

CONVENTIONAL AND ISLAMIC LETTER OF CREDIT: COMPARISON AND IMPLEMENTATION

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Abstract

This study attempts to provide the insight about payment method in international trade, especially by using Letter of Credit both conventional and Islamic way. It study is exploratory and using qualitative method of research. It reviews and analyses the previous literatures and other secondary data to conduct the study. The secondary data for this research were gathered through library research. This study also did the documentary analysis. Based on the data collected, Letter of Credit is the most secured and commonly used as the method of payment for International Trade. However, there are issues on the Conventional Letter of Credit which are not Shariah-compliant. Islamic financial institutions around the world are trying to come up with Islamic Letter of Credit, despite of some issues and challenges in implementing Islamic Letter of Credit. This study attempts to provide the insight about payment method in international trade, especially by using Letter of Credit both conventional way and Islamic way.

Keywords: *Islamic Letter of Credit, International Trade, UCP 600, Letter of Credit*

Introduction

Trade has been recognized to be an important tool in the economy activities. It has created many jobs and demands for trade financing including for import and export purpose. According to the World Trade Organization, trade financing is a vital to the economy by supporting almost of the global trade. In the history of Islam, the Prophet (PBUP) was involved in trading activities with traders from other countries. Aside from the Prophet's tradition, there are numerous verses in Qur'an that encourage Muslims to conduct trade with people of foreign lands.

Letter of credit (LOC) is one of the payments mechanisms in international trade. It is widely used particularly in sale transaction where the seller and the buyer are not residing in the same country. A long distance in location between **the** two parties is always invites uncertainty, speculation and worries because it is very hard to trust each other. Treating with someone who you don't know or being with him in same place is very dangerous especially when the sale involves a big number of money and expensive goods. The both dealers in this situation are unwilling to start giving commitment unless they make sure that their deal will be protected. The sellers would not be interested to par their good unless they have been guaranteed payment will be received. Likewise, the buyers will also not be very generous to advance the payments of the goods unless they have been that they will receive the goods. In this case LOC/LC/L/C serves an important tool to overcome of trustworthiness between buyer and seller. The function of Letter of Credit is to provide an efficient payment through using the bank as 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 while the buyer does not have to pay until all the documents has been presented with compliance.

Letter of Credit is believed as the most common and most effective method payment being used for international trade. Letter of Credit is ruled by the UCP 600, where a lot of things from UCP is not Sharia compliant. Therefore, Islamic Banking comes up with the Islamic Letter of Credit. But the implementation of Islamic Letter of Credit itself still having some of issues and challenges.

In general, this study aims to discuss about the method of payment in international trade between the conventional way and Islamic way. Furthermore, this study also discusses in more detailed about letter of credit and Islamic Letter of Credit. This study attempts to provide insights about payment method in international trade, especially by using Letter of Credit both conventional way and Islamic way.

This research compiles the knowledge from analyzing the payment method for international trade, especially by using the Letter of Credit. This research would provide better strategy to regulate and provide an effective policy in implementing the Islamic Letter of Credit.

Literature Review

International Trade

The history of international trade can be traced back to the years between 1776 and 1826, where there are 2 respectively publication from Adam Smith on *Wealth of Nation* and from David Ricardo on *Principles of Economics*. Adam Smith's publication talking more about the division of labor, in the nascent large-scale industries of his homeland England, provided the base for lowering labor costs, which ensured effective competition across countries. Meanwhile David Ricardo's publication talking more about the theory of free trade. (Ben, 2010)

In an economic point of view, international trade can be defined as a field in economics that applies microeconomic models to help understand the international economy. (Saylor Foundation, 2012) In a simple word, international trade can be defined as the exchange of goods and services across international borders or territories.(Economic Concepts, 2012)

There are 3 models that explain international trade, these models are:

1. Ricardian Model: This model focuses on comparative advantage and perhaps it is the most important concept in international trade theory. In this model, countries are specializing their self in producing what they can produce best (Krugman & Obstfeld, 2009)
2. Heckscher-Ohlin Model: This model was built as an alternative to the Ricardian Model. This theory argues that the pattern of international trade is determined by differences in availabilities of the factor of production. So that countries will export those goods that make concentrated use of locally abundant factors and will import goods that make concentrated use of factors that are locally scarce. (Blaugh, 2006)
3. Gravity Model: In its basic form, this model predicts that trade based on the distance between countries and the relations of these countries. This model is the copy of the law of gravity for chemical elements which also considers distance and physical size between two objects. But in economic approaches use through economic analysis. Other factors such as income level, diplomatic relationships between countries, and trade policies are also included in this model. (Nello, 2009)

Furthermore, the reasons why countries are inclined to do international trade, There are 5 basic reasons why the countries are doing international trade with another countries, such as follows: (The Saylor Foundation, 2012)

1. Differences in Technology: International trade can occur between countries if the countries differ in their technological abilities to produce goods and services. The term technology here refers to the techniques being used by the countries to combine the resources (such as land, capital, labor and entrepreneurship) to produce goods and services.
2. Differences in Resources Endowments: Resource endowments in here are referring to the skill and abilities of a country's workforce, natural resources available within the country and the sophistication of the stock

- of its capital (such as machinery, infrastructure, and communication systems).
3. Differences in Demand: Individuals in different countries may have different preferences or demands for various products. For example, Indonesians tend to demand more rice than the Germans'.
 4. Existence of Economics of Scale in Production: The existence of the economic scale in production is sufficient to generate the international trade between countries. Economic of scale in here refers to a production process in which the cost of production will fall when the scale of production rises
 5. Existence of Government Policies: Government tax and subsidize program from a country can altering the prices charged for goods and services. These changes can be sufficient to generates an international trade between countries. In these circumstances, international trade may arise solely due to the differences in government policies, taxes and subsidize across countries.

