credit in International Trade*, International Islamic Conference on Islamic Banking and Finance IICiBF 2007, The Bridge Between Ideals and Realities, Kuala Lumpur, Crown Plaza Hotel, 23-25 April, 2007, by International Islamic Univeristy Malaysia, at 8.

²³ Ibid.

²⁴ Al-Maidah: 77

²⁵ Guidelines on Bankers Acceptances (2004), Appendix, issued by Jabatan Pengawalan, Bank Negara Malaysia.

²⁶ Encik Wan Nawawi Hassan, Zealot Associates (personal communication, 7 April, 2008)

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amount varies from one country to another country subject to the currencies and number of days the delay occurs. Some banks are charging at 5%, others at 7% and there are cases where the quantum is charged at 9%. The word 'expenses' on the other hand refers to the amount incurred by the reimbursing bank in the process of handling of documents and communication. This amount is also varies from one country to another country and not pre-determined. Sometimes these charges are exorbitant and do not reflect the actual cost incurred.²⁷

This article, without further argument, clearly contradicts with the *Shari'ah* principles as it represents *ribā* (interest) and *gharār* (uncertainties) elements. Allah said:
"Allah hath permitted trade and forbidden riba"²⁸

Likewise, the Prophet (PBUH) prohibited in his hadith narrated by Muslim, 'Ahmad, 'Abu Dawud, Al Tirmidhi, Al Nasa'i, Al Darami and 'Ibn Majah on the authority of 'Abu Hurayra the pebble sale and the *gharār* sale.

To remedy the presence of these prohibited elements, article 1 of the UCP 600 provides an option where banks can modify or exclude certain clause which is deemed not agreeable by trading parties and banks. By virtue of this article, Islamic banks can eliminate clauses inherent to *ribā* (interest) or *gharār* (uncertainties). It may seem as an effective mitigation mode as far as *Shari'ah* principles is concerned, but it may trigger another problem within non-Muslim banking society worldwide who do not subscribe to *Shari'ah* principles. This would make negotiation LC or negotiation of documents under Islamic LC unattractive.

As a long term remedial step, it is imperative for the Muslim society worldwide through a recognized Islamic trade body to establish a specific standard international rules on incidental charges which comply with the *Shari'ah* principles. This however, should not deprive the rights of any parties, including banks to claim monetary compensation or indemnity on the negligence incurred. This formulation is viewed as critical as the Islamic LC is not only circulating within the Islamic banking system but also practiced by conventional banking system worldwide.

As far as applications and operations, Islamic LC is still governed by the widely accepted general guidelines, UCP. This is to say that when one uses the LC *al-wakālah*, there is no interest will be charged in the case where late reimbursement by the reimbursing bank when the documents had been negotiated. The negotiating bank cannot claim the interest from the issuing bank for late reimbursement. This applies to both, Islamic bank and conventional banks when dealing with LC *al-wakālah*.

(4) Insurance and INCOTERMS 2000

Another important standard rules governing the operations of LC is International Commercial Terms or INCOTERM 2000 in short. These rules emphasize on distribution of costs, risks and obligations among the trading parties, importer and exporter.

Movement of goods is the second event to take place after the issuance of the LC. Either by vessel, train, airplane, road or combination of any of these modes, there are costs incurred in relations to transportation, insurance, import and export duty, custom clearance and other incidental charges. These rules will determine who should pay the charges, when to make delivery, the place of delivery and how the delivery should be made. Transport charges for example, eventhough differ based on geographical location and by the choice of mode of transport, but it does not form an element of *gharār* (uncertainty). This is due to the fact that this charge is certain to be incurred in order to move the goods from place of origin to the final destination. In practice, this cost is pre-determined where it is incorporated into the price of the goods and reflected in the invoice or pro-forma invoice which would then be indicated in the LC.

