

# **Implementation of the Islamic Letter of Credit in International Trade**

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## **ABSTRACT**

*Letters of credit play a crucial role in international trade and have been described as the lifeblood of international commerce. Issued by banks, transacted through banks and largely funded by banks, the banking sector across the world is directly involved in financing international trade through letters of credit. In view of its importance, it is vital to study its nature and to obtain a clear understanding of the way it operates and then to look at it from the viewpoint of the Shariah. Only in this manner can we formulate letters of credit and adopt operational methods that are consistent with the principles of Islamic trade and finance. A treatment of letters of credit that is useful and one that will attract all concerned parties must address the current scenario of international trade. Importers, exporters and intermediaries must be assured that the solutions proposed are viable. We are basing our study of letters of credit on the International Chambers of Commerce Publication 500 1993 Revision on Documentary Credits, generally referred to as UCP 500, and where necessary explanations on provisions in the UCP 500 found in the International Standard Banking Practice (ISBP). The introduction of Islamic concepts into and the modification of letters of credit to meet the requirements of the Islamic trade and finance will enhance the efficacy of letters of credit and strengthen its position in international trade. For Muslims the central role of letters of credit in international trade makes it imperative that it should both conceptually and operationally accord with Shariah principles. The letter of credit has evolved through trade practices that over time has secured the force of law and there had been no attempts in its formative stages to introduce Shariah values into its content and implementation. It is the object of this paper to establish in clear terms the underlying principles and practice of letters of credit, to look at it from the Shariah standpoint and to suggest changes to current practice that have to be undertaken to bring letters of credit within the ambit of the Shariah and consistent with the Islamic value system.*

## **INTRODUCTION**

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## **1. Introductory Remarks**

Letters of credit play a crucial role in international trade and have been described as the lifeblood of international commerce. Issued by banks, transacted through banks and largely funded by banks, the banking sector across the world is directly involved in financing international trade through letters of credit.

In view of its importance, it is vital to study its nature and to obtain a clear understanding of the way it operates and then to look at it from the viewpoint of the Shariah. Only in this manner can we formulate letters of credit and adopt operational methods that are consistent with the principles of Islamic trade and finance.

A treatment of letters of credit that is useful and one that will attract all concerned parties must address the current scenario of international trade. Importers, exporters and intermediaries must be assured that the solutions proposed are viable.

We are basing our study of letters of credit on the International Chambers of Commerce Publication 500 1993 Revision on Documentary Credits, generally referred to as UCP 500, and where necessary explanations on provisions in the UCP 500 found in the International Standard Banking Practice (ISBP)

The introduction of Islamic concepts into and the modification of letters of credit to meet the requirements of the Islamic trade and finance will enhance the efficacy of letters of credit and strengthen its position in international trade.

For Muslims the central role of letters of credit in international trade makes it imperative that it should both conceptually and operationally accord with Shariah principles.

The letter of credit has evolved through trade practices that over time has secured the force of law and there had been no attempts in its formative stages to introduce Shariah values into its content and implementation.

It is the object of this paper to establish in clear terms the underlying principles and practice of letters of credit, to look at it from the Shariah standpoint and to suggest changes to current practice that have to be undertaken to bring letters of credit within the ambit of the Shariah and consistent with the Islamic value system.

## 2. Objectives

- An appreciation of Islamic concepts pertaining letters of credit in international trade
- Issues arising from the implementation of Islamic letters of credit in international trade, banking and finance.
- Solutions proposed by Islamic Scholars
- Development and progressive implementation of the Islamic letter of credit.
- Creation of a permanent body of experts on to formulate, establish the framework, rules and regulations and the global infrastructure for the Islamic letter of credit.
- Discussion on certain legal and Shariah issues

## 3. Introduction to International Trade and Methods of Trade Settlements.

The elements that are necessary to constitute in international trading transaction are:- buyer, seller, country of export and country of import.

Settlement for trades done / payment for goods imported can be done in one of several methods and the choice of a particular method depends on the nature of relationship between the parties and the economic strength and policies of the countries where the sellers and buyers are located. The most frequently used methods of payment are as follows :-

### **Payment in advance:**

This is applicable to cash transactions. The buyer places the funds at the disposal of the seller prior to shipment of the goods or provision of services.<sup>1</sup> This term of payment is used in situations where :

- The buyer's credibility is doubtful.
- There is an political or economic environment in the buyer's country is unstable.
- There can be delay in the receipt of funds from the buyer, due to events beyond his control.<sup>2</sup>

### **Open account:**

This payment method is based on trust. The buyer receives the goods without issuing any negotiable document or any instruments evidencing the transaction. There is no enforceable commitment of the par of the buyer to pay. This is in the very nature of the transaction which can be defined as :- an arrangement between the buyer and seller whereby the goods are manufactured and delivered before payment is required.<sup>3</sup>

### **Documentary collection:**

This is an arrangement whereby the goods are shipped and the relevant bill of exchange (draft) drawn by the seller on the buyer, and/or documents(s) sent to the buyer's bank to

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<sup>1</sup> Charles Del Busto, MR. *ICC Guide to Documentary Credit Operations*, p. 19. For more information see: Johnson Pang, MR. *Documentary Credit & Collections for the Export and Import Trade*, P.16.

<sup>2</sup> See Charles Del Busto, *ICC Guide to Documentary Credit Operations*, p .19.

<sup>3</sup> *Ibid*, p 19.

one of its correspondent banks located in the domicile of the buyer with clear instructions for collect payment/.<sup>1</sup>

### **Documentary Credit, Letter of credit, LC**

The letter of credit is one of the important types of payment in the international trade and we are discussing it at length.

