Issues of Letter of Credit in Malaysian Islamic Banks

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Abstract: This paper discussed the prevailing issues currently faced by Islamic banks on the offering of Letter of Credit (LC), originally brought forward by the International Chamber of Commerce, using Shariah contracts and puts forth recommendations on practical solutions to solve the issues. The study adopted a qualitative method where the information on the issues of Islamic LCs was gathered throughout interviews with different bankers closely involved in LC issuance from 12 Islamic banks in Malaysia. The results indicate that there are three vital issues related to LCs offered by Islamic banks which lead to Shariah non-compliance issues. The issues revolve around the conversion of LC Wakalah (agency) to LC Murabahah (cost-plus), the existence of a sale contract between the customer and exporter and lastly the title of goods stated in the bill of lading. The findings recommend several solutions in relation to LCs within the underlying Shariah contracts to ensure that their operation complies with the Shariah requirements and Malaysian laws, standards and regulations. This paper highlights the issues of Islamic LC yet to be discussed thoroughly based on the views of a panel of experts and Islamic bankers.

Keywords: issues; letter of credit; Islamic banks; Islamic finance; Malaysia

1. Introduction

Global Islamic finance assets are forecasted to reach USD 3.69 trillion by 2024, according to the 2020 Islamic Finance Development Report released by Refinitiv and the Islamic Corporation for the Development of the Private Sector. Correspondingly, global Islamic finance assets increased by 14 percent year-on-year to USD 2.88 trillion in 2019, with the Gulf Cooperation Council (GCC) reaching USD 1.2 trillion, followed by Middle East and North Africa at USD 755 billion (excluding the GCC), and Southeast Asia recording USD 685 billion (The Star, 11 December 2020). Undoubtedly, Islamic banks (IBs) have been able to launch their status in the global financial industry due to the Shariah-compliant outlook of their products and services. Significantly, the products and services rendered by Islamic financial institutions need to comply with the requirements of Islamic laws, in which they must be free from riba' (interest), gharar (uncertainty), and maysir (gambling). Islamic banks need to improve their institutional reputation and image through Shariah compliance quality, which is the distinctive attribute that sets them apart from their conventional counterparts (Alam et al. 2021). Alam et al. (2021) also outlines in his study the way Shariah Governance mechanisms affect the standard of Shariah compliance and the effectiveness of Islamic banks.

One of the products offered by financial institutions is the Letter of Credit (LC). LC is considered a trade-bill product that is commonly offered in conventional banks, as well as Islamic banks. LC protects the interests of both the seller/exporter and buyer/importer as it facilitates international trade, hence, it is a prevalent device and reliable instrument for the payment of raw materials, stock and inventories on intermediate goods (Teoh 2016;

Horowitz 2010). LC is a written undertaking by a bank, provided to a seller (the beneficiary) at the request, and on the instructions of the buyer (the applicant), to pay at sight (cash) or at a determinable future date (usance) to a stated sum of money within a prescribed time limit. Nevertheless, the documents submitted to the issuing bank should fulfill the terms and conditions of the credit (Teoh 2016; Luk 2011; Kit and Loghandran 2003). The buyer/importer's bank, on the other hand, is the issuing bank or the paying bank which verifies the documents submitted in order to issue the LC for the customer and make a payment to the seller/exporter (Teoh 2016; Luk 2011; Pang 2000). Since LC was introduced by the International Chamber of Commerce, the governing rule for both Islamic and conventional LC is the Uniform Customs and Practice for Documentary Credits (UCP) where the latest version is UCP600 (ICC International Chamber of Commerce 2018; Muhammad and Ahmed 2016; Syed Alwi et al. 2013). However, Syed Alwi et al. (2013) highlighted the Shariah issues arising in a few Articles of the UCP 600 once they became the governing rules of LC Wakalah (agency) and LC Murabahah (cost-plus). For example, Articles 5 and 7 of UCP 600 mention clearly that LC transactions should be solely based on documents. This implies that there would be no need for the bank which issues LC to check on the existence and condition of the goods traded. In the case of LC Murabahah, where the Islamic banks become the owner of the goods, and LC Wakalah, where the bank is the agent for the customer, Islamic banks are supposed to be responsible for the condition of the goods to be traded and delivered in LC transactions. Thus, it is not easy for Islamic banks to offer LC based on Islamic principles (LC-i) due to the restriction over the observation implied by the UCP 600 as the governing rules and also the need to abide to Shariah requirements.

Conversely, Islamic banks in Malaysia are governed by the Islamic Financial Services Act 2013 (IFSA 2013) under the Laws of Malaysia and consequently, need to abide by the decisions made by the Shariah Advisory Council of Bank Negara Malaysia (BNM) concerning the products and services offered. Furthermore, they need to conform correspondingly to their own respective Shariah Advisory Committees established within their Islamic financial institutions (Yaakob and Abdullah 2015). Subsequently, the decisions made by the Shariah Advisory Council of BNM are published on the BNM's website for reference under the Resolutions of Shariah Advisory Council of BNM (BNM 2017a). Simultaneously, BNM also issued a few standards and guidelines on Shariah (Islamic laws) contracts to be used in Islamic banks with the most prominent standard being the Murabahah Standard (BNM 2017b). Other than IFSA 2013 and the standards outlined, there is also the governing framework for Islamic financial institutions, namely the Shariah Governance Framework (SGF) 2011 where in its latest version, the Shariah Governance Policy Document 2019, Islamic banks' responsibilities and accountability in issuing Islamic facilities and services are highlighted and further enhanced (BNM 2019).