Insurance on the other hand would ensure the interest of both parties are protected in the event of loss to the goods or damaged during the transit to the final destination. The element of *gharār* cannot be avoided concerning insurance when dealing with importer or exporter from the western countries as their insurance services operates on conventional system basis. For example, if the exporter is domiciled in Italy, it would defeat the purpose of Islamic

²⁷ Ibid.

²⁸ Al-Quran, Surah Al-Baqarah 2:275.

LC should the parties trade on terms like c.i.f (cost, insurance, freight), c.i.p (carriage and insurance paid to) and d.d.u (delivery duty unpaid) where insurance procurement is at the disposal of the exporter.²⁹

To mitigate such situation, the trading parties may agree to trade on other terms where the procuring of the insurance is at the importer's disposal such as ex-work, f.c.a, f.a.s (free alongside ship), f.o.b (free on board), c.f.r (cost and freight) and the like. This has to be cleared prior to drafting a sales contract.³⁰

Although this complication can be unfolded, but there are other problems which may hinder such mitigation step and may not be practical in some situations. Tangible services such as insurance on cargo generates high profit where in some countries outwards payment for such service would not be allowed and restricted by political or trading policies. However, thus far, there is yet a case of dispute which causes unnecessary delay concerning procuring of cargo insurance between trading parties.

(5) *Aqad*

Aqad comes from Arabic word which means tie or bond. It is an agreement between first and second party through *ijab* (offer) and *qabul* (acceptance) where it is an endeavor of bonding an agreement. The reason of having an *aqad* is to clarify and produce willingness between both party who is in contract and knowing its implication. *Aqad* can be done even though the goods do not exist at the place or during the time the *aqad* is declared.³¹ This is based on the hadith narrated by al-Bukhari and Ibn Umar (R.A) when he said,

"I've entered into transaction with Usman. Mine is Wadi and His in Khaibar."

In Islamic LC, *aqad* plays an important role in ascertaining the legality of the transaction. It is one of the elements which differentiate the practice of Islamic and conventional LC. In *Majlis aqad*, the issuing bank and an applicant who is an importer should expressly declare their intentions to be bound by the LC at the time the LC is issued. The second following *aqad* should take place by the time the documents presented for financing under *al-murābahah* or *al-mushārakah*

In practice, the *aqad* normally comes in the form of written statement printed in the standard form such as an application form for issuance of LC. It is also included as a clause of the agreement of LC contract itself. However, certain banks may draft a separate appointment letter of representative to be signed by bank and customer.³² This practice is *Sharī'ah* compliant and more practical, as Allah had said:

"O ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing."³³

(6) Discrepancy Fee

Similar to conventional, Islamic LC is also governed by the principle of strict compliance which indicates that documents must strictly comply with the credit requirement. Seller beneficiary will be paid by the bank only on compliance of his documents. Any errors or discrepancies in documents will discharge the bank from honouring the payment. In practice, the bank may impose discrepancy fee against any discrepancies found in documents. The original purpose of discrepancy fee is to educate the beneficiary to be more careful in preparing his documents and to reduce the high rate of rejection due to discrepant documents. However, at the same time, it serves as an easy money to the bank as the bank has an absolute right to charge any amount and sometimes this amount is excessive. So far, there is no standard measurement to the amount of discrepancy fee and this practice seems prejudice the beneficiary. At the same time, it makes the payment by using LC non-attractive as traders may refuse to use this method of payment for fear of being caught by discrepancies and must pay an expensive discrepancy fee. Thus, beneficiary's position is oppressed and this practice is contradicted to shariah principle which forbids the practice of oppression. This can be based on the following hadith, where the prophet (P.B.U.H) said in Hadith 24 of Forty Hadith by An-Nawawis that:

"I have forbidden oppression for Myself and have made it forbidden amongst you, so do not oppress one another."

²⁹ See INCOTERMS 2000. [on-line]: <<http://en.wikipedia.org/wiki/Incoterm>>

³⁰ Ibid.