### **Definition of the Letter of Credit**

The letter of credit is 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, in order to,

- make payment to or to the order of a third party (the "Beneficiary"), or accepts and pay bills of exchange(Draft (s)) drawn by the Beneficiary, or
- authorises another bank to effect such payment, or to accept and pay such bills of exchange(Draft (s)), or
- authorises another bank to negotiate, against stipulated document(s)provided that the terms and conditions of the Credit are complied with.
- Authorises another bank to accept a deferment payment undertaking

Thus the letter of credit also referred as documentary credit , documentary letter of credit, or commercial letter of credit is an arrangement whereby the applicant (the importer) requests in the form of instruction the issuing bank (the importer's bank) pay the exporter on its own behalf. Effectively, it is an undertaking issued by a bank for the account of the applicant or for its own account, to pay the beneficiary the value of the draft and /or against documents provided that the terms and conditions of the letter of credit are complied with.<sup>2</sup>

Through the letter of credit the seller is assured he will receive payment for the goods he has exported to his client. And for payment to be made by the bank , the seller is required to present the bank the necessary shipping documents confirming the delivery of goods purchased within the given time frame.

The commercial letter of credit deals only with documents and if the documents are compliant the seller will be paid. Thus, the letter of credit is a document issued by a bank or any other financial institution, which permits / entitles the beneficiary of the credit to obtain payment through his bank subject to compliance with the terms and conditions stipulated in the letter of credit. In international trade it functions as a banking mechanism which allows importers to offer secure terms to exporters.<sup>3</sup>

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<sup>1</sup> Charles Del Busto, MR. *ICC Guide to Documentary Credit Operations*, p.20.

<sup>2</sup> *Ibid*, p.22.

<sup>3</sup> See: Charles J. Woelfel, MR. 199. *Encyclopedia of banking & finance*, Glenn G. Munn, F.L. Garcia and Charles J. Woelfel, 10<sup>th</sup> Edition, p. 694. *Dictionary of finance*, Oxford University Press, 1993, p 161. Graham Bannock, MR. *International Dictionary of Finance*, John Wiley & sons, Inc, USA, 2000, p. 156. *Dictionary of Finance and International terms*, Barron's Financial Guides, Barron's Educational

## The stages of the letter of credit

Based on the above, we can identify the stages in the transaction of a letter of credit and these are:

- The buyer and the seller agree on the terms and conditions of the sale, including products description, quantity, price, means of transport, period of credit offered (if any), latest date of shipment, etc. They also agree that payment is to be by letter of credit.
- The buyer applies to his bank for issue of the letter of credit and the bank, depending on their assessment of the buyer's credit standing may require cash cover or reduction of other lending limits base on the business relationship between the bank and the applicant.
- The issuing bank issues L/C, sending it to the Advising bank – nowadays this is generally by SWIFT, although it can be done by telex and post .
- The advising bank establishes authenticity of the letter of credit using signature books or test codes, then informs seller (beneficiary). The advising bank may confirm L/C or not depending on the terms and conditions agreed between seller and buyer and the instruction given by the issuing bank.
- The seller should check the L/C to ensure sure that it faithfully reflects the contract and the proforma invoice, and that all its terms and conditions can be met.
- If the buyer is not in position to provide all the documents required in the LC within the time, he has to write to the buyer and request the necessary amendment to the LC
- The seller ships the goods, then prepares all the documents required in the L/C (invoice, transport document etc.) Before presenting the documents to the bank, the seller should check for discrepancies, and where necessary rectify the documents to make them compliant.
- The documents are presented to the Nominated bank. The nominated bank checks the documents against the L/C. If the documents are compliant, the bank pays the seller and forwards the documents to the Issuing bank
- The Issuing bank checks the documents at its end. If all the documents are in order, it reimburses the seller's bank immediately
- The Issuing bank debits the buyer and releases the documents (including transport document), so that the buyer can claim the goods from the carrier
- The letter of credit cycle is complete.

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Series, Inc, USA, 1985, p 207. Derick G Hanson, *Dictionary of banking and Finance*, Pitman publishing LTD, UK, 1985, p. 399. *A Desktop Reference Manual of Compliance Terms*, Regulatory Compliance Associates, Inc, USA, 1990, p 93.

## **FIRST PART**

### **Legal and shariah issues in letters of credit (LC)**

- 1. Framework and infrastructure of the of the Letter of credit**
- 2. Basic types of letter of credit and its Islamic legal Shariah issues**
- 3. Evaluation the different Letters of Credit and the parties involved in the operation of the LC.**
- 4. Implementation of Maqasid in solving problems in the Letter of Credit**
- 5. Implementation of Maslaha in documents required in the letter of credit**

## 1. Framework and infrastructure of the Letter of credit

From the conceptual stage, the letter of credit was produced and developed by the international business community under the precepts of Western civilization. It came under the auspices of international chamber of commerce which published rules to regulate the content and procedure of letters of credit used in international trade.

The development of these rules and regulations governing letters of credit was a long drawn process spanning several decades. Its gradual evolution can be seen from the several international seminars and conferences held in the United State and Europe starting from the New York Bankers Commercial Credit conference in 1920.<sup>1</sup>

The first revision of the documentary rules and regulations took place in 1974 and it came into effect on 1 October 1975. Published by the International Chamber of commerce, this UCP contained 47 articles. Ten years later, in 1983 the UCP underwent another update and revision. This revision entered into force on 1 October 1984. Called UCP 400 it contained 55 articles. A further update and revision took place in 1993. Known as UCP 500 it contains 49 articles and is currently in use. It has been accepted by the international business community and regulates international payments made through letters of credit.

In November 2006, after more than 3 years of extensive discussions of the national committees of the ICC and other parties – the insurance companies, freighting companies and shipowners, the latest revision of the UCP called UCP 600 is due to be implemented in July 2007.

From the historical point of view, the guidelines for the use of letters of have being the subject of a an ongoing process of the updates and revisions and contributions to its development through the national committees of the ICC of has been extensive and now there is the involvement of the affected industries – the insurance, freighting and shipping companies.

However, basically it remains a product of the Western practitioners and experts. It is they who formulate the structure of UCP and the fundamental concepts, terms and the condition of the documentary credits fall within the parameters of Western perceptions of international trade. It remains basically a Western document and since the 1920's when the UCP was formulated Western influence on the conduct of international trade has entrenched itself and any new developments are basically to provide for shortcomings in practice while the concepts remain strictly Western.