Shariah non-compliance issues may possibly be confronted by those Islamic banks which do not comply to all the rules and regulations established by Bank Negara. The Shariah non-compliance (SNC) risk is defined as "The risk that arises from the bank's failure to comply with rules and principles determined by the relevant Shariah regulatory councils" (Islamic Financial Services Board (IFSB 2016)). Indeed, Shariah compliance is the main ingredient and the predominant factor in operations of the Islamic financial institutions. Business and operations may lead the Islamic bank to be exposed to the risk of non-compliance, and failure to adhere to the Shariah principles and values when carrying out financial activities (Yaakob and Abdullah 2015). It was stated that " . . . any person who contravenes or disregards the subsection (1) or subsection (3) of Section 28 of IFSA 2013, commits an offence and shall, on conviction, be liable to imprisonment for a term not more than eight years or a fine not more than twenty-five million ringgit or be subject to both penalties" (IFSA 2013). IFSA 2013 introduced end-to-end Shariah compliance regulatory framework for Islamic Financial Institutions. The act was enacted to provide: (i) The comprehensive regulation and supervision of Islamic financial institutions, payment systems and other relevant entities in Malaysia to ensure all the activities, product and services offered comply with Shariah laws. (ii) The oversight of the Islamic money market

and Islamic foreign exchange market. (iii) The promotion of financial stability and Islamic Financial Institutions' compliance with Shariah laws and principles.

Islamic banks are under pressure to design products with favorable characteristics from a business standpoint because they compete in highly competitive marketplaces. Replicating the conventional products using approaches from legal and financial engineering is a simple way to achieve this. While doing so satisfies economic and market requirements, it occasionally comes at the expense of diminishing the basic tenets of Shariah. However, using items that undermine or violate Shariah principles can be costly for Islamic banks. Any money earned from transactions that are not Shariah compliant is immediately excluded from the bank's revenues and donated to a charitable organization. Thus, a bank's income and profitability may suffer as a result of non-compliance with Shariah. In the long-term, the view of stakeholders about Islamic banking practices can be significantly impacted by the dilution of Shariah principles, leading to a significant loss of confidence and credibility. Shariah non-compliance might place the Islamic financial sector at risk of instability and lead to bank failure because the majority of customers use Islamic banks for religious reasons (Ahmed 2014; Qattan 2006).

2. Background

2.1. Issues in the LC in Islamic Banks

Based on the interviews with the many bankers from their respective Islamic banks in Malaysia, there are only two Shariah contracts used for LC at the moment, namely wakalah (agency) or murabahah (cost-plus). For Islamic financing, murabahah is the most popular contract and has been used in 75% of all transactions (Tlemsani et al. 2020). According to Mr. Z of ABC Bank (personal communication, 10 November 2018), the Islamic banks in Malaysia previously offered LC based on a musyarakah (joint-partnership) contract but this is no longer offered due to the high risk related to the offering of the contract. Islamic banks will issue LC upon the customer's request and credit worthiness. In situations where the customer, who is the buyer/importer, has money and wants to use his own funds to pay the seller/exporter, an LC Wakalah product is offered to the customer and fees or commission will be charged by the bank for issuing the LC (Muhammad and Ahmed 2016). The principle of wakalah bil ujrah (fee-based agency) is applied whenever the Islamic banks want to charge fees or commissions to their customers (Naim and Zainol 2015). On the other hand, LC Murabahah is offered to customers who have no money or funds to pay the seller/exporter. In LC Murabahah, the customer is appointed as the purchasing agent for the goods by the Islamic bank which is the owner of the goods required by the customer. Once the documents of the goods reach their issuing banks, the goods will be sold to the customer at a selling price comprising the cost and profit margin using the contract of murabahah (Muhammad and Ahmed 2016; Borhan 2005).

Therefore, this study attempted to discuss issues on LC Murabahah or LC Wakalah based on the interviews conducted with bankers from Islamic banks. Murabahah is a contract of sale and certainly not a mode of financing; however, if it is used as a mode of financing in LC Murabahah, it has to meet specific Shariah requirements. The Islamic bank has to be involved in the selling and purchasing of tangible assets instead of being a creditor that extends the loan to the customer (Lahsasna 2014; Usmani 2005). For instance, a murabahah contract between the bank and the customer can only be executed after the bank has completed the purchase of the good from the original seller. Additionally, an Islamic bank cannot be the owner of the goods in the event that the customer (as the importer) has initially purchased the goods from the exporter before approaching the Islamic bank for financing (Lahsasna 2014).

In addition, according to Mr DEF of XYZ Bank (personal communication, 23 June 2018), sometimes the banker does not detect the Shariah issue that he/she encounters in LC Murabahah and LC Wakalah due to the lack of Shariah understanding in implementing LC. For example, the bankers in some Islamic banks permit the conversion of LC Wakalah to LC Murabahah in situations where the customers fail to make payments to the banks.

This conversion is not permitted according to Shariah because of the difference in nature of the two contracts of wakalah and murabahah. Another LC Murabahah practice that could raise Shariah issues according to Mr DEF of XYZ Bank is when a customer applies for financing at the bank but has already executed a sale contract with the supplier or exporter. Can the Islamic bank still provide the customer with LC Murabahah in this situation as the bank is unable to retain ownership of the goods because the customer already owns them? In a situation where a customer asks for LC Murabahah, Mr. DEF of XYZ Bank said that the Islamic banks usually accept the sale contract or proforma invoice without fully understanding the differing effects of the two documents on the financing contract for LC Murabahah. The title on the Bill of Lading, which should use the name of the customer instead of the bank, was the last issue raised by Mr. DEF of XYZ Bank on LC Wakalah.

Consequently, Islamic banks which offer LC through the underlying contracts based on wakalah and murabahah must fulfill all the Shariah requirements to avoid the consequences, especially Shariah non-compliance issues even though the operational mechanism of Islamic LC is very much similar to the conventional LC. Hence, the main contribution of this paper is to discuss the misconception of LC practices from Islamic perspectives, and to propose a practical solution to the issues faced by LCs based on the underlying contracts of murabahah and wakalah. The main issue of Islamic LC pertains to the practice of LC Murabahah as there is a concern that the implementation of murabahah in Islamic banks may lead to interest-based transactions if it does not fully satisfy the Shariah requirements of al-bay' (sale) (Lahsasna 2014; Abdul Rahman et al. 2014; Siddiqi 1983).

This study aimed to close the research gap by interviewing bankers at Islamic banks to see how they address the issues related to Islamic LC that were identified in previous literature and by communicating directly with the bankers who engage specifically with the products. Where suitable, this study proposed some practical solutions to the issues.

The remainder of this study is outlined organized as follows. The following section presents details on the concept of LC from conventional and Islamic perspectives. Subsequently, the research methodology is then specified in the next section. Following the research methodology, the findings of the analysis and discussion of the research are presented. Lastly, the concluding section ends the study by indicating the research conclusion, research recommendations and practical implication of the study.

