FINANCING INTERNATIONAL TRADE IN THE CONTEXT OF ISLAMIC AND "WESTERN" BANKING

'A thesis submitted to the University of Manchester for the degree of Doctor of Philosophy in the Faculty of Humanities'

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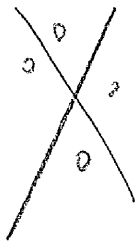

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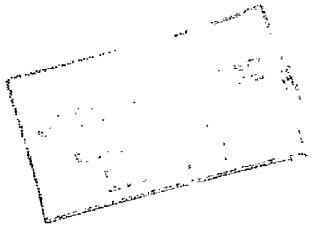

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ABSTRACT

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FINANCING INTERNATINAL TRADE IN THE CONTEXT OF ISLAMIC AND "WESTERN" BANKING

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The objective of this thesis is to examine the role of Islamic banking in financing international trade in light of the prohibition of interest (riba). In addressing the issue of Islamic finance, the thesis intends in particular to draw an analytical comparison of the financing of international trade in Islamic banking and in western banking. Therefore, the murabaha letter of credit which is used in Islamic banking in financing international trade is contrasted with the conventional letter of credit which represents the western method of financing international trade. The various relationships and risks associated with each transaction are evaluated in light of two fundamental principles of the letter of credit transaction: strict compliance and autonomy of the credit.

DECLARATION

No portion of the work referred to in the thesis has been submitted in support of an application for another degree or qualification of this or any other university or other institution of learning.

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First Chapter: The Introduction

The objective of this thesis is to examine the role of Islamic banking in financing international trade in light of the prohibition of interest (riba). In addressing the issue of Islamic finance, the thesis intends in particular to draw an analytical comparison of the financing of international trade in Islamic banking and in western banking. Therefore, the murabaha letter of credit which is used in Islamic banking in financing international trade will be contrasted with the conventional letter of credit which represents the western method of financing international trade. The various relationships and risks associated with each transaction will be evaluated in light of two fundamental principles of the letter of credit transaction: strict compliance and autonomy of the credit.

The thesis consists of an introduction, two main parts, and a conclusion. The first part of the thesis deals first with the doctrine of riba which is a very important doctrine in Islamic law that shaped the concept of Islamic banking. It will analyse the meaning and the implications of this doctrine as it applies to modern Islamic banking. The sources of funds for Islamic banks are then investigated. This will be followed by an examination of the Islamic banking financial methods. Finally, the financing of international trade through murabaha will be considered in a whole chapter.

The second part of the thesis deals with the finance of international trade through letters of credit. The two fundamental principles of letters of credit will be the point of concern in this part. After providing introductory information about the letter of credit, the principle of strict of compliance will be explored. Next, the principle of autonomy will be investigated with its fraud exception. While these fundamental principles will be examined

in light of their interpretation by English law, references to American law are also used occasionally as needed, especially on issues that demand extra attention.

The conclusion part of the thesis is concerned primarily with comparing the financing of international trade through the murabaha letter of credit with financing of international trade through the conventional letter of credit. The different relationships between the parties in each transaction will be analysed. In addition, this conclusion will identify the various risks that are associated with each transaction and will assess the techniques, if any, used in tackling these risks.

The objective of Islamic banking is to provide banking and financial facilities according to Islamic principles. The fundamental concept of Islamic banking today is avoiding riba (usury) in all transactions and financial activities. The Jordan Islamic Bank for Finance and Investment Law (1978) summarises the purpose of Islamic bank by articulating that the Islamic bank "aims at meeting the economic and social needs in the field of banking services, financing, and investment operations on a non-usurious basis. In particular these objects shall include:

a) Expanding the extent of dealing with the banking sector by offering non-usurious banking services, with special emphasis on introducing services designed to revive various forms of collective social responsibility on a basis of mutual benefit.

b) Developing means to attract funds and savings, and channeling them into participation in non-usurious banking investments.

c) Providing the necessary financing to meet requirements of the various sectors, particularly those which are not likely to benefit from usurious banking facilities."[1]

The theoretical principles of Islamic banking are identical in all Islamic banks, but the application of some of these principles sometimes varies among Islamic banks.[2] Therefore, it is important to analyse those differences and to examine how they affect the current practice of Islamic banking.

While the practice of Islamic banking still lacks regulation and standardisation, some countries have established special regulations for Islamic banks in their jurisdictions, such as Malaysia (Act No. 276, The Islamic Banking Act 1983)[3], Egypt (Law No. 48/1977)[4], Iran (Law for Usury-Free Banking 1983)[5], Kuwait (Islamic Banking Law No.30 in 2003)[6], United Arab Emirates (The Law No. 6 for Islamic Banks, Financial Institutions and Investment Corporations in 1985)[7] and Yemen (The Law No. 21 for Islamic Banks in 1996)[8].

In addition, the behaviour of the Islamic banks is influenced by the *fatwas* (Islamic legal opinions) furnished by the bank's Shariah[9] Supervisory Committee as a response to questions raised by the bank regarding various

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[1] S Haron, Islamic Banking Rules & Regulations (Pelanduk Publications, Malaysia 1997) 10.

[2] M Ainely, 'A Central Bank's View of Islamic Banking' in , European Perceptions of Islamic Banking (Institute of Islamic Banking and Insurance, London 1996) 13.

[3] http://www.bnm.gov.my/index.php?ch=14&pg=17&ac=16&full=1 (accessed on 13/10/08).

[4] http://www.egyptlaws.com/comprehensive04.html (accessed on 13/10/08).

[5] http://www.irtp.com/howto/partner/partner/appendix/appii.htm (accessed on 13/10/08).

[6] http://www.cbk.gov.kw/PDF/Superv/IS_Summary.pdf (accessed on 13/10/08).

[7] http://centralbank.ae/pdf/LawNo6-1985-IslaminBanks.pdf (accessed on 13/10/08).

[8] http://www.islbank.com/report.htm (accessed on 13/10/08).

[9] Islamic law.

banking and financial activities. The Committee makes its rulings on the basis of Islamic law principles.[10]

Most of the conventional financial instruments are interest-based. However, Islamic finance has a different approach, as it is opposed to charging and dealing with interest. Islamic financial instruments are based on profit-and-loss sharing. The Islamic Bank of Britain outlines that "[t]he main difference between Islamic and conventional banking is that Islamic teaching says that money itself has no intrinsic value, and forbids people from profiting by lending it, without accepting a level of risk – in other words, interest (known as "riba") cannot be charged. To make money from money is prohibited – wealth can only be generated through legitimate trade and investment. Any gain relating to this trading [is] shared between the person providing the capital and the person providing the expertise".[11]

In other words, while interest plays an essential role in conventional finance, Islamic banking offers alternative tools that are interest-free. Examples of Islamic financial vehicles are murabaha, musharaka, and mudaraba.

Murabaha finance is a transaction in which the bank buys goods and resells them to the customer at a marked-up price. The customer usually makes

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[10] The role of this Committee is to "formulate the bank's interpretation of the [Shariah] (Islamic Divine Law). This interpretation is reflected in fatawas (legal opinions) issued by the Committee. In the event of disputes between the bank and its clients over an Islamic legal point, the decisions of the Committee are final. Additionally the [Shariah] Supervisory Committee, whose member are Islamic legal scholars, reviews all of the bank's activities (with a jurisdiction equal to that of financial auditors), and prepares its report. The Committee's certification that the bank does not deviate from the Islamic [Shariah] is printed in the bank's annual report". N Ray, Arab Islamic Banking and the Renewal of Islamic Law (Graham & Trotman Limited UK 1995) 19.

[11] http://www.islamic-bank.com/islamicbanklive/FAQs/2/Home/1/Home.jsp (13/10/08).

payment to the bank on an installment basis.[12] The Murabaha procedure begins when the customer files an application to the bank requesting the purchase of specified kind of goods. The bank studies and evaluates the application. If the evaluation shows that the transaction is sound, the bank then signs a promise-to-purchase agreement with the customer. This agreement should contain five essential elements:

1. A bank's promise to purchase the goods

2. A bank's promise to resell the goods to the customer when the bank owns them

3. A customer's promise to buy the goods when they come under bank ownership

4. The marked-up price, which resembles the bank's profit

5. The way the customer pays the total amount (the goods price plus profit), which usually is in installments.[13]

When the bank obtains the required goods from the seller, a murabaha contract is executed between the bank and the customer in which the ownership of the goods is transferred from the bank to the customer.

Murabaha is the most utilised mode of finance in Islamic banking, not just for its simplicity, but also because financing through murabaha contains a

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[12] T Ingram, 'Islamic Banking, a Foreign Bank's view', published in the book: , Islamic Banking and Finance (Butterworth & Co., London 1985) 56, F Al-Omar and M Abdel-Haq, Islamic Banking, Theory, Practice & Challenges (Zed Books Ltd, UK and USA 1996) 12 , M Cole & W Elliot, 'Islamic Banking: A Western Lawyer's Perspective' in European Perceptions of Islamic Banking (Institute of Islamic Banking and Insurance, London 1996) 63, M Arsheed, Al-Shamel Fi Muamalat Wa Amaliat Al-Masarif Al-Islamiah (Dar Al-Nafaes Li Al-Nashr Wa Al-Tawzeea, Jordan 2001) 73, A Al-Tayar, Al-Bunuk Al-Islamiah Bain Al-Nazariah Wa Al-Tatbeeq (Dar Al-Watan, Riyadh, Saudi Arabia 1994) 177 and A Naser, Usul Al-Masrefiah Al-Islamiah Wa Qadaiah Al-Tashgheel (Matabea Al-Manar Al-Arabia, Cairo, Egypt 2000) 73.

[13] M Cole & W Elliot, 'Islamic Banking: A Western Lawyer's Perspective' in European Perceptions of Islamic Banking 63, Arsheed, Al-Shamel Fi Muamalat Wa Amaliat Al-Masarif Al-Islamiah (n12) 73, Al-Tayar, Al-Bunuk Al-Islamiah Bain Al-Nazariah Wa Al-Tatbeeq 177 & Naser, Usul Al-Masrefiah Al-Islamiah Wa Qadaiah Al-Tashgheel 73.

very low risk since the bank does not have to worry about the success of the customer's project. In addition, murabaha is short-term financing, which means that the bank can obtain a profit in a short period of time and enjoys fast circulation of its fund.[14] The finance of international trade through murabaha will receive special consideration in this thesis.

Musharaka finance is a form of a partnership in which the bank and the customer fund the project jointly. In other words, the bank will finance the project by participating as a partner. The bank provides part of the funding and the rest is covered by the customer, and any profit or loss will be shared by the bank and its partner. The project is managed according to the agreement between the partners. Sometimes, the bank agrees that the project is managed completely by its partner. In that case, the bank is not involved in the business of running the project, but it participates to the extent that it demands sufficient satisfaction that the project is performed soundly and according to the plan.[15]

Another form of musharaka finance is what it is called musharaka with an end-to-ownership (or diminishing musharaka). In this kind of musharaka, while the bank shares the profit with the customer, the fund it receives is paid in installments. Every time the bank receives part of its fund, its share of the profit is reduced accordingly. When the bank has been repaid its entire investment, it withdraws completely from the project and the partner becomes the sole owner of the whole project.[16]

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[14] Arsheed, Al-Shamel Fi Muamalat Wa Amaliat Al-Masarif Al-Islamiah, 84.

[15] Al-Omar & Abdel-Haq, Islamic Banking, Theory, Practice & Challenges 12, Naser, Usul Al-Masrefiah Al-Islamiah Wa Qadaiah Al-Tashgheel 157, Arsheed, Al-Shamel Fi Muamalat Wa Amaliat Al-Masarif Al-Islamiah 34 & Al-Tayar, Al-Bunuk Al-Islamiah Bain Al-Nazariah Wa Al-Tatbeeq 175.

[16] Arsheed, Al-Shamel Fi Muamalat Wa Amaliat Al-Masarif Al-Islamiah 35.

Unlike musharaka, in mudaraba, the contribution of capital comes only from the bank. Article V-36 of the Regulations Relating to the Law of Usury-Free Banking in Iran briefly defines mudaraba as "a contract whereby one of the two parties undertakes to provide capital on proviso that the other party employs such capital in trade and that both parties share the resulting accrued profit".[17] The bank plays no role in the management of the project, but it shares the profit according to a pre-agreed ratio. If there is a loss, it is incurred by the bank alone.[18]

The Islamic bank also offers another form of mudaraba, which is mudaraba with an end to ownership (diminishing mudaraba). The transaction in this kind of mudaraba is similar to the one described in musharaka with an end-to-ownership (diminishing musharaka), where the bank remains a partner and shares the profits until it obtains its capital. Upon receipt of the capital, the bank partnership ends and the ownership of the whole project transfers to the customer.[19]

The first attempt to launch an Islamic bank occurred in Egypt in 1963. The bank operated successfully for four years before being closed for political reasons.[20] The commercial success of that attempt encouraged the idea of Islamic banking. The Egyptian experiment was followed by a steady and strong movement toward the establishment of Islamic banking institutions

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[17] Article V-36, The Law for Usury-Free Banking of the Islamic Republic of Iran 1985.

[18] V Nienhaus, 'Islamic Economic, Finance and Banking, Theory and Practice' in European Perceptions of Islamic Banking 4, Al-Omar & Abdel-Haq, Islamic Banking, Theory, Practice & Challenges, (n12) 12, Arsheed, Al-Shamel Fi Muamalat Wa Amaliat Al-Masarif Al-Islamiah, (n12) 49 & Al-Tayar, Al-Bunuk Al-Islamiah Bain Al-Nazariah Wa Al-Tatbeeq 174.

[19] M Arsheed, Al-Shamel Fi Muamalat Wa Amaliat Al-Masarif Al-Islamiah (Dar Al-Nafaes Li Al-Nashr Wa Al-Tawzeea, Jordan 2001) 49.

[20] Nienhaus, 'Islamic Economic, Finance and Banking, Theory and Practice' in European Perceptions of Islamic Banking 5, S Haron, Islamic Banking Rules & Regulations (Pelanduk Publications, Malaysia 1997) v & Arsheed, Al-Shamel Fi Muamalat Wa Amaliat Al-Masarif Al-Islamiah 12.

everywhere. Today there are over 240 Islamic banking institutions worldwide. With assets exceeding $ 200 billion, Islamic banking has become a powerful global financial phenomenon.[21]

Surprisingly, Islamic banks do not only exist in the Muslim world, but they are spread around the globe.[22] In Asia, there are more than 80 Islamic banks.[23] In Africa, there are 35 Islamic banks.[24] There are also several Islamic banks in Europe. The Islamic Bank International of Denmark, which was established in 1983 in Denmark, was the first Islamic bank in Europe.[25] The European Islamic Investment Bank[26] and the Bank of London & the Middle East[27] are examples of institutions that are practicing Islamic finance in the UK.

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[21] D El-Hawary, 'Regulating Islamic Financial Institutions' (2004) (32227) World Bank Policy Research Working Paper 2.

[22] K Tacy, 'Islamic Finance: A Growing Industry in the United States' (2006) 10 NC Banking Inst 355. Tacy asserted that "[t]here are now at least 265 Islamic financial institutions operating in approximately forty countries, with total assets topping $262 billion and deposits over $202 billion".

[23] M Khaf, 'Islamic Bank at the Threshold of the Third Millennium' 3 http://monzer.kahf.com/papers/english/isl_bank_at_treshold_of_millennium.pdf (accessed on 28/10/08).

[24] M Khaf, 'Islamic Bank at the Threshold of the Third Millennium' 3.

[25] , Encyclopaedia of Islamic Banking and Insurance (Institute of Islamic Banking and Insurance, UK 1995) 313.

[26] "EIIB was incorporated in January 2005 and received authorisation by the FSA in March 2006. In April 2006, EIIB opened for business, and in May 2006 completed its IPO and was admitted to London's AIM market. In November 2006 EIIB opened a representative office in Bahrain. EIIB's mission is to achieve excellence in the provision of Sharia'a compliant investment banking products and services. EIIB aims to deliver a full choice of alternative investment opportunities, enabling Islamic investors to construct balanced and sophisticated portfolios which can access a full range of asset classes internationally" The European Islamic Investment Bank, http://www.eiib.co.uk/html/aboutus.asp (13/10/08).

[27] In a brief background about the Bank of London & the Middle East (BLME), it has been stated that: "(BLME) is a fully Sharia'a compliant wholesale bank in the heart of the City of London. BLME is managed by a quality team bringing together a combination of highly experienced international financiers and leading experts in Islamic finance. BLME was incorporated in August 2006 and received FSA authorisation in July 2007. Since authorisation, BLME has provided innovative Sharia'a compliant funding for our diverse client base. The majority of our Corporate Banking client base is located mainly in the UK, US and Europe. At the heart of our business strategy remains the building of an institution which will provide business solutions, using innovative Sharia'a compliant investment and financing products, whilst addressing all the financial needs of our customers. BLME carries out its business with fairness, transparency and integrity which

On observing of the growth of Islamic banking in Europe, R.T. Fox, the chairman of Kleinwort Benson Bank, declared that "the presence of so many participants persuaded the Western counterparts that Islamic institutions were a large and continuing source of finance, and they began to review and adjust their own trading methods and financing requirements accordingly".[28]

In addition, due to significantly high demand, many conventional banking institutions began to offer some Islamic banking products.[29] Those "financial institutions – including but not limited to, Citibank, Goldman Sachs, BNP-Paris-Bas and UBS – have established Islamic banking Shariah compatible services in several countries."[30]

In 2004, the Financial Services Authority in the UK approved the establishment of the first completely British independent Islamic bank, which was named the Islamic Bank of Britain.[31] This historic decision verifies the striking importance of, and the increasing demand for Islamic banking. It signifies the ongoing vigorous movement of the world into a new era of coexistence of Islamic and conventional banks.

There is no question that the banking and financial industry has tremendous legal and transactional difficulties and challenges, and this

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are the basic tenets of Islamic Finance". Bank of London and Middle East, http://www.blme.com/company.html (accessed on 13/10/08).

[28] R.T. Fox, 'Islamic Banking – A view from the city of London' in European Perceptions of Islamic Banking (Institute of Islamic Banking and Insurance, London 1996) 22.

[29] S Rehman, 'Globalization of Islamic Finance Law' (2008) 25 Wis Int'l LJ 625 at 641-642. Rehman remarked that "[t]here are several reasons cited for this recent growth: (1) strong demand from large immigrant and non-immigrant Muslims; (2) growth of oil wealth (demand from the Persian Gulf); and (3) competitive products attracting Muslim and non-Muslim investors".

[30] D El-Hawary, 'Regulating Islamic Financial Institutions' (2004) (32227) World Bank Policy Research Working Paper 2.

[31] W Kay, 'FSA Approves First Purely Islamic Bank' (9/8/2004) The Independent (London) 38.

applies specially to Islamic banks, which encounter more challenges than other financial institutions. "These challenges have mainly [arisen] from the lack of a supportive environment, inadequate regulation and the infant stage of Islamic banking".[32]

This thesis is motivated by the strong belief that, through this kind of comparative study, many of the difficulties and challenges that are associated with Islamic financial and banking transactions can be overcome and thereby leading to a more effective legal framework for these transactions.

[32] F Al-Omar and M Abdel-Haq, Islamic Banking, Theory, Practice & Challenges (Zed Books Ltd, UK and USA 1996) 109.

FIRST PART: ISLAMIC BANKING AND FINANCING INTERNATIONAL TRADE

Second Chapter: The Doctrine of Riba (Usury)

Introduction

The main objective of Islamic banks is to have banking activities without riba. Therefore, In order to understand the function of Islamic banking, it is vital to investigate the meaning of riba in Islamic law and its contemporary implications in banking.

This chapter attempts to examine the concept of riba from all possible dimensions. First, it introduces the linguistic meaning of riba in Arabic. The meaning of riba in light of the Quran and the Sunnah[33] will follow through investigation of the Quranic verses and the traditions of the Prophet. The meaning of the Quranic verses and the traditions of the Prophet will be dealt with through the texts contributed by the early scholars who interpreted those Islamic law main sources. Next, the issue of riba in the early jurists' work, fiqh[34], will be analysed to highlight that the main focus of that work was on the issue of riba in sale. Finally, the chapter will explore the meaning of riba in its contemporary context. The existence of modern banking has a profound impact on the way that the concept of riba is understood today. The treatment of riba will be examined through two major trends, the traditional and the modern views.

[33] Sunnah and Hadiths are the Prophet's traditions, which include his sayings, actions and approvals.
[34] Fiqh is the Arabic word that refers to the Islamic legal jurisprudence.

Definition of Riba

To comprehend the genuine meaning of the word riba, it is important to shed light on its literal meaning as well as its juristic sense and to establish the relationship between these different dimensions.

Literal meaning of riba

In Arabic, the word *riba* connotes the meaning of increase, excess and growth. The land that is higher than its surrounding area called rabiah (hill) and rabwah for that reason.[35] In addition to the use of *riba* in the above literal meanings, The Arabs in the pre-Islamic era used the word *riba* to refer to usurious transactions. When a debtor was unable to pay the amount that was due, the creditor would defer the due date if the debtor agreed to increase the amount.[36] Arabs considered this kind of transaction riba. Although dealing with riba in the pre-Islamic era was common, it was not an honorable or respected practice. That is why the reconstruction of Al-Kaabah[37] in Mecca could not be financed with money that generated from riba because such a sacred building should only be built with untainted funds.[38]

Pursuing the linguistic root, several verses in the Quran used the word *riba* to imply the meaning of increase and growth. The following are some examples.

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[35] Ibn Manzur, Lisan Al-Arab (Maktabat Lubnan, Beirut 1985) 14/304 (volume:14, page:304) & Al-Fairuzabadi, Al-Qamus Al-Muheet (Al-Muasasah Al-Arabiah Li Al-Tibaah Wa Al-Nasher, 1990) 4/332 (volume:4, page:332).
[36] Al-Tabari, Jami' Baian Al-Quran (Dar Al-Hadeeth, Cairo, Egypt 1987) 1/67.
[37] Al-Kaaba is a name refers to a holy construction in Mecca.
[38] Ibn Hisham, Al-Seerah Al-Nabaweiah http://sirah.al-slam.com/display.asp?f=hes1208.htm (accessed on 16/08/2008).

1- Describing the condition of the earth when it reacts to the pouring of the rain, the Quran said "and you see the earth desolate, then when We sent down water upon it, it freshened up and developed [*rabat*] and produced beautiful pairs of all kinds."[39] The verse conveys the meaning of the earth's development and growth through the use of the Arabic word *rabat* (increased), which is the past tense of the word *riba*.

2- In Fussilat Chapter, a verse says, "And among His Signs in this: thou seest the earth barren and desolate; but when We send down rain to it, it is stirred to life and yields increase [*rabat*]. Truly, He Who gives life to the *(dead)* earth can surely give life to *(men)* who are dead. For He has power over all things."[40] Again, the meaning of growth and increase were expressed by the word *rabat*.

3- The Quran also mentions *rabwah* (hill), which, as indicated above, reflects its increase over its surroundings: "And the likeness of those who spend their wealth in search of Allah's pleasure, and for the strengthening of their souls, is as the likeness of a garden on a height [*rabwah*]. The rainstorm smiteth it and it bringeth forth its fruit twofold. And if the rainstorm smite it not, then the shower. Allah is Seer of what ye do."[41]

4- Moreover, the Quran uses the word riba to refer to the usurious transactions that were common in the pre-Islamic era. In Al-Imarn Chapter,

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[39] Chapter 22, verse 5, translated by Ahmed Raza Khan & Mohammed Aqib Qadri, http://www.multimediaquran.com/quran/022/022-005.htm (accessed on 16/08/2008).
[40] Chapter 41, verse 39, translated by Yusuf Ali, http://www.harunyahya.com/Quran_translation/Quran_translation41.php (accessed on 16/08/2008)
[41] Chapter 2 verse 265, translated by Pickthal, http://www.multimediaquran.com/quran/002/002-265.htm (accessed on 16/08/2008).

verse 130 states "O ye who believe! Devour not usury (*riba*), doubled and multiplied; but fear Allah; that ye may (really) prosper."[42]

Juristic meaning of riba

The juristic definitions of *riba* are inconsistent because Muslim scholars had different opinions of usurious transactions. Imam Ibn Qudama, a Hanbali Jurist[43], defines *riba* as "an excess in particular things."[44] The Hanafi School[45] defined riba as "an excess that lacks consideration in sale."[46] Although these definitions attempt to clarify the meaning of riba, in essence, they cloud that meaning. By examining various juristic definitions of riba, some common features can be discerned:

1- They share the view that *riba* is an excess.

2- They look at the riba transactions strictly in terms of sales, not in terms of loans. In most of the jurists' works, riba is only discussed in the Book (chapter) of Sales.

Nabil Saleh offers a more comprehensive definition of riba. He defines riba as "unlawful gain derived from the quantitative inequality of the counter-values in any transaction purporting to effect the exchange of two or more species, which belong to the same genus and are governed by the same efficient cause. Deferred completion of the exchange of such species, or even of species which belong to different genera but are governed by the

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[42] Chapter 3, verse 130, translated by Yusuf Ali, http://www.harunyahya.com/Quran_translation/Quran_translation3.php (accessed on 16/08/2008).

[43] The Hanbali School is one of the four main Islamic legal jurisprudence schools. The Hanbali School was found by Ahmed Ibn Hanbal.

[44] Ibn_Qudamah, Al-Mughni (Dar Al-Kitab Al-Arabi, Beirut 1972) 4/4.

[45] The Hanafi School, found by Abu Haneefah is one of the four main schools on Islamic legal jurisprudence.

[46] Al-Sarkhasi, Al-Mabsut (Dar Al-Maref Li Al-Tebaah Wa Al-Nashr, Beirut) 12/109.

same 'illa, whether or not deferment accompanied by an increase in any one of the exchange countervalues."[47] Despite the length of this definition, it discusses the two types of riba, which are Riba Al-Fadl and Riba Al-Nasiah.[48] It also covers the elements that when they are part of a transaction, they make it usurious.

The Relationship between the literal and the juristic definitions

Having examined the literal and the juristic meanings of *riba*, it can be easy to see their relationship. While the literal meaning provides a general sense of the word *riba* to refer to all kinds of increase and growth, the juristic meaning restricts its connotation to a specific kind of increase, which is the one that occurs in trade or debt transactions.

Riba (Usury) and the Quran

The ban of riba in the Quran was revealed in four distinctive stages. Each stage has its own features and characteristics that set it apart from the others.

The first stage

In Surah (Chapter) Al-Rum, Allah encourages people to give to charity instead of taking riba (usury). In this stage, the Quran had not yet forbidden riba, but it demonstrates how the reward of giving charity will be multiplied by Allah, as compared to the taking of riba, which will not be

[47] N Saleh, Unlawful Gain and Legitimate Profit in Islamic Law, Riba, Gharar and Islamic Banking (Second edn, Graham & Trotman, London 1992) 16.
[48] The types of riba will be examined later.

multiplied. Allah said "That which ye give in [riba] in order that it may increase on (other) people's property hath no increase with Allah; but that which ye give in charity, seeking Allah's Countenance, hath increase manifold."[49]

However, the Quran commentators do not all agree this verse of the Quran refers to riba in its juristic meaning. In fact, few of them support that understanding,[50] while others believe the verse concerns the person who gives gifts for the sake of receiving a return.[51] Imam Alshwkani cited Alssudi "The [word] riba in this position [in the verse] is the gift that the man gives to his brother requesting a reward for it. And because that does not increase with Allah, the person is not rewarded from Allah..."[52] In their translation of the verse, Dr. Muhammad Khan and Dr. Muhammad Al-Hillali adopted the later opinion. Their translation reads:

"And that which you give in gift (to others), in order that it may increase (your wealth by expecting to get a better one in return) from other people's property, has no increase with Allah, but that which you give in zakat seeking Allah's Countenance then those, they shall have manifold increase."[53]

The second stage

In this stage Allah unveiled in Surah Al-Nnisa that he had forbidden riba on some people. He stated that those people were banned from taking riba,

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[49] Surah Al-Rum, Chapter 30, Verse 39, Translated by Mohammad Marmaduke Pickthall, http://www.multimediaquran.com/quran/030/030-039.htm (accessed on 16/08/2008).
[50] Al-Shawkani, Fath Alqadeer, Al-Jamea bain Fannai Al-Riwaiah Wa Al-Deraiah Min Ilm Al-Tafseer (Dar Al-Fiker, Beirut 1981) 9/118-120.
[51] Al-Shawkani, Fath Alqadeer 9/118-120.
[52] Al-Shawkani, Fath Alqadeer 9/118-120.
[53] M Khan and M Al-Hillali, Interpretation of the Meanings of the Noble Qura'an in the English Language (Dar-us-Salam Publications, 1995) 578.

but because of their disobedience, Allah also banned them from some of the things that were lawful. The verses said:

"We made unlawful for them certain (foods) good and wholesome which had been lawful for them;- in that they hindered many from Allah's Way. That they took usury, though they were forbidden; and that they devoured men's substance wrongfully; - we have prepared for those among them who reject faith a grievous punishment. But those among them who are well-grounded in knowledge, and the believers, believe in what hath been revealed to thee and what was revealed before thee: And (especially) those who establish regular prayer and practice regular charity and believe in Allah and in the Last Day: To them shall We soon give a great reward."[54]

The third stage

By revealing the verse in Surah (Chapter) Al Imaran, Allah forbade riba. This verse is considered the first verse that contains the prohibition of riba. Clearly, Allah announced "O ye who believe! Devour not usury, doubled and multiplied; but fear Allah; that ye may (really) prosper."[55]

The Quran commentators assert that when the verse said "Doubled and multiplied", this is not meant to confine the prohibited transactions of riba to the condition of being doubled and multiplied. Instead they believe that the intent of the verse is to express the state of taking riba by the people at that time because they used to impose riba by way of doubling and

[54] Surah Alnessa, Chapter 4, verse 160-161. Translated by Yusuf Ali http://www.harunyahya.com/Quran_translation/Quran_translation4.php (accessed on 16/08/2008).

[55] Al Imaran Chapter 3, verse 130, translated by Yusuf Ali http://www.harunyahya.com/Quran_translation/Quran_translation3.php (accessed on 16/08/2008).

multiplying it if the debtor was not able to repay the debt when it became due.[56]

However another view provides different interpretation. This view argues that the purpose of the phrase "doubled and multiplied" in the verse is to restrict the prohibited transactions to the ones that have excessive riba.[57] Consequently, they believe that the prohibition of little interest "was not taken from the gracious book (Quran), but it was taken from the procedural rule which, stipulates that what applies to the 'few' must be applied to the 'many' in order to rebut pretexts (means) and finally close the door...".[58]

The fourth stage

"Those who devour usury will not stand except as stand one whom the Evil one by his touch Hath driven to madness. That is because they say: "Trade is like usury," but Allah hath permitted trade and forbidden usury...". [59]

The emphatic and severe prohibition against dealing with riba was revealed in this stage. In Surah Al Baqarah, Allah describes the people who are taking riba in a very horrific way "Those who devour usury will not stand except as stand one whom the Evil one by his touch hath driven to madness".[60] Allah declared that He made sale lawful while riba is not. Furthermore, He warns the people that if they do not give up riba and repent then they should await a war from Allah and his messenger "O ye

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[56] Al-Tabari, Jami' Baian Al-Quran (Dar Al-Hadeeth, Cairo, Egypt 1987) 1/59
[57] M Rida, Tafseer Al-Manar (Second edn, 1947) 3/114.
[58] S Homoud, Islamic Banking, The Adaptation of Banking Practice to Conform with Islamic Law (Cambridge University Press, UK 1985) 113.
[59] Surah Al Baqrah, Chapter 2, verses 275-281, translated by Yusuf Ali http://www.harunyahya.com/Quran_translation/Quran_translation2.php (accessed on 16/08/2008).
[60] Surah Al Baqrah, Chapter 2, verses 275-281, translated by Yusuf Ali http://www.harunyahya.com/Quran_translation/Quran_translation2.php (accessed on 16/08/2008).

who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers. If you do not, take notice of war from Allah and His Messenger."[61]

There is a reason behind the revelation of these verses of the Quran. A Quran commentator, Al-Tabari, mentioned that Thaqeef Tripe promised the Prophet that they would eliminate all the riba that they had imposed. When Banu Amer (from Thaqeef Tripe) requested Banu Almughairah to pay the riba that existed between them before Islam, Banu Almughairah refused to pay riba under Islam. Therefore, they brought the issue to Attab Ibn Osaid, who was appointed by the Prophet to govern Mecca. Attab asked the Prophet for his opinion on the conflict. Eventually, the riba verses of Surah Al Bqarah were revealed. When those verses reached Banu Amer, they said that they could not stand in a war against Allah and his Prophet and declared that they gave up all riba.[62]

Those riba verses were the last verses revealed in the Quran.[63] Juraij, an early Muslim scholar, said that the Prophet died nine days after those verses were revealed.[64]

In their understanding of the word (Al-Riba) in the above verse, the Quran commentators took two different trends.

The First Trend

The word (Al-Riba) is a general (*'aam*) word, meaning that it comprehends all kinds of riba, whether it is riba Al-Fadhel or Al-Naseeah,[65] and whether

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[61] Surah Al Baqrah, Chapter 2, verses 275-281, translated by Yusuf Ali http://www.harunyahya.com/Quran_translation/Quran_translation2.php (accessed on 16/08/2008).
[62] Al-Tabari, Jami' Baian Al-Quran (Dar Al-Hadeeth, Cairo, Egypt 1987) 1/71.
[63] Al-Tabari, Jami' Baian Al-Quran 1/76.
[64] Al-Tabari, Jami' Baian Al-Quran 1/76.

it is riba in loans or in sales. It contains even the kind of riba that is prohibited by the tradition of the Prophet.[66] Ibn Al-Arabi was one of the commentators who embraced this approach, saying "The correct [view] is that it is general because they [the people at that time] were trading and dealing with riba. Riba was well known among them. The man would trade the other in credit and when the time is due he would say 'pay or increase' [meaning: that the creditor asks the debtor to pay off the debt. If the debtor is not able to do so, the creditor would allow a delay and impose an increase in the debt]".[67]

The Second Trend

This trend holds that the word (Al-Riba) is a *mujmal* word. In Islamic law, the *mujmal* word is the word that lacks clarification, thus, no ruling can be derived from it unless it is explained by another source. The Hanafi jurists, who favored that view, argue that the word (Al-Riba) is *mujmal* and that it is clarified by what the Prophet has said regarding riba. Al Jasas, one of the Hanafi jurists, said that the root of the word (Al-Riba) in Arabic is increase and this word was transferred from the linguistic meaning to the legal meaning. Therefore it lacks clarification. He added that it is unacceptable to use this *mujaml* word to consider a transaction illegal.[68]

Riba and the Sunnah[69]

Many authentic Hadiths have been reported on the issue of riba. Those Hadiths can be classified into two groups. The First group consists of the

[65] These types of riba will be explained later.
[66] Al-Qurtubi, Al-Jamea Li Ahkam Al-Quran (Dar Al-Kitab Al-Arabi Li Al-Tibaah Wa Al-Nasher, 1967) 3/356-357.
[67] Ibn_Al-Arabi, Ahkam Al-Quran (Second edn, Isa Al-Babi Wa Shurakao, 1967) 1/240.
[68] A Aljasas, Ahkam Al-Quran (Dar Al-Fiker, Beirut 1991) 1/470.
[69] Sunnah and Hadiths are the Prophet's traditions, which include his sayings, actions and approvals.

Hadiths that demonstrate the prohibition and the awfulness of dealing with riba, without giving any explanations of the kind of transactions that can be considered riba. It is narrated that Jabir said, "The Messenger of Allah, on whom be peace, cursed the devourer of usury as also its giver, the scribe of the deed and the witnesses to it, and said: They are [a]like (in the degree of sin)."[70] Another example is the Hadith that narrated by Ibn Masud that the Prophet "condemned the receiver, the giver of Riba and also the witnesses and the scribe of the transaction; they are alike."[71] Finally, Abdullah Bin Handalah narrated that the Prophet said: "A dirham[72], which one consciously devours, is thirty-six times worse than fornication."[73]

The second group represents the Hadiths that deal with the riba transactions themselves. It is narrated by Obadah Ibn Al-Samit that the Prophet said "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, of equal measure, handful for handful. If there is difference in kind, then sell as you please, if by handful, then by handful."[74] It is also narrated that the Prophet said, "sell not gold for gold except in equal quantity, nor sell anything for the same thing in lesser quantity, nor sell silver for silver except in equal quantity: sell not anything for the same thing in lesser quantity, nor sell anything present for that which is absent."[75]

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[70] Muslim, Saheeh Muslim (Matbaat Muhammad Ali Subhi, 1971) 5/44 & Al-Bukhari, Saheeh Al-Bukhari (Dar Al-Hadeeth, Cairo 1983) 3/47, translated by A Qureshi, The Theory of Interest (Ashraf Press, Lahore 1974) 43.