Thus, the letter of credit was formulated by Western banks and it is their understanding of finance and financial procedures that international trade practices were built - it is as pure western product in its terms and conditions and application. This is obvious if we look to its history from the time of its inception.

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<sup>1</sup> See: Frans P.DE Rooy, *Documentary Credits*, Kluwer Law and taxation Publisher, Netherlands, p.9.



From its beginnings till today, letters of credit in international trade have evolved without any contribution from the Islamic business community. UCP in its present form and in its terms and conditions as applicable to letters of credit evidences this fact. Any contribution by the national committees of Muslim countries in the 1983, 1993 and 2006 revisions have been on peripheral matters. These revisions do not go to core issues. Western concepts remain at the core of the UCP and its practice accords with the West's ideas and practices.

Thus, the most important amendment made in the revision 1983 was about the standby letters of credit, in addition to numbers of textual amendments and five new provisions have been incorporated: articles: 11, 24, 25, 30 and 33.<sup>1</sup> and the same goes to the revision 1993.

UCP 500 contains 49 articles distributed across 7 major sections namely : general provisions and definitions, form and notification of credit, liabilities and responsibilities, documents, miscellaneous provisions, transferable credit, assignment of proceeds. These articles regulate the proper procedure and provide for the mechanisms of the LC. The practice of UCP 500 is explained by ISBP - International Standard Banking Practice with 200 guidelines which reflect banking practice and has the approval of the ICC banking commission. This clarification of the rules and regulations of the UCP standardises and improves the practice of letters of credit . However, in none of its provisions has the Islamic position been considered.

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

It is our duty to further study and focus on the development of the UCP and build on Islamic concepts to produce a set of rules and regulations that are founded on our understanding of Islamic law practice.

It is strongly recommended the existing UCP be studied, reviewed, amended, supplemented and in the process a new set of rules developed to make the UCP an Islamic product. It is a must for Islamic financial institutions and banks to create documentary credits whose rules and regulations, terms and conditions benefit the international Islamic business community.

This Islamic UCP will comply with the requirement of the Islamic law in order to be implemented in the Muslim world for the benefit of the UMMAH.

Basically this is the responsibility of Muslim scholars, Muslim thinkers and researchers who are conversant with and are engaged in the area of international banking and

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<sup>1</sup> See: Frans P. DE Rooy, *Documentary Credits*, p.12.

international trade finance. It is also the duty of the Islamic banks and the Islamic institutions to develop a purely Islamic documentary credit.

## **2: Basic types of letter of credit and its Islamic legal procedure and process.**

As we know there are a few types of letter of credit, basically we are concerned for the moment with two major types of LC which are LC at sight and LC at deferred payment.

### **A: LC at sight:**

This letter of credit, also called sight documentary credit, basically permits immediate payment to the beneficiary upon presentation to the bank of the specified documents.<sup>1</sup> To this extent, this LC does not create any problems from the Islamic point of view. From the beginning the bank procedures are acceptable - starting with the issuing bank proceeding to the negotiation bank all stages are based on the contractual agreement between the buyer and the seller. No credit or loan is involved in this operation.

However if we take into consideration the observations below, we note that in this operation the buyer opens the LC at sight through his bank (the issuing bank) and the beneficiary receives the LC through his bank (the advising bank), executes the export based on the letter of credit and submits the documents required by the LC to the nominated bank. The transaction is processed by both banks and at the end the buyer gets his documents and clears the goods and the exporter gets his payment. The entire operation is clear, even with the involvement of the various parties in the LC such as the correspondent bank, the reimbursing bank and the confirming bank - it does not affect the LC being managed under Islamic lines.

However we should address two issues here to ensure the clean operation of the LC, these are as follows:

#### **1. The first issue is the settlement of payment to the negotiation bank**

Basically the negotiating bank will pay the beneficiary the letter of credit value upon submission of compliant documents and then reimburse itself by claiming reimbursement from the reimbursing bank. In practice, the bank imposes charges for handling the LC and treats the payment given to their client (the beneficiary) as an advance (loan) and the bank imposes interest on the amount from the date it pays to the date it is reimbursed. Because the funds take some time to reach the negotiating bank due to procedures involved exporters end up paying interest to the bank.

How do we avoid this banking procedure which leads to interest payment which is in conflict with Islamic law? The seller can avoid paying interest by waiting for payment to come from the reimbursement bank. By doing this he can avoid interest payments to

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<sup>1</sup> for more information see: Johnson Pang, *Documentary Credit & Collections for the Export and Import Trade*, Pelanduk Publications, 1992, p.77.

the negotiation bank for the period between payment and reimbursement. He can also safe on the handling charges for negotiation which with some banks can be substantial.

At the end of the operation the seller gets his payment from the reimbursement bank not from the negotiation bank.

## **2. The second issue is the payment made by the applicant to the issuing bank**

At the stage of the opening of the letter of credit, the issue we are faced with is the payment made by the applicant to the issuing bank for opening the LC. Usually the bank opens the LC from a line established for the applicant and charges are levied for utilization of the line.

Let us investigate if there is any conflict with the charges imposed for issue of the LC and Islamic requirements. We propose to look at three different fact situations :-

### **The First category : The LC is issued against 100 % cash marginl**

If the applicant opens an LC against his own funds – provides 100% cover, such an LC is acceptable and complies with the requirements of the Islamic law.

### **Second category : The LC is fully uncovered:**

The second category is where the applicant opens an LC with nil cover. Here the importer does not deposit any of his own funds towards the issue of the LC and the Bank issues the LC 100% against a credit facility extended by it to the importer. This LC is not acceptable, and it does not comply with the Islamic law.

