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AN OVERVIEW OF SHARĪ'AH ISSUES REGARDING THE APPLICATION OF THE ISLAMIC LETTER OF CREDIT PRACTICE IN MALAYSIA[#]

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Abstract

The Letter of Credit (LC) serves as an instrument of payment in international trade. Its aim is to facilitate trade between seller and buyer in different countries. To date, the Islamic banking environment promotes the use of the Islamic LC as a method of financing in international trade, particularly to Muslims and to the general public as a whole. Thus far, this facility is offered not only by Islamic banks, but also by all commercial banks. It is basically governed by the same rules of the UCP 600 that regulate the conventional LC. Realising the peculiarity in the application of this conventional rule to the Islamic LC, this paper focuses on the aim of harmonising the practice of the Islamic LC with the requirements of Sharī'ah principles where elements such as interest (ribā) and uncertainty (gharar) are prohibited. It begins by giving the background of the Islamic LC in Malaysia. Next, it discusses the definition and types of Islamic LCs,

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murābaḥah (cost-plus sale), wakālah (agency) and mushārakah (partnership), as the issuance of the 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 Sharī'ah issues in the practice of the Islamic LC, such as governing rule, subject-matter, interest, INCOTERMS and insurance, contract ('aqd), discrepancy fee, and exclusion of risk of goods in the Islamic LC. Discussion of these issues leads us to identify whether they are in compliance with Sharī'ah principles. In relation to this, various proposals are suggested to harmonise the rules applicable to the Islamic LC and Sharī'ah principles.

Keywords: Conventional LC, Islamic LC, UCP 600, Sharī'ah principle.

I. INTRODUCTION

The Letter of Credit (LC) is one of the payment mechanisms in international trade. It has been widely used, particularly in trade transactions where the seller and the buyer do not reside in the same country. A great distance between both parties always invites worry as it is very difficult to trust each other. Dealing with someone who is not known, or not seen in person before is very dangerous, especially when the sales involve a huge amount of money and expensive goods. Both parties in this situation will be reluctant to give any commitment unless they are assured that their positions are protected. A seller is not willing to part with his goods unless he has been guaranteed payment. Likewise, the buyer is also not so generous as to advance payment on the goods unless he feels secure that he will receive the goods according to his orders. In this case, the LC serves as an important tool to overcome the problems of trustworthiness between such persons. The role and function of the LC is to provide efficient payment through the bank as a reliable paymaster for advance payment. The seller is automatically paid once he presents to the bank documents which strictly comply with the credit requirements, whereas the buyer does not have to pay until all the documents required under the LC have been presented in conformity with the terms and conditions of the LC. (Jack, 2000; King, 2001).

This mode of payment is used in Malaysia by many traders and the business community particularly when dealing with international trade. The LC used is either conventional, which has long been practiced or Islamic, which is starting to gain popularity in the business community. For the latter, its operational aspects are similar to the former. It is governed by the same Uniform Custom and Practice (UCP)[1] that is applicable to the conventional LC, which standardises the operational aspects of the *wakālah* (agency) LC (where the bank is acting as an agent to issue an LC and make payment on behalf of a customer who has deposited the full amount of purchase price and pay for the agency services). One of the distinct features of the Islamic LC is that it can be issued based on the *wakālah* principle and can integrate with various other principles associated with sale or financing, such as *murābaḥah* (cost-plus sale) or *mushārakah* (partnership).

II. BACKGROUND OF THE ISLAMIC LC IN MALAYSIA

The Islamic LC was introduced in Malaysia by Bank Islam Malaysia Berhad (BIMB) in 1983 when the bank began operations. It was followed by Malayan Banking Berhad (Maybank), and Bank Bumiputera Malaysia Berhad (BBMB) in 1993. In 1999, Bank Muamalat was set up as a full-fledged Islamic Banking institution with the *wakālah* LC as one of the main products offered. Nowadays, the LC is offered by almost all conventional and Islamic banks in Malaysia.[2]

Currently, it is observed that the number of Islamic LCs issued in Malaysia is still much less as compared to conventional LCs.[3] This is due to the fact that the strong application of the conventional LC

1 UCP is a compilation of customary rules which regulate the implementation and operation of the LC. It was first published in 1933 and the latest publication is the UCP 600 which has been implemented on 1st July 2007. Even though the UCP has no force of law, it has been applied in all LC transactions.

2 There are 17 Islamic Banks and 22 Conventional Banks in Malaysia.

3 This fact has been unanimously agreed to by the majority of Malaysian Commercial Banks during personal interviews with the author.

has denied the applicability of the Islamic LC which is comparatively new and still needs some space to gain customers' confidence in utilising this product. In addition, bankers also need to develop their expertise in Sharī'ah principles in order to operate the Islamic LC with a clear understanding of documentation in order to gain customer confidence.[4] It is interesting to note that with the emergence of the Islamic banking system, non-Muslim bank staff are practically and directly involved in handling Islamic banking products.

Another factor which discourages the use of the Islamic LC, and Islamic products in general, is that the Islamic banking system in Malaysia is offered as an option rather than the primary banking choice. Thus, it gives Muslim customers, and the public at large, an option to choose between conventional and Islamic.