[71] Muslim, Saheeh Muslim 5/40, translated by Qureshi, The Theory of Interest 6.

[72] A dirham is one unit of currency that is made of silver.

[73] Ibn Hanbal, Musnad Al-Imam Ahmed (Al-Maktab Al-Islami Li Al-Tibah Wa Al-Nasher, 1978) 4/33, translated by Qureshi, The Theory of Interest 43.

[74] Muslim, Saheeh Muslim 5/60 & Al-Bukhari, Saheeh Al-Bukhari 3/77, translated by Qureshi, The Theory of Interest 61.

[75] Al-Bukhari, Saheeh Al-Bukhari 3/80, translated by Qureshi, The Theory of Interest 61.

The Hadiths that tackle riba transactions are the grounds for Muslim scholars to divide riba into two kinds: Riba Al-Fadl (riba in excess) and Riba Al-Naseiah (riba in deferment).

Riba Al-Fadl (riba in excess)

Riba Al-Fadl is a sale transaction that involves an excess in quantity of one of the exchanged objects over the other when both belong to the same genus.[76] As the above Hadiths say, when gold is traded for gold, they have to be equal in quantity, and thus, any excess in one of the items would make the transaction fall into riba Al-Fadl. For the transactions to be lawful, the same equality rule should apply when trading silver for silver, dates for dates, wheat for wheat, or salt for salt. Otherwise, the transaction would be acts of riba Al-Fadl.

This excess in quantity is not permissible even if one of the exchanged items is of better quality than the other. Therefore, It is considered riba Al-Fadl if two kilos of low-quality wheat are exchanged for one kilo of high-quality wheat. Sawad Ibn Ghazeiah[77] brought the Prophet some good dates from the village of Khaibar. The Prophet wondered if all of Khaibar's dates were that good. Sawad explained that he had traded two measures of low-quality dates for one measure of good dates. Immediately, the Prophet told him that it was unlawful to do so and provided him with an explanation of practices considered permissible. The Prophet said, "Don't

[76] Al-Kasani, Badaea Al-Sanaea Fi Tarteeb Al-Sharaea (First edn, Matbaat Al-Jamaliah, Egypt 1950) 4/115, Al-Mesri, Nehaiat Al-Muhtag Ila Sharh Al-Minhaj fi fiqh Al-Imam Al-Shafeie (Sharikat Wa Matbaat Mustafa Halabi Wa Awladuo, Egypt 1979) 3/428 & Al-Nawawi, Al-Majmua Sharh Al-Muhathatb (Matbaat Al-Tadhamun Al-Akhawi, Egypt 1997) 9/339.

[77] Al-Shawkani, Nail Al-Awtar Sharh Muntaqa Al-Akhbar (Sharekat Matbaat Mustafa Al-Babi Al-Halabi Wa Awladuh, Egypt 1973) 5/210.

do that. Sell the [low-quality] dates for money and then buy good dates with money".[78]

Though most of the Prophet's companions do not dispute the prohibition of riba Al-Fadl, few of them, including Ibn Abbas, Ibn Al-Zubair, Osamah Ibn Zaid and Zaid Ibn Al-Arqam, hold the view that riba Al-Fadl is lawful.[79] They rely on the literal interpretation of the Hadith as narrated by Osamaah Ibn Zaid, which said, "No riba except in Al-Nasieah."[80] However, the supporters of the majority interpreted the Hadith differently. They said that the meaning of "No riba except in Al-Naseiah" is that the prohibition of Al-Nasieah is much greater or that riba Al-Nasieah is practiced more frequently than the other. They argue that Arabs used to say: "there is no scholar in town except Zaid," which does not really mean that he is the only one. It simply means that he is the most knowledgeable scholar in town. Others suggest that the above Hadiths that confirm the prohibition of riba Al-Fadl, such as the one narrated by Obadah, supersedes the Hadith that says "No riba except in Al-Naseiah."[81]

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[78] Al-Sanani, Subul Al-Salam Sharh Bulugh Al-Maram (Dar Ihiaa Al-Turath Al-Arabi, Beirut 1982) 3/40.

[79] Ibn_Hajar, Fateh Al-Bari (Muhib Al-Deen Al-Khateeb, 1977) 4/382, Al-Shawkani, Nail Al-Awtar Sharh Muntaqa Al-Akhbar (Sharekat Matbaat Mustafa Al-Babi Al-Halabi Wa Awladuh, Egypt 1973) 5/216, Al-Sanani, Subul Al-Salam Sharh Bulugh Al-Maram 3/47, Al-Kasani, Badaea Al-Sanaea Fi Tarteeb Al-Sharaea 4/116, Ibn_Rushd, Bidayat Al-Mujtahid Wa Nihaiat Al-Muqtasid (Maktabat Al-Kuliat Al-Azhariah, Egypt 1966) 2/127, Ibn Qudamah, Al-Mughni 4/10 & Al-Subki, Takmilat Al-Majmua Sharh Al-Muhathab (Zakaria Ali Bin Yusuf Matbaat Al-Imam, 1968) 10/22.

[80] Muslim, Saheeh Muslim 5/50 & Al-Bukhari, Saheeh Al-Bukhari 3/98.

[81] Al-Shawkani, Nail Al-Awtar Sharh Muntaqa Al-Akhbar 5/105-187, Ibn Hajar, Fateh Al-Bari 4/388, Al-Sanani, Subul Al-Salam Sharh Bulugh Al-Maram 3/47, Ibn_Qudamah, Al-Mughni (Dar Al-Kitab Al-Arabi, Beirut 1972) 4/50 & Ibn_Rushd, Bidayat Al-Mujtahid Wa Nihaiat Al-Muqtasid 2/129.

Riba Al-Naseiah (riba in deferment)[82]

While riba Al-Fadl deals with issues of quantity, riba Al-Naseiah concerns issues related to delivery time. When gold is traded for gold or wheat for wheat two conditions have to be met: equal quantity and prompt delivery. If there is an excess in quantity, riba Al-Fadl would exist. If there is a deferment in the delivery of one of the exchanged objects, riba Al-Nasieah would occur.

However, when metal is traded for metal or food for food and the objects are from different genus', like gold for silver or wheat for dates, the equality condition is not enforced, but the transaction has to meet the prompt delivery condition. Again, if there is a delay in the delivery of one of the objects, the transaction would fall in the area of Riba Al-Nasieah.

The last case is when metal is traded for food. If, for example, gold is traded for dates or silver for wheat, sales transactions could be conducted freely without meeting either the equality or the promptness conditions.

[82] Al-Sanani, Subul Al-Salam Sharh Bulugh Al-Maram 3/51 (Hadith No. 784), Al-Nawawi, Al-Majmua Sharh Al-Muhathatb (Matbaat Al-Tadhamun Al-Akhawi, Egypt 1997) 9/341 & Ibn Qudamah, Al-Mughni 4/10 & Al-Subki, Takmilat Al-Majmua Sharh Al-Muhathab 10/56.

Ibn Al-Qaiem's View[83]

Ibn Al-Qaiem, in his book, Ilam Al-Muwaqeein, adds thoughtful aspects to these two types of riba. He describes riba Al-Fadl as the *Hidden Riba* and riba Al-Naseiah as the *Apparent Riba*. In his opinion, the 'Apparent Riba' is prohibited as such and cannot be permissible under any circumstances unless there is a pressing necessity.

On the contrary, the *Hidden Riba* is forbidden because it might be a means to the 'Apparent Riba'. The degree of prohibition of the *Hidden Riba* is not as great as the degree of prohibition of the *Apparent Riba* so the *Hidden riba* can be permissible when there is a real need for it.

Ibn Al-Qaiem provides an instance that demonstrates his opinion. He maintains that according to the rules that govern sales transactions, riba Al-Fadl (the Hidden Riba) is committed if gold is traded for gold with an excess in the countervalue. Yet, because people at that time were really needed to sell their golden jewelry for golden currency, the excess under this special circumstance was permissible.

Riba and Fiqh (Islamic Jurisprudence)

The main issue that caught the concern of the Muslim jurists in their treatment of the issue of riba is the subject of *illah* (efficient cause). *Illah* or efficient cause is a criterion (or a description) which when it is found in an object, the object will be deemed a *ribawi* (riba-related) one. Professor Frank Vogel defines illah as "the attribute of an event that entails a particular divine ruling in all cases possessing that attribute; it is the basis

[83] Ibn_Al-Qaiem, Ilam Al-Muwaqeein An Rab Al-Alameen (Dar Al-Jeel, Beirut 1971) 2/145-155.

for applying analogy (*qiyas*) to the two cases."[84] He further adds that "*Ribawi* goods are therefore goods that exhibit one of the 'efficient causes' occasioning application of riba rules".[85]

The Hadiths that tackled riba transactions mentioned only six kinds of goods that can be subject to riba. As in the Hadith narrated by Obadah, the Prophet said "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, of equal measure, handful for handful. If there is difference in kind, then sell as you please, if by handful, then by handful."[86] Ibn Hazm and his followers, who reject the use of analogy as a means to reach rulings in Islamic law, argue that riba cannot be found in any objects except the ones mentioned in the Hadiths.[87] However the vast majority of Muslim jurists agree that riba can be found in these six objects and in any other objects that share the six in their *illah* (efficient cause). Those jurists again agree in dividing those six items into two groups but disagree regarding the *illah* that can be inferred in each group.[88] The first group composes gold and silver and the second group contains the remaining four items. The following are the most prominent opinions on the *illah* in each group.

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[84] F Vogel and S Hayes, Islamic law and finance, Religion, Risk and Return (Kluwer Law International, The Netherland 1998) 75.
[85] F Vogel and S Hayes, Islamic law and finance, Religion, Risk and Return 75.
[86] Muslim, Saheeh Muslim (Matbaat Muhammad Ali Subhi, 1971) 5/60 & Al-Bukhari, Saheeh Al-Bukhari (Dar Al-Hadeeth, Cairo 1983) 3/77, Translated in A Qureshi, The Theory of Interest (Ashraf Press, Lahore 1974) 61.
[87] Ibn_Hazam, Al-Muhala (Matbaat Al-Imam, Egypt 1986) 9/537 & Al-Shawkani, Nail Al-Awtar Sharh Muntaqa Al-Akhbar (Sharekat Matbaat Mustafa Al-Babi Al-Halabi Wa Awladuh, Egypt 1973) 5/195.
[88] Al-Kasani, Badaea Al-Sanaea Fi Tarteeb Al-Sharaea (First edn, Matbaat Al-Jamaliah, Egypt 1950) 4/130, Ibn_Rushd, Bidayat Al-Mujtahid Wa Nihaiat Al-Muqtasid (Maktabat Al-Kuliat Al-Azhariah, Egypt 1966) 2/129, Al-Desuqi, Hasheiat Al-Desuqi Ala Al-Sharh Al-Kabeer (Dar Al-Fikr, Beirut 1988) 3/47 & Ibn_Qudamah, Al-Mughni (Dar Al-Kitab Al-Arabi, Beirut 1972) 4/120.

The first group: Gold and Silver

1- The Weight

Abu Hanifah and Imam Ahmed in one version of his opinion think that *illah* (efficient cause) in gold and silver is the weight.[89] Therefore, anything that is sold by weight can be subject to riba. For example iron, cotton and copper are *ribawi* (riba-related) items. According to this opinion, if iron is traded for iron, or cotton for cotton, or copper for copper the objects have to be equal in their weights; otherwise, the transaction would be usurious.

2- Currency

Imam Al-Sahfei[90], Imam Ahmed in a version of his opinion[91], Ibn Tymeiah[92] and Ibn Al-Qayem[93] are of the opinion that *illah* in gold and silver is the currency. So, if a certain object in any given time and place is used as currency, this object would be riba-related. For example, if iron were used as currency, so people would use it as means of payment, then iron would become a riba-related object, and iron would be subject to the rules that govern riba-related items.

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[89] Ibn_Qudamah, Al-Mughni 4/125, Al-Nawawi, Al-Majmua Sharh Al-Muhathatb (Matbaat Al-Tadhamun Al-Akhawi, Egypt 1997) 9/393, Al-Shawkani, Nail Al-Awtar Sharh Muntaqa Al-Akhbar (Sharekat Matbaat Mustafa Al-Babi Al-Halabi Wa Awladuh, Egypt 1973) 5/220.

[90] Al-Nawawi, Al-Majmua Sharh Al-Muhathatb 9/393-395.

[91] Ibn_Qudamah, Al-Mughni 4/125.

[92] Ibn_Taymeiah, Majmua Al-Fatawa (First edn, Matbaat Al-Sunnah Al-Muhammadeiah, 1965) 29/472.

[93] Ibn_Al-Qaiem, Ilam Al-Muwaqeein An Rab Al-Alameen (Dar Al-Jeel, Beirut 1971) 2/156.

The second group: salt, wheat, barley and dates

1- The Volume

Imam Abu Hanifah[94] and Imam Ahmed[95] say that *illah* (efficient cause) in those items is the volume. This opinion states that whenever there is an item that is sold by volume; this item should belong to this group whether the item is food, such as rice, or not food, such as henna.

2- Foodstuff

Being foodstuff is the *illah* that Imam Al-Shafei[96] and Ahmed in one version of his opinion[97] chose for the above four items. In their opinion, any items are considered food would fall in this group. They provide rice, fish and fruits as examples of these items.

3- Foodstuff plus weight or volume

Imam Al-Shafei in his old opinion and Ibn Taymeiah think that *illah* in those four items is being foodstuff. The other element is being sold either by weight or volume.[98] They provide the example of eggs as an item that is food, but not sold by weight or volume, thus eggs are excluded from this group.

Rules governing riba-related items

Examining the jurists' analysis, it can be concluded that when riba-related items are traded, certain rules should be implemented:

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[94] Ibn_Humam, Fath Al-Qadeer Sharh Al-Hidaiah (Matbaat Mustafa Ahmed, 1980) 7/4.
[95] Ibn_Qudamah, Al-Mughni 4/105.
[96] Al-Nawawi, Al-Majmua Sharh Al-Muhathatb 9/395-397.
[97] Al-Mardawi, Al-Insaf (Matbaat Al-Sunnah Al-Muhammadiah, 1977) 5/12.
[98] Al-Nawawi, Al-Majmua Sharh Al-Muhathatb 9/397, Ibn_Qudamah, Al-Mughni 4/107. & Al-Nawawi, Rawdat Al-Talibeen (First edn, Al-Maktab Al-Islami Li Al-Tibaah Wa Al-Nasher, 1968) 3/773.

1- The traded items belong to the same group.

   If an item is traded for an item and both belong to the same group but from a different genus, e.g., gold for silver or dates for wheat, they don't have to be equal in quantity, but they do have to be hand for hand, which means that the items have to be delivered immediately. However if the items are from the same genus, e.g. gold for gold or dates for dates, besides the immediate-delivery condition, the items have to be equal in quantity. It is not permissible to exchange two kilos of dates for one kilo of dates even if they differ in the quality, but it is lawful to exchange two kilos of wheat for one kilo of dates as long as they are delivered immediately.

2- The traded items belong to different group.

   Examples of this situation are when gold is traded for wheat or silver is traded for dates. The items do not have to be equal in quantity nor do they have to be delivered immediately.

Contemporary Views on Riba

In the 1960s, the most imperative issue that dominating the minds and the discussion of Muslim scholars was that of riba and interest.[99] The subject of riba in the early jurists' works was tackled in the context of sale transactions, and the issue of riba in loan was barely being discussed in Islamic law books. This trend diverged when banking activities began to emerge and to have a profound impact on the economic and financial life.

[99] A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation (E. J. Brill, Leiden, The Netherlands 1996) 17.

When the early scholars interpreted the Prophet's Hadith that is narrated by Obadah Ibn Al-Samit "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, of equal measure, handful for handful. If there is difference in kind, then sell as you please, if by handful, then by handful",[100] most of their debates and arguments were about those six kinds of goods and how to classify them and how to extract the rules of riba that could apply to the exchange-of-goods-for-goods transactions. Today, in light of modern commercial activities, this kind of transactions is hardly to be found.

The focus of the contemporary Muslim jurists in their treatment of the subject of riba began to turn from sale into loan transactions, and the issue of interest moved to the top of their concern. As the Islamic thoughts toward banking and interest with regard to riba developed, two main streams came into sight: the traditional and the modern views.

The traditional view represents the majority of Muslim scholars who, in their interpretation of riba, rely on the few texts provided by the early jurists regarding riba in loan, which conclude that any increase over the principal in loan is riba.[101] The modern view, in contrast, being influenced by the financial role that banks play in enhancing economic development, has different opinions on riba and interest. These modern opinions deviate from the mainstream and have not received much acceptance in the Muslim world.

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[100] Muslim, Saheeh Muslim (Matbaat Muhammad Ali Subhi, 1971) 5/60 & Al-Bukhari, Saheeh Al-Bukhari (Dar Al-Hadeeth, Cairo 1983) 3/77, Translated in A Qureshi, The Theory of Interest (Ashraf Press, Lahore 1974) 61.

[101] A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation (E. J. Brill, Leiden, The Netherlands 1996) 17.

This section will shed the light on the subject of riba in its contemporary interpretation, which concerns mainly the issue of riba in loan and whether interest falls into the definition of riba. This issue will be addressed by examining the traditional and the modern views on riba.

Traditional view

The vast majority of contemporary Muslim scholars believe that any increase over the principal in loan transactions is riba. Therefore, any kind of interest is considered riba. In supporting their view, the traditional scholars cited the verses of the Quran that prohibited riba and declared war on the persons who deal with it, such as "Those who devour usury will not stand except as stand one whom the Evil one by his touch hath driven to madness. That is because they say: 'Trade is like usury,' but Allah hath permitted trade and forbidden usury... O ye who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers. If ye do it not, take notice of war from Allah and His Messenger."[102] They explain that those Quranic verses have not confined the prohibition of riba to a particular kind of practice, so that ban should be implemented to reach any kind of increase over the principal whether it is in loan or in sale. From the Sunnah, they cited that the Prophet said "verily all pre-Islamic riba is void and the first riba I invalidated is Al-Abas' riba."[103] They argue that

[102] Surah Al Baqrah, Chapter 2, verses 275, 278-279, translated by Yusuf Ali http://www.harunyahya.com/Quran_translation/Quran_translation2.php (accessed on 16/08/2008).
[103] Muslim, Saheeh Muslim (Matbaat Muhammad Ali Subhi, 1971) 4/41.

Al-Abas' riba was riba in debt and most of the debt is the result of a loan; thus riba in loan should be prohibited.[104]

Because there is no explicit indication in the Quran or the Sunnah about riba in loan, the traditional scholars rely mainly on the very few texts that have been reported from the early jurists on the issue of riba in loan. Ibn Rushd, the Grand Son, one of the early leading jurists in the Maliki School, points out that "the scholars have agreed that riba is in two things; sale and debt. Riba in debt is two kinds; one has received a unanimous agreement that is the pre-Islamic riba, which is the one is banned. [The practice of the pre-Islamic riba is that] they used to provide loan with increase. They used to say give me more time and I will pay you more. That is the riba that the Prophet referred to in the farewell pilgrimage when he said 'verily all pre-Islamic riba is void and the first riba I invalidated is Al-Abas' riba.'"[105]

Another early jurist whose thoughts heavily influenced the traditional view is Al-Jasas. In his interpretation of the Quranic verse that related to riba, he says "the riba that Arabs knew and practiced was lending dirhams and dinars [money] for a deferred date with a stipulated increase over the sum borrowed."[106]

The essential rule that the traditional scholars inherited from the early jurists and built their view upon is 'Whatever loan draws benefit is riba'. There are no particular attributes of the loan that can fall under this rule except that it provides benefit. The loan does not have to be money. Animals, goods and metals can be subject to this basic rule. Ibn Qudama,

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[104] S Dunia, Al-Shubuhat Al-Muaserah Li Istihlal Al-Riba (Maktabat Wahbah, Cairo 1994) 41.

[105] Ibn Rushd, Bidayat Al-Mujtahid Wa Nihaiat Al-Muqtasid (Maktabat Al-Kuliat Al-Azhariah, Egypt 1966) 2/128-129.

[106] A Aljasas, Ahkam Al-Quran (Dar Al-Fiker, Beirut 1991) 1/635.

an early Hanbali jurist, says "every loan that has a stipulation of an increase is unlawful without opposition [among scholars]."[107] Therefore, if two kilos of dates have been given out as loan, what should be returned is exactly two kilos of dates. If there is a stipulation that the return should be more than the principal, this transaction becomes riba.

Most of the Islamic organisations and bodies that dealt with the issue of riba held the traditional view. In 1965, many scholars and delegates from about 35 Islamic countries gathered in Cairo to discuss the issue of riba and some other important matters. This assembly formed what it is called the Second Islamic Conference for the Academy of Islamic Research. Among the eminent scholars who participated were Ali Al-Khafif, Muhammad Abu Zahrah, Ali Abdul Qadir, Muhammad Al-Saies and Muhammad Al-Fadel Ben Ashoor. The conference concluded with the following statement about riba.

1- All kind of interest against loan is unlawful without distinction between loan for productive or consumption purposes as the reports from the Quran and Sunnah are clear on the ban of both kinds.
2- Simple riba and massive riba are both unlawful.
3- Riba in loan is forbidden and it cannot be justified by the Islamic principles of need or necessity.[108]

A similar decision was reached by the Board of the Islamic Fiqh Congress in its second conference, which took place in Jeddah, Saudi Arabia in 1991. It added that any increase over the principal whether it occurs at the

[107] Ibn_Qudamah, Al-Mughni (Dar Al-Kitab Al-Arabi, Beirut 1972) 4/354.
[108] Second Islamic Conference for the Academy of Islamic Research, Cairo, 1965 in Al-Qardawi, Fwaed Al-Bunuk Hia Al-Riba Al-Muharam (Second edn, Dar Al-Sahwah Li Al-Nashr Wa Al-Tawzeea, 1991) 130.

time when the debt becomes mature or it is stipulated as interest when signing the loan contract is considered riba.[109] Likewise, the Second Conference of Islamic banking in Kuwait in 1983[110], the Azhar Fatwa Committees, and the Academy of Muslim World League in its sixth decision have produced contributions that are in harmony with the traditional view.[111]

Looking at the practical perspective, it is the traditional view that has the greatest impact on shaping the framework of Islamic banking. Abduallah Saeed observes the effect of this view on the practice of Islamic banking. He explains that "To put this [traditional view] interpretation into practice, Islamic banks would have to reject at least in theory, all the transactions and contracts which involved an explicit interest element in a legal sense".[112]

Modern Views on Riba

The modern views on riba are conveyed by scholars, most of whom consider the matter of riba from the angle of modern economic need, rather than a mere application of the traditional Islamic law.

These modern views, which devised a new interpretation of riba, provide a different perspective on interest that deviates from the mainstream perspective. This section set out the most common of the modern views.

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[109] Second Conference of the Islamic Fiqh Congress, Jeddah, Saudi Arabia, 1991 in Al-Qardawi, Fwaed Al-Bunuk Hia Al-Riba Al-Muharam (Second edn, Dar Al-Sahwah Li Al-Nashr Wa Al-Tawzeea, 1991) 134.

[110] The Second Conference of Islamic banking, Kuwait, 1983 in Al-Qardawi, Fwaed Al-Bunuk Hia Al-Riba Al-Muharam (Second edn, Dar Al-Sahwah Li Al-Nashr Wa Al-Tawzeea, 1991) 143.

[111] Al-Qardawi, Fwaed Al-Bunuk Hia Al-Riba Al-Muharam (Second edn, Dar Al-Sahwah Li Al-Nashr Wa Al-Tawzeea, 1991) 130.

[112] A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation (E. J. Brill, Leiden, The Netherlands 1996) 35.

A. Riba is only in sale, not in loan[113]

This view is based on the idea that riba only occurs in sale transactions and no riba could be found in a loan transaction. The following points highlight the most important evidence presented to support this view.

1- The word 'Al-Riba' that is used in the Quran is a *mujmal* word[114], which lacks an explanation. The explanation for that word is found in the Sunnah when the Prophet says "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, of equal measure, handful for handful. If there is difference in kind, then sell as you please, if by handful, then by handful."[115] In essence, the meaning of this *mujmal* word should be understood through the explanation that has been provided by the Prophet, which confines 'Al-Riba' into sale transactions.[116] This view asserts that the word 'Al-Riba' cannot be defined as the pre-Islamic riba because there is no prove of such a definition. Moreover, many scholars rejected this understanding by emphasising that the word 'Al-Riba' is a *mujmal* word and the Hadith is its clarification. Al-Nasafi asserted "and also Al-Riba verse is '*mujmal*' because its meaning is ambiguous and that cannot be comprehended by the linguistic meaning as [Al-Riba] linguistically means increase, but Allah did not intend that

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[113] R Ridah, Al-Riba Wa Al-Muamalat Fi Al-Islam (First edn, Maktabat Al-Thaqafah Al-Deeniah, Egypt 2001) 9.
[114] As indicated before, in Islamic law, the *mujmal* word is the word that lacks an explanation.
[115] Muslim, Saheeh Muslim (Matbaat Muhammad Ali Subhi, 1971) 5/60 & Al-Bukhari, Saheeh Al-Bukhari (Dar Al-Hadeeth, Cairo 1983) 3/77, Translated in A Qureshi, The Theory of Interest (Ashraf Press, Lahore 1974) 61.
[116] R Ridah, Al-Riba Wa Al-Muamalat Fi Al-Islam 10.

meaning".[117] Another Hanafi scholar, Al-Shashi, says "The '*mujmal*' word is [the word that] indicates several meanings...[and its actual meaning cannot be understood] unless there is an explanation from the speaker. An example of that is what Allah says 'and [He] prohibited Riba.'[118],[119]

In an elaboration of the meaning of the *mujmal* word, Sadr Al-Shareeah Al-Hanafi says "The '*mujmal*' is like Al-Riba verse. [When the verse says] "and bans Al-Riba", [the meaning] is '*mujmal*' because Al-Riba in the Arabic language is the excess and not every excess is forbidden...and [we don't know] what kind of excess is intended thus it is 'mujmal'."[120]

Some of the scholars argue that the word Al-Riba in the Quran is explained by the Hadith where the Prophet says "verily all pre-Islamic riba is void."[121] However, the modern view[122] responds by emphasising that the *mujmal* word 'Al-Riba' cannot be explained by that Hadith because it contains the use of the term 'pre-Islamic riba' and there is no explanation of the pre-Islamic riba in any Hadith. This lack of clarity of the meaning of the pre-Islamic riba renders this term as a *mujmal* one that needs an explanation just like the word Al-Riba in the Quran.[123]

2- Riba in loan has never been proved by a verse of the Quran or any authentic Hadith. The Hadith that says "every loan that drags

[117] R Ridah, Al-Riba Wa Al-Muamalat Fi Al-Islam 12.
[118] Verse 275, Chapter Al-Baqrah.
[119] R Ridah, Al-Riba Wa Al-Muamalat Fi Al-Islam 13.
[120] R Ridah, Al-Riba Wa Al-Muamalat Fi Al-Islam 12.
[121] Muslim, Saheeh Muslim (Matbaat Muhammad Ali Subhi, 1971) 4/41.
[122] The modern view here is the view that believes that there is no riba in loan.
[123] R Ridah, Al-Riba Wa Al-Muamalat Fi Al-Islam 14.

benefit is riba" is not authentic.[124] Nonetheless, all the authentic Hadiths indicate that riba occurs in sale transactions, such as the Hadith that says: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, of equal measure, handful for handful. If there is difference in kind, then sell as you please, if by handful, then by handful."[125]

This modern view also quoted some of the early Hanafi jurists' definitions of riba, which express that riba is in sale, such as the definition provided by Al-Sarkhasi, "it is the excess that lacks consideration stipulated in sale."[126]

However, some of the traditional scholars argue that technically the loan transaction is considered as a sale transaction because of the exchange nature of them both. Therefore all the Hadiths and quotes that talk about riba in sale they also talk about riba in loan since the loan transaction is considered as a sale transaction.

In response to this argument, the modern view explained that the loan transaction is totally different from the sale transaction. The modern view explained that if the loan is a sale transaction then it is not permissible to loan two kilos of dates and ask that it should be returned in two months because in sale transactions it is not permissible to sell two kilos of dates for two kilos of dates to be received in two months. But since that there is agreement among scholars that it is permissible in loan transactions and not

[124] R Ridah, Al-Riba Wa Al-Muamalat Fi Al-Islam 22.
[125] Muslim, Saheeh Muslim (Matbaat Muhammad Ali Subhi, 1971) 5/60 & Al-Bukhari, Saheeh Al-Bukhari (Dar Al-Hadeeth, Cairo 1983) 3/77, Translated in A Qureshi, The Theory of Interest (Ashraf Press, Lahore 1974) 61.
[126] R Ridah, Al-Riba Wa Al-Muamalat Fi Al-Islam 18.

permissible in sale transactions, it is then obvious that loan transactions are different from sale transactions and they cannot be the same.[127]

3- For more support of its argument, the modern view cited some of the scholars' words asserting that the loan is different from the sale. Ibn Al-Qaim said that the loan transaction and the sale of silver for silver in deferment have the same picture but the sale transaction is a great sin while the loan is associated with a great reward.[128] In addition, the modern view stated that some jurists cited the Hadith "every loan drags benefit is riba" as proof that the increase in loan is riba. If a loan is considered as a sale, they would not have needed to rely on such an unauthentic Hadith because they would have sound Hadiths on sale, which contain enough evidence that riba is in sale. Relying on such an unauthentic Hadith indicates that loan is different than sale.[129]

4- Providing loan is like teaching the Quran. Providing loan to the needy is preferable because it is an act of worship and teaching the Quran is preferable as well. Taking charge for providing loan is like taking charge for teaching the Quran, which is not prohibited. In other words, this view utilises analogy, which is an acceptable method for finding rules in Islamic law. This view analogised charging money to provide a loan to charging money for teaching

[127] R Ridah, Al-Riba Wa Al-Muamalat Fi Al-Islam 35.
[128] Ibn_Al-Qaiem, Ilam Al-Muwaqeein An Rab Al-Alameen (Dar Al-Jeel, Beirut 1971) 2/53.
[129] R Ridah, Al-Riba Wa Al-Muamalat Fi Al-Islam (First edn, Maktabat Al-Thaqafah Al-Deeniah, Egypt 2001) 41.

the Quran. The outcome of this analogy is that both should share the same ruling, which is being lawful.

5- This modern view noted that some jurists believe that the excess in loan is *makrooh* (not preferred). This Islamic legal term means that the act is not prohibited; it is rather lawful but it is not preferred. Ibn Haman narrated that Atta said "they used to dislike every loan that provides benefit."[130] The message that this modern view attempts to extract from such a quote, and from similar ones provided by other jurists, is that those Muslim scholars do not consider the increase over the principal in loan transaction as riba; otherwise they would not have categorised such a transaction as a non-preferred one. Instead, they would have expressed its clear illegality.[131]

[130] R Ridah, Al-Riba Wa Al-Muamalat Fi Al-Islam 45.
[131] R Ridah, Al-Riba Wa Al-Muamalat Fi Al-Islam 41.

B. Doubled and Multiplied Increase (Excessive Interest vs. Small Interest)

Relying on the verse in Al-Imarn Chapter, this view suggests that there is a difference between a small and excessive increase over the loan amount.[132] It asserts that the verse says explicitly "Oh you who believe, devour not riba doubled and multiplied,"[133] which provides a clear message that the prohibition is confined to doubled and multiplied charge, i.e., excessive interest. This view suggests that, according to the Quranic verse, if banking interest is small and does not reach the point of doubling the principal it should be lawful.

This opinion received severe criticism from Muslim scholars on the basis that this is not a valid understanding of the verse. They argue that the intention of the verse is to explain how riba used to be charged during that time.[134] By no means does this verse intend to establish a distinction between a small and excessive rate of increase. Those scholars assert that the valid interpretation of the verse is that the phrase "doubled and multiplied" is a demonstration of the way the people used to charge riba. In addition, the other verse, in Al-Baqarah Chapter, is clear in its prohibition of any kind of riba, whether it is a small increase or a large increase: "and give up what remaining of your demand for riba."[135] This command is followed by a verse that adds more emphasis to the concept when it says,

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[132] Albanna, Al-Riba Waelaqatuh bi Al-Mumarasat Al-Masrifiah Fi Al-Bunuk Al-Islamiah (Dar Al-Fikr Al-Islami, Cairo, Egypt 1986) 13-43.
[133] Verse 130, Chapter Al-Imran.
[134] Albanna, Al-Riba Waelaqatuh bi Al-Mumarasat Al-Masrifiah Fi Al-Bunuk Al-Islamiah 29.
[135] Verse 278, Al-Baqarah Chapter.

"but if ye turn back, ye shall have your capital sums."[136] It is apparent that the verse allows only the principal to be returned and does not allow even the small charging of riba. Moreover, this verse was revealed later than the Al-Imarn verse and so its meaning should prevail over the former one.[137]

C. Riba only occurs when debt becomes due

This view, stated by Rasheed Ridah, provides that not all kinds of increase over the principal are riba. Riba is confined to the situation where the increase occurs when the debt becomes due, not at the time of the contract.[138] In other words, if at the time of forming the contract, the parties stipulate a certain increase over the principal, this transaction is lawful and the increase is not riba. However when the debt matures, it is illegal to charge interest in return of deferring of payment as such an action would resemble the pre-Islamic riba, where the creditor used to say to the debtor at the maturity date, "either pay or increase." In essence, the practice that is considered riba, in Ridah's view, is when the creditor charges interest in the situation where the debtor is unable to return the debt, but the transaction is lawful if that interest is stipulated at the time of executing the contract. Accordingly, Rida's definition of riba is that "it is the money that is taken in order to defer the matured debt...whatever the root of that debt is, whether it is sale or loan or something else." He further added that "it is not included in riba the profit that is [stipulated] at the

[136] Verse 279, Al-Baqarah Chapter.
[137] Albanna, Al-Riba Waelaqatuh bi Al-Mumarasat Al-Masrifiah Fi Al-Bunuk Al-Islamiah 29.
[138] R Ridah, Al-Riba Wa Al-Muamalat Fi Al-Islam 110.

time of making the contract. Riba is only what is given for the sake of delaying the matured debt".[139]

In support of this view, Rida relies solely on his understanding of some of the interpretations articulated by some of the early scholars.[140] An example of such an interpretation is given by Al-Qurtubi. He states that the Arabs "when the debt becomes due, they used to say to the debtor 'either pay or increase.'"[141] Another example is provided by Abu Al-Waleed Ibn Rushd. He says that "the pre-Islamic riba was in debt...When the debt becomes due he [the creditor] would say 'either pay or increase.' If he [the debtor] pays, he [the creditor] takes it, otherwise [if the debtor was unable to pay], he [the creditor] increases the debt and extends the date".[142]

Rida argues that such definitions are clear indications that riba only arises when interest is asked for at the time that the loan matures and there is no difficulty in Islamic jurisprudence if interest has been provided for at the time of the making of the original loan.[143]

D. Loan for consumption purpose vs. loan for production purpose[144]

This view tries to draw a distinction between the loan for consumption purposes and the loan for productive purposes. It argues that riba can only be found where interest is charged in a loan for consumption purposes while interest can be legitimately charged in a loan for production

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[139] R Ridah, Al-Riba Wa Al-Muamalat Fi Al-Islam 110.
[140] R Ridah, Al-Riba Wa Al-Muamalat Fi Al-Islam 82.
[141] Al-Qurtubi, Al-Jamea Li Ahkam Al-Quran (Dar Al-Kitab Al-Arabi Li Al-Tibaah Wa Al-Nasher, 1967) 3/356.
[142] R Ridah, Al-Riba Wa Al-Muamalat Fi Al-Islam 90.
[143] R Ridah, Al-Riba Wa Al-Muamalat Fi Al-Islam 74.
[144] This view is provided by Maroof Al-Dawalibi in a lecture he delivered in the Conference of the Islamic Fiqh in Paris. See Al-Sanhoori, Masadir Al-Haq Fi Al-Fiqh Al-Islami (Maahd Al-Dirasat Al-Arabiah Al-Aliah, 1956) 3/259.

purposes. This view maintains that the reason behind the prohibition of riba is the prevention of injustice. The riba verse in Al-Baqrah Chapter is concluded by stating the rationale for the ban of riba "Deal not unjustly and ye shall not be dealt with unjustly."[145] That is the ground on which this view stands. It asserts that injustice in riba can be committed if the wealthy creditors take advantage of the poor debtors in society and that can be found only where the loan is taken for consumption purposes. However the situation is different where production is the main reason behind the taking out of the loan, as there would be no exploitation of poverty and therefore no perpetration of injustice.

