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Examining Contracts used in Islamic Trade Financing: Issues in Bai Al-Dayn and Murabahah

Nur Ermiedza Binti Radzali,

Nurul Awfa Binti Muhammad Noor Habibi,

Nurul Amira Bt Mohd Sabri, and

Siti Aqilah Binti Ismail

International Islamic University of Malaysia (IIUM)

Abstract

In an interest-based economy, trade transactions are financed through credit for the purpose of acquiring and selling goods in the domestic or international markets. In an Islamic economy, trade operations may be financed through credit or on a participatory basis. The purpose of this paper is to review two Islamic financial contracts; Murabahah and Bai Al-Dayn. This paper also aims to review Islamic Trade Finance (ITF) and issues concerning ITF facilities, given they are operating under conventional International Chamber of Commerce (ICC) rules. To achieve the research goals, data has been gathered from journal articles, books, industry reports, and product disclosure statements issued in Malaysia. This paper highlights the underlying issues for Murabahah and Bai Al-Dayn, and provides recommendations to overcome the challenges associated with processes shaped by the underlying Islamic trade finance contract.

Keywords: Trade Finance; Bai Al-Dayn; Murabahah; Malaysia; Islamic Contracts; Islamic Trade Finance

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1. Introduction

The history of Islamic trade finance dates back to the ninth century, when Muslim merchants travelled overland and created a "commercial diaspora" (Cole, 2008) with Islamic values and standards served as a common legal system for trade. Although the Islamic Golden Age ended at the end of fifteenth century, the twentieth century witnessed a gradual switch to Shariah compliant financial products (Oseni, 2013). Islamic financial products used in modern trade finance include Musharakah (joint venture partnership), Mudarabah (trust investment contract), Murabahah (cost-plus financing) and Bai Al-Dayn (deferred payment sale). Murabahah and Bai Al-Dayn are commonly used in trade finance; therefore, this paper mainly focuses on these two types of Islamic trade finance: Murabahah and Bai Al-Dayn.

Trade finance plays an important role in economic development. Businesses need a line of credit to pay for inventories and long-term finance to acquire capital goods. Businesses engaged in international trade require guaranteed payment or credit instruments to cover the cost of goods or to extend credit to their customers (Saadallah, 2007). Trading activities -- especially international trade -- need an intermediary or financial instrument to manage cash flow. Apart from intermediaries, facilities for producing documentation as proof of the transaction are important aspects of keeping track of the progress of the trading process as well as shipment. There are various types of facilities which different Islamic banks use with various Shariah compliant facilities for international trade financing (Oseni, 2013). Therefore, it is important to examine the most prominent facilities used for financing. The facilities offered for importing goods involve Letters of Credit (LC), Trust Receipts or also known as Murabahah Working Capital Financing (MCWF), Islamic Accepted Bills (IAB) import, and Cash-lines facilities. As for export transactions, the facilities involved are Export Credit Re-financing (ECR) Pre-Shipment, Cash-lines Facilities and Term Financing.

Islamic trade finance provides an alternative to conventional trade finance, which relies heavily on interest. To attain and implement the prohibition of riba (interest or usury) under Shariah principles, it is necessary to understand the adverse relationship between usury and trade, as well as the complementary interrelationship between trade, money and the real economy in Islamic banking and finance (Choudhury et al., 2018). This paper studies the underlying Shariah principles and their impact on the understanding of the trade versus riba and bank-savings rule. This study uses library-based research in which data was collected from academic publications, industry reports, classical texts and product disclosure statements published by Islamic commercial banks in Malaysia.

2. Islamic Trade Finance

Muslims are prohibited from engaging in interest-based financial transactions and, at the same time, they are encouraged to pursue trade. Islamic trade finance is thus based on credit instruments that avoid charging interest, such as the using of participatory instruments or asset-backed securities (Saadallah, 2007). Participatory finance involves the participation of the financier in the financial transaction, in which both financier and the finance seeker share the profit and risk according to agreed ratio. Murabahah is one of the participatory finance contracts, where a financier purchases a good in order to resell it to a customer who is not able to make the purchase directly. The financier then sells the commodity to the customer at a mark up that both the bank and customer agree on upfront. Murabahah is an acceptable form of credit sale under Islamic law. A commodity Murabahah contract is often used for the products of Letter of Credit, Trust Receipt or Murabahah Working Capital Financing (MWCF), Islamic Accepted Bill (Import) and credit line facility.