2.2. Letter of Credit in Conventional Banks

The UCP 600 defines the letter of credit as follows: "Credit means any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation" (Uniform Custom and Practice", No. 600 of the International Chamber of Commerce 2007). The use of letters of credit is vital in facilitating international trade due to the nature of international business transactions, as well as other components including distance, distinctive laws in respective countries, and the problem of recognizing those parties involved in business transactions (Al-Kilani 2009). Therefore, both parties of the sale contract could possibly decide to pay the price of the product through a letter of credit to mitigate the complications they may encounter. Nonetheless, a commitment, usually by a bank on behalf of a client, is made to pay a beneficiary, such as a supplier of goods, a stated amount of money under specified conditions such as upon shipment of the goods. It is a form of financial guarantee protecting the buyer's risk and guaranteeing payment to the seller; the bank will only make payment upon presentation of proof of shipping and other stipulated documents, which complies with the terms and conditions of the LC. The term letter of credit is generally employed in international trade, as it is the most frequently utilized system of payment by sellers and buyers in their sales contracts (Hashim et al. 2012).

Usually, the buyer releases a letter of credit through a bank with the seller's approval beforehand; in order for the seller to transmit the goods, they have to confirm the transaction. Consequently, the seller will obtain the confirmation that he will accept the goods' price from the bank, as the bank pledges to be responsible for sending money once the bank

issues the LC. Nevertheless, the bank needs to be assured that the buyer can support the payment. Thus, the buyer is responsible for depositing funds with the bank before the bank issues the LC, or the bank might arrange financing for the buyer as part of the LC. Indeed, once the bank issues the LC, the bank then makes a pledge, hence, the bank is liable for sending the money. The LC is a guarantee that the issuing bank is responsible for the payment to the advising or confirming bank, which makes it secure for sellers. Figure 1 illustrates the procedure of LC in the conventional space where the issuing bank is originally the medium of payment to the exporter on behalf of the importer through the advising or confirming bank.
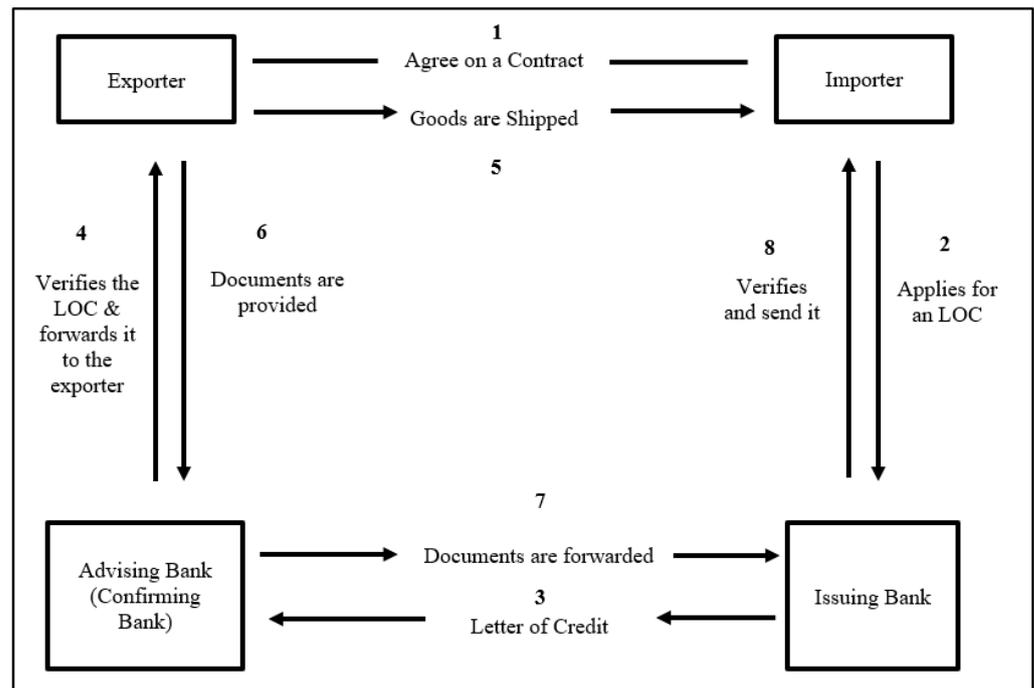
Figure 1. A process flow of the operation of LC Conventional. Source: Drip Capital https://www. dripcapital.com/resources/blog/letter-of-credit-lc (accessed on 4 January 2020).

2.3. Letter of Credit in Islamic Banks

The common underlying Shariah contracts for LC offered by Islamic banks in Malaysia are murabahah and wakalah. For LC Wakalah, the bank acts as a paying agent on behalf of the customer, hence the bank is entitled to a fee for the service known as a fee-based income. While in LC Murabahah, the bank acts as a seller to sell the goods at a mark-up price to the customer. Thus, LC Murabahah is entitled to the selling price known as a fund-based income. A contract of sale based on murabahah refers to the selling and purchasing of an asset or goods where the acquisition cost and the mark-up price are disclosed to the purchaser (BNM 2017b). Thus, LC Murabahah is offered to the customer in the event that the customer is in need of funding from the bank. In the case of LC Murabahah, firstly, the customer is supposed to act as the purchasing agent for the bank. Secondly, the bank pays the price of the asset or goods to the exporter through the advising/negotiating bank and sells them at a price consisting of a cost plus a profit margin to the customer. Lastly, the price must be settled upon by the customer (Muhammad and Ahmed 2016). Figure 2 illustrates the process flow of the operation of LC Murabahah.

In the case that the customer has his own funding and requests LC issuance, the Islamic bank will offer LC Wakalah in which fees or commission will be charged to the customer (Muhammad and Ahmed 2016). The full amount to be paid to the exporter through the advising/negotiating bank has to be deposited with the Islamic banks under the principle of trust (amanah). The process flow of the operation of LC Wakalah is depicted in Figure 3.