[145] Verse 279, Chapter Al-Baqarah.

Conclusion

This chapter investigated the meaning of the concept of riba, which is the primary principle that the whole idea of Islamic banking is built upon. It attempted to find the inherent meaning of riba by first seeking the definition of riba in its linguistic roots.

Then it traced the meaning of the concept of riba in Islamic law. While linguistically the word 'riba' refers to the meaning of increase and excess, Islamic law provides a limitation on that generality to confine the concept of riba to specific type of transactions.

The Chapter delved deeply into Islamic law to examine the concept of riba in the Quran, Sunnah and Fiqh (Islamic jurisprudence). Many of the Quran interpreters are of the opinion that the Quranic verses refer to a specific kind of riba, the pre-Islamic riba where the lender charges interest against the credit that he provides. However this understanding has not gained total acceptance as some Muslim scholars believe that 'Al-Riba' in the Quran is a *mujmal* word that lacks explanation, which is provided in the Sunnah.

In the Sunnah, the Prophetic Hadiths that considered the issue of riba received much attention from jurists as those Hadiths shed more light on the practical aspects of riba. Tackling the issue of riba from a sale perspective, the Hadiths focus the attention of jurists toward riba in sale, overlooking the issue of riba in loan transactions. In light of those Hadiths, the early jurists, in their Islamic law books dealt with the issue of riba from the angle of sale, and very few of the early scholars take the issue of riba in loan into consideration. Most jurists divide riba into two kinds; riba al-fadl, which is riba in excess and riba al-naseea, which is riba in deferment.

This treatment of riba in early Islamic law, which leans heavily toward riba in sale, leads to great confusion among contemporary scholars who encounter a new challenge in the wake of the existence of modern banking activities and the major crucial demand for financial facilities. The legacy of the early scholars offers little help in the area of riba in loan and financial transactions, which today is the area in desperate need for guidance. The most dominant voices in the Islamic world are the voices of the scholars who hold the traditional view toward riba. This traditional view has a strict and literal interpretation of riba, which considers any increase over the principal in loan as the greatest level of riba, and thus rules out all kinds of interest. On the other hand, the modern views, which try to ease the tension, provide a relaxed approach toward riba in loan. Although those views seem more compatible with modern financial demands, they are forcefully rejected by Muslim scholars for deviating from the traditional path of understanding riba.[146]

In practice, Islamic banks, in their attitudes and transactions, are influenced by advocates of the traditional view. Respectful of the traditional interpretation of Riba, they took the initiative of developing Islamic banking techniques that did not fall foul of the prohibition on Riba.[147]

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[146] A Kharofa, The Loan Contract in Islamic Shariah and Man-Made Law (Second edn, Leeds Publications, UK 2002) 172, A Al-Tayar, Al-Bunuk Al-Islamiah Bain Al-Nazariah Wa Al-Tatbeeq (Dar Al-Watan, Riyadh, Saudi Arabia 1994) 80-85, S Dunia, Al-Shubuhat Al-Muaserah Li Istihlal Al-Riba (Maktabat Wahbah, Cairo 1994) 125-126, M Al-Shaibani, Shubuhat Muaserah Li Istihlal Al-Riba (First edn, Dar Alam Al-Kutub Li Al-Tibaah Wa Al-Nashr Wa Al-Tawzia, Riyadh, Saudi Arabia 1991) 37-86, O Al-Ashqar, Al-Riba Wa Atharuh Ala Al-Mujtama Al-Insani (Second Edition edn, Maktabat Al-Manar, Jordan 1988) 34-110 & A Al-Ameen, Al-Wadaea Al-Masrafiah Al-Naqdiah Wa Istethmaruha Fi Al-Islam (First Edition edn, Dar Al-Shuruq, Saudi Arabia 1983) 283-294.

[147] A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation (E. J. Brill, Leiden, The Netherlands 1996) 82.

The Islamic Bank of Britain summarises this understanding toward riba when it asserts in an explanation of their belief that "Islamic teaching says that money itself has no intrinsic value, and forbids people from profiting by lending it, without accepting a level of risk – in other words, interest (known as "riba") cannot be charged. To make money from money is prohibited – wealth can only be generated through legitimate trade and investment. Any gain relating to this trading [is] shared between the person providing the capital and the person providing the expertise."[148] In addition, the Institute of Islamic Banking and Insurance clearly establishes that the "[t]he basic principle of Islamic banking is the prohibition of Riba-(Usury - or interest)".[149]

[148] http://www.islamic-bank.com/islamicbanklive/FAQs/2/Home/1/Home.jsp (accessed on 16/11/08).
[149] http://www.islamic-banking.com/ibanking/whatib.php (accessed on 16/11/08).

Third Chapter: Sources of funds and Methods of Finance

Introduction

This chapter provides background about the sources of funds that are available for Islamic banks. That will be followed by an investigation of the various financial methods that are implemented by Islamic banks. The focus of this investigation will be on mudaraba, musharaka, ijarah, salam and istisna as these are the most financial methods used in Islamic banking. While Murabaha is also considered as one of the most important financial instruments in Islamic banking, this chapter will not touch upon this subject as a whole chapter will be devoted to discuss Murabaha when tackling the issue of financing international trade.

The sources of funds in Islamic Banking

Islamic banks have different sources for their funds. They range from the paid-up capital that is provided by the shareholders to the various kinds of banking accounts to the fees that are charged for the services that are provided by the bank.[150] These sources are explored in this section.

I. Paid-up capital

For any Islamic bank, the initial source of fund is the capital that is advanced by the bank's shareholders in the establishment of the bank.[151]

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[150] F Latif and H Eddin, 100 Questions & 100 Answers on Islamic Banks (International Association of Islamic Banks) 50.

[151] A Al-Suwaidi, Finance of Internatinal Trade in the Gulf (Graham & Trotman Limited UK 1994) 65 & A Alias, N Kamarulzaman and R Bhupalan, Guide to Islamic Banking in Malaysia: An Overview (Institut Bank-Bank Malaysia (IBBM), Malaysia 1993) 7.

II. The Banking Accounts

The banking accounts are the most important source of funds not only for Islamic banks but also for conventional banks. The following is an investigation of the concept of deposit in Islamic law and the kinds of accounts that are utilised in Islamic banks: the current account, the savings account, and the investment account.

The Concept of Deposit in Islamic Law

Definition of Deposit

The Muslim jurists provide several definitions of deposit from different perspectives. The Hanafi School produces its definition by looking at the deposited object. This school maintains that a deposit is "the money kept in the trustee's custody."[152] Looking at deposit from the perspective of the action itself, the Maliki School states that a deposit is "a delegation for safekeeping the money".[153] Although each school defines deposit from different perspectives, understanding the concept of deposit is the same – that it, it is the safekeeping of somebody's money.

The nature of the deposit contract

The deposit contract is revocable by each party because a deposit is viewed as a trusteeship, where the contract is not binding[154]. However, the Shafei School provides an exception to this rule. It asserts that if the revocation of

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[152] Q Zadah, Takmelat Fath Al-Qadeer (Al-Matbaah Al-Ameeriah, Egypt) 88-89.
[153] Al-Desuqi, Hasheiat Al-Desuqi Ala Al-Sharh Al-Kabeer (Dar Al-Fikr, Beirut 1988) 3/419 (volume:3, page:419).
[154] Ibn Qudamah, Al-Mughni (Dar Al-Kitab Al-Arabi, Beirut 1972) 9/256, Al-Bahuti, Kashaf Al-Kinaa Ala Matn Al-Iqnaa (Matbat Al-Hukumah, Saudi Arabia 1974) 4/185 & Nawawi, Rawdat Al-Talibeen (First edn, Al-Maktab Al-Islami Li Al-Tibaah Wa Al-Nasher, 1968) 6/326.

the deposit contract would harm the other party, the contract becomes binding[155]. In fact, this is the basic rule of contract in Islamic Law, as emphasised by Al-Shihab Al-Ramli, who said if the cancellation of a revocable contract would harm the other party, the contract would be transformed to an irrevocable one.[156]

Liability

Because the deposit is considered to be a trusteeship contract between the depositor and the depositee, the latter serves as a trustee, and therefore is not liable for loss of, or damage to, the deposit, unless he is negligent.[157]

However, a minor view asserts that the depositee should be liable whenever the deposit is lost or damaged in his custody, whether he is negligent or not. This view relies on the judgment of Omar Ibn Al-Katab, the second Caliph, and one of the Prophet's most knowledgeable companions, who held that Anas Ibn Malik was liable for the deposit that was lost in his custody.[158] However, the majority's reply is that it is actually bound to the general rule, and the reason Omar held the depositee liable was because the depositee may have been negligent.[159]

This basic rule of being exempt from liability cannot be taken away from the depositee, even if the parties agree to the contrary. Any condition in the contract which holds the depositee liable is considered void because it is

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[155] Z Al-Ansari, Asna Al-Matalib & Hashiat Al-Ramli Ala Asna Al-Matalib (Matbaat Al-Maimaniah, Egypt 1983) 3/67.
[156] Z Al-Ansari, Asna Al-Matalib & Hashiat Al-Ramli Ala Asna Al-Matalib 3/67.
[157] Ibn_Nujaim, Al-Bahr Al-Raeq Sharh Kanz Al-Daqaeq (Dar Al-Kutub Al-Arabiah Al-Kubra, Egypt 1913) 7/273, Al-Bahuti, Kashaf Al-Kinaa (Matbat Al-Hukumah, Saudi Arabia 1974) 4/186 & Al-Samnani, Rawdat Al-Qudat (Muasasat Al-Risalah, Beirut, Lebanon 1984) 2/608.
[158] Ibn_Qudamah, Al-Mughni (Dar Al-Kitab Al-Arabi, Beirut 1972) 9/257.
[159] Ibn_Qudamah, Al-Mughni 9/257.

inconsistent with the juristic rules. In addition, there is no legitimate legal cause for the liability.[160] Obaid Al-Anbary disagrees with the rest of the jurists by remarking that if the parties agree the depositee is liable in the case of loss or damage, they should stick with their agreement. However, none of the scholars support this opinion.[161]

On the other hand, if the parties agree the depositee is not liable, even if he has been negligent, this condition is also void, because it contradicts the rules of trust where the depositee should be held liable whenever he is found to be negligent.[162]

Exceptions to Liability

As stated above, the depositee originally is not liable for loss of, or damage to, the deposit, unless he has been negligent. This basic rule has some exceptions, one of which is where the depositee can be found liable, even where he has not been negligent. The following are the exceptions to the liability rule:

1- If the depositor asks for the deposit to be saved in a certain manner, the depositee must abide by that instruction, otherwise he will be liable. If the depositee has not been instructed where to keep the deposit, he must save the deposit in a proper place, where similar objects are likely to be saved.[163]

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[160] Z Al-Ansari, Asna Al-Matalib & Hashiat Al-Ramli Ala Asna Al-Matalib (Matbaat Al-Maimaniah, Egypt 1983) 3/76.
[161] Al-Qadi_Abdulwahab, Al-Ishraf Ala Masael Al-Khelaf (Matbat Al-Iradah, Tunis) 2/42.
[162] Z Al-Ansari, Asna Al-Matalib & Hashiat Al-Ramli Ala Asna Al-Matalib (Matbaat Al-Maimaniah, Egypt 1983) 3/76.
[163] Ibn_Nujaim, Al-Bahr Al-Raeq Sharh Kanz Al-Daqaeq (Dar Al-Kutub Al-Arabiah Al-Kubra, Egypt 1913) 7/279 & Z Al-Ansari, Asna Al-Matalib & Hashiat Al-Ramli Ala Asna Al-Matalib 3/81.

2- The depositee must return the deposit as soon as the owner demands it. Failure to do so without a legitimate reason will render the depositee liable.[164] Ibn Qudamah explains that by failing to return the deposit when the depositor demands it, the depositee becomes liable, because he is holding somebody's money without that person's permission.[165]

3- The depositee is also liable if, instead of keeping the deposit in his safekeeping, he transfers it into a third party's custody. The reason for the depositee's liability in this instance is that he performs an action on somebody's property without his permission. In addition, the depositor transferred his money to the depositee's custody out of trust, and the third party does not posses that trust.[166] However, Ibn Abi Laila asserts that the depositee should not be held liable. He argues that it is the depositee's responsibility to safeguard the deposit in a manner and place he deems suitable.[167] Moreover, when the depositor gives his money to the depositee, there is an implied consent that the depositee has the right to act reasonably on the depositor's behalf to protect the deposit. Likewise, when the depositee accepts the deposit, he possesses the right of saving it, and therefore should be able to transfer his own right to a third party.[168]

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[164] Al-Shawkani, Al-Sail Al-Jarar Al-Mutadafiq Ala Hadaeq Al-Azhar (Dar Al-Kutub Al-Ilmaiah, Beirut, Lebanon 1984) 3/343.
[165] Ibn_Qudamah, Al-Mughni (Dar Al-Kitab Al-Arabi, Beirut 1972) 9/269.
[166] Ibn_Nujaim, Al-Bahr Al-Raeq Sharh Kanz Al-Daqaeq (Dar Al-Kutub Al-Arabiah Al-Kubra, Egypt 1913) 7/274 & Z Al-Ansari, Asna Al-Matalib & Hashiat Al-Ramli Ala Asna Al-Matalib (Matbaat Al-Maimaniah, Egypt 1983) 3/76.
[167] Ibn_Al-Munther, Al-Ishraf Ala Mathahib Ahl Al-Ilm (Tabat Qatar, Qatar 1983) 1/252.
[168] Ibn_Al-Munther, Al-Ishraf Ala Mathahib Ahl Al-Ilm 1/252.

The profit generated from utilising the deposit

The Muslim jurists are divided on the issue of who has a right to the profit derived from the utilisation of the deposit without the depositor's permission. While some jurists believe the profit should belong to the depositor, because it is generated from his money,[169] other jurists assert the profit ought to be given to the depositee because he provides the effort. This view further maintains that if the money is lost, the depositee will be liable, so the profit he makes is a hedge against liability.[170] Disagreeing with both views, a third view argues that the profit should be spent on charitable causes, because both the depositor and depositee have no legitimate grounds for receiving any profit.[171] Ibn Taimyah provides the last view saying that the profit should be shared by the depositor and depositee. He relies on the judgment of Omar Ibn Al-Khatab, who held that the profit should be shared by the parties.[172]

[169] Ibn_Al-Munther, Al-Ishraf Ala Mathahib Ahl Al-Ilm 1/257.
[170] Al-Hatab, Mawahib Al-Jaleel Sharh Mukhtasar Khaleel (Matbaat Al-Saadah, Egypt 1971) 5/255.
[171] Ibn_Al-Munther, Al-Ishraf Ala Mathahib Ahl Al-Ilm 1/257.
[172] Al-Bali, Mukhtasar Al-Fatawa Al-Mesriah Li Ibn Taymiah (Matbaat Al-Sunnah Al-Mahamadiah, Egypt 1948) 379.

Current Accounts in Islamic Banking

The current account is the kind of account that customers open to protect their money, facilitate commercial transactions, and meet day-to-day payment activities.[173] Most Islamic banks do not take any charges for opening and operating such an account. Customers have the right to withdraw funds from their accounts at any time as there is no restriction on the amount the customers can withdraw at one time. There just must be sufficient funds in the account.[174] While the bank guarantees the return of the funds, the profits that are generated from utilising the funds belong to the bank alone.[175] The customers are not entitled to share any profits, and the bank is not allowed to provide any interest.[176] Islamic banks in Iran represent an exception to that general practice. Article 6 of the Law of Islamic Banking (1983) allows Islamic banks to grant gifts to their customers as an appreciation for keeping their funds in the bank's custody. The purpose of granting such appreciation is to attract more deposits.[177]

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[173] F Al-Omar and M Abdel-Haq, Islamic Banking, Theory, Practice & Challenges (Zed Books Ltd, UK and USA 1996) 30-31, A Al-Heeti, Al-Masarif Al-Islamiah Bain Al-Nazarieah Wa Al-Tatbeeq (First edn, Dar Usamah, Jordan 1998) 264, ElAshker, The Islamic Business Enterprise (Croom Helm, London 1987) 123 & A Alias, N Kamarulzaman and R Bhupalan, Guide to Islamic Banking in Malaysia: An Overview (Institut Bank-Bank Malaysia (IBBM), Malaysia 1993) 8.

[174] F Al-Omar and M Abdel-Haq, Islamic Banking, Theory, Practice & Challenges 30-31, A Ahmad, Development and Problems of Islamic Banks, Islamic Research and Training Institute (Islamic Development Bank, Jeddah, Saudi Arabia 1987) 17.

[175] F Al-Omar and M Abdel-Haq, Islamic Banking, Theory, Practice & Challenges 30-31, N Ray, Arab Islamic Banking and the Renewal of Islamic Law (Graham & Trotman Limited UK 1995)18.

[176] F Al-Omar and M Abdel-Haq, Islamic Banking, Theory, Practice & Challenges 30-31, A Ahmad, Development and Problems of Islamic Banks, Islamic Research and Training Institute (Islamic Development Bank, Jeddah, Saudi Arabia 1987) 17, N Ray, Arab Islamic Banking and the Renewal of Islamic Law 18, ElAshker, The Islamic Business Enterprise (Croom Helm, London 1987) 123 & M Lewis and L Algaoud, Islamic Banking (Edward Elgar UK & USA 2001) 46-47.

[177] S Haron, Islamic Banking Rules & Regulations (Pelanduk Publications, Malaysia 1997) 309.

Legal Consideration

It is a debatable issue whether these current accounts should be governed under the concept of loans or the concept of deposits under Islamic law. The current practice of Islamic banking follows the opinion that the current accounts should be considered as a loan. This viewpoint is based its argument on the grounds that despite the fact that those accounts are labeled as deposits, they do carry the characteristics of a loan. The first striking characteristic of the loan contract found in the current accounts is the guarantee of the return. In Islamic law the deposit is considered to be a trust, so and the depositee is regarded as a trustee and is not liable for any loss or damage to the deposit. Even if a term is laid down in the contract that holds the depositee liable, that term is void. Unlike the deposit contract, in the loan contract, the return of the principle is guaranteed even in case of loss or damages.[178]

Secondly, in a deposit contract, the ownership of the deposit remains in the hands of the depositor and the depositee is obliged to return the same item that he received from the depositor. However, in a loan, the ownership of the item moves into the hands of the debtor who does not have to return the same item but rather the value of the loan. That circumstance is exactly the situation in banking practice. In the current accounts, the customer's ownership of the money deposited is dissolved, and the bank enjoys full

[178] A Al-Heeti, Al-Masarif Al-Islamiah Bain Al-Nazarieah Wa Al-Tatbeeq (First edn, Dar Usamah, Jordan 1998) 260, M Irsheed, Al-Sahmil Fi Muamalat Wa Amaliat Al-Masarif Al-Islamiah (First edn, Dar Al-Nafaes Li Al-Nashr Wa Al-Tawzeea, Jordan 2001) 157-159, A Al-Tayar, Al-Bunuk Al-Islamiah Bain Al-Nazariah Wa Al-Tatbeeq (Dar Al-Watan, Riyadh, Saudi Arabia 1994)130 & R Al-Mesri, Buhuth Fi Al-Masarif Al-Islamiah (First edn, Dar Al-Maktabi Li Al-Tibaah Wa Al-Nashr Wa Al-Tawzeea, Syria 2001) 199.

ownership of the money, pledging the return of its value whenever that value is demanded.[179]

Thirdly, the bank that manages current accounts blends the customer's funds with the funds of others and with the bank's own funds. Yet according to Islamic rules regarding deposits, the depositee is not allowed to mix the deposit with his own money in a way that the deposit cannot be distinguished, and doing so will render the depositee liable. This opinion emphasises that if the current accounts are considered as a deposit, the bank cannot mix the funds, as such an action constitutes a contradiction of the Islamic rules of deposit.[180]

Moreover, the Muslim jurists assert that generally it is not permissible that the depositee uses the deposit. If the depositee uses the deposit without the consent of the depositor, that action is deemed to be a breach of the trust. However, according to the jurists, if the depositor allows the use of the deposit, the deposit will become a loan. This situation is found in the practice of current accounts. The bank receives the deposits and utilises them with an explicit or implicit consent of the customers. If arguably the current account is considered as a deposit, according to the jurists, this deposit will be transformed into a loan.[181]

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[179] A Al-Ibadi, Mawqif Al-Shareiah Min Al-Masarif Al-Islamiah Al-Muaserah (Al-Maktabah Al-Asreiah, Beirut, Lebanon) 43, M Irsheed, Al-Sahmil Fi Muamalat Wa Amaliat Al-Masarif Al-Islamiah (First edn, Dar Al-Nafaes Li Al-Nashr Wa Al-Tawzeea, Jordan 2001) 157-159, G Al-Jamal, Al-Masarif Wa Al-Amal Al-Masrefiah Fi Al-Shareiah Wa Al-Qanun (Dar Al-Itihad Al-Arabi Li Al-Tibaah, 1972) 176 & MB Al-Sadr, Al-Bank Al-Laribawi Fi Al-Islam (Second edn, Dar Al-Kitab Al-Lubnani, Beirut, Lebanon 1973) 84.

[180] A Al-Ibadi, Mawqif Al-Shareiah Min Al-Masarif Al-Islamiah Al-Muaserah 202, R Al-Mesri, Buhuth Fi Al-Masarif Al-Islamiah (First edn, Dar Al-Maktabi Li Al-Tibaah Wa Al-Nashr Wa Al-Tawzeea, Syria 2001) 199.

[181] A Al-Ibadi, Mawqif Al-Shareiah Min Al-Masarif Al-Islamiah Al-Muaserah 41, M Irsheed, Al-Sahmil Fi Muamalat Wa Amaliat Al-Masarif Al-Islamiah (First edn, Dar Al-Nafaes Li Al-Nashr Wa Al-Tawzeea, Jordan 2001)157-159 & S Humud, Tatweer Al-

Despite the fact that Islamic banks follow the trend that considers current accounts as loans, there is a minority view that those accounts should be regarded as deposits not loans. This view looks favourably on the intention of the parties rather than the features of the current accounts and argues that the customer by opening the current account does not intend to loan the money to the bank. According to this view, the ultimate purpose of opening a current account is to arrange for safekeeping of the money and facilitate both payment and commercial activities. Therefore current accounts should be regarded as deposits not loans, and the bank is permitted to utilise the funds because of the customer's implicit consent.[182]

The Consequences of the Conflict

If the current accounts are regarded as deposits, the bank cannot guarantee the return of the capital because under the principle of deposit, the depositee is not liable for the loss or damages to the deposit unless in case of negligence.[183] However, if the current account is a loan, the return is fully guaranteed. On the other hand, the bank cannot provide any profit on such current accounts if they are identified as loans because that profit would fall into the area of riba, but considering the current accounts as deposits will provide a legitimate ground to the granting of profit on the accounts.

Amal Al-Masrefiah Bima Yatafiq Wa Al-Shareiah Al-Islamiah (First edn, Dar Al-Itihad Al-Arabi, 1976) 291.

[182] A Al-Heeti, Al-Masarif Al-Islamiah Bain Al-Nazarieah Wa Al-Tatbeeq (First edn, Dar Usamah, Jordan 1998) 261, R Al-Mesri, Buhuth Fi Al-Masarif Al-Islamiah (First edn, Dar Al-Maktabi Li Al-Tibaah Wa Al-Nashr Wa Al-Tawzeea, Syria 2001) 190-191, A Al-Ameen, Al-Wadaea Al-Masrafiah Al-Naqdiah Wa Istethmaruha Fi Al-Islam (First Edition edn, Dar Al-Shuruq, Saudi Arabia 1983)234.

[183] A Al-Baali, Al-Istithmar Wa Al-Raqabah Al-Shareiah Fi Al-Bunuk Wa Al-Muasasat Al-Maliah Al-Islamiah Dirasah Fiqhiah Wa Qanuniah Wa Masrifeiah (Maktabat Wahbah, Egypt 1991) 43.

In summary, the adoption of the view that the current accounts are loans will produce the following results:

1- When the customer deposits money in a current account, the bank becomes the legal owner of that fund, and therefore has the right to mix it and utilise it.

2- The bank guarantees the return of the fund. Any loss or damages will not protect the bank from liability.

3- Any profit generated by the utilisation of the current account is for the bank alone, and any loss incurred is borne by the bank alone.

4. The bank cannot provide its customers with any profit as it will be deemed riba according to the dominant rule that whenever a loan produces a benefit, that benefit is considered to be riba.[184]

Saving Accounts

As its name indicates, customers open this account for the purpose of saving their money. The bank would be able to utilise the funds that are deposited in the saving accounts if the customer authorises the bank to invest these funds. The customer then would share the profit that the bank makes in its investment which is distributed at the end of each financial year. However, if the customer does not authorise the bank to utilise these funds, the bank is under no obligation to share the profit with the customer and the customer can withdraw from this account at any time.[185]

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[184] A-G Nasir, Usul Al-Masrefiah Al-Islamiah Wa Qadaia Al-Tashgheel (Second edn, Matabia Al-Manar Al-Arabi, Egypt 2000) 69-70.

[185] A Al-Suwaidi, Finance of Internatinal Trade in the Gulf (Graham & Trotman Limited UK 1994) 66, M Zineldin, The Economics of Money and Banking (Almqvist & Wiksell International, Sweden 1990) 70, M Lewis and L Algaoud, Islamic Banking (Edward Elgar UK & USA 2001) 47-48 & A Alias, N Kamarulzaman and R Bhupalan, Guide to

Investment Accounts

The investment account is opened by customers who seek investment opportunities for their funds, which the bank uses for short-term and long-term investment.

The funds in the investment account have to be kept by the bank for a certain period of time. For example, in the Dubai Islamic Bank, the deposited amount in the investment account has to be more than 10,000 Dirham and the period has to be no less than three months.[186]

The funds that are deposited in the investment account are utilised along with the bank capital in the bank's activities, and thus, the depositors are treated as co-investors in terms of sharing the profit and loss. The distribution of the profit and loss is stated clearly in the contract that is signed by the bank and the depositor. The bank does not guarantee the return of these funds.

The scope for withdrawals from investment accounts is limited but the depositor would be allowed to withdraw from their accounts if a prior notice is given to the bank, taking into consideration that the amount withdrawn is excluded from any profit.

There are two types of investment account in Islamic banks; conditional and unconditional. In the conditional type, the holder of the investment account specifies the kind of projects in which the bank can invest his money. He also shares with the bank any profit or loss at the end of the project. In contrast, funds in the unconditional account can be used by the

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Islamic Banking in Malaysia: An Overview (Institut Bank-Bank Malaysia (IBBM), Malaysia 1993) 9.

[186] Dubai Islamic Bank, General Introduction of its objectives, Activities and Investment (Dubai 1984) 7.

bank in any activities without limitation by the customer and the profit and the loss are again distributed between the bank and the customer.[187]

III. Fees from Chargeable Services

The fees that the bank charges for the services it provides to its customers are also a source of the bank's funds. The following is a list of some of these services.

1- "Remittances and transfers
2- Sale and purchase of foreign currencies
3- Sale of traveller's cheques
4- Safeguarding jewellery and other valuables
5- Collection arrangements for promissory notes, cheques, bills of lading and all other instruments
6- Issue guarantees in favour of third parties
7- Acting as depositary and agent, accepting agencies and appointing agents with or without fee
8- Receiving subscription payments related to establishment of new shareholding companies or capital increases
9- Acting on behalf of customers to purchase and sell goods

[187] A Al-Suwaidi, Finance of Internatinal Trade in the Gulf 67, F Al-Omar and M Abdel-Haq, Islamic Banking, Theory, Practice & Challenges (Zed Books Ltd, UK and USA 1996) 31, M Zineldin, The Economics of Money and Banking 73, A Al-Malqi, Al-Bunuk Al-Islamyah, Al-Tajribah Bayn Al-Fiqh Wa Al-Qanoon Wa Al-Tatbeeq (Al-Markaz Al-Thaqafi Al-Arabi, Beirut, Lebanon 2000) 235, Y Al-Shabeeli, Al-Khadamat Al-Istithmaryah Fi Al-Masarif Wa Ahkamuh Fi Al-Fiqh Al-Islami (First edn, Dar Ibn Al-Jawzi, Saudi Arabia 2005) 126-127, M Lewis and L Algaoud, Islamic Banking (Edward Elgar UK & USA 2001) 48 & A Alias, N Kamarulzaman and R Bhupalan, Guide to Islamic Banking in Malaysia: An Overview (Institut Bank-Bank Malaysia (IBBM), Malaysia 1993) 10.

10- Opening documentary letters of credit in favour of the exporter either fully covered by the customer or according to the methods of mudaraba, musharaka and murabaha financing".[188]

[188] A Al-Suwaidi, Finance of Internatinal Trade in the Gulf (Graham & Trotman Limited UK 1994) 68.

Islamic Banking Financial Methods

This section deals with the financial methods that are commonly used in Islamic banking; namely: Mudaraba, Musharaka, Ijarah, Salam and Istisna. While the function of these financial instruments are different, they all share the same principle of avoiding riba (usury) which is usually presented in conventional banking in the form of interest.

I. Mudaraba Finance

Mudaraba, a well-known custom in Arabia, was used before Islam as a means of financing the caravan trade. This method was later used by the Prophet Muhammad when he was appointed by Khadija[189] and others as an active manager in trading with their money. The Prophet also approved the mudaraba transactions and their terms that were imposed by his uncle, Abbas Ibn Abd Al-Mutalib. Moreover, prominent companions of the Prophet such as Umar and Uthman, the second and third Caliphs used mudaraba when they entrusted the orphans' money to the merchants to invest it in their trade between Madinah and Iraq.[190]

Mudaraba is a partnership contract in which the funds (capital) are provided by the investor while the effort and management are provided by the active partner; and the profit is shared. In other words, the 'investor' entrusts the money to the 'active partner', who controls the management of the business—whether in trade, industry, or service—in an agreed-upon manner in order to make a profit. The

[189] Khadija became later the wife of the Prophet.
[190] A Al-Suwaidi, Finance of Internatinal Trade in the Gulf (Graham & Trotman Limited UK 1994) 73.

active partner subsequently returns the principal to the investor in addition to a predetermined share of the profits; the active partner keeps the remainder. The division of profits between the two parties must be on a proportional basis. Profits cannot be a lump sum or a guaranteed return. In a valid mudaraba, the investor is not liable for losses beyond the amount of the original capital paid while the active partner—who does not normally partake in the investment in terms of money—does not bear any share of the losses, except for his time and effort. Any loss in the original funds is borne only by the investor. However, the loss must not exceed the amount of the capital originally paid when establishing the mudaraba partnership. The investor will not bear any loss stemming from negligence, fraudulent behaviour, or bad management on the part of the active partner.[191]

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[191] A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation (E. J. Brill, Leiden, The Netherlands 1996) 51, N Ray, Arab Islamic Banking and the Renewal of Islamic Law (Graham & Trotman Limited UK 1995) 70, N Saleh, Unlawful Gain and Legitimate Profit in Islamic Law, Riba, Gharar and Islamic Banking (Second edn, Graham & Trotman, London 1992) 71, A Al-Suwaidi, Finance of Internatinal Trade in the Gulf (Graham & Trotman Limited UK 1994) 74, T Rahman, 'Mudarabah and the Pakistan Perspective' (2002) 19 J of Islamic Banking & Finance 7, I Abdal-Haqq, 'A Model of Islamic Banking in the West: IslamiQ' (2001) 6 The J of Islamic L & Culture 101 at 112, M Lewis and L Algaoud, Islamic Banking (Edward Elgar UK & USA 2001) 40-42, N Zaidi, Eliminating Interest From Banks in Pakistan (Royal Book Company, Karachi, Pakistan 1987) 148, 179, M Bassiouni, G Badr and K Dorph, Interests and Banking in Islamic Law (MidAmerica-Arab Chamber of Commerce, USA 1990) 43, M Iqbal and D Llewellyn, Islamic Banking and Finance, New Perspectives on Profit-Sharing and Risk (Edward Elgar, UK & USA 2002) 57, E Kazarian, Islamic Versus Traditional Banking, Financial Innovation in Egypt (Westview Press Inc, USA 1993) 62, S Naqvi, History of Banking and Islamic Laws (Hayat Academy, Karachi, Pakistan 1993) 81, T Wohlers-Scharf, Arab and Islamic Banks, New Business Partners For Developing Countries (Development Centre of the Organisation for Economic Co-Operation and Development, France 1983) 84, E Kazarian, Islamic Banking in Egypt (Team Offset, Sweden 1991) 110, S Amin, Islamic Banking and Finance: The Experience of Iran (Vahid Publication Tehran, Iran 1986) 32, A Hammad, Islamic Banking Theory and Practice (Zakat and Research Foundation, Ohio, USA 1989) 36, A Hoque, 'Objectives and Functioning of Islamic Banking in the Context of a Poor Country Like Bangladesh' in A Hoque (Editor), Reading in Islamic Banking (Islamic Foundation Bangladesh, Bangladesh 1987) 158-159, M Muslehuddin, Banking and Islamic Law (Islamic Publications LTD, Pakistan 1993) 85, A Alias, N Kamarulzaman and R Bhupalan, Guide to Islamic Banking in Malaysia: An Overview (Institut Bank-Bank Malaysia (IBBM), Malaysia 1993) 6, B Sabahi, 'Islamic Financial Structures as

Mudaraba Requirements

According to Muslim scholars, for mudaraba transaction to be lawful, certain requirements have to be met.

1- The funds (capital) must be money, not goods or articles. Clothing, machinery, or any property other than money is not acceptable as capital for mudaraba as the actual value of such items can vary, and this might lead to disputes between the parties.[192] However, in an opinion expressed by Imam Ahmed and Ibn Abi Laila, it is acceptable for the capital to be goods or any other items.[193]

2- If the prospective active partner owes a debt to the investor, that debt cannot be used as a capital for mudaraba. There are two reasons for this rule. The first reason is that the investor might use mudaraba as a means to recover the money that he lent to the prospective partner and thereby profit from of that debt, which Islamic law views as forbidden riba. The second reason is that by using that debt as capital, especially if the prospective partner is in financial difficulty, the investor might take advantage of this situation and set conditions in his favour that place the perspective partner at a disadvantage.

Alternatives to International Loan Agreements: Challenges for U.S. Financial Institutions' 24 Ann Rev Banking & Fin L 487 at 493, K Tacy, 'Islamic Finance: A Growing Industry in the United States' (2006) 10 NC Banking Inst 355 at 359, C Richardson, 'Islamic Finance Opportunities in the Oil and Gas Sector: An Introduction to an Emerging Field' (2006) 42 Tex Int'l LJ 119 at 129, A Ibrahim, 'The Rise of Customary Business in International Financial Markets: An Introduction to Islamic Finance and The Challenges of International Integration' (2008) 23 Am U Int'l L Rev 661 at 709 & H Juwana, Y Barlinti and Y Dewi, 'Sharia Law as a System of Governance in Indonesia: The Development of Islamic Financial Law' (2008) 25 Wis Int'l LJ 773 at 780.

[192] Al-Kasani, Badaea Al-Sanaea Fi Tarteeb Al-Sharaea (First edn, Matbaat Al-Jamaliah, Egypt 1950) 6/82.

[193] Ibn_Qudamah, Al-Mughni (Dar Al-Kitab Al-Arabi, Beirut 1972) 5/17 & Al-Mardawi, Al-Insaf (Matbaat Al-Sunnah Al-Muhammadiah, 1977) 5/410.