³¹ Sayid Sabiq, Fikih Sunnah, Jilid 12-14.

³² Exploratory study by researcher on Malaysian commercial banks.

³³ Al-Baqarah 2:282.

Thus, the idea that discrepancy fee should not be charged against minor discrepancy which is not disputed by the buyer and did not detrimental to the business of the bank,³⁴ should be upheld.

(7) Risk of goods in murabahah financing

An ally to the principle of strict compliance is autonomy principle.³⁵ It means LC is independent and separate form the underlying sale contract. Article 4 and 5 of the UCP 600 expressly highlights that LC is a separate contract and banks deal with documents only and not with goods. Therefore, as far as the goods are concerned, bank is not responsible to any risk. Since the emergence of Islamic LC in international trade is considered quite recent despite the application of *Sharī'ah* concepts in financial institutions in the last century, one big question is how far has the autonomous concept applicable in Islamic LC? In this argument, fairness and equity do not seem to exist since only one party that is the bank is protected.³⁶ In practice, to further secure the bank from financial loss of *al-murābahah* financing, a disclaimer clause is added in the *al-murābahah* financing contract which discharges the bank in the event of non-compliance of the goods.³⁷ This is practice is not *Sharī'ah* compliant as the Prophet emphasized that:

“...Whoever imposes a condition (in business transactions or others) which is not in Good's book (law), that condition is invalid...”

In relation this, the Prophet (PBUH) also said in hadith narrated by Al-Tirmidhi that:

“All merchants are resurrected on the day of judgements as sinners, except for those who feared Allah, treated their customers well and were truthful.”

Similarly, It is provided by article 189 of the *Mejelle*:

“A sale with a condition which is not for the benefit of one of the contracting parties is lawful but the condition is bad.”

Therefore, such condition is void. On principle, from the *Sharī'ah* point of view, the financial loss incurred should be borne by the bank based on the argument that the goods must remain in the risk of the bank during the period before the ownership of the said goods are transferred to the applicant and before *al-murābahah* contract is executed. This is to support the fact that in such event, the applicant has already suffered a loss for failing to fulfill his trade obligation with another party who has agreed to buy from him. If the said commodity is raw material which needed to be processed into finished goods, this would mean his production line has to be temporarily shut down, or perhaps permanently.

Conclusion

The main idea of applying the Islamic concept in banking is to eliminate the element of *riba* in trade transactions as well as in savings in conformity with the Islamic teaching. Likewise, LC also works on the same principles which forbid any element of *ribā* (interest) and *gharar* (uncertainties). Apart from that, it is also upheld that justice should be given to all parties involve in LC transaction which consist of bankers, importers and

³⁴ See, Ahcene Lahsasna, *Implementation of the Islamic Letter of Credit in International Trade*, International Islamic Conference on Islamic Banking and Finance IICiBF 2007, The Bridge Between Ideals and Realities, Kuala Lumpur, Crown Plaza Hotel, 23-25April, 2007, by International Islamic Univeristy Malaysia, at 15.

³⁵ Chuah, Jason, (2005) *The Law of International Trade*, 3rd Edition: Sweet & Mawell.

³⁶ See, Mohammad Hashim Kamali (2006) *Equity and Fairness in Islam*, Ilmiah Publishers Sdn. Bhd: Kuala Lumpur, at 102. “Islamic banks have tendered to avoid taking risk and often devoted their resources to safer modes of financing, or else that they have modified and manipulated existing modes of transaction in various ways so as to transfer commercial risk mainly to customer.”