Bai Al-Dayn is used for the purchase and sale of debt (debt trading) at a discount or at a negotiated price (Obaidullah, 2007). Among the products under this contracts are Islamic Accepted Bill (Export), Export Credit Re-financing (ECR) Post-Shipment and Domestic or Foreign Bill of Exchange Purchase (D/BFBEP). Under Commodity Murabahah, there are products of Export Credit Re-financing (ECR) Pre-Shipment, Cash-lines Facility and Term Financing. Table 1 summarises Islamic financial instruments that adopt Bai Al-Dayn and Murabahah.

Table 1: List of Instrument using Bai Al-Dayn and Murabahah

No.	ITF Instruments	Murabahah/ Commodity Murabahah	*Bai Al-Dayn*
1	Islamic Accepted Bills - Import	✓	
2	Islamic Accepted Bills - Export		✓
3	Islamic Export Credit Refinancing – Pre-shipment	✓	
4	Islamic Export Credit Refinancing – Post-shipment		✓
5	Bills of Exchange		✓
6	Islamic Letter of Credit	✓	

As a member of the International Chamber of Commerce (ICC), all operations and banking practices of Islamic financial institutions in Malaysia are governed by the Uniform Customs and Practice for Documentary Credits (UCP 600) rules, the widely recognised rules governing international trade finance (Low, 2010). ICC rules do not completely contradict Shariah principles; however, there are inconsistencies that need to be resolved (Oseni, 2013) in order to ensure a feasible framework for Islamic financial institutions to operate in international trade in accordance with Islamic values. Additionally, these institutions are governed by local regulations relating to financial transactions, such as the Bill of Exchange Act 1949, that regulate the banking practices for issuing Bills of Exchange including collection, noting and dispute. Islamic financial institutions in Malaysia are also governed by Shariah standards and operational requirements issued by the central bank of Malaysia, Bank Negara Malaysia.

2.1. Islamic Accepted Bills

An Islamic Accepted Bill is equivalent to the Acceptance of traditional bankers, a financial market instrument used to finance domestic and foreign trade (Hakim, 2007). Also known as an Interest-Free Accepted Bill, an Islamic Accepted Bill is formulated on the Shariah principles of Murabahah (cost-plus financing) and Bai Al-Dayn (debt trading). Islamic Accepted Bills can be purchased and sold using forward purchase and forward sales agreements (Billah, 2019). Islamic Accepted Bills are used as liquidity instruments and there should be a genuine transaction between the transacting parties with adequate documentary evidence. This is the main difference between an Islamic Accepted Bill and conventional Banker Acceptance.

2.2. Islamic Letter of Credit

The Letter of Credit is frequently used in international trade, as security for the seller pending reimbursement from the issuing bank (Billah, 2019; Gundogdu, 2018; Oseni, 2013). One of the issues in using Letters of Credit is the legality of using a percentage-based fee as the bank charges for deferred payment under Islamic law. Considering all documentary credits are governed by UCP 600, Islamic banks that provide Letters of Credit might be exposed to transit interest upon claiming from the reimbursing bank. Article 13 (b)(iii) and Article 16 of UCP 600 fixed that in the case of failure in releasing funds on the first request, the issuing bank will have to bear all expenses and interest losses incurred (International Chamber of Commerce, 2007). While it is not permissible to use a percentage-based fee as interest, it is permissible to charge a lump sum for services rendered (Oseni, 2013).

2.3. Bills of Exchange

A bill of exchange is a written order binding one party to make a specified payment to a named payee on demand at some point in the future (Lewis, 2007). The bill of exchange differs in the Islamic and Western worlds largely because lending at interest is prohibited according to Shariah principles. Islamic law considers profit stemming from exchange transactions to be usurious (Rubin, 2010) because the fluctuation of exchange rates presents a currency risk (Lewis, 2007). Because of the Islamic attitudes to usury, no profit is permitted on differences in exchange rates and thus the use of bills of exchange was confined to personal networks in Medieval times (Rubin, 2007). An Islamic acceptance bill of exchange is traded under the Bai Al-Dayn mechanism, where the exporter purchases the bill from the importer at a mutually agreed price and the agreed amount is payable on maturity (Kuforiji, 2019).