There are a lot of advantages that can a country get from doing international trade with another country. One of the advantages is international trade can lead the country to an economic growth by providing the policy measures and economic infrastructure are accommodative enough to cope with the social and financial changes that comes with it. (Vijayasari, 2013) UNCTAD also stating that international trade is a powerful enabler of an economic development. And international trade also has an impact on national income where international trade can rise the economy's income-generating opportunities. International trade also can reduce the cost of goods and services that are not domestically available at reasonable prices, and increase quality and variety of such goods and services in the marketplace. (UNCTAD Secretariat, 2014)

In Islamic perspective, basically Islam encourages free and fair trade, including international trade. There were several events during the time of Prophet Muhammad (PBUH) showing the positive stance of Islam towards free market. One of the commonly referred event is Prophet reluctance to fix prices of some commodities because of market condition. Islam has a complete set of rulings regarding international trade. Classical scholars such as *al-Shafi'i* believes that international trade is favourable in Islam. The reason is because human beings are social in nature, trading even with *harby* is permissible unless trading for *mushaf* and strategic materials (such as weapons and its materials). There are five guiding principles regarding int. trade; justice and fairness, wise management, transparency, maintaining ethical dimension, adherence to rule of the games stipulated by *shariah*.

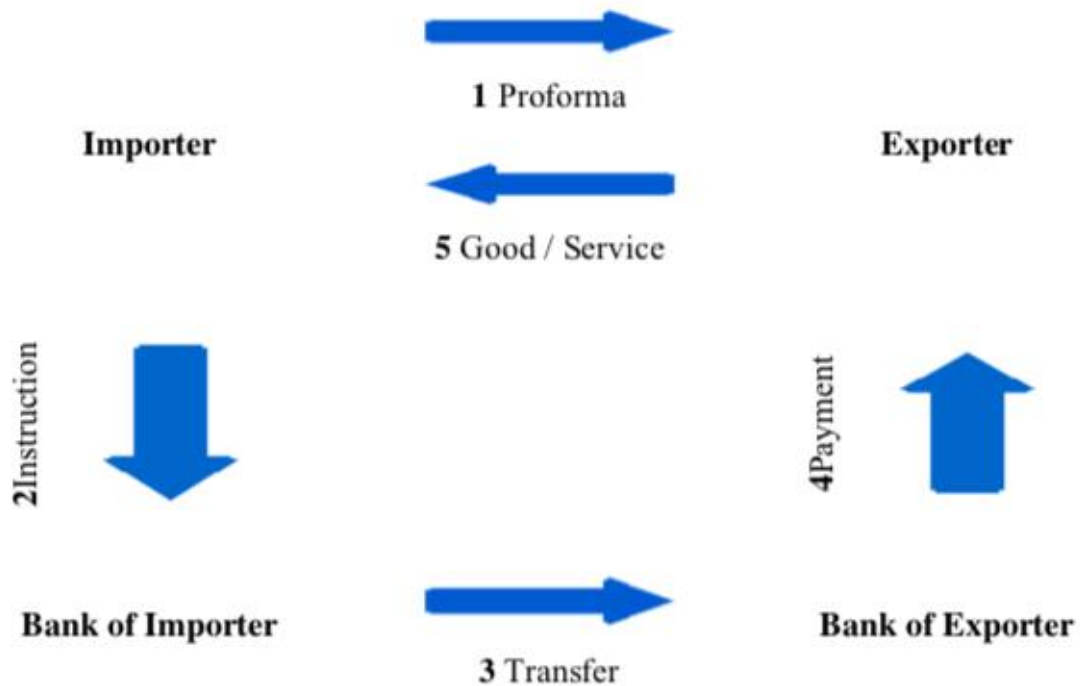
Conventional Payment Method for International Trade

There are 5 common conventional payment methods in international trade, which are:

1. Cash in Advance

With cash-in-advance payment terms, an exporter can avoid credit risk because payment is received before the ownership of the goods is transferred. For international sales, wire transfers and credit cards are the most commonly used cash-in-advance options available to exporters. With the advancement of the Internet, escrow services are becoming another cash-in-advance option for small export transactions. However, requiring payment in advance is the least attractive option for the buyer, because it creates unfavourable cash flow. Foreign buyers are also concerned that the goods may not be sent if payment is made in advance. Thus, exporters who insist on this payment method as their sole manner of doing business may lose to competitors who offer more attractive payment terms. (U.S. Department of Commerce, 2012) The model of this payment is:

