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**Application of Documentary Credits in
Commercial and Islamic Banks: Shariah
Appraisal**

“A dissertation submitted in partial fulfillment of the requirements for the award of the degree of master of laws in Islamic commercial law”.

Submitted by:

Mohamed Abdirahman

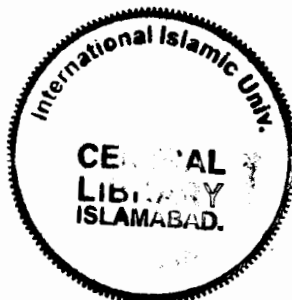
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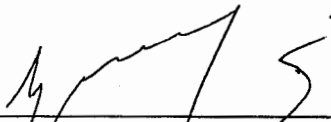
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**IN THE NAME OF ALLAH, MOST GRACIOUS, MOST
MERCIFUL**

**APPLICATION OF DOCUMENTARY CREDITS IN COMMERCIAL
AND ISLAMIC BANKS: SHAIRAH APPRAISAL**

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I

DEDICATION

DEDICATED TO MY PARENTS

**“My Lord! Bestow on them thy mercy even as they cherished me in
childhood”**

SURAH AL ISRA (VERSE: 24)

II

AKNOWLEDGEMENT

All praise be to Almighty Allah the creator of this universe who enabled me to accomplish this research work.

I would like to acknowledge my deep sense of gratitude to my honorable and respectful supervisor Dr. Muhammad Nawaz Ul Hassani for continuously providing all possible support and guidance.

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III

ABSTRACT

International trade increasingly demanded to find out secure and guarantee methods of facilitating payments between the trading partners in different countries.

As result, documentary credit has been developed to resolve problems and difficulties arising out in payments of international trade.

Of all methods of payments for goods in international trade available at present time, documentary credits are the most important mechanism for payments because they offer guarantee and security to both parties i.e. The buyer and the seller.

In this research, the first chapter is the introduction to documentary credits.

What is meant by documentary credit? Why they are so important in international trade? What are the parties involving in the credit transaction? What are the types of the documentary credit? Lastly, what are the major clauses of the credit?

All the answers of these questions have been analyzed in the first chapter of this research. The second chapter analysis the current application of documentary credit in commercial banks.

In this chapter, we analyzed how documentary credit is applied in commercial

banks what are the procedures and requirements necessary to issue documentary credit, what are the obligation of the issuing bank and lastly what are the consequences for failure to pay bank charges.

The third chapter discusses application of documentary credit in Islamic banks and how the practices of Islamic banks are different from that of commercial banks. We have seen that Islamic banks apply documentary credit in three ways firstly on the basis of Wakalah secondly on the basis of murabaha to the purchase order and thirdly Musharakah.

The fourth chapter, which is the last overviews shariah appraisal of documentary credit and the analysis of uniform custom and practices for documentary credits brochure 600 which is recently published by international chamber of commerce in Paris in the light of Islamic law¹.

We concluded in this analysis that wherever documentary credit transaction is made subject to UCP rule, a provision should be included in the underlying sale contract by the parties that any thing which is in violation with Islamic principles are null and void for the purpose of carrying out credit the transaction.

¹ See ICC website available at www.iccwbo.org

IV

INTRODUCTION AND IMPORTANCE OF THE STUDY

Documentary credit is a written undertaking by a bank known as (issuing bank) in favor of a seller (the beneficiary of the credit) on behalf of the buyer (the applicant of the credit) for the payment of specified amount of money within certain period of time on condition that the seller should present confirming documents as mentioned in the credit.

Usually the seller stipulates in the sale contract between himself and the buyer that the sale price should be paid through documentary credit arrangement.

The buyer, by performing his part of the contract approaches to his bank and requests to issue documentary credit in favor of the seller and gives the details about the goods to be imported, documents required by the seller to tender to the paying bank and other instructions required by the seller to observe in order to receive payment from the bank.

If the bank agrees with the buyer the issuance of documentary credit in favor of the seller, asks him to undertake that will reimburse the amount of money that the bank will pay to the seller and other banks charges and commissions.

The seller is informed about the opening of the documentary credit in his favor either the branch of the issuing bank at the locality of the seller another bank authorized by the issuing bank to advise the seller that the documentary credit has been issued in his favor and that he should present confirming documents within the time mentioned in the credit.

It is the responsibility of the seller to dispatch the required goods and tender confirming documents within the period specified in the credit.

Once the seller presented the confirming documents he will not be paid immediately, however if the bank satisfied after examining these documents that they are confirming documents and that the seller has observed other instructions mentioned in the credit, the bank will pay to him if the payment is sight payment or delay the payment until maturity if the payment is deferred payment.

The paying bank sends these documents to issuing bank which also reimburses to the paying bank and later the issuing bank hands over these documents to the applicant and asks him to reimburse to the amount paid to the seller and other banks charges if he did not deposited full amount of the sale price and other bank charges at the beginning.

Most of the cases customers of the commercial banks rarely deposit full amount of the sale price and other bank charges instead they get loan from the bank and agree with bank that they will pay to the bank with interest on a specified future date agreed by them.

Once the buyer reimbursed to issuing bank and collected the imported goods from its port of destination and the seller is paid the sale price and at the same time the paying bank has been reimbursed by the issuing bank, the documentary credit transaction is over.

The above mentioned introduction of documentary credit transaction shows us the importance and significance of documentary credit instrument in international trade. Documentary credits are considered the most common method of payment in international trade and therefore it has been described by English judges as “the blood of international trade.”¹

¹ The law and practice of international trade tenth edition by LEO'ARCY and CAROLE MURRAY, pub. London sweet and Maxwell 2000 p. 187.

The different locations of the seller and the buyer in international trade and their interests that will harm international trade can be resolved by using documentary credit instrument that offers security and guarantee to both the seller and the buyer. The importance of documentary credit to both parties is that the seller has assurance that he will be paid by a bank at his locality as soon as he presents confirming documents to the paying bank and he is also assured against exchange risk. He can also sue the bank if the bank refuses to pay the seller after presenting confirming documents and he proves that he observed all the instructions mentioned in the credit.

Similarly the seller can obtain finances from the bank for the operation of production or purchase before the shipment especially if the sale agreement involves production of some goods in sequences that may need huge amount of money.

As far as the buyer is concerned, he can ask the bank to finance that particular transaction and does not need to have his own fund available to pay the seller. He is also satisfied that he will get valid documents of title to collect goods from its port of destination.

Thus, knowing about application of documentary credit in commercial and Islamic banks and the differences between both these applications is very important.

Similarly it is very important to know about shariah appraisal on documentary credits. Therefore, this research has significant importance.

Hypothesis

Documentary credits are totally or partially repugnant with Islamic injunctions or
They are totally or partially in conformity with Islamic injunctions.

Literature Review

A lot of books have been written on documentary credits by both Muslim and western scholars.

They widely discussed documentary credits its definition, nature, stages, obligations of issuing and paying bank etc.

For example encyclopedia of Islamic law and shariah standard did not deeply discuss the application of documentary credits in Islamic banking and how they are different from those in commercial banks.

Therefore, it will be clear to us in this research by comparing the applications of documentary credits in commercial and Islamic banks.

Objectives of the research

This research is aimed at:

1. To identify definitions, types, stages and the parties of documentary credit transaction.
2. To analyze applications of documentary credits in commercial and Islamic banks.
3. To explore the shariah appraisal on documentary credits.
4. To analyze uniform custom and practice for documentary credits in the light of Islamic law.

Methodology of the research

In this research the methodology adopted is descriptive method of research.

This includes:

1. Library and documentary research.
- 2 Continuity descriptions and data analyze.
3. I discussed the topic and the matters related to it in detailed and divided this discussion into four chapters and then distributed these chapters to the sub different titles and elaborated about each relevant matter in this sub titles.
4. I also mentioned proper place of references given in the thesis.

CHAPTER NO.1 INTRODUCTION TO DOCUMENTARY CREDITS

1.1 Definition of Documentary Credits

When we are going to discuss about documentary credits, we must know the meaning of documentary credits in the beginning, so that it is proper time to explain the meaning of documentary credits.

There are two types of its meaning: first, its literal meaning and second its technical meaning.

Literal meaning

Literally, the English name “documentary credit” also known as letter of credit derived from the French word “accreditation” a power to do something, which is taken from the Latin word “accreditivus” which means trust¹.

When a seller agrees to be paid by means of a letter of credit, the seller is Looking at a reliable bank that has an obligation to pay the amount Stipulated in the credit, as long as the seller performs his duties to an extent that met the requirements contained in the letter of credit.

Technical meaning

there are numerous attempts to define documentary credits, but all these definitions explain its basic elements.

¹ Wikipedia available at <http://www.wikipedia.org>

The following are some definitions of documentary credits:

1. Black's law dictionary¹, defines documentary credits as: an instrument under which the issuer (a bank) at the customer's request, agrees to honor a draft or other demand for payment made by a third party (the beneficiary) as long as the draft or demand complies with specified conditions, and regardless of whether any underlying agreement between the customer and the beneficiary is satisfied.

2. Article 2 of uniform customs and practice for documentary credits (UCP brochure 600)², defines documentary credits: any arrangement, however, named or described, whereby a bank (the issuing bank) acting at the request and on the instructions of a customer (the applicant or on its own behalf),
 - a) is to make payment or to the order of third party (the beneficiary) or is to accept and pay bills of exchange (draft(s)) drawn by the beneficiary, or
 - b) authorizes another bank to effect such payment, or to accept and pay such bills of exchange (draft(s)), or
 - c) another bank to negotiate against stipulated documents provided that the terms and conditions are complied with.

¹ Black's law dictionary eight edition p. 923

² ICC brochure 600, the UCP is available from the ICC and at <http://www.iccwbo.org>

2. Encyclopedia of banking and finance¹, defines documentary credits which is also letters of credit as: an instrument drawn by a bank, known as credit issuing bank (and eventually the drawee bank) on behalf of one of its customers (or on behalf of a customer of one of its domestic correspondents), known as the principal (who guarantees payment to the credit issuing bank), authorizing another bank at the home or abroad, known as the credit notifying bank or negotiating bank (and the payer bank), to make payments or accept drafts drawn by a fourth party, known as the beneficiary, when such beneficiary has complied with stipulations contained in the letter.

4. Muslim scholars defines documentary credits² as: a written undertaking by a bank (known as the issuer) given to the seller (the beneficiary), as the buyer's (applicant's or orderer's) instruction or it is issued by the bank for its own use, to pay specified amount of money within a certain period of time on condition that the seller presents documents for the goods confirming to the instructions.

From the above definitions, it means that documentary credits is the banker's written undertaking given to the seller (the beneficiary) for the payment of specified amount of money on behalf of its customers (the buyer) within a

¹ Encyclopedia of banking and finance tenth edition p. 695 by CHARLES J. WOELFEL

² Shariah standards pub.2003 by Auditing and accounting organization for Islamic financial institutions p.249

certain period of time, on condition that the seller present documents (usually including transport documents) confirming to terms and conditions stated in the credit and advised by the bank to the seller. This and others definition mentioned above illustrates the basic characteristics of documentary credits.

Thus, documentary credits represent the bank's commitment to pay certain sum of money on behalf of its customers to a third party (the beneficiary) under precisely defined terms and conditions.

It is also important to note here that the bank's commitment to pay is enforceable only when the seller or the beneficiary performs all the conditions mentioned in the letter of the credit.

1.2 Elements of a documentary Credit

The following are the elements of documentary credit:

1. Payment mentioned in the undertaking is given by a bank (issuing bank)
2. Applicant of the documentary credit is represented by the bank i.e. the issuing bank.
3. Beneficiary of the credit who is the seller receives the amount of the money mentioned in documentary credit from the bank.
4. Specific documents representing the supply of goods.
5. Time specified.
6. Conformity of representing documents with terms and conditions.
7. Specific place to the presentation of documents.

1.3 Characteristics of documentary Credit

The following are the characteristics of documentary credit.