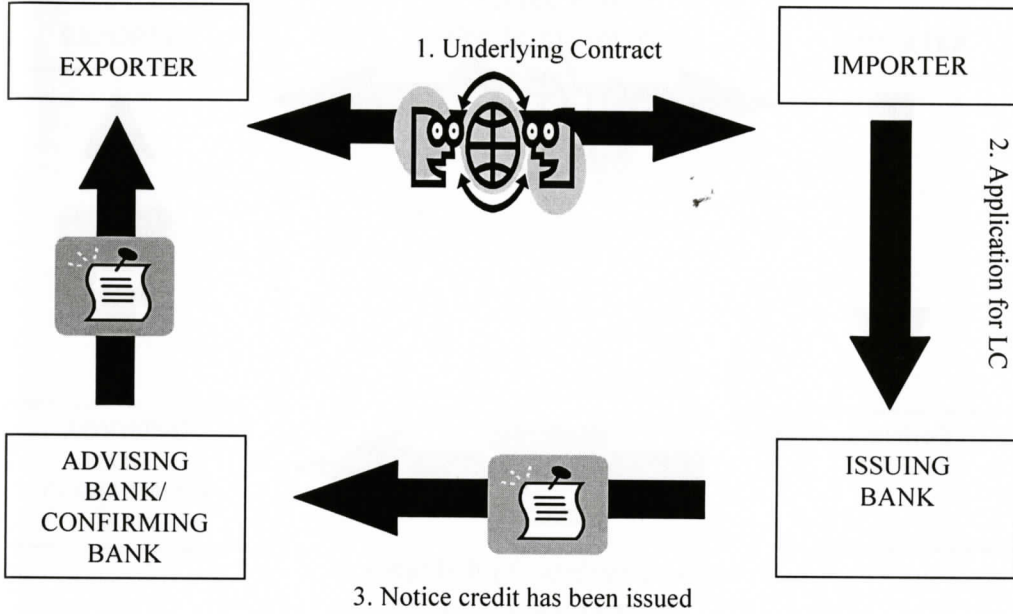
³⁷ Example of such disclaimer that has been included in the application form for LC, for the sake of reputation, the name of the bank is not disclosed, “The bank and its nominated bank shall not be held responsible for the performance by the beneficiary of its obligation to the Applicant. The bank shall not be responsible for any consequences arising out of any delay mistake or omission which may occur happen in the transmission of message(s), letter(s) or document(s) of fro any errors in the translation or interpretation thereof”.

exporters. Thus, despite the similarities between conventional and Islamic LC, Islamic LC practically could not work in the same way as conventional LC. In certain aspects, they should differ.

ROCEDURE TO ISSUE LC AI-WAKALAH

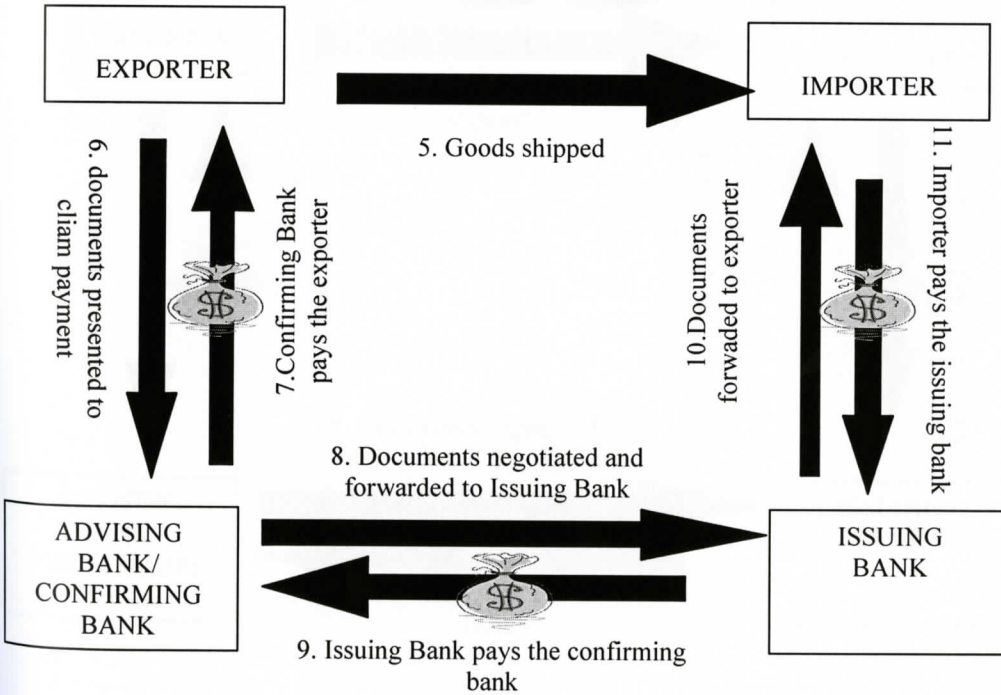
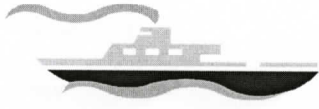
(Extracted from the materials of Islamic Trade Finance Workshop, By Noel Wong, on 17-18 August, 2007, at Park Royal Hotel – modification and animation added)

