Shariah Legitimacy of Islamic Letter of Credit and Shipping Guarantee Procedure adopted by Islamic Banks in Pakistan

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Abstract

Islamic banking had gained much popularity among public especially in Muslim countries including Pakistan. Islamic Letter of Credit is an important product of Islamic banks when customers are involved in international trade. Similarly, the Shipping Guarantee is very useful for importer to get their goods released from port in case goods reach before receipt of shipping documents. This process is carried through documents. At one side Islamic bank in importer’s country is called issuing bank and the bank involved in exporter’s country is called negotiating bank. Banks all over the world follow UCP rules for process of letter of credit. Islamic banks are not supposed to follow the same procedure as adopted by conventional banks. In this study, we have explored which underlying contracts are made base for facility of letter of credit and shipping guarantee. Further we investigated whether dealing mere in documents and not checking physical condition and existence of goods is Shariah compliant or not. We found that Wakalah and Murabaha are the most widely used contracts in Pakistan for trade financing purpose. First of all a Wakalah contract is made with the customer and then second contract is Murabaha or any other. Other contracts made after Wakalah contract may be Musawma, Musharkah or Ijarah. Scholars are of the view point that the process of letter of credit may be concluded without noticing the goods as goods are determined through detailed specifications in written form and to precede further constructive possession is also permissible. There is not prohibited element in shipping guarantee; hence it is also Shariah compliant.

Keywords- Islamic Letter of Credit, Shipping Guarantee, Shariah Legitimacy, Wakalah, Murabaha, UCP Rules

Introduction

All five Islamic banks in Pakistan (till date) provide facility of Letter of Credit to their customers engaged in international trade that is import of goods from other countries and export of goods to other countries. Letter of Credit (LC) is very popular product as it facilitates and protects both the importer and the exporter.

Islamic banking has experienced a phenomenal growth since its beginning till today and it has potential for more. Due to its growth and acceptability, the financial circles whether they are Muslims or non-Muslims are attracted towards it. Provision of letter of credit or say trade finance is such a thing in which more than one country is linked. For example, if we consider Pakistan’s imports and exports, there are a number of countries of the world from with this international trade are done. Therefore both the Shariah legitimacy and practical usability of Islamic letter of credit is of much importance for individual banks, for the regulators and for the parties involved in international trade. Archer & Ahmed (2003) provided estimation that the Islamic banks are expected to get up to 50% of total savings of the Muslims in coming few years. According to Islamic Banking Bulletin (December 2017) published by SBP total assets of Islamic banks in Pakistan have reached Rs.2, 272 billion and overall share in banking industry has reached 12.4%.

The procedure of ILC thus is expected to be similar to the one practiced by conventional banks. However, Islamic banks have to base their procedure on some Islamic mode of financing as they are not meant to do financing activity involving interest (earn money on money for time period factor only). Islamic banks in Malaysia are reported to use Murabaha, Musharkah and Wakalah arrangements for this purpose (Nik Norzrul Thani, et al., 2003). We are interested in exploring that what modes of finance are being used by Islamic banks in Pakistan for international trade financing.

It is pertinent to note here that in case of a Letter of Credit, an Islamic bank has to make deal with other bank (called negotiating bank) which may be situated in any country and may be an Islamic or conventional one. Due to this fact, Islamic banks are supposed to adhere to the rules given by International Chamber of Commerce for international trade financing which are known as Uniform Customs and Practice (UCP) for documentary credits. Therefore, making the procedure of ILC Shariah compliant and its global acceptance is a challenge for Islamic banks and the regulator also. The newest version of rules issued by ICC is known as UCP-600. Banks of the world deems these rules fit for LC as they provide a uniform mechanism of international trade settlements through involvement of commercial banks (Chatterjee, 2006). These rules provide roles, rights and liabilities of all the parties involved in documentary credit or LC. However, there is a possibility that some or more of rules are not compatible teaching of Islam. This is the area which we are going to explore and will provide solution if any issue is found in this regard.

Literature Review

Islamic finance is exposed to uncertain legal circumstances when it is meant for international trade. If its practices are not standardized in a global context, it will hinder its growth. Therefore a suggestion has been forwarded to make an international treaty among Islamic financial institutions, regulatory bodies towards standardization. Uniformity in practices of international trade financing like that of UCP-600 will provide recognition to Islamic finance, country party and stable financial system. In this way world-wide financial market will realize the viability and credibility of Islamic finance.