Negotiability

Documentary credit are usually negotiable, the issuing bank is bound to pay not only the beneficiary, but also any bank nominated by the beneficiary.

To be negotiable, the letter of credit must include such condition that it is negotiable on demand or at a definite time.

Revocability

Documentary credit may be either revocable or irrevocable.

A revocable letter of credit may be revoked or modified for any reason, at any time by the issuing bank without notification.

Once the documents have been presented and met the terms and conditions in the letter of credit, and the draft is honored, the letter of credit cannot be revoked.

Transfer and Assignment

Beneficiary has the right to transfer or assign the right to receive the payment to a third person provided that it is mentioned in the documentary credit that it is transferable or assignable.

Sight and Time Drafts

All letters of credit require the beneficiary to present a draft and specified documents in order to receive payment.

There are two types of drafts: sight and time.

(A) Sight draft is payable as soon as it is presented for payment.

The bank is allowed to take a reasonable time to review the documents before making payment.

(B) Time draft is not payable until the lapse of a particular time period stated on the draft.

The bank is required to accept the draft as soon as the documents complied with credit terms.

The issuing bank has a reasonable time to examine those documents and it is binding for issuing bank to accept draft and pay money at maturity.

Legal action

The beneficiary is able to sue the advising bank in his own country if the bank refuses to honor the credit, provided that the beneficiary proves that he has complied with all the instructions mentioned in the documentary credit and he has presented specified documents to the advised bank on time¹.

Concern of the parties

In a documentary credit operations all concerned parties deal with documents, and not with goods, services or other performances to which the documents may relate².

¹ International trade p.181 by Indira Carr pub. Gavendish publishing Limited

² See article 5 of UCP

1.4 History of documentary credits

Documentary credits also called letters of credit or commercial letters of credits are the most common method of payment for goods in international trade and have been described by English judges as “the blood of international commerce”¹. The origin of letter of credit is not clearly known but “some scholars believe that the origin of letters of credit goes back to ancient Egypt and Babylon, which had system of banking”².

“It is also verified that banks of ancient Greece prepared letters of credit”.

“With the collapse of the Roman Empire the role of the banks as well as the great extent of commerce between trading nations diminished. It was not until the 12th and early 13th century that banks in Genoa, Venice, Florence and other European cities were re-established”³.

At this time merchants had to face two major problems:

(A) Traveling with gold and that was very dangerous; and

(B) The commerce generated currency was not sufficient to satisfy the needs of traders.

“The earliest devices with which merchants tried to solve these problems

¹ Per Kerr L.J. R.D. Harbottle(mercantile) Ltd V. national Westminster bank Ltd 1978.

² The law of letters of credit and bank guarantees by Agasha Mugasha p.37

³ See more detail at this website: <http://infodagang2u.blogspot.com/2007/11/history-of-letter-of-credit.html>

were with the bills of exchange and letters of credit. In their early history these two payment instruments operated in a very similar way, and letters of credit were used to supplement the bills of exchange.

There are commentators who believe that their development in Europe was inspired by the discoveries made by Marco Polo in the 13th century who reported the use of currency and other negotiable documents in China”.

To explain their early operation the following illustration gives comprehensive example: a Florence¹ merchant who bought wool from an Amsterdam merchant issued a bill of exchange to the Dutch merchant’s agent in Florence directing a third party (the drawee) to pay the sum due for the wool.

The agent, having taken the bill in payment for the wool, could travel across Europe by road or by sea to a commercial centre, where he would meet the drawee and ask the drawee for payment.

The drawee would pay the draft either

- (1) in gold (such payment would be rare);
- (2) by “clearing”, that is, by setting the draft off against sums due from the Dutch merchant on other drafts; or
- (3) by accepting the draft and returning it to the agent. In the third case, the holder had a readily marketable instrument, which he could use to trade or which he

¹ Is the capital of Italian region of Tuscany.

could take with him to other commercial centers.

The Medici Bank during 15 century, between 1385 to 1401 in Italy were issued letters of credit¹.

“By the 17th century letters of credits were common financial instruments both in the European continent and in England². At this time they functioned more like a traveler's cheque”.

”By the 19th century British banks had a virtual monopoly on the issuance of letters of credits”.

“This was due to the fact that in world trade the Pound Sterling was the most accepted currency and the bankers of London gained a pre-eminent position in the field of international finance”.

In the United States letters of credit emerged from the “competition of factorage houses for business, which led to the issuance of promises to accept drafts against shipments”. “The growing number of manufacturers and their relationships with foreign traders, the specialization of banking activities and the technological development such as the more frequent use of telegraph for communicating the terms of the contracts facilitated the increasing use of letters of credit”.

”The outbreak of first world war 1914-1918 broke the well-established and trusted

¹ Medici bank was the largest and most respected bank in Europe during 15th century.

² International banking p.54 by NICHALOS L.DEAN N& JO ANNE CALUASAK BY New York of finance.

trading links that had existed between the merchants worldwide.

In order to keep on trading merchants were forced to create new links with firms often unknown or not trusted". "These circumstances were favorable for the extensive use of letters of credit which invited a trustworthy paymaster, a bank, into the merchants relationship".

Since that time, various customs and practices have been developed.

The international chamber of commerce in Paris, in cooperation with various national chambers and banks developed the uniform customs and practices for documentary credits.

1.5 Importance of Documentary Credits

In international trade, the different locations of the seller and the buyer in different countries make a simultaneous exchange of goods for money difficult¹.

This means that the seller after the sale agreement and delivery of the goods to the buyer in his place can not get or take the price of the goods from the buyer immediately and at the same time.

The seller would prefer to be paid for the goods as soon as he sent the goods to the buyer for the following two reasons:

The first reason is financial reasons that the seller would be able to release his capital tied with in the goods at the earliest opportunity.

The second reason is psychological reasons that the seller will be in uncertainty of not knowing whether he will be paid the price of the goods when they reach their destinations or not.

It is possible that the buyer becomes insolvent by the time the goods reached his country and he is unable to pay the price of the goods due to insufficient of funds.

The buyer also would wish to pay the price of goods preferably on delivery since he is not sure that he will receive the goods or not and whether or not it is the quantity, the type of the quality and the kind of the goods he ordered.

The conflicting interest of the seller and the buyer that are likely to eliminate the

¹ International trade p.181 by Indira Carr pub. Gavendish publishing Limited

international trade can be resolved by adopting modes of payment which protected by security to both parties equally.

One of them is documentary credits which provides security to both parties international trade.

Under documentary credits, the buyer agrees to pay the seller using a reliable paymaster, generally a reputable bank in the seller's country who pays against the presentation of the stipulated documents that comply with the terms of the credit. The importance of documentary credit arrangement to both parties is that the seller has the assurance that he will be paid by a bank, reliable and reputable bank in his own country and currency as soon as he present the stipulated documents to the bank and he is also assured against exchange risk.

Similarly he will be able to sue the bank, for instance, refusal to honor the credit on the presentation of the documents specified in the contract of sale¹.

It also enables the seller to obtain finances for the operation of production or purchase before the shipment, specially when the sale agreement involves production of some goods in sequences that may need huge amount of money and the bankers may agree to advance money against goods, whether finished or in process of manufacturing, as their sale and payment of the sale price is fully assured. As far as the buyer is concerned he can raise credit on the strength of the

¹ see International banking p.54 by NICHALOS L.DEAN N& JO ANNE CALUASAK BY New York of finance.

documents from the bank and does not need to have his own funds available to pay the seller. The buyer has also the guarantee that he will receive valid documents of title to goods and these documents will prove the shipment of the correct quality, quantity and the kind of the goods for which he placed the order.

1.6 Parties to a documentary credit

In the process of a documentary credit transaction, there are essentially four parties involved.

These parties can be referred to by a number of terms, as follow:

1. Buyer: meaning importer or applicant.

He directs his application to the issuing bank, which will usually be a bank at his place of business.

2. Seller meaning Exporter who is the Beneficiary of the credit.
3. The Issuing or Opening Bank (Importer's Bank)
4. The Advising or confirming bank: usually a bank in the exporter's country which may or may not be the exporter's Bank.

TH For

1.7 The issuer and the applicant

The legal relationship between the applicant and the issuing bank is a primarily contract of a guarantee as the bank guarantees the payment of the sale price from the beneficiary¹.

The instructions which the applicant gives to the issuing bank reflects the agreement on the underlying sale contract between the applicant and the beneficiary, and at the same time form the basis for the documentary credit which is opened later on by the issuing bank.

Still these two contracts i.e. the underlying sale contract between the seller and the buyer and the reimbursement agreement between the buyer and the issuing bank are separate and distinct contracts from each other.

The bank's main obligation is to open the credit based on the instructions given by the applicant, it assumes an obligation to both the customer and the beneficiary that it will, after proper examination of the documents, make payment to the specified beneficiary under the terms of the credit, and will forward the documents received from the seller to the buyer.

The obligation to honor confirming documents and make payment to the seller is contingent, upon the performance of the beneficiary however, any performance

¹ The law of letters of credit and bank guarantees by Agasha Mugasha p.27

undertaken must be proper. Similarly that is the obligatory duty of applicant as regard to the issuing bank to reimburse the bank in respect of amount paid by the bank to the seller.

In addition, the buyer usually must pay any commissions agreed upon as well as take over the original and approved documents that the bank had received from the seller.

These obligations are very crucial especially to the issuing bank because the bank pays to the beneficiary and there may be a possibility of the applicant's inability to repay it to bank.

To provide safeguard against to any possibility of default arising from the applicant as regard to issuing bank, the right of demanding security from applicant is given to the issuing bank and also it protected by general principles of law.

This right gives the bank the right to enforce its security interest in the property of the applicant and may also give the right of set off.

The bank also contracts for the right to accelerate the amount of outstanding due to the documentary credit which the bank treats as a loan.

1.8 The application

The letter of credit or documentary credit is initiated by a application to the issuer.

This application itself is very brief and excessive details are avoided.

The application contains the applicant's instructions and takes either of three forms¹:

1. The customer or the applicant completes an application form which enables the issuing bank to create a computer data file;
2. The applicant creates a data file and sends it to the issuing bank to consider and to open the credit.
3. The applicant completes an application form and a coded telex is sent instead of a computer transmission.

The application is usually made on the issuer's standard form which, together with the reimbursement agreement, form the terms and conditions upon which the issuing bank is prepared to open the credit.

This application constitutes an offer to contract, which the bank may accept, usually by the conduct of issuing the credit

¹ The law of letters of credit and bank guarantees by Agasha Mugasha p.21

1.9 The reimbursement agreement

Once payment is properly made, the issuing bank has the right of reimbursement from its customer¹.

The proper fulfillment of its obligation to honor confirming documents by the advising or confirming bank as specified in the documentary credit and instructed by the issuing bank gives rise to this right of reimbursement.

The reimbursement agreement may consist of a set of terms prepared by the issuing bank, agreed to and signed by the applicant or it also may take in the form of an application for a loan by the applicant in which the bank accepts.

Generally, the reimbursement agreement reflects the general lending principles, which are intended to protect the banks on the credit they lent.

Thus, the bank would have to pursue against the applicant to obtain reimbursement for payments made.

It is also important to realize here that the bank is in possession of the documents of title before the buyer released these documents by repaying the money outstanding from him or released against trust receipt.

These documents are kind of security for the bank waiting for reimbursement.

If the buyer pays the amount of money outstanding from him, than the bank

¹ International banking p.54 by NICHALOS L.DEAN N& JO ANNE CALUASAK BY New York of finance.

presents the documents of title to the buyer. But in case he did not pay, the bank may retain these documents until the buyer pays the money or the bank may give documents of title against a promise from the buyer that he will pay at a later date in which the bank and the buyer may agree.

Trust receipt

When documents are released against a promise, they are usually released against what is called a trust receipt¹.

The trust receipt gives the bank a security interest in the merchandise.

This trust receipt, must be executed, signed by the customer, and presented to the bank in exchange for documents that give title to the merchandise.