To avoid that, the Islamic legal scholars attempted to close this door.[194]

3- The capital has to be known and defined to the parties. If the amount of the mudaraba fund is unknown, the transaction is void. Any undefined terms in regard to the capital might lead to disputes between the parties. To avoid such potential disputes, the provided capital has to be clear and known to both parties.[195]

4- The mudaraba funds have to be given to the active partner for the contract to be valid.[196]

5- The parties' share of the profit has to be clear when mudaraba contract is executed. The calculation of profits is to be based on a specified percentage, not a lump sum of money.[197] If no percentage is defined, the default rule stipulates that the profits will be divided equally between both parties.[198] In addition, as the mudaraba is a partnership, neither party can be the sole recipient of the profits; the profits must be shared.[199]

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[194] A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation (E. J. Brill, Leiden, The Netherlands 1996) 56 & Ibn_Qudamah, Al-Mughni (Dar Al-Kitab Al-Arabi, Beirut 1972) 5/74.

[195] Al-Kasani, Badaea Al-Sanaea Fi Tarteeb Al-Sharaea (First edn, Matbaat Al-Jamaliah, Egypt 1950) 6/82.

[196] Al-Kasani, Badaea Al-Sanaea Fi Tarteeb Al-Sharaea 6/84.

[197] Ibn_Rushd, Bidayat Al-Mujtahid Wa Nihaiat Al-Muqtasid (Maktabat Al-Kuliat Al-Azhariah, Egypt 1966) 2/178 & Ibn_Qudamah, Al-Mughni (Dar Al-Kitab Al-Arabi, Beirut 1972) 5/38.

[198] Al-Kasani, Badaea Al-Sanaea Fi Tarteeb Al-Sharaea 6/85.

[199] Ibn_Qudamah, Al-Mughni (Dar Al-Kitab Al-Arabi, Beirut 1972) 5/35.

Types of Mudaraba

Two types of mudaraba contracts exist: restricted and unrestricted.

1- Restricted

In the restricted mudaraba, the active partner is limited to certain types of business; such limitations apply to time, places for transactions, or other conditions. An example of restricted mudaraba can be found in the stipulation that certain type of wood should be brought from a specified place and sold at a certain price during a specified time. The active partner should comply with these limitations otherwise the active partner is liable for any loss resulting from his negligence or violations of the terms of the contract. The profit is to be distributed according to the parties' agreement.[200]

2- Unrestricted Mudaraba

In this type of mudaraba, no restrictions are imposed on the active partner. The active partner maintains the freedom to perform and manage the mudaraba project without any limitations. He has the liberty to travel with the mudaraba capital, deal with third parties, engage in another partnership, and mix the mudaraba capital and goods with his own money and goods. He also can sell the mudaraba goods for cash or credit. The profit and loss are dealt with according to the general rules of mudaraba which dictate that the profit is

[200] A Al-Suwaidi, Finance of Internatinal Trade in the Gulf (Graham & Trotman Limited UK 1994) 75.

divided between the partners based on a pre-agreed formula and the loss is sustained only by the investor.[201]

Mudaraba in Islamic Banks

Through mudaraba, an entrepreneur would approach an Islamic bank seeking funds to establish a business. Instead of providing a loan, the bank provides the money, the entrepreneur provides his effort and management, and they share the profit. The bank is the investor and the entrepreneur is the active partner.

In Islamic banks, mudaraba is usually used for financing short-term projects. Before the bank engages in a mudaraba transaction, the finance seeker (the client) has to provide sufficient information about the mudaraba project such as the type of goods, the cost of acquiring them, and the expected sale price and profit. If the transaction is approved, a mudaraba agreement will be formed between the bank and the client: the bank provides the funds and the client will manage the project as an active partner. At the end of the project, the bank receives, along with its share of the profit, the funds that had been invested in mudaraba.

The mudaraba contract specifies the amount of capital invested by the bank in the project. The bank does not hand the money over to the client, but deposits it into a mudaraba account which is opened for that purpose. Any payment to a third party is going to be handled by the bank from this account and the client does not have direct access to it.

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[201] A Al-Suwaidi, Finance of Internatinal Trade in the Gulf 76.

The mudaraba contract contains details on how the project is to be managed. The active partner is responsible for buying the goods, storing them, obtaining proper insurance and marketing them. In managing a mudaraba project, the active partner has to comply with the contract. If the active partner violates any of the contract terms, he will be held liable.[202]

Duration of Mudaraba

According to Shafii and Maliki schools, specifying the duration of mudaraba will void the contract, because this could cause the active partner to miss an opportunity and ruin his plans that he establishes for the mudaraba projects; this could also lead to the loss of potential profit. However, the Hanafi and Hanbali schools allow the parties to agree on a specific duration for mudaraba.

As for the practice of Islamic banking, the duration of the agreement can be specified without difficulty as mudaraba is used mostly for financing short-term projects.[203] Moreover, setting time limits for the mudaraba agreement is very important for the bank since the duration of the project is an essential element in calculating the bank's profit. Therefore, keeping the bank's fund beyond the expiry date of the mudaraba project would cause loss to the bank. That is why the International Islamic Bank for Investment and Development stipulates

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[202] A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation (E. J. Brill, Leiden, The Netherlands 1996) 55-56, M Lewis and L Algaoud, Islamic Banking (Edward Elgar UK & USA 2001), R Wilson, Islamic Business, Theory and Practice (The Economist Intelligence Unit, London, UK 1984) 26-27 & K Holden, 'Islamic Finance: "Legal Hypocrisy" Moot Point, Problematic Future Bigger Concern' (2007) 25 BU Int'l LJ 341 at 351.

[203] A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation 54.

in its mudaraba agreement that "[t]he contract would automatically be cancelled by its expiry date. The mudarib must return the funds of the mudaraba to the investor with any compensation for keeping the funds during the time of the contract without making them productive". [204]

Guarantee

According to medieval jurisprudence, the general rule in mudaraba dictates that the investor cannot seek any kind of guarantee from the active partner to ensure the return of the capital and the profit because the mudaraba forms a fiduciary relationship between the parties and the active partner is considered a trustworthy person. Malik and Shfii insist that taking guarantees from the mudaraba partner would void the contract. [205]

However, in practice, Islamic banks demands that the active partner provides guarantees. From the bank's perspective, these guarantees are not meant to secure the bank's advanced funds and the expected return but to ensure that the performance of the active partner complies with the agreed terms. The contract of Faisal Islamic Bank of Egypt asserts that "if it is proved that the active partner misused or did not properly protect the goods or funds or acted contrary to the investor's terms, the active partner should bear the loss, and should provide guarantee against such a loss". [206]

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[204] International Islamic Bank for Investment and Development, 'Aqd Mudaraba (Contract of Mudaraba) (Cairo, Egypt) 22.

[205] A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation 54.

[206] Faisal Islamic Bank of Egypt, 'Aqd Mudaraba (Contract of Mudaraba) (Faisal Islamic Bank of Egypt, Cairo).

Moreover, the Islamic banks have additional means at their disposal to safeguard their investment. For instance, in any mudaraba transaction, the active partner is required to provide the bank with, in addition to project accounting records, periodic records of the progress of mudaraba. If the active partner fails to provide these documents within the stipulated timeframe, his profit would be reduced in proportion to that delay. Moreover, the active partner has to allow the bank access to monitor the progress of mudaraba project and the performance of the active partner.

If the project does not achieve the expected profit, or if the bank considers the project a failure, or if the active partner acts in violation of the terms of the contract, the bank either can take over the management of the project or request the liquidation of the assets. The bank has the right to do so without recourse to law.[207]

Profit and Loss

The Islamic bank and its client should specify the profit-ratio when they conclude the contract. As previously stated, the division of profits in mudaraba must be on a proportional basis with no allocation of a specific fixed sum to one party. The bank cannot stipulate its profit as a percentage calculated from its advanced fund, because the

[207] A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation 58.

percentage has to be calculated from the profit, not from the capital invested. [208]

In addition, two issues regarding mudaraba profit are matters of concern for Muslim scholars. The first issue is the stipulation that there has to be profit in the transaction. In other words, in any commercial transaction, there is a potential of making profit and also there is a potential of sustaining loss. Is it acceptable that the parties stipulate that in this transaction there has to be profit only and no loss? Hanafi and Hanbali schools hold the view that in this situation, the mudaraba contract is valid but the condition is void. However, Maliki and Shafii schools contented that adding this condition to the agreement will render the whole transaction voidable. [209] The second issue is whether it is acceptable to agree that all of the profit goes to one party. While the Shafii and Hanbali schools disallow that, the Maliki School accepts it. The Hanifi School, however, asserts that if the parties agree that all the profit should be given to the active partner, the transaction is a loan and not a mudaraba transaction, and therefore, it should be subject to the loan rules.[210]

If the mudaraba project does not produce any profit, the active partner is not compensated for his time or effort. However, the investor (the Islamic bank) bears the loss alone unless it proves that the loss is due

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[208] N Ray, Arab Islamic Banking and the Renewal of Islamic Law (Graham & Trotman Limited UK 1995) 75 & MN Siddiqi, Banking Without Interest (The Islamic Foundation, UK 1983) 27-32.

[209] N Ray, Arab Islamic Banking and the Renewal of Islamic Law 72.

[210] N Ray, Arab Islamic Banking and the Renewal of Islamic Law 72. Examples of the loan rules are the guarantee of the return of the capital by the debtor and the prohibition of interest.

to the active partner's misconduct or violation of the agreement. Under these circumstances, the active partner is liable for the loss. [211]

[211] A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation (E. J. Brill, Leiden, The Netherlands 1996) 58, MN Siddiqi, Issues in Islamic Banking, Selected Papers (The Islamic Foundation, UK 1983) 23 & A Al-Darir 'Types and Methods of Investment in Islamic Thought' in A Hoque (Editor), Reading in Islamic Banking (Islamic Foundation Bangladesh, Bangladesh 1987) 139.

II. Musharaka Finance

The literal meaning of musharaka in English is partnership. In musharaka finance, the Islamic bank contributes part of the capital. In other words, the client provides part of the musharaka project capital and the bank provides the rest. The Islamic bank and its client, who is the bank's partner in the musharaka project, share the loss in proportion to their contribution to the capital. However, the profit is divided between the partners according to their agreement.[212]

[212] A Al-Heeti, Al-Masarif Al-Islamiah Bain Al-Nazarieah Wa Al-Tatbeeq (First edn, Dar Usamah, Jordan 1998) 496-498, N Thani, Law and Practice of Islamic Banking and Finance (Sweet & Maxwell Asia, Malaysia 2003) 49, N Saleh, Unlawful Gain and Legitimate Profit in Islamic Law, Riba, Gharar and Islamic Banking (Second edn, Graham & Trotman, London 1992) 113, I Abdal-Haqq, 'A Model of Islamic Banking in the West: IslamiQ' (2001) 6 The J of Islamic L & Culture 101 at 112 & A Yaacob and H Ibrahim, Islamic Financial Services and Products (Institute of Islamic Understanding Malaysia (IKIM), Kuala Lumpur, Malaysia 1999) 7-15, M Lewis and L Algaoud, Islamic Banking (Edward Elgar UK & USA 2001) 42-43, N Zaidi, Eliminating Interest From Banks in Pakistan (Royal Book Company, Karachi, Pakistan 1987) 148, M Bassiouni, G Badr and K Dorph, Interests and Banking in Islamic Law (MidAmerica-Arab Chamber of Commerce, USA 1990) 41, E Kazarian, Islamic Versus Traditional Banking, Financial Innovation in Egypt (Westview Press Inc, USA 1993) 64, N Zaidi 'Interest-Free Banking, Modes of Financing' in Interest-Free Banking (The Institute of Bankers in Pakistan, Karachi, Pakistan 1994) 150, T Wohlers-Scharf, Arab and Islamic Banks, New Business Partners For Developing Countries (Development Centre of the Organisation for Economic Co-Operation and Development, France 1983) 84, S Amin, Islamic Banking and Finance: The Experience of Iran (Vahid Publication Tehran, Iran 1986) 33, A Hammad, Islamic Banking Theory and Practice (Zakat and Research Foundation, Ohio, USA 1989) 35, R Wilson, Islamic Business, Theory and Practice (The Economist Intelligence Unit, London, UK 1984) 27, A Alias, N Kamarulzaman and R Bhupalan, Guide to Islamic Banking in Malaysia: An Overview (Institut Bank-Bank Malaysia (IBBM), Malaysia 1993) 6, K Holden, 'Islamic Finance: "Legal Hypocrisy" Moot Point, Problematic Future Bigger Concern' (2007) 25 BU Int'l LJ 341 at 351, B Sabahi, 'Islamic Financial Structures as Alternatives to International Loan Agreements: Challenges for U.S. Financial Institutions'24 Ann Rev Banking & Fin L 487 at 493, K Tacy, 'Islamic Finance: A Growing Industry in the United States' (2006) 10 NC Banking Inst 355 at 359, C Richardson, 'Islamic Finance Opportunities in the Oil and Gas Sector: An Introduction to an Emerging Field' (2006) 42 Tex Int'l LJ 119 at 129, A Ibrahim, 'The Rise of Customary Business in International Financial Markets: An Introduction to Islamic Finance and The Challenges of International Integration' (2008) 23 Am U Int'l L Rev 661 at 711 & H Juwana, Y Barlinti and Y Dewi, 'Sharia Law as a System of Governance in Indonesia: The Development of Islamic Financial Law' (2008) 25 Wis Int'l LJ 773 at 780.

Diminishing Musharaka

In diminishing musharaka, the bank's partner gradually gains ownership of the project. In essence, the Islamic bank's share in the partnership reduces over time until the project is completely owned by the client. This is done by the agreement between the partners that the bank would periodically receive, besides its share of the profit, part of the funds the bank invested in the musharaka until the bank receives all its contribution and the client (bank's partner) becomes the sole owner of the project.[213]

Diminishing musharaka was first implemented in Egypt when an Islamic branch of an Egyptian bank entered into diminishing musharaka with a transportation company to finance the purchase of a fleet of buses. The bank provided four million Egyptian pounds and the transportation company paid one million Egyptian pounds. Every year the bank received a share of the profit in addition to a return of part of the four million pounds that the bank had contributed. The bank's share of the profit reduced every year in proportion to its participation in the partnership. In

[213] A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation (E. J. Brill, Leiden, The Netherlands 1996) 64, N Ray, Arab Islamic Banking and the Renewal of Islamic Law (Graham & Trotman Limited UK 1995) 62, M Irsheed, Al-Sahmil Fi Muamalat Wa Amaliat Al-Masarif Al-Islamiah (First edn, Dar Al-Nafaes Li Al-Nashr Wa Al-Tawzeea, Jordan 2001) 35, A Yaacob and H Ibrahim, Islamic Financial Services and Products (Institute of Islamic Understanding Malaysia (IKIM), Kuala Lumpur, Malaysia 1999) 15-18, S Naqvi, History of Banking and Islamic Laws (Hayat Academy, Karachi, Pakistan 1993) 133-134, A Al-Darir 'Types and Methods of Investment in Islamic Thought' in A Hoque (Editor), Reading in Islamic Banking (Islamic Foundation Bangladesh, Bangladesh 1987) 143, B Sabahi, 'Islamic Financial Structures as Alternatives to International Loan Agreements: Challenges for U.S. Financial Institutions'24 Ann Rev Banking, Fin L 487 at 493 & K Tacy, 'Islamic Finance: A Growing Industry in the United States' (2006) 10 NC Banking Inst 355 at 359 & A Ibrahim, 'The Rise of Customary Business in International Financial Markets: An Introduction to Islamic Finance and The Challenges of International Integration' (2008) 23 Am U Int'l L Rev 661 at 711.

five years the bank had recovered its four million pounds and the transportation company became the sole owner of the fleet of buses.[214]

The capital of musharaka

As mentioned above, both the bank and the client will provide the musharaka capital. There is however no specification as to how much the bank should participate in the project. The preliminary study which the bank conducts to evaluate the musharaka project and assess the client's financial position will determine how much the bank is going to invest in the project. In some situations the bank would contribute up to 90% of the total capital.[215]

Guarantees

For the purpose of securing their investments, Islamic banks require guarantees. The following are some examples.

1- A cheque signed by the client for the amount that has been invested by the bank in musharaka project. The bank has the right to use the cheque if the client breaks the terms of the musharaka contract.

2- The bank may keep any cash balance, documents and commercial papers that belong to the partner (client). The bank has the right to use them if the client defaults on any payments that are owed to the bank.

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[214] A Al-Masri, Al-Masrif Al-Islami Ilmyan Wa Amalyan (First edn, Maktabat Wahbah, Cairo 1988) 69.
[215] A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation 65.

3- If the musharaka goods are sold on credit, the client will be a guarantor for any debt that is required from a third party.[216]

Management of Musharaka

Musharaka is a financial method utilised by Islamic banks where both the bank and its partner provide the funds for the project. In principle, each partner that participates in the musharaka capital has the right to participate in the musharaka management. However, the partners can agree that the management of musharaka project is to be carried out by one of them and the other partner maintains a role as a silent partner, who does not participate in the management of the musharaka project but who shares the profit and the loss. In practice, Islamic banks leave the management to the client and the bank maintains the role of monitoring the project and the performance of the partner.[217] The way in which the project should be managed is governed by the terms of the contract. The following are examples of some of these terms.

1- The musharaka goods should be stored under the joint supervision of both the client and the bank. The goods should be sold by the client for cash and for the amount mentioned in the agreement. The client does not have the right to sell the goods on credit or at a price less than the contracted price unless there is a written consent from the bank.

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[216] A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation 61-67, N Ray, Arab Islamic Banking and the Renewal of Islamic Law (Graham & Trotman Limited UK 1995) 62.

[217] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 10, A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation 61.

2- The client has to submit periodic reports to the bank regarding the musharaka project and the sold goods and their prices.

3- The client has to insure the musharaka goods against any risks throughout the musharaka project.

4- The client cannot mix musharaka goods with his own goods. Nor can the client use the musharaka goods as collateral to secure a loan without a written authorisation from the bank.[218]

The Division of Profit

The agreement on how the profit is divided between the partners should take place at the time of making the contract; otherwise, the partnership is going to be void.

The profit should be divided as a certain percentage of the profit allocated to each partner. Therefore, it is not acceptable to stipulate that the partner should be given a percentage of the partner's contribution to the capital as a profit. In addition, the profit should not be a defined amount. For example, it is not permitted to agree that A should be given £10,000 every year as a profit, nor is it permitted to agree that A is given annually, as a profit, an amount that equals 10% of his investment. However, if the partners agree that A should be given 10% of the profit, this is acceptable.[219]

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[218] A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation 66.

[219] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 7 & N Zaidi, Eliminating Interest From Banks in Pakistan (Royal Book Company, Karachi, Pakistan 1987) 151, 161.

In Islamic banks, there are no standard rules as to how the profit should be distributed in musharaka. Each partner's share of the profit depends to a great extent on his contribution to the capital and on the role the partner plays in conducting the project. According to the Islamic Bank of Investment and Development, the profit is distributed as follows:

1- A percentage of the profit goes to the partner for his management of the project.
2- A percentage of the profit for the bank for its task of monitoring the project and the performance of the partner.
3- The rest of the profit is divided between the bank and the client based on the ratio of their capital contribution.[220]

The musharaka contract of the Islamic branch of the Bank of Misr (Egypt) stipulates that in distribution the profit, a percentage of the profit is allocated to the bank for its banking services, and a percentage to the bank's partner for his effort in managing the project. The remaining balance is distributed between the bank and the partner according to their investment.[221]

The practice concerning the amount that the bank's partner should be given from the profit for his effort in managing the project varies among Islamic banks. For example, while Faisal Islamic Bank of Egypt allocates between 20% to 60% of the profit for the partner, Tadamon Bank allocates between

[220] International Islamic Bank for Investment and Development, Application for Musharaka Financing.
[221] Bank Misr, Aqd Al-Musharaka (Contract of Musharaka).

15% to 45% based on the duration of the project and the effort of the partner.[222]

Loss sharing

The Islamic law scholars have agreed that the loss is divided between the partners in proportion to their share of the capital. Therefore, if a partner contributed 60% of the capital, that partner should bear 60% of the loss. Any provision that contradicts this rule is void. However, if the loss is a result of the partner's negligence or mismanagement or not complying with musharaka contract, the partner is liable.[223]

Termination of musharaka

The musharaka partnership can be terminated by any of the partners upon giving proper notice to the other partner. When the partnership is terminated, if the musharaka asset is in liquidated form, it should be distributed between the partners in proportion to their participation in the capital. However, if the musharaka asset or part of it is not in liquidated form, the partners can agree to divide the asset among themselves as it is or can liquidate it and distribute it among themselves after liquidation.

Nevertheless, if there is disagreement among the partners with regard to liquidating the asset, then the asset should be distributed in its non-liquidated form and the partners cannot be forced to liquidate the asset.

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[222] Bank Al-Tadamon Al-Islami, Al-Tajir Al-Saduq Wa Badai'l Al-Istithmar Al-Ribawai (Bank Al-Tadamon Al-Islami 1988) 18.

[223] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 8, A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation 69 & N Zaidi, Eliminating Interest From Banks in Pakistan (Royal Book Company, Karachi, Pakistan 1987) 172.

However, if there is a problem with the partition of the non-liquidated asset, such as in the case of machinery, then the asset has to be liquidated.

If one of the partners wishes to terminate the musharaka contract, but the other partners decide to continue, the partner who wants to terminate can sell his share to the partnership and withdraw, and therefore the partnership can still be running because the departure of one of the partners does not mean the termination of the whole partnership. The value of the share can be reached through an agreement between the partners, and in the event of dispute, the partners have no choice but to resort to liquidation or separation of the asset.[224]

In the practice of Islamic banking, the bank's client (partner) has the right to terminate the musharaka after giving proper notice to the bank. The partner is liable for any loss incurred by the bank as the result of the partner's termination. However, the bank cannot be compensated for the loss of profit.[225]

Likewise, the Islamic bank has the right to terminate the contract at will. The Islamic bank of Jordon musharaka contract stipulates that the bank, without recourse to law, has the right to terminate the contract and seek liquidation of the musharaka agreement if the client contravenes the terms of the contract or if the bank reaches the understanding that continuing the

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[224] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 11 & N Ray, Arab Islamic Banking and the Renewal of Islamic Law (Graham & Trotman Limited UK 1995) 62-63.

[225] N Ray, Arab Islamic Banking and the Renewal of Islamic Law 64 & A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation 67

musharaka project would cause loss to the bank or if it is not going to be beneficial.[226]

The musharaka contract is also terminated in the event of the death of the partner or the partner becomes insolvent. In addition, the loss of the musharaka project leads to the termination of the contract.[227]

An important question is whether it is acceptable to include in the contract a clause to restrict one of the partners from terminating the contract unilaterally and to stipulate that it has to be a majority's decision for the termination to take effect and the partner who seeks termination should sell his shares to the partnership. From an Islamic legal perspective, this question was not answered. However, for the advantage of the musharaka project, someone might conclude that it is better for the partners to include such a clause protecting the partnership against a premature termination especially when the project is showing potential signs of success and when the termination of the musharaka would destroy the project and lead to a great loss.[228]

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[226] Jordan Islamic Bank, Aqd Al-Musharaka (Contract of Musharaka).
[227] N Ray, Arab Islamic Banking and the Renewal of Islamic Law 66.
[228] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 12.

III. Ijarah Finance

Ijarah is a lease contract whereby the Islamic bank leases an asset to the client for a specified period of time.[229] The utilisation of ijarah in Islamic banking as a means of finance has witnessed rapid growth. This is because this method permits the bank to provide equipment, property and different kinds of assets to businesses and individuals while keeping the title to these assets under the bank's ownership, thus assuring a safe and effective protection of the bank's interest.[230] That makes the risk in financing through ijarah very low as the bank always has the right to terminate the ijarah agreement and reclaim possession of the asset in the event that the client defaults in the payment or fails to fulfil any of the contractual obligations.[231]

Through ijarah finance, the Islamic bank purchases the object that is demanded by the client and leases it to the client for a specified length of

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[229] A Al-Malqi, Al-Bunuk Al-Islamyah, Al-Tajribah Bayn Al-Fiqh Wa Al-Qanoon Wa Al-Tatbeeq (Al-Markaz Al-Thaqafi Al-Arabi, Beirut, Lebanon 2000) 505, N Saleh, Unlawful Gain and Legitimate Profit in Islamic Law, Riba, Gharar and Islamic Banking (Second edn, Graham & Trotman, London 1992) 120, N Thani, Law and Practice of Islamic Banking and Finance (Sweet & Maxwell Asia, Malaysia 2003) 44, L Allawi, 'Leasing: an Islamic Financial Instrument' in Butterworths Editorial Staff, Islamic Banking and Finance (Butterworths & Co (Publishers) Ltd, London 1985) 120, M Lewis and L Algaoud, Islamic Banking (Edward Elgar UK & USA 2001) 56, E Kazarian, Islamic Versus Traditional Banking, Financial Innovation in Egypt (Westview Press Inc, USA 1993) 65, N Zaidi 'Interest-Free Banking, Modes of Financing' in Interest-Free Banking (The Institute of Bankers in Pakistan, Karachi, Pakistan 1994) 149, A Alias, N Kamarulzaman and R Bhupalan, Guide to Islamic Banking in Malaysia: An Overview (Institut Bank-Bank Malaysia (IBBM), Malaysia 1993) 7, H Ahmed, 'Not Interested in Interest? The Case For Equity-Based Financing in U.S. Banking Law' (2007) 2 Entrepreneurial Bus LJ 479 at 491, C Richardson, 'Islamic Finance Opportunities in the Oil and Gas Sector: An Introduction to an Emerging Field' (2006) 42 Tex Int'l LJ 119 at 128 & H Juwana, Y Barlinti and Y Dewi, 'Sharia Law as a System of Governance in Indonesia: The Development of Islamic Financial Law' (2008) 25 Wis Int'l LJ 773 at 781.

[230] N Thani, Law and Practice of Islamic Banking and Finance 46 & I Warde, Islamic Finance in the Global Economy (Edinburgh University Press, UK 2001) 135.

[231] A Al-Malqi, Al-Bunuk Al-Islamyah, Al-Tajribah Bayn Al-Fiqh Wa Al-Qanoon Wa Al-Tatbeeq (Al-Markaz Al-Thaqafi Al-Arabi, Beirut, Lebanon 2000) 520. This is similar to what is known in the UK as Financial Leasing. For more on this, see L Sealy and R Hooley, Commercial Law (Fourth edn, Oxford University Press, USA 2009) 927.

time and for a pre-agreed amount of rent. Subsequent to signing the ijarah agreement, the Islamic bank opens an account in which the lessee would deposit the rent according to the terms of the agreement. [232] At the end of the ijarah term, in most cases, the client would have the option of returning the object to the bank, renewing the ijarah contract or purchasing the object with a new contract for a discounted price. [233] Indeed, in most cases, the bank prefers that the lessee either purchase the leased object at the end of the lease agreement or renew the agreement for another term. The bank does not want to end up with an old piece of equipment or machine and assume the burden of selling it on the market. [234]

Obligations of the bank (lessor) and the client (lessee)

Under a modern ijarah contract, the bank is obliged to purchase the object from the supplier according to the specifications provided by the client. The bank has to grant the client access to the object at the agreed time and does not have the right to use the object. The bank is under no obligation to

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[232] A Al-Malqi, Al-Bunuk Al-Islamyah, Al-Tajribah Bayn Al-Fiqh Wa Al-Qanoon Wa Al-Tatbeeq 516, R Wilson, Islamic Business, Theory and Practice (The Economist Intelligence Unit, London, UK 1984) 29 & K Holden, 'Islamic Finance: "Legal Hypocrisy" Moot Point, Problematic Future Bigger Concern' (2007) 25 BU Int'l LJ 341 at 350.

[233] A Al-Malqi, Al-Bunuk Al-Islamyah, Al-Tajribah Bayn Al-Fiqh Wa Al-Qanoon Wa Al-Tatbeeq 506, A Hammad, Islamic Banking Theory and Practice (Zakat and Research Foundation, Ohio, USA 1989) 38, B Sabahi, 'Islamic Financial Structures as Alternatives to International Loan Agreements: Challenges for U.S. Financial Institutions' 24 Ann Rev Banking & Fin L 487 at 494, K Tacy, 'Islamic Finance: A Growing Industry in the United States' (2006) 10 NC Banking Inst 355 at 358, A Ibrahim, 'The Rise of Customary Business in International Financial Markets: An Introduction to Islamic Finance and The Challenges of International Integration' (2008) 23 Am U Int'l L Rev 661 at 713 & Q Latif, 'Islamic Finance' (2006) 1 JIBFL 10.

[234] M Zineldin, The Economics of Money and Banking (Almqvist & Wiksell International, Sweden 1990) 84, A Al-Malqi, Al-Bunuk Al-Islamyah, Al-Tajribah Bayn Al-Fiqh Wa Al-Qanoon Wa Al-Tatbeeq (Al-Markaz Al-Thaqafi Al-Arabi, Beirut, Lebanon 2000) 512. Similar to this mode of finance is practiced in the UK in the form of Hire-Purchase. See L Sealy and R Hooley, Commercial Law (Fourth edn, Oxford University Press, USA 2009) 453 & G McCormack, Secured Credit under English and American Law (Cambridge University Press, UK 2004) 125.

provide any technical or maintenance services during the ijarah term. Nevertheless, the bank has the right to periodically inspect the leased object to ensure that it is being used according to the agreement and that it operates as expected and is being provided by the client with satisfactory maintenance.[235]

The client, however, has to fulfil several obligations. In some of the Islamic banks' agreements, the client is responsible for the delivery of the object from the supplier to his possession and bears any risks associated with that delivery. Besides paying the rent in a pre-agreed manner, the client should service and maintain the object and obtain insurance to protect it against any risks. [236] The agreement of Faisal Islamic Bank of Bahrain stipulates that once the leased object is in the possession of the lessee, the lessee bears the risk of loss or damage or any other risk associated with the object. [237]

Ijarah-and-purchase transaction

Ijarah-and-purchase is a lease contract with the option to purchase the leased property at the end of the ijarah term. From the Islamic bank's perspective, ijarah-and-purchase is a very important tool in financing the acquisition of movable and immovable properties such as equipment, machinery, building, and land. The ijarah-and-purchase transaction starts when the bank's client expresses his intention to enter with the bank into an ijarah agreement for a specified property with the desire to purchase that

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[235] A Al-Malqi, Al-Bunuk Al-Islamyah, Al-Tajribah Bayn Al-Fiqh Wa Al-Qanoon Wa Al-Tatbeeq 510.

[236] A Al-Malqi, Al-Bunuk Al-Islamyah, Al-Tajribah Bayn Al-Fiqh Wa Al-Qanoon Wa Al-Tatbeeq 510.

[237] Faisal Islamic Bank of Bahrain, Al-Taqreer Al-Sanawi (Annual Report) (Faisal Islamic Bank of Bahrain 1988) 18.

property at the end of the ijarah term. The bank purchases the property from its owner and appoints the client as an agent in receiving the property. When the client informs the bank of receiving the property according to specifications, an ijarah contract is formed between the parties. At the end of the ijarah period and when the client fulfils the contract terms and performs all of the rentals, ownership of the object is transferred to the client by a new sale contract with no or with a discounted price.[238] Although the sale transaction is optional in most of ijarah-and-purchase agreements, in some Islamic banks, such as the Iranian Islamic banks, the purchase of the leased property at the end of the ijarah contract is not optional but obligatory and the client must purchase the property. [239]

This transaction is performed in some Islamic banks in one contract. However, some contemporary scholars opposed tying the ijarah and sale contracts together. Their opposition to the transaction is because the Islamic law does not allow the performance of two contracts in one where

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[238] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 78, N Thani, Law and Practice of Islamic Banking and Finance (Sweet & Maxwell Asia, Malaysia 2003) 48, M Zaman, Banking and Finance, Islamic Concept (International Association of Islamic Banks, Karachi, Pakistan 1993) 177, M El-Gmal, A Basic Guide to Contemporary Islamic Banking and Finance (ISNA, USA 2000) 14, M Bassiouni, G Badr and K Dorph, Interests and Banking in Islamic Law (MidAmerica-Arab Chamber of Commerce, USA 1990) 44, E Kazarian, Islamic Versus Traditional Banking, Financial Innovation in Egypt (Westview Press Inc, USA 1993) 65 & N Zaidi 'Interest-Free Banking, Modes of Financing' in, Interest-Free Banking (The Institute of Bankers in Pakistan, Karachi, Pakistan 1994) 149-150, M Kahf, 'Financing International Trade, an Islamic Alternative' (Internatinal Seminar: The Economic and Financial Imperatives of Globalisation an Islamic Response, Organised by Institute of Islamic Understanding Malaysia (IKIM) 1999) 18, A Al-Malqi, Al-Bunuk Al-Islamyah, Al-Tajribah Bayn Al-Fiqh Wa Al-Qanoon Wa Al-Tatbeeq (Al-Markaz Al-Thaqafi Al-Arabi, Beirut, Lebanon 2000) 518, M Shabeer, Al-Muaamalat Al-Malyah Al-Muaaserah Fi Al-Fiqh (Dar Al-Nafaes, Jordan 1998) 281 & H Juwana, Y Barlinti and Y Dewi, 'Sharia Law as a System of Governance in Indonesia: The Development of Islamic Financial Law' (2008) 25 Wis Int'l LJ 773 at 781.

[239] J Atyah, Al-Bunuk Al-Islamyah Bain Al-Huryah Wa Al-Tanzeem, Wa Al-Taqleed Wa Al-Ijtihad, Wa Al-Nazaryah Wa Al-Tatbeeq (First edn, Matabi' Al-Dawha Al-Hadeethah, Qatar 1986) 45.

the execution of one contract depends on the other. Those scholars suggest that this transaction should be done through one of the following methods:

1- Ijarah with a separate promise from the lessor to sell the property to the lessee at the end of the ijarah term. This promise is binding on the lessor only.

2- Ijarah with a promise to gift. Here, the lessor signs a separate promise to gift the leased object to the lessee at the end of the ijarah term.

In addition, the scholars insist that for the validity of these methods, two requirements have to be met.

1- The promise should not be tied to the ijarah contract and therefore should be done separately.

2- The promise should be binding on the lessor only.

These methods have been implemented by some Islamic banks to avoid being involved in any transactions that might be contrary to Islamic law principles, despite the fact that the promise in some of these transactions is not performed separately.[240] An example of ijarah with a promise to gift can be found in the ijarah agreement of Al-Jumaih, where clause no. 4 states: "In the event that the lessee has made all the payments within the specified period which is 36 months, the ownership of the car will be transferred as a gift to the lessee at the end of the ijarah term and the lessor is only responsible for the expenses of transferring the car into the lessee's ownership".[241]

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[240] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 78 & K Al-Hafi, Al-Ijarah Al-Muntahiah Bi Al-Tamleek (Second edn, Saudi Arabia 2001) 66.

[241] Al-Jumaih, Aqd Ijar Muntahi Bi Al-Tamleek (Ijarah-and-purchase contract).

The ijarah agreement of Baraka Islamic Bank for Investment and Development provides an example of ijarah with a promise to sell. This agreement contains a clause expressing a binding promise from the Islamic bank that upon the fulfilment of the lessee's contractual obligations, including the payment of all the rents, the bank transfers the property to the lessee's ownership within seven days without any additional charge on the part of the lessee.[242]

Moreover, a seminar held in Kuwait Financial House in 1987 regarding the validity of ijarah-and-purchase transaction concluded that such a transaction should be considered as an ijarah with the promise to gift. It also concluded that such a transaction is allowed on the condition that the ijarah terms and the rent are defined clearly in the contract. In addition, the ownership of the property is not transferred until the end of the ijarah term based on a previous written promise by the bank to gift this object to the client at the end of the ijarah term.[243]

Relationships in ijarah-and-purchase transaction

For the purpose of highlighting the relationships created between the parties in ijarah-and-purchase transaction, the following scenario should be considered.

A client applies to an Islamic bank expressing interest in acquiring a property through ijarah-and-purchase transaction. If the bank approves the client's application, the bank authorises the client to contact the supplier and purchase the property on behalf of the bank. The bank leases the

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[242] M Shabeer, Al-Muaamalat Al-Malyah Al-Muaaserah Fi Al-Fiqh (Dar Al-Nafaes, Jordan 1998) 69.