Basically, the operation of LC Wakalah is similar to conventional LC. In LC Wakalah, the Islamic bank serves as an agent that handles the payment between the importer and exporter and does not finance the transaction (Muhammad and Ahmed 2016).
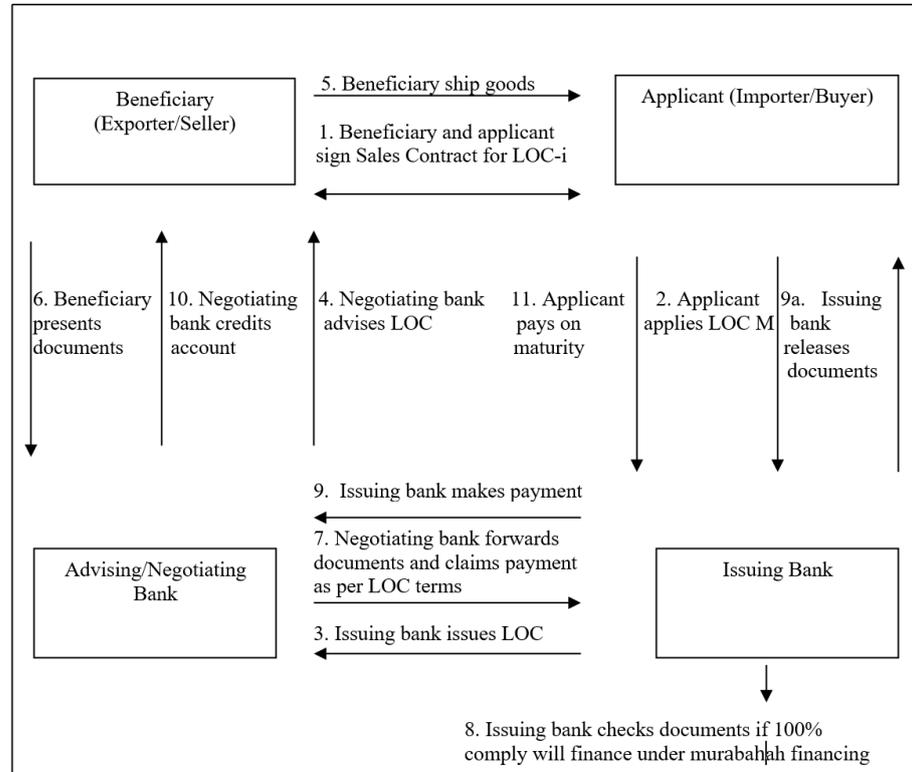
Figure 2. The process flow of the operation of LC Murabahah.
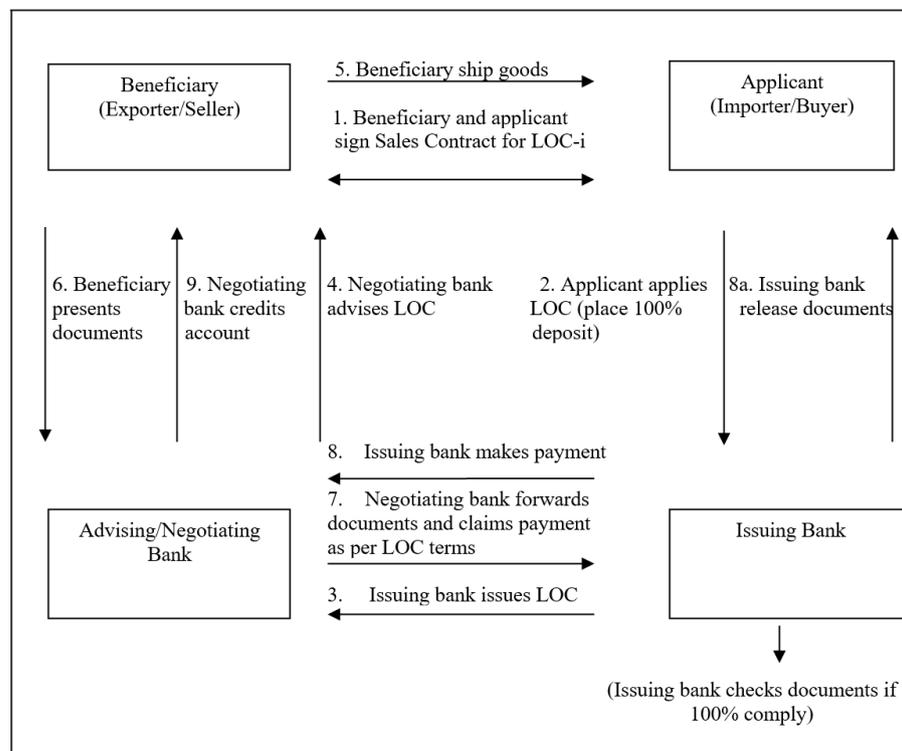
Figure 3. The process flow of the operation of LC Wakalah.

Based on the above explanation on the background of this paper, the Shariah point of view on the issues of Islamic LC has to be clarified among bankers and customers. Since LC is an ICC product, this paper aimed to discuss the issues faced by Islamic banks while providing LC Murabahah or LC Wakalah. In order to prevent Shariah non-compliance, this study also aimed to propose practical solutions to issues in Islamic LC that are in line with the requirements of Shariah.

3. Methodology

This study was an exploratory study which sought to investigate issues on LC within the contract of murabahah and wakalah adopted by Islamic banks in Malaysia. These issues arose in light of the previous literature and an interview session with senior bankers who work in Islamic banks' LC Wakalah and Murabahah operations. A qualitative design was employed and interviews were conducted with twelve Islamic banks offering LC services. Significantly, the collection of information for this research was based on 12 semi-structured interviews conducted mainly as face-to-face interviews. The difficulty in securing the cooperation of 16 Islamic banks in Malaysia for the study's interviews was the greatest limitation to its success. Only 12 Malaysian Islamic banks consented to take part in the study and share their experiences of managing LC Wakalah and Murabahah. Certain banks lack professionals in Islamic LC who are qualified to respond to any questions about LC, which is was the fundamental cause of the rejection.