### **Third category: The LC is covered partially:**

If the applicant opens an LC with less than 100% of the value of the LC which means that the applicant covers a certain percentage of the LC value the LC is acceptable to the extent of the value paid by the importer, but it has a conflict with the Islamic law with respect to that portion that is not covered.<sup>1</sup>

### **Statement of the issue and solving the problem of the LC at sight**

The issue that has to be resolved is connected to the uncovered amount in the LC. Thus, the applicant is required to pay the full value of the LC to the bank in order to obtain an LC that is consistent with Islamic practice. Any of the other options – nil coverage or partial coverage do not meet Islamic requirements. The reason being - the bank will provide the this facility against interest, and any amount not covered by cash will be considered as a credit facility for which interest is payable.

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<sup>1</sup> See: حسن عبد الله الأمين، تقنيات المال والاقتصاد المعاصرة من منظور إسلامي (كوالالمبور: دار التجديد، ط1، 1422هـ، 2002م)، ص11.

There is a straight forward solution to this problem and this is by adopting an altogether different approach. We should change the structure of the facility that the bank is giving from one that is a loan to a Mudarbah or Musharakah or Guarantee or Murabaha transaction. These transactions are clarified in detail later in this paper.

Thus, to avoid a conflict with Islamic requirements, the bank should not treat the uncovered amount in the LC as a loan – if this approach is adopted there is no solution. However, if the bank replaces the loan by other arrangements which are well known in Islamic law<sup>1</sup>, the LC can be brought in line with Islamic requirements without affecting the operation of the LC and its handling by the banks. Any change will be at its structural level. We propose to explain the ideas in the second part in this paper.

By adopting a different approach, the issues raised at the application and issue stages for sight letters of credit can be satisfactorily resolved and a sight LC that complies with the requirements of Islamic law made available to Muslim traders.

## **B. Deferred payment or term LC**

The deferred payment LC usually provides for payment to be deferred by 60 or 90 days. Payment can, subject to agreement between the parties, be deferred for a longer period. The actual period is determined by agreement between parties and the agreement of the bank that provides this facility.

The difference between a sight and deferred payment LC is that with a sight LC payment is made promptly (upon sight of complying documents) whereas with a deferred LC payment is made at the end of the stipulated period.

With a deferred LC we may be faced with legal issues and conflict with the requirements of Islamic law. The issue pertains the payment term – unlike a sight LC, payment is made at a future date, even with the presentation of the documents which comply with the terms and conditions of the LC, payment is made at a future fixed or due date.<sup>2</sup>

In an LC where payment is deferred, the issuing bank will levy charges and interest for the duration of the period where payment is deferred. The exporter normally discounts the LC with his bank and receives an amount less than the LC value – the amount deducted is to account of charges and interest from the date the LC is discounted to the due date. In effect the Bank is treating this as a loan transaction – extending a loan against the security of guaranteed payment at a future date - the discount is only given when the issuing bank accepts the draft and confirms settlement date- and levying interest for the period of the loan.

The legal issues arising pertain this loan and interest.

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<sup>1</sup> Such as Mudarbah or Musharakah or guarantee or Murabaha, and other business transaction related to the finance and banking in Islam.

<sup>2</sup> for more information see: Frans P.DE Rooy, *Documentary Credits*, p.55. Johnson Pang, *Documentary Credit & Collections for the Export and Import Trade*, p.79.

## **Solving the problem of the deferred payment or term LC**

Basically the operation of deferred payment or term LC has two parts :- the first relates to the applicant who is opening the deferred payment / term LC, the second relates to the beneficiary who raises finance for his business through discounting he has with his bank or under Export Credit Refinancing (ECR) with financial institutions who offer this facility.

The applicant has two options to choose from :-

**First option:** The applicant and his bank agree to transact under the concept of Al Murabah. Here, the bank will establish the LC utilizing its own funds. This is under an agreement between the importer and the bank that the bank buys the goods from the beneficiary to be sold to the importer. The bank then sells the goods to their client (importer) at the price agreed with settlement on deferred terms. The bank will get its profit from this transaction under the concept of Al Murabahah. The LC operation under this concept is clean and consistent with Islamic requirements. However, this method does not find the support of banks, because the bank doesn't want to get directly involved in business transactions - they just want to provide services against profit.

**Second Option:** The second option is essentially the same as with LC at sight. In both, the issue that has to be addressed is the interest element in the loan extended by the bank. To overcome this, so we can displace the loan and the accompanying interest to an acceptable Islamic business transaction such al Mudarabah. In this way, the whole transaction will meet the requirements of Islamic law..

### **3. An examination of the content and parties in Letters of Credit**

If we go through any LC we will find that certain particulars fundamental and together constitute the structure of an LC. We are setting out all the terms that we come across, although some of the terms may appear in some letters of credit and not in others, eg. provisions the pertain to confirmed letters of credit will not appear in letters of credit that are not confirmed. The whole list will read as follows :- Applicant, Beneficiary, Issuing Bank, Advising Bank, Correspondent Bank, Reimbursing Bank, Confirming Bank, Date of issue, Date and Place of Expiry, Currency Code Amount, Maximum Credit Amount, Latest Negotiation Date, Expiry Date and Place, Latest Shipment, Port of Origin and Port of Discharge, Irrevocable Letter of Credit, Confirmed, Irrevocable Letter of Credit, Revocable Letter of Credit, Restricted Letter of Credit, Freely Negotiable Letter of Credit, Revolving Letter of Credit, Non-transferable Letters of Credit, Transferable Letter of Credit, Earliest Date of Shipment and Latest Date of Shipment, Date for Shipment, Partial Shipment, Installment Shipment, Transshipment, Description of the goods and/or service, Period for presentation, Confirmation instructions.<sup>1</sup>

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<sup>1</sup> The particular of the LC are collected through study from official LC received from overseas buyer from different countries worldwide through Banks base in Malaysia such as: Standard Chartered Bank, CITI Bank, HSBC Bank, MAYBANK, AM Bank, Scotiabank, and others.

As far as the Islamic letter of credit is concerned the above requirements and parties are acceptable if they comply with the requirements of Islamic law.