[243] M Shabeer, Al-Muaamalat Al-Malyah Al-Muaaserah Fi Al-Fiqh 284.

property to the client. At the end of the ijarah (lease) term, the bank passes the ownership of the property to the client on a sale contract. Based on the above scenario, different kinds of relationships can be seen in the ijarah-and-purchase transaction. First, when the client acts on behalf of the bank in contacting the supplier and acquiring the property, this is a principal/agent relationship. Apparently the bank is the principal and the client is its agent. There is also a relationship between the supplier and the Islamic bank. Although the Islamic bank does not contact the supplier directly, the bank is the actual buyer and therefore a sale relationship is formed between the bank and the supplier in which the bank is the buyer and the supplier is the seller. Then there is an ijarah (lease) relationship between the bank and the client, in which the bank is the lessor and the client is the lessee. At the end of the ijarah term, there is a sale relationship in which the bank is the seller and the client is the buyer. Through this sale transaction, the ownership of the property is transferred from the bank to the client.[244]

Therefore, since the Islamic bank is the actual purchaser of the property from the supplier, all expenses associated with purchasing that property, should be borne by the Islamic bank. In addition, the Islamic bank is responsible for insuring and delivering the property. Until the property is received by the lessee, the bank is liable for any loss or damages that might

[244] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 77 & A Al-Malqi, Al-Bunuk Al-Islamyah, Al-Tajribah Bayn Al-Fiqh Wa Al-Qanoon Wa Al-Tatbeeq (Al-Markaz Al-Thaqafi Al-Arabi, Beirut, Lebanon 2000) 509.

occur to the property. Under the ijarah principles, the lessee cannot be held responsible for any of these expenses.[245]

However, the lessee is liable for any damages that the property sustains because of the lessee's negligence or misuse. The lessee can also be made responsible for any wear and tear while the property is in his possession, but for any damage or loss that happens out of the lessee's control, the lessor is responsible, as the owner of the property.[246]

Penalties for defaulting in payment

Some Islamic banks impose a penalty in the event the lessee defaults on paying the rent. However, this practice has been criticised by some contemporary scholars. They explain that when the payment of rent is due, it becomes a debt and charging a penalty on that debt would be riba (usury) which is prohibited in Islamic law. As an alternative, some scholars suggest that the defaulting lessee should be charged a fixed amount that would be distributable for charitable causes.

Therefore, the bank would open a charity fund for the purpose of depositing these charges and then use them for charitable aims such as providing interest-free loans for the needy.

As this suggestion may solve the problem of usury, some Islamic banks used it in their ijarah agreement. Some of their agreements may contain wording that is similar to the following:

"The Lessee hereby undertakes that, if he fails to pay rent on its due date, he shall pay an amount calculated at ... per cent per annum to the charity

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[245] MT Usmani, An Introduction to Islamic Finance 74.
[246] MT Usmani, An Introduction to Islamic Finance 74.

fund maintained by the Lessor which will be used by the Lessor exclusively for charitable purposes approved by the *Shari'ah* and shall in no case form part of the income of the Lessor". Although this will not compensate the bank for its loss sustained as the result of the lessee's failure to meet his payment obligations, it might provide at least a minimum protection to the bank against the dishonest lessees who take advantage of this situation knowing that the Islamic bank will not charge them a penalty.[247]

Termination of the Ijarah agreement

Muslim scholars agree that ijarah is a binding contract. Therefore, unless the contract provides otherwise, the ijarah cannot be terminated without the consent of both the lessor and the lessee.[248] According to the Al-Jumaih Corporation ijarah contract, in the event that the lessee wishes to terminate the contract before the end of its term, the lessee has to return the leased car with a written form signed by both parties.[249] In another ijarah contract that is used by Tawkeelat Al-Jazeerah Corporation, the contract provides that the lessee has the right to terminate the contract at any time before the end of the ijarah term but he has to submit a written notice demanding the termination of the agreement. In addition, the lessee has to return the leased car and pay its rent until the date the car is returned to the lessor plus compensation in a sum equalling half of the rent for the remaining

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[247] MT Usmani, An Introduction to Islamic Finance 77.
[248] K Al-Hafi, Al-Ijarah Al-Muntahiah Bi Al-Tamleek (Second edn, Saudi Arabia 2001). 217, MT Usmani, An Introduction to Islamic Finance 77.
[249] Sharika Al-Jumaih, Aqd Ijar Muntahi Bi Al-Tamleek (Ijarah-and-purchase contract).

period. Moreover, the lessee undertakes any repair or maintenance as the car is required to be in good condition.[250]

However, some Islamic banks stipulate that if the ijarah contract is terminated whether by the lessee or the lessor, the lessee is required to pay for the remaining ijarah term. This practice has been criticised on the ground that it deviates from the Islamic law ijarah principle which dictates that the lessee is only responsible for paying the rent for the period that the object was in his use.[251]

Another situation in which the ijarah contract can be terminated is where the parties agree that the lessee has the choice of purchasing the object at the end of or during the contract and the lessee expresses his intention to purchase the leased property before the end of the contract. In this case the ijarah contract is terminated and the parties would perform a purchase contract. The ijarah contract of Tawkeelat Al-Jazeerah Corporation asserts that in the event the lessee wishes to purchase the leased car before the end of the ijarah term, he has to inform the lessor in writing. Upon receiving the letter, the lessor would calculate the remaining payment the lessee has to pay to own the car, taking into consideration the amount of rentals that has already been paid.[252]

Moreover, in the event that the lessee defaults in paying the rent or fails to fulfil any of the contract obligations, the lessor has the right to terminate the ijarah contract. According to the Al-Rajhi ijarah contract, if the lessee

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[250] Sharika Tawkeelat Al-Jazeerah, Aqd Ijar Muntahi Bi Al-Tamleek (Ijarah-and-purchase contract).

[251] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 77.

[252] K Al-Hafi, Al-Ijarah Al-Muntahiah Bi Al-Tamleek (Second edn, Saudi Arabia 2001) 217.

fails to meet any of his contractual obligations or defaults in the payment of two consecutive rents, the lessor has the right to terminate the contract.[253] Furthermore, the ijarah contract of The Islamic Bank for Development provides that the lessor has the right to terminate the ijarah agreement by a written notice if the lessee is unable to pay any due instalment.[254]

[253] Sharika Al-Rajhi Li Al-Istithmar, Aqd Iyjar Mqroon Bi Wa'd Al-Baya' (Al-Rajihi Ijarah Contract).
[254] International Islamic Bank for Investment and Development, Aqd Al-Ijarah (Ijarah Contract).

IV. The Salam Finance

Salam is a sale transaction where the price is paid when the contract is concluded but the goods are delivered in the future. In principle, this kind of sale should not be acceptable as the goods are not in the seller's possession at time of the contract. However, out of public necessity, the Prophet allowed the salam sale. At that time, small farmers were needed money to take care of their crops and meet their family's financial needs until the harvest. The buyers, by the salam sale, would be able to secure the goods. Moreover, by paying in advance, the buyers would pay less than they would for the market price of the goods that were delivered on the spot. The buyers find the discounted price to be an incentive for paying in advance. Therefore, salam is seen as an alternative to obtaining a loan at interest as this practice conflicts with Islamic law.[255]

Difference between salam and ordinary sale

Although salam is considered a kind of sale, there are differences between a salam sale and an ordinary sale. In a salam sale, the contract has to state when the goods are to be delivered. This is not required in an ordinary sale. In addition, the goods in a salam sale are not available at time of the

[255] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 83, N Saleh, Unlawful Gain and Legitimate Profit in Islamic Law, Riba, Gharar and Islamic Banking (Second edn, Graham & Trotman, London 1992) 89, N Thani, Law and Practice of Islamic Banking and Finance (Sweet & Maxwell Asia, Malaysia 2003) 39, P Moore, Islamic Finance, A Partnership for Growth (Euromoney Publications PLC, London 1997) 43, M Lewis and L Algaoud, Islamic Banking (Edward Elgar UK & USA 2001) 55-56, A Hammad, Islamic Banking Theory and Practice (Zakat and Research Foundation, Ohio, USA 1989) 38, B Sabahi, 'Islamic Financial Structures as Alternatives to International Loan Agreements: Challenges for U.S. Financial Institutions'24 Ann Rev Banking & Fin L 487 at 496, K Tacy, 'Islamic Finance: A Growing Industry in the United States' (2006) 10 NC Banking Inst 355 at 360 & A Ibrahim, 'The Rise of Customary Business in International Financial Markets: An Introduction to Islamic Finance and The Challenges of International Integration' (2008) 23 Am U Int'l L Rev 661 at 714.

contract, which is, in the view of many scholars, not acceptable in an ordinary sale. As for the price of the goods, unlike an ordinary sale, in a salam sale, the price has to be paid in advance, when the contract is executed. Finally, a salam sale is confined to goods that can be accurately specified in quality and quantity. This condition is not required in an ordinary sale.[256]

Salam finance in Islamic Banking

Salam, in Islamic banks, is used for financing agricultural and commercial projects. The Islamic bank arranges with the farmer or the merchant to purchase the goods with an advanced payment and the delivery of goods is at a specified future date. The Islamic bank can make profit by purchasing the goods for less than the market price and benefiting from the difference between the two prices when selling the goods.[257]

However, there is a difficulty the Islamic bank encounters with such a transaction: the Islamic bank does not receive money from its clients as in ordinary transactions; it receives goods. The Islamic bank still is not in a sophisticated position in dealing with different kinds of goods from different kinds of clients. As a solution, some Islamic banking experts suggest parallel salam, in which the bank engages in two independent salam transactions. The first salam transaction is between the bank and the client where the bank is a buyer and the client is a seller and the goods are agreed to be delivered at a certain time in the future. In the second transaction, the bank engages with a third party in a salam contract with the

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[256] N Thani, Law and Practice of Islamic Banking and Finance 42.
[257] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 86.

agreement that the bank sells the same goods for the third party with a price higher than the price in the first salam transaction and with a delivery time that coincides with the first one. Therefore, in this second transaction the bank acts as a seller and the third party acts as a buyer. By this kind of arrangement, the bank would be able to achieve profit while avoiding the inconvenience and the risks of dealing with goods.[258] However, it has to be borne in mind that the two salam contracts are separate from each other, and thus in the event that the first seller fails to deliver the goods at the agreed time, the bank is still liable under the second salam contract to deliver the goods according to the agreement. An example of the parallel salam is when the bank enters into a salam contract with a seller to purchase 10,000 kilos of rice to be delivered on the first day of January 2009. The bank pays £5,000 for the goods when signing the contract. Subsequently, the bank arranges another salam contract with a buyer by which the bank sells 10,000 kilos of rice for £5,500 and the goods to be delivered to the buyer also on the first day of January 2009.

It has been also suggested that if the idea of parallel salam proves to be impractical, the bank can obtain a promise from a third party to purchase the goods from the bank at a higher price. Based on this promise, once the goods are received by the bank, a sale contract is signed between the bank and the third party. To use the rice example again, if the bank agrees with a buyer to purchase, based on salam, 10,000 kilos of rice for £5,000 cash and the goods are to be delivered in January 2008, the bank can then obtain a promise from a third party to purchase from the bank 10,000 kilos of rice

[258] MT Usmani, An Introduction to Islamic Finance 87.

for £5,500. Immediately after the bank receives the 10,000 kilos of rice, a sale contract is concluded between the bank and the third party.

Guarantees

The Islamic bank may require the client to provide guarantees. The purpose of these guarantees is to ensure that the client is going to deliver the goods at the agreed time. If the client does not deliver the goods or fails to deliver them according to the agreement, the bank can use these guarantees to obtain the goods from the market or to recover its advanced funds.[259]

[259] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 87 & M Al-Amine, 'Istisna' and its Application in Islamic Banking' (2001) 16 Arab Law Q 22.

V. Istisna Finance

The idea of istisna finance has stemmed from what is known in Islamic law as the istisna sale, which is a sale of a manufactured product, where the buyer pays for a product that is going to be manufactured and then delivered to the buyer on a specified date in the future. That means that the subject of the contract is a product that does not exist when the istisna agreement is made. The parties cannot conclude an istisna contract on objects that already exist or that are not manufactured, such as agricultural or commercial products. However, an istisna transaction can be used for example for the construction of houses and other buildings.[260]

The price in istisna does not have to be paid in advance. In fact it is up to the parties to determine the time of payment and whether the buyer pays for the object in advance or upon delivery. The parties can also agree to divide payment into installments. At the end of each of the manufacturing stage the seller is entitled to an installment. For example, where istisna is utilised in construction houses, the parties can agree that whenever the

[260] MT Usmani, An Introduction to Islamic Finance 88, M Irsheed, Al-Sahmil Fi Muamalat Wa Amaliat Al-Masarif Al-Islamiah (First edn, Dar Al-Nafaes Li Al-Nashr Wa Al-Tawzeea, Jordan 2001)117, M Hamid, 'Istisna: A Classical Concept in a Modern Framework' in A Siddiqi Anthology of Islamic Banking (Institute of Islamic Banking and Insurance, London 2003) 361, M Lewis and L Algaoud, Islamic Banking (Edward Elgar UK & USA 2001) 56, K Tacy, 'Islamic Finance: A Growing Industry in the United States' (2006) 10 NC Banking Inst 355 at 360, A Abdallah, 'Forms of Investment in Real Estates in Islamic Perspectives' in M Mahdi (Editor), 'Islamic Banking Modes For House Building Finance' (Proceedings of a workshop organised in Khartoum, Sudan in 1991 by the Islamic Research and Training Institute of Islamic Development Bank and the Sudanese Estates Bank, , Published by Islamic Research and Training Institute, Islamic Development Bank, Saudi Arabia 1995) 44, C Richardson, 'Islamic Finance Opportunities in the Oil and Gas Sector: An Introduction to an Emerging Field' (2006) 42 Tex Int'l LJ 119 at 131 & Q Latif, 'Islamic Finance' (2006) 1 JIBFL 10.

contractor finishes a phase of the project, the contractor receives an installment of the contract price.[261]

At the time of contract, the parties have to identify clearly all specifications that are related to the subject matter, such as the sizes, quality, quantity, the materials to be used, and the place and time of delivery.[262]

An interesting question in Islamic law literature is whether or not the seller has to manufacture the product himself or can hire somebody else for this job. The dominant view in Islamic law, which has been followed by Islamic banks, is that the product does not have to be manufactured by the seller; it can be done by a third party.[263]

The difference between Salam and Istisna

While istisna resembles salam in the fact that they are both a sale of something that does not exist at the time of making the contract, there are distinctive differences between these two transactions. In istisna, the subject matter has to be something that can be manufactured, but in salam that is not the case. With regard to payment, the price in salam has to be paid at the time of the contract. In istisna, the payment can be paid at any time that is acceptable to both parties. Salam and istisna also differentiate

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[261] P Moore, Islamic Finance, A Partnership for Growth (Euromoney Publications PLC, London 1997) 42, MT Usmani, An Introduction to Islamic Finance 91 & B Sabahi, 'Islamic Financial Structures as Alternatives to International Loan Agreements: Challenges for U.S. Financial Institutions'24 Ann Rev Banking & Fin L 487 at 495.

[262] P Moore, Islamic Finance, A Partnership for Growth (Euromoney Publications PLC, London 1997) 42.

[263] M Hamid, 'Istisna: A Classical Concept in a Modern Framework' in A Siddiqi, Anthology of Islamic Banking (Institute of Islamic Banking and Insurance, London 2003) 362.

in the time-of-delivery issue. While in salam, the time of delivery has to be specified in the agreement, in istisna, that is not required.[264]

The Nature of Istisna Contract

The majority of Muslim scholars maintains the view that before the seller starts manufacturing the goods, the istisna contract is non-binding. In other words, any of the parties can terminate the contract at any time as long as the seller has not started making the goods. If the seller starts manufacturing the goods and finishes the work, the contract is still revocable by any of the parties until the goods are delivered to the buyer. Therefore, once the goods are delivered to the buyer and they are in conformity to the agreed specifications, the contract is binding and the parties have to fulfill their contractual obligations; otherwise, the party who rejects the goods or refuses to complete the contractual obligations will be in breach of the contract.[265]

However, taking into consideration the harm that a party might sustain as a result of the termination of istisna contract by the other party and for the protection of modern trade and for the benefit of economic growth in the Islamic world, the Council of Islamic Fiqh has decided in 1992 that istisna is a binding contract once the contract is signed between the parties

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[264] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 89, N Thani, Law and Practice of Islamic Banking and Finance (Sweet & Maxwell Asia, Malaysia 2003) 42, Y Al-Shabeeli, Al-Khadamat Al-Istithmaryah Fi Al-Masarif Wa Ahkamuh Fi Al-Fiqh Al-Islami (First edn, Dar Ibn Al-Jawzi, Saudi Arabia 2005) 2/511 & M Al-Amine, 'Istisna' and its Application in Islamic Banking' (2001) 16 Arab Law Q 22 at 24-26.

[265] A Al-Heeti, Al-Masarif Al-Islamiah Bain Al-Nazarieah Wa Al-Tatbeeq (First edn, Dar Usamah, Jordan 1998) 563, N Thani, Law and Practice of Islamic Banking and Finance 43, MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 89, N Saleh, Unlawful Gain and Legitimate Profit in Islamic Law, Riba, Gharar and Islamic Banking (Second edn, Graham & Trotman, London 1992) 77 & M Hamid, 'Istisna: A Classical Concept in a Modern Framework' in A Siddiqi Anthology of Islamic Banking (Institute of Islamic Banking and Insurance, London 2003) 363.

regardless of whether the process of manufacturing the product has started or not. In practice, the Islamic banks follow this view.[266]

The Time of Delivery

The istisna contract specifies when the product should be delivered to the buyer. The buyer can include in the agreement the latest date for delivery so if the seller fails to meet that date, the buyer is under no obligation to accept the product. In addition, as the delay in delivering the product may cause loss to the buyer, some of the istisna contract contains a liquidated damages clause, which imposes a penalty on the seller if there is delay in delivering the product. However, the Fiqh Academy opposes charging a penalty for the delay as it resembles the taking of riba (usury) which is forbidden in Islamic law.[267]

Istisna Finance in Islamic Banking

As Islamic banks are not in the business of manufacturing products, Islamic banks utilised what is known as back-to-back istisna finance. Through this transaction, the bank engages into two istisna contracts. In the first contract, the bank agrees with the client, who demands a yet-to-be-manufactured product, that the bank will provide this product to the client at a certain time for an agreed price. The bank then engages in a second istisna contract with the manufacturer. In this contract, the manufacturer agrees to manufacture the product for the bank for a price that should be

[266] A Daghi, Buhuth Fi Al-Iqtisad Al-Islami (Dar Al-Bashaer Al-Islamyah, Beirut, Lebanon 2002) 394.
[267] M Hamid, 'Istisna: A Classical Concept in a Modern Framework' in A Siddiqi Anthology of Islamic Banking (Institute of Islamic Banking and Insurance, London 2003) 365.

less than the first istisna contract. Therefore, in the first istisna contract, the bank is a seller, but in the second contract the bank is a buyer. While the bank pays the price of the second contract up-front, the price in the first istisna contract is usually paid by the client on an installment basis. For an illustration of the back-to-back istisna, the following example should be considered:

For the purpose of expanding its business, a large airline approaches an Islamic bank requesting the purchase of 10 airplanes to be delivered in one year. After signing an istisna agreement with the airline, the Islamic bank engages in another istisna agreement with an airplane factory. The airplane factory agrees to manufacture the 10 airplanes according to the bank's client's specifications and to deliver them on the exact date specified in the first contract. The price in the first contract is to be paid by the airline in installments. The price in the second contract, which is less than the first one, is paid to the airplane factory by the bank in cash. The Islamic bank makes its profit from the difference between the first and the second contracts.[268]

Islamic banks also utilise istisna in financing the construction of buildings and other construction projects. The Islamic banks do not necessarily engage in the construction business themselves, but through back-to-back istisna, Islamic banks can hire contractors who are more qualified to handle

[268] N Thani, Law and Practice of Islamic Banking and Finance (Sweet & Maxwell Asia, Malaysia 2003) 44, M Hamid, 'Istisna: A Classical Concept in a Modern Framework' in A Siddiqi Anthology of Islamic Banking (Institute of Islamic Banking and Insurance, London 2003) 363, T Khan, Interest-Free Alternatives For External Resource Mobilization (With Special Reference to Pakistan) (Islamic Research and Training Institute, Islamic Development Bank, 1997) 43-45 & A Ibrahim, 'The Rise of Customary Business in International Financial Markets: An Introduction to Islamic Finance and The Challenges of International Integration' (2008) 23 Am U Int'l L Rev 661 at 714.

that kind of business. In this transaction, again, the bank would sign two istisna contracts. The first istisna contract is between the bank and the client who seeks the construction of a building. The second istisna contract is between the bank and a third party, which is the contractor.[269] However, if the work does not fully comply with the client's specifications as stated in the first istisna agreement, the Islamic bank is liable to the client.

The following is an illustration of the steps that are commonly implemented in financing the construction of projects through istisna.

1- The client submits an application to the engineering department in the Islamic financier requesting the construction, through istisna finance, of a project such as a building, a factory, a hospital, or a warehouse.
2- Along with the application, the client provides all the necessary plans and blueprints of the project.
3- The Islamic financier runs a study on the project.
4- If the study results in the approval of the project, the financier requests that the client provide part or all of the following guarantees:
    a. A mortgage on the land.
    b. A signed check of all the funds that are provided by the financier.
    c. A signed document that gives the financier the right to collect the project revenues.

[269] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 91 & K Holden, 'Islamic Finance: "Legal Hypocrisy" Moot Point, Problematic Future Bigger Concern' (2007) 25 BU Int'l LJ 341 at 352.

5- After signing the istisna agreement which includes details of all the project specifications and the rights and the obligations of the parties involved, the financier, either through its engineering department or through a second istisna contract with an independent contractor, begins the construction work.[270]

Moreover, through istisna transaction, Islamic banks finance several kinds of governmental projects, such as bridges and highways. In most of these projects, the Islamic banks receives the contract price through what is called BOT, where the government grants the Islamic banks the right to operate the project and obtain the price directly from their operation of the project.[271]

[270] M Irsheed, Al-Sahmil Fi Muamalat Wa Amaliat Al-Masarif Al-Islamiah (First edn, Dar Al-Nafaes Li Al-Nashr Wa Al-Tawzeea, Jordan 2001) 124.
[271] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 91.

Conclusion

The various sources that feed Islamic banks with funds have been examined in this chapter. These sources of funds include paid-up capital, the current, saving and investment accounts, and the fees that are obtained through chargeable services.

Subsequently, in-depth investigations about the most financial instruments that are utilised by Islamic banks have been dealt with in this chapter. These financial instruments are mudaraba, musharaka, ijarah, salam, and istisna.

Mudaraba is the primary financial instrument implemented in Islamic banks. In mudaraba, which is a form of partnership, the finance is provided by the bank and the effort is provided by the client, the active partner. The profit, in mudaraba, is divided between the partners according to their agreement, but the loss is borne by the bank alone. The management of the mudaraba project is carried out by the active partner, who is responsible for buying, storing and selling the goods.

The active partner in managing the project has to comply with the terms of mudaraba contract; otherwise he will be liable for any loss incurred because of the active partner's negligence or violations of the terms of the contract.

At the end of the mudaraba project the active partner returns the funds that have been advance by the bank in addition to the pre-agreed percentage of the profit. While in Restricted Mudaraba, the active partner in carrying out the project is confined to the limitations that are specified in the contract,

in Unrestricted Mudaraba, the active partner is allowed to perform what is suitable for the business without any limitations.

According to Islamic law scholars, the duration of mudaraba should not be specified. However, Islamic banks find it more useful to set a time limit for mudaraba.

To ensure that the mudaraba project is running properly and according to the agreement, the Islamic bank has the right to monitor the management of the project. In addition, the Islamic bank may require that the active partner provide periodic report on the progress of the project.

In musharaka, which is also a form of partnership, the funds are provided by both the bank and the partner. They share the profit according to their agreement and the loss is borne according to their contribution to the capital. In diminishing musharaka, the capital of the project is also provided by both the bank and the partner. However, over the duration of musharaka, the bank receives back its advanced funds until the partner becomes the sole owner of the project. Any of the partners can terminate the musharaka partnership by giving proper notice. The assets of the project are then divided between them according to their contribution to the capital.

Ijarah finance is conducted by the bank through a lease of a property to the client for a specified period of time. Upon the request of a client, the bank would purchase a property and then lease it to the client. At the end of the ijarah term, the client may renew the lease contract, return the property to the bank, or purchase it at a discounted price.

The termination of the ijarah contract has to be with the agreement of both the lessee and lessor. However, the parties can agree differently. Some of the modern ijarah agreements give the lessee the right to terminate the contract at any time on condition that the lessee would pay half of the rent for the remaining period. Other agreements would require that the lessee, when terminating the contract, to pay the whole rent for the remainder of the contract term.

The third method of finance carried out by Islamic banks is salam, which is a sale contract. However, the feature that distinguishes salam from the ordinary sale is that the price in salam is paid in advance for goods that are not available with the seller yet, and they will be delivered to the buyer in the future. In addition, while in the ordinary sale, it is not required to specify the time of delivery, in salam, it is required. In Islamic banks, salam finance may be performed through what is known as parallel salam, in which the bank engages in two independent salam contracts. In the first one the bank, acting as a buyer, would agree with a client/seller to purchase certain kind of goods at a specified time in the future. The bank then, in the second salam, agrees with a third party to sell the goods that were the subject of the first salam contract at a higher price, and the time of delivery would be the exact time agreed upon in the first contract.

Similar to salam finance is istisna finance. Salam and istisna are both a sale of something that is going to be delivered in the future. However, istisna is a sale of a manufactured product. Unlike salam, the price in istisna does not have to be paid at the time of executing the contract but the parties can agree otherwise.

In Islamic banking, istisna finance is carried out through what is called back-to-back istisna, in which the bank engages in two istisna contracts. This method of finance was illustrated in this chapter by the example of the airline which approached an Islamic bank for the finance of acquiring ten airplanes. In this scenario, the bank, in the first istisna contract, agreed to sell the airline ten airplanes and to be delivered at a specified time in the future. The price for the airplanes was to be paid to the bank in instalments. The bank then contracted an airplane factory for the purpose of supplying ten airplanes with the descriptions and delivery time that was specified by the airline in the first contract. In this second istisna contract, the bank, which pays the price for the airplanes in cash, acted as a buyer. Because the bank sold the airplanes to the airline for a price higher than the price it paid to purchase them from the airplanes factory, the difference between the prices was the bank's profit. Therefore, through the utilisation of back-to-back istisna, which involves two istisna contracts, the bank would provide the finance for the manufacturing of specified products, and at the same time, make a profit from the difference between the prices in the first and the second istisna contracts.

Fourth Chapter: Financing International Trade in the context of Murabaha

Introduction

Murabaha is a sale transaction in which the seller, upon the buyer's request, purchases described commodities from a third party and sells them to the buyer for a pre-agreed profit.[272] The majority of Muslim scholars are of the opinion that Murabaha in itself is a valid transaction based on verses of the Quran and on Islamic legal principles. In the Quran, the lawfulness of sale in general has been established in several positions. For example, in Chapter Al-Baqarah, it is declares that "Allah hath permitted trade."[273] Based on this verse, Al-Shafie has inferred that "the principle is that all kind of sale is lawful...except the one that the Prophet has prohibited."[274] Such evidence suggests that murabaha transaction is lawful as it is a sale transaction.

In addition, according to Islamic legal principles, the default rule for any transaction or contract is its lawfulness. This well-established principle

[272] A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation (E. J. Brill, Leiden, The Netherlands 1996) 76, M Bassiouni, G Badr and K Dorph, Interests and Banking in Islamic Law (MidAmerica-Arab Chamber of Commerce, USA 1990) 45, I Warde, Islamic Finance in the Global Economy (Edinburgh University Press, UK 2001) 133, S Amin, Islamic Banking and Finance: The Experience of Iran (Vahid Publication Tehran, Iran 1986) 33, A Hammad, Islamic Banking Theory and Practice (Zakat and Research Foundation, Ohio, USA 1989) 34, R Wilson, Islamic Business, Theory and Practice (The Economist Intelligence Unit, London, UK 1984) 28, A Al-Darir 'Types and Methods of Investment in Islamic Thought' in A Hoque (Editor), Reading in Islamic Banking (Islamic Foundation Bangladesh, Bangladesh 1987) 145-146, A Alias, N Kamarulzaman and R Bhupalan, Guide to Islamic Banking in Malaysia: An Overview (Institut Bank-Bank Malaysia (IBBM), Malaysia 1993) 7, K Holden, 'Islamic Finance: "Legal Hypocrisy" Moot Point, Problematic Future Bigger Concern' (2007) 25 BU Int'l LJ 341 at 348, H Ahmed, 'Not Interested in Interest? The Case For Equity-Based Financing in U.S. Banking Law' (2007) 2 Entrepreneurial Bus LJ 479 at 489-490, W Hegazy, 'Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism PURE LEGALISM' (2007) 7 7 Chi J Int'l L 581 at 598, B Sabahi, 'Islamic Financial Structures as Alternatives to International Loan Agreements: Challenges for U.S. Financial Institutions' 24 Ann Rev Banking & Fin L 487 at 495, K Tacy, 'Islamic Finance: A Growing Industry in the United States' (2006) 10 NC Banking Inst 355 at 357-358, H Juwana, Y Barlinti and Y Dewi, 'Sharia Law as a System of Governance in Indonesia: The Development of Islamic Financial Law' (2008) 25 Wis Int'l LJ 773 at 780 & Q Latif, 'Islamic Finance' (2006) 1 JIBFL 10.

[273] Chapter Al Baqarah, verse 275, translated by Yusuf Ali, http://www.harunyahya.com/Quran_translation/Quran_translation2.php (20/10/08).

[274] Al-Shafii, Al-Um (Dar Al-Shaab, Cairo, Egypt) 3/2 (volume:3, page:2).

emphasises that, by default, any transaction or contract is lawful unless evidence from the Quran or the Sunnah expressly declares the prohibition or the unlawfulness of such a transaction or contract. Muslim jurists apply this fundamental principle whenever they encounter a new transaction. Therefore, the jurists do not look for evidence of the lawfulness of a new transaction because it is lawful by default. However, if someone claims the unlawfulness of a transaction, that person should present the evidence to support this claim. The rationale behind this principle is that the Quran and Sunnah have already explained what is prohibited. According to the Quran, "He [Allah] hath explained to you in detail what is forbidden to you."[275] Thus, since all prohibited transactions are detailed in the Quran and Sunnah, any other transactions should be lawful. By applying this principle on murabaha, Muslim scholars concluded that this transaction should be lawful as no evidence exists in the Quran or the Sunnah to suggest otherwise.[276]

Moreover, Muslim scholars who believe in the legality of the murabaha transaction argue that, by examining the transactions prohibited in the Quran and the Sunnah, it can be deduced that that prohibition was imposed on such transactions for the purpose of preventing injustice and blocking ways that might lead to disputes between the parties. The scholars added

[275] Chapter Al Anam, verse 119, translated by Yusuf Ali, http://www.harunyahya.com/Quran_translation/Quran_translation6.php (20/10/08).
[276] Y Al-Qardawi, Baia' Al Murabaha Li Al Amir Bi Al Shiraa Kama Tujreeh Al Masarif Al Islamiah (Third edn, Dar Al Qalam, Kuwait 1986) 23.

that, by studying murabaha transaction, it becomes apparent that this transaction does not lead to injustice. Therefore, it should be lawful.[277]

Murabaha has been utilised by Islamic banks significantly for the purpose of financing international trade. This chapter investigates the conditions that have to be met in murabaha transactions and examines how murabaha is conducted in Islamic banks in financing international trade.

Conditions of Murabaha

In addition to legal requirements for sale transactions, for murabaha transactions to be lawful, three conditions have to be met. The first condition is the knowledge of the goods cost and profit. The second condition is that the original price of obtaining the goods should not be unique.[278] Finally, the murabaha transaction should not involve riba. The following is a discussion of each of these conditions.

1- Knowledge of the cost of the goods and the profit

This condition dictates that the buyer has to be aware of the cost of the goods that the seller has obtained and the profit that is added to the cost. Without such knowledge, the sale is void.[279] However, disagreements arose among medieval Islamic law scholars regarding what should be considered in calculating the cost of the goods. The Hanafi School takes the view that, in calculating the cost of goods, all expenses incurred in obtaining, producing, and altering these goods, such as the cost of cutting and dying

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[277] Y Al-Qardawi, Baia' Al Murabaha Li Al Amir Bi Al Shiraa Kama Tujreeh Al Masarif Al Islamiah 21-31 & A Al-Heeti, Al-Masarif Al-Islamiah Bain Al-Nazarieah Wa Al-Tatbeeq (First edn, Dar Usamah, Jordan 1998) 525.

[278] This will be explained below.

[279] Ibn_Qudamah, Al-Mughni (Dar Al-Kitab Al-Arabi, Beirut 1972) 6/266, Ibn_Muflih, Al-Mubdea (Al-Maktab Al-Islami, Lebanon 1980) 4/103 & Ibn_Qudamah, Al-Kafi Fi Fiqh Al-Imam Ahmed (Second edn, Al-Maktab Al-Islami, Lebanon 1979) 2/94.

of the cloth or delivering the goods, should be included. The customary practice of merchants should also be considered in calculating the cost of goods. That is why the Hanafis exclude expenses the seller sustains for storing the goods and travelling to acquire the goods because, according to the customary practice at that time, these expenses are not included.[280]

Distinguishing between expenses that have a direct effect on the goods from those that do not have a direct effect, the Malikis assert that expenses such as the cutting and dying of the cloth—where direct effect occurs—should be included as well as they contribute to the calculation of the profit. However, carrying and delivering the goods, which can be included in the cost, cannot be considered when calculating the profit as these costs do not have a direct effect on the goods.[281]

Holding a more practical view, the Hanbalis assert that the seller can add all expenses spent on goods to the cost of these goods as long as the seller discloses all details about the expenses to the buyer.[282] This view has been adopted by Islamic banks due to its obvious practical implications.[283]

2- Price of obtaining the article should not be unique

This condition asserts that the article which is the subject of murabaha should not be purchased by a unique, non-fungible object. For example, a

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[280] Ibn Abdeen, Hashyat Ibn Abdeen (Dar Al-Fiker, Lebanon 1364) 5/113-137, Al-Kasani, Badaea Al-Sanaea Fi Tarteeb Al-Sharaea (First edn, Matbaat Al-Jamaliah, Egypt 1950) 5/223, Ibn Rushd, Bidayat Al-Mujtahid Wa Nihaiat Al-Muqtasid (Maktabat Al-Kuliat Al-Azhariah, Egypt 1966) 2/214, IA-H Al-Shaibani, Al-Mabut (Idarat Al-Quran Wa Al-Uloom Al-Uloom Al-Islamyah, Karatshi, Pakistan) 5/158 & M Al-Seewasi, Sharh Fath Al-Qadeer (Dar Al-Fikr, Lebanon) 6/507

[281] Al-Desuqi, Hasheiat Al-Desuqi Ala Al-Sharh Al-Kabeer (Dar Al-Fikr, Beirut 1988) 3/160.

[282] M Al-Bahuti, Sharh Muntaha Al-Iradat (Matbaat Ansar Al-Sunnah Al-Muhammadyah, 1947) 2/183 & Al-Bahuti, Kashaf Al-Kinaa Ala Matn Al-Iqnaa (Matbat Al-Hukumah, Saudi Arabia 1974) 3/231.

[283] N Ray, Arab Islamic Banking and the Renewal of Islamic Law (Graham & Trotman Limited UK 1995) 41 & N Saleh, Unlawful Gain and Legitimate Profit in Islamic Law, Riba, Gharar and Islamic Banking (Second edn, Graham & Trotman, London 1992) 96.

cow would not be a valid consideration for the article because the value of the cow can vary, thereby preventing accurate calculations of the cost of the article.[284] However, a different opinion has been emerged in regards to this issue, allowing a unique, non-fungible object to serve as a valid price for the article.[285]

3- Murabaha transaction should not lead to riba[286]

When an object falls under the definition of Mal Ribawi (object that is subjected to riba rules),[287] it is unlawful to be sold for an object of the same genus. For example, the sale of three kilos of dates for two kilos of dates or the sale of gold for a lesser amount of gold is not allowed as it makes the transactions riba (usurious).