The Islamic banks involved in this research are Affin Islamic Bank Berhad, MBSB Bank Berhad, Bank Islam Malaysia Berhad, Alliance Islamic Bank Berhad, Bank Muamalat Malaysia Berhad, RHB Islamic Bank Berhad, Al Rajhi Banking & Investment Corporation (Malaysia) Berhad, CIMB Islamic Bank Berhad, Maybank Islamic Berhad, Kuwait Finance House (Malaysia) Berhad, HSBC Amanah Malaysia Berhad, and Standard Chartered Saadiq Berhad. However, the Islamic banks' and the staff's identity were not disclosed in the analysis, rather each of the banks were identified as Bank 1 to Bank 12, respectively. The interviews were conducted with the staff who act as managers and are directly involved in the offering of Islamic LC facilities within their respective banks. Other than obtaining the information directly from the bank managers, websites, brochures and prospectus were also inspected to understand the applied Shariah contracts, process of the LC operation and the documentation required for the LC and the issues related to it.

The interview sessions with the managers in their respective banks were conducted by the researchers. All of the managers' interview questions were developed with the research objective in mind, which was to discuss the current issues associated with the provision of LC in Islamic banks since it is an ICC product. The questions were designed such that the managers could respond to them according to the LC Wakalah and LC Murabahah standards used by their respective banks. Some of the managers also provided justifications for the practices used by their banks. Next, all the conversations during the interview sessions were transcribed and analyzed using content analysis, a research tool for the subjective explication of the information through the systematic categorization of coding and the identification of themes, patterns or subject matter (Hsieh and Shannon 2005). As the primary source for the issues addressed in this study, the study compiled all the transcriptions from the interviews with the managers who provided information. Personal communication is a term used to describe this sort of qualitative data collection where an individual is interviewed. There were two potential types of informants involved in the qualitative research; some informants allowed the researchers to reveal their identities while some of them preferred to remain unidentified or anonymous. However, all of the informants in this research preferred to remain anonymous regarding the information they shared in order to avoid future disputes. Thus, the informants were marked as R1 to R12, respectively. All the information gained from the interview on the issues of LC is detailed and discussed in this paper.

The information gathered from the interviews and other bases was classified according to the preferences indicated in the interview involving issues on LC practices among the

Islamic banks. Subsequently, this phase is recognized as pattern coding, where information is divided into segments. Pattern coding is practical because it allocates a large amount of information to a smaller number of the analytical units, and allows researchers to understand the analysis during the collection of information, in order to best utilize the results of the fieldwork (Miles and Huberman 1994). The overview of all the answers to the interview questions is apportioned into subsections as exhibited in the next section under the issues on the practice of LC Wakalah and LC Murabahah. The researchers discussed the issues from Shariah and operational perspectives after all the issues had been brought up with the participants and their responses had been gathered. In order to assist the Islamic banks to avoid Shariah non-compliance, certain practicable solutions are proposed for resolving the LC Wakalah and LC Murabahah issues.

4. Findings

Based on the interviews conducted with the recruited bankers from Islamic banks in Malaysia, a few issues were identified on the practice of LC Murabahah and LC Wakalah.

4.1. Issue 1: What Is the Shariah Issue That May Arise When LC Wakalah Is to Be Converted to LC Murabahah in the Middle of LC Issuance?

The twelve Islamic banks in Malaysia have different ways of offering the different types of LC. Three methods can be observed in Table 1 in terms of how Islamic banks in Malaysia offer the LC facility. The first is where the Islamic banks offer both LC Wakalah and LC Murabahah. Six out of twelve Islamic banks practice this setting. The second method is where five Islamic banks offer only LC Wakalah. In the third, only LC Murabahah is offered by a bank to the customer.

Table 1. Islamic Banks in Malaysia and the Types of Letter of Credit Offered.

No.	Name of the Banks	LC Wakalah	LC Murabahah	Bankers' Identification
1.	Bank 1	Yes	Yes	R1
2.	Bank 2	Yes	Yes	R2
3.	Bank 3	Yes	Yes	R3
4.	Bank 4	Yes	Yes	R4
5.	Bank 5	Yes	Yes	R5
6.	Bank 6	Yes	Yes	R6
7.	Bank 7	Yes	No	R7
8.	Bank 8	Yes	No	R8
9.	Bank 9	Yes	No	R9
10.	Bank 10	Yes	No	R10
11.	Bank 11	Yes	No	R11
12.	Bank 12	Yes, but not offered to customer	Yes	R12

According to R1, R2, R3, R4, R5 and R6 during the interview sessions, most of the Islamic banks offer both LC Wakalah and LC Murabahah as outlined in the first method. In LC Wakalah, the bank only acts as a paying agent for the customer when the customer is required to deposit 100% of his own money to the bank to be paid to the seller/exporter using the LC facility issued by the bank. On the other hand, LC Murabahah is offered to the customer in situations where the customer does not have money and requires financing from the bank. Prior to the initiation of murabahah between the bank (seller) and the customer (buyer), the bank's ownership of the goods is established. Therefore, the customer is appointed by the Islamic bank as its purchasing agent to buy the goods

from the seller/exporter for the bank. Upon completion of the purchase evidenced by the documents of the goods received by the bank, the goods are subsequently sold to the customer at a mark-up price, which will be payable on a deferred basis. Either one of the two Islamic LCs will be offered to the customers based on the bank's evaluation of their request and credit worthiness. It is easier for Islamic banks to offer both types, LC Wakalah and LC Murabahah, to their customers for them to select from.

For the second setting where the Islamic banks only offer LC Wakalah, R7 from Bank 7 (personal communication, 20 May 2018) emphasized that some Islamic banks offer LC Wakalah based on its nature as the method of payment and settlement for international trades and not a mode of financing. If the customer requires financing, the Islamic bank will offer a murabahah contract separately. One of the bankers, R8, from Bank 8 (personal communication, 19 August 2018) shared his experience in international trade where some customers only wanted Islamic banks to issue LC to facilitate their needs and did not require the financing. Therefore, Islamic banks may offer LC purely based on a wakalah basis.