There are several banks involved in the LC process. These are the issuing bank, advising bank, the correspondent bank, the nominated bank which either pays or negotiates, the transferring bank, the confirming bank, the claiming bank and the reimbursing bank. Of these banks the issues of concern for the implementation of Islamic requirements pertains only the issuing and negotiating bank. If the issuing bank opens an LC at sight, as has been mentioned earlier, the stages of its implementation will not pose any problems, there being no inconsistency with the Islamic law. If, however the issuing bank opens a deferred payment / term LC we may be faced with the legal implications mentioned earlier.

The issuing and negotiating banks, who are the main banks in the letter of credit process can affect the procedures under which the LC operates. Also playing an influential role are the banks and financial institutions which step in to finance deferred payments letters of credit at the request of the seller (exporter).

#### **4. Implementation of Maqasid in solving problems of discrepancy in the Letter of Credit**

Discrepancies in documents is one of the problems faced by beneficiaries of the letters of credit. It has been said that discrepancies are found in more than 75% of presentations. In view of this and the consequences – non payment of claims against letters of credit and penalties imposed for

discrepant documents, we have to look at lessening the harshness with which banks treat discrepancies. Banks earn from discrepancies and are quick to pick them up and penalise the presenter/ beneficiary. The importer, on the other hand is anxious for his goods and in most cases waives the discrepancies and accepts the documents with discrepancies provided that the discrepancies do not hinder him from obtaining possession of the goods.

The question is :- under what circumstances should the bank be permitted to penalise the beneficiary for discrepancies.

We recommend that discrepancies be approached from the standpoint of their seriousness and that minor discrepancies be distinguished from major discrepancies. This must be done in the context of a fair and reasonable evaluation to the harm the discrepancy does to the business transaction

The guiding consideration must in all case be - it is unjust and to impose charges without Haq This is the case, as very often happens, where banks penalise the beneficiary / presenter for minor discrepancies – even where it has no negative effect on the business transaction for which the LC was issued. This failure to distinguish between minor and major discrepancies is unjustly presenters.

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For more details on the definition on each particulars see: M A Davis, *The Documentary Credit Handbook*, USA, 1988, P. 19 – 24.

The minor discrepancy should be passed over without penalties being imposed . We should in this stage implement the Maqasid of Shariah to address and resolve the problem. This is particularly recommended where there is zero risk to the bank from accepting the discrepancy. This applies where the bank acts strictly as agent for the importer who opens the LC against 100% cash margin. The client is taking all the risks , and the bank should not be entitled to impose a penalty where the importer accepts the documents with discrepancies.

Penalties / charges for discrepancies may be acceptable if the bank participates in the risk through committing it's funds for the issue of the LC. The bank is entitled to protect it's investment and need not tolerate discrepancies in the documents presented which can delay payment by the applicant or cause problems in clearing the goods. It is this participation in the risk that alone can entitle the bank to charge for discrepancies.

## **5. Implementation of Maslaha in documents required under the letter of Credit**

Basically there are some standard documents required in the LC, and usually the documents required are related to the type of the products – thus there are different requirements to be met for food products and non food products. However there are other additional documents which are required to satisfy the requirements of the importing country. Let us review some of the documents required in the LC and evaluate them under the concept of Maslaha in Islam.

### **A. Standard Documents**

These documents are common documents that the seller has no choice but to provide when he submits documents to the bank , these documents are generally required under letters of credit and it does not matter if the product is edible or non edible, industrial or non industrial. These documents are: Draft (bill of exchange), Commercial Invoice, Packing List, Certificate of Origin, Transport Documents (most of the time is: Marine/Ocean Bill of Lading).<sup>1</sup> These documents are primary documents and the seller is normally required to present them in compliance with the requirements of the LC. Seen from Islamic law perspective - these documents are a must to maintain the security and integrity of international trade and to ensure that all parties involved are able to transact business safely as it protects the interest of the parties involved.

### **B. Additional Document**

There are other additional documents required from the seller to ensure the cargo is received in good condition. Some of these are required from the applicant while the others are required from the government authorities / agencies who are alone authorised to issued these documents. Yet others are preferable or optional and for reassuring the buyer.

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<sup>1</sup> See some these documents required in the official LC from banks. See also: Charles Del Busto, *ICC Guide to Documentary Credit Operations For The UCP500*, International Chamber Of Commerce, 1994, P. 63-88.

If the laws / regulations of the importing country require these additional documents, the buyer has to indicate these among the list of documents which have to be presented to negotiate the LC and the shipper (buyer) will have to procure and present these documents to avoid non payment of the grounds of discrepancy of failing to furnish a complete set of documents.

The following are the usual additional documents : Inspection Certificate, Insurance Document, Radioactivity Analysis Certificate, Phytosanitary Certificate, Health Certificate, Shipping Certificate, Certificate of Analysis, Certificate of Quality and Weight, Marketing and Validity certificate, Chromatographic certificate.

It is advisable, in the interest of business, that the additional documents required are discussed between the parties – the seller and the buyer, before it is included as a condition to be met in the LC. This will prevent disagreements and additional costs and charges in the event that the seller is not in position to provide the said documents and the clause in the LC has to be amended. Some of the documents are not necessary to clear the cargo but preferable or optional,

and the absence of those document will not affect the business. In such cases, both parties are advised to prepare a draft of the LC requirements and iron out any problem areas before instructing the bank to issue the final LC. This will facilitate presentation of compliant documents and will benefit and be in the interest of both parties and there is here Maslaha for both of them.

With increased efficiencies and shorter periods to reach export destinations, in particular ports that are relatively close to Malaysia, cargoes inevitably reach the destination before the documents. Examples of such journeys are :- Port Klang (Malaysia) to Karachi (Pakistan), Port Klang (Malaysia) to Dubai and Port Klang (Malaysia) to Bandar Abbas (Iran). These voyages take an average of one week. Within this limited period it is very difficult to prepare and present a long list of documents -especially where official documents issued by government agencies are involved as there are formalities to be complied which are time consuming. The documents are sent as one set and the delay in obtaining some documents delays the dispatch of the set . This delay in the dispatch of documents puts the buyer in very vulnerable position. The cargo arrives before the documents. The importer (buyer) is unable to produce the bills of lading and in the case of food products the health and phytosanitary certificates necessary to clear his cargo and finds himself paying demurrage. The demurrage charges at some ports can be very high. This diminishes the profitability of the business and there are times when excessive demurrage payments wipes out profit and the importer suffers losses.