Therefore to accept the global challenge, it is need of the day to make future of Islamic finance industry vibrant with the support of standardization at least to the prime products like letter of credit to avoid possible conflicts (Hakimah Yaacob & Apinzan Abdullah, 2012).

Letter of credit is governed by International Chamber of Commerce, having its head office in Paris. The ICC has issued rules for documentary credits which are known as UCP 600. UCP stands for |Uniform Customs and Practice for Documentary Credits. There is an issue with Islamic letter of credit when banks deal solely in documents and do not check the condition of the goods.

As Islamic bank buy the goods, becomes owner of those goods, so it is important that bank has knowledge about condition and existence of goods. Most of the Islamic banks have not included this element in their procedure of LC (SFS Alwi et all, 2013).

Shipping Guarantee is an important facility provided the importers. There is not much difference in conventional SG and Islamic SG. Main feature of Islamic SG is that it is based on Kalafah contract. For that period bank is liable during which customer holds the SG. In this way banks are exposed to financial risk. They are also exposed to credibility risk in international market. Hence banks must be conscious while issuing SG. (SFS Alwi et all, 2015)

For a banking system to be qualified to Islamic, the system must be consistent with Islamic rules both in objectives and procedures (Baele, Farooq and Ongenal, 2014)

Islamic financial institutions adopt their policies and practices according to Shariah law and abstain from involvement in any procedure or activity which is against values of Islam. But when Islamic banks work in different countries with different social and economic environments, they are supposed to adopt certain policies according to the specific circumstances of those places but be Shariah compliant at the same time. Among such factors, the international trade and business law of respected country is an important one which the banks have to keep in consideration while providing services to their clients.

Financing is important activity of Islamic banks just like their conventional counter parts. As Islamic banks are restricted to provide loan or any financial support based on interest, they provide financing on profit and loss sharing basis or based on pre-determined prices like musawma or predetermined profit rate after declaration of the cost (Haron, 1998).

To separate approaches are being followed for providing facilities related to import and export business. For example MCB Pakistan and BMI of Malaysia offers Letter of Credit facilities whereas other like BIMB of Malaysia and DIB of United Arab Emirates prefer to provide guarantee letters (Haron, 1998).

AAOIFI (Accounting and Auditing Organization of Islamic Financial Institutions) was established in 1991 as an independent organization in Bahrain. This body has provided its rules for different products of Islamic banks including the facility of LC and the Shipping Guarantee. However, in Pakistan mostly banks are following IFRS standards with some modifications. Lack of internationally recognized accounting standards also cause a difficulty in reporting or otherwise of Islamic products including services of letter of credit and shipping guarantee (Ahmed, Akhtar, Ahmad, Aziz, 2017).

Research Objectives

- To explore LC and Shipping Guarantee procedure adopted by Islamic Banks in Pakistan
- To view rules set by ICC for trade financing with the lens of Islamic teachings
- To explore process of Shipping Guarantee and its Shariah Legitimacy

Research Questions

- What is the procedure of ILC in Pakistan?
- What are underlying Islamic Contracts for ILC arrangement
- What the Shariah scholars say about important global rules followed by Islamic banks in trade financing?
- Is Shipping Guarantee Shariah compliant?