Figure 1. The Model of Cash in Advance Payment



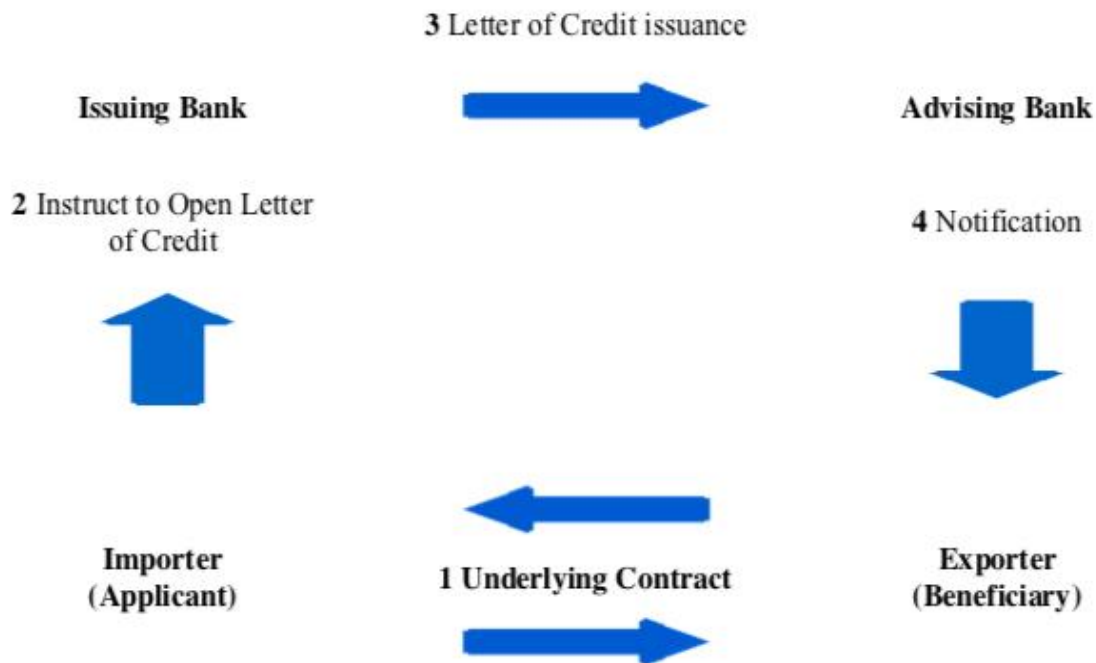
Source: (Tufekci & Unal, 2010)

2. Letter of Credit (LC)

Letters of credit (LCs) are one of the most secure instruments available to international traders. An LC is a commitment by a bank on behalf of the buyer that payment will be made to the exporter, provided that the terms and conditions stated in the LC have been met, as verified through the presentation of all required documents. The buyer establishes credit and pays his or her bank to render this service. An LC is useful when reliable credit information about a foreign buyer is difficult to obtain, but the exporter is satisfied with the creditworthiness of the buyer's foreign bank. An LC also protects the buyer since no payment obligation arises until the goods have been shipped as

promised.(U.S. Departement of Commerce, 2012). The model of this payment is:

Figure 2. The Model of Letter of Credit Payment

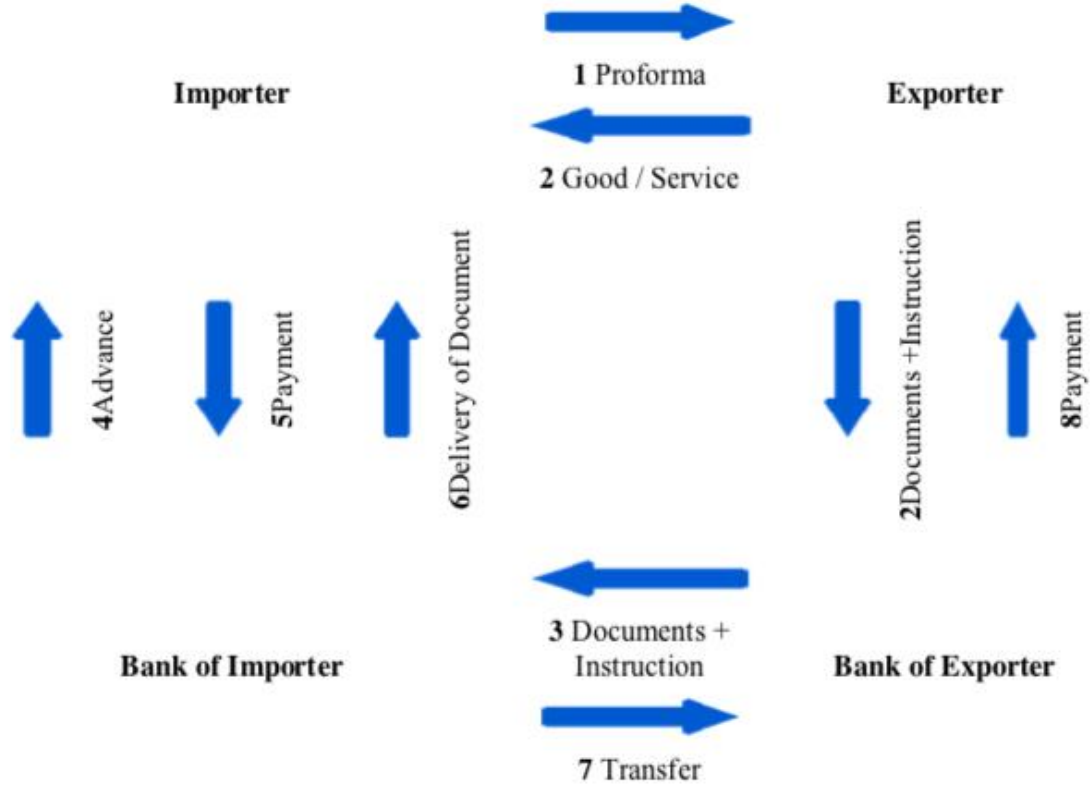


Source: (Tufekci & Unal, 2010)

