Towards Restructuring the Legal Framework for Payment System in International Islamic Trade Finance

Umar A. Oseni, Ph.D.
Assistant Professor,
Ahmad Ibrahim Kulliyyah of Laws,
International Islamic University Malaysia
umaroseni@iium.edu.my
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INTRODUCTION

- Gradual integration of the Islamic finance industry into the global financial system

- International payment system regulated by DC system

- Apart from UCP 600, other systems include:
  - ISP98 of IIBLP
  - LC issued under Art. 5 NY UCC.

- UCP 600 is accepted & recognized worldwide including amongst the IFIs.

Underlying Issue

How to calibrate the existing legal framework of UCP 600 to allow for Sharī'ah-compliant DC system in international Islamic trade finance?
INTERNATIONAL ISLAMIC TRADE FINANCE

- Transnational trade business not new to Muslims, as it dates back to about 14 c. ago.

- Modern IFIs actively engage in international Islamic trade finance

- The Banker 2011: Almost all the top 345 IFIs adopt the DC system

- IDB established Int’l Trade Finance Corporation (ITFC) in May 2006.

- ITFC utilizes DC system, most probably UCP 600.
Financing Facilities for International Islamic Trade

- IFIs & Sharī‘ah-compliant companies utilize various financing modes.
- In international trade financing, IFIs act as:
  (a) Agents
  (b) Partners
  (c) Guarantors of payments
  (d) Seller/buyer of Goods
  (e) Charge fees and impose compensation for defaults
## Case Study of Islamic Int’l Trade Facility

### PT Angels Products - Structured Murabahah Trade Finance

<table>
<thead>
<tr>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mandated Lead Arranger (MLA)</td>
<td>International Islamic Trade Finance Corporation (ITFC)</td>
</tr>
<tr>
<td>Client</td>
<td>PT Angels Products (Indonesian sugar refiner)</td>
</tr>
<tr>
<td>Amount</td>
<td>$25 million – warehouse financing</td>
</tr>
<tr>
<td>Tenor</td>
<td>Maximum tenor of 3 months on revolving basis</td>
</tr>
<tr>
<td>Collateral Manager</td>
<td>Peterson Mitra Indonesia (on behalf of Control Union)</td>
</tr>
<tr>
<td>Supplier</td>
<td>Czarnikow Group</td>
</tr>
<tr>
<td>Date of Signing</td>
<td>October 1, 2009</td>
</tr>
</tbody>
</table>

Source: (International Islamic Trade Finance Corporation, 2009)
THE DOCUMENTARY CREDIT SYSTEM

- DC System - the most widely used for imports & exports
- DC is the promise of banker to pay when specified shipping documents are presented to it.
- The governing principles of LC developed overtime as a result of customary banking practices
- Definition of “credits” in Article 2 of UCP 600
- Mechanism of DC described in Guaranty Trust Co. of New York v. Hannay & Co.
## Stages in a Typical DC Transaction

<table>
<thead>
<tr>
<th>Stage</th>
<th>Contract</th>
<th>Procedure and Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Underlying Contract &amp; Documentary Credit</td>
<td>An underlying contract of sale between the buyer (Importer) and seller (Exporter) in different countries where it is agreed that payment shall be effected through a documentary credit.</td>
</tr>
<tr>
<td>2</td>
<td>Issuance of Letter of Credit</td>
<td>The buyer (applicant) instructs the Issuing Bank (bank at his place of business) to open a documentary credit in favour of the seller (beneficiary). The LC is issued at this stage.</td>
</tr>
<tr>
<td>3</td>
<td>Agreement between Issuing Bank and Advising Bank</td>
<td>The Issuing bank arranges with another bank (Advising Bank) at the seller’s place of business through a contract to negotiate, accept or pay the seller’s draft when the correct documents are tendered.</td>
</tr>
<tr>
<td>4</td>
<td>Contract Between Advising Bank and Seller</td>
<td>A contract between the Advising bank and the Seller where the former informs the latter that it will negotiate, accept or pay his draft upon the delivery of the stipulated documents.</td>
</tr>
<tr>
<td>5</td>
<td>Implied contract between Issuing Bank &amp; Seller</td>
<td>An implied contract between the Issuing Bank and the beneficiary (seller) which is an obligation to pay for the supply of goods in contract of sale on behalf of the applicant (buyer)</td>
</tr>
</tbody>
</table>
RULINGS OF SHARĪ‘AH BODIES ON LC

- Operating within a conventional set-up poses some challenges
- IFIs resort to Shariah scholars/Boards on aspects of the DC system.
- Scope: Rulings of IIFAJ, Rulings of Sharī‘ah Boards of selected IFIs, and AAOIFI Standard on DC.
First: It is not permitted to charge a fee for issuing a letter of guarantee (in which, customarily, the amount and the period of guarantee are considered) whether it is with or without cover.

Second: The administrative expenses for issuing a letter of guarantee of both kind (sic) are permissible by Shari'a, provided they do not exceed actual expenses for services of the same kind. In the event a partial or total cover is presented, it is permissible to take into account, when estimate of expenses is determined, the possible effort which may be required to provide the cover (Islamic Development Bank, 2000: 19).
Rulings of Selected IFIs on DC

- Most questions brought before the Sharī‘ah Boards spring from DC transactions with conventional banks
- Sharī‘ah Rulings on Documentary Credit
AAOIFI Sharī‘ah Standard on DC System

- AAOIFI Sharī‘ah Standard No. 14
- The adoption, adaptation, Islamization & harmonization approaches to DC
- AAOIFI recognizes INCOTERMS 2000 & UCP 500 (now 600)
- The problem of blanket incorporation of UCP 600 regardless of any further qualification
BIFURCATION OR HARMONIZATION?

Harmonization of Rules

- Adaptation and more Practicable
- AAOIFI’s choice for LC
- UCP 600 and Non-Shari‘ah compliant provisions

Bifurcation of Rules

- Total overhaul of existing legal regimes
- AAOIFI or IFSB to come up with guidelines acceptable among IFIs
- ITFC can champion the implementation of a new DC system among OIC countries
CONCLUSION

- Restructuring the legal framework for payment system in Int’l trade is required.

- Short-term & long-term plans are needed:
  
  *Short-term:* UCP 600 with modifications - AAOIFI.
  
  *Long-term:* A new Sharī‘ah-based legal framework for transactions among IFIs or banks in OIC.

- International standard setting bodies to be proactive and not reactionary.
Thank you!