This is another occasion where the implementation of Maslaha is required to protect the business interests of the buyer. Governments should look into this matter as their own traders tend to loose out, and this, for no fault of their own. Measures should be implemented to streamline the operations and only those documents that can be provided within the short shipment period should be required. We have to look to the (Darar) Harm to the buyer, and in this case look at the matter from Al Maslaha point of



view and some of the Islamic rules related to (RAF Al Haraj) in solving the problems of all parties that stand to suffer harm.

## **SECOND PART**

### **Towards the Islamic letter of credit (ILC) (Infrastructures, Concept, Procedures, Implementation & Challenges)**

- 1. Introducing the Islamic Letter of credit to international trade.**
- 2. Global Infrastructure of the Islamic Letter of Credit**
  - a. Creation of the Islamic Business environment (IBE)**
  - b. Creation of the Global Islamic Bank Network (GIBN)**
  - c. Islamization of the major parties involved in the LC in non Islamic Banks (Issuing bank, Correspondence bank, negotiating bank, reimbursement bank, financing bank, confirming bank).**
  - d. Creation of the Global Islamic Bank Consul (GIBC)**
  - e. Creation of the International Islamic Chamber of Commerce and Industries (IICCI).**
- 3. The Islamic letter of credit: Concept and procedure**
- 4. Implementation of the Islamic Letter of credit in OIC members.**
- 7. Towards Global Implementation of the Islamic Letter of credit.**
- 8. Global challenges for the Islamic Letter of Credit**

## **1. Introducing the Islamic Letter of credit to international trade**

While there is an urgent need to implement the Islamic letter of credit in international trade, this should not be seen as problematic as several features in the proposed Islamic letter of credit are similar to the usual LC (meaning not compliant with the Shariah or Islamic requirements) and the key players, the banking and finance companies, will be comfortable with it.

It is important to note that the purpose of the implementation of the Islamic letter of credit is not to totally replace the letter of credit current in international trade with one that is wholly new and unfamiliar.

Our objective in calling for the implementation of an Islamic letter of credit is to bring all business transactions within the Islamic law. Given the central role of letters of credit in international trade, this cannot be achieved without extending Islamic legal requirements to letters of credit. The only difference between the usual LC and the Islamic Letter of Credit is that the ILC takes into consideration the requirements of Islamic law in banking, finance and business transactions. What this means is that the LC must comply with the rules and regulations and the Maqasi of Shariah. The Islamic LC that emerges will overcome the conflicting positions between the Shariah and letters of credit in international trade.

Islamic law is already being implemented by banks in finance companies in wide range of their activities and this permits all types of businesses, trading activities and investments to be done within the framework of Islamic Law. None of these have disrupted the business environment and have instead improved the business environment. The implementation of the Islamic letter of credit will likewise work within the existing business environment and contribute to its improvement.

### **Our objectives are :-**

- to introduce an Islamic product in banking and finance in domestic and international markets ;
- without replacing completely the existing LC, introduce changes that will bring it in compliance with Islamic Law ;
- to implement an Islamic letter of credit that has the same structure and whose major components are similar to the LC currently is use ;
- to implement an Islamic letter of credit that complies with Islamic law at all stages of it's implementation and in it's operational procedures ;
- to work on the common grounds – areas where the LC is not in conflict with Shariah laws ;
- through the implementation of the ILC attain justice and equity for all parties involved and ensure that charges and other payments are not unjust imposed;
- finally, impress on all parties that the introduction of the Islamic letter of credit and the practices that accompany its implementation will benefit not only the parties to the LC but business as a whole

## **2. Global Infrastructure of the Islamic Letter of credit**

We must appreciate that a global infrastructure is required to support an Islamic letter of credit. The components of this structure are as follows :-

### **A. Islamic Business Environment (IBE)**

The implementation of the Islamic Letter of credit is related to the business environment, we cannot talk about a workable ILC in domestic and international trade without creating an Islamic business environment for it, otherwise it will be very difficult to get an ILC which strictly complies with the Islamic Law.

The business environment is one where business in law and in practice conforms to Islamic law. The constitution of the business must be based on the Shariah, and all the rules and regulations which regulate business and trade must be sourced from Islamic law provisions. With this approach ILC procedures will comply with the Shariah and all the particulars contained in the ILC including the function of the parties involved will be within the requirements of the Shariah.

We understand from the above :-

- To establish the Islamic letter of credit, we are required to create an Islamic business environment. This will prevent conflicts between Islamic requirements in formulating the letter of credit and the text of the usual LC used by parties in international trade
- What we mean by an Islamic business environment is a state of affairs where all rules and regulations in trade and business are derived from Islamic law and the Shariah is the point of reference
- The Islamic business environment covers the activities of bank and finance and business and company law. The aim of the Islamic business environment is to meet in full the requirements of the Islamic law, and achieve a state where there is no conflict at all between the LC and the Shariah.

### **B: Creation of the Global Islamic Bank Network (GIBN)**

The LC is issued by banks or financial institutions and to ensure the issue and use of Islamic letters of credit we have to provide a global Islamic banking network. This is unavoidable as the LC process is conducted through banks, it is essentially a bank to bank transaction, starting from the issuing bank and proceeding to the advising bank, confirming bank, negotiation bank, reimbursing bank and with ECR transaction the financing bank.

Thus to facilitate the ILC, we are required to create a Global Islamic Bank Network to oversee the Islamization of banks involved in the LC, namely the issuing bank, advising bank, confirming bank, negotiating bank, financing bank, reimbursement bank. These parties are the major players and working under the auspices of the Global Islamic Bank Network can help the Muslim business community conduct international trade in strict compliance with the requirements of Shariah laws.