2.4. Islamic Export Credit Refinancing

Funded by the Export Import Bank of Malaysia Berhad (EXIM Bank) at a special rate, the Islamic Export Credit Refinancing (IECR) scheme is an alternative short term pre- and post-shipment financing provision for exporters in Malaysia (Export Import Bank of Malaysia Berhad, 2019). The scheme excludes businesses activities and commodities that are haram, for example: gambling, sale and purchase of pork and alcohol, or distribution of pornography. IECR is advanced to manufacturers or trading companies for the purchase of goods, and the exporters who use IECR as a mode of financing may obtain t finance for the period of credit extended to the buyer (Billah, 2019).

3. Shariah issues on trade finance

Given the importance of Islamic trade finance, it is vital to study the financial instruments used and to understand Shariah rulings on the documentary credit system.

This section first looks at the Shariah issues relating to the application of the Murabahah contract in Islamic trade financial instruments, then examines the concept of Bay Al-Dayn.

3.1. Islamic banks as partners on the principle of Murabahah

An Islamic bank acts as a partner under a Murabahah contract; however, in practice, Islamic financial institutions keep their commercial role to minimum in order not to deviate from their traditional financial function (Saadallah, 2007). For example, the institution may avoid building up inventories of goods. However, Islamic financial institutions are exposed to commercial risk attached to their ownership of goods, which cannot be totally avoided under the Murabahah contract because of their role as partners (Saadallah, 2007). They could however, minimise the risk by specifying standards and negotiating t terms and conditions.

3.2. Islamic banks as sellers/buyers of goods on the principle of Murabahah

An Islamic bank cannot open a Letter of Credit before purchasing the goods from the supplier, based on the Shariah principle that one cannot sell what one does not have (Oseni, 2013). In order to maintain Shariah compliance, the bank could enter another contract before executing the sale of contract. Unlike conventional banking, Islamic banking has multiple contractual relationships between the banker and their clients, and there are situations where the contracting parties could opt for a new contract arrangement or restructuring of existing contractual relationship as a result of default (Oseni, 2013). The sequence of the transactions must strictly follow Shariah principles.

3.3. Pricing in Murabahah contracts

Although interest-bearing transactions are prohibited under Shariah law, Islamic financial institutions are allowed to charge commissions or fees for services rendered, and compensation penalties for default of payment (Oseni, 2013). However, the profit margin in Murabahah contracts is subject to controversy among Shariah scholars because the practice of calculating a profit rate margin resembles riba (Lahsasna, 2014; Saeed, 2011). More specifically, it is common for Islamic banks to take a pragmatic approach in taking time into consideration when determining profit rates. One main argument is that, charging extra for time is a type of usury which is prohibited under Islamic law while others argue that it is permissible (Saeed, 2011). In the light of controversy over the calculation of profit rates, Thomson Reuters introduced the Islamic interbank benchmark rate (IIBR), which can be used as a unique indicator for benchmarking fees (Oseni, 2013).

3.4. Shariah Issues of Bai Al-Dayn as an Islamic trade financial instrument

Rather than the operational and governance issue, the main issue with Bai Al-dayn in Islamic trade finance instruments is the legitimacy of this contract itself. There are three opinions; the one that allows sale of debt, the one that disallows it and one that allows it subject to the type of sale of debt. All of the four schools of Islamic jurisprudence -- Hanafis, Shafies, Malikis and Hanbalis -- allow the sale of debt to debtor on the grounds that the creditor has full rights on the debt so might as well sell his debt to the debtor provided that certain conditions are fulfilled (Amin, 2007). This debt sale is in reality an exchange of an existing counter value for another existing counter value (Bai hadir bi hadir) which will not lead to any dispute among the transacting parties who are the creditor and debtor.

The second opinion is that sale of debt is not permissible. The Prophet S.A.W said: “Do not sell that which you do not possess” (Narrated by Abu Dawood, Hadith 3503). This highlights the Shariah principle that you cannot sell what you do not have. However, there are exceptions to this rule. The Shariah Advisory Council of Bank Negara Malaysia resolved that Bai Al-Dayn Bi Al Sila is permissible (Securities Commission Malaysia, 2018, p. 136).