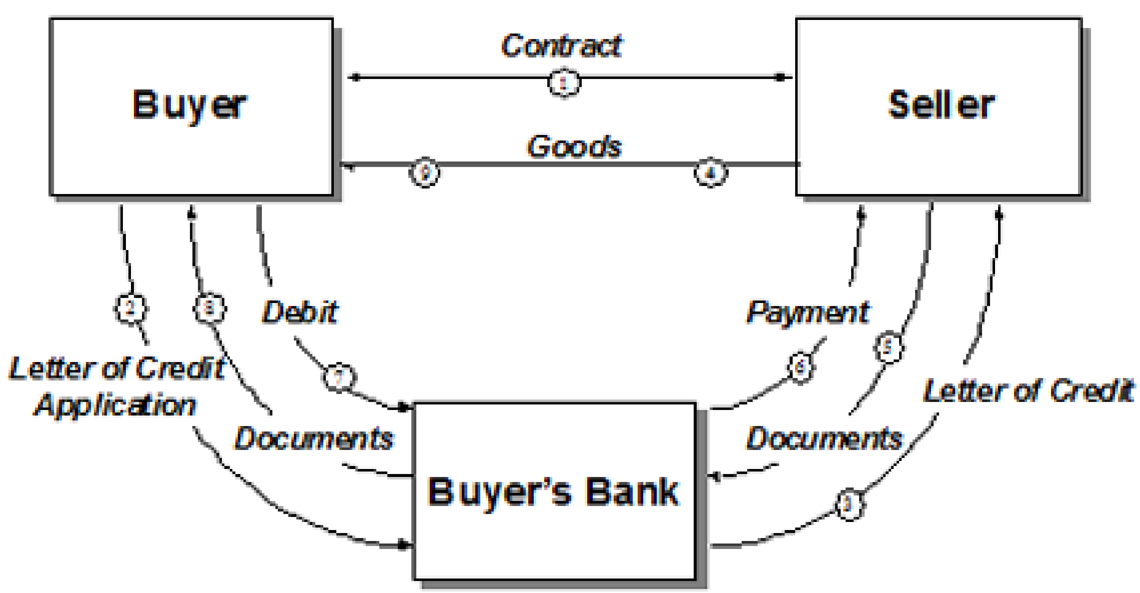
Methodology

Information has been collected from 5 Islamic banks through survey forms and personal interviews about the working of Islamic LC. UCP-600 rules are to be analyzed using lens of Shariah and perspective of religious scholars will be taken for those rules which are, or at least seems to be, not compatible with teachings of Islam.

Explanation of Key Concepts

Letter of Credit

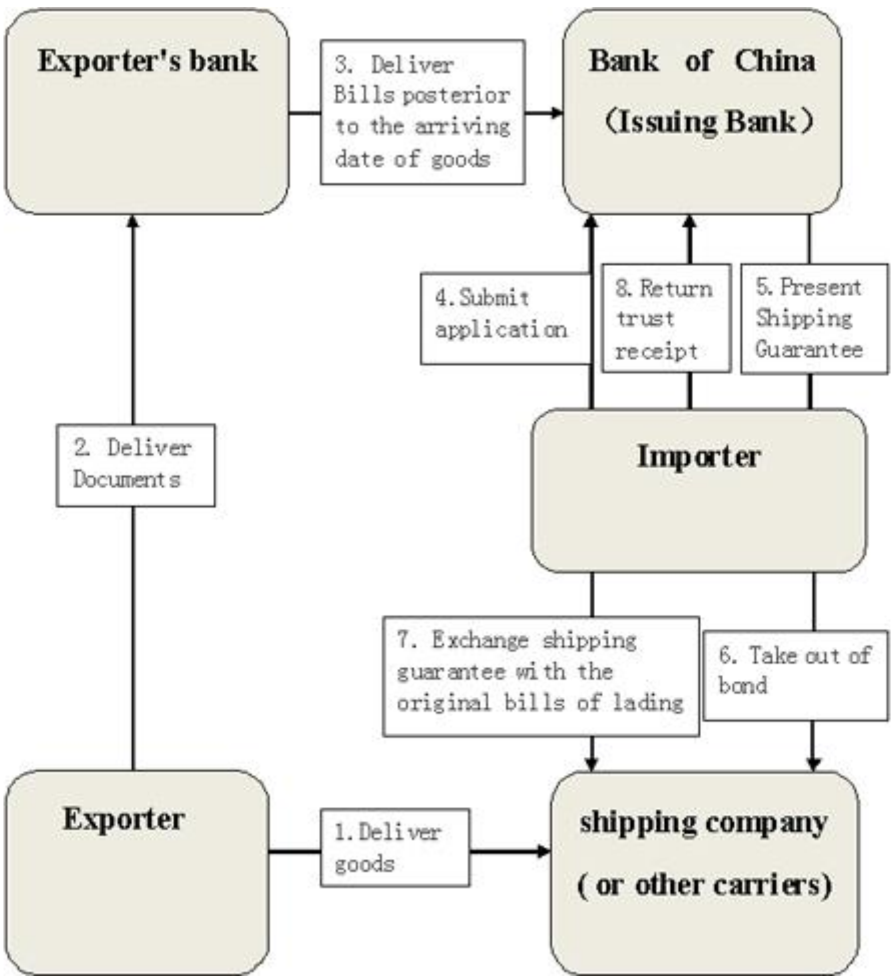
The facility of Letter of Credit is provided by commercial banks to provide safety for the exporters. For example a trader from Pakistan wants to import a certain brand of TV sets from Japan. Now the exporter does not want to risk of payment as his customer belongs to another country. Therefore he will demand a Letter of Credit from the importer to safeguard receipt of money for his sales. In this case the importer will request his bank in Pakistan to issue a LC in favor of exporter's bank in Japan. LC is actually a guarantee given by the importer's bank that once goods are shipped by the seller, the bank will release payment to the seller. In this way import-export transactions are settled and fee charged by banks for this service becomes the income of the banks.