We can see from the above that :

- the creation of the Global Islamic Bank Network (GIBN) is vital to ensure processing of letters of credit within the framework of Islamic legal requirements ;.
- the Global Islamic Bank Network (GIBN) will control the Islamization of the major party involved in the LC (Issuing Bank, advising bank, confirming bank, negotiating bank, financing bank, reimbursement bank, ) ;
- The Global Islamic Bank Network (GIBN) protects the ILC from any conflict with the Islamic law.

### **C: Islamization of the major parties involved in the LC in non Islamic Bank**

The principal banks involved in LC transactions are, as mentioned, the Issuing bank, advising bank, confirming bank, negotiating bank, financing bank and reimbursement bank.

In order to ensure a clean Islamic letter of credit we should take advantage from the new approach of these banks in providing a window for Islamic banking . We should try to negotiate with them the Islamic approach in handling letters of credit to minimize the conflict between the Letter of credit and the Islamic requirements.

### **D: Creation of the Global Islamic Bank Consul (GIBC)**

We propose setting up a Global Islamic Bank Consul (GIBC). This is essentially a committee of experts who control the process of the ILC and make sure that it is established and processed within the requirements of Islamic law. Each bank in the Global Islamic Bank Network (GIBN) must have a supervisor from the GIBC to follow up the LC transaction to ensure that it complies with Islamic requirements

Summary of the above :-

- Creation of the Global Islamic Bank Consul (GIBC) is an initial step to control the process of the ILC.
- The Global Islamic Bank Consul operates worldwide and works with the Global Islamic Bank Network to ensure the Islamization of the LC.
- Each bank member of the Global Islamic Bank Network (GIBN) is required to have a legal and Shariah supervisor from the Global Islamic Bank Consul (GIBC) to follow up on ILC to ensure compliance with proper procedures

### **E: Creation of the International Islamic Chamber of Commerce and industries (IICCI).**

It is strongly recommended to have an international Islamic body in form of the Islamic International Chamber of Commerce and Industries to oversee the international operation of the LC and develop standard banking requirement of the LC.

To summarize the above :-

- The creation of international Islamic body in form of International Islamic Chamber of Commerce and industries (IICCI) is recommended ;
- This organization will create and circulate international Islamic standards for International Islamic Trade ;
- This organization will create the international Islamic banking standards, or modify the existing UCP 500 (uniform Custom Practice) and the International Standard Banking Practice (ISBP);
- All the new issues will be referred to the new organization which will provide a forum for discussions and clarifications on the ILC and international trade generally.

### **3 The Islamic letter of credit - Concept and procedures**

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

Further, these five major Islamic business transactions can accommodate the different types of LC transactions currently in use.

These Islamic contracts can serve as the platform for implementation of the Islamic letter of credit in the international trade. In addition the provide for a professional approach and straightforward procedures for Islamic banking operations.

#### **A. Interpretation of the Islamic letter of credit according to the concept of the Al – Wakalah**

Under Al Wakalah, the bank will act on behalf of its client who will authorize the bank to represent him in issuing the letter of credit and all it's subsequent operations. This includes the terms of the letter of credit that is issued and checking for compliance of documents when a payment claim is made. The bank receives payment/ commission or Ujra for the services provided. The role of the bank in the Al Wakalah is permitted in Islam.<sup>1</sup>

The essence of an Al Wakala is as follows :

- The customer informs his bank to open the LC and authorizes it to act on his behalf under the Wakalah concept ;
- The bank issues the LC according to the instructions and the advice of its client and according to the terms and conditions agreed upon as found in documents confirming the sale provided by the client ;
- The bank will charge its client fees as commission or (Ujra) for the services rendered ;

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<sup>1</sup> See: الموسوعة العلمية والعملية للبنوك الإسلامية، ص503

- The bank will request payment towards the issue of the letter of credit. The amount paid will be subject to the agreement between the bank and their client. It can vary from the full amount or a nominal deposit depending on the business relationship between the bank and their client ;.

This is a straightforward LC operation done in accordance with Islamic legal requirements based on the well know principles of Al Wakalah.<sup>1</sup>

## **B. The Islamic letter of credit under Al Murabahah**

In an LC linked to Al Murabahah, the Bank at the request of their client imports goods for him through an LC established to the seller with whom the buyer has a contract. The bank utilizes its own funds to open the LC and the terms of the LC are in accordance to the terms agreed between the seller and the buyer. By doing this it assists their client to purchase the goods he requires without having to immediately commit his own funds. Applying the Al Murabahah contract, the bank in turn sells the goods to their client at the price agreed upon, which includes the banks profit. Depending on the terms of the Al Murabahah, payment can be prompt or deferred. LC operations built on the Al Murabahah contract is permitted by Islamic law.<sup>2</sup>

## **C. The Islamic letter of credit under Al Musharakah**

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

The details of this arrangement are as follows :-

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

<sup>1</sup> For more details on Al Wakalah see: , Sheikh Ghazali Sheikh Abod, Syed Omar Agil, Aidit Hj. Ghazalli, *An Introduction to Islamic Economics & Finance*, P, 321.

<sup>2</sup> For more information on Al Murabahah see:

حاشية الدسوقي على الشرح الكبير، ج3، ص159 وما بعدها. ومن الدراسات المعاصرة: بيع المرابحة وتطبيقاتها المعاصرة في المصارف الإسلامية (دمشق: دار الفكر، ط1، 1425هـ، 2004م)، ص93 وما بعدها. المتطلبات الشرعية لصيغ الاستثمار والتمويل (هيئة المحاسبة والمراجعة للمؤسسات المالية الإسلامية، 1421، 2000م)، ص14-25.

Sheikh Ghazali Sheikh Abod, Syed Omar Agil, Aidit Hj. Ghazalli, *An Introduction to Islamic Economics & Finance*, P, 322.