Alternatively, the bank may reserve a right to have the goods stored for its account with condition that any sale of such goods may be made only with the consent of the bank.

This stipulation usually protects the bank's position to obtain reimbursement in case the buyer became insolvent. However, when the payment is made and reimbursement was obtained by the paying bank, the documentary credit transaction is now closed for that particular shipment.

¹ International banking p.54 by NICHALOS L.DEAN N& JO ANNE CALUASAK BY New York of finance.

1.10 The applicant and the beneficiary

The legal relationship between the applicant and the beneficiary is a contract of a sale.

Reflecting this underlying sale agreement, the applicant or the buyer approaches to the issuing bank requesting to open a credit in favor of the seller, in particular the buyer tells his bank which documents the beneficiary has to present, where and how, and the amount of the credit and details of payment e.g. sight, deferred sight payment, against acceptance or negotiation of drafts etc.

Lastly, the issuing Bank, which is normally located in the country of the buyer, advises the beneficiary through a correspondence bank located in the country of the beneficiary of the credit to make payment if the documents presented by the seller comply with terms and conditions stated in the documentary credit.

Once the beneficiary presents the required documents on time and these documents are found to be in order, he is entitled to get payment from the advising or confirming bank.

1.11 The issuing and the advising or confirming banks

The contract between the issuing and the advising or confirming bank is a contract of a agent, being the issuing bank is a principal and the advising or confirming bank is an agent.

The advising bank as the name represents, notifies to the beneficiary about the opening of documentary credit in the beneficiary's favor and directs to him that the payment will be made when he submits the specified documents under documentary credit.

Some times the issuing bank nominates itself as paying bank, in which payment will be made on receipt of the correct documents stated in the documentary credit.

If the bank does not nominates itself as paying bank, then the advising bank would be responsible for sending the documents to the issuing bank and has no other obligation under the documentary credit i.e. the advising bank acts as post office and is not bound to pay the beneficiary.

Exceptionally, under very limited circumstances the advising bank incur liability such as errors in making of its advisement.

On another hand, in addition of informing to the beneficiary, a confirming bank

assumes both the obligations and rights of the issuer of the documentary credit, including the obligations to make payments in accordance with the terms and conditions stated in documentary credit.

These obligations and rights are assumed as the confirming bank were the original issuer.

The confirming bank assumes a separate obligation to make payment under the terms of the documentary credit.

In this way the beneficiary has the independent promise from both the banks to make payment upon presentation of the documents.

This will convince to the beneficiary that the risk of non payment is assured.

That is the reason why many instances a bank's confirmation of documentary credit is more useful to the parties.

Therefore, in order the advising or confirming bank claim reimbursement for any payment made under the documentary credit the advising or confirming banks must obey the instructions given by the issuing bank.

Some times, some difficulties arise in practice due to the fact that the instructions given by the issuing bank are not clear or are intended to mean something different from what they convey.

Therefore, it is the responsibility of the advising or confirming bank to make sure that what actually is the intent of issuer beyond any doubt.

1.12 The advising or confirming bank and the beneficiary

The contract between the advising or confirming bank and the beneficiary depends upon the nature of the documentary credit¹.

It becomes legally enforceable and binding contract in the case of a confirmed credit, that is irrevocable and confirmed documentary credit which has been confirmed by advising bank, who became confirming bank, as soon as it is communicated to the beneficiary.

If there is delay in making payment or wrongful dishonor of confirming documents, the issuing bank and the confirming bank both are liable for any loss suffered by the beneficiary and the beneficiary has a cause of action and may sue either bank or both of them provided that the beneficiary proves that he complied with the terms and conditions mentioned in the documentary credit and presented these documents on time.

If such proof is convinced by the court then damages may be awarded in addition to the payment due. If the documentary credit is revocable, and unconfirmed credit the advising bank is only intermediary bank and there is no legal relationship or undertaking contract between the bank and the beneficiary.

¹ See Paget's law of banking ninth edition by Maurice Megrah and F.R. Ryder pub. London Butterworths.

Similarly where the documentary credit is irrevocable but unconfirmed, the advising bank does not provide any undertaking on its part, and therefore beneficiary not have any contractual relationship with the seller.

The advising bank, in this case is merely acting as an agent of the issuing bank.

Such a credit is deemed to be revocable at any time without notice, however, the advising bank can claim reimbursement in respect of any payment made up to the time notice of a revocation reached him.

But as regards the beneficiary, a revocable credit may be withdrawn at any time without notice and paying bank is not bound to advise the beneficiary of its revocation, though the bank may inform him about such revocation.

It is decided that in the absence of the revocability and irrevocability of the documentary credit, that the credit is deemed to be revocable.

An irrevocable credit, however, once issued or advised to the beneficiary can not be amended without prior consent from him.

1.13 Stages of documentary credits

A documentary credit transaction involves a number of stages, the following are the stages of documentary credit transaction¹.

1. The exporter agrees the sales contract with the importer and the terms and conditions of the documentary credit.

In other words, the exporter and the overseas buyer agree in the contract of a sale that the payment shall be made under documentary credit and specify the terms and conditions in which such credit shall operate.

2. The importer asks the bank at his locality known as issuing bank to open documentary credit in favor of the exporter known as beneficiary on terms and conditions he provided to the bank.

In other words, the overseas buyer acting as applicant for the credit instructs a bank at his place of business to open a documentary credit in favor of the exporter on terms specified by the buyer in his instructions to the issuing bank.

3. The issuing bank ask a bank in the exporter's country to advise the credit to the Exporter.

¹ The law and practice of international trade tenth edition by LEO' ARCY and CAROLE MURRAY, pub. London sweet and Maxwell 2000 p. 185.

4. The advising bank informs the exporter the credit that has been issued in his favor and sends him a copy of the documentary credit.
5. The exporter examines the documentary credit to make sure that the terms conditions are as agreed with the importer.
6. The exporter dispatches the goods to the importer and presents shipping and other documents in accordance with terms and conditions of the documentary credit to the advising bank.

7. The advising bank checks the documents against the credit.

In other words the bank checks whether the documents submitted by the seller are in the conformity with terms and conditions mentioned in the documentary credit.

8. On the presentation of the documents by the seller and after the examination of these documents, the bank i.e. the advising or confirming bank accepts the documents if they conform with terms of the credit and pay the seller.

The payment will be effected only according to the terms of the credit.

If the credit calls on sight payment then the bank will pay on sight of the documents.

Where the credit is on deferred payment terms such as pay three weeks after sight, the payment will take place at the stipulated time.

9. The bank i.e. the advising or confirming bank which has paid the seller will be reimbursed by the issuing bank, and the issuing bank will be reimbursed by the buyer.

1.14 The major clauses of a documentary credit

A documentary credit contains several clauses, some major terms and conditions of a documentary credit are discussed below¹.

1. **Type of credit:** the heading of documentary credit indicates the type of the credit and its purpose. Therefore, every bank has its own documentary credit form.

2. **Applicant and Beneficiary:** the name and the address of the applicant of the credit and intended beneficiary whose favor the credit has been opened is also mentioned.

3. **Value of credit and the Currency:** the amount of money to which the bank ensures to pay and the type of the currency to be used is specifically mentioned in the documentary credit.

¹ Wikipedia available at <http://www.wikipedia.org>

4. Identification of documents: the documents required that the seller has to submit is also specifically identified.

This includes: transport documents, invoices, insurance documents...etc.

5. Description of goods: brief description of goods and packing instructions are mentioned in this clause.

6. Shipment: the shipment clause may contain:

A) part shipment which means shipment of goods in lots or installments, which is more than one shipment.

B) Transshipment which means the carriage of goods by more than one vessel.

The credit must specify whether it is transshipped or part shipped.

7. Collection of charges: this clause is indicated as to which party whether the seller or the buyer should bear the expenses and other bank charges.

8. Availability of the Documentary credit: the availability of the credit by Negotiation or sight payment or deferred payment or acceptance which is specified in the documentary credit.

9. **Validity period:** this clause identifies the expiry date or the validity date of the credit.

This period should be enough so that it will provide to the seller sufficient time to complete the transaction.

10. **Reimbursement clause:** this clause indicates the method for obtaining the amount of money paid by the nominating bank, when the reimbursement shall be obtained.

11. **Laws applicable to the credit:** this clause specifies the laws applicable to the credit in case of a dispute.

Here parties also specify the applicability of their contract by UCP 600 or not¹.

11. **Precise contents of the underlying contract:** concise contents of the underlying sale agreement between the buyer and the seller is mentioned in the documentary credit.

¹ UCP means uniform custom and practice for documentary credit published by International chamber of commerce Paris.

1.15 Types of documentary credit

There are various kinds of documentary credits that are currently in use.

the following are the different kinds of documentary credits¹.

1. Revocable and irrevocable credits

A revocable documentary credit is one which can be amended or cancelled at any time before the expiry date and without prior consent from the seller but before the authorized draft is presented for acceptance or payment.

However, once the negotiating bank has negotiated the documents strictly in terms and conditions of the credit, this credit can not be revoked.

In other hand, an irrevocable documentary credit can not be amended, cancelled or withdrawn without the consent of all parties involving the credit. Article 9d (i) explains that an irrevocable credit can neither be amended nor cancelled without the agreement of the issuing bank, the confirming bank and the beneficiary.

This type of credit gives the seller complete protection and satisfaction as the payment of sale price is assured by the bank.

¹ Practice and law of banking in Pakistan by Israr H. Siddiqi p.121
see also shariah standard.

Confirmed and unconfirmed credits

A confirmed credit is the one which has been confirmed by the advising bank. by confirming such credit, the bank undertakes to pay the seller if the issuing bank defaults for any reason, provided that the terms and conditions of the credit are complied with.

This type of credit is always irrevocable and gives the maximum security to the seller that payment will be made upon the presentations of stipulated documents.

An unconfirmed credit is that credit which exclusively depends upon the issuing bank's obligation and the advising bank merely informs the beneficiary about the terms and conditions of the documentary credit without adding its own undertaking.

Sight and Deferred credit

If the beneficiary of a documentary credit is to obtain payment immediately on presentation of stipulated documents, it is the sight credit.

In this case, the advising bank is instructed to pay, or arrange for payment, to the seller the moneys due on presentation of the documents.

If the credit provides for deferred payment i.e. that the payment shall be made at future date that is to pay on maturity date determinable in accordance with the stipulations of the credit it is deferred credit.

The deferred payment credit may, for example, provide for payment after 120 days from the date of the bill of lading and in this case, the payment shall be made after 120 days.

Acceptance credit

When the credit stipulates payment to the beneficiary to be made upon the maturity of a bill of exchange drawn under the terms of the credit it is an acceptance credit or term credit.

Upon the presentation of the documents to the correspondent bank, the beneficiary does not receive payment but acceptance of the draft on the face of it, which either he holds until maturing or discounts it.

Negotiation credits

If the beneficiary of a credit is to be paid after the bill of exchange has been negotiated under a credit by an authorized bank it is a negotiation credit

In other words, under the negotiating credit, the advising bank is only authorized to negotiate a bill of exchange drawn by the seller on the buyer or the issuing bank. The advising bank will indorse the bill and negotiate it subject to the deduction of discount or interest and commission, according to the terms of the credit.

Standby credit

The standby credit is an undertaking by a bank to make payment to the beneficiary or to accept bills of exchange drawn on him, provided that he complies with the stipulations of the credit. The bank may also authorize another bank to effect payment if the documents are in accordance with the instructions of the credit. This type of credit is intended to protect the beneficiary in case of a default of the other party to the underlying contract.

In a standby credit the required documents need not include the transport documents rather it may be activated by a document of any description e.g. a demand by the beneficiary or statement from him that the other party is in default. Thus, standby credit resembles to a letter of bank guarantee or performance bond.

Revolving credit

It is that credit which contains a condition that the credit amount is automatically renewed or reinstated in certain situations without a new application of credit or need of amendments in the terms and conditions of the credit. It may arise in a situation that the shipment of goods is to be made over a period of time consecutively. Thus a revolving credit, for instance, is corollary to a sole distribution.