Shipping Guarantee

In international trade, sometimes it happens that imported goods reach the country of importer before the shipping documents. If good remain there at the port, the importer have to bear costs of demurrage which are normally charged on per day basis. In order to provide facility to the importer the Bank provides a guarantee to the transporting company or its agent that shipping documents will be submitted as soon as received, so release the goods of the importer. This facility also provides liquidity to the importer as he may sell the goods early in the market and can raise funds.

Process



Shariah Scholars

In context of Islam religion, Shariah scholars are those persons who are specialized in the field of Islamic rules and laws for worship as well as for transactions (Muaamlat). In general every Muslim is required to have knowledge of Islam sufficient for his/her daily needs. Whereas Shariah Scholars is group who have in-depth knowledge as an expert of Shariah.

Analysis and Discussion

We asked open-ended and closed-ended questions form Islamic bankers and Shariah scholars. Responses of open-ended questions have been summarized in the later discussion whereas here we are presenting two representative cases of answers to the closed ended questions:

First:

Q.1 Do you use Murabaha Contract or Wakalah Contract or both for the purpose of Letter of Credit?

Answer: Murabaha contract for LC purpose.

Q.2 Would you explain briefly the process of LC via use of above contracts?

Answer: As approved sanctuary advice from risk department. We take security documents.. and issue MMFA (Master Murabaha Finance agreement) and Agency agreement as well.

Q.3 Do the bank "notices" goods before trade finance activity via Murabaha or Wakalah arrangement?

Answer: Yes… we take arrival memo from customer to funds disbursement.

Q.4 (If answer to Q.4 is NO) How will you justify that above method is as per Islamic Principles?

Answer: Not applicable

Q.5 If SBP make it obligatory for Islamic Banks to check the goods first, will there be any practical difficulty for the banks to do so?

Answer: Bank makes agent its customer and banks official visits the delivery place… If it is apply on every transaction. Then bank should hire more staff for this purpose.

Second:

Q.1 Do you use Murabaha Contract or Wakalah Contract or both for the purpose of Letter of Credit?

Answer: In Meezan Bank we prefer Murabaha/Musawamah Contract.

Q.2 Would you explain briefly the process of LC via use of above contracts?

Answer: Customer acts as an agent in this case, negotiates the deal with exporter and then as per deal he places "Order Form" with Meezan bank and also provides Performa Invoice. Bank establishes LC as per Performa Invoice. After goods reach Pakistan will be owned by Meezan Bank. Bank then sells these goods after signing the Murabaha/Musawamah contract with the customer thereafter customer get the goods released from Customs.

Q.3 Do the bank "notices" goods before trade finance activity via Murabaha or Wakalah arrangement?

Answer: No

Q.4 (If answer to Q.3 is NO) how will you justify that above method is as per Islamic Principles?

Answer: Practically it is not possible because Govt. regulations are not supported to declare/notice imported goods physically. When goods reach on Pakistan Port, these are under custody of Custom Authorities and as per Customs Rules no one can access the inbound area of Customs where goods are placed. Therefore after payment of custom duties and other Govt. taxes, documents can be handed over to Bank/Representative or Customer, at those stage goods can be declared/notice. Therefore it is not possible to check the goods in custom bounded area. Moreover it is not obligatory to physically check the goods before Murabaha Contract in my opinion there is no Shariah Violation to that. It is important that product/goods existed physically and supported evidences are available like Commercial Invoices/ Packing List along with B/L which will also be in the name of bank then goods can be declared/notice and bank can sale the good on the basis of constructive possession of the goods.