3. Documentary Collection (D/C)

A documentary collection (D/C) is a transaction whereby the exporter entrusts the collection of the payment for a sale to its bank (remitting bank), which sends the documents that its buyer needs to the importer’s bank (collecting bank), with instructions to release the documents to the buyer for payment. Funds are received from the importer and remitted to the exporter through the banks involved in the collection in exchange for those documents. D/Cs involve using a draft that requires the importer to pay the face amount either at sight (document against payment) or on a specified date (document against acceptance). The collection letter gives instructions that specify the documents required for the transfer of title to the goods. Although banks do act as facilitators for their clients, D/Cs offer no verification process and limited recourse in the event of non-payment. D/Cs are generally less expensive than LCs. (U.S. Departement of Commerce, 2012) The model of this payment is:

Figure 3. The Model of Documentary Collection Payment

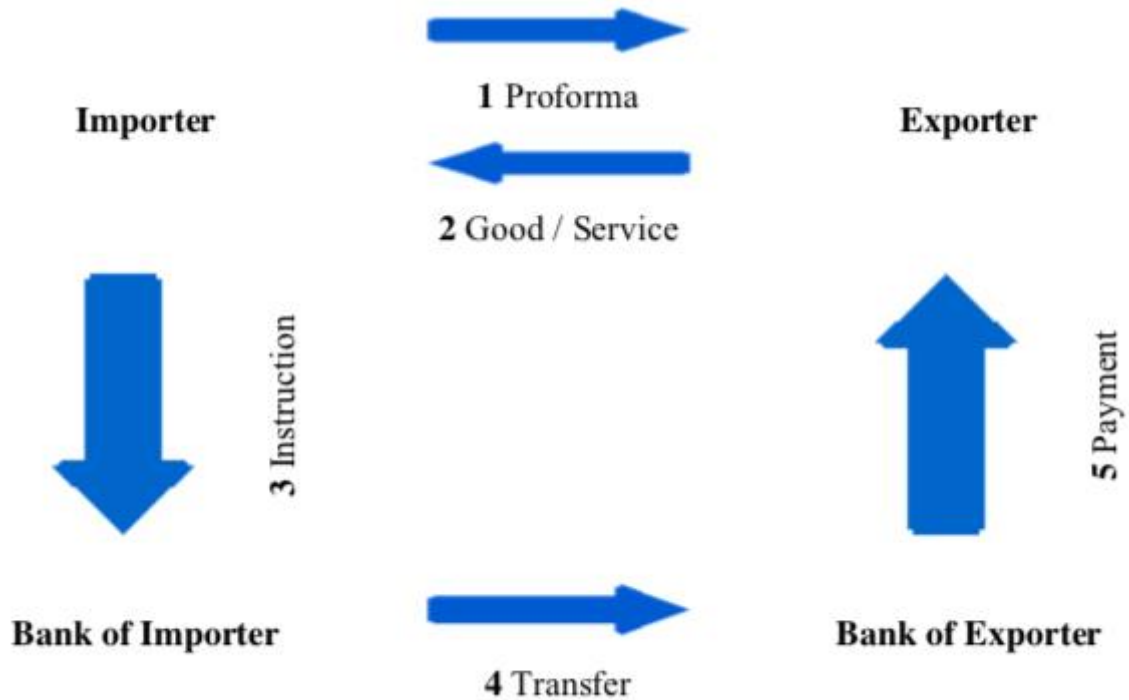


Source: (Tufekci & Unal, 2010)

4. Open Account

An open account transaction is a sale where the goods are shipped and delivered before payment is due, which in international sales is typically in 30, 60 or 90 days. Obviously, this is one of the most advantageous options to the importer in terms of cash flow and cost, but it is consequently one of the highest risk options for an exporter. Because of intense competition in export markets, foreign buyers often press exporters for open account terms since the extension of credit by the seller to the buyer is more common abroad. Therefore, exporters who are reluctant to extend credit may lose a sale to their competitors. Exporters can offer competitive open account terms while substantially mitigating the risk of non-payment by using one or more of the appropriate trade finance techniques covered later in this Guide. When offering open account terms, the exporter can seek extra protection using export credit insurance. (U.S. Departement of Commerce, 2012) The model of this payment is:

Figure 4. The Model of Open Account Payment



Source: (Tufekci & Unal, 2010)