Transferable credit

Is a transferred by the original beneficiary to one or more beneficiaries.

This entitles the beneficiary a right to request the executing bank to make the credit available partially or totally to another beneficiary or beneficiaries.

Back to back credit

In a certain situations the beneficiary is not in a position to supply goods to the buyer as he may have to purchase them from another supplier or manufacturer after making payment to them.

In this case back to back credit also called countervailing credit is arranged.

In back to back credit¹, the beneficiary of the first credit opens another credit for the supplier or manufacturer of the goods on the strength of the first credit.

Thus, back to back credit transaction involves two separate credits, wherein the beneficiary of the first credit becomes the applicant of the second credit, which means that the second credit issued is guaranteed by another bank.

In such cases, the terms of both the credits should be identical however, the prices and invoices may be different.

¹ Practice and law of banking in Pakistan by Israr H. Siddiqi p.121.

Packing credit

The packing credit, sometimes called anticipatory credit, is intended to assist the beneficiary (exporter) in the production or procurement of the goods sold.

The credit is payable at a time prior to the shipment of the goods, and against documents other than a transport documents e.g. warehouse receipt, evidencing that the goods are in existence or forwarder's certificate (FCR) certifying that the goods have been received for shipment, or an air dispatched registering post receipt.

This type of credit is convenient method of finance for the small exporter who is not familiar with shipping practice. For example the exporter sells some materials to the importer and arranges that the purchase price shall be paid under documentary credit against a forwarder's receipt, he is not concerned with the actual shipment.

In other hand, the buyer is certain that the goods sold are not in the possession of the seller at the time of receiving the purchase price.

The above mentioned example, the arrangement can be made that the buyer, through the bank, is to make an advance on the purchase price, the advance being payable on production of the stipulated documents like forwarder's certificate.

Red clause credit

It is that credit with a special clause that authorizes the negotiating bank to make advances to the beneficiary to enable him to purchase raw materials or facilitate shipping of the goods. It is named red clause credit because it is printed in red ink to draw attention the nature of credit.

Green clause credit

This is another type of pre shipment credit used mainly in Australian wool trade. It is a refinement of the red clause credit which allows not only the pre shipment advances but also cover storage in the name of the opening bank

CHAPTER NO.2 APPLICATIONS OF DOCUMENTARY CREDITS IN COMMERCIAL BANKS

2. Application of documentary credits in commercial banks

When we are talking about the application of documentary credits in commercial banks, it is important to recall back the stages of documentary credits so that it is easier for us to understand the procedure required by the applicants to follow.

In fact this will also make clear to us to understand the current application of documentary credits in commercial banks.

For example, if a seller received an order from a buyer in another country for a purchase of certain goods and that he wants assurance before making shipment or before starting to manufacture the goods ordered that the price of goods should be paid to him upon the delivery of these goods¹.

He will then require from foreign buyer to open a documentary credit in his favor, in which the price of goods will be payable to him upon the proof that the shipment has been made in accordance with the order.

¹ International banking by NICHOLAS L. DEAK and JOANNE C. CELUSAK pub. New York institute of finance p.38

Upon the presentation of such proof, the bank will pay the exporter.

The above illustrated example, the buyer and the seller usually stipulates in the underlying sale contract that the price of the goods will be paid through documentary credit arrangement.

2.1 Practices of documentary credits in commercial banks

The procedure and the application of documentary credits in commercial banks are as follow¹.

1. The applicant request to his bank or any other bank at the place of his business the issuance of documentary credit.

He also submits to the bank the instructions required by him from the seller to observe and the underlying sale contract along with the application of the documentary credit.

In order to process the application of the documentary credit as requested by the applicant, the bank demands from him to provide security to ensure that he will reimburse to the bank in regards the amount of the money which the bank will pay to the beneficiary through the advising or confirming bank and that he will repay all bank charges including commissions and expenses of the documentary credit

¹ See international trade law by Inira Carr p.200 and also finance of international trade 5th edition by Alasdair Watson p.150

2. The beneficiary of the credit afterwards is informed about the opening of the documentary credit in his favour either by the branch of the issuing bank in the beneficiary's country or another bank which is authorized by the issuing bank known as the advising bank. If the credit is confirmed later on, then the advising bank adds its confirmation to the documentary credit.

3. The beneficiary presents the stipulated documents to the bank after he has made shipment of the goods to the applicant i.e. the buyer.

4 . The bank examines these documents and accepts provided that they are confirmed with terms and conditions as mentioned in the documentary credit and pays the beneficiary.

However, if the bank observed that the documents are not in accordance with the terms of the credit, refuse to make payment and ask the beneficiary to present correct documents on specified time in order to avail the payment.

If he fails to present correct documents within that period determined by the bank, the bank will not make any payment at all.

5. The advising or confirming bank sends confirmed documents presented by the seller to the issuing bank, and later on the issuing bank hand over these

documents to the applicant in order to collect goods at the port

2.2 Requirements of the applicant

There are no set of requirements for applicants of a documentary credit, however, in practice reputable customers of the bank such as companies, partnership firms and merchants who deal with international trade are usually applicants of the documentary credit¹.

The only requirement that banks takes into consideration is that the applicant must not be a defaulter in any bank either internationally or locally and at the same time has not been declared as insolvent.

If the bank satisfies that the applicant is neither a defaulter nor declared as insolvent by any court, the bank will accept to issue documentary credit, even though he has no sufficient fund in his account to pay the seller.

In this situation, where the applicant does not have his own fund available to pay the seller, he usually gets finance from the bank in the form of a loan and agrees with the bank that he will reimburse the amount that the bank will pay to the beneficiary and also repay other expenses and commissions including bank charges that the bank will spend in the operation of the credit on specified future date.

¹ Corporate section city bank Islamabad

1.2 The opening of the credit

It is the responsibility of the buyer to initiate opening of the credit with his bank after concluding the sale agreement with the seller.

He should also give to the bank the instructions required from seller to comply with and documents that he needs to tender to the bank.

It is necessary that the credit opened by the buyer should conform to terms and conditions agreed upon by the parties in the contract of the sale.

The opening of a credit is generally regarded and presumed as condition precedent to the delivery of the goods by the seller.

This means that the seller is not bound to perform his party of the contract until the documentary credit is opened¹, which is the sole duty of the buyer in order to ascertain that the payment will be made as agreed in the sale contract.

However, it is also possible that the parties may have agreed to the opening of the credit as a condition precedent of the contract of sale itself.

For example, when the parties agreed that the contract of the sale shall be subject to the opening of a credit in which the case the opening of the credit is a condition precedent the formation of the contract of sale itself.

¹ international trade law by Indira Carr pub.Gavendish publishing limited Britain,1996 p.188

1.2.1 When it must be opened

Usually the contract of sale will make express provision as to the date at which the documentary credit has to be opened.

Some times it is agreed upon by the parties that the credit shall be opened by a certain date e.g. the parties may agree that the credit shall be opened from 1st January.

Thus, if the contract of the sale stipulates a fixed date for opening documentary credit, than it must be opened by that date.

Some times it is provided that the credit should be opened immediately which means that the credit has to be opened at once within such time as it is required for a person of a reasonable diligence to establish the credit¹.

Where the contract does not expressly provide a date for opening the credit but stipulates a shipment period, the credit should be opened before entire shipment period.

Where the contract does not provide when the credit shall be opened, the credit has to be opened within a reasonable time² and in this case the parties are not entitled to assume that the existence of the contract of sale depends on the opening of the credit by the buyer, however, the parties may agree that the contract shall be

¹ The law and practice of international trade, tenth edition by LEO D'ARCY and CAROLE MURRAY London sweet and Maxwell 2000

² This is an implied term of the contract.

subject to the opening of the credit, in which case the opening of the credit is a condition precedent to the conclusion of the sale contract

The credit is regarded as opened when the advice of the credit is communicated by the advising bank to the beneficiary.

1.2.2 The expiry date of the credit

The documentary credit must stipulate an expiry date at which documents mentioned in the credit be presented by the seller to the paying bank.

Article 6 of UCP 600 provides that all credits must stipulate an expiry date and a place for presentation of documents for payments¹.

The credit some times stipulates, in addition to its expiry date that the documents presented to the bank shall indicate certain shipment date².

If the bills of lading presented by the seller to the bank show a later date, the bank will refuse to accept the documents and make payment, therefore, the expiry date of the credit should not be confused with the shipment date.

The shipment date is the earlier date shown in the bill of lading as the date when the goods were dispatched.

¹ See article 6 of UCP 600

² The law and practice of international trade tenth edition by LEO D'ARCY and CAROLE MURRAY, pub. London sweet & Maxwell 2000 p.188

1.2.3 Failure to open the credit

Where the buyer failed to open the credit as stipulated in the sale contract, the seller is entitled to claim damages for the breach of that stipulation in the sale contract and sue him in the court of law provided that the seller is suffered loss. Damages awarded to the seller may be ordinary damages, special damages or nominal damages.

In ordinary damages, the amount of compensation recoverable from the buyer is the difference between the contract price and the market price at the date of the breach of the contract¹.

In special damages, the amount of damages payable to the seller would include the profit the seller would have made from the contract which had successfully completed².

It is some times possible that the damages awarded to the seller is nominal damages, in which the court may award in a situation when the aggrieved party has not suffered any loss at all but is awarded in recognition of his right.

¹ The law and practice of international trade, tenth edition by LEO D'ARCY and CAROLE MURRAY London sweet and Maxwell 2000

² In trans trust SPRL v Danubian trading Co Ltd 1952, the contract was the purchase of steel. The buyer did not open the credit on time as stipulated and the seller claimed lost of profits as damages. The court held that the seller could recover the lost profits.

1.4 Bank charges

In order the bank performs all services relating to documentary credit operations including the opening of the credit, directing the correspondent bank to tender the beneficiary about the opening of the credit and sending confirmed documents, undertaking the payment of the sale price etc, the bank charges some amount of money to its client known as service charges.

This includes expenses and commissions incurred by the bank for the purpose of processing the application of documentary credit.

Usually the bank charges 2.5 percent of the all cost of the goods of the export¹.

The clients or applicants of documentary credits are of two types:

- i. applicants who pay the sale price and the bank charges fully at the time of opening the credit.

These types of applicants are rare in nature and the bank acts as the agent of the applicants for processing the credit until the goods reach to the buyer.

When the bank received the documents of title from the advising or confirming bank and the goods are reached at their designated port, the bank hands over these documents to the applicant to collect the goods.

- ii .applicants who pay the sale price and the bank charges partially or does

¹ City bank Islamabad.

not make any payment at all, but requests the bank to finance this particular transaction.

These types of applicants ask the bank to give a loan and execute with bank an agreement that they will repay this loan with interest and other bank charges within specified time agreed upon by the applicant and the bank.

1.4.1. Failure to pay bank charges

We have already mentioned in first chapter under the head of 'reimbursement agreement' various ways in which the bank safeguards its position if the applicant failed to reimburse to the bank the amount of money outstanding from him.

In this situation, when the applicant could not repay the money outstanding from him in any reason, the bank usually enforce the security interest in the property of the applicant lying with the bank and deduct the amount of money the bank owes from the applicant and returns the rest to the applicant or makes set off.

1.5 Documents required from the sellers to present to the bank

It is common for buyers to require presentation of certain documents from the sellers and which is usually stipulated in the documentary credit.

It is the duty of the sellers to tender proper documents confirming with the instructions mentioned in the credit in order to get payment from the paying bank.

Once the documents are found to be in order, payment will be made by advising or confirming bank to which documents were presented for payment.

The following are the documents required from the sellers to tender to the bank.

1.5.1 Bills of lading

Bills of lading are receipts for goods for shipment, i.e. Document evidencing the receipt of goods for shipment, a contract between the exporter and the shipper that stipulates the delivery of goods from port of shipment to port of destination and also documents representing title of the goods¹, specifying who is entitled the possession of the merchandise upon their arrival.