III. DEFINITION OF THE ISLAMIC LC

A number of definitions have been given to the Islamic LC. The AAOIFI Standard refers to the LC as a documentary credit and defines the Islamic LC as:

> "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." (AAOIFI, 2007)

Apart from the above definition, there are definitions of the LC given by Malaysian commercial banks. For example, Bank Islam Malaysia Berhad defines the Islamic LC as:

> "a written undertaking by Bank Islam at the request of the Buyer/Applicant to pay the Seller/Beneficiary a

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

> certain sum of money as stipulated in the LC, provided that the Seller/Beneficiary complies with the terms and conditions of the credit." (Bank Islam, 2008)

A similar definition is given by Bank Muamalat Malaysia, whereby the 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." (Bank Muamalat, 2008)

Based on the above definitions, it is seen that the Islamic LC is an undertaking by a bank to pay subject to conformity of the documents to the contractual instructions as with the conventional LC. These definitions also indicate that the Islamic LC and the conventional LC carry out the same role and function, which is to facilitate trade. The only distinction between them is that the Islamic LC operates based on Sharī'ah principles. The inclusion of Sharī'ah principles into the application and operations of the LC generally, does not change the existing characteristics and neither does it change the primary functions of the LC in trade. Sharī'ah principles only separate the element of *ribā* (interest) and *gharar* (uncertainty) in LC transactions, which do not alter the governing rules, UCP and other international rules published by the International Chamber of Commerce (ICC).[5] In cases where the provision in the UCP contradicts the Sharī'ah principle, for example, interest on negotiation, an additional term will be inserted to avoid such a provision taking effect.

Moreover, the Islamic LC is distinct from the conventional LC in the sense that the function of the bank is not just as a mere financier

5 The ICC, which was established in 1919, is an international non-governmental body whose common aim is to facilitate international trade finance. The commission has more than 500 members in 85 countries, the majority of them from developing countries. See, Sarna, Larza, (1986) at p.55; see also, An ICC Banking Commission Global Survey (2010) at p.14.

to advance payment, but it is also acts as a "seller" in the case of *murābaḥah* and as a "business partner" in the case of *mushārakah*. The concept of *murābaḥah* suggests that the bank is a seller who buys and resells the same to the applicant. On the other hand, *mushārakah* is a partnership in a mutually agreed business undertaking where both parties agreed on a certain profit sharing.

All three of the Islamic concepts, that is *wakālah*, *mushārakah* and *murābaḥah*, can exist at the same time in one single LC transaction. In Malaysia particularly, the *wakālah-murābaḥah* combination is widely used throughout banks nationwide. This is because the conventional banking system, which has existed for many years, proved to be compatible and accommodative to the application of the principles of Sharī'ah. However, since the essence of the Malaysian banking system is broadly based on "lending", the application of the *mushārakah* principle is not well accepted by the commercial banks and the majority of merchant banks. Commercial banks in particular, are restricted under the Banking and Financial Institution Act 1989 (BAFIA) from indulging in any business venture involving their customers (Section 2(1) and Section 32, BAFIA, 1989). The *mushārakah* LC is related to matters of domestic banking policy, whereby commercial banks, on principle, do not jointly take part in any business venture, hence are not liable for the loss of the goods.[6] The *mushārakah* LC is, however, widely practiced in Middle East countries.[7]

A. The LC under Wakālah

In the *wakālah* LC, the customer (principal) may ask the bank to issue the LC by providing a written instruction to the seller. Upon approval, the bank would instruct the customer to place the full amount of the price of the goods in the bank (agent) as a security. The bank accepts the deposit which is placed under lien where the principle of *wadī'ah yad ḍamānah* (deposit cum guarantee) is applied. (Standard Chartered, 2009). Then, the bank establishes the LC in favour of the exporter and collects its commission and other charges incurred. Upon negotiation

6 Interview with officers in charge of LCs in some Islamic banks in Malaysia.
7 *Ibid.*

of the document, the issuing bank would pay the negotiating bank utilising the customer's deposit. Subsequently, the bank releases the documents to the applicant or buyer and charges fees for its services under the principles of *ujrah* (fee). (Bank Negara, 2009).

With reference to the situation mentioned above, in the *wakālah* LC, an agency relationship exists between the bank and the customer, whereby the bank acts as an agent to the customer (the importer/ buyer). Delegation of agency is where the customer or the applicant hands over the instruction in writing to the bank by completing a standard form indicating details of the 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 *'aqd*[8] (contract) 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 once the documents are found to be in compliance. Acting as an agent, the issuing bank is only relaying the guarantee of payment to the exporter. The bank is not a purchaser, but is only an agent to make a payment on behalf of the importer. The goods are, in actual fact, fully paid for by the applicant from the deposit placed with the bank. Being an agent, the bank is entitled to receive commissions apart from the service charge obtained on issuance of the LC. It is customarily and expressly stated that the LC issuance fee in Malaysia is 0.1% per month or part thereof based on the Malaysian amount equivalent until expiry (The Association of Banks in Malaysia (ABM) Rules, H5, 1984). Currently, the *wakālah* LC is practiced by all full-fledged Islamic banks in Malaysia.

8 *Aqad* comes from an Arabic word which means tie or bond. It is an agreement between the first and second party through *ijab* (offer) and *qabul* (acceptance) where it is an endeavour of bonding an agreement. The reason for having an *aqad* is to clarify and produce awillingness between both parties to the 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.

B. The LC under Mushārakah

Under *mushārakah*, the bank issues the LC and both the bank and the customer contribute to the purchase price under the LC. They later share the profits of the business venture based on the pre-agreed profit-sharing ratio. Losses are borne proportionate to capital contribution (in paying purchase price). For instance, where a customer of the Islamic bank has been awarded a contract for supplying certain merchandise to a particular organisation, he may propose 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 *mushārakah* which will be operated on the basis of profit-sharing. (Khir, Gupta & Shanmugam, 2008).