Diagram I



4. Advise LC, notice credits has been issued

Diagram II



PROCEDURE TO ISSUE LC AI-MUSHARAKAH

(Extracted from the materials of Islamic Trade Finance Workshop, By Noel Wong, on 17-18 August, 2007, at Park Royal Hotel – modification and animation added)

Diagram I

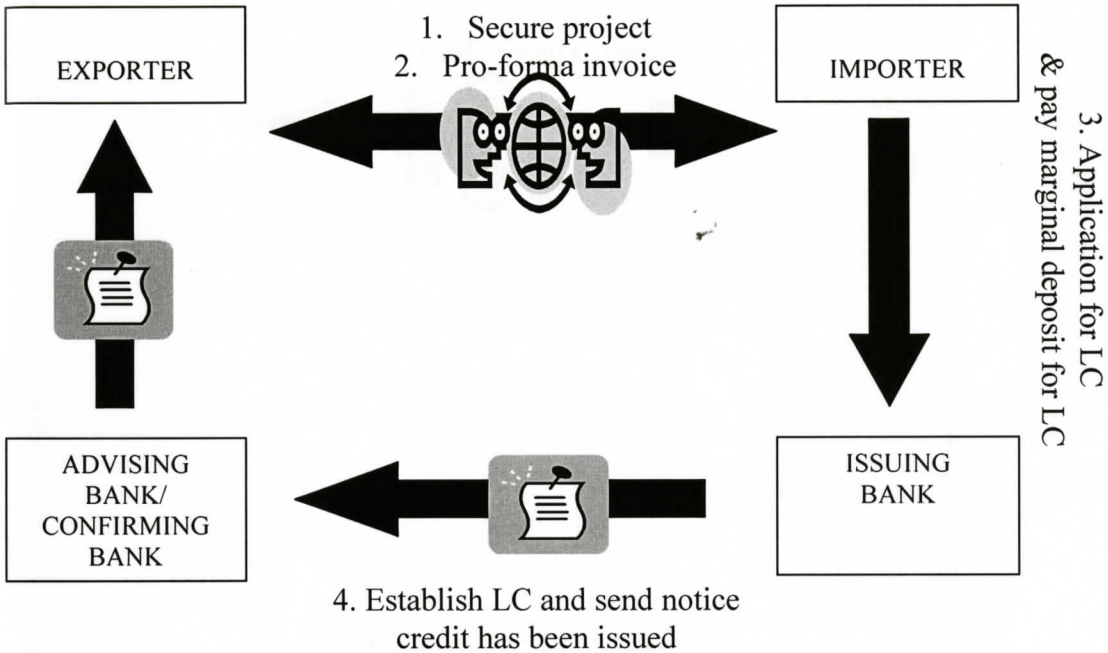
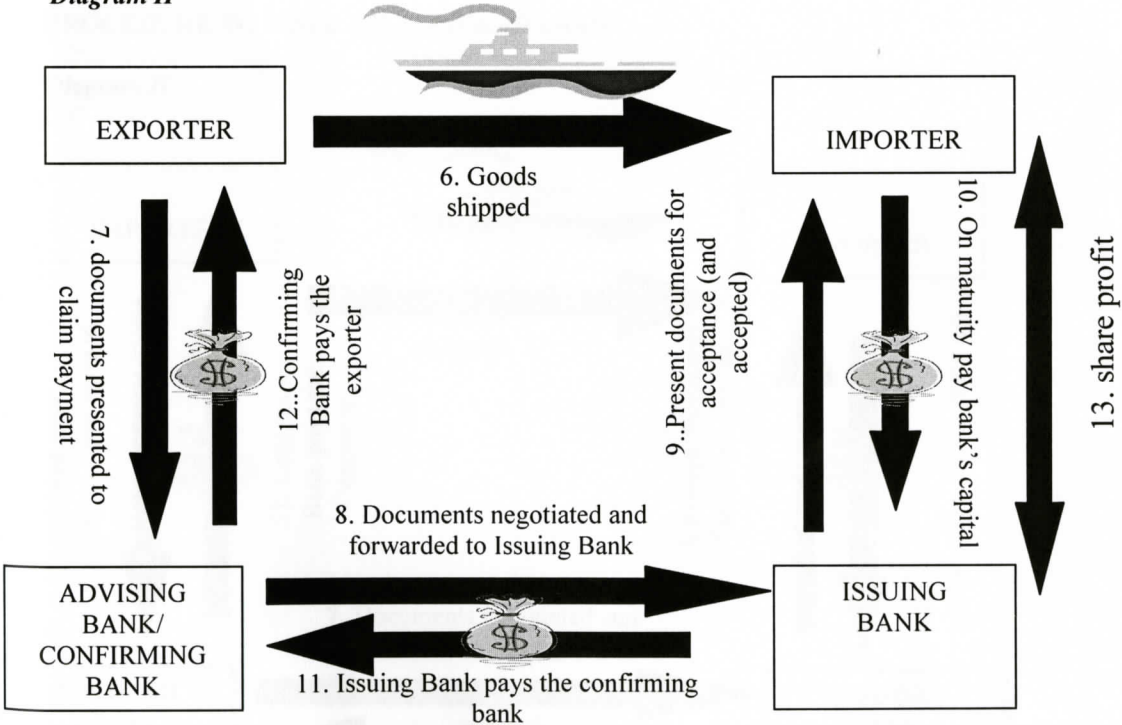