An LC opened on Al Musharaka is permitted in Islam.<sup>1</sup>

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

Under the concept of the Al Daman (Guarantee) the Bank guarantees the payment obligations of the applicant. The seller ships the goods against the guarantee of payment by the Bank. The actual transaction is along the lines of a letter of credit but the document contains within it the guarantee from the Bank and it is the financial standing of the Bank and not the buyer that is relied upon by the seller.

Under this LC :-

- (a) the applicant requests his Bank to provide a letter of guarantee under the Al Daman concept;
- (b) the bank proceeds to establish a letter of guarantee thus permitting the applicant to conclude his business with the seller;
- (c) the letter of guarantee has the form of an LC and subject to the terms of the LC the Bank pays the seller thus discharging its responsibility;
- (d) the Bank may request the applicant to place a deposit for this facility under the agreement between them;

the bank charges the applicant a fee for the services.

Charges for the service of providing a guarantee is allowed in Islam and an LC issued on the strength of a Bank guarantee is permitted in Islam.<sup>2</sup>

#### **E. The Islamic letter of credit under Mudarabah:**

Basically Al Mudarabah is a contractual relationship between two parties where the first party (can be one or a number of persons) provides the capital and the other party (again one or more persons) runs the business with the profit shared at an agreed rate.<sup>3</sup>

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

By applying this Islamic concept we can offer a solution to what lies at the core of the problem in the current practice of letters of credit. We can rid the system of interest /

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<sup>1</sup> For more information on Al Musharakah see:

الحصني، كفاية الأخيار، ج1، ص271-273. حاشية الدسوقي على الشرح الكبير، ج3، ص348 وما بعدها. ابن قدامة، المغني، ج5، ص109 وما بعدها. ابن حجر الهيتمي، تحفة المحتاج بشرح المنهاج، ج2، ص313. السرخسي، المبسوط، ج11، ص162 وما بعدها. Sheikh Ghazali Sheikh Abod, Syed Omar Agil, Aidit Hj. Ghazalli, *An Introduction to Islamic Economics & Finance*, P, 321.

<sup>2</sup> For more details on Al Daman see:

ابن قدامة، المغني، ج5، ص55. السرخسي، المبسوط، ج19، ص194 وما بعدها.

<sup>3</sup> Sheikh Ghazali Sheikh Abod, Syed Omar Agil, Aidit Hj. Ghazalli, *An introduction to an Islamic economic and finance*, p. 254.

riba levied on funds provided by the banks. This is to be replaced with a profit sharing arrangement.

#### **4. Implementation of the Islamic letter of credit among OIC members.**

Islamic transactions, with emphasis in our case on those which support letter of credit operations, are not widespread. The methodologies have to be fine tuned through practice. Problems arising in practice must be addressed and resolved. It is suggested that for a start the Islamic letter of credit be introduced in OIC countries. This will provide a real life scenario to validate/rectify/improve the modalities and we will in time have viable letter of credit operations that strictly comply with the Shariah..

Thus, it is of utmost importance that :-

- The implementation of the Islamic letter of credit should start with the OIC members.
- The implementation of the Islamic letter of credit among OIC members will provide the platform to meet challenges that emerge in a real life scenario and build a body of precedents to fine tune the Islamic LC and put it on a firm footing

#### **5. Towards Global Implementation of the Islamic Letter of credit.**

Our objective is to implement worldwide the Islamic letter of credit. The availability and the practice of the Islamic letter of credit should not be restricted only to the Muslim community. The Islamic letter of credit has elements within it that will benefit the business community generally and introduce into business practices that are more equitable and contribute to the betterment of society as a whole.

Thus, any strategic planning for Shariah based letters of credit must be global in its reach and position the Islamic letter of credit as a wholly Islamic product. In time it will be seen as Islamic contribution to improving and enhancing international trade.

The Islamic approach is clearly more dynamic as it works through a co-operative relationship between the owners of capital and businessmen and industrialists to establish among them an equitable relationship while earning profits for both.

#### **6. Global challenges for the Islamic Letter of Credit**

We have to appreciate the serious challenges we will face in promoting worldwide the Islamic letter of credit. The Islamic product in finance and banking which we are promoting can seriously undermine financial and banking practices as it will be a more equitable system.

We will face objections to a letter of credit that is based on purely Islamic concepts and which derives its regulations and rules from Islamic law. We will have to face the difficult task of convincing banks and business communities from very different backgrounds and business practices to accept a scheme that they may not be familiar with.



Targeting the global community will have to be done under the following difficult conditions :-

- The global environment in banking and finance is not entirely suitable for the Islamic letter of credit. Leading banks and financial institutions that must take the lead are controlled by non Muslims and they are not interested to implement Islamic law in the international trade ;
- Current standards in many Islamic banks and finance companies are not upto to international standards ;
- The implementation of the Islamic letter of credit needs an international Islamic body with specializations in all the different areas of banking and finance, in Islamic law and other related specializations to enable the building of a comprehensive framework, rules and regulations which can be the basis for the implementation of the Islamic letter of credit and ensure that in all aspects it complies with the requirements of the Shariah.
- The network of Islamic banks is not sufficiently widespread and unless it extends it's reach to include all if not most countries it clearly will not be possible to promote Shariah based letters of credit on a global scale.

### **Conclusion**

In conclusion, we recommend the following:

- More work and effort be directed towards creating a Islamic business environment
- The Global Islamic Bank Council is requested to set up a Global Islamic Bank Network (GIBN)
- Establish an International Islamic Chamber of Commerce with national committees in all Muslim countries and entrust them the duty of formulating and bringing into effect a new Islamic Uniform Customs and Practice (IUCP), and subsequently, from the practice of banks in the use of the IUCP publish the International Islamic Standard Banking Practice (IISBP) as a guide to interpretation of the IUCP
- Implementation of the Islamic letter of credit among OIC members through Islamization of the LC usages of the major parties involved - issuing bank, correspondence bank, negotiating bank, reimbursement bank, financing bank and confirming bank)
- Introduction and Implementation of the Islamic Letter of credit globally