Similar to the *wakālah* LC, the first step in establishing the *mushārakah* LC begins with the customer issuing an instruction or request in writing to the issuing bank. The customer deposits enough money with the bank for his share of the cost of goods to be purchased or imported as per the *mushārakah* agreement which the bank accepts under the principle of *wadī'ah yad ḍamānah*. The bank issues the LC and pays the proceeds to the negotiating bank, utilising the customer's deposit, as well as its own share of financing, and subsequently releases the documents to the customer. Finally, the customer takes possession of the goods and disposes of these in the agreed manner.

C. The LC under Murābaḥah

Under the *murābaḥah* LC, the bank provides a financing facility to the customer or applicant whereby he is given a certain period of time to make 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 higher price agreeable to the customer. The new selling price constitutes a mark-up of a 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. Furthermore, it permits the customer to collect the sale 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 a *murābaḥah* LC facility. (Mei Pheng & Detta, 2007).

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 *ʿaqd* 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 *murābaḥah*. 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, utilising its own funds. The bank then sells the goods to the customer at a sale price comprising its cost and a profit margin under the principle of *murābaḥah* for settlement on a deferred term. (Bank Negara, 2009).

D. Differences between Murābaḥah LC and Mushārakah LC Operations

Trade transactions generally can be carried out either by applying *murābaḥah* or *mushārakah*. The role, or involvement, of a bank in a particular business venture would determine whether *murābaḥah* or *mushārakah* is applied. If for instance, the bank is also contributing to the capital investment jointly with the buyer, it is said that the concept of *mushārakah* 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 *murābaḥah* is applied. In a *murābaḥah* transaction, the banker-customer relationship is best described as seller-buyer relationship.

As discussed above, *murābaḥah* is a credit business transaction where the amount of purchases, or "debt", is paid after the goods are sold to the final buyer. The bank would then acquire the goods for its customer from the exporter. 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 whatsoever to determine the ways the goods should be disposed of but only relies on its customer. The bank only benefits from the total capital invested in the

said business venture where it earns some profit. The customer on the other hand, could purchase the inventories without having paid for them upfront. The bank however, is not liable or responsible for any loss should the business venture fail. In other words, whether or not there is failure or success, the customer is liable to honour the selling price to the bank on the agreed date.[9]

Unlike *murābaḥah*, *mushārakah* witnesses the involvement of the bank in a particular business venture carried out by the buyer with 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 for the business venture. In practice, the bank provides consultation and advice on the management of funds and the customer runs the day-to-day business operations. 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 in accordance to the ratio of the invested capital.

In both cases above, the LC is used as the payment mechanism where the bank acts as an agent for the buyer to convey the message to the seller that the payment is guaranteed provided that the terms and conditions of the LC are complied with. In practice, under the *murābaḥah* trade transaction, where the bank does not have any control over the business venture, the type of goods involved is restricted to inventory and stock, for example, sugar, flour, spare parts and commodities. This is to ensure that they are disposed of within the shortest time period.

On the other hand, under *mushārakah*, the bank has some control over the business venture. Therefore, this concept requires the bank to look into the wider picture of the business venture, whereas, under *murābaḥah* the bank is only concerned with the small sub-activity of the business venture.

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9 Interview with officers in charge of LCs in some Islamic banks in Malaysia.

IV. SHARĪ'AH ISSUES IN THE ISLAMIC LC

Even though the abovementioned Islamic LC is generally compliant with Sharī'ah principles, there are some issues that need to be determined and addressed in order to harmonise them with the acceptable Sharī'ah principles. The issues include the applicability of the UCP 600, subject-matter or goods traded, interest (*ribā*), insurance and INCOTERMS 2000 (International Commercial Terms 2000),[10] exclusion of liability, *'aqd* in *murābaḥah* and discrepancy fee.

A. Applicability of the UCP 600 to the Islamic LC

The application and operation of the LC is primarily, though not solely, governed by the international standard rules known as UCP, issued by the ICC. This set of rules, though neither a statute nor having legal force, has been adopted by all countries worldwide as a standard trade practice pertaining to application and operation of LCs. The latest version of UCP is the UCP 600.

An interesting question is the issue of whether the UCP 600 can govern the application and operation of the Islamic LC? It is important to note that the emergence of the Islamic banking system that produces the Islamic LC, technically speaking, does not produce "new" LC products. Based on the abovementioned definitions of the Islamic LC, the objective and function of the LC, whether conventional or Islamic, do not explain the technical differences. Therefore, the Islamic LC is governed by the same conventional UCP which "remains a product of the Western practitioners and experts". (Lahsasna, 2007). Premised on this, it is strongly recommended that:

> "The existing UCP be studied, reviewed, amended, supplemented and in the process a new set of rules and

10 INCOTERMS lists the contractual parties' duties such as delivery of goods, distribution of costs, risks, procurement of cargo insurance and contract of carriage. For instance, in a contract which is used on CIF (Cost, Insurance, Freight) terms, it is already prescribed by the INCOTERMS that a seller is under a duty to arrange for a contract for the carriage, procure the cargo insurance and ensure delivery to the final destination in the country of the buyer. If the buyer wishes to arrange for the carriage, he cannot amend the CIF term but choose another term, FOB (free on board).

> regulations that are founded on our understanding of Islamic law practice." (Lahsasna, 2007)

In order to judge the rationale of the above recommendation, it is fundamental to scrutinise the rules contained in the UCP 600 from the Sharī'ah principles perspective. Additionally, a thorough study should be initiated to modify the rules of the UCP 600 in order to harmonise them with the Sharī'ah principles. With regards to the issue of applicability of the conventional UCP in the Islamic LC, an analogy can be based on a liberal approach demonstrated by Ibn Taymiyyah:

> "The underlying principle in contracts and stipulations is *ibāḥah* (permissibility) and validity. Any contract or stipulation is prohibited and void only if there is an explicit text [from the Quran and the Sunnah of the Prophet (peace be upon him)] or *ijma'* (the consensus of Muslim jurists) or a *qiyas* (analogy) proving its prohibition and voiding." (Ibn Taymiyyah, 1978)

Thus, Islam does not prohibit the application of any rules which are by nature conventional, provided that their application does not contradict with Sharī'ah principles.