Diagram II

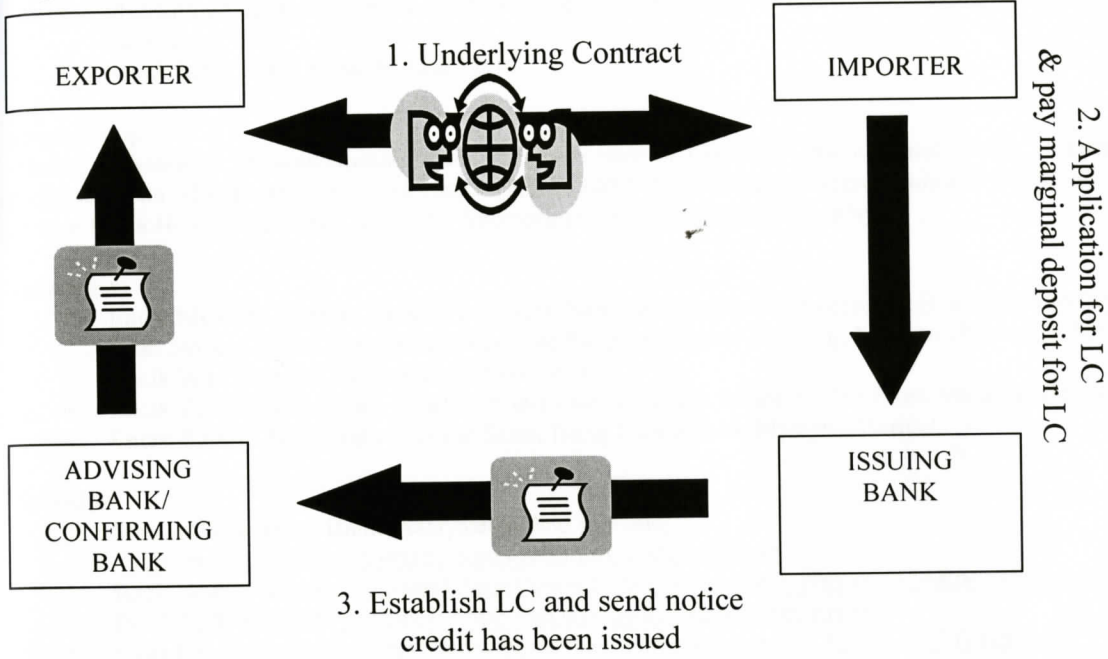


5. Advise LC, send notice credit has been issued

PROCEDURE TO ISSUE LC AI-MURABAHAH

(Extracted from the materials of Islamic Trade Finance Workshop, By Noel Wong, on 17-18 August, 2007, at Park Royal Hotel – modification and animation added)

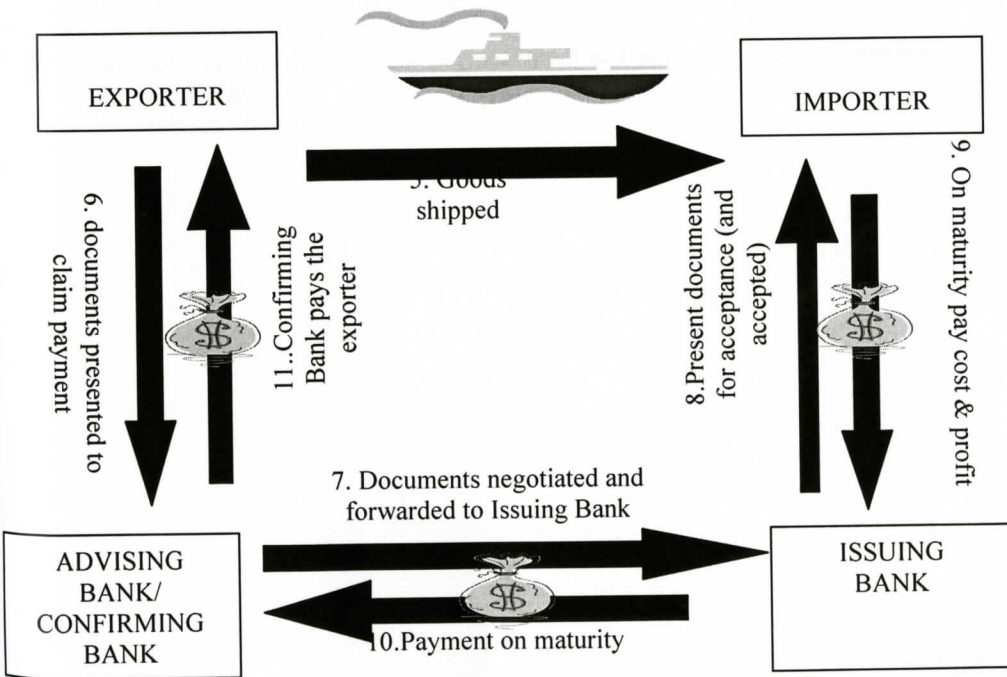
Diagram I



4. Advise LC, send notice credit has been issued

PROCEDURE TO ISSUE LC AI-MURABAHAH

Diagram II



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