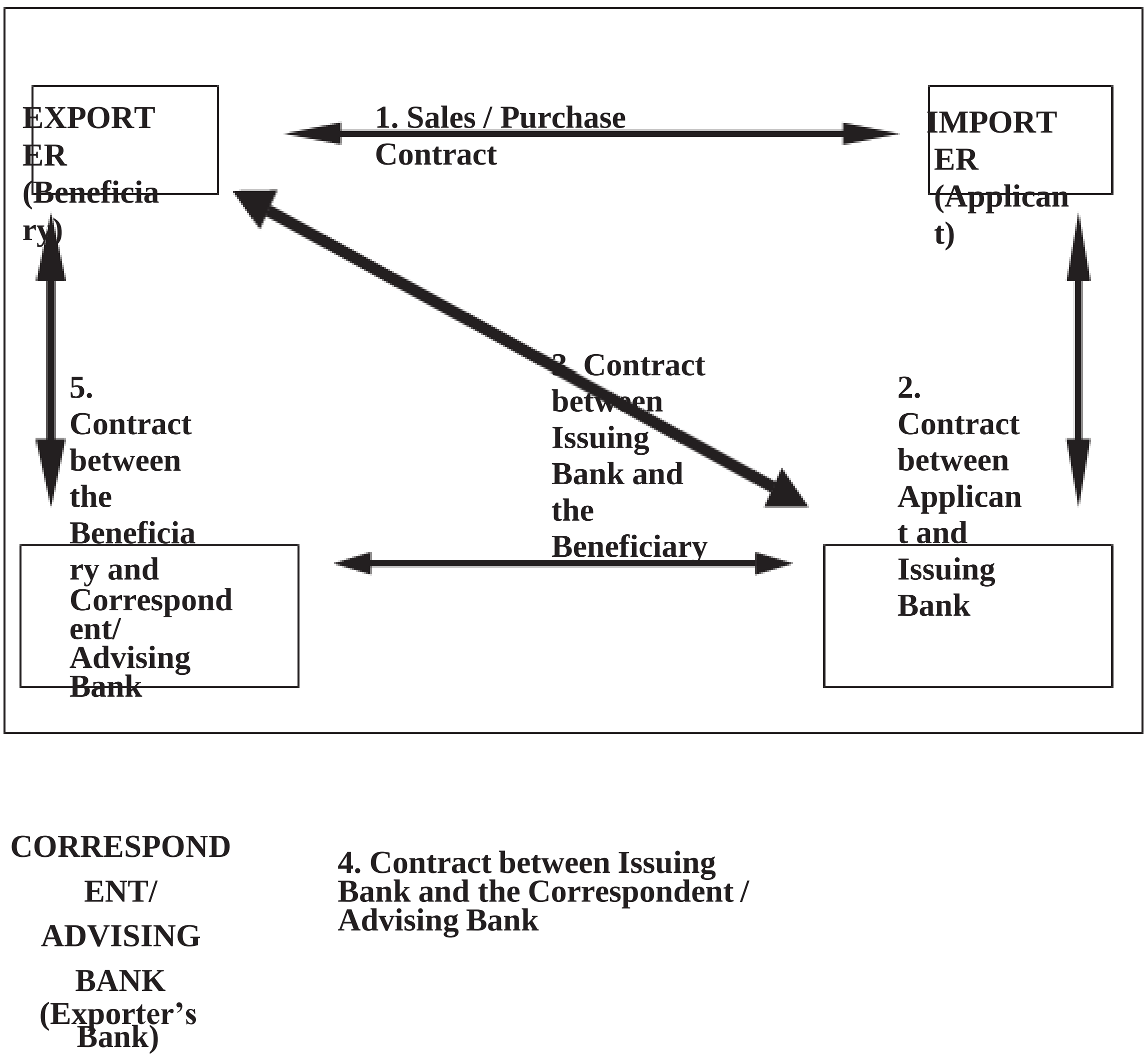
Q.5 If SBP make it obligatory for Islamic Banks to check the goods first, will there be any practical difficulty for the banks to do so?

Answer: It can be only practical when SBP first make arrangement with Govt. / Custom authorities to allow inspection the goods before signing of Murabaha Contract then it might be possible.