B. Subject-matter or goods traded

Obviously, under the Islamic LC, goods traded must be *ḥalāl* (permissible) by nature and origin. Allah says:

> "Eat of that which Allah hath bestowed on you as *ḥalāl* and good and keep your duty to Allah Whom you are believers." (Al-Maidah: 77)

Thus, all parties, bank, importer and exporter must be fully aware that they are only allowed to deal with *ḥalāl* goods. This requirement of course, is not relevant in the conventional LC where as long as the goods have an economic value and are legal, they are allowed to be transacted and dealt with.

However, there is one question arising relating to the issue of *ḥalāl* goods in the *wakālah* LC. How to determine whether the goods are really *ḥalāl* before the *wakālah* LC is issued? This practice differs from one country to another. Some banks in foreign countries require a certification from the exporting country to certify that the goods are *ḥalāl*. In Malaysia, the Central Bank of Malaysia has established a listing of all the goods which are not entitled to be financed under Islamic financing facilities, such as "live swine, race horses, meat of swine, fresh, chilled or frozen, pig, ham" (Bank Negara Guidelines on Accepted Bills-i (AB-i) 1991, Table A; Section 3, IBA 1983). At the same time, all the products and guidelines of an Islamic bank have to be scrutinised by its Sharī'ah Committee, whose duties and responsibilities are clearly outlined by the Guidelines on the Governance of the Sharī'ah Committee for the Islamic Financial Institutions issued by the Central Bank of Malaysia.

The practice among Malaysian Islamic banks varies with regards to the prohibition of goods traded. Some banks may refuse to finance the goods which are *ḥalāl* by nature and origin but the purpose of buying the goods is not for *ḥalāl* use. For example, the generator is imported to be used in the casino or pub. The generator being the subject matter of the sale is *ḥalāl*, but the objective of buying the generator is forbidden since it is to be used in a casino. The implication of such a situation where the permissible and forbidden things are mixed together is explained by an Islamic legal maxim as:

> "Where there is a mix of the permissible and the forbidden, then it becomes forbidden." (Ibn Nujaim, 1999)

On the other hand, there are banks that may ignore the objective of the goods purchased as long as the goods itself are *ḥalāl*. This approach suits the opinion of Muslim jurists who rely on the injunction of the Quran; as Allah says:

"O you who believe! Ask not of things which, if they were made known to you, would trouble you" (al-Mā'idah: 101).

In addition, it could be argued that if the objective of buying the goods came to the bank's knowledge before the contract of payment (LC) is concluded it is recommended that the bank should not be involved in such a transaction. However, if the knowledge of the

objective of the buying or selling of the goods is absent, the bank is permitted to give financing. Therefore, Sharī'ah compliance starts by analysing the nature of customers' businesses, which includes the types of goods normally purchased by the customers. It is in compliance with the criterion of Islamic law, which encourages righteous things and forbids the bad. Therefore, in giving financial assistance the bank should give priority to promoting righteous things among Muslims; as Allah says:

> *"Cooperate in righteousness and taqwa (piety)" (al-Mā'idah: 2).*

C. Ribā (Interest)

For a conventional bank, the issue of default is dealt with by imposing *ribā*. *Ribā* in its legal sense means an excess (al-Mirghīnānī, 1985).

> In a Sharī'ah context, it is defined as:
> "a predetermined excess or surplus over and above the loan received by the creditor conditionally in relation to the specified period." (El Ghousi, 1985)[11]

It is forbidden in the Quran, the Sunnah of the Prophet (peace be upon him) and *ijma'*. In the Quran, Allah says:

> "Those who devour usury (*ribā*) will not stand except as one stands whom the Devil has driven mad by [his] touch. That is because they say, "Trade is just like *ribā*; whereas Allah permits trading and forbids *ribā*." (al-Baqarah: 275)

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11 This definition is similar with the definition given by Al-Kasani which defined *riba* as "the stipulation of a premium paid to the lender in return for his allowing a delay in repayment", Al-Kāsānī, Abū Bakr ibn Mas'ūd. *Badā'i' al-Ṣanā'i' fi Tartīb al-Sharā'i'*, 5:178.

Generally speaking, the UCP 600 does not contain any provisions which associate with *ribā,* except in Article 13(b)(iii) which provides:

> "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.[12] In practice, this "penalty" amount is not pre-determined at the point of the issuance of the LC but is only disclosed by the reimbursing bank upon claiming reimbursement from the issuing bank in the case where the documents are negotiated.[13] The "penalty" amount varies from one country to another subject to the currencies and number of days the delay occurs. Some banks charge 5%, others 7% and there are cases where the quantum is charged at 9%.[14] The word "expenses" on the other hand refers to the amount incurred by the reimbursing bank in the process of handling of the documents and communications. This amount also varies from one country to another country and is not pre-determined. Sometimes these charges are exorbitant and do not reflect the actual cost incurred.[15] The interest amount will be charged to the account of the seller.