For the Islamic bank that offers only LC Murabahah as depicted in the third setting, the execution of the murabahah contract occurs when such a service is granted to customers who need financing/funding for the settlement. R12, an officer of Bank 12 (personal communication, 3 September 2017), explained that the appointment of the customer as a purchasing agent is finalized at the beginning of the process. In LC Murabahah, the Islamic banks offer murabahah financings such as a Murabahah Trust Receipt, Murabahah Working Capital Financing or Trade Murabahah Working Capital Financing to the customer if he needs financing. However, the financing will not be granted to the customer in the case where the customer suddenly notifies the Islamic bank that financing is no longer needed since he has sufficient funds to make the full settlement. The LC Murabahah will be cancelled and replaced with an LC Wakalah service which allows the bank to authorize the process of making a payment to the exporter using the customer's money. R12 emphasized that by offering just LC Murabahah, it is very unlikely for the customer to be able to convert his LC Wakalah to LC Murabahah. The customer will not be offered the LC Wakalah, but the Islamic bank will use it in the event that it is required.

R12 also shared the experience of some Islamic banks facing Shariah issues due to offering both LC Wakalah and LC Murabahah. There were cases where some customers initially requested LC Wakalah from the Islamic bank assuming that they had enough funds to pay for the LC. However, when the documents arrived and the customers were supposed to the make payment, they realized that their funds were insufficient and then decide to convert their LC Wakalah to LC Murabahah.

The conversion from LC Wakalah to LC Murabahah raises a Shariah concern in relation to the appointment of the customer as the purchasing agent. Under LC Wakalah, the bank acts as the agent for the customer according to the mandate outlined in the LC Wakalah. The customer is the principal dealing with the exporter to purchase the goods for itself. On the other hand, under LC Murabahah, the customer, prior to the execution of Murabahah, must act as the agent to deal with the exporter on behalf of the bank. Therefore, when the conversion into LC Murabahah takes place without proper cancellation of LC Wakalah, the underlying contracts in both LCs are in parallel still deemed to be effective, which consequently creates confusion and ambiguity on the role of the customer. Such confusion appears because the arrangement results in contradiction between the objectives of each underlying contract (muqtada al-'aqd) for LC Wakalah and LC Murabahah.

The researchers are of the opinion that the Islamic banks offering both LC Wakalah and LC Murabahah have to ensure that the conversion is executed in the proper manner, in which failure to adhere to the rules would lead to Shariah non-compliance issues. The conversion from LC Wakalah to LC Murabahah requires proper cancellation of the former prior to execution of the latter. Without proper termination of the LC wakalah, such conversion renders the execution of two conflicting contracts that are contradicting in terms of their natures, purposes and requirements, which is prohibited by Shariah. This practice also causes ambiguity and confusion on the status of the subject matter of the

contract. For instance, the status of the goods under LC Wakalah might be owned by the customer, meanwhile it is supposedly also owned by the bank (as seller) under LC Murabahah. It is not permissible in Shariah to combine two or more contracts which have different natures if such combination causes uncertainty and ambiguity. This conversion is forbidden due to the element of the prohibited execution of two contracts in a single contract, based on the hadith that disallows two sale transactions in one sale contract (Saleem 2013; al-Naisaburi 1990). Both murabahah and wakalah contracts should have proper offer and acceptance processes through the appropriate documentation or by other ways accepted by 'urf tijari (customary business practice) which is not against Shariah requirements (Lee 2014).

The conversion of LC Wakalah into LC Murabahah in the middle of the transaction is permissible provided that the former is properly terminated, and the customer has yet to purchase the goods from the exporter. The appointment of the customer as the purchasing agent to purchase the goods on behalf of the bank under LC Murabahah would still be possible to allow the bank to own the asset before the murabahah contract can be concluded. Upon the execution of the sale and purchase contract that establishes the ownership of the bank, the bank as the owner sells the goods to the customer at a murabahah price.

Notwithstanding the above, a problem would arise if the customer had executed the sale and purchase contract with the exporter. Such conversion to LC Murabahah by employing a murabahah sale contract would lead to a Shariah concern. The reason being is that the asset is not owned by the bank. Instead, it is owned by the customer, which disqualifies the bank from selling the goods at a murabahah price to the customer. Thus, any execution of murabahah as the underlying contract for LC Murabahah would be invalid because the ownership of the asset, as one of the main requirements of Shariah, is not met.

To resolve this issue, the ownership of the bank for the asset must be established before the asset can be subsequently sold to the customer. This can be achieved by transferring the ownership of the asset from the customer to the bank through a sale and purchase transaction prior to the execution of the murabahah contract. The Islamic bank may advise the customer to sell the goods to the Islamic bank on a spot basis. Subsequently, upon completion of the first transaction, the bank at its discretion sells the same goods to the customer under a separate and independent murabahah contract at a murabahah price comprising the bank's profit margin over the cost price payable on a deferred basis. This arrangement is referred to as bay' al-'inah (buyback sale) (Muhammad and Ahmed 2016; Abdul Rahman 2010; al-Zuhayli 2002). Even so, this approach is contentious for many scholars. Thus, those scholars who allow the bay' al-'inah arrangement to be applied have established very stringent Shariah requirements. In this regard, the Shariah Advisory of Central Bank of Malaysia (SAC BNM) who permitted the 'Inah arrangement imposed very strict conditions to be adhered to by Islamic banks (Lahsasna 2014). The Shariah resolution of SAC BNM resolved that there should be two clear and separate agreements, i.e., Asset Purchase Agreement and Asset Sale Agreement which must be executed independently at different intervals and in proper sequence. The SAC BNM strictly do not permit any element of inter-conditionality between the two sale and purchase contracts. There shall be no stipulation of terms and conditions to repurchase or resell the asset back to the original seller. Therefore, the buyer in the first contract shall have full ownership of the asset, full risk and liability associated with the asset and full right not to resell the asset back to the original seller. The Islamic bank can offer personal financing using the tawarruq (commodity murabahah) facility if the customer suddenly applies for financing, instead of conversion.

4.2. Issue 2: What Is the Shariah Issue When the Customer or Importer Has Already Signed the Sale Contract with the Exporter and Wants to Seek Murabahah Financing from the Islamic Bank?

