APPLICATION OF A SHARI’AH BANKING MODULE TO FINANCE TRADE

The following core concepts are the basics of Islamic Trade module that is being widely discussed and reported to have been put into practice by several countries. In view of the apparent successes achieved by various banks in different parts of the world especially the countries where Shari’ah law is in force, there is a demand in other countries too to provide with banking facilities that are in line with Shari’ah banking. Taking into consideration the large trade volumes routed through banks by clients who are practicing Islamic religion devoutly, a number of banks from non Muslim countries including Sri Lanka have at least provided a window for Shari’ah compliant banking. The number of banks providing Shari’ah banking as well as the number of customers relying on Shari’ah banking is expected to be increased in the years to come. In this context it would be worth the while to focus our attention to Shari’ah banking in order to understand the future banking needs especially with regard to trade finance. .

1. Murabah – sale of goods to another party for a price that includes the cost and a mutually agreed profit
2. Musharakah – Partnership with profit & loss sharing: all parties in this agreement provide capital and share profit in a mutually agreed ratio and losses in the ratio of capital contribution.
3. Wakalah – Agency arrangement: One party appoints another party to perform certain task for the benefit of and at the risk of the principal.
4. Zaman – A payment or performance guarantee issued in support of a third party
5. Istisna – sale of goods with deferred delivery: payment is made either upfront or in installments, for delivery of goods in a future date according to specifications and timeframes agreed between the parties concerned.

Import Finance

In terms of article 2 of UCP 600 an issuing bank is permitted to establish letters of credit on its own behalf. This provision allows the banks to import goods consigned to them enabling them to have the absolute ownership. Further more it has been the regulation in Sri Lanka for many years that the goods should be consigned to the order of a local bank for both export and import transactions. This regulation, although not a hard and fast rule anymore; has now become an accepted practice in Sri Lanka and almost all the banks continue to call for bills of lading drawn to the order of local banks with the underline interest of retaining the title to the goods in a trade transaction. The provisions contained in the UCP 600 and the prevailing practice in the market, have created an ideal ground situation for murabah financing in Sri Lanka.

Murabah Financing

The concept of murabah financing is to sell goods to another party with an agreed profit. It goes without saying that one must first own the goods to make a sale. In a scenario where goods are consigned to the order of a bank, the ownership of the consignment automatically remains with the bank. In another word, the bank retains the title to the goods and with an option to transfer the goods for consideration of a sale price thereby transferring the ownership of the goods to a prospective buyer. The same situation may be viewed in the form of Letters of Credit transactions. The importer comes to an agreement (Wakalah) with the bank to purchase goods from the bank that has imported under its name as per the requirement of the buyer. This agreement would be more or less similar to that of the letter of credit application used by banks for opening of letters of credit. The wakalah (agreement) will permit the importer to act as the agent of the bank to source the merchandise and negotiate terms as desired by him. This method will allow the buyer to remain competitive in the market in terms of price, quality and timely delivery of goods.
In the above type of transaction, a bank also might consider a total financing facility without any other collateral purely depending on title to the goods for its trustworthy corporate and retail clients. In financing this type of transaction a bank may work out its funding cost depending on the duration of the facility and the volatility of currency in the transaction and may include a percentage of profit taking into account the cost and the risks involved.

Musharakah Financing

This is a concept that supports an arrangement to share profit and loss in a transaction. Under Musharakah arrangement the parties involved contribute capital and share profit in a mutually agreed ratio and take up losses in the ratio of capital contributed. This method of payment can be conveniently applied for facilities based on collateral either cash or assets (movable or immovable). In a case of L/C transaction where a certain percentage of cash margin has been taken as collateral, the bank would expect a lesser percentage of profit than that of an L/C opened in nil Margin. In the event the bank decides to dispose the goods pertaining to the L/C due to non-payment by the importer for any reasons, the importer might either forego the entire share of margin or a portion out of the margin placed at the time of opening the letter of credit towards reducing the loss incurred by the bank.
When a bank decides to finance the entire import transaction under musharakah, it might go to the extent of retiring import bill through import financing adhering to its concept of sharing profit and loss. Under normal circumstance a bank may consider granting an import loan (Trust Receipt/Pledge Loan) for an agreed percentage of the value of goods. Application of customary import financing in the form of musharakah financing for the benefit of the sectors who wish to be away from the regime of borrowing on interest is possible and it may also be encouraged for the growth of the banking industry. However there appears to be a misconception among the practicing bankers that once the bank and the customer sign an agreement (Istisna) on Musharakah financing concept that the agreeing parties cannot deviate from the original agreement. For an example the customer might face a situation where he