This Article 13(b)(iii) contradicts the Sharī'ah principles as it represents *ribā.* To remedy the presence of this prohibited element, Article 1 of the UCP 600 provides an option where banks can modify or exclude certain clauses which are deemed as not agreeable by trading parties and banks. By virtue of this Article, Islamic banks can

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12 "Without delay" here means the time frame within which the Issuing Bank must make the reimbursement available to the Negotiating Bank. The time frame is expressed in number of days, for example, 3 working days, 5 working days or 7 working days. Should the Issuing Bank fail to respond within the specified number of days, the interest on late reimbursement is charged.

13 Interview with officers in charge of LCs in some Islamic banks in Malaysia.

14 *Ibid.*

15 *Ibid.*

eliminate clauses involving *ribā*. It may seem an effective mitigation mode as far as Sharī'ah principles are concerned, but it may trigger a problem with conventional banks worldwide that do not subscribe to Sharī'ah principles. This would make negotiation of the Islamic LC or negotiation of documents under the Islamic LC unattractive.

Technically, in the sight LC,[16] payment is direct upon receipt of the compliant documents where the issuing bank will effect the payment to the seller's bank immediately. (Todd, 2007; Jack, 2001; Article 6(b), UCP 600). However, "immediately" does not mean the proceeds are available to the seller within one or two days. This is simply because firstly, a bank is given a definite number of days, that is within five (5) banking days, to check and establish whether or not the documents tendered are in strict compliance (Article 14(b), UCP 600). Secondly, if the LC involves foreign currency, it will involve a few banks before the proceeds reach the seller.[17] In this regard, Articles 13(iii) and (iv) of the UCP 600 impose the burden on the issuing bank to always ensure a reasonable time to respond to the request for reimbursement by the claiming bank.[18] In the event the issuing bank is found not to respond to the reimbursement claim within a reasonable time, the claiming bank is entitled to claim a certain sum of interest as compensation for the loss suffered by the claiming bank due to the delay. The interest amount normally would be determined by the claiming bank. The interest incurred in this instance does not concern any of the trading parties, either seller or buyer. It only involves the banks. There are some cases where this type of "penalty" is charged to the seller or the buyer; generally these cases are isolated and happen only in cases where the claiming bank has negotiated the documents.[19] In cases where the documents are negotiated against indemnity or against reserved, the interest charged will be debited to the seller's account. In this instance, the bank will

16 In this type of LC, the seller beneficiary will get his payment immediately upon compliance of documents.

17 *Ibid.*

18 The claiming bank is either the confirming bank or negotiating bank.

19 Negotiation means "the purchase by nominated bank of draft (drawn on a bank other than the nominated bank) and/a documents under a complying presentation, by advancing or agreeing to advance funds to the beneficiary on or before the banking day on which reimbursement is due to the nominated bank". Article 2 UCP 600.

require the seller to execute the additional agreement in which the seller will be advanced the proceeds of sales before the documents are sent to the issuing bank for examination. In the event the documents are found discrepant, the negotiating bank has the right to debit the seller's account together with the interest which in this case, will be determined by the negotiating bank.[20]

Unlike the sight LC, payment under the deferred LC would not be immediate but on a determinable future date, (Jack, 2001; King, 2001). Under this LC, the seller is required to submit a bill of exchange with a specific tenor,that is 30 days sight, 60 days sight or 90 days sight in accordance with the conditions of the LC. (Jack, 2001; Todd, 2007). Upon acceptance by the issuing bank, the seller will then be notified of the maturity date. The seller can expect his payment to reach his account approximately seven (7) to ten (10) working days from the maturity date. However, the deferred LC does not prohibit the seller from obtaining payment before the maturity date. The seller can request his bank to purchase his documents and pay him immediately. When his bank agrees, the documents will be negotiated and sent for payment to the issuing bank. In this case, the seller's bank normally charge a certain sum of interest at a certain percentage on the seller, running from the value date until receipt of reimbursement from the issuing bank.

Hence, notwithstanding the fact that the application and operation of the Islamic LC is governed by the UCP 600, Sharī'ah's stand, which forbids the use of interest, must prevail. This is not the case in the *wakālah* LC where the buyer has deposited the whole amount of payment in the issuing bank. Therefore, there is no issue of transit interest since the bank will upon receipt of documents in full compliance of the LC terms, pay the buyer as per instruction by utilising the buyer's deposit.

Similarly, when one uses the *wakālah* LC, the interest should not be charged in the case of late reimbursement by the reimbursing bank if the documents have been negotiated. That is to say, the negotiating bank cannot claim the interest from the issuing bank for late reimbursement. This applies to both Islamic and conventional banks when dealing with the *wakālah* LC.

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20 *Ibid.*

As far as Malaysian banks are concerned, in order to avoid interest (which starts to run from the payment date), the Islamic banks, acting as a negotiating bank, apply two alternatives to close the door to interest. Either the bank does not pay on compliance of the seller's documents but payment is made only after the issuing bank has credited money to the reimbursing bank, or alternatively, the issuing bank is notified through one clause in the LC[21] and the issuing bank will provide funds to the reimbursing bank prior to the effective date of payment. In this case, the customer or seller beneficiary does not have to wait until the issuing bank credits the payment to the negotiating bank's account. This process is more beneficial to the beneficiaries since they will get a more expedient payment once their documents have complied with the LC terms and conditions.[22] In addition, some Islamic banks may perform a reciprocal agreement with their correspondent bank that there will be no giving or taking of interest by both parties. This agreement normally is made upfront when the sales contract is executed.

The next issue that arises is whether the late reimbursement on first demand in the LC operations is considered a default. It is customary practice that interest is charged on the first demand for late reimbursement by the issuing bank. The late interest incurred is normally charged to the account of the applicant, but in some cases it is borne by the issuing bank.