¹ See finance of foreign trade and foreign exchange, second edition by Asrar H. Siddiqi p.58 pub. Royal book company and international banking by Nicholas L. Deak and JoAnne Celusak p.55 pub. New York institute of finance

They are signed by an authorized person on behalf of the ship owner, who undertakes to deliver goods at their destination port as they were when the goods were received for shipment.

When bills of lading issued and properly signed, several copies are often required as an alternate to assure in case of loss and any of them is suitable and permissible for collection of the goods.

Once collection is made, all the other copies become void.

This policy gives protection to the paying bank and also to the exporter in case the original bill of lading is lost.

Bills of lading usually include a brief description of goods, providing the terms on which they are to be carried, the name of the carrying vessel and the port of discharge.

These details must correspond to the requirements expressed in the application of the documentary credit.

Further more, if the credit stipulates a particular date or time of shipment, the stipulation must be complied with.

Clean bill of lading

A clean bill of lading, in English practice is one which bears no superimposed clause or notation which expressly declares a defective condition of the goods or

the packaging instructions¹. It is the responsibility of seller to present confirmed bill of lading, corresponding the requirements mentioned in the credit.

The questions whether bills of lading are clear or unclear is in practice and in law is vexed one.²

To tie the question to the goods and packing is too narrow. A buyer has the right to a bill of lading which is usual in form and appropriate to the particular trade.

Therefore, it is the duty of the paying bank to decide whether or not the bill is one which is authorized to accept and if the bank is in doubt, it refuse provided that it must be justified in refusing to pay.

1.5.2 Commercial invoices

The invoice is a statement of the seller to a buyer describing what he has sold, the price of the goods, the weight lists and such other details including the shipping marks which appear on packages and on the bills of lading ... etc.

Most countries specify the information they require to be shown on invoices, for example details of import licenses and exchange permits.

It is non negotiable document that does not convey title to the holder.

¹ Paget's law of banking ninth edition by Maurice Megrah and F.R. Ryder pub. London Butterworths 1982 p.550

² Paget's law of banking ninth edition by Maurice Megrah and F.R. Ryder pub. London Butterworths 1982 p.550

Unless it is specified, banks may refuse invoices issued for amounts in excess of the amount provided for the credit, even though no payment in excess of the amount specified in the documentary credit is requested.

Therefore, the invoices must correspond exactly with that found in the credit.

Further more, it may be stipulated in the credit for presentation of consular invoices with the bill of lading. A consular invoice is presented to the nearest foreign consular official for examination where it is stamped and signed.

In some countries, custom practices may require such an invoice (also known as Customs invoice) for price or exchange control and statistical purpose.

Whenever custom invoices are required, it should be presented to custom authorities, as it is important for customs clearance of the goods.

1.5.3. Insurance documents

Documents showing a complete insurance cover that has been issued and duly signed by insurance company in accordance with stipulation contained in the credit against any loss or damage which may occur during shipment.

Cover must be effective at the latest from the date of loading on board or dispatch and the insurance documents must be expressed in the same currency as the credit.

The credit must state the type of the insurance required and any additional risks covered. In the absence of such stipulation, the bank will accept the insurance documents as presented by the seller and has no responsibility for any damage or risks not covered therein¹.

In most transactions, involving a shipment of merchandise, it is important that an insurance policy covering the risks that may occur during the transit of the goods be borne by one of the parties, most properly the seller who should tender some documents including insurance documents, however, the contract of sale must clearly stated who is responsible for arranging the insurance at all stages from the time when the goods leaves from the seller until the buyer takes its possession..

1.5.4. Certificate of origin

In addition to the documents mentioned above, and in order to benefit from possibly lower custom duties, the certificate of origin is useful addition to the list of the required documents.

It is main purpose which is to certify the country where the goods were produced to incorporate in the customs invoice.

In some countries this certificate is issued by a local chamber of commerce showing that the goods are originated from the exporting country and not from a third country.

¹ Article 28 of UCP 600

1.6. Obligation of the bank

Upon presentation of the specified documents by the seller, the obligation of the bank starts, and it is the duty of the bank to examine these documents to ensure that they comply, on their face, with the terms and conditions of the credit and decide whether to accept or reject these documents.

1.6.1. Inspection of the documents

When payment is sought by the seller, the terms of the credit must be analyzed word by word in order to confirm and see whether the documents presented by the seller are in conformity with terms and conditions of the credit.

The bank has a reasonable time to examine these documents beyond any doubt.

In deciding whether the time taken is reasonable or not, courts will take into account three factors:

Firstly, banking practices, this means the prevailing normal period that most of the banks take to examine documents tendered by the seller in order to receive payment under the credit.

secondly, the technical language contained in the documents and the thirdly the length of the documents¹. It is the duty of the bank to exercise a reasonable care in examining the documents.

The acceptance or rejection of the documents by the bank is dependent on whether the documents presented by the seller are in conformity of the terms and conditions of the credit.

If the paying bank found that the documents do not meet the requirement of the credit, for instance there is discrepancy of the documents, the bank would reject and the beneficiary will not receive any payment from the bank.

Discrepancy of the documents

The discrepancy of the documents may exit in two ways:

Firstly, there may be an ambiguity in the credit instructions and secondly, there may be an ambiguity with respect to the documents tendered by the seller.

If the credit instructions are ambiguous, the bank should ask the issuing bank for clarification.

If this is not possible the bank is protected if it has acted reasonably².

If minor discrepancies are found between the terms of the credit and the

¹ Bankers trust Ltd v state bank of India 1991

² The law and practice of international trade tenth edition by LEO D'ARCY and CAROLE MURRAY, pub. London sweet & Maxwell 2000 p.188

documents presented to the bank, they are referred to a discrepancy officer for resolution. In banking practices, however, in the case of minor discrepancies, the beneficiary is paid provisionally against specific indemnity.

This specific indemnity undertakes to compensate the bank against any loss arising from making such payment despite discrepancies in the document.

The paying bank has no right to make payment but do so at its own discretion¹. generally, if discrepancies are found, the paying bank should refer to and inform this fact to the originating bank, which will also forward to its client for approval or rejection.

This procedure of obtaining express consent to accept the documents in spite of discrepancies will extend the time allowed for presentation of documents under the terms of the credit and also to pay the seller.

In case, the client gave his written consent and accepted these documents despite the existence of discrepancies, the issuing bank will forward this approval to the paying bank which will pay to the seller.

In case the seller is paid provisionally under the indemnity agreement, such agreement will come to an end.

¹ Finance of foreign trade and foreign exchange, second edition by Asrar H. Siddiqi p.143 publ. royal book company.

1.6.2. The two fundamental principles

In relation of the examination of documents by the paying bank two fundamental principles are found and applicable to the credit.

1. The autonomy of the credit, and
2. The doctrine of strict compliance.

The autonomy of the credit

According to this principle, the documentary credit is independent and distinct from the underlying contract of sale¹.

Therefore, the duty of the advising or paying bank is only limited whether the documents submitted by the seller corresponds to those instructions specified and mentioned in the credit.

This principle is known as the autonomy of the credit².

If the bank observed that the documents tendered by the seller, on their face are in conformity to the instructions mentioned in the credit, then the bank will accept these documents and pay to the seller.

The only exceptional case that the bank will refuse to pay the seller occurs if the

¹ The law and practice of international trade tenth edition by LEO D'ARCY and CAROLE MURRAY, pub. London sweet & Maxwell 2000 p.188

² See articles 3 and 4 of UCP

bank proved to its satisfaction or came into his knowledge that the documents are fraudulent and that the seller was involved in the fraud case.

This is commonly referred to as the fraud exception.

The doctrine of strict compliance

The legal principle that the bank is entitled to refuse documents which do not strictly conform with the instructions mentioned in the documentary credit is known as the doctrine of strict compliance.

The reason is that the advising or paying bank is the agent of the issuing bank and if an agent with limited authority acts beyond his limits, the principal is entitled to repudiate the act of the agent.

Therefore, the bank will accept if the documents tendered by the seller are, on their face in strict conformity with the terms and conditions of the credit and if they are not in accordance with the instructions specified in the credit the bank will reject the documents.

1.6.3. Fraud in documentary credits

We have mentioned earlier one of the principles in which the documentary credits are found and that is autonomy of the documentary credit.

This principle says that the bank which deals with documentary credit transaction will not involve in any dispute between the parties to the underlying sale contract or any other contracts.

The only exception to this principle is the fraud exception that the bank may refuse to the seller's request of getting payment if it is proved to its satisfaction that the seller is involved in a fraud.

This fraud is mostly related to the documents submitted by the seller to the bank. They may be forged or untrue in relation to the goods to which they refer, though on their face they may appear to be correct.

The applicant of the credit or the buyer usually raises this allegation of fraud in order to prevent the bank from paying the seller.

In this situation, the buyer may allege that the seller shipped defected goods instead of confirming goods as mentioned in the credit or that the bills of lading were forged or fraudulently false.

In this case, it is not the obligation of the bank to ascertain or make sure whether the alleged fraud can be proved by the buyer but the bank may generally evaluate the evidence placed before it by the buyer.

In ascertaining alleged fraud, three situations must be classified.

1. Where there is allegation of fraud communicated by the buyer to the bank that the fraud has occurred and that allegation is found on mere suspicion or the bank

itself found such fraud on the basis of suspicion, and no more facts can be established, bank should pay the seller. The reason is that mere suspicion may not be the basis of refusing to pay the seller unless there is clear evidence both as the fact of the fraud and as to the bank's knowledge.

2. where it is clearly established to the satisfaction of the bank that the fraud has occurred and there is unambiguous evidence before it that the documents or some of the documents are forged but the circumstances show that the seller is not involved in that fraud for example there is a possibility that the fraud was committed by a third party e.g. a forwarder or loading broker, in this case the bank should pay the seller¹.

3. where the bank has sufficient proof and evidence that a fraud has been committed and that the seller knew of this fraud for example, the seller himself tendered false documents or some body else does this fraud with his knowledge, the bank should not have to pay the seller if both these facts are clearly established.

¹ united city merchants (investment) Ltd v. royal bank of Canada case 1983.
The house of lord held in this case that the bank should pay in spite of its knowledge of the fraud because not only the bank and the buyer but also the seller were deceived by the fraud of the third party.

1.6.4. Evidence of fraud

It is well known principle of Islamic law that the burden of proof lies with the plaintiff and oath is administered to defendants who deny such allegations.

The holy prophet (P.B.A.H) said “البينة على المدعي واليمين على من أنكر”¹

Similarly, it is also well established principle of law that the plaintiff should proof his allegations if he wants to get remedy from the court.

Therefore in any case where a fraud has been alleged either by the buyer, the applicant of the credit or the paying bank a sufficient evidence must be brought by either party before the court of law in order to decide the case.

1.7.1 Application of uniform custom and practices in international trade

The laws applicable to the documentary credit operations are the uniform custom and practices for documentary credits (UCP 600), a set of universally accepted and recognized rules which has been published by international chamber of commerce in Paris².

The first rules of uniform custom and practices for documentary credits were drafted at the international chamber of commerce congress in Vienna in 1933.

¹ See Sahih al Bukhari wa muslim

² ICC brochure 600, the UCP is available from the ICC and at <http://www.iccwbo.org>

Reflecting numerous changes in international trading and transport techniques occurring, the international chamber of commerce in corporation with various national chambers and banks subsequently revised uniform customs and practices for documentary credits, the last of them is uniform custom and practices for documentary credits (UCP 600).

Generally, the UCP rules are applicable only if the parties incorporated them into their contract or when the text of the credit expressly indicates that it is subject to uniform custom and practices for documentary credits.

Article 1 of UCP provides that the uniform customs and practices for documentary credits shall apply to all documentary credits when the text of the credit expressly indicates that it is subject to UCP rules.¹

Uniform custom and practices (UCP) do not have the force of law but if the parties have incorporated them into their contract, it is binding on them unless excluded or modified by the credit document.