The third opinion is that the sale of debt to non-debtors is permissible. The main concern of Islamic scholars and jurists is to avoid debt selling before qabadh. The Maliki and Shafie schools allow this type of sale of debt under certain conditions should be fulfilled and monitored. One of the conditions is; if the payment is the same type of dayn it should be sold at par value. The debtor must confirm the debt and have legal capacity; payment is not of the same type as dayn, if so it should be sold at par value, the dayn should be goods that are tradable before taking possession. However, Hanafi scholars disallowed this type of sale of debt on the ground that the seller (creditor) may fail to deliver the payment to the buyer, despite the fact that the debt is established as the liability of the debtor. Hence, this renders the contract voidable.

The non-standardization of Shariah rulings over Bai Al-Dayn and lack of consensus among different schools of thought regarding the legitimacy of Bai Al-Dayn leads to the use of less debateable contracts such as Commodity Murabahah or Bai Al-Dayn Bi Al Sila. This view is supported by Bacha (2008) who claimed that Bai Al Dayn is not as popular as it once was due to the controversy.

Table 2 summarises Islamic banks which use either Bai Al-Dayn or Commodity Murabahah or Bai Al-Dayn Bi Al Sila.

Table 2: Islamic banks Commodity Murabahah or Bai Al-Dayn

No.	Islamic Banks	Murabahah/ Commodity Murabahah	Bai Al-Dayn	Bay Al-Dayn Bi Al Sila
1	Affin Islamic Berhad			✔
2	RHB Islamic Berhad	✔		
3	Maybank Islamic Berhad		✔	
4	Public Islamic Bank		✔	
5	Bank Rakyat	✔		
6	Bank Islam Malaysia Berhad	✔		
7	Bank Muamalat Malaysia Berhad		✔	
8	HSBC Amanah Malaysia Berhad	✔		
9	Kuwait Finance House		**X**	
10	Al-Rajhi		**X**	

This data was collected from the product disclosure sheets and official websites of the banks. It can be seen that some banks avoid Bai Al-Dayn and use financial instruments that are less controversial. Three out of ten Islamic banks in Malaysia use the concept of Commodity Murabahah for Islamic Accepted Bills for sale or export (RHB Islamic Berhad, Bank Rakyat and HSBC Amanah). KFH and Al-Rajhi do not offer Bai Al-Dayn. At the time of writing, there are three banks adopting Bai Al-Dayn (Maybank Islamic, Public Islamic, and Bank Muamalat). Affin Islamic offers Islamic Accepted Bills on the principle of Bai Al-Dayn Bi Al-Sila, which refers to purchase of debt in exchange for a commodity, followed by disposal of the commodity by customer for cash (Affin Islamic, 2017). It is a financing facility whereby the bank purchases the customer's right to the debt in the exchange of commodity (Securities Commission Malaysia, 2018).

4. Conclusion and Recommendation

Based on the literature review, we found that there are a few operational Shariah issues in the use of Bay Al-Murabahah and Bai Al-Dayn in trade financing. In Murabahah, there are pricing issues, use of interest rate as benchmark issues, sale contract between the importer and the exporter issues, issues in letter of credit conversion to trade Murabahah and issues in the execution of Murabahah financing in LC Murabahah together with the issuance of Shipping Guarantee.

As for Bai Al-Dayn, the issues lie at the very nature of the contract itself rather than the operational mechanism. Issues such as the legitimacy of the contract, selling debt to discounting and non-standardization of rulings that mean banks moving away from it. Besides, there are also Shariah issues in Murabahah ITF instruments in relation to the regulations such as the UCP 600 issue of LC whereby the bank only deals with documents not the goods.

There are a few recommendations to improve the current regulatory framework of Islamic trade finance. First, there should be a global governance framework and guidelines for Islamic trade finance to solve the issue of non-standardization. There are guidelines for Islamic trade finance in Malaysia such as guidelines for Export Credit Refinancing, guidelines on Accepted Bills and the comprehensive Shariah Standards and Operational Requirements from Bank Negara Malaysia. However, currently, Islamic trade finance is subject to the same rules and regulations as conventional trade finance, including UCP 600-Documentary Collection, URC522-Uniform Rules for Collection, INCOTERMS 2010, URDG 758-Uniform Rules of Guarantee, ISP98-International Standby Practice. These rules and regulations are detailed and comprehensive but they should be harmonised with Shariah standards.

Lastly, the viability of blockchain technology and smart contracts should be taken into consideration by the Islamic banks. The use of blockchain technology could help to minimise the administrative burdens (Muneeza et al., 2018) in preparing Shariah compliant trade finance. It is equally important to verify the compatibility and feasibility of blockchain technology before integrating it with existing technology.

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