Under Sharī'ah principles, the bank is allowed to collect an additional charge which is termed *ta'wīḍ* (compensation). *Ta'wīḍ* means giving compensation for loss incurred resulting from harmful occurrence. (Wizarah Al-Awqaf, 1993). It signifies a penalty agreed upon by the parties in *'aqd* as compensation that can rightfully be claimed by the creditor when the debtor fails to or is intentionally late in meeting his obligation to pay back the loan. In this case, failure by a solvent debtor to pay his debt on time is considered as causing injustice to the creditor. This is based on the *Hadith* where the Prophet (PBUH) says:

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21 Such as "Upon receipt of telex or notice of negotiation confirming strict compliance of documents to the credit terms, we shall remit payment as per confirming bank's instruction within five working days".

22 Interview with officers in charge of LCs in some Islamic banks in Malaysia.

"The rich (solvent) who delay the payment of a debt are committing tyranny." (Sahih al-Bukhari, 1404 A.H)

Thus, the imposition of *taʿwīḍ* is permissible in a late reimbursement or delay in payment (by a solvent customer). The late reimbursement in this case is considered as causing harm to the bank. However, it should be noted that the permissibility of *taʿwīḍ* is subject to certain conditions outlined by the Central Bank of Malaysia. (Central Bank of Malaysia, 2007). Firstly, the amount of *taʿwīḍ* cannot exceed the actual loss suffered by the financier. Secondly, the determination of compensation is made by a third party, which is the Central Bank of Malaysia. Thirdly, the default or delay of payment is due to negligence on the part of the customer. Based on the above guidelines, it can be understood that *taʿwīḍ* can only be applied in the cases of late payment or default for a financing. The question that arises here is whether late reimbursement in the LC can be considered as a default?

Reimbursement is the amount required to be paid to the bank (reimbursing bank) which in turn will remit the said payment to the bank that has negotiated the documents (negotiating bank) and paid the seller. The issuing bank will remit the reimbursement amount to the reimbursing bank before it reaches the seller's bank. It could be the funds pledged by the buyer upon issuing instruction to issue an LC or could be funded in advance by the issuing bank. The late interest that is charged in relation to reimbursement is normally caused by the delay in crediting the said funds into the issuing bank's Nostro account[23]which is maintained with the reimbursing bank.

In LC operations, all correspondent banks, including the issuing bank, are required to maintain a foreign currency current account with their respective reimbursing banks in foreign countries specifically for the purpose of reimbursement. These accounts require the minimum amount to be maintained at all times to meet the reimbursement obligations which are constantly funded by the issuing bank. As the funds emanate from the issuing bank, technically speaking, it is not considered as a loan. The loss, if any, caused by late reimbursement

23 Foreign exchange account maintained by a non-local (correspondent) bank with a local bank in local currency, available [on-line]: http://www.businessdictionary.com/definition/nostro-account.html, viewed on 30 December, 2009.

will only be suffered by the seller. Therefore, the late charges should be levied to justify the amount of loss suffered by the seller, and not by the reimbursing bank or any party in the LC operation chain.

What seems to be another problem is that the foreign currency current account in foreign countries, or in short, the Nostro Account of Malaysian banks which hold various foreign currencies such as the US dollar, Pound Sterling, Euro and Japanese Yen, are maintained in countries where Sharī'ah principles are not observed in their banking systems. When the *wakālah* LC is issued in foreign currency, many reimbursement banks in foreign countries are reluctant to do away with the interest which has long been their source of income. This problem is faced by all Islamic banks worldwide in dealing with the *wakālah* LC. As interest is strictly prohibited in Islam, there must be one specific guideline in existence, applicable internationally, similar to INCOTERM or UCP as a guiding force in handling the *wakālah* LC. This guideline must be recognised by the international trade community. Without a recognisable and enforceable guideline in place, the operation of the *wakālah* LC would not be fully understood by the non-Muslim community worldwide.

Secondly, the additional charge is only justifiable when there is an element of intentional delaying or negligence in remitting the reimbursement. In practice, there are many factors that contribute to delay in crediting the reimbursement, such as communication problems, wrong account number, wrong Bank Identifier Code (BIC) and wrong currency, which do not concern the buyer and the seller. As such, an investigation is considered necessary to be carried out to ascertain the reasons before it is decided that the late charges are to be levied.

D. Insurance and INCOTERMS 2000

Another important standard set of rules governing the operations of the LC is INCOTERMS. These rules emphasise distribution of costs, risks and obligations of the importer and exporter.

Movement of goods is the second event to take place after the issuance of the LC. Whether by ship, train, airplane, road or any combination of these modes, there are costs incurred in relation 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. Even though the transport charges differ based on geographical location and depend on the choice of mode of transport, it does not form an element of *gharar.* This is due to the fact that this charge is confirmed to be incurred in order to move the goods from place of origin to the final destination. In practice, this cost is pre-determined and 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.

To ensure the interests of both parties are protected in the event of loss or damage of the goods during transit to the final destination, the goods are insured by conventional insurance. A majority of Sharī'ah scholars conclude that conventional insurance is unlawful as it involves elements of *ribā*, *maysir* (gambling), *gharar* and invalid transfer of risk from the insured to the insurer. (Muhammad Ayub, 2007). The element of *gharar* cannot be avoided concerning conventional insurance when dealing with importers or exporters from Western countries as their insurance services operate on a conventional basis. For example, if the exporter is domiciled in Italy, it would defeat the purpose of the *wakālah* 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. (INCOTERMS, 2000).

To mitigate such a 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 (free carrier), f.a.s (free alongside ship), f.o.b (free on board) and c.f.r (cost and freight). This has to be expressly cleared prior to drafting a sale contract.