The four main contracts in international trade are sale contracts, a contract of carriage, contract of insurance and contract of payment. The core contract is a sale contract, whereas the rest of the contracts are based on it. The buyer/importer and the seller/exporter

will confirm the terms and conditions of the trade and sign the sale contract (Luk 2011; Pang 2000). A sale contract consists of all the obligations of the contracting parties in doing trade, namely the amount to be paid and the delivery of goods (Teoh 2016; Lookofsky 2004). Normally, the method of payment such as using documentary credit or the LC payment transaction is also mentioned clearly in the sale contract and it is agreed upon by both parties. The customer will apply LC from the issuing bank in favor of the seller/exporter and comply with the sale contract (Teoh 2016; Luk 2011; Pang 2000).

The problem that may arise under these circumstances is that the customer who needs LC Murabahah financing from the Islamic bank has conducted a sale contract with the seller/exporter. Once the customer executes a sale contract with the seller/exporter, he will become the owner of the goods, which renders the Islamic bank unable to offer LC Murabahah to this customer. If the Islamic bank agrees to issue LC Murabahah to the customer in this situation, the bank has to purchase the goods from the seller/exporter, but this is prohibited since the customer has entered into a sale contract on the same goods with the seller/exporter. The Prophet Muhammad peace be upon him (PBUH) clearly prohibited a Muslim to enter into the existing sale of another Muslim in his following hadith: "None of you can sell over a sale of his brother." (al-Bukhari 1993).

The issuing bank which is the Islamic bank can never be the owner of the goods as required in LC Murabahah once a sale contract has already been executed between the buyer/importer with the seller/importer because the goods now belong to the customer where as in Murabahah financing the Islamic bank should own the goods before it can sell them. One of the requirements of Murabahah contracts as stated in Murabahah Standard issued by BNM is that the bank must be the owner of the goods before selling the goods to the buyer (BNM 2017b).

Among the twelve Islamic banks, the researchers observed two practices in handling this situation. For the first practice, only one bank out of twelve Islamic banks applied it. According to R1 from Bank 1 (personal communication, 25 November 2018), he opined that it is permissible for the Islamic bank to issue an LC Murabahah service to the customer who has executed a sale contract with the seller/exporter because this is the act of fuduli (an uncommissioned agent). Shari'a Standards of Accounting and Auditing Standards for Islamic Financial Institutions (Shari'a Standards 2015) states that fuduli is "the act of an uncommissioned agent where a person who discharges (in the absence of any need or urgency) the affairs of others without being an agent or having a right to do so by virtue or Shariah. The deal becomes subject to the ruling on the fuduli, even when the acts of a real owner make him appear an agent. The approval or denial of a contract concluded by an uncommission agent is subject to the discretion of the owner." R1 further explained that in the situation where the bank accepts the customer's deed in conducting a sale contract with the seller/exporter even before the LC Murabahah facility is applied, this deed can be accepted under fuduli. The Islamic bank will appoint the customer to be the purchasing agent on its behalf to buy the goods with the issuance of LC Murabahah.

For the second practice, eleven Islamic banks put it to practice. Based on the interviews, the bankers stated that it is a requirement for their customers to have the trade facility agreement with the bank before LC Murabahah is offered. According to R5 from Bank 5 (personal communication, 18 June 2018), usually a trade facility agreement comprises of few bank's services such as a bank guarantee, letter of credit, trust receipt, banker's acceptance, and shipping guarantee offered to the customer. An officer from Bank 12, R12 (personal communication, 3 September 2017) stated that any facilities offered to the customer are within certain limits based on the customers' credit standing and worthiness. From the beginning of the trade facility agreement, the customer is appointed as the banks' purchasing agent and thus, the customer can conduct any contract of sale on behalf of the bank. Any application from the potential customer who has executed a sale contract with the seller/exporter earlier will not be accepted due to an invalid sequence of conducting the sale process in line with the Murabahah contract according to Shariah requirements. Therefore, any customer intending to apply for LC Murabahah must only have and show

the pro forma invoice, which is a document provided by an exporter to a buyer in advance of a shipment describing the quantity and value of goods to be shipped. Pro forma invoices are used to apply for import licenses, letters of credit, and foreign exchange permits (Teoh 2016; Gipson 1994) from the issuing bank. Otherwise, the purchase order can also be accepted by the Islamic bank to issue LC Murabahah where it consists of a quotation from the seller/exporter comprising the price, the amount and all the details of the goods to be purchased.

Interestingly, the researchers found that some of the customers did not disclose the fact to the bank where they had executed a sale contract with the sellers/exporters. According to R5 (personal communication, 18 June 2018), based on his experience and observation of the other Islamic banks, in reality the Islamic banks—especially the big banks—never ask about the existence of a sale contract between the customer and the seller/exporter because they do not have the time to do so. These bankers deal with hundreds of LC issuances per day as compared to the small Islamic banks with very few customers per day. Thus, R5 emphasized the need for some mechanisms to guarantee that this situation is handled wisely and properly by Islamic banks to avoid invalid transactions which could lead to any non-Shariah compliance issues.

It was observed in this research that the appointment of the customer to be the Islamic bank's purchasing agent in the trade facility agreement is possibly the best solution to adopt. With the agency appointment, the customer is free to execute a sale contract with the seller/exporter based on consent from the bank. In this situation, the customer is an authorized agent. Thus, the issue of fuduli does not arise. Ali and Kamaruzaman (2018) mentioned that the Shariah Advisory Council of Bank Negara Malaysia (SAC BNM) in its 139th meeting, held in 2013, was concerned about the suitability of applying fuduli in the structure of Islamic banking as fuduli usually takes place without the consent of the principal agent from the beginning unlike the appointment of an agent in the financial instruments where the appointment is properly structured and pre-arranged. Fuduli would be problematic in situations where the bank and customer do not have any earlier engagement.

During the time of the Prophet Muhammad PBUH, the agent in fuduli was appointed at the beginning by the Prophet himself and the agent acted beyond the knowledge of the principal agent (Hassan 2007). However, the Prophet PBUH later approved the deed of his agent. The proof is found in a hadith by the Prophet Muhammad (PBUH) which states the following:

> "Verily the Prophet (PBUH) gave one dinar to 'Urwah to buy a goat, thus (on his cleverness) he bought two goats, thus he sold one goat for one dinar, and he came to the Prophet with one dinar and one goat, thus the Prophet made supplication for his trading, for if he bought even a land he will surely earn profit." (al-Khatabi n.d.)