Murabaha Stages

The finance of international trade in the form of murabaha is conducted through five distinct stages. It begins when the customer files an application to the bank requesting the finance of a certain transaction by murabaha. The bank then carries out its own study about the application and the customer, which is followed by the forming of a promise-to-purchase agreement between the bank and the customer. The bank subsequently issues a letter of credit and purchases the goods from the

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[284] Al-Kasani, Badaea Al-Sanaea Fi Tarteeb Al-Sharaea (First edn, Matbaat Al-Jamaliah, Egypt 1950) 5/220, Al-Sarkhasi, Al-Mabsut (Dar Al-Maref Li Al-Tebaah Wa Al-Nashr, Beirut) 13/81 & IA-H Al-Shaibani, Al-Mabut (Idarat Al-Quran Wa Al-Uloom Al-Uloom Al-Islamyah, Karatshi, Pakistan) 5/160.

[285] Al-Desuqi, Hasheiat Al-Desuqi Ala Al-Sharh Al-Kabeer (Dar Al-Fikr, Beirut 1988) 3/160, Ibn_Rushd, Bidayat Al-Mujtahid Wa Nihaiat Al-Muqtasid (Maktabat Al-Kuliat Al-Azhariah, Egypt 1966) 2/214 & Al-Nawawi, Rawdat Al-Talibeen (First edn, Al-Maktab Al-Islami Li Al-Tibaah Wa Al-Nasher, 1968) 3/530.

[286] Al-Kasani, Badaea Al-Sanaea Fi Tarteeb Al-Sharaea (First edn, Matbaat Al-Jamaliah, Egypt 1950) 5/222.

[287] For more details on this, see Chapter Two: The Doctrine of Riba.

overseas supplier. Finally, upon obtaining the goods, the murabaha contract is initiated between the bank and the customer during which the bank sells the goods to the customer. The following is an examination of each of these stages.

The First Stage: The Customer's Application to the Islamic Bank

The murabaha transaction starts when the customer submits an application to the Islamic bank requesting funds for specific goods via murabaha. In addition to information about the customer, the application contains specifications about the goods such as quality, quantity, and cost. The application should also identify the source of the goods and how the goods will be transported. The method of payment and need for an import license should also be determined in the application.[288]

The Second Stage: The Study of the Application

After the customer submits the application and before the bank decides to accept or refuse the application, the Islamic bank runs a study on this application similar to those taking place in any credit transaction. This study seeks to evaluate the creditworthiness of the customer and the feasibility of the transaction in addition to any potential risks that might be involved.[289] The bank will examines the customer's financial status and

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[288] MA Omar, 'Al Tafaseel Al Ilmyah Li Aqd Al Murabaha Fi Al Nizam Al Mesrafi Al Islami' (Khutat Al Istithmar Fi Al Bunuk Al Islamiah, Al Jawanib Al Tatbeeqiah Wa Al Qadhayah Wa Al Mushkilat, a Conference held in Jordan with a collaboration of the Islamic Development Bank, Islamic institution for research and training 1987) 185 & A Al-Suwaidi, Finance of Internatinal Trade in the Gulf (Graham & Trotman Limited UK 1994) 98.

[289] A Al-Suwaidi, Finance of Internatinal Trade in the Gulf 98.

determines the kind of guarantee the customer should provide to secure the transaction. In addition to the cost of the whole transaction and the bank's profit, the marketability of the goods is also investigated by the bank to assess if the goods can be easily sold and the bank's funds recovered in case the customer fails to conclude the transaction. Moreover, the bank examines whether the transaction complies with the Islamic law and the law of the jurisdiction.[290]

The Third Stage: The Promise to Purchase

Once a customer's application for murabaha financing is approved by the Islamic bank, both the customer and the bank enter into a promise-to-purchase agreement. In this agreement, the bank promises to purchase the goods from the supplier to sell them to the customer and the customer promises to purchase the goods from the bank.

Terms of the agreement

Several terms are incorporated into the promise-to-purchase agreement. The following discussion provides a detailed description of the most common terms included in the Islamic bank promise-to-purchase forms, which are signed by both the bank and the customer:[291]

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[290] MA Omar, 'Al Tafaseel Al Ilmyah Li Aqd Al Murabaha Fi Al Nizam Al Mesrafi Al Islami' (Khutat Al Istithmar Fi Al Bunuk Al Islamiah, Al Jawanib Al Tatbeeqiah Wa Al Qadhayah Wa Al Mushkilat, a Conference held in Jordan with a collaboration of the Islamic Development Bank, Islamic institution for research and training 1987) 187.

[291] A Al-Hamid, Tajribat Al Bunuk Al Tijariah Al Saudiah Fi Baia Al Murabaha Lil Amir Bi Al Shira (First edn, Dar Bilansiah, Riyadh, Saudi 2003) 109-112, MA Omar, 'Al Tafaseel Al Ilmyah Li Aqd Al Murabaha Fi Al Nizam Al Mesrafi Al Islami' (Khutat Al Istithmar Fi Al Bunuk Al Islamiah, Al Jawanib Al Tatbeeqiah Wa Al Qadhayah Wa Al Mushkilat, a Conference held in Jordan with a collaboration of the Islamic Development Bank, Islamic institution for research and training 1987) 189, A Al-Suwaidi, Finance of Internatinal Trade in the Gulf (Graham & Trotman Limited UK 1994) 100.

1- Introductory information on each party and the subject of the murabaha transaction.

2- Descriptions of the goods and their quantity.

3- The calculation of the cost of purchasing the goods from the supplier and the cost of insuring and shipping the goods and any cost the bank might sustain in the process of obtaining the goods.

4- The calculation of the Islamic bank's profit of the transaction.

5- The expression of the customer's intention to purchase the goods.

6- The period of time in which the customer should execute the murabaha contract once the customer is notified by the bank of the arrival of the goods and failure to do so will be deemed as a customer's withdrawal from the transaction.

7- Information about the kind of collateral the customer is required to provide when signing the murabaha contract to secure the transaction.

8- Specification of the down payment (arbun) to be paid at the time of signing this promise-to-purchase agreement. The purpose of this advanced payment is to cover any loss the bank might incur as a result of the customer's refusal to conclude the transaction. In addition, it serves to clarify the customer's willingness to be involved in the transaction.

In addition to the terms detailed here, some Islamic banks add additional terms that can be described as follows:[292]

[292] A Al-Hamid, Tajribat Al Bunuk Al Tijariah Al Saudiah Fi Baia Al Murabaha Lil Amir Bi Al Shira (First edn, Dar Bilansiah, Riyadh, Saudi 2003) 109-112 and MA Omar, 'Al Tafaseel Al Ilmyah Li Aqd Al Murabaha Fi Al Nizam Al Mesrafi Al Islami' (Khutat Al Istithmar Fi Al Bunuk Al Islamiah, Al Jawanib Al Tatbeeqiah Wa Al Qadhayah Wa Al

1- A statement that the carrier is considered an agent for both the bank and the customer, which means that once the goods are in the carrier's possession, they are automatically regarded as being in the bank's possession and are automatically transferred into the customer's possession, thereby reducing the bank's risk in possessing the goods.

2- A statement that any damages resulting from any party's withdrawal from the transaction or failure to fulfil its promise will be the liability of that party and damages will be evaluated through arbitration. Some forms hold only the customer liable in the event of withdrawal or failure to comply with the agreement and clear the bank from any liability.

3- A promise from the customer to be bound by Islamic law and thus not to purchase the goods unless they are in the bank's possession and not to pay a down payment to the supplier.

4- A statement that, if the customer submits incorrect information or documents, the customer is liable for any damages or losses incurred as a consequence of the incorrect information or documents.

5- A statement that any disputes should be resolved in an Islamic court according to Islamic law.

6- Some forms indicate that whatever is not covered by the agreement will be subject to the law of the Islamic bank's jurisdiction in such a way that does not contradict with Islamic law. Other forms

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Mushkilat, a Conference held in Jordan with a collaboration of the Islamic Development Bank, Islamic institution for research and training 1987) 189 & A Al-Suwaidi, Finance of Internatinal Trade in the Gulf (Graham & Trotman Limited UK 1994) 100.

specify that any disputes between the parties should be solved through arbitration.

7- A clear expression that the Islamic bank will bear no liability if the supplier refuses to sell the goods, delays the shipment of the goods, or fails in any way to comply with the terms of the sale agreement. However, the customer is liable for any harm sustained by the bank due to the supplier's failure.

Binding or not binding

This promise-to-purchase agreement has been subject to much disagreement among Muslim scholars. The controversial legal issue is whether such a promise is binding or not. In other words, is the bank bound to honour its promise and purchase the goods from the supplier? Is the customer also bound to purchase the goods from the bank? If such a promise is not binding, then both parties have the right to exit the transaction without fulfilling their promises. In practice, Islamic banks differ on whether the promise to purchase should be binding, although the majority are of the opinion that this promise should be binding.[293] The following is a discussion of the different opinions on this issue.

The first opinion: The promise to purchase is binding and both parties have the obligation to fulfil their promises[294]

[293] A Al-Suwaidi, Finance of Internatinal Trade in the Gulf 102-103.

[294] A Al_Maneea, Buhuth Fi Al-Iqtisad Al-Islami (First edn, Al-Maktab Al-Islami, Lebanon 1996) 130-136 & A Al-Hamid, Tajribat Al Bunuk Al Tijariah Al Saudiah Fi Baia Al Murabaha Lil Amir Bi Al Shira (First edn, Dar Bilansiah, Riyadh, Saudi 2003) 233.

This opinion refers to the following evidence from the Quran, the Prophet's traditions, the sayings of the early scholars, and the decisions of some Islamic banking conferences.

a. The Quran:

    1. In Chapter Al Saf, Allah condemns the people who made a promise but did not follow through as they said they would: "O ye who believe! Why say ye that which ye do not? Grievously odious is it in the sight of God that ye say that which ye do not."[295]
    2. In another instance, Allah punished those who dishonoured their promises with Him and told lies. He said, "So He hath put as a consequence hypocrisy into their hearts, (to last) till the Day, whereon they shall meet Him: because they broke their covenant with Allah, and because they lied (again and again)."[296]

b. The Prophet's traditions[297]:

    1. In one Hadith, the Prophet advises his followers not to break their promises: "If any of you made a promise then do not break it."
    2. In another Hadith, the Prophet indicates that the habit of breaking a promise is a sign of hypocrisy: "It is a sign of hypocrisy when [a person] made a promise, [and then he]

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[295] Surah Al Saf, Chapter 61, verses 3 and 4, translated by Yusuf Ali (accessed 22/11/08) http://www.harunyahya.com/Quran_translation/Quran_translation61.php.
[296] Surah Al Tawbah, Chapter 9, verses 77, translated by Yusuf Ali (accessed 22/11/08) http://www.harunyahya.com/Quran_translation/Quran_translation9.php.
[297] A Al_Maneea, Buhuth Fi Al-Iqtisad Al-Islami (First edn, Al-Maktab Al-Islami, Lebanon 1996) 131.

broke [his promise] even if he prayed and fasted and claimed he was a Muslim."

c. It is the opinion of many of the Prophet's companions, such as Abu Bakr, Jaber Ibn Abdullah, and Abdullah Ibn Omar.

d. It is also the opinion of many of the early scholars who came after the Prophet's companions including

    1. Omar Ibn Abdulaziz.[298]
    2. Al Hasn Al Basri. In the book of Fath Al Bari, Ibn Hajar said that Al Hasan Al Basri uphold this opinion in his judgment.[299]
    3. Abdullah Ibn Shubromah. In the book of Omadat Al Qaria, Al Ayni said that the judge Abdullah Ibn Subromah ruled against someone who failed to uphold a promise and jailed him as punishment for breaking such a promise.
    4. Abu Baker Ibn Al Arabi. In his book Ahkam Al Quran, Ibn Al Arabi said "and the correct in my opinion is that the promise is [binding] in all circumstances unless there is a [legitimate excuse]."[300]

e. Islamic banking conferences

The First Islamic banking Conference in Dubai supported the view that the promise to purchase is binding on both the bank and the

[298] Ibn_Hajar, Fateh Al-Bari (Muhib Al-Deen Al-Khateeb, 1977) 5/290.
[299] Ibn_Hajar, Fateh Al-Bari 5/290.
[300] Ibn_Al-Arabi, Ahkam Al-Quran (Second edn, Isa Al-Babi Wa Shurakao, 1967) 4/788.

customer. The same conclusion was reached by the Second Islamic Conference held in Kuwait.[301]

The second opinion: The Promise to purchase is not binding

This opinion holds the view that the promise to purchase in murabaha is not binding. It argues that making the promise to purchase binding will convert the promise into a sale contract. If the promise to purchase in murabaha becomes a sale contract that will bring about something that resembles three impermissible transactions; namely, the sale of something the person does not have, the two sales in one, and Inah sale. The following is a discussion of each of these transactions.

1- The sale of something the person does not have[302]

According to this view, if the promise to purchase is binding, murabaha will resemble the transaction of 'the sale of something the person does not have'—a forbidden transaction in Islamic law. According to Imam Shafii, the founder of the Shafii School, "if a man shows a man an article and says: buy this [for me] and I will give you so and so profit on it. If the man buys the article, this transaction is permissible, and the one who said 'I will give you profit on it' has the option of buying it or not.....but if they stipulated that it is binding on both of them, that is void.....one reason is that they made a sale transaction before the seller owns the article."[303]

In addition, a Hadith narrated by Abdullah Ibn Amar indicated that the Prophet said: "It is forbidden: sale and loan, and two conditions in sale,

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[301] S Al-Rabiah, Siyagh Al-Tamweel Bi Al-Murabaha (Markaz Al-Makhtutat Wa Al-Turath Wa Al-Wathaeq, Kuwait 2000) 44-45.
[302] A Fayadh, Al Tatbeeqat Al Masrafiah Li Baia' Al Murabaha Fi Daw Al Fiqh Al Islami (Dar Al Nashr Li Al Jamiaat, Egypt 1999) 85 & A Abuzaid, Baia' Al Murabaha Wa Tatbeeqatuh Al Muaasrah Fi Al Masarif Al Islamiah (Dar Al Fikr, Syria 2004) 137.
[303] Al-Shafii, Al-Um (Dar Al-Shaab, Cairo, Egypt) 3/33.

and profit without liability, and sale of something you do not have". [304] In another Hadith, one of the Prophit's companions told him that sometimes he was asked to sell something that he did not have, so he would go to the market to purchase it and sell it to the person. The Prophet replied "don't sell what you do not have."[305] Al-Shawkani asserts that the apparent meaning of the ban in the Prophet's Hadiths is that the sale of something that is not within a person's ability and ownership is forbidden.[306] In another attempt to explain the meaning of the 'sale of something you do not have', Ibn Al-Munther highlighted that it might refer to one of two meanings: "The first is when someone says: 'I sell you...a certain house', but the house is not at present at the time of sale. This is similar to gharar[307] because it might get damaged...The second is when he says: 'I sell you this house...on the condition that I purchase it from its owner or on the condition that its owner will deliver it to you'. That is void in every way because it is gharar as he might not be able to purchase it or the owner might not deliver it to him."[308]

2- Two sales in one

It was argued that the result of making the promise binding is that the murabaha would fall under the prohibition of 'two sales in one'. According to this opinion, the first sale is the promise-to-purchase agreement and the second one is the murabaha sale contract. The sanction of this kind of sale

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[304] Al-Shawkani, Nail Al-Awtar Sharh Muntaqa Al-Akhbar (Sharekat Matbaat Mustafa Al-Babi Al-Halabi Wa Awladuh, Egypt 1973) 5/234.
[305] Al-Shawkani, Nail Al-Awtar Sharh Muntaqa Al-Akhbar 5/235.
[306] Al-Shawkani, Nail Al-Awtar Sharh Muntaqa Al-Akhbar 5/235.
[307] Gharar has been translated as the "uncertainty in the object of a contract". See N Ray, Arab Islamic Banking and the Renewal of Islamic Law (Graham & Trotman Limited UK 1995) 28.
[308] Ibn_Hajar, Fateh Al-Bari (Muhib Al-Deen Al-Khateeb, 1977) 5/252.

was taken from the Hadith in which the Prophet forbade 'two sales in one'.[309] However, the meaning that this Hadith attempts to convey is a matter of dispute among scholars; thus, different interpretations of the meaning of 'the two sales in one' have arisen. Ibn Al-Qaym mentioned two attempts of the scholars to explain the meaning of this forbidden transaction. The first explanation is when someone says: "I will sell you this object for so and so if you pay in cash and so and so if you pay on credit". The second is when someone says: "I will sell you this object on credit for a hundred dinars due in one year and buy it back from you at the same time for eighty dinars in cash". After highlighting the weakness of the first explanation, Ibn Al-Qaym remarked that he favoured the second one.[310] Another explanation was suggested by Al-Shafie when he provided an example of a person who said: "I will sell you my goods if you sell me your goods or rent me your house".[311]

Relying on the definition of 'two sales in one' that was chosen by Ibn Al-Qaym, some Islamic banking scholars who support the view that the promise to purchase is binding argue that the situation in murabaha differs from what has been prohibited in the Hadith. According to the scholars, the Hadith attempts to prevent 'two sales' when the intention of the parties is not a sale, but money; in other words, the sale is only a disguise for a loan transaction to avoid riba. However, murabaha involves a genuine sales transaction. Moreover, the two-sales-in-one transaction includes two prices

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[309] Al-Shawkani, Nail Al-Awtar Sharh Muntaqa Al-Akhbar 5/231.
[310] Ibn_Al-Qaiem, Tahtheeb Sunan Abi Dawood (Dar Al-Maarifah, Lebanon) 5/106.
[311] Al-Shawkani, Nail Al-Awtar Sharh Muntaqa Al-Akhbar 5/231, Al-Sanani, Subul Al-Salam Sharh Bulugh Al-Maram (Dar Ihiaa Al-Turath Al-Arabi, Beirut 1982) 3/32.

for the same goods—one for cash payment and one for credit payment; in murabaha, there is only one defined price for the goods.[312]

3- Bay Al-Inah (Inah Sale)

This opinion, which finds the promise to purchase not binding, argues that making the promise binding will turn the transaction into Inah sale, which is unlawful. According to some Muslim scholars, whenever an over priced article is sold on credit and, at the same time, purchased from the same buyer by the same seller with cash for less, this transaction is Inah.[313] To understand this transaction and the justification behind its prohibition, the following example should be considered:

B, who is in need of money, approaches S and they arrange a transaction in which S sells B a horse for 120 Dinars, due two years from the date of the transaction. S then immediately buys it back from B for 100 Dinars cash, payable at the time of the transaction. Apparently, the parties' attention here was the money, not the horse; they used what appeared to be a sales transaction to avoid committing riba. Therefore, instead of lending 100 Dinars for 120 Dinars due in two years, which is considered riba, the parties agree to the same terms under the guise of a sales transaction. The final outcome is still riba, but it is disguised in the form of a sale.

One maliki scholar, Al-Dardeer also provides another form of Inah which, to some extent, resembles what occurs in a modern murabaha transaction. He describes a transaction in which a buyer approaches a seller regarding

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[312] Y Al-Qardawi, Baia' Al Murabaha Li Al Amir Bi Al Shiraa Kama Tujreeh Al Masarif Al Islamiah (Third edn, Dar Al Qalam, Kuwait 1986) 74.

[313] Y Al-Qardawi, Baia' Al Murabaha Li Al Amir Bi Al Shiraa Kama Tujreeh Al Masarif Al Islamiah 55, A Abu_Zayd, Baia' Al-Murabaha Wa Tatbeeqatuh Al-Muasirah Fi Al-Masarif Al-Islamyah (Dar Al-Fiker, Syria 2004) 103 & A Fayadh, Al Tatbeeqat Al Masrafiah Li Baia' Al Murabaha Fi Daw Al Fiqh Al Islami (Dar Al Nashr Li Al Jamiaat, Egypt 1999) 87.

an article and says to him: "buy it [from the market] for ten in cash and I will buy it from you for twelve due in a month". According to Al-Dardeer, this transaction is unlawful because it involves loan that leads to profit, which is riba.[314]

While Hanafi, Maliki, and Hanabali schools take the view that an Inah sale is unlawful[315], the Shafii School is of the opinion that an Inah sale is permissible [316]. The schools that disallow Inah remark that there are a number of Hadiths that prohibit dealing with Inah. For example, in one Hadith the Prophet forbade Inah when he mentioned it as one of four acts resulting in a certain punishment from Allah (God).[317] These schools also argue that Inah is prohibited because it is a means to commit riba. However, the Shafii School disagrees with this opinion, asserting that the Hadiths that talk about Inah are not sound and therefore cannot be relied upon for the prohibition of this transaction. The Shafii maintains that, "if a man bought from a man an article and he received it and the price was on credit, it is permissible for the other man to buy it back from the man who bought it...for cash, for less or for more".[318] This example demonstrates exactly the kind of transaction that is unlawful in the view of the other schools, although the Shafii School permits it.

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[314] Al-Dardeer, Al-Sharh Al-Kabeer (Dar Al-Fiker, Lebanon) 3/89.
[315] Al-Dardeer, Al-Sharh Al-Kabeer 3/89, Ibn_Qudamah, Al-Mughni (Dar Al-Kitab Al-Arabi, Beirut 1972) 4/127, M Al-Seewasi, Sharh Fath Al-Qadeer (Dar Al-Fikr, Lebanon) 5/208 & M Al-Bahuti, Sharh Muntaha Al-Iradat (Matbaat Ansar Al-Sunnah Al-Muhammadyah, 1947) 2/158.
[316] Al-Rafie, Fath Al-Azeez Sharh Al-Wajeez (Dar Al-Fiker, Lebanon) 8/231.
[317] Al-Shawkani, Nail Al-Awtar Sharh Muntaqa Al-Akhbar (Sharekat Matbaat Mustafa Al-Babi Al-Halabi Wa Awladuh, Egypt 1973) 5/294.
[318] Al-Shafii, Al-Um (Dar Al-Shaab, Cairo, Egypt) 3/79.

The payment of arbun (down payment)[319]

Upon signing the promise-to-purchase agreement, an advance—called an arbun—that represents part of the murabaha contract cost is paid by the applicant/customer to the bank. In addition to providing an indication of the buyer's seriousness, this advance serves to secure the bank's fund against any loss incurred as a result of the applicant's withdrawal from the transaction.

Arbun has been defined as a down payment that is paid by the buyer with the understanding that, if the sale is concluded, that payment would be deducted from the price of the goods. But if the buyer decides not to proceed with the sale, the seller can retain the payment.[320]

Early scholars have disagreed on the validity of taking the arbun. Although the Hanbali School accepts the taking of the arbun; the Hanafi, Maliki and Sahfii schools invalidate it,[321] citing the prohibition of the arbun by the Prophet.[322] They further argue that taking the arbun involves a form of gambling because, if the transaction is concluded successfully, the arbun is deducted from the transaction price; otherwise, the buyer loses the arbun, resulting in the seller being unjustly enriched.[323]

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[319] A Fayadh, Al Tatbeeqat Al Masrafiah Li Baia' Al Murabaha Fi Daw Al Fiqh Al Islami (Dar Al Nashr Li Al Jamiaat, Egypt 1999) 107 , A Abu_Zayd, Baia' Al-Murabaha Wa Tatbeeqatuh Al-Muasirah Fi Al-Masarif Al-Islamyah (Dar Al-Fiker, Syria 2004) 229 & A Al_Maneea, Buhuth Fi Al-Iqtisad Al-Islami (First edn, Al-Maktab Al-Islami, Lebanon 1996) 147.

[320] Ibn_Rushd, Bidayat Al-Mujtahid Wa Nihaiat Al-Muqtasid (Maktabat Al-Kuliat Al-Azhariah, Egypt 1966) 2/122.

[321] Ibn_Qudamah, Al-Mughni (Dar Al-Kitab Al-Arabi, Beirut 1972) 6/331-332.

[322] Al-Sanani, Subul Al-Salam Sharh Bulugh Al-Maram (Dar Ihiaa Al-Turath Al-Arabi, Beirut 1982) 2/334.

[323] Ibn_Rushd, Bidayat Al-Mujtahid Wa Nihaiat Al-Muqtasid (Maktabat Al-Kuliat Al-Azhariah, Egypt 1966) 2/122, Al-Nawawi, Al-Majmua Sharh Al-Muhathatb (Matbaat Al-Tadhamun Al-Akhawi, Egypt 1997) 9/335 & Al-Desuqi, Hasheiat Al-Desuqi Ala Al-Sharh Al-Kabeer (Dar Al-Fikr, Beirut 1988) 3/63.

Meanwhile, in accepting the arbun, the Hanbali School relies on a Hadith in which that when the Prophet was asked about the arbun he approved it.[324] This school also cited that Nafea Ibn Alharith purchased a building to be used as a prison for 4,000 Dirhams from Safwan Ibn Omayah, pending the approval of the Caliph Omar. The two agreed that, if Omar did not accept it, Nafea would pay Safwan 400 Dirhams for withdrawing from the transaction.[325] Some of the Prophet's companions, such as Omar and Ibn Omar, also accept the taking of arbun.[326]

A contemporary opinion justifies the taking of the arbun on the grounds that it has become a means of facilitating trade and is widely accepted in the modern commercial context.[327] Moreover, the arbun provides the seller with protection against loss that might occur due to the buyer's withdrawal from the transaction.[328]

With regard to Islamic banks' position towards the arbun, four different views can be found.[329] The first view does not accept the taking of the arbun, relying on the opinion of the three Islamic law schools previously mentioned. The second view, as expressed by the Assembly of Islamic Fiqh, allows the taking of the arbun only at the time of initiating the murabaha sale contract but not during the promise to purchase period.[330]

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[324] Al-Shawkani, Nail Al-Awtar Sharh Muntaqa Al-Akhbar (Sharekat Matbaat Mustafa Al-Babi Al-Halabi Wa Awladuh, Egypt 1973) 5/235.
[325] Ibn_Qudamah, Al-Mughni (Dar Al-Kitab Al-Arabi, Beirut 1972) 6/331-332.
[326] Ibn_Qudamah, Al-Mughni 6/331-332.
[327] A Fayadh, Al Tatbeeqat Al Masrafiah Li Baia' Al Murabaha Fi Daw Al Fiqh Al Islami (Dar Al Nashr Li Al Jamiaat, Egypt 1999) 115.
[328] A Al_Maneea, Buhuth Fi Al-Iqtisad Al-Islami (First edn, Al-Maktab Al-Islami, Lebanon 1996) 155.
[329] A Fayadh, Al Tatbeeqat Al Masrafiah Li Baia' Al Murabaha Fi Daw Al Fiqh Al Islami 117.
[330] Resolution No. 86/3/76 of the Assembly of Islamic Fiqh in A Fayadh, Al Tatbeeqat Al Masrafiah Li Baia' Al Murabaha Fi Daw Al Fiqh Al Islami (Dar Al Nashr Li Al Jamiaat, Egypt 1999) 116.

The reason behind this distinction is that the seller—i.e., the Islamic bank—has not gained ownership of the goods yet and therefore is not allowed to collect the goods' price or part of it; otherwise, the bank would fall foul of the prohibition about the 'sale of something you don't have'.[331] The third view permits the taking of arbun at the time of signing the promise-to-purchase agreement and allows the bank to retain it when the buyer refuses to conclude the sale. This was also the opinion of the Islamic legal consultant of Kuwait Financial House: when asked about the arbun, he remarked that the taking of arbun is allowed at the time of conducting the promise to purchase and the bank has the right to confiscate it if that has been agreed between the parties.[332] The fourth view is similar to the previous view, but differs in allowing the bank to deduct from the arbun only the amount that compensates the bank for its loss or damage, returning the rest to the buyer.[333]

Attitudes towards the arbun have also been affected by the issue of how the arbun should be considered. It has been argued that the arbun should be looked at as liquidated damages for the loss that the seller might encounter. Therefore, the seller is entitled to keep the entire arbun even if the loss is less than that. On the other hand, if the loss is greater than what has been paid in the arbun, the seller cannot request the buyer make up the difference. Another opinion suggests that the arbun should be perceived as compensation for a real or expected harm. This opinion argues that

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[331] A Abu_Zayd, Baia' Al-Murabaha Wa Tatbeeqatuh Al-Muasirah Fi Al-Masarif Al-Islamyah (Dar Al-Fiker, Syria 2004) 232.
[332] A Fayadh, Al Tatbeeqat Al Masrafiah Li Baia' Al Murabaha Fi Daw Al Fiqh Al Islami (Dar Al Nashr Li Al Jamiaat, Egypt 1999) 116.
[333] A Fayadh, Al Tatbeeqat Al Masrafiah Li Baia' Al Murabaha Fi Daw Al Fiqh Al Islami (Dar Al Nashr Li Al Jamiaat, Egypt 1999) 109.

payment of the arbun would prevent the seller from selling the article to another potential buyer, which might entail the loss of an opportunity of selling the article at all or selling it for a better price—either way causing harm to the seller; thus, the arbun should be treated as a remedy to cure that harm. A third opinion asserts that the arbun should be considered as the cost of restraining the seller from selling the article to a different buyer and the cost of providing the buyer with the option of proceeding with the sale or opting out of it.[334]

The Fourth Stage: Purchasing goods from the supplier

Prior to the bank getting involved in purchasing the goods from the supplier, the customer in most cases has a preliminary arrangement with the supplier as the Islamic bank initially has no direct contact with the supplier. This arrangement between the customer and the supplier considers the issues related to the goods, such as the specifications and the price of the goods and the method of payment and delivery. The supplier normally provides the customer with a pro forma invoice, which the customer attaches to the murabaha application. It should be noted that, in contacting the supplier, the customer is only allowed to make negotiations and arrangements without advancing any payment or executing any sale contract as doing otherwise makes the whole murabaha transaction void and the bank would refuse to get involved in such a transaction.[335] Some Islamic banks require the customer to sign a form stating that the customer

[334] A Al_Maneea, Buhuth Fi Al-Iqtisad Al-Islami (First edn, Al-Maktab Al-Islami, Lebanon 1996) 159.
[335] The researcher's interview with Adnan Babseel, Islamic Supervision Board, Al-Ahli Bank, Jeddah, Saudi Arabia (August 2006).

is responsible for the supplier's action and the bank is not liable for any harm sustained by the customer as a result of the supplier's delay in supplying the goods or failure to fulfil the sale transaction.[336]

Based on the information pertaining to the goods and their supplier, which is included in the pro forma invoice and is also provided by the customer, the bank contacts the supplier and issues a letter of credit in favour of the supplier. [337] According to Islamic law, a contract can be initiated by any means leading to its objective establishment, including oral or written expression, or the conduct of the parties. Issuing a letter of credit is considered to be an offer from the bank, while the shipping of the goods and submission of the shipping documents are considered to be forms of acceptance from the supplier; thus, in this way, a sale contract is constituted between the bank and the supplier.[338]

If the supplier is not designated by the customer, a specific department in the Islamic bank searches for offers from different suppliers and selects the best offer available in the market. In any event, whether the suppliers are contacted by the bank or the customer, all shipping documents have to be in the bank's name and for the account of the customer, as the Islamic bank is the party purchasing the goods from the supplier.[339] In addition, for those transactions that involve very expensive goods or goods in very large

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[336] A Al-Suwaidi, Finance of Internatinal Trade in the Gulf (Graham & Trotman Limited UK 1994) 117.
[337] A Al-Suwaidi, Finance of Internatinal Trade in the Gulf 117.
[338] MA Omar, 'Al Tafaseel Al Ilmyah Li Aqd Al Murabaha Fi Al Nizam Al Mesrafi Al Islami' (Khutat Al Istithmar Fi Al Bunuk Al Islamiah, Al Jawanib Al Tatbeeqiah Wa Al Qadhayah Wa Al Mushkilat, a Conference held in Jordan with a collaboration of the Islamic Development Bank, Islamic institution for research and training 1987) 193-194.
[339] A Al-Suwaidi, Finance of Internatinal Trade in the Gulf 117.

quantity, the Islamic bank may conclude the purchase transaction abroad by itself or through its representatives.[340]

Some Islamic banks might appoint the customer as an agent to approach the supplier, form a sale contract on behalf of the bank, and then act also as the bank's agent in selling the goods to the customer himself. This is usually done for obvious reasons as the customer, in most cases, is more experienced than the bank in that particular area of trade; thus, it would be rational to allow the job to be handled by the party who can perform it best. However, some of the Islamic banking scholars disagree with this method and embrace the view that it is unlawful for a person to act for two different parties in concluding a contract of sale. They also contend that this might be a means of trying to get around the prohibition on riba by performing what appears to be a legitimate sale transaction while it is in fact a loan with interest, and the goods are just to cover up the usurious transaction.[341]

The Fifth Stage: Murabaha Sale

The final stage in the murabaha transaction is the execution of murabaha sale between the Islamic bank and the customer. Once the Islamic bank notifies the customer that the Islamic bank has obtained the goods from the supplier, the customer has to execute the murabaha contract with the Islamic bank. Some Islamic banks stipulate in the promise-to-purchase agreement that the customer has to conclude the murabaha contract within

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[340] A Al-Suwaidi, Finance of Internatinal Trade in the Gulf 119.

[341] MA Omar, 'Al Tafaseel Al Ilmyah Li Aqd Al Murabaha Fi Al Nizam Al Mesrafi Al Islami' (Khutat Al Istithmar Fi Al Bunuk Al Islamiah, Al Jawanib Al Tatbeeqiah Wa Al Qadhayah Wa Al Mushkilat, a Conference held in Jordan with a collaboration of the Islamic Development Bank, Islamic institution for research and training 1987) 185.

fifteen days of receiving the notice, while other Islamic banks require the customer to do so within seven days.[342] This final stage of the murabaha transaction deals with issues such as the time when the murabaha contract can be executed, who bears the risks of loss of, or damage to, the goods, the calculation of the murabaha transaction price, method of payment, situations in which the bank or customer refuses to conclude the transaction, and the customer defaulting in the payment.

When the murabaha contract can be concluded

Before the Islamic bank is able to initiate a murabaha contract with the buyer, the bank has to acquire ownership of the article. The Islamic law schools have examined whether the seller—prior to concluding the sale—is required merely to gain ownership of the goods or whether possession of the goods should also be obtained. This discussion will analyse the schools' beliefs as well as explore how modern Islamic banks deal with this issue in practice.

Several Hadiths report the Prophet's ban on selling goods before obtaining them. In one Hadith, the Prophet said, "don't sell what you don't have".[343] According to another Hadith, the Prophet asserted that "it is unlawful: loan and sale, two conditions in one sale...and the sale of something you don't have".[344] Based on these and other Hadiths, the Islamic law scholars have agreed that the seller's ownership of the goods is an essential requirement

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[342] MA Omar, 'Al Tafaseel Al Ilmyah Li Aqd Al Murabaha Fi Al Nizam Al Mesrafi Al Islami' (Khutat Al Istithmar Fi Al Bunuk Al Islamiah, Al Jawanib Al Tatbeeqiah Wa Al Qadhayah Wa Al Mushkilat, a Conference held in Jordan with a collaboration of the Islamic Development Bank, Islamic institution for research and training 1987) 199.

[343] Al-Shawkani, Nail Al-Awtar Sharh Muntaqa Al-Akhbar (Sharekat Matbaat Mustafa Al-Babi Al-Halabi Wa Awladuh, Egypt 1973) 5/235.