In Muslim countries, particularly Malaysia, the best alternative is to use *takāful* (Islamic insurance).[24] It is referred to as:

> "an insurance concept in Sharī'ah whereby a group of participants mutually agree among themselves to

24 This arises from the *fatwā* which says that conventional insurance is *ḥarām*. It was also introduced to complement the operation of Bank Islam which was established in 1983.

> guarantee each other against defined loss or damage that may inflict upon any of them by contributing as *tabarru'* or donation in the *takāful* funds." (Bank Negara, 2009)
>
> It is also defined as:
>
> "*Takāful* is a scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need, whereby the participants mutually agree to contribute for the purpose." (Section 2, Takaful Act 1984)

It is confirmed that the *takāful* concept has gained acceptance by a majority of Sharī'ah scholars. (Muhammad Ayub, 2007). This concept requires that the nature of the main insurance contract should be converted to a contributory arrangement in which the losses to members may be covered from the *takāful* pool on the basis of mutual help and service. (Muhammad Ayub, 2007) On the other hand, in conventional insurance, the policyholder's liabilities and rights remain contingent and he losses the amount given as premium if the event of insurance does not occur. (Muhammad Ayub, 2007) In the Islamic LC transaction, the bank includes a clause in the facility agreement that the customer should take up *takāful* coverage. The *takāful* policy taken against the cargo must be submitted to the issuing bank as proof that the cargo is insured by the buyer in the case of a free on board (f.o.b) transaction. On the other hand, where the trade is transacted on a cost, insurance, freight (c.i.f) basis, the seller is required to submit the same to the negotiating bank before the policy's expiry date.[25]

Since the *takāful* coverage is not widely practiced, particularly in Western countries, this could be a major hindrance to parties who transact by way of the *wakālah* LC. To avoid being involved with *ribā*, the buyer in particular could choose to trade on ex-work or f.o.b instead of other trade terms such as cost and freight (c.f.r), c.i.f or

25 Such a kind of clause is taken from facility agreements by some of the Islamic banks in Malaysia.

any other D terms. By using ex-work or f.o.b terms, the buyer can, at his disposal, choose to procure cargo insurance by taking up *takāful* coverage in his own country.

E. Exclusion of Liability

The LC is independent and separate from the underlying sale contract. (Article 4, UCP 600). As far as the bank is concerned, it deals with documents only and not with goods. (Article 5, UCP 600). Therefore, as far as the goods are concerned, the bank is not responsible for any risk to the goods. Since the emergence of the Islamic LC in international trade is considered as quite recent, despite the application of Sharī'ah concepts in financial institutions, one major question is how far is the autonomous concept applicable in the Islamic LC? In this argument, fairness and equity do not seem to exist since only one party, the bank, is protected. (Kamali, Mohammad Hashim , 2006). In practice, to further secure the bank from financial loss in *murābaḥah* financing, a disclaimer clause is added in the contract which discharges the bank from any liability in the event of non-compliance of the goods. In other words, the bank shall not be held responsible for the performance by the beneficiary of its obligation to the applicant. In addition, the bank is also not liable for any consequences arising out of any delay, mistake or omission which may occur in the transmission of messages, letters or documents or from any errors in the translation or interpretation thereof. (Article 37(b), UCP 600). This practice seems to contravene Sharī'ah as the Prophet (PBUH) has prohibited any stipulation of conditions which give unfair advantage to the buyer or seller based on the following *ḥadīth*:

> "...Whoever imposes a condition (in business transactions or others) which is not in Good's book (law), that condition is invalid..." (Sahih al-Bukhari, 1404 A.H)

Similarly, it is provided by 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." (Article 189, Mejelle).

It is argued that the bank being a seller in *murābaḥah* financing can exclude liability, as long as the buyer has checked the condition of the goods and knows more about their condition before purchasing the goods. (Ahmed & Abu Ghuddah, n.d). The risk in this case falls under the buyer's liability should the goods be found to be sub-standard or otherwise not complying with the contract description. However, if the buyer neither sees the goods nor has an opportunity to examine the goods, the risk is shifted to the bank.[26] In certain situations, the buyer has only the opportunity to see the sample of the goods in the case of a bulk sale. Moreover, if damage to the goods is caused by the bank's negligence prior to delivery to the buyer, the bank must be liable. Therefore, the risk lies with the bank regardless of any disclaimer clause in the LC contract. (Ahmed & Abu Ghuddah, n.d; Zubairi, 2006; Chuah, 2007).

Therefore, such a condition seems not to be in line with Sharī'ah requirements as it is not fair and prejudices the customer's position. On the other hand, it gives full protection to the banks from any liabilities. In 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 at the risk of the bank during the period before the ownership of the said goods is transferred to the applicant and before the *murābaḥah* contract is executed. (Ahmed & Abu Ghuddah, n.d). This is to support the fact that in order to complete a sale under the Sharī'ah principle, one of the main requirements is to ensure that the condition of the goods is acceptable to the buyer. (Usmani, 2002). Under a *murābaḥah* transaction, the bank has become the seller who sells the goods to its customer, the buyer. Therefore, it is absolutely compulsory on the part of the bank to ensure three important things

26 There is no such issue in the Conventional LC since Article 4, UCP 600 indicates that the bank deals with documents only and has no liability on the goods. Thus, risk lies in the hand of the buyer irrespective of the condition of the goods.

concerning the goods: the existence, ownership and condition. The *ʿaqd* can only take place once all these three basic elements are in conformity.