5. Consignment

Consignment in international trade is a variation of open account in which payment is sent to the exporter only after the goods have been sold by the foreign distributor to the end customer. An international consignment transaction is based on a contractual arrangement in which the foreign distributor receives, manages, and sells the goods for the exporter who retains title to the goods until they are sold. Clearly, exporting on consignment is very risky as the exporter is not guaranteed any payment and its goods are in a foreign country in the hands of an independent distributor or agent. Consignment helps exporters become more competitive on the basis of better availability and faster delivery of goods. Selling on consignment can also help exporters reduce the direct costs of storing and managing inventory. The key to success in exporting on consignment is to partner with a reputable and trustworthy foreign distributor or a third-party logistics provider. Appropriate insurance should be in place to cover consigned goods in transit or in possession of a foreign distributor as well as to mitigate the risk of non-payment. (U.S. Department of Commerce, 2012)

Letter of Credit (LC) and Implementation of UCP 600

Letter of Credit or LC are claimed to be the most famous and common method of payment in international trade. It was all because the characteristic of LC which can manage to give security and facilitating trade between exporter and importer. (Kerr J, 1977)

Types of LC that are commonly used are: (Credit Suisse, 2014)

1. Sight LC: payment is made to the seller immediately after the required documents have been submitted to the authorized bank, provided the conditions in the letter of credit have been met. Banks are, however, allowed a reasonable period of time for checking purposes (not more than five working days after they receive the documents).
2. Deferred Payment LC: In the case of a letter of credit with deferred payment, the payment to the seller is not made when the documents are submitted, but instead at a later time defined in the letter of credit.
3. Acceptance LC: In the case of an acceptance credit, the payment to the seller is not made when the documents are submitted, but instead at a later time defined in the letter of credit.
4. Negotiation LC: Under UCP 600 (Uniform Customs and Practice for Documentary Credits, 2007 revision, article 2) negotiation means the purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank) and/or 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.
5. Transferable LC: Transferable letters of credit are particularly well adapted to the requirements of international trade. They allow an intermediary to transfer a letter of credit to a supplier, thus enabling the intermediary to reduce the extent to which it uses its own funds to process business transactions.
6. Standby LC: Standby letters of credit are similar to guarantees. Due to their documentary nature, they fall under the UCP. Standby letters of credit can also be issued under ISP98 (International Standby Practices). If the guaranteed service/payment is not provided, the seller can invoke the bank's obligation to pay by submitting, together with any other documents that the letter of credit might require, a declaration stating that the letter of credit customer has failed to meet his obligations/payment.
7. Revolving LC: If the buyer requests partial deliveries of the ordered goods at specific intervals (contract for delivery by instalments), payment can be made under the terms of a revolving letter of credit that covers the value of each consecutive instalment. The bank is normally liable for the total value of all agreed partial deliveries. However, the second partial payment is not effective until the first instalment has been paid, and so forth.
8. Red Clause LC: In the case of a red clause credit (letter of credit with advance payment), the seller can request an advance for an agreed amount (defined in the terms and conditions of the letter of credit) from the correspondent bank. This advance is basically intended to finance the manufacture or purchase of

- the goods to be delivered under the letter of credit. The advance is normally paid against receipt and a written undertaking from the seller to subsequently deliver the transportation documents before the credit expires.
9. Green Clause LC: Unlike the red clause letter of credit, in the case of a green clause letter of credit, the advance is normally paid not only against receipt and a written undertaking from the seller to subsequently deliver the transportation documents before the credit expires, but also against receipt of an additional document providing proof that the goods to be shipped have been warehoused.
 10. Unconfirm LC: In the case of an unconfirmed letter of credit, the correspondent bank merely notifies the seller that a letter of credit has been opened. In this case, it makes no promise to pay and is therefore not required to honour documents presented by the seller. As a result, the seller may rely exclusively on the issuing bank (letter of credit bank) and therefore bears the collection risk of the issuing bank and the country risk – according to their domicile – as well as the transfer risk.
 11. Confirmed LC: If the correspondent bank confirms the letter credit (on behalf of the issuing bank), then it is committing itself towards the seller to honour documents that are in compliance with the documentary credit terms and presented on time. In this case, the seller receives not only an obligation by the issuing bank but also a legally equivalent and independent promise of payment on the part of the correspondent bank. The seller then bears the collection risk of the confirming bank and, if this bank is not domiciled in his country, the corresponding country risk – according to its domicile – as well as the transfer risk.
 12. Revocable LC: All letters of credit subject to the current “Uniform Customs and Practice for Documentary Credits” (UCP 600), which is effectively the norm nowadays, are regarded as irrevocable. It is possible in theory to open a revocable letter of credit, but this is no longer done in practice for various reasons (difficult wording/insufficient security [revocation]).
 13. Irrevocable LC: An irrevocable letter of credit is a firm commitment by the issuing bank to make payment if the documentary credit conditions are fulfilled. It may not be amended or cancelled without the consent of the seller and all obligated banks. If the seller wishes to amend or cancel individual conditions of the letter of credit, then he must ask the buyer to issue an instruction to the issuing bank in this respect.

LC is being regulated by the Uniform Customs and Practice for Documentary Credit (UCP). UCP contains a compilation of rules, which are originated from ancient traders’ practices. The first UCP being published is UCP 1933. The latest UCP now is UCP 600 and being implemented worldwide since 1st July 2007. (Hashim, 2015) UCP is neither an international convention, nor it is a law. However, UCP is become forceful since it has been incorporated by reference in the majority of LC

used worldwide. Article 1 of the UCP stating:

"The Uniform Custom and Practice for Documentary Credits 2007 Revision, ICC Publication no. 600 ("UCP") are rules that apply to any documentary credit ("credit") (including, to the extent to which they may be applicable, any standby letter of credit) when the text of the credit expressly indicates that it is subject to these rules. They are binding on all parties thereto unless expressly modified or excluded by the credit."