In United States of America uniform commercial code is applicable to documentary credits but the provisions of UCP are also applicable where the parties have agreed to apply them in their contract.

In countries which have national banking associations, the general standard conditions applied by them usually incorporate the provisions of uniform customs and practice for documentary credits

¹ see article 1 of UCP

CHAPTER NO. 3 APPLICATIONS OF DOCUMENTARY CREDITS IN ISLAMIC BANKS

3. Application of documentary credits in Islamic banks

Islamic banks just like others commercial banks issues documentary credits.

The ways by which Islamic banks issues documentary credits is widely different from the way commercial banks issue documentary credits.

Such differences arise at the application of the documentary credit particularly when the bank is principal financier.

For example, as we have explained earlier, customers of commercial banks seek from the bank to finance fully or partially a particular transaction like sale contract and get finance in the form of loan with interest that payable within specified date in future.

This practice of charging interest is riba which is repugnant with Islamic principles and therefore it is prohibited in Islam.

In other hand Islamic banks eliminated the concept of charging interest to their customers in dealing with documentary credits.

They entertained ways and system of applying documentary credits which is lawful according to Islamic principles.

Customers of Islamic banks are divided into two main categories¹.

1. Customers who pay fully in advance all the expenses of the transaction including sale price and other bank charges.

In this case the bank represents on behalf of its client merely as agent.

3. Customers who pay partially or do not pay at all the expenses of the transaction.

In the former case the customer seeks from the bank to pay the remaining amount of the money so that the bank will share the finance of that particular transaction while in the later case the customer requests from the bank to finance whole the transaction like the purchase of truck or motors and agrees with the bank to sell them on cost plus profit principle on deferred payment basis.

Following that division mentioned above, Islamic banks issue documentary credit on the basis of one of the following manner².

1. On the basis of Wakalah or contract of agency.
2. On the basis of Murabahah to the purchase order³.
3. On the basis of Musharakah contract.

¹ Al masarif al islamoyah bayna nadariyah wa al tadbiiq by Dr. cabdirizaq rahim jadi al hayti p.410 pub.dar usamah li nashri wa al tawzic Jordan aman

² taqwiim ada al nashat al masrafy al islami p.162 by Dr. qhasan qalcawi and al ixtiraf fil mucamalat al maliyah, sharxu kitab abjidiyat al tijariyah al islamiyah p. 576 pub. Dar al diya

³ The current application of majority of Islamic banks is based on Murabaha contract like Qatar Islamic bank, Jordan Islamic bank, faisal Islamic bank in Egypt.. etc.

We will explain how Islamic banks apply each of them in detail in the following pages.

3.1. How Islamic banks practice documentary credits

As foresaid Islamic banks issue documentary credits in three ways, here we explain each of them in detail.

3.1.1 On the basis of Wakalah or contract of agency

Before we explain how the concept of wakalah or contract of agency is being applied or works in Islamic banks, it is suitable to define wakalah literally and technically.

3.1.2. Definition of Wakalah

Literal meaning of wakalah

Literally Wakalah means either protection as Quran says in surah Al-e-imran:

“وَقَالُوا حَسْبُنَا اللَّهُ وَنِعْمَ الْوَكِيلُ” and they said: Allah (Alone) is sufficient for us, and he is “the best disposer of affairs (for us)¹.”

or delegation of authority as Quran says in surah Ibrahim: “وَعَلَى اللَّهِ فَلْيَتَوَكَّلِ”

¹ Surah Al Imran chapter 3 verse number 173

”الْمُتَوَكِّلُونَ“¹”and in Allah (Alone) let those who trust, put their trust¹.”

And in surah Hud Allah says:”إِنِّي تَوَكَّلْتُ عَلَى اللَّهِ رَبِّي وَرَبِّكُمْ“

”I put my trust in Allah, my lord and your lord.”

It is said that he has delegated his authority or empowered to Mr. so and so.

Technical meaning of wakalah

Wakalah has been defined in different ways by different authors but all these definitions carry same meaning.

The following are some definitions of wakala:

1. Wakalah is to substitute an agent for the principal to perform on behalf of the principal an act, which admits of representation.²
2. Wakalah is to employ a person to act on behalf of another or represent another person in dealing with lawful and permissible things that are known.³
3. An agent is a person employed to do any act for another or represent another in dealing with third persons.⁴

the person who acts on behalf of another or who has been delegated the authority

¹ Surah Ibrahim chapter 13 verse number 12 and surah Hud chapter 12 verse number 56

² Islamic law of contracts and business transactions by Dr.Muhammad Tahir Mansuri p.61 pub. Shariah academy international Islamic university Islamabad.

³ al ixtiraf fil muamalat al maliyah, sharhu kitab abjidiyat al tijariyah al islamiyah p. 576 pub. Dar al diya

⁴ section 182 of contract act 1872.

is called an agent or (wakil) and the one whose behalf the act is done is known as principal or (asil).

The contract which creates the relationship of principal and agent is called an agency.

3.1.3. Features of wakalah contract

1. Customer appoints the bank to act or represent on his behalf for the operation of the documentary credit¹.
2. The customer pays in advance the sale price i.e. he make 100% deposit.
3. Undertaking of payment by the bank.
4. There is no financing from the bank

2.1.4. Application of wakalah as documentary credit

Documentary credits can be issued under Wakalah contract (agency relationship) in which the role of the bank is to act on behalf of its customer as a paid agent after the applicant deposited full amount of the sale price of goods of import.

In this case, the mere duty of the bank is to represent on behalf of the applicant until the operation of the documentary credit is over.

The example how the concept of wakalah is applied as documentary credit in an Islamic bank is as follow²:

1. The customer request from the bank to issue or open documentary credit in

¹ Bank Muamalat in Malaysia, available at www.muamalat.com

² Bank of Muamalat in Malaysia, available at www.muamalat.com

favor of a seller (the beneficiary of the credit) for the payment of certain amount of money within specified time period and give the details of the goods to be imported and instructions required from the seller to comply with.

2. The bank provides documentary credit facility to his customer and requests him to pay in advance the sale price of the goods to be imported.

3 . The bank issues documentary credit in favor of the beneficiary and forwards it to the advising or negotiating bank, directing to pay the seller provided that the seller comply with instructions mentioned in the credit and present the stipulated documents.

4. The advising bank informs to the seller about opening documentary credit in his favor and asks him to present the specified documents within stipulated time in order to receive payment.

5. The seller ships the goods and tenders required documents to the advising or negotiating bank.

6. The advising or negotiating bank check documents whether they are in accordance with instructions of the credit and forwards to the issuing bank.

7. The advising or negotiating bank pays to the seller and gets recompensation from the issuing bank.

8. Upon the receipt of documents, the issuing bank repays to the advising or negotiating bank utilizing the customer's deposit or fund and subsequently hands over documents of title to the customer in order to collect the goods.

9. The operation of documentary credit is over and the bank charges the customer fees and commissions for its services.

2.2 On the basis of Murabahah to the purchase order

2.2.1 Definition of Murabahah

Murabahah is sale of goods at a price covering the purchase price plus profit margin agreed upon the contracting parties¹.

Or it is a sale of goods at a price which includes a profit margin agreed to by both parties.

The purchase of selling price, other costs and the profit margin must be clearly stated at the time of the sale agreement.

Under this contract, the customer approaches the bank and seeks to finance the purchase of a certain goods to be brought at specific locality and registered bank's name and undertakes that he will sell them from the bank with profit over and above the original price.

The customer does not enter into contract with bank but signs a memorandum of understanding which states the general frame work of the contract like the terms

¹ Islamic law of contracts and business transactions by Dr. Tahir Mansuri p.214 pub. Shariah academy International Islamic University Islamabad.

and conditions of the contract, the profit margin and the schedule of payment etc.

The bank will enter into actual sale contract with the client if the commodity is owned by the bank.

This banking murabahah is known as murabahah to the purchase order.

Basically, Murabahah is a trust sale in which the buyer relies upon genuineness of the purchaser as regards the cost he mentions to the buyer.

Therefore, it is the obligation of the seller to be honest and truthful in stating the price at the purchased goods and if he purchased with discount that should be benefited by the buyer.

2.2.2. Conditions of murabahah

The following are conditions of murabahah contract¹:

1. Disclosure of the cost price

For the validity of Murabahah transaction, it is necessary that the second purchaser i.e. the Murabahah purchaser should know the original price of the goods. If the cost price is not disclosed in the Murabahah contract, the contract is not named Murabahah contract.

¹ See shariah standard and also see *Fiqh al islami wa adilatuhu* by Zuhayli Vol.2 p.162

2. Fixation of profit

The seller of the Murabahah contract must determine the profit that he wants to add to the cost price in the contract of Murabahah.

It is permissible to fix the profit in figures e.g. hundred rupees or in percentages

3. Validity of the first contract

The first contract between the Murabahah financier and the seller of that particular commodity must be valid contract.

If the first contract is irregular, then the second contract between the Murabahah seller and the Murabahah purchaser will be invalid because Murabahah is resale of a commodity with profit and invalid sale is not permitted in Islam

4. Ascertainment of cost price

Murabahah transaction is only valid where the cost price is ascertained and exactly known by the contracting parties.

If the cost price is not known, the commodity can not be sold on Murabahah basis.

This arises where the Murabahah seller has purchased two or more things in a single transaction and he does not know the price of each commodity exactly.

2.2.3. Application of Murabahah as documentary credit

Issuance of documentary credit on the basis of murabahah to the purchase order takes place as follow¹:

1. The customer approaches to the bank and request to purchase for him certain commodity promising that he will purchase them (probably on credit) in the stated cost price with profit margin on the basis of Murabahah to the purchase order. He also provides the description of the required commodity.
2. If the bank agrees to his request, it starts to issue documentary credit and the purchase of required goods for himself. The actual contract of Murabahah will be concluded if the commodity is owned by the bank.

The bank also asks the client to give an undertaking to purchase the goods with stated profit margin. In order to secure good performance by the Murabahah purchaser, the bank may ask him to furnish a security in the form of a mortgage.
3. After the bank has purchased required goods and taken possession of them, it enters into actual Murabahah contract with the client and hands over goods to the client.

¹ See Mucamat al maliyah al mucasarah fil fiqh al islami by Dr. M.Usman Shabir pub. Dar al nafa'is p.285 and al ixtiraf fil mucamat al maliyah, sharxu kitab abjidiyat al tijariyah al islamiyah p. 576 pub. Dar al diya

2.3. On the basis of Musharakah agreement

2.3.1 Definition of Musharakah

Literal meaning of Musharakah

The term Sharikah is used in its literal sense to mean mixing or mingling two things in such way that one of them can not be distinguished from the other.

Technical meaning of Musharakah

In its technical sense, various definitions has been expressed by Muslim jurists but the most comprehensive definition which combines all the ingredients of Sharikah perhaps is the Hanafi definition.

Hanafi defines Sharikah as a contract between two or more people for participation in capital and its profit¹.

Thus Musharakah is a relationship between two parties or more, of whom contributes capital to a business and divide the net profit and loss.

In law partnership act 1932 defines partnership as: a relationship between persons who have agreed to share the profits of a business carried on by all or any of them acting for all¹.

¹ Ibn Abidin, radd al muhtaj. Vol.3 p.211

4. In case of defect in the goods discovered later on, the Murabahah purchaser can return it to the bank and claim reimbursement.

This was the relationship between the Islamic bank and the importer or the applicant of the credit.

As far as the relationship between the Islamic bank and the advising bank is concerned, it is a relationship of lender and borrower with avoiding interest or riba.

Usually Islamic banks develop mutual relationship with other conventional banks based on free interest transaction like exchangeable deposit (Wadicah Mutabadillah). For example, Islamic banks deposit some amount of money in advising bank permitting to use free of interest.