Conclusion

As regard to the procedure adopted by Islamic banks for LC issuance is concerned, this procedure is based on certain Islamic contracts like Wakalah, Murabaha, Musawma, Musharkah and Ijarah. Which contract/arrangement will be made depends on the requirement of customer that what sort of goods he wants to import. Market department of the bank first of all analyze the goods desired by the customer and the product in which he is interested. First of all contract of agency (Wakalah) is made with the customer whereby bank appoints him/her as the agent of bank. The following figure depicts the underlying contracts and process flow of ILC:

Figure : Typical contracts arising from a letter of credit transaction (Bergami, Roberto 2004, p. 261)



The customer in the capacity of agent, negotiate price with the importer, settle terms and finally get the goods at port after getting the clearance from excise department. After Wakalah agreement, bank enters into second agreement that is most appropriate according to needs of the customer. For example an arrangement may be Wakalah and Murabaha where bank settles price of the goods on cost plus beforehand. After successful Wakalah and Murabaha agreement, LC is issued in favor of the concerned exporter using the same process as used in conventional mode. Customer get the goods released on behalf of the bank, then Murabaha contract is practically executed whereby sale of goods is made on cost plus basis from bank to the customer and customer get the ownership of goods and right to use those, resultantly. Other form of such an arrangement is that bank fixes its profit, means that profit of bank will not depend on the amount of LC. The customer will pay a fix profit to the bank. LC will be issued accordingly.

Musawma contract is different from Murabaha in the sense that here final price of the goods will be settled between customer and the bank without refereeing to the cost. Whereas in Ijarah bank take joint ownership of the asset to be imported and then give the asset on lease to the customer whereby customer pays regular installments usually on monthly basis. Each installment includes certain amount of rental and principal amount. After the expiry of lease period, asset is sold to the customer on nominal price. Murabaha and Wakalah/Musawma can be done at the same time. In Murabaha, a profit is settled already. Profit is fixed. It do note depend on amount of LC. Bank appoints customer as agent to import goods and get them released. Documentation is more in Islamic banks as compared to conventional banks for the process of LC which makes this facility a little bit expensive of time consuming to the customer. However, customers choose Islamic bank to save them from prohibited element of conventional finance that is interest (Riba).

Bank pays Wakalah agreement fee to the importer company as wakeel. Bank deals in documents seized before the shipment of goods. Bank does not notice the goods before finalizing the deal. It is not possible for bank to go abroad to notice the goods. Cost and profit is allowed. Bank does not take physical possession. Bank provides a guarantee which is allowed in Islam. MCB Islamic bank, for instance, issue LC to its customers via Wakalah and Murabaha arrangement. Documents are the proof of that which goods have been ordered to the exporter. As compared to these whereby bank deals in documents, there is another option that is to buy online. Here even documents are not involved to support any transaction. Therefore online transaction is not accepted in Shariah, said by one of the Shariah scholars. According to another Scholar’s view point, in documentary credit if risk pertaining to goods is transferred to the buyer, then this is allowed. AAOIFI has allowed constructive possession. Therefore banks may enter into international trade finance and facilitation business through Islamic modes of finance whereby they do not get physical possession of the goods. However, opinion of classical Scholars is in contradiction to this process. But modern Scholars are in favor of LC.

During process of LC, banks follow UCP rules. Of which Rule 7 states that when documents are completed, issuing bank must honor it. We were of the view that this rule is in contradiction of Islamic teachings as the buyer has not witnessed the goods throughout the process. We interviewed Shariah scholars to check the validity of this issue. We came to know that actually the contract of Murabaha is executed when the goods come on the port of importer's country. Here the risks associated with goods are owned by the bank and then sale and purchase activity is actually done. To refer this whole process, by taking prominent element involved, this arrangement has been named as Murabaha arrangement for LC. As for purchase of goods by the bank from exporter is concerned, specifications and characteristics of goods are presented in detail in written so that element of indeterminacy of goods is no more there. Hence, we conclude that compliance of UCP rule 7 by Islamic banks is not in contradiction with teachings of Islam and that the procedure of Islamic Letter of Credit (ILC) is legitimate as per Shariah.

As per legitimacy of Shipping Guarantee (SG) is concerned, it is also Shariah compliant as it does not involve any thing which is prohibited in Islam. Bank provides a guarantee to the shipping company that let the importer pick-up his goods and the required documents will be provided within the promised period.

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