There are 4 Key Characteristics of UCP 600 which are: (Hashim, 2015)

1. LC is a separate form from the underlying sale contract. As stated on Article 5 UCP 600:
"Banks deal with documents and not with goods, services or performance to which the documents may relate."
2. All LC credit are irrevocable. As stated on Article 3 UCP 600:
"A credit is irrevocable even if there is no indication to that effect."
3. In LC transaction, exporter must present the documents to the bank in order to claim payment for the good. These documents must be in strict compliance with the LC's requirements.
4. If exporter's documents contain discrepancies, a bank does not need to honour and must send a notice of refusal to the exporter or their banks.

Islamic letter of credit - Concept and procedures (Lahsasna 2007)

To introduce a workable letter of credit in finance and banking in international trade, one that complies with Islamic legal requirements while accommodating to the maximum existing practices in LC, we can structure the LC in accordance with the five main Islamic legal contracts. These are: *Al Wakalah*, *Al Murabahah*, *Al Musyarakah*, *Al Daman* and *Al Mudarabah*. Through these and other Islamic business transactions such as *Al Hawalah* and *Al Ijarah* LC operations can be brought in line with the laws governing Islamic banking and finance. Further, these five major Islamic business transactions can accommodate the different types of LC transactions currently in use. These Islamic contracts can serve as the platform for implementation of the Islamic letter of credit in the international trade.

1. Interpretation of the Islamic letter of credit according to the concept of the *Al-Wakalah*

Under *Al Wakalah*, the bank will act on behalf of its client who will authorize the bank to represent him in issuing the letter of credit and all its subsequent operations. This includes the terms of the letter of credit that is issued and checking for compliance of documents when a payment claim is made. The bank receives payment/commission or *Ujra* for the services provided. The role of the bank in the *Al Wakalah* is permitted in Islam.

The essence of an *Al Wakalah* is as follows:

- The customer informs his bank to open the LC and authorizes it to act on his behalf under the *Wakalah* concept;

- The bank issues the LC according to the instructions and the advice of its client and according to the terms and conditions agreed upon as found in documents confirming the sale provided by the client;
- The bank will charge its client fees as commission or (*Ujrah*) for the services rendered
- The bank will request payment towards the issue of the letter of credit. The amount paid will be subject to the agreement between the bank and their client. It can vary from the full amount or a nominal deposit depending on the business relationship between the bank and their client.

This is a straightforward LC operation done in accordance with Islamic legal requirements based on the well know principles of *Al Wakalah*.

2. The Islamic letter of credit under *Al Murabahah*

In an LC linked to *Al Murabahah*, the Bank at the request of their client imports goods for him through an LC established to the seller with whom the buyer has a contract. The bank utilizes its own funds to open the LC and the terms of the LC are in accordance to the terms agreed between the seller and the buyer. By doing this it assists their client to purchase the goods he requires without having to immediately commit his own funds. Applying the *Al Murabahah* contract, the bank in turn sells the goods to their client at the price agreed upon, which includes the banks profit. Depending on the terms of the *Al Murabahah*, payment can be prompt or deferred. LC operations built on the *Al Murabahah* contract is permitted by Islamic law.

3. The Islamic letter of credit under *Al Musharakah*

Al Musharakh is a contract between the Bank and the applicant where the value of the LC issued by the Bank and the profits of the transaction are shared between the Bank and the applicant. The terms of the contract depend on the negotiations between the parties, the better the relationship the better the terms he can obtain from the Bank. The details of this arrangement are as follows:

- The applicant requests his bank to open an LC based on *Al Musharakah* principles;
- The applicant (buyer) and the Bank agree to purchase the goods that the buyer has agreed to purchase from his seller. Their respective share of the purchase price and profit are agreed. Thus, as an example, the Bank may pay 70% and the applicant the remaining 30% and they can share the profits in the same ratio or the Bank can agree to give the applicant a higher percentage of profit;
- The Bank establishes a letter of credit to the seller;
- Upon receipt of the shipping documents, the Bank releases the documents to the applicant for him to clear the goods;
- The Bank and the applicant share the profit in accordance with the terms of the *Musharaka* contract

4. The Islamic letter of credit under *Al Daman (Al Kafalah)* (Guarantee)

Under the concept of the *Al Daman* (Guarantee) the Bank guarantees the

payment obligations of the applicant. The seller ships the goods against the guarantee of payment by the Bank. The actual transaction is along the lines of a letter of credit but the document contains within it the guarantee from the Bank and it is the financial standing of the Bank and not the buyer that is relied upon by the seller. Under this LC:

- the applicant requests his Bank to provide a letter of guarantee under the *Al Daman* concept;
- the bank proceeds to establish a letter of guarantee thus permitting the applicant to conclude his business with the seller;
- the letter of guarantee has the form of an LC and subject to the terms of the LC the Bank pays the seller thus discharging its responsibility;
- The Bank may request the applicant to place a deposit for this facility under the the agreement between them; the bank charges the applicant a fee for the services. Charges for the service of providing a guarantee is allowed in Islam and an LC issued on the strength of a Bank guarantee is permitted in Islam.