If an Islamic bank is issued documentary credit in favor of overseas exporter, it forwards to the advising bank directing to pay the seller in its account or fund in the advising bank. However, if the advising bank paid more than the Islamic bank's deposit or fund, the advising bank does not charge interest :

2.3.2 Application of Musharakah as documentary credit

Islamic banks use Musharakah as a mode of financing in two ways.

1. Project financing

Islamic banks provide project finance on the basis of Musharakah.

two or more of its customers approach the bank for finance of a specific project on the basis of Musharakah.

If the bank agreed with the customers to share the finance of the project, the bank and the other partners provide complete finance.

All parties including the bank have equal rights to participate in the management of the project and the profits are distributed according to the agreed ratio, which need not to be the same as the capital proportion.

In case of a loss, all parties share exactly in accordance to their proportion in which each partner provided for the finance of the project.

Thus, the bank before financing the project on Musharakah basis gets evaluated by its experts and if the bank found that such project is profitable enters into such agreement and issues documentary credit in order to complete the project .

Such type of Musharakah terminates with the completion of the project.

¹ see partnership act 1932 section 4

2. Financing of a single transaction

Islamic banks also provides finance to the medium and small business traders.

The customers of the bank approach the bank and request to finance a purchase of certain commodity or goods on the basis of Musharakah.

If the bank considers that such transaction is profitable, than the bank provides finance to purchase the requested goods on the basis of Musharakah and issues documentary credit. If the goods are received and collected from the port the sale of that goods and subsequent profit are shared by the customers and bank according to pre agreed ratio.

In case a loss arises the bank and the customer share that loss in accordance with the ratio that each partner invested.

2.4. The difference between application of documentary credits in commercial and Islamic banks

There are two main differences between applications of documentary credits in commercial and Islamic banks.

The first difference is the question of liability that commercial banks are not liable in case of loss or destruction of goods of import before the delivery of such goods

to the customer. This means that the customer is liable in case of loss or destruction of goods of import before it come to his possession.

In Islamic banks the tradition is different and the bank is liable any loss or destruction of goods of import before it hands over to the customer.

The reason is that the goods are owned by the bank and in case of loss or destruction before it is delivered to customer, the bank is liable till the ownership is not passed to the customer.

The second difference relates the goods after their arrival, in commercial banks the duty of the bank is only confined to confirm whether the documents forwarded to him are in accordance with the instructions mentioned in the credit. In case of defect in the commodity, the buyer can not return it to the bank as the bank is not responsible.

This means that in documentary credit operation, the bank deals with documents and not goods and services. In Islamic banks the situation is different and the bank is liable in case a defect is discovered in the goods later on.

The buyer can return defected goods to the bank and claim re imburement for that defect¹.

This means that the duty of the Islamic bank is to deliver to his customer requested goods in kind, quality and quantity.

¹ Al masarif al islamiyah beyna nadariyah wa al tadbiq by Dr.cabdulrasaq rahim publ.dar usamah li nashri wa tawsic aman Jordan 1998.

CHAPTER NO. 4 SHARIAH APPRIASAL ON APPLICATION OF DOCUMENTARY CREDIT

4.1 Introduction of Uniform custom and practices for documentary credits (UCP 600)

The new current rules of Uniform Custom and Cractices for documentary credits came into force on 1 July 2007.

Theses rules are called UCP (brochure 600) that replaced previous version (UCP 500) which had been operative since 1994.

This version has been drafted in a way that will incorporate or address changes in international banking practice regarding documentary credit operations.

The international chamber of commerce itself labeled this new version as the most comprehensive in the entire history of the rules.

After four years of review, UCP 600 was finalized, hoping to remove the discrepancies in the previous version.

There was much confusion in the previous version (UCP 500) amongst the bankers regarding documentary credit transactions, resulting in 70% of the presentations not being honoured due to discrepancies.

The goal of this version (UCP 600) is therefore to reduce dispute rates, lower rates of inquiries regarding interpretations of certain articles and reduce lawsuits

resulting from such confusion. This version (UCP brochure 600) contains only 39 articles that are clearer, concise and more organized whereas the previous version (UCP brochure 500) contained 49 Articles.

The structure of Uniform Custom and Practices for documentary credits are as follow:

Articles 1-5 application, definitions, interpretations, independence of credits and underlying contract and distinction of documents and goods.

Articles 6-10 availability, expiry date and place for presentation, issuing and confirming banks undertakings, advising of credits and amendments.

Articles 11-15 pre advised credits, nominated bank, reimbursement arrangements, examination of documents and complying presentation.

Articles 16-18 discrepant of documents, waiver and notice, original documents and Copies and commercial invoice.

Articles 19-27 transport documents

Articles 28 insurance documents

Articles 29-37 extension of expiry date, tolerances, partial drawings or shipments, installment drawings or shipments, hours of presentation, disclaimer on effectiveness of documents, disclaimer on transmission and translation, force majeure, and disclaimer for acts of an instructed party.

Articles 38-39 transferability of credits and assignment of proceeds.

4.2 Analysis of Uniform custom and practices for documentary credits in the light of Islamic law

The basic perception in Islamic law regarding commercial transactions is that all the commercial transactions are valid as far as they are not repugnant with Islamic injunctions.

In other words the original rule about transactions is permissibility.

Keeping in mind this basic principle we are able to analyze uniform custom and practices for documentary credits in the light of Islamic law.

In order to know what are the rules that are contrary with Islamic principles it is better to comment those important rules relating to the rights, duties and obligations of the applicant, beneficiary and banks respectively so that it will be clearer to us to raise objections.

Here we comment the main rules of UCP.

Article (1) this article indicates the application of uniform custom and practices for documentary credits which says that these articles are rules which apply to any documentary credit and once they are referred to in the credit documents, they are binding on all parties unless otherwise parties exclude these rules in their contract or modify it.

If the documentary credit transaction referred that, it is subject to the UCP rules, it is necessary to include a statement or stipulate in the documentary credit that it will not violate sharia rules and principles¹.

Similarly documentary credit agreement must explicitly state that any interest will not be acted upon and the bank will not entertain any activities that contravene injunctions of sharia while executing documentary credit transaction.

Articles (2-3) definitions and interpretations: article 2 defines some terms used in uniform custom and practices for documentary credits and article 3 gives the interpretation of these terms used in UCP and says that words in the singular include the plural and vice verse.

Further more it says that all documentary credits are now irrevocable even if there is no indication to that effect.

Previously, UCP (brochure 500) all documentary credits may be revoked if stated such condition in the credit.

Although this article states that documentary credits are irrevocable but it does not prevent the rights of the contracting parties to indicate that revocable credits is being issued by the bank if the parties agreed upon it.

¹ Shariah standard item 3/7/1 p.254

Article (4) credits v. contracts:

This article states that the credit by its nature is separate and distinct from the underlying sale contract between the applicant of the credit and the seller.

The banks are in no way concerned with such contract even if any reference to it is included in the credit.

This is true because documentary credit transaction is a combination of different contracts, therefore the documentary credit agreement between the applicant of the credit and the issuing bank is a separate and distinct from the sale agreement between the buyer, the applicant and the seller.

These articles are not conferring rights to the parties but they are general and are not contrary with Islamic principles

Article (5) this article states that the banks deal with the documents and not with goods, services and performances to which the documents may relate.

The analyzing of the article we need to discuss the nature of the documentary credit agreement between the issuing bank and the applicant of the credit.

The contract between the issuing bank and the applicant is a contract of an agency in which the applicant gives to the issuing bank certain instructions that the seller must comply with and the bank acts on behalf of its client.

The bank undertakes that the seller will be paid if he presents complying documents to the advising or confirming bank within the period mentioned in the

credit. Here the obligation of the bank as an agent of its client is clear and that is to hand over to the applicant complying documents as specified in the credit in which the case the bank is obliged to execute the credit when it conforms to the instructions except upon a proof of fraud or forgery of the documents¹.

Therefore in dealing with documentary credit transaction, it takes place on the basis of documents alone and executed without reference to the goods.

A question may arise here that is what about if the subject matter of the sale is defective and what is the position of the bank regarding defective goods?

It may happen some times after collecting goods at its destination that the buyer found the goods with some defects.

In this situation, such defect may arise during transportation of the goods or it may be from the beginning.

In this case, if the defect is from the beginning the buyer must inform the seller about such defect and ask him to perform his part of the contract or he may sue him in a court of law in fraud case.

As far as the position of the bank is concerned, the bank is the agent of its client and once it handed over to the applicant apparently complying documents in which the bank satisfied its truthfulness, the obligation of the bank regarding the credit transaction ended and the bank has no concern with that defect.

¹ Shariah standard item number 3/1/4 p.252 and item 2/4/1 p.251

Article (7-8) obligations of issuing and confirming banks: these two articles describes the obligations of the issuing and confirming banks and says that if the stipulated documents are presented to a advising bank or issuing bank and that they constitute a complying presentation, the issuing, advising or confirming bank must pay if the credit is available by sight payment or pay at maturity if the credit is available by deferred payment.

It is the duty of issuing bank to reimburse advising or confirming bank that has honoured or negotiated a complying presentation and forwarded such documents to the issuing bank.

Similarly, the confirming bank has to reimburse another bank nominated by it if that bank has honoured stipulated documents and forwarded to it.

If a bank is authorized or requested by an issuing bank to confirm a credit however, that bank is not willing to confirm such credit, it must inform to the issuing bank immediately and may advise the credit without confirmation.

Generally, it is not permissible for the bank to undertake any transaction in documentary credit that pertains to goods or other materials that are prohibited by the sharia or is based on a contract that is void or irregular according to sharia due to vitiating conditions. It is not also permissible for the bank to discount payment on bills of exchange with deferred and delayed payment before its maturity at less than their nominal value¹.

¹ Shariah standard item number 3/1/3p.251

Articles (9-11) these articles are describing the advising and amendments of credits and say that a credit may be advised to a beneficiary through an advising bank in which if it adds its confirmation becomes confirming bank

It is the duties of the advising bank to convey accurately the terms and conditions of the credit, however, if the bank not satisfied apparent authenticity of the credit, it must inform without delay to the issuing bank from which the instructions appear to have been received.

The credit can neither be amended nor cancelled without the agreement of the issuing, confirming banks and the beneficiary.

If the bank amended the credit, the terms and conditions of the original credit will remain in force until the beneficiary communicates his acceptance of such amendments to the advising or confirming bank.

If the beneficiary fails to signify his consent to any amendments made in the credit will be deemed notification of acceptance by the beneficiary, however, a partial acceptance will be deemed notification of rejection of the amendment.

These articles apparently are not repugnant with Islamic injunctions as they are describing the procedure of advising and amending of credits.

Articles (12-13) these articles indicates nomination and bank to bank reimbursement arrangements and say that nominated bank if not confirming bank is not liable to honour or negotiate if complying documents is presented by the

seller to that nominated bank except when expressly agreed to by that nominated bank and communicated to the beneficiary.

It further says that the credit must state if the reimbursement is subject to ICC rules for bank-to-bank reimbursements, however, if the credit does not state that the following apply:

1. An issuing bank must provide reimbursement authorization to the reimbursing bank with subject to expiry date.
2. a claiming bank shall not require to supply a certificate of compliance with the terms and conditions of the credit to the issuing bank
3. An issuing bank will be responsible for any loss together any expenses incurred if reimbursement is not provided on first demand.
4. reimbursing bank's charges are for the account of the issuing bank, however, if the charges are for the account of the beneficiary, it is the responsibility of the issuing bank to indicate in the credit and in the reimbursement authorization. This seemed to be contradictory with Islamic injunctions specially when reimbursement is not provided on first demand and consequently any loss of interest together with other expenses shall be born by the issuing bank.

Clearly, this *riba alnas'a* arising out of the delayed payments of the reimbursement Agreement.

Therefore, it is prohibited by clear text of Quran and sunnah and must be avoided at bank to bank reimbursement arrangements.

Thus banks should arrange its relationships with other banks on the basis of non payment of interest and avoidance of other prohibited transactions¹.