In this particular hadith, the Prophet Muhammad PBUH appointed 'Urwah to be his agent to buy a goat and at the end 'Urwah managed to buy a goat and brought an extra one dinar for the Prophet Muhammad PBUH. The Prophet Muhammad PBUH allowed his act and praised him for his deeds. Fuduli in buying and selling transactions is permissible according to the majority of Muslim scholars based on the said hadith (Lahsasna 2014). Nevertheless, the situation in question is different from the situation in which the concept of fuduli was applied during the time of the Prophet PBUH because this so-called agent came from an unrecognized institution and tried to be the agent for the Islamic banks to purchase goods from the seller/exporter. Thus, LC Murabahah may not be offered to customers who executed a sale contract with the seller/exporter before applying for the service from the Islamic banks. In this situation, only LC Wakalah can be offered to the customer, and the financing part can be arranged via a tawarruq arrangement. The Islamic banks have to develop a mechanism to verify whether the customer has executed a sale contract with the seller/exporter to avoid invalid transactions especially in issuing an LC Murabahah service for the customers.

4.3. Issue 3: What Is the Right Party to Have the Title of Goods in The Bill of Lading?

A contract of carriage of goods, a receipt for the goods shipped and a document of title to the goods is basically a bill of lading (Teoh 2016; Luk 2011; Pang 1988). A bill of lading is very important in LC issuance because the issuing bank will only issue a payment once they receive the original bill of lading from the seller/exporter. Only the master of a ship or vessel will issue the bill of lading as a certification that the goods have been delivered to the buyer/importer. Islamic banks have two different practices with regard to the bill of lading and the title of goods stated in it.

The first practice was reported by ten out of twelve Islamic banks involved in this research who stated that the title of goods in the bill of lading, which has the name of the consignee, should be made out to the order of the bank which is the issuing bank for both LC Wakalah and LC Murabahah as specified in their LC instructions. The first presents no issue to be practiced for LC Murabahah because the Islamic bank is the owner of the goods. However, the customer is the owner of the goods in LC Wakalah and the title of the goods in the bill of lading should hold his name. According to R9 from Bank J (personal communication, 13 October 2017) the practice of these Islamic banks is mainly to protect their interest and ensure control over the goods once they arrive at the port and before they change the title of the goods to the customer. R9 admitted that this exercise is purely to follow conventional banks. They do not want the customer to deliver the goods straight from the port without obtaining consent from the bank if the title of goods is made out to the order of the customer. According to R10 from Bank 10 (personal communication, 6 January 2017), this practice is a security measure for the bank in ensuring the customer pays the bank first before he can deliver the goods from the port.

For the second practice, R4 from Bank 4 (personal communication, 10 November 2017) and R11 from Bank 11 (personal communication, 19 January 2017) emphasized that their banks' practice is to specify the customer on the title of goods in LC Wakalah because the customer is the owner of the goods in this LC. In LC Wakalah, the customer has provided 100% of the funds in the bank and he deserves to have the bill of lading consigned directly to him. However, R4 and R11 agreed to the practice of putting the title of goods under the Islamic banks for LC Murabahah because the ownership of the goods is with the bank.

During the interviews, the researchers observed that most of the bankers agreed that the practice of placing the ownership under the bank's name in LC Wakalah is purely in line with the practices of conventional banks. Hence, they agreed that their bank should follow the practice to put the title of goods in LC Wakalah in the name of the customer since he is the owner of the goods and there is no potential issue of non-payment. However, if the issuing bank insists on putting its name on the bill of lading for LC Wakalah, it has to obtain the customer's consent. Having the clause that the goods are to be made out of the order of the banks indicates that the ownership of the goods belongs to the bank while in reality, the goods belong to the customer in LC Wakalah. The researchers believed that it is permitted in Shariah for the name of the agent to be disclosed in all documents relating to the sale and purchase contract between the seller/exporter and the agent, provided that the bank and the customer agreed and it must be made clear in writing to avoid potential disputes in future. It must also be made clear that the bank as the owner assumes the risk of ownership over the goods.

Based on the discussion on the three issues on both LC Wakalah and LC Murabahah in Islamic banks, each bank adopts its own way to practice the Islamic LC but it is argued that the practice is not fully in line with Shariah requirements which may lead to a Shariah non-compliance event. The researchers feel that some Islamic banks do adopt the best practices when handling such issues. However, sometimes the best practice is not known to the other banks. This is where the role of BNM is very important as it can provide guidelines for the Islamic banks so that they can offer LC in the very best manner and remain Shariah compliant. In order to produce good guidelines, the experiences and practices among the Islamic banks in operationalizing the LC should be gathered by BNM and the best practice should be selected. The guidelines will help and provide assurance to the Islamic banks

so they are able to offer the best service and practice to their customers according to the Shariah requirements.

5. Conclusions

Islamic LC originated from the practices of conventional banks but has been tailored to the Shariah requirements stated in some laws and regulations issued by BNM when it is offered by the Islamic banks. Nevertheless, sometime the Islamic banks may face issues that may lead to non-Shariah compliance when offering LC Wakalah and LC Murabahah. According to the findings, there are three crucial issues with the LCs provided by Islamic banks that cause further Shariah non-compliance problems. The issues focus on the conversion of the LC Wakalah (agency) to the LC Murabahah (cost-plus), the existence of a sale contract between the customer and the exporter, and finally, the ownership of the goods as stated in the bill of lading. The problem arises among the Islamic banks due to two main reasons, namely the lack of understanding of the Shariah requirements among the bankers and the absence of specific guidelines issued by BNM on Islamic LC. Thus, several recommendations can be made in light of the study's findings. To ensure that they can act appropriately in accordance with regulatory and Shariah requirements and avoid mistakes that could result in Shariah non-compliance issues in the banks, Islamic bankers must first familiarize themselves with Shariah knowledge in addition to knowledge of conventional LC facilities. Second, BNM needs to develop appropriate LC standards or guidelines that Islamic banks can utilize as a reference in order to prevent confusion and Shariah non-compliance. In terms of the study's practical implication, BNM may use the practical solutions suggested in this paper for the three issues for direction in creating Islamic LC standards or guidelines that will direct bankers in their daily activities.

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