F. ʿAqd in Murābaḥah Financing

In the Islamic LC, *ʿaqd* plays an important role in ascertaining the legality of the transaction. It is one of the elements which differentiates between the practice of the Islamic and conventional LC. In *majlis al-ʿaqd* (contractual session), an issuing bank and an applicant who is an importer should expressly declare their intention to be bound by the LC at the time of issuance. Once the *ʿaqd* on the *wakālah* LC is completed and issued, the first stage of the transaction is completed. The second transaction is another *ʿaqd*, which takes place upon arrival of the goods. The Issuing Bank will in this case, produce a new agreement, a *murābaḥah* agreement which signifies that the bank agrees to re-sell the goods on credit to the importer. The second following *ʿaqd* should take place by the time the documents are presented for financing under *murābaḥah* and when the existence of the goods is confirmed.

In practice, the *ʿaqd* normally comes in the form of a written statement printed in standard form, such as an application form for issuance of the LC. It is also included under one clause of the agreement of the LC contract itself. However, certain banks may draft a separate appointment letter of the representative to be signed by bank and customer.[27] This practice is Sharīʿah compliant and more practical, as Allah says:

> "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." (Al-Baqarah: 282).

The Sharīʿah issue pertaining to *ʿaqd* arises where some banks in practice may perform both (*ʿaqd* for *wakālah* and *murābaḥah*) concurrently. This practice falls under the category of two contracts in

27 Interview with officers in charge of LCs in some Islamic banks in Malaysia.

one which is prohibited by the *ḥadīth* forbidding two transactions in one. (Ibn Hajr, n.d). To avoid such unlawful practices, it is suggested that the signing of the *wakālah* agreement be made separately from the *murābaḥah* agreement. In other words, the signing of such agreements is made in two different contractual sessions. Furthermore, some banks instruct the customer to sign a *murābaḥah* agreement (which represents *'aqd*) regardless of the existence of the goods prior to the presentation of documents. This practice contradicts Sharī'ah based on the *ḥadīth* where the Prophet (PBUH) says:

> "It is not permissible for a man to sell foodstuffs at random (or haphazardly) (juzafa) until the purchaser knows its measurement." (Sahih al-Bukhari, 1404A.D)

Thus, the principles of Sharī'ah require that the existence of the goods and all relevant information such as the original price of the goods and all costs incurred together with the presentation of documents is a pre-requisite before such *'aqd* takes place and should be observed accordingly.

G. Discrepancy Fee

Similar to the conventional LC, the Islamic LC is governed also by the principle of strict compliance which indicates that documents must strictly comply with the LC requirement. The seller beneficiary will be paid by the bank only on the compliance of his documents. Any errors or discrepancies in documents will discharge the bank from honouring the payment. In practice, the bank may impose a discrepancy fee for any discrepancies found in the documents. The original purpose of the discrepancy fee was to educate the beneficiary to be more careful in preparing his documents and to reduce the high rejection rates due to discrepancies in documents. However, at the same time, it serves as easy money for the bank as the bank has an

absolute right to charge any amount.[28] So far, there is no standard measurement of the amount of the discrepancy fee and this practice seems to prejudice the beneficiary. At the same time, it makes the payment by using the LC unattractive as traders may refuse to use this method of payment for fear of being caught by discrepancies, so resulting in them paying an expensive discrepancy fee. Thus, it seems unfair to the beneficiary and this practice contradicts the Sharī'ah principle which forbids the practice of oppression. In a *ḥadīth*, the Prophet (PBUH) says that Allah says:

> "I have forbidden oppression for Myself and have made it forbidden amongst you, so do not oppress one another." (Ibnu Hjr, n.d, hadith no. 1532; Collection of Forty Hadith by Imam Nawawi, 1996, hadith no. 24)

Thus, the idea that a discrepancy fee should not be charged for a minor discrepancy which is not disputed by the buyer and is not detrimental to the business of the bank should be upheld (Lahsasna, 2007). Moreover, the practice of charging a discrepancy fee can be totally eradicated considering the fact that buyers in normal situations are always willing to waive discrepancies (Lahsasna, 2007). They are more interested in taking possession of the goods irrespective of the discrepancies (Lahsasna, 2007). In addition, the nature of the agency relationship between the bank (agent) and the buyer (principal) entails that the principal's decision binds the agent. Therefore, if the buyer has agreed to accept the documents, the agent, that is the bank, is not entitled to impose such a discrepancy fee (Lahsasna, 2007).

Alternatively, the fee can be charged, but the amount should not exceed the staff costs of the bank. Furthermore, it should be a control measure in the implementation of the discrepancy fee so as to uphold justice and give fair treatment to customers.

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28 See Smith, Donald R, (2008). The author mentioned that a survey of more than 1,000 corporate users in the past year revealed that one of the reasons which discourages applicants and beneficiaries from using the LC results from the discrepancy fee. The author referred to the discrepancy fee as "a nuisance fee", and claimed that "this has turned into a profit centre for some banks, who find 'mythical discrepancies' in documents".

IV. CONCLUSION

The main reasons for applying the Islamic concept in banking is to eliminate the element of *ribā* in trade transactions as well as to be in conformity with Islamic law principles. Likewise, the LC also works on the same principles which forbid any element of *ribā* and *gharar*. Apart from that, it is also upheld that justice should be given to all the parties involved in LC transactions: bankers, importers and exporters. Thus, despite the similarities between the conventional and Islamic LC, the Islamic LC practically should not work in the same way as the conventional LC. In certain aspects, it should differ in practice and in the principles governing its operation.

As a long term remedial step, it is imperative for the Muslim society worldwide, through a recognised Islamic trade body, to establish specific standard international rules on incidental charges which comply with the Sharī'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 is also practiced by the conventional banking system worldwide.

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