Articles (14-16) these articles are describing the standard for examination of documents, complying presentation and discrepancies of documents.

The standard for examination of documents has been determined and the banks should examine a presentation on the basis of documents alone whether or not the documents appear on their face to constitute complying presentation within five banking days following the day of presentation, however, if the bank determines that the presentation is complying, it must honour.

If the bank determines that a presentation does not complying, it may refuse to honour or it may its sole judgment approach the applicant for a waiver of such discrepancies.

If the bank takes the decision to refuse presented documents, it must give notice to the presenter stating:

1. The reasons for its refusal
2. that the bank is holding the documents until it receives a waiver from the applicant and agree to accept it.

¹ Shariah standard item 3/7/6 p.255

3. that the bank is holding the pending documents for further instructions from him.

These articles discussed above are not contrary with Islamic injunctions as they generally prescribes the procedure and the standard for examining documents.

Article (18) commercial invoices: this article prescribes the requirements of commercial invoices and says that the commercial invoice must appear:

1. To have been issued by the beneficiary.
2. Must be made out in the name of the applicant.
3. Must be made out in the same currency as in the credit.
4. The description of the goods must correspond with that appearing in the credit.

It further says that the advising or confirming bank may accept a commercial invoice issued for an amount in excess of the amount mentioned in the credit but the advising or confirming bank must get consent from the applicant of the credit and the issuing bank in which the case its binding on all parties.

For the permissibility of the above-mentioned case, any kind of interest must be avoided.

Articles (17--27) these articles are commonly discussing original and transport documents and their mode of transport whether by air, ship, rail, road...etc.

These articles are not repugnant with Islamic injunctions as they are indicating mode of delivering the subject matter of the sale but again any thing in violation with Islamic principles must not be entertained during transport activities.

Article (28) insurance documents and coverage: this article states that insurance documents such as insurance policy, insurance certificate etc and says that insurance documents must be issued and signed by an insurance company or their agencies or proxies and such signature must indicate whether the agent or proxy has signed on behalf of the company.

It further says that the date of the insurance document must be no later than the date of shipment and at same time, it must indicate the amount of the insurance coverage and be in the same currency as specified in the credit.

This article refers, as it is about conventional insurance that it is prohibited according to Islamic law.

Such kind of insurance must be discouraged and Islamic alternative of insurance be used.

Articles (31-32) partial installment of shipments: this articles permits partial installment of shipments and says that partial installments are allowed, however, shipments within given periods stipulated in the credit if shipped after specified periods, ceases the credit to be available for any subsequent installments.

Presentations consisting more than one set of transport documents showing shipment of the same means of conveyance and for the same journey or showing on more than one means of conveyance within same mode of transport will be regarded as covering partial shipment, however, if they indicate different dates of shipment the latest date of shipment of any of the sets of transport documents will be regarded as the date of shipment.

These articles as they appear are not repugnant with Islamic principles because they are generally prescribing shipments of the goods whether partial shipments or installment shipments and their mode of transport.

Articles (34-36) these articles elaborate liability of the banks on effectiveness of documents, transmission and force majeure.

the bank assume no liability or responsibility for the consequences arising out of delay, loss in transit, mutilation or other errors arising in the transmission of any message, letters or documents when such messages, letters, documents are sent according to the requirements stated in the credit.

Similarly, the bank is not liable for the form of falsification, or legal effect of any document or for the general or particular conditions stipulated in a document nor the description, quantity, quality, condition, packing, delivery etc of the goods of the transport once complying presentation is made by the bank.

The bank is not also liable for the consequences arising out of the interruption of

its business by factors beyond its control e.g. acts of God, wars, riots, etc.

these articles are not repugnant with principles of sharia because once the bank fulfilled his party of obligation that is presenting complying documents as specified in the credit, its obligation ended and the bank is not liable any further claim.

Articles (38-39) these articles are indicating transferability of the credits and assignments of proceeds. A documentary credit may be transferred in whole or in part to another beneficiary if it is specified that condition in the credit .

If the credit is transferred it must accurately reflect the terms and conditions mentioned in the credit.

These articles as they appear are not contrary with Islamic principles, as it is the right of the contracting parties to agree whether the credit is subject to transfer or not and as far as the credit is not pertaining to prohibited transaction by the sharia. Thus, banks should have to see before issues once of documentary credit whether or not the intended transaction is prohibited by the sharia.

1.3. Evaluation of the two fundamental principles in the Light of Islamic law

So far, we have discussed these two principles during our analysis of uniform custom and practices for documentary credits in the light of Islamic law, it is now easy and straight forward to evaluate these principles and see whether they are contrary with Islamic injunctions or not.

We have earlier said that two fundamental principles are found and applicable to documentary credits. These principles are:

1. Autonomy of the credit and,
2. Doctrine of strict compliance.

The first principle is the autonomy of the credit that states the credit is independent and separate from the underlying sale contract art.4 of UCP.

This means that the bank is only concerned whether the documents presented by the seller correspond instructions mentioned in the credit; therefore, the credit transaction is only paper transaction.

The second principle is the doctrine of strict compliance that indicates the bank should strictly accept complying documents which accurately reflects the instructions mentioned in the credit.

If we take up the first principle that is the autonomy of the credit, we have shown that the credit is distinct and separate from the underlying sale agreement or any other agreement that the credit may relate.

We have also said that the credit transaction itself is separate contract between the applicant and the issuing bank, which undertakes to pay the seller if he fulfills the terms and condition of the credit and the applicant agrees with the bank to reimburse the amount due to him on specified period mentioned in the credit, usually after collecting the goods from the designated port.

In this case, the bank is not permitted to charge interest against delayed payment of the amount due to the applicant.

The second principle, it is the primary duty of the bank to make sure that the seller should present complying documents according to the terms of the credit.

If the documents presented by the seller do not correspond the terms and conditions of the credit, the bank is entitled to reject these documents.

Thus, it is clear that these principles are not contrary with Islamic principles, because they are explaining duties and obligations of the banks so there will not be any dispute in the future.

1.4 Analysis of bank charges

Banks usually charges some amounts of money while issuing documentary credit facility. This includes the charges of issuing or advising banks and charges obtained by commercial banks for partial payment of the credit amount¹.

Firstly, the charges of issuing bank is permissible as far as the bank charges actual expenses incurred in issuing the documentary credit and providing the required services whether it is in the form of lump sum or certain percentage of the total amount of the credit².

In this regard, there is no barrier from sharia prospective to charge some amount of money for an agent related services in documentary credit, whether it is in the form of lump sum or a percentage of a known amount in return of services and efforts rendered by the issuing bank.

Therefore, Muslim jurists upheld the permissibility of charging wages for agency. Secondly, the charges obtained by commercial banks for the partial payment of the credit amount is an interest against the delayed payment of the remaining credit amount. This is a loan agreement with interest, which is prohibited by clear text of Quran and sunnah.

¹ Al bunuk al islamiyah, al manhaj wa al tadbiq p. 167, al musicah, al ilmiah wa al camaliyah lil bunuk qismu sharci al majalah al awal, and bank al ribawi fil islam p.133

² Shariah standard item 3/3 p.252

1.5. Analysis of Documentary Credits in light of Islamic

Law

Generally, in dealing with documentary credit transaction, includes agency for providing required services and institutional guarantee to the seller.

As both the agency and guarantee, contracts are permissible according to Islamic law, documentary credit transaction becomes permissible¹.

But modern Islamic scholars has disagreed the shariah appraisal of the documentary credits in two opinions:

The first opinion considers that the documentary credit is either based on contract of agency and pledge (contracts of Wakalah and Rahn) or it is a contract of assignment (contract of Hawala) or it is a new contract.

This opinion is mentioned in the encyclopedia of Islamic law, which says that: this transaction is permissible totally from the shariah perspective based on the following²:

1. Contract of agency and pledge (contract of Wakalah and Rahn): this transaction is contract of paid agency to pay the seller and to present complying documents before the seller is paid.

The agency to pay the seller is stipulated with condition that the seller be paid after presenting the specified documents mentioned in the credit, and

¹ Shariah standard p. 251

² Musacah al fiqhiyah al Kuwaitiyah namudaj 3, hawala section 38 p. 244-246

stipulated agency is binding. Therefore, this contract of agency is combined with collateral pledge or rahn constructively for the imported goods which are in the possession of the agent until the applicant pay to the bank who represented him to pay.

2. In a documentary credit transaction, the applicant transfers to issuing bank his obligation to pay the seller, thus, the applicant becomes transferor with consent of the parties involving in the credit transaction.

In one hand, the bank pays to the seller through the advising bank and in this regard, the issuing bank is the agent of the applicant and in the remaining part of the transaction is hawala¹.

There is no paid hawala here because this will disregard the nature of the hawala as it is gracious contract but the bank is charging against services and efforts rendered to the applicant.

3. It is possible to describe as a new contract, which necessities by the circumstances of the trade derived from the basic principle of Islamic law that says the perception of the shariah regarding commercial transactions is that all the transactions are lawful unless they are prohibited by the shariah and keeping in the mind changes in time and necessities of the people.

¹ Ibl.

Therefore, this new transaction is permissible as it is not contrary with Islamic injunctions¹.

The second opinion considers documentary credits transaction as a contract of guarantee (Daman) because the banks guarantees to pay the seller on the basis of their strong financial position and facilitates for both the seller's and buyer's rights arising out from the sale contract.

In this regard, the banks provide guarantee to both the seller and the buyer².

¹ ibl

² Al musical al cilmiyah wal al camaliyah lil bunuk al islami, qismu sharci section 1 p. 505

CONCLUSIONS

Documentary credit is a written undertaking by a bank in favour of the seller (the beneficiary) for the payment of specified amount of money (through intermediary bank at the locality of the seller) on behalf of its customer (the buyer) within certain period of time, on condition that the seller should present documents confirming to the terms and conditions as mentioned in the credit.

The applications of documentary credits in commercial and Islamic banks are different as we have seen chapters 1 and 2 in this research.

such differences arises at the implementation time being different concepts are applied. In commercial banks when the customer requests from the bank to issue documentary credit in favour of the seller for the purchase of certain goods and the bank agrees thereto, two situations may arise:

1. that the customer pays full amount of the sale price and other bank charges
2. that the customer pays partially the sale price and seeks a loan from the bank to finance the remaining amount payable at specified future date as agreed by them.

Thus the application of documentary credit in commercial banks in one hand is permissible according to Islamic law and in other hand is prohibited.

The former is when the applicant pays full amount of the sale price and other bank charges in which the case the banks is the agent of the applicant to complete the transaction and the later is when the applicant obtains a loan from the bank to

finance the remaining amount of the transaction and pay interest as agreed by them.

In case of Islamic banks the situation is different and the concepts of wakalah (the contract of agency), Murabahah to the purchase order and Musharakah agreement are entertained along with the application of documentary credit.

The first concept, wakalah concept is applied when the applicant pays full amount of the sale price and other banks charges.

This is similar to the first situation we have illustrated earlier when we were discussing the application of documentary credit in commercial banks but the name is only different.

The second concept is the concept of Murabahah to the purchase order which is a sale of goods at a price covering the purchase price and profit margin agreed upon the contracting parties.

Under this contract, the customer requests from the bank to finance the purchase of certain goods to be brought at specific locality and undertakes that he will sell from the bank with profit margin.

The customer in this stage does not conclude a contract with the bank but signs a memorandum of understanding that he will sell from the bank when the goods come into the possession of the bank.

The third concept, Musharakah agreement arises when two or more clients of the Islamic bank approaches the bank and requests from the bank to finance specific

project on the basis of Musharakah or financing single transaction on the basis of Musharkah.

If the bank considers that it is profitable, than the bank and other customers share the finance of such specific project or that single transaction and issues documentary credits.

The profits are distributed according to the agreed ratio and in case of loss, all parties share according to their proportion.

I would like to conclude this research by saying that the applications of documentary credits in commercial banks are partially repugnant with Islamic principles specially when applicants seek a loan from the bank and repay them with interest.

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