5. The Islamic letter of credit under *Mudarabah*:

Basically, *Al Mudarabah* is a contractual relationship between two parties where the first party (can be one or a number of persons) provides the capital and the other party (again one or more persons) runs the business with the profit shared at an agreed rate.

In the LC issued under the *Mudarabah* scheme, the Bank invests its own funds to issue the letter of credit and participates in the profit that the investment generates. The distribution of the profits is in accordance with an agreement entered into between the Bank and the applicant before the LC is established.

By applying this Islamic concept that we can offer a solution to what lies at the core of the problem in the current practice of letters of credit. We can rid the system of interest/*riba* levied on funds provided by the banks. This is to be replaced with a profit-sharing arrangement.

Research Methods

This study is exploratory and used qualitative method of research. It reviews and analyses the previous literatures and other secondary data to conduct the study. The secondary data for this research were gathered through library research. This study also did document analysis. Document analysis involves a systematic procedure for reviewing or evaluating documents including both printed and electronic material (Bowen, 2009). It requires that material and data be examined and interpreted to gain meaning and understanding to develop empirical knowledge (Corbin & Strauss, 2008).

Finding and Analysis

Sharia Issues for Islamic LC

1. Governing rule:

The application and operation of letter of credit is primarily though not solely governed by the stander international rule known as Uniform Custom and practice for Letter of Credit (UCP), issued by international chamber of commerce. This set rule has been adopted by all the countries as stander trade practice pertaining to application and operation of L/C. the attest version of UCP is the UCP 600. (Ahmad, 2010)

An interesting question is the issue of whether the UPC600 can govern the application and operation of the Islamic L/C, it is important to note that the emergence of Islamic banking system that produce the Islamic L/C, technically speaking, does not produce new L/C. Based on the Islamic L/C definition, the objective and function of L/C whether conventional or Islamic do not explain the technical differences. Therefore, the Islamic L/C is governed through the same method of conventional UCP which "remain a product of the western practitioners and experts" (Lahsasna, 2007).

As result of this, the international Islamic business community needs Islamic documentary credit in their international business transactions to ensure that transactions meet the Islamic legal requirement in business and trade. The introduction of an Islamic Letter of credit will also promote to the global business community Islamic law and practice.

It is strongly recommended the existing UCP be studied, reviewed, amended, supplemented and in the process a new set of rules developed to make the UCP an Islamic product. It is a must for Islamic financial institutions and banks to create documentary credits whose rules and regulations, terms and conditions benefit the international Islamic business community. Thus, This Islamic UCP will comply with the requirement of the Islamic law in order to be implemented in the Muslim world for the benefit of the UMMAH. (Lahsasna 2007)

2. Subject matter or goods traded:

Clearly, under the Islamic Letter of Credit, goods traded must be permissible (halal) by nature and origin. Allah says:

"Eat of that which Allah hath bestowed on you as halal and good and keep your duty to Allah whom you are believers." (Al-maidah: 77).

Therefore, all parties' bank, importer and exporter must be fully aware that they are only allowed to deal with halal goods. This requirement of course is not relevant in the conventional L/C as long as the goods has value and not illegal.

However, there is one question arising relating to the issue of halal goods in ILC al-wakalah, that is how to determine whether the goods are really halal before the L/C al-wakalah issued? This practice differs from one country to another. In

some countries the bank requires a certificate from the exporting country to certify the goods are halal. For instance, in Malaysia, bank Negara (central bank of Malaysia) has established a listing of all goods which are not entitled to be financed under Islamic facilities, such as "live swine, race horses, meat of swine, fresh, chilled or frozen, pig, ham". At the same time all the products and guidelines of an Islamic bank have to be scrutinized by sharia committee. (Aziz 2009)

3. *Riba* (interest):

Generally speaking, the UCP600 does not contain any provisions which associate with *riba*, 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 in accordance with the terms and condition of credit"

The "interest" expressed in this article refers to the penalty amount that is to be paid by the L/C issuing bank to the reimbursing bank in the event of failure to provide reimbursement without delay. In practice this "penalty" amount is not predetermined at the point of the issuance of the LC but is only disclosed by reimbursing bank upon claiming reimbursement from the issuing bank in the case whether the document is negotiated.

This article, without further argument, clearly contradicts with the sharia principles as it represented interest (*riba*) and uncertainties (*ghara*) element, Allah said "Allah hath permitted trade and forbidden *riba*" (al-baqara: 2:225).

To remedy the presence of these prohibition element. Article 1 of the UCP 600 provides an option where banks can modify or exclude certain clauses inherent to *riba* or *ghara*. It may seem as an effective mitigation mode as far as sharia principles is concerned, but may trigger another problem within non-Muslim banking society worldwide that do not subscribe to sharia principles. This would make negotiation LC or negotiation of documents under Islamic LC unattractive.