would find it difficult to dispose the goods held in pledge due to a price fluctuation in the market. In such a situation selling of goods at the agreed date might force both bank and the customer to take a huge loss as both have agreed to share the profit and the loss. To meet such contingencies the agreement could make a provision to extend the facility further for a mutually agreed period.
Not only letters of credit business but also documents for collection on both D/P (Documents against Payment) and D/A (Documents against Acceptance) can be accommodated under either Murabah or Musharakah financing. It all depends on the agreement between the bank and the client. If the importer wants to purchase the goods relating to the documents sent to the bank for collection, he needs only to agree with the bank that the goods will be consigned to the order of the bank by the suppliers. Uniform Rules for Collection (URC522) provides specifically for this type of arrangement in its article 10 stipulating that goods should not be dispatched directly to the address of a bank or consigned to or to the order of a bank without prior agreement on the part of that bank. Under Murabah import financing a bank will deliver the documents against payment of the bill value plus its profit (commission). In the case of customers who need time to settle bills, a bank may either consider a trust receipt or a pledge facility simply against a Zaman (Guarantee) undertaking to pay within a specific period or against an Istisna agreement thereby undertaking to pay in installment or on a deferred date.

Export Finance

It is not necessary to explain in detail the concept of Murabah and Musharaka financing since I have dealt with the two concepts extensively in the above paragraphs. One must bear in mind that the above two concepts can be applied to any type of financing including imports and exports. I would therefore take only a few examples to explain how practically the two concepts can be applied for financing exports.

The concept of Murabah is to sell goods for a profit at a mutually agreed price. In a typical post shipment finance transaction, an exporter gets his bill discounted/purchased by his bank to meet his working capital requirements which is necessary to continue his export business. Under the situation the banks will credit proceeds of the bills after taking their profit by way of discounts. This is not an unusual phenomenon but an ongoing international practice. Generally the discounting facilities are granted after making due assessment of the clients, buyers, commodities, political and economic situation of the buyers country. These salient features will continue to play a major role even under Murabah finance since the emphasis of this type of financing is to earn profit and any deviation from the standard practice might have a negative impact on the profitability of a transaction. Meanwhile the banks will continue to retain the title to the documents until the final buyer pays the bill and take charge of the documents. Generally the bills that are not under letters of credit are discounted/purchased with recourse to the sellers (exporters). This position too can be retained under Murabah through a bill of exchange or by obtaining a general letter of indemnity that is equal to Zaman undertaking to pay the bill in case of default by the buyer. It generally provides for the bank to dispose the goods to any other party and reduce its losses.

The concept of Musharakah financing is to share profit and losses in a transaction. In an export transaction where payment is arranged through a confirmed letter of credit or against a bill of exchange avalised by a bank, Musharakah concept may be put into practice without making any major changes to the prevailing procedure. In view of the secured nature of the transaction the banks would be willing to offer attractive rates for purchase of bills under letters of credit and bills avalised by buyer's bank. Hence the seller gets more profit from the transaction than that of the transaction referred to in the above paragraph. Under this type of transaction a bank might be willing to have a lesser profit but it would be satisfied with the profit taking into account the secured nature of the transaction. This type of financing is arranged without recourse to the exporter and therefore the loss is greatly minimized as far as the exporter is concerned.

Not only for post shipment finance that Shari'ah concept be applied but also for pre shipment finance. The most common facility obtained by the exporters at the pre shipment stage is Packing Credit. In a packing credit agreement an exporter agrees to buy the raw materials for manufacture of goods with bank finance and set off the financial facility with the proceeds of the export bill presented to the bank for purchasing or discounting. This type of conventional pre shipment facility may be structured in a manner described in Istisna whereby the bank agrees to pay upfront for the goods that the exporter agrees to sell to the bank in the form of presentation of documents at a future agreed date.

Conclusion

I believe that any process can successfully be implemented if there is a level playing field. To create a level playing field for trade transactions it needs lot of time and effort of the parties involved especially in an environment where commodity prices are determined by market forces. Although, we would expect that equivalent goods in different countries should cost the same in a free market after conversion into a particular currency, we know it by practice it would not be so. Therefore the profit opportunities from cross-border trade would be temporary. It is understood that fixing of profit in advance for a facility in respect of an international trade transaction unless entered into a forward exchange contract will not create an ideal environment for a level playing field. In such a scenario a bank might tend to fix an unusually increased volatility rate for the currency in a transaction to ensure that it would not lose its profit margin. This situation might force the importer under Shari'ah to withdraw from the market as he is unable to compete with other importers who are free to dispose their goods at a lesser price with yet at a profit. This aspect in my view needs attention of the parties involved when entering into an agreement.

However my effort was to explain in a easy to understand language how a Shari'ah financing module could be adopted to finance international trade without deviating from the existing practices.

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