[344] Al-Shawkani, Nail Al-Awtar Sharh Muntaqa Al-Akhbar 5/234.

of the sale.[345] However, they differ on whether the seller is required, in addition to owning the goods, to possess them. Al-Shafie takes the view that it is unlawful to sell any kinds of goods before possessing them. Abu Hanifa also disallows the sale of an object before possessing it except in the sale of real property. They rely on the story that Ibn Omar, one of the Prophet's companion, bought oil and when he was about to sell it for a profit, Zaid Ibn Thabit—another of the Prophet's companions—, told him that he should not sell the oil until he obtains full possession. He explained that the Prophet forbade merchants from selling goods until they have possession of them. Meanwhile, Imam Ahmed distinguished between foods and other items. In his opinion, only foods are required to be possessed before they can be sold as it was narrated that the Prophet forbad the sale of food before possessing it. According to Ahmed's understanding, the Hadith only mentioned food; thus, all other items are excluded from the ban. Similarly, Imam Malik limited the possession requirement to goods that are subject to riba, such as dates and salt. He also cited the Hadith in which the Prophet disallowed the sale of food until possession is achieved.[346]

This discussion leads to another issue: How can the possession of goods be obtained? In other words, what kinds of conduct satisfy this condition? Islamic law schools are of the opinion that the possession of the goods is

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[345] Al-Nawawi, Al-Majmua Sharh Al-Muhathatb (Matbaat Al-Tadhamun Al-Akhawi, Egypt 1997) 9/259.

[346] Ibn_Qudamah, Al-Mughni (Dar Al-Kitab Al-Arabi, Beirut 1972) 4/121-130, M Al-Seewasi, Sharh Fath Al-Qadeer (Dar Al-Fikr, Lebanon) 6/510-516, Ibn_Qudamah, Al-Kafi Fi Fiqh Al-Imam Ahmed (Second edn, Al-Maktab Al-Islami, Lebanon 1979) 2/27-28, Ibn_Rushd, Bidayat Al-Mujtahid Wa Nihaiat Al-Muqtasid (Maktabat Al-Kuliat Al-Azhariah, Egypt 1966) 2/144-147 & Ibn_Taymeiah, Majmua Al-Fatawa (First edn, Matbaat Al-Sunnah Al-Muhammadeiah, 1965) 4/476-486 .

subject to the customary practice of the people. One notable exception is that Shafis and Malikis hold the view that possession of real property is obtained when the buyer is given the right to access and use the property.[347] Following the majority's view, the Fiqh Academy concluded that the possession of goods is obtained according to the status of the goods and the customary practice of the people.[348]

In modern practice, the majority of Islamic banks follow the opinion that the seller is not only required to own the goods, but also have full possession of them before the seller can engage in a murabaha contract.[349] That is what the International Association of Islamic Banks reached when it stated that:

"Selling is postponed until the bank gets actual ownership and possession of goods and becomes responsible for any defects therein."[350] The Fatwah committee in Faisal Islamic Bank of Egypt[351] and the Islamic International Bank for Investment and Development[352] expressed the same opinion. In addition, a fatwa produced by the Second Conference of Islamic Bank maintained that, for murabaha sale to be lawful, full possession of the goods must be obtained by the bank before conducting the sale. Moreover,

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[347] Al-Desuqi, Hasheiat Al-Desuqi Ala Al-Sharh Al-Kabeer (Dar Al-Fikr, Beirut 1988) 3/144-145.
[348] W Al-Zuhaily, Al-Fiqh Al-Islami Wa Adilatuh (Dar Al-Fiker, 1996) 9/575.
[349] N Ray, Arab Islamic Banking and the Renewal of Islamic Law (Graham & Trotman Limited UK 1995) 48.
[350] International Association of Islamic Banks, Directory of Banks and Financial Institutions Members of the Association (International Association of Islamic Banks, Saudi Arabia 1990) 36-37.
[351] Faisal Islamic Bank of Egypt, fatwa hay'a al-raqaba al-shar'iyya (Faisal Islamic Bank of Egypt, Cairo) 11-12.
[352] Al-Ghazzali, Bay' Al-Murabaha (Islamic International Bank for Investment and Development, Cairo) 12.

the risk of loss must be borne by the bank, and in case of defect the bank is responsible for returning the goods to the supplier.[353]

The requirement that the bank should own and possess the goods before engaging in a murabaha contract puts the bank in tremendous risk as the goods might get lost or damaged during the period when the goods are under the bank's ownership and possession. Some Islamic banks, in order to reduce these risks, follow the view that possession of the goods is not required to complete the sale transaction. They assert that the only requirement is to obtain ownership of the goods.[354] Islamic banks also adopt different techniques in tackling such risks associated with the goods. These techniques will now be considered.

Who bears the risks of the goods?

As a general rule, the seller bears the risk of the goods being lost or defective until they are within the buyer's possession. That is why both the Fifth Conference of Islamic Jurists Fiqh Academy[355] and the Second Conference of Islamic Banks announced that, for murabaha transactions to be valid, the Islamic bank has to obtain the goods and bear the risk of the loss of, or damage to, the goods until they are delivered to the customer.[356] In practice, some Islamic banks, such as the Islamic Bank of Jordan, follow the general rule and bear the risks.[357] However most Islamic banks

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[353] Y Al-Qardawi, Baia' Al Murabaha Li Al Amir Bi Al Shiraa Kama Tujreeh Al Masarif Al Islamiah (Third edn, Dar Al Qalam, Kuwait 1986) 10.
[354] N Ray, Arab Islamic Banking and the Renewal of Islamic Law 48.
[355] A Al-Suwaidi, Finance of Internatinal Trade in the Gulf (Graham & Trotman Limited UK 1994) 103.
[356] A Al-Salus, 'Makhater Al-Tamweel Al-Islami' (Al-Mutamar Al-Alami Li Al-Iqtisad Al-Islami (International Conference for Islamic Economic) June 2005) 13.
[357] M Shihatah, 'Tajribat Al Bank Al-Islami Al Orduni in Khutat Al Istithmar Fi Al Bunuk Al Islamiah, Al Jawanib Al Tatbeeqiah Wa Al Qadhayah Wa Al Mushkilat' (a conference

endeavour to employ methods to eliminate or minimise such risks associated with the goods.

In addition to obtaining insurance, banks can address the risk of loss of goods by reducing the amount of time the goods remain in their possession. One way of doing that is by appointing the customer as an agent for the bank to receive the goods from the supplier and sell them—again, on behalf of the bank—to the customer himself. That means that the moment the customer receives the goods on behalf of the bank is the exact moment the goods will be conveyed to the customer's ownership and possession.[358] Similar results can be accomplished by appointing the shipper to act on behalf of the bank and the customer in obtaining ownership and possession of the goods. Thus, when the shipper receives the goods, the bank's ownership and possession of the goods are accomplished and ownership and possession of the goods are automatically transferred to the customer.[359]

As for the risk of the goods being defective, Islamic banks differ on whether to stipulate that the bank is not liable for any defect found in the goods.[360] This different practice stems from the disagreement among the

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held with a collaboration of the Islamic Development Bank, Islamic institution for research and training, Amman, Jordan 1987) 459.

[358] Al-Shabeeli, Al-Khadamat Al-Istithmaryah Fi Al-Masarif Wa Ahkamuh Fi Al-Fiqh Al-Islami (First edn, Dar Ibn Al-Jawzi, Saudi Arabia 2005) 458-459, A Al-Malqi, Al-Bunuk Al-Islamyah, Al-Tajribah Bayn Al-Fiqh Wa Al-Qanoon Wa Al-Tatbeeq (Al-Markaz Al-Thaqafi Al-Arabi, Beirut, Lebanon 2000) 444.

[359] N Ray, Arab Islamic Banking and the Renewal of Islamic Law 48, A Fayadh, Al Tatbeeqat Al Masrafiah Li Baia' Al Murabaha Fi Daw Al Fiqh Al Islami (Dar Al Nashr Li Al Jamiaat, Egypt 1999) 13 & A Abu_Zayd, Baia' Al-Murabaha Wa Tatbeeqatuh Al-Muasirah Fi Al-Masarif Al-Islamyah (Dar Al-Fiker, Syria 2004) 222.

[360] A Al-Hamid, Tajribat Al Bunuk Al Tijariah Al Saudiah Fi Baia Al Murabaha Lil Amir Bi Al Shira (First edn, Dar Bilansiah, Riyadh, Saudi 2003) 379-380 & MA Omar, 'Al Tafaseel Al Ilmyah Li Aqd Al Murabaha Fi Al Nizam Al Mesrafi Al Islami' (Khutat Al Istithmar Fi Al Bunuk Al Islamiah, Al Jawanib Al Tatbeeqiah Wa Al Qadhayah Wa Al Mushkilat, a Conference held in Jordan with a collaboration of the Islamic Development Bank, Islamic institution for research and training 1987) 198.

Islamic law jurists regarding this issue. Abu Haneefah, and Imam Ahmed are of the opinion that it is lawful that the seller stipulates that he is not responsible for any defect regardless of whether or not the seller was aware of it; consequently, the buyer will not have the right to return any defective goods.[361]

Meanwhile, Imam Shafi, and Ibn Hazm embrace the opinion that the seller is liable for any defect in the goods unless he makes the buyer aware of that defect. However, Imam Ahmed, in another narration, and Imam Malik present a different opinion. They hold that the seller is liable for defects about which he knows but is not liable for defects of which he is not aware. This concurs with the view of two of the Prophet's companions, Othman Ibn Affan and Zayd Ibn Thabit.[362] Therefore, if the Islamic bank stipulates that it will not be responsible for any defect found in the goods, based on the first juristic opinion, this condition is correct and the Islamic bank will not be held liable for any defect found in the goods. On the other hand, based on the second opinion, this condition is void and in the event that a defect is found in the goods, the customer has the right to return the goods and rescind the sale. However, based on the third opinion, the bank will not be held liable if it was not aware of the defect.[363]

Ironically, some commentators believe that the Islamic bank should not attempt to escape its liability in regard to goods as that would strip the

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[361] Ibn_Qudamah, Al-Mughni (Dar Al-Kitab Al-Arabi, Beirut 1972) 4/198, Al-Sarkhasi, Al-Mabsut (Dar Al-Maref Li Al-Tebaah Wa Al-Nashr, Beirut) 13/91, Ibn_Abdeen, Hashyat Ibn_Abdeen (Dar Al-Fiker, Lebanon 1364) 4/591 & Ibn_Rushd, Bidayat Al-Mujtahid Wa Nihaiat Al-Muqtasid (Maktabat Al-Kuliat Al-Azhariah, Egypt 1966) 2/234.

[362] Ibn_Qudamah, Al-Mughni (Dar Al-Kitab Al-Arabi, Beirut 1972) 4/197, Al-Sarkhasi, Al-Mabsut (Dar Al-Maref Li Al-Tebaah Wa Al-Nashr, Beirut) 13/91 & Ibn_Hazam, Al-Muhala (Matbaat Al-Imam, Egypt 1986) 9/141-144.

[363] A Al-Hamid, Tajribat Al Bunuk Al Tijariah Al Saudiah Fi Baia Al Murabaha Lil Amir Bi Al Shira (First edn, Dar Bilansiah, Riyadh, Saudi 2003) 383.

transaction of its distinctive feature as a sale transaction and convert it into a usurious transaction, making the murabaha label a mere cover-up.[364]

Calculation of the murabaha transaction price

As previously mentioned, one of Islamic law's requirements for the sale of murabaha is that the seller and buyer have knowledge of the original price of the goods and the added profit. In modern murabaha transactions, the murabaha price is mentioned twice: 1- in the promise-to-purchase form and 2- in the murabaha contract. However, the murabaha price in these two positions is not necessarily the same. This fact can be used against the view that argues that the promise-to-purchase agreement should not be binding because making it binding would render the promise to purchase a sale contract. The fact that the murabaha price is not yet finalised at this stage is an effective response to such an argument because in the sale contract the price has to be definite and not subject to change, which is not the case during the promise-to-purchase stage. In fact, different factors might bring about the change to the murabaha price. One of these factors is when the supplier ships part of the goods and refuses to ship the rest. Another factor is changes to the original price between the time of making the promise to purchase and the time of executing the sale with the supplier.[365] In addition, the fluctuation of the currency rate and the change of the required tax might contribute to changes in the murabaha price.[366]

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[364] A Al-Salus, 'Makhater Al-Tamweel Al-Islami' (Al-Mutamar Al-Alami Li Al-Iqtisad Al-Islami (International Conference for Islamic Economic) June 2005) 13.

[365] This issue, namely; the change of the purchase price of the goods, is discussed below in more detail.

[366] MA Omar, 'Al Tafaseel Al Ilmyah Li Aqd Al Murabaha Fi Al Nizam Al Mesrafi Al Islami' (Khutat Al Istithmar Fi Al Bunuk Al Islamiah, Al Jawanib Al Tatbeeqiah Wa Al

Islamic banks differ in their practice of mentioning the transaction price in the murabaha contracts. Some Islamic banks mention the transaction price collectively, without going into detail about the elements that lead to such a price. Other Islamic banks provide more detail on how the transaction price is reached.[367]

To calculate its profit and thus the murabaha transaction price, Islamic banks take into consideration two essential elements—namely, the original purchase price and the additional expenses sustained by the bank in obtaining the goods.[368]

1- The original purchase price[369]

The original purchase price refers to the price of the goods when purchased by the bank from the supplier. Obviously, this original purchase price is an essential element in determining the resale price of the goods. However, situations exist in which the original purchase price might be less or more than the market value of the goods at the time of the murabaha contract. For example, a bank may purchase goods from a supplier for £1000, but at the time of signing the murabaha sale contract with the customer, the

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Qadhayah Wa Al Mushkilat, a Conference held in Jordan with a collaboration of the Islamic Development Bank, Islamic institution for research and training 1987) 201-202.

[367] MA Omar, 'Al Tafaseel Al Ilmyah Li Aqd Al Murabaha Fi Al Nizam Al Mesrafi Al Islami' (Khutat Al Istithmar Fi Al Bunuk Al Islamiah, Al Jawanib Al Tatbeeqiah Wa Al Qadhayah Wa Al Mushkilat, a Conference held in Jordan with a collaboration of the Islamic Development Bank, Islamic institution for research and training 1987) 202.

[368] A Al-Suwaidi, Finance of Internatinal Trade in the Gulf (Graham & Trotman Limited UK 1994) 119 MA Omar, 'Al Tafaseel Al Ilmyah Li Aqd Al Murabaha Fi Al Nizam Al Mesrafi Al Islami' (Khutat Al Istithmar Fi Al Bunuk Al Islamiah, Al Jawanib Al Tatbeeqiah Wa Al Qadhayah Wa Al Mushkilat, a Conference held in Jordan with a collaboration of the Islamic Development Bank, Islamic institution for research and training 1987) 203-208.

[369] A Al-Suwaidi, Finance of Internatinal Trade in the Gulf (Graham & Trotman Limited UK 1994) 105-106, MA Omar, 'Al Tafaseel Al Ilmyah Li Aqd Al Murabaha Fi Al Nizam Al Mesrafi Al Islami' (Khutat Al Istithmar Fi Al Bunuk Al Islamiah, Al Jawanib Al Tatbeeqiah Wa Al Qadhayah Wa Al Mushkilat, a Conference held in Jordan with a collaboration of the Islamic Development Bank, Islamic institution for research and training 1987) 203-205 & Y Al-Shabeeli, Al-Khadamat Al-Istithmaryah Fi Al-Masarif Wa Ahkamuh Fi Al-Fiqh Al-Islami (First edn, Dar Ibn Al-Jawzi, Saudi Arabia 2005) 489.

market price of the goods increases to £1100. The Islamic bank would normally consider the price of the goods at the time of purchase from the supplier regardless of the change that occurs before the execution of the murabaha contract. Another example is when the increase in the market price of the goods results from growth or gains occurring after the Islamic bank purchases the goods from the supplier and before selling the goods to the customer. This situation can be seen when goods are sheep, cows, etc., and there is an increase in their quantity due to breeding. In this case the Islamic bank would add to the original price to reflect that growth or gain.

The price of the goods might also change as a result of damage or loss to part of the goods. Some Islamic banks would reduce the murabaha contract price according to that damage or loss. However, as previously explained, most Islamic banks would arrange an agreement with the customer by which the Islamic bank would bear no responsibility for any damage or loss to the goods.

Another situation that affects the original price of the goods is the fluctuation of the currency rate. For example, an Islamic bank purchases goods from an overseas supplier using foreign currency (e.g., $100,000) and sells it to the customer using a local currency (e.g., pound sterling); if the rate value of the dollar changes from $2 per pound at the time the bank purchases the goods to $2.50 per pound at the time of murabaha contract, the price of the goods changes from £50,000 to £40,000. In this situation, according to the preferred juristic opinion, the Islamic bank should consider the currency rate at the time of executing the murabaha contract.

The change of the original value of the goods could also stem from a discount provided by the supplier. For example, if the value of the goods originally is £100,000 but at time of purchase—and because of the large order—the supplier offers a 10 percent discount making the goods price falling into £90,000. There are two juristic opinions relate to this issue. The first, which is the opinion of the Maliki School, is that the seller (the Islamic bank) may opt to make the same reduction for the buyer (the customer). The seller can choose to pass on the reduction in the sale price, but if the seller does not make the reduction, then the buyer has the right to refuse to execute the murabaha contract. The second opinion, which was favoured by Hanafi, Shafei, and Hanbali schools, is that if the discount is provided before the execution of the first contract (i.e., the contract between the bank and the supplier), the seller (the Islamic bank) has to make the same reduction in price. However, if the discount is obtained after the execution of the first contract, then the seller does not have to reduce the price. In practice, most Islamic banks, in calculating the murabaha price, take into account any discount given by the supplier to the advantage of the customer.

2- Additional expenses

Additional expenses may include the cost of inspecting and shipping the goods, insurance premium, tax and custom duty. The juristic view on the expenses that can be added to the original price of goods in the sale of murabaha was previously discussed herein. It has been also remarked that at the practical level, Islamic banks are of the opinion that any expenses the

bank incurs in the process of obtaining the goods should be considered in calculating the total price of the murabaha transaction.

Withdrawal from the murabaha transaction

When the bank purchases goods from the supplier and informs the customer of their availability, based on the promise-to-purchase agreement, the customer has to fulfil his promise by purchasing the goods from the bank. If for any reason the customer decides to withdraw from the transaction—in other words, refuses to purchase the goods from the bank—the bank's reaction depends heavily on its attitude toward the promise-to-purchase agreement. Islamic banks that embrace the view that this is not a binding promise normally attempt to recover their funds by selling the goods and bearing any loss without seeking compensation from the customer.[370] These Islamic banks could reduce such risk by arranging for an option with the supplier that enables the Islamic bank to return the goods to the supplier in the event the customer withdraws from the transaction.[371] Nevertheless, it is understandable that this kind of arrangement cannot be always reached.

However, Islamic banks that follow the trend that perceives the promise to purchase as binding will pursue the customer for any loss, including loss of profit they sustain as a result of the customer's failure to conclude the transaction. These Islamic banks will attempt to recover their losses by

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[370] A Abu_Zayd, Baia' Al-Murabaha Wa Tatbeeqatuh Al-Muasirah Fi Al-Masarif Al-Islamyah (Dar Al-Fiker, Syria 2004) 227 & MA Omar, 'Al Tafaseel Al Ilmyah Li Aqd Al Murabaha Fi Al Nizam Al Mesrafi Al Islami' (Khutat Al Istithmar Fi Al Bunuk Al Islamiah, Al Jawanib Al Tatbeeqiah Wa Al Qadhayah Wa Al Mushkilat, a Conference held in Jordan with a collaboration of the Islamic Development Bank, Islamic institution for research and training 1987) 211.

[371] A Abu_Zayd, Baia' Al-Murabaha Wa Tatbeeqatuh Al-Muasirah Fi Al-Masarif Al-Islamyah 227.

forfeiting the down payment (arbun) provided by the customer at the time of signing the promise-to-purchase form. While some Islamic banks take the position that they would seize the whole arbun even if it exceeds the bank's damages, other Islamic banks embrace the view that they can only take from the arbun the amount that corresponds with their loss and they must return the remainder of the amount to the customer.[372]

On the other hands, if the bank is the party who withdraws from the transaction by refusing to purchase the goods for the customer or refusing to conclude the murabaha transaction, the same distinction also applies. If the transaction was built on the view that the promise-to-purchase is not binding then the customer cannot pursue the bank for damages; however, if the promise was binding, the issue will be referred to an arbitration committee to decide what compensation should be granted to the customer.[373]

The Method of Payment

In Islamic banking, the murabaha contract price is normally paid by the customer in credit and over a period of time.[374] According to the majority

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[372] A Abu_Zayd, Baia' Al-Murabaha Wa Tatbeeqatuh Al-Muasirah Fi Al-Masarif Al-Islamyah 228 & MA Omar, 'Al Tafaseel Al Ilmyah Li Aqd Al Murabaha Fi Al Nizam Al Mesrafi Al Islami' (Khutat Al Istithmar Fi Al Bunuk Al Islamiah, Al Jawanib Al Tatbeeqiah Wa Al Qadhayah Wa Al Mushkilat, a Conference held in Jordan with a collaboration of the Islamic Development Bank, Islamic institution for research and training 1987) 211.

[373] A Abu_Zayd, Baia' Al-Murabaha Wa Tatbeeqatuh Al-Muasirah Fi Al-Masarif Al-Islamyah 228.

[374] M Cole & W Elliot, 'Islamic Banking: A Western Lawyer's Perspective' in European Perceptions of Islamic Banking (Institute of Islamic Banking and Insurance, London 1996) 63, F Vogel and S Hayes, Islamic law and finance, Religion, Risk and Return (Kluwer Law International, The Netherland 1998) 140, A Fayadh, Al Tatbeeqat Al Masrafiah Li Baia' Al Murabaha Fi Daw Al Fiqh Al Islami (Dar Al Nashr Li Al Jamiaat, Egypt 1999) 145 & B Sabahi, 'Islamic Financial Structures as Alternatives to International Loan Agreements: Challenges for U.S. Financial Institutions'24 Ann Rev Banking & Fin L 487 at 495.

of Islamic legal scholars, the deferred payment (in credit)—whether performed in a lump sum or in instalments—is permitted[375] as it was narrated that the Prophet bought food from a Jew with deferred payment, pledging his shield.[376] Furthermore, the Assembly of Islamic Fiqh, in their decision no. 72/65, confirmed the legality of sales in credit and by means of instalment payments.[377]

As an incentive for early payment, some Islamic banks state in the murabaha contract that the bank has the right to return part of its profit if the customer manages to pay all or part of the contract price earlier than the due date. Although this issue was met with contradicting views among Muslim jurists, the Assembly of Islamic Fiqh followed the opinion that accepts this practice. The Assembly of Islamic Fiqh concluded in its decision no. 72/66 that the reduction of future debt for early payment is lawful and does not fall under the forbidden riba as long as this is not established in a previous agreement.[378]

Default in Payment

One of the problematic challenges Islamic banks encounter is the issue of the default in payment. In conventional finance, this issue is solved by simply imposing interest on the party in default. However, as interest is considered to be riba (usury) under Islamic financial principles, Islamic

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[375] M Irsheed, Al-Sahmil Fi Muamalat Wa Amaliat Al-Masarif Al-Islamiah (First edn, Dar Al-Nafaes Li Al-Nashr Wa Al-Tawzeea, Jordan 2001) 89 & A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation (E. J. Brill, Leiden, The Netherlands 1996) 78.

[376] Muslim, Saheeh Muslim (Matbaat Muhammad Ali Subhi, 1971) 2/55 & Al-Bukhari, Saheeh Al-Bukhari (Dar Al-Hadeeth, Cairo 1983) 1/186.

[377] Majalat Jamiat Al-Malik Abdulazeez (Markaz Al-Nashr Al-Ilmi, 1992) 4/88.

[378] Al-Hamid, Tajribat Al Bunuk Al Tijariah Al Saudiah Fi Baia Al Murabaha Lil Amir Bi Al Shira (First edn, Dar Bilansiah, Riyadh, Saudi 2003) 346.

banks cannot resort to such a treatment and have to find another way to deal with this dilemma.[379]

There is a danger that unfaithful customers could take advantage of the situation by defaulting in payment, knowing that the Islamic bank would never charge interest.[380] Therefore, Islamic banks have attempted to develop various methods to deal with the issue of defaulting in payment, including the following.

1- Registering the name the defaulting buyers as bad debtors, thereby, preventing them from obtaining any financial facilities in future transactions.[381]

2- Inserting a clause in the murabaha contract stipulating that, in the event of default in payment, the deferral feature of payment is removed and the remaining transaction price becomes immediately due. This unpaid amount can be recovered by the collateral the customer provided when signing the murabaha contract or by the bank getting repossession of the goods.[382]

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[379] N Miller, 'Late Payment Fees in Islamic Finance: Is it Permissible for an Islamic Bank to Impose Penalties for Late Payment?' (2007) 7 JIBFL 422.

[380] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 55 & A Al-Malqi, Al-Bunuk Al-Islamyah, Al-Tajribah Bayn Al-Fiqh Wa Al-Qanoon Wa Al-Tatbeeq (Al-Markaz Al-Thaqafi Al-Arabi, Beirut, Lebanon 2000) 481 .

[381] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 58, Al-Hamid p. 308.

[382] A Al-Hamid, Tajribat Al Bunuk Al Tijariah Al Saudiah Fi Baia Al Murabaha Lil Amir Bi Al Shira (First edn, Dar Bilansiah, Riyadh, Saudi 2003) 307, A Fayadh, Al Tatbeeqat Al Masrafiah Li Baia' Al Murabaha Fi Daw Al Fiqh Al Islami (Dar Al Nashr Li Al Jamiaat, Egypt 1999) 168 & MA Omar, 'Al Tafaseel Al Ilmyah Li Aqd Al Murabaha Fi Al Nizam Al Mesrafi Al Islami' (Khutat Al Istithmar Fi Al Bunuk Al Islamiah, Al Jawanib Al Tatbeeqiah Wa Al Qadhayah Wa Al Mushkilat, a Conference held in Jordan with a collaboration of the Islamic Development Bank, Islamic institution for research and training 1987) 210.

3- Imposing a penalty on the defaulting buyer. This issue of a financial penalty has not been welcomed by all Islamic banking scholars. In fact, it was met with different opinions.

The first opinion:

This view rejects the idea of charging a financial penalty whether this penalty is stipulated in the contract or not and whether its purpose is to compensate the bank for any damages or merely for punishing the defaulting debtor. The reason behind this rejection, according to this view, is that inflicting financial penalty resembles the charging of interest, which conflicts with Islamic banking principles.[383] It also contradicts the Islamic principle in dealing with the insolvent debtor, as one verse in the Quran asserts that—if the debtor is in financial difficulty—he should be granted a grace period until this difficulty has been overcome.[384] In addition, several juristic bodies have declaree the same restriction on charging a penalty. For instance, the annual session of the Fiqh Academy states that, "if the debtor is late in paying the instalments in due time, it is unlawful to charge any penalty on the debt whether with previous stipulation or without stipulation as this is

[383] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 56, A Al-Hamid, Tajribat Al Bunuk Al Tijariah Al Saudiah Fi Baia Al Murabaha Lil Amir Bi Al Shira (First edn, Dar Bilansiah, Riyadh, Saudi 2003) 322, A Fayadh, Al Tatbeeqat Al Masrafiah Li Baia' Al Murabaha Fi Daw Al Fiqh Al Islami (Dar Al Nashr Li Al Jamiaat, Egypt 1999) 175 & A Al Maneea, Buhuth Fi Al-Iqtisad Al-Islami (First edn, Al-Maktab Al-Islami, Lebanon 1996) 407.

[384] Chapter Al Baqarah verse 280.

the forbidden riba."[385] The same conclusion was reached by the Fiqh Council held in Mecca in 1989.[386]

The second opinion:

In an attempt to prevent the charging of a penalty from being classified as riba, some scholars have suggested that such a charge should be allowed on condition that the charge would be spent on charitable causes and would not be mixed with the bank's own funds. This view argues that charging a penalty would punish the defaulting debtor and, by allocating this charge for charity, the charge would be protected from falling under the forbidden riba (usury).[387]

The third opinion:

The third opinion embraces the view that imposing a financial penalty is permissible unless the debtor's insolvency can be established to the bank's satisfaction.[388] In reaching this understanding, this opinion cites a Hadith in which the Prophet said

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[385] A Al-Hamid, Tajribat Al Bunuk Al Tijariah Al Saudiah Fi Baia Al Murabaha Lil Amir Bi Al Shira (First edn, Dar Bilansiah, Riyadh, Saudi 2003) 322.

[386] A Fayadh, Al Tatbeeqat Al Masrafiah Li Baia' Al Murabaha Fi Daw Al Fiqh Al Islami (Dar Al Nashr Li Al Jamiaat, Egypt 1999) 176.

[387] S Muscati, 'Late Payment in Islamic Finance' (2006-2007) 6 UCLA J Islamic & Near EL 47 at 56, MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 59, A Al-Hamid, Tajribat Al Bunuk Al Tijariah Al Saudiah Fi Baia Al Murabaha Lil Amir Bi Al Shira (First edn, Dar Bilansiah, Riyadh, Saudi 2003) 324 & A Al Maneea, Buhuth Fi Al-Iqtisad Al-Islami (First edn, Al-Maktab Al-Islami, Lebanon 1996) 421.

[388] MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 57, A Al-Hamid, Tajribat Al Bunuk Al Tijariah Al Saudiah Fi Baia Al Murabaha Lil Amir Bi Al Shira (First edn, Dar Bilansiah, Riyadh, Saudi 2003) 325, A Fayadh, Al Tatbeeqat Al Masrafiah Li Baia' Al Murabaha Fi Daw Al Fiqh Al Islami (Dar Al Nashr Li Al Jamiaat, Egypt 1999) 170, Buhuth Fi Al-Iqtisad Al-Islami (First edn, Al-Maktab Al-Islami, Lebanon 1996) 414 & MA Omar, 'Al Tafaseel Al Ilmyah Li Aqd Al Murabaha Fi Al Nizam Al Mesrafi Al Islami' (Khutat Al Istithmar Fi Al Bunuk Al Islamiah, Al Jawanib Al Tatbeeqiah Wa Al Qadhayah Wa Al Mushkilat, a Conference held in Jordan with a collaboration of the Islamic Development Bank, Islamic institution for research and training 1987) 211.

"the well-off person who delays the payment of his debt subject himself to punishment and disgrace."[389] According to this opinion, the Hadith allows imposing punishment on the person who defaults in payment and the financial penalty is considered a type of punishment. In addition, this opinion asserts that the debtor, by defaulting in the payment, causes harm to the Islamic bank, and according to the Islamic law principle, the harm should be removed. Therefore the penalty should be allowed as a compensation for the damages the bank sustains as a result of the customer's failure to meet the payment obligation.

With regard to the calculation of this penalty, it has been suggested that it should be calculated based on the percentage of the profit the bank has made during the time of default. Another view suggests the calculation of the penalty should be according to the revenue the investment accounts have generated.[390]

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[389] Al-Shawkani, Nail Al-Awtar Sharh Muntaqa Al-Akhbar (Sharekat Matbaat Mustafa Al-Babi Al-Halabi Wa Awladuh, Egypt 1973) 5/255, translated by MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 57.

[390] P Moore, Islamic Finance, A Partnership for Growth (Euromoney Publications PLC, London 1997) 121-122, MT Usmani, An Introduction to Islamic Finance (Kluwer Law International, The Netherlands 2002) 56, A Saeed, Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation (E. J. Brill, Leiden, The Netherlands 1996) 87, A Al-Hamid, Tajribat Al Bunuk Al Tijariah Al Saudiah Fi Baia Al Murabaha Lil Amir Bi Al Shira (First edn, Dar Bilansiah, Riyadh, Saudi 2003) 326, MA Omar, 'Al Tafaseel Al Ilmyah Li Aqd Al Murabaha Fi Al Nizam Al Mesrafi Al Islami' (Khutat Al Istithmar Fi Al Bunuk Al Islamiah, Al Jawanib Al Tatbeeqiah Wa Al Qadhayah Wa Al Mushkilat, a Conference held in Jordan with a collaboration of the Islamic Development Bank, Islamic institution for research and training 1987) 210, 280 & S Muscati, 'Late Payment in Islamic Finance' (2006-2007) 6 UCLA J Islamic & Near EL 47 at 59.

Conclusion

In Islamic banking, murabaha is the most important method for financing international trade. Murabaha is a form of sale established between the customer and the bank in which the bank purchases specified goods and sells them to the customer, with an added profit. To be valid, murabaha transactions have to comply with the legal requirements of sales transactions. In addition, parties engaging in murabaha should have knowledge of the cost of obtaining the goods and the added profit.

In modern Islamic banking, murabaha transactions start with an application submitted to the bank by the customer requesting the purchase of specified goods through murabaha. This application includes information about both the goods and the customer. If the customer's application is approved, the bank and the customer enter into a promise-to-purchase agreement. Under this agreement, the bank promises to purchase the specified goods from their supplier and sells them to the customer. The customer also promises to purchase the goods from the bank when they become available.

Whether this promise is binding or not binding remains very controversial and leads to serious consequences. The significance of this matter is particularly evident in the event that the bank purchases the goods from an overseas supplier but the customer refuses to conclude the murabaha agreement. If the Islamic bank embraces the view that the promise to purchase is not a binding agreement, the bank will not be able to force the customer to accept the goods and conclude the murabaha agreement. Unless the bank arranges with the supplier to return the goods if the customer refuses them, the bank would undertake the effort of selling the

goods to recover its purchase advance and consequently bear any loss. If the bank is not able to recover all or part of its fund, the bank cannot chase the customer for compensation but will sustain the loss alone. However, if the promise is binding, the customer must conclude the murabaha agreement, otherwise the bank would recover any loss from the down payment provided by the customer when signing the promise-to-purchase agreement. Likewise, if the bank is the party to refuse to conclude the murabaha contract, if the promise is binding the bank has to compensate the customer for any damages incurred as a result of the bank's failure to conclude the contract. However, if the promise to purchase is not binding, the customer has to look elsewhere to finance his international transaction and is not compensated for any loss.

After forming a promise-to-purchase agreement, the bank issues a letter of credit in favour of the supplier and purchases the specified goods from the supplier. In this transaction, apart from the preliminary negotiation of the sale that might take place between the customer and the supplier, no direct relationship exists between the customer and the supplier; rather, the relationship is between the bank and the supplier. The issuing of a letter of credit is considered an offer from the bank while the shipping of the goods is considered an acceptance from the supplier to the bank's offer. Therefore, a sale contract is initiated between the bank and the supplier in which the bank is the buyer and the supplier is the seller.

To escape any liability towards the customer because of the supplier's action, some Islamic banks stipulate in the promise-to-purchase agreement that the bank is not liable for any harm sustained by the customer as a

result of the supplier's delay in supplying the goods or failure to conclude the sale transaction, stating that the customer is the party responsible for the supplier's actions.

When the goods are bought and pass into the bank's ownership, the bank bears any risk associated with the goods until a murabaha contract is executed and the goods are sold to the customer. To minimise such risks, Islamic banks adopt different methods, such as appointing the shipper as the agent acting on behalf of both the bank and the customer. Once the goods are received by the shipper, ownership of the goods is immediately transferred to the customer. The authorisation of the client to act on behalf of the bank in receiving the goods from the supplier is another method that might be used to minimise the bank's risk. To address the risk of the goods being defective, some Islamic banks insert a clause in the promise-to-purchase agreement stipulating that the bank is not responsible for any defect found in the goods. However, the validity of such clauses remains a matter of dispute among Muslim scholars.

Once the goods come under the bank's ownership, a murabaha contract is established between the bank and customer in which the bank sells the goods to the customer for a previously agreed upon price. The price for the goods is usually paid in instalments and over an established period of time. Although the murabaha price is mentioned in the promise-to-purchase agreement and in the murabaha contract, the murabaha price in these two situations is not necessarily the same. Several factors might contribute to the changing of the murabaha price between the time of signing the promise-to-purchase agreement and the time of signing the murabaha

contract. Such factors include discounts offered by the supplier and fluctuations in currency rates.

Finally, if the customer defaults in the payment, some Islamic banks would impose a penalty on the defaulting customer. However, as this penalty might be confused with interest, it has been suggested that this charge should be spent on charitable causes and not to be mixed with the bank's funds. As another way of dealing with the issue of default in payment, some Islamic banks might stipulate in the contract that—in the event the customer is late in paying any of the instalments—the entire murabaha price becomes immediately due.

SECOND PART:

FINANCING INTERNATINAL TRADE IN THE CONTEXT OF "CONVENTIONAL" LETTERS OF CREDIT

Fifth Chapter: Letters of Credit and the Principle of Strict Compliance

Introduction

This chapter begins with a brief introduction to the letter of credit. The introduction is followed by a discussion of the doctrine of strict compliance. While there are two types of letters of credit, commercial and standby, [391] the focus of this thesis will be on the commercial letter of credit since it deals with the finance of international trade..