As long as term remedial step, it is imperative for Muslim society worldwide through recognizer Islamic trade body to establish a specific international rule on incidental charges which comply with the sharia principles. This however, should not deprive the rights of any parties, include banks to claim monetary compensation or indemnity on the negligence incurred. This formulation is biewd 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 application and operational Islamic LC is still governed by the widely accepted general guideline, UCP. This is to say that when one uses the LC *al-wakala*, 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 banks and conventional banks when dealing with LC *al-*

wakalah.(Aziz 2009)

4. *Aqad*:

In Islamic LC, *aqad* play an important role in ascertaining the legality of transaction. It 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 intention to be bound by the LC at the time the LC is issued. Once the *aqad* on the *wakalah* LC is completed and issued, the first of transaction is completed. The second following *aqad* should take place by the time the documents presented for financing under *al-murabaha* or *al-musharaka*.(Aziz 2009)

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

"O ye who believe! When ye deal with each other, in transaction involving future obligations in fixed period of time, reduce them to writing" (Al-Baqrah: 282)

The sharia issue pertaining to *aqad* arises where some banks in practice may perform both (*aqad* for *Wakalah* and *murababah*) concurrently. This practice falls under the category of two contracts in one which is prohibited by the *hadith* forbidding two transaction in one. Thus, the principles of sharia require that existence of the goods and all relevant information such as the original price of goods and all cost incurred together with the presentation of documents is paper-requisite before such *aqad* takes place and should be observed accordingly. (Ahmad, 2010)

5. Discrepancy fee

Similar to the conventional LC, the Islamic LC is governed also by the principle of strict compliance which indicates that document must strictly comply with the LC requirement. The seller beneficiary will be paid by the bank only the compliance of his documents. Any errors or discrepancies in document will discharge the bank from honoring 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 document. However, at the same time it serves as easy money for the bank as the bank has an absolute right to charge any amount. 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 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 Sharia principle which forbids the practice of oppression. Furthermore, 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 should be upheld. (Lahsasna 2007)

6. Risk of goods in *Murabahah* financing

An ally to the principle of strict compliance is autonomy principle. (Chuah, 2005) It means LC is independent and separate from 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 not responsible to any risk. Since the emergence of Islamic LC in international trade is considered quite recent despite the application of Shariah 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 (Kamali, 2006). In practice, to further secure the bank from financial loss of al *Murabahah* financing, a disclaimer clause is added in the *al-Murabahah* financing contract which discharges the bank in the event of non-compliance of the goods." This is practice is not Sharia 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 Mejele:

"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 Sharia 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-Murabahah* 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. (Aziz 2009)

Sharia Bodies Ruling on Islamic LC

There was (or there is still) the conflicting needs to integrate into the global financial system as well as maintain the unfeigned commitment to Sharia rules. In order to overcome this challenge, the Islamic banks resorted to notable Sharia scholars and Sharia Boards on every aspect of the conventional payment system of documentary credit, some of them are: (Oseni, 2013)

1. Sharia Rulings on Documentary Credit System of Selected Banks

First generation Islamic Banks such as Jordan Islamic Bank, Dubai Islamic Bank and Faisal Islamic Bank have different methods of financing international trade through the documentary credit system while it has consistently strived to maintain Sharia compliance of the whole process.

2. The AAOIFI Sharia Standard on the Documentary Credit System

AAOIFI Sharia Standard No. 14, the documentary credit framework gives general definition of the system, general features of existing documentary credit system and General Sharia rulings and regulations to serve as specific guidelines for Islamic Financial Institutions that finance International Sharia-compliant trade. Article 3/2/2 of the AAOIFI Sharia Standard on documentary credit said "It is permissible to secure international transactions using documentary credit provided that the secured transaction does not violate the rules of Sharia". The other important things is that the underlying contract, which triggers the issuance of documentary credit, must be absolutely Sharia compliant.

Issues and Challenges on Implementing Islamic LC

There might be global issues will occur to implementing Islamic LC, such as: (Lahsasna, 2007)

1. The global environment in banking and finance is not entirely suitable for Islamic Letter of Credit.
2. Current standards in many Islamic Banks and finance companies are not up to the international standards
3. The implementation of Islamic Letter of Credit still needs a comprehensive frameworks, rules and regulations which can be the basis for the implementation of the Islamic Letter of Credit and ensure that all aspects of Islamic Letter of Credit are complies with the requirements of Shariah
4. The network of Islamic banks is not sufficiently widespread and unless it extends its reach to include all if not most countries it clearly will not be possible to promote Shariah based letters of credit on a global scale.

Conclusion

As mentioned, trade is an important tool in the economic activities of a country. A secure and efficient method of payment are needed in every international trade transaction. Letter of Credit is believed as the most secure and efficient as the payment method for every international trade transaction. Letter of Credit which are widely accepted is the one that are covered by the UCP 600. But, those kinds of Letter of Credit having some shariah issues, such as *Riba*. Now Islamic Financial Institutions around the world are trying modifying the UCP by changing the non-shariah compliant contents inside UCP 600 and turn it into Shariah compliant. and come up their own Islamic Letter of Credit by doing *wakalah*, *musyarakah* and *Murabahah*. But the problem for that is there is the need for international standard practice among the growing sprouts of Islamic banks and financial institutions across the world. Based on this study, we can recommend:

1. Put more work and effort to widening the Islamic Business environment
2. Establishing one body or institution to create a new Islamic Uniform Customs and Practice (IUCP) which can be accepted and implemented worldwide
3. Introducing and implementing Islamic Letter of Credit globally

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