Letter of Credit, Introductory information

The letter of credit[392], also known as a documentary credit, is an important mechanism in the finance of international trade, so much so that it has been described as "the life blood of international commerce".[393]

In ordinary sale transactions, the buyer pays the money to the seller and obtains the goods. However, international sale transactions are more

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[391] The primary purpose of standby credit is to "guarantee the performance of an obligation owed to the beneficiary". A Mugasha, Letters of Credit and Bank Guarantees (The Federation Press, Sydney 2003)14. For more on standby credit see Tarsem Singh Bhogal & Arun Kumar Trivedi, International Trade Finance, A Pragmatic Approach, Palgrave Macmillan USA 2008 81, R Jack, A Malek and D Quest, Documentary Credits (Third edn, Butterworths, UK 2001) 335, AG Guest (editor), Benjamin's Sale of goods (Seventh edn, Sweet & Maxwell, London 2006) 2054, L Sealy and R Hooley, Commercial Law (Fourth edn, Oxford University Press, USA 2009) 913 & J Dolan, The Law of Letters of Credit, Commercial and Standby Credits (Warren, Gorham & Lamont, 1996) 1-15.

[392] Article 2 of the UCP 500 (Uniform Customs and Practice for Documentary Credits) defines the letter of credit as:
"any arrangement...whereby a bank (the issuing bank), acting at the request and in accordance with the instructions of a customer (the applicant) or on its own behalf, i. is to make payment to or to the order of a third party (the Beneficiary), or is to accept and pay bills of exchange (Drafts) drawn by the Beneficiary, or ii. authorises another bank to effect such payment, or to accept and pay such bills of exchange (drafts), or iii. authorises another bank to negotiate against stipulated document(s), provided that the terms and conditions of the Credit are complied with." However, under the UCP 600, the definition of the credit has been narrowed as Article 2 states "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". Under UCC Article 5 (Section 5-102 (a)(10), letter of credit is defined as: "definite undertaking...by an issuer to a beneficiary at the request or for the account of an applicant or, in case of a financial institution, to itself or for its own account, to honour a documentary presentation by payment or delivery of an item of value".

[393] Kerr LJ in R.D. Harbottle (Merchantile) Ltd, v. National Westminster Bank Ltd, [1978] QB 146 at 155.

complicated and sophisticated because the seller and the buyer are from different countries, and the sale agreement in itself does not provide the buyer and the seller with security that each party would faithfully execute its obligations. This causes the seller to fear that the buyer might obtain the goods and default on the payment, and the buyer would worry that the seller might take the money and keep the goods. Moreover, multiple parties are involved in the transaction: bank, the goods forwarder, the shipper, and the insurer. Therefore, the need for a letter of credit to facilitate the sale transaction at international level becomes necessary. That is because with letter of credit, the finance of international trade is conducted through the bank which plays the role of an intermediary. Under the letter of credit mechanism, the bank assures the seller that the goods price will be paid as soon as the seller ships the goods and tenders to the bank the required documents. The bank also assures the buyer that no money will be paid until the goods are shipped and proper documents are submitted.[394]

The critical role of the letter of credit in international trade can be appreciated in the following example. A British buyer enters an agreement with a Brazilian seller to purchase a certain amount of coffee. Under the classical method of payment, which is to a great extent built on trust; the British buyer advances the money to the seller and waits for the goods to arrive, or the parties might agree that the payment would be made after the buyer receives the goods. Either way, this kind of transaction does not provide any protection to the parties. If the seller performs first, there is no

[394] R Jack, A Malek and D Quest, Documentary Credits (Third edn, Butterworths, UK 2001) 2-3 & AG Guest (editor), Benjamin's Sale of goods (Seventh edn, Sweet & Maxwell, London 2006) 1934.

guarantee that the buyer will pay for the goods. Likewise, if the buyer pays the money first, there is no assurance that the seller would fulfil his promise and ship the goods. However, the letter of credit would provide this missing protection in international trade. Under the letter of credit mechanism, the British buyer and the Brazilian seller would agree that the buyer would open a letter of credit in favour of the seller. The British buyer (the applicant)[395] would approach its bank (the issuer)[396] requesting that the bank open a letter of credit in favour of the Brazilian seller (the beneficiary).[397] When the Brazilian seller is informed of the opening of the letter of credit which contains the issuing bank's promise of payment against documents, the seller ships the goods to the buyer and submits to the bank the required documents which normally consist of the invoice, the bill of lading and the insurance certificate. When the bank receives the required documents, the bank advances payment to the seller. The bank then would be reimbursed by the buyer. Therefore, through the letter of credit, the buyer and the seller would accomplish their commercial objectives in a secure and efficient way.[398]

It was also suggested that letter of credit assists in eliminating or minimising, from a seller's perspective, three kinds of risks associated with intentional trade. The first risk is the insolvency of the buyer. Without the protection of the letter of credit, if the seller realises that the buyer

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[395] Article 2 of the UCP 600 defines the applicant as "the party on whose request the credit is issued".

[396] The issuing bank is "the bank that issues a credit at the request of an applicant or on its own behalf". Article 2 UCP 600.

[397] According to Article 2 of the UCP, the beneficiary is "the party in whose favour a credit is issued".

[398] AG Guest (editor), Benjamin's Sale of goods (Seventh edn, Sweet & Maxwell, London 2006) 1934.

becomes insolvent and therefore would not be able to pay for the goods, the seller would have no choice but to attempt to get whatever he could of his money by disposing of the goods in a foreign country where he may have no previous experience about the marketing or the business environment. It may also be very difficult for the seller to get fully compensated for his loss even if the matter was taken to court. Secondly, there is the dishonesty-of- the-buyer risk, where the buyer would refuse the goods not for insolvency reason but perhaps because the buyer finds a better deal in the market. By utilising the letter of credit, the dishonest buyer would not be able to avoid paying the seller as the payment is done through the bank. Thirdly, there is the honest-dispute risk, where there is a disagreement between the buyer and seller which might lead to the buyer's refusal to accept the goods either on a legitimate or an illegitimate basis.[399] However, with letter of credit, the buyer would not be able to refuse the goods and stop the payment because the letter of credit transaction is performed independently regardless any disputes about the underlying transactions.[400]

[399] A Fama, 'Letters of Credit: The Role of Issuer Discretion in Determining Documentary Compliance'53 Fordham L Rev 1519 at 1591.
[400] See next chapter: The Autonomy Principle.

Stages of the Letter of Credit Transaction[401]

Typically, sale transactions that involve the use of letters of credit are performed through the following stages.

1- The sale of goods contract

The letter of credit agreement usually stems from the sale of goods contract. When the parties engage in a sale of goods contract, they agree that payment is to be made through the mechanism of the letter of credit.

2- Application to the bank.

At this stage, the buyer/applicant fills in an application requesting the bank to open a letter of credit in favour of the seller. In this application form, the applicant includes instructions regarding the documents that have to be submitted by the seller/beneficiary and the descriptions of the goods which have to be specified in these documents.

3- The issuing of the credit

The bank/issuer upon the request of the applicant opens a letter of credit in favour of the seller/beneficiary, promising to make payment or honour drafts against conforming documents. Subsequently, a notice of the opening of the credit is sent to the seller/beneficiary directly from the issuing bank or, in most cases, through a correspondent bank which is located in the seller's country. By adding its undertaking under the credit, the correspondent bank becomes a confirmer of the credit.[402]

4- Realisation of the credit

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[401] AG Guest (editor), Benjamin's Sale of goods (Seventh edn, Sweet & Maxwell, London 2006) 1936, R Jack, A Malek and D Quest, Documentary Credits (Third edn, Butterworths, UK 2001)5-6.

[402] Article 2 (7) of the UCP 600 defines the confirming bank as "the bank that adds its confirmation to a credit upon the issuing bank's authorization".

After being informed of the opening of the credit, the seller ships the goods to the buyer and submits the required documents to the bank. These documents are examined by the bank to ensure that they conform to the credit. If satisfied that the tendered documents are in strict compliance with the credit, the bank would honour the seller's tender.[403] The bank then is reimbursed by the buyer/applicant.

Standardisation of Letter of Credit Rules

For the purpose of harmonising the practice of letters of credit, the International Chamber of Commerce (ICC) has endeavoured to issue a set of rules called the Uniform Customs and Practice for Documentary Credits (the UCP). These rules do not have the force of law and they are not applicable unless they are explicitly incorporated into the credit.[404]

The first complete version of the UCP was released in 1933 but was only adopted in some European countries and some banks in the United States. This version was revised in 1951 and was adopted by banks in Asia, Africa, and Europe. However, for political and other reasons, banks in the United Kingdom and most of Commonwealth countries did not join. Nevertheless, in America, this version was received with acceptance.

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[403] Article 2 (9) of the UCP 600 asserts that "Honour means: a. to pay at sight if the credit is available by sight payment. b. to incur a deferred payment undertaking and pay at maturity if the credit is available by deferred payment. c. to accept a bill of exchange ("draft") drawn by the beneficiary and pay at maturity if the credit is available by acceptance".

[404] Article 1 of UCP 500 made it clear that: "The Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication No.500, shall apply to all Documentary Credits where they are incorporated into the text of the Credit. They are binding on all parties thereto, unless otherwise expressly stipulated in the Credit". In addition, Article1 of the UCP 600 pointed out that "The Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication No. 600 ("UCP") are rules that apply to any documentary credit ("credit") (including, to the extent to which they may be applicable, any standby letter of credit) when the text of the credit expressly indicates that it is subject to these rules. They are binding on all parties thereto unless expressly modified or excluded by the credit".

In 1962 the ICC witnessed a major achievement by publishing a revised UCP and this time with the approval, alongside the previous participants, of the banks in the United Kingdom and the Commonwealth Nations. This publication, which took effect in 1963, provided a comprehensive version with a more refined set of provisions.

With the assistance of the United Nations of Commission on International Trade Law (UNCITRAL) and banking organisations through an ad hoc committee, the ICC revised the UCC again. This resulted in the issue of a revised UCP in 1974, which was met with a greater international approval. Taking into account the world technological developments, the UCP 1983 Revision took place.[405] This Revision was followed by the 1993 Revision, known as the UCP 500, and became effective on January 1, 1994.[406]

In 2006, and after four years devoted to revising and drafting, the ICC drafting group came up with a new version of the UCP. This new UCP (UCP 600) was enforced on July 1, 2007 to replace the previous one.[407] The rationale behind producing UCP 600 was: "(a) to make the UCP more accessible and user-friendly; (b) to resolve certain specific issues perceived to exist in UCP 500; and (c) to further harmonise international practice."[408] With the intention of simplifying the UCP provisions, the UCP 600

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[405] The UCP 1983 Revision took effect in 1984.

[406] AG Guest (editor), Benjamin's Sale of goods (Seventh edn, Sweet & Maxwell, London 2006) 1938-1940, R Jack, A Malek and D Quest, Documentary Credits (Third edn, Butterworths, UK 2001)11, P Gillies and G Moens, International Trade and Business: Law, Policy and Ethics (Cavendish Publishing, Australia 1998) 389 & L D'Arcy, C Murray and Barbara, Schmitthoff's Export Trade, The Law and Practice of International Trade (Tenth edn, Sweet & Maxwell, London 2000) 168.

[407] M Isaacs and M Barnett, 'International Trade Finance - Letters of Credit, UCP 600 and Examination of Documents' [2007] JIBLR, R Bergami, 'What Can UCP 600 Do for You?' (2007) 11 VJ 1, P Downes, 'UCP 600: Not So Strict Compliance' (2007) 4 JIBFL 196 & J Wood, 'Drafting Letters of Credit: Basic Issues Under Article 5 of The Uniform Commercial Code, UCP 600, and ISP98' (2008) 125 Banking LJ 103.

[408] M Isaacs and M Barnett, 'International Trade Finance - Letters of Credit, UCP 600 and Examination of Documents'[2007] JIBLR.

managed to not only to decrease the number of articles from 49 to 39, but also the number of words from approximately 11,000 to approximately 9,500 words.[409]

In addition, "[t]here is also hope that the revision will reduce the number of discrepancies and thus the number of presentations that fail on account of rejected documents." [410] While the new rules resemble to a great extent the previous ones, this new UCP, as Professor James Byrne observes, "contains many positive improvements over its predecessor. It is more readable, more coherent, and has absorbed and reflects some hard-won lessons about LC rule drafting forced on the ICC by series of untoward (but understandable) judicial opinions". [411]

In the United States, the rules of letters of credit are codified in UCC article 5. The latest version of UCC article 5 was released in 1995 and was adopted in almost all the states.[412]

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[409] J Byrne, The Comparison of UCP600 & UCP500 (The Institute of International Banking Law & Practice, INC., USA 2007) vi.
[410] M Isaacs and M Barnett, 'International Trade Finance - Letters of Credit, UCP 600 and Examination of Documents' [2007] JIBLR.
[411] J Byrne, The Comparison of UCP600 & UCP500 (The Institute of International Banking Law & Practice, INC., USA 2007) vii.
[412] D Regal, 'Basic Principles of Letters of Credit' (2002) 832 PLI/Comm 13 at 22 & X Gao, The Fraud Rule in the Law of Letters of Credit, A Comparative Study (Kluwer Law International, Netherlands 2002) 22.

The Doctrine of Strict Compliance[413]

[413] See R Jack, A Malek and D Quest, Documentary Credits (Third edn, Butterworths, UK 2001) 170, AG Guest (editor), Benjamin's Sale of goods (Seventh edn, Sweet & Maxwell, London 2006) 2030, W Hedley, Bills of Exchange and Bankers' Documentary Credits (Second edn, Lloyd's of London Press Ltd., London 1994) 284, L Sealy and R Hooley, Commercial Law (Fourth edn, Oxford University Press, USA 2009) 857, A Mugasha, Letters of Credit and Bank Guarantees (The Federation Press, Sydney 2003) 127, M Bridge, The International Sale of Goods (Second edn, Oxford University Press, New York, USA 2007) 276, L D'Arcy, C Murray and Barbara, Schmitthoff's Export Trade, The Law and Practice of International Trade (Tenth edn, Sweet & Maxwell, London 2000) 172, J Dolan, The Law of Letters of Credit, Commercial and Standby Credits (Warren, Gorham & Lamont, 1996) 6.03, P Gillies and G Moens, International Trade and Business: Law, Policy and Ethics (Cavendish Publishing, Australia 1998) 397, R Goode, Commercial Law (Third edn, Penguin Books, London 2004) 976, E Adodo, 'Conformity of Presentation Documents and a Rejection Notice in Letters of Credit Litigation: A Tale of Two Doctrines' (2006) 36 Hong Kong LJ 309, R Dole, 'Applicant Ad Hoc Waiver of Discrepancies in the Documents Presented under Letters of Credit' (2005) 58 SMU L Rev 1453, D Regal, 'Basic Principles of Letters of Credit, What Lawyers Need to Know about UCC Article 5 - Letters of Credit ' (2002) 832 PLI/Comm 13, G Mclaughlin, 'On the Periphery of Letter-of-Credit Law: Softening the Rigors of Strict Compliance' (1989) 106 Banking LJ 4, R Rosenblith, 'Litigating the Letter of Credit Case-Liability of Banks Under the Currrent and Revised Uniform Commercial Code, What Lawyers Need to Know about UCC Article 5' (2003) 847 PLI/Comm 163, K Roane, 'Hanil Bank v. PT. Bank Negara Indonesia (Persero): Continuing the Quandary of Documentary Compliance Under International Letter of Credit' (2004) 41 Hous L Rev 1053, M Moses, 'Letters of Credit and the Insolvent Applicant: A Recipe for Bad Faith Dishonor' (2005) 57 Ala L Rev 31, J Gustavus, 'Letter of Credit Compliance Under Revised UCC Article 5 and UCP 500' (1997) 114 BLJ 55, Fama, G Vethan, 'The Sacred Cow of Equity and Strict Compliance in Letter of Credit Law: Recent Trends and Projections' (1994) 6 SPG Int'l Legal Persp 45, EP Ellinger, 'New Problems of Strict Compliance in Letters of Credit'[1988] JBL 320, J Arkins, 'Snow White v. Frost White: The New Cold War in Banking Law' (2000) 15 (2) JIBL 30, T Pifer, 'The ICC Publication of International Standard Banking Practice (ISBP) and the Probable Effect on United States Letter of Credit Law' (2006) 12 Tex Wesleyan L Rev 631, C Schmitthoff, 'Discrepancy of Documents in Letter of Credit Transactions'[1987] JBL 94, J Dolan, 'Letters of Credit: A Comparison of UCP 500 and the New U.S. Article 5'[1999] JBL 521, S Pullen and D Hakim, 'Examination of Documents'[2003] Finance and Credit Law, Finance Group, Mayer Brown, Rowe & Maw LLP, London , B Nathan, 'Letter of Credit, Beneficiary Beats issuing Bank Based on Conforming Documents and Untimely and Improper Dishonor' (2003) 105 (7) Business Credit, New York 12, A Johnson, 'Letter of Credit and Original Documents - Again' (1999) 14 (9) JIBL 287, C Johnson, 'Letter of Credit: Fraud Exception/Rule of Documentary Compliance' (1987) 2 (2) JIBL 52, M Isaacs and M Barnett, 'International Trade Finance - Letters of Credit, UCP 600 and Examination of Documents'[2007] JIBLR , R Bergami, 'What Can UCP 600 Do for You?' (2007) 11 VJ 1, J Head, 'How Letters of Credit Operate in International Commercial Transactions: An Introduction to UCP' (2008) 77 JKSBA 16, E Cook, 'Canada: Letters of Credit: Bank's Liability' (1994) 9 (9) JIBL 189, E Arban, 'The Doctrine of Strict Compliance in the Italian Legal System' (2005) 23 Ariz J Int'l & Comp L 77, P Downes, 'UCP 600: Not So Strict Compliance' (2007) 4 JIBFL 196, P Grassi, 'Letter of Credit Transactions: The Bank's Position in Determining Documentary Compliance, A Comparative Evaluation Under U.S., Swiss and German Law' (1995) 7 Pace International Law Review 81, JonathanThier, 'Letters of Credit: A Solution To The Problem of Documentary Compliance' (1982) 50 Fordham L Rev 848, B Kozolchyk, 'Strict Compliance and the Reasonable Document Checker' (1990) 56 Brook L Rev 45, R Sappideen, 'International Commercial Letters of Credit: Balancing the Rights of Buyers and Sellers in Insolvency'[2006] JBL 133, J Wood, 'Drafting Letters of Credit: Basic Issues Under Article 5 of The Uniform Commercial Code, UCP 600, and ISP98' (2008) 125 Banking LJ 103 & T Conley, 'Hanil Bank v. PT. Bank Negara Indonesia: The

For letters of credit to achieve their objective as secure and effective means in financing international trade, the doctrine of strict compliance should be properly enforced. [414] This doctrine dictates that the beneficiary's presentation has to strictly comply with the requirements of the credit; otherwise this presentation should be rejected.[415] The court, in English, Scottish and Australian Bank Ltd v. bank of South Africa, announced:

"It is elementary to say that a person who ships in reliance on a letter of credit must do so in exact compliance with its terms. It is also elementary to say that a bank is not bound or indeed entitled to honour drafts presented to it under a letter of credit unless those drafts with the accompanying documents are in strict accord with the credit as opened". [416]

It is the bank's duty to examine the documents and ascertain that the documents are complying with the credit as Article 14 (a) UCP 600 stated:

"A nominated bank[417] acting on its nomination, a confirming bank, if any, and the issuing bank must examine a presentation to determine, on the

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Problem With Form Over Substance in Documentary Compliance Rules' (2001) 50 Cath U L Rev 977.

[414] The standard required to determine whether the documents are in strict compliance with the credit or not will be discussed in more detail later. See subheading: The Standard for strict compliance.

[415] In addition to strict compliance, there are less important standards, such as the Bifurcated standard, which imposes strict compliance in the issuer/beneficiary relationship but a lower degree of compliance; namely, substantial compliance, in the issuer/applicant relationship. Therefore, "[u]nder the bifurcated standard, the account party cannot complain when the issuer honors documents that are not strictly complying but that do satisfy the substantial compliance test". J Dolan, 'Performance of the Credit by the Issuer' (1986) 399 PLI/Comm 579 at 586. For more on Bifurcated standard, see also J Dolan, 'Letter-of-Credit Disputes between the Issuer and its Customer: The Issuer's Right under the Misnamed "Bifurcated Standard"' (1988) 105 Banking LJ 380, A Fama, 'Letters of Credit: The Role of Issuer Discretion in Determining Documentary Compliance' (1985) 53 Fordham L Rev 1519, B Kozolchyk, 'Strict Compliance and the Reasonable Document Checker' (1990) 56 Brook L Rev 45 & C Mooney, 'Developments and Selected Issues Concerning Letters of Credit and UCC Article 5' (1991) C664 ALI-ABA 367.

[416] English, Scottish and Australian Bank Ltd v bank of South Africa (1922) 13 Ll L Rep 21 at 24.

[417] The nominated bank has been defined by Article 2 (12) of the UCP 600 as "the bank with which the credit is available or any bank in the case of a credit available with any bank".

basis of the documents alone, whether or not the documents appear on their face to constitutes a complying presentation."[418]

The bank, as the Article pointed out, in determining whether the documents are complying or not, is required to examine the documents "on their face" and not to extend its examination beyond that. The ICC, in its commentary publication on UCP 600, explained the meaning of the phrase "on their face" by remarking that this phrase "does not refer to a simple front versus the back of a document, but extends to the review of data within a document in order to determine that a presentation complies with international standard banking practice[419] and the principle contained in UCP". [420] Furthermore, "Banks are not obliged to go beyond the face of a document to establish whether or not a document complies with a requirement in a documentary credit or with any requirement in the UCP".[421]

If the documents appeared to be in compliance with the credit, the bank is under obligation to accept these documents. Article 15 UCP 600 asserts:

a. When an issuing bank determines that a presentation is complying, it must honour.

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[418] UCP600 Article 14(a).

[419] "International standard banking practice includes practices that banks regularly undertake in determining the compliance of documents. Many of these practices are contained in the ICC's publication *International Standard Practice for the examination of Documentary* under Documentary Credits ("ISBP") (ICC Publication No. 681); however, the practices are broader than what is stated in this publication. Whilst the ISBP publication includes many banking practices, there are others that are also commonly used in documentary credit transactions beyond those related to the examination of documents". International Chamber of Commerce, Commentary on UCP 600 (ICC Publication No. 680, International Chamber of Commerce, Publications Department, France 2007) 16.

[420] International Chamber of Commerce, Commentary on UCP 600 (ICC Publication No. 680, International Chamber of Commerce, Publications Department, France 2007) 62.

[421] International Chamber of Commerce, Commentary on UCP 600 (ICC Publication No. 680, International Chamber of Commerce, Publications Department, France 2007) 62.

b. When a confirming bank determines that a presentation is complying, it must honour or negotiate[422] and forward the documents to the issuing bank.

c. When a nominated bank determines that a presentation is complying and honours or negotiates, it must forward the documents to the confirming bank or issuing bank.[423]

While the UCP does not mention that compliance to the credit should be strict, UCC article 5 makes this point explicitly as it says:

"Except as otherwise provided in Section 5-109, an issuer shall honor a presentation that, as determined by the standard practice referred to in subsection (e), appears on its face strictly to comply with the terms and conditions of the letter of credit. Except as otherwise provided in Section 5-113 and unless otherwise agreed with the applicant, an issuer shall dishonor a presentation that does not appear so to comply".[424]

Therefore, if the bank fails to honour conforming documents; the bank is legally liable to the beneficiary for wrongful dishonour.[425] On the same ground, if the bank fails to execute its obligations in examining the documents in light of strict compliance rule and pays against non-conforming documents, the bank may be held liable to the applicant for wrongful honour. It has been clearly emphasised that "if they [banks] stray

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[422] Article 2 (11) of the UCP 600 asserts that: "Negotiation means the purchase by the nominated bank of drafts (drawn on a bank other than the nominated bank) and/or documents under a complying presentation, by advancing or agreeing to advance funds to the beneficiary on or before the banking day on which reimbursement is due to the nominated bank".

[423] UCP 600 Article 15.

[424] UCC Section 5-108 (a).

[425] A Mugasha, Letters of Credit and Bank Guarantees (The Federation Press, Sydney 2003) 127.

outside the terms of their mandate they may well be liable in damages to their principals [applicants]".[426]

It has been suggested that the rationale for strict compliance rules is that the bank in its performance under the credit is acting as the applicant's agent and the agent is under an obligation to adhere to the principal's mandate, otherwise, the agent will be liable. Therefore the bank has to examine the documents to ensure that they are strictly conformed to the applicant's mandates which are specified in the credit. In addition, by doing so, the applicant/buyer can be protected from the possible dishonesty of the beneficiary/seller. Moreover, the bank is not involved in the business of trade and is not required to know the custom and the practice of commercial activities; thus, the bank does not have to look beyond the presented documents but the bank is under obligation to make sure that these documents are in compliance with the credit.[427]

At common law, the doctrine of strict compliance is strongly established. In Equitable Trust Company of New York v. Dawson Partners, Ltd., [428] the buyers, Dawson Partners in London, agreed to purchase vanilla beans from the sellers, J. H. Rogge & Co. in Batavia, and the payment was to be by means of an irrevocable letter of credit. One of the credit requirements was the presentation of a certificate issued by the Dutch Government

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[426] W Hedley, Bills of Exchange and Bankers' Documentary Credits (Second edn, Lloyd's of London Press Ltd., London 1994) 285.

[427] L D'Arcy, C Murray and Barbara, Schmitthoff's Export Trade, The Law and Practice of International Trade (Tenth edn, Sweet & Maxwell, London 2000) 172, L Sealy and L Sealy and R Hooley, Commercial Law (Fourth edn, Oxford University Press, USA 2009) 857 & E Adodo, 'Conformity of Presentation Documents and a Rejection Notice in Letters of Credit Litigation: A Tale of Two Doctrines' (2006) 36 Hong Kong LJ 321-322.

[428] Equitable Trust Co. of New York v. Dawson Partners Ltd (1927) 27 Ll L Rep 49 (HL).

"certifying the goods to be sound and sweet and of prime quality".[429] The sellers later informed the buyers that the government did not issue this kind of certificate. Therefore, the parties agreed to substitute it with "a certificate of quality to be issued by experts who are sworn brokers".

The instruction of this amendment sent to the bank in Batavia through a coded system. Due to this coded system which does not differentiate between plural and singular words, the correspondent bank wrongfully understood the instruction as a requirement of "a certificate issued by a sworn expert". As a result, the bank accepted from the sellers a certificate that was signed only by one expert, and the sellers fraudulently managed to obtain payment and ship rubbish with only 1 percent vanilla beans.

The buyer refused to reimburse the bank, claiming that the bank paid against non-conforming documents as the credit required a certificate issued by experts and the bank accepted a certificate that was issued by only one expert.[430]

The majority of the House of Lords held that the bank was not entitled to be reimbursed because it had not adhered to the credit mandate and, as a result, failed to execute its obligations under the credit. Lord Summer asserted:

"It is both common ground and common sense that in such a transaction the accepting bank can only claim indemnity if the conditions on which it is authorised to accept are in the matter of the accompanying documents strictly observed. There is no room for documents which are almost the same, or which will do just as well. Business could not proceed securely on

[429] (1927) 27 Ll L Rep 49 (HL) at 50.
[430] (1927) 27 Ll L Rep 49 (HL) at 51.

any other lines. The bank's branch abroad, which knows nothing officially of the details of the transaction thus financed, cannot take upon itself to decide what will do well enough and what will not. If it does as it is told, it is safe; if it declines to do anything else, it is safe; if it departs from the conditions laid down, it acts at its own risk. The documents tendered were not exactly the documents which the defendants had promised to take up, and *prima facie* they were right in refusing to take them". [431]

In another case, JH Rayner and Co v. Hambros Bank Ltd[432], a buyer opened a confirmed credit in favour of a seller for the purchase of 'coromandel groundnuts'. Under the credit, the goods were described as 'coromandel groundnuts'. When the seller made a presentation, it was rejected by the bank for lack of conformity with the credit. The bank argued that while the invoice described the goods correctly as 'coromandel groundnuts', the bill of lading was defective as it described the goods as 'machine-shelled groundnut kernels'. However the seller contended that in commercial sense, both descriptions are valid for this commodity. The Court of Appeal held that the bank was right in rejecting the seller's tender as it was non-conforming. The court made it clear that the bank cannot and it is not required to possess knowledge of all the goods that are the subject matter of the credit and be aware of all their descriptions. MacKinnon LJ said "it is quite impossible to suggest that a banker is to be affected with knowledge of the customs and customary terms of every one of the thousands of trades for whose dealings he may issue letters of credit".[433] Highlighting the same principle and expressing that the bank is required to

[431] (1927) 27 Ll L Rep 49 (HL) at 52.
[432] JH Rayner and Co v. Hambros Bank Ltd [1943] 1 KB 37 (Court of Appeal).
[433] [1943] 1 KB 37 (Court of Appeal) at 41.

strictly adhere to the credit's mandate, Goddard LJ said "It does not matter whether the terms imposed by the person who requires the bank to open the credit seem reasonable. The bank is not concerned with that. If it accepts the mandate to open the credit, it must do exactly what its customer requires it to do. If the customer says: "I require a bill of lading for coromandel groundnuts," the bank is not justified, in my judgment, in paying against a bill of lading for anything except coromandel groundnuts, and it is no answer to say: "you know perfectly well that 'machine-shelled groundnut kernels are the same as coromandel groundnuts'". For all the bank knows, its customer may have a particular reason for wanting "coromandel groundnuts" in the bill of lading".[434]

The position of the bank with regard to non-conforming documents

If the bank encountered non-conforming documents, one of the actions the bank is entitled to take is to reject the documents and refuse payment. This action can be illustrated by Equitable Trust Company of New York v. Dawson Partners, Ltd.[435] As outlined before, the buyers in this case contracted to purchase vanilla from the sellers and opened a letter of credit in favour of the sellers. One of the credit requirements was the presentation of a certificate of quality signed by experts. However, due to confusion in exchanging messages, the bank accepted a certificate that was signed by only one expert. The court held that the bank was not entitled to be

[434] [1943] 1 KB 37 (Court of Appeal) at 42.
[435] Equitable Trust Co. of New York v. Dawson Partners Ltd (1927) 27 Ll L Rep 49 (HL).

reimbursed as it should have rejected this presentation because it did not conform to the credit. [436] In another case, Soproma SPA v. Marine & Animal By-Products[437], American sellers, Marine & Animal By-Products, agreed to sell 1000 tons of CHILIA FISH FULLMEAL to Italian buyers, Soproma S.P.A. The parties agreed that the payment would be through an irrevocable letter of credit which was issued by the Banca Nazionale del Lavoro, of Padova.[438] Among the credit requirements were that the bill of lading was to be marked "freight pre-paid" and the sellers should submit a certificate that the goods contain 70% minimum protein. However, when the sellers submitted the documents for payment, the sellers' tender was rejected for several discrepancies. Among these discrepancies was that the bill of lading was marked "collect freight" instead of "freight pre-paid". In addition, the attached certificate did not show that the content was 70% minimum protein but 67%. The sellers attempted to provide a second tender directly to the buyers but that was also rejected. The court found that rejecting the documents was the right action as the documents did not conform to the credit.[439]

Under Art. 16 of UCP 600, if the bank decides to refuse the beneficiary's tender, the bank has to give notice to the presenter of its refusal. The notice has to state:

"i. that the bank is refusing to honour or negotiate; and

[436] (1927) 27 Ll L Rep 49 (HL) at 52.
[437] Soproma SPA v. Marine & Animal By-Products [1966] 1 Lloyd's Rep 367.
[438] [1966] 1 Lloyd's Rep 367 at 380.
[439] [1966] 1 Lloyd's Rep 367 at 389.

ii. each discrepancy in respect of which the bank refuses to honour or negotiate; and

iii. a) that the bank is holding the documents pending further instructions from the presenter; or

b) that the issuing bank is holding the documents until it receives a wavier from the applicant and agrees to accept it, or receives further instructions from the presenter prior to agreeing to accept a waiver; or

c) that the bank is returning the documents; or

d) that the bank is acting in accordance with instructions previously received from the presenter". [440]

In addition, if the bank, upon examining the documents, finds that the documents are not in compliance with the credit, the bank can also pay under reserve. That is what the bank has done in Banque De L'Indochine ET DE Suez SA v. JH Rayner (Mincing Lane) LTD.[441] In that case, the confirming bank after examining the documents tendered by the sellers, rejected the documents for several discrepancies. After discussing the matter with the sellers, the bank paid the sellers under reserve.[442] Subsequently, the documents were forwarded to the issuing bank which also rejected them. The confirming bank then went after the sellers seeking reimbursement of the money that the bank had paid under reserve. However, the sellers refused to reimburse the bank, alleging that they had paid the conforming bank under reserve on the understanding they would

[440] UCP 600 Article 16.
[441] Banque De L'Indochine ET DE Suez SA v. JH Rayner (Mincing Lane) Ltd (1983) 2 WLR 841 (Court of Appeal).
[442] (1983) 2 WLR 841 (Court of Appeal) at 843.

reimburse the confirming bank only in the event the documents rejected by the issuing bank for discrepancies that were established to be valid discrepancies.[443]

Therefore, the bank brought an action against the sellers to recover the money the bank had paid the sellers under reserve. The trial court in this case and also the Court of Appeal first tackled the issue of whether the confirming bank had a valid ground for rejecting the documents tendered by the beneficiary. Both courts agreed that the documents were defective and the confirming bank was right in rejecting them. Parker LJ stated:

"In the present case the tender was, in my judgment, bad, both as to individual documents and as a set".[444] Then the courts examined the meaning of the expression 'payment under reserve'. Parker LJ emphasised that such an expression does not have a particular definition, and that its meaning should be determined in each case based on the surrounding circumstances. He stated:

"It is clear from the evidence that no uniform banking practice exists either as to the form of the indemnity or guarantee which is used in the case of payment notwithstanding irregularities, nor as to the consequences of a payment being made under reserve. There was evidence that payment was normally made under reserve only when the beneficiary was a reputable and valued customer of the remitting bank but no one appears really to have considered what the consequences would be".[445] He added:

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[443] (1983) 2 WLR 841 (Court of Appeal) at 845.
[444] (1983) 2 WLR 841 (Court of Appeal) at 851.
[445] (1983) 2 WLR 841 (Court of Appeal) at 845.

"In the absence of any established custom the question I have to determine is what is the meaning of the expression "in the light of surrounding circumstances"". [446]

In determining the intention of the parties in the present case in using the expression 'under reserve', Parker LJ asserted that the following circumstances should be considered:

"(i) that the remitting bank genuinely believes that there are one or more discrepancies justifying non-payment; (ii) that the beneficiary believes that the bank is wrong and that he is entitled to payment; and (iii) that both parties hope that, notwithstanding the alleged irregularities, the issuing bank will take up the documents and reimburse the remitting bank".[447]

It was held that based on these circumstances what the conforming bank and the sellers meant by using the expression "under reserve" was that the sellers would be bound to reimburse the confirming bank if the issuing bank rejected the documents. To further clarify the meaning of the phrase 'payment under reserve' in this particular situation, Donaldson MR expressed the court's view through the following dialogue:

> "*Merchant*: "These documents are sufficient to satisfy the terms of the letter of credit and certainly will be accepted by my buyer. I am entitled to the money and need it."
>
> Bank: "If we thought that the documents satisfied the terms of the letter of credit, we would pay you at once. However we do not think that they do and we cannot risk paying you and not being paid ourselves. We are not sure that your buyer will authorise payment, but we can of course ask."
>
> *Merchant*: "But that will take time and meanwhile we shall have a cash flow problem."
>
> Bank: "Well the alternative is for you to sue us and that will also take time."

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[446] (1983) 2 WLR 841 (Court of Appeal) at 845.
[447] (1983) 2 WLR 841 (Court of Appeal) at 845.

Merchant: "What about your paying us without prejudice to whether we are entitled to payment and then your seeing what is the reaction of your correspondent bank and our buyer?"

Bank: "That is all right, but if we are told that we should not have paid, how do we get our money back?"

Merchant: "You sue us."

Bank: "Oh no, that would leave us out of our money for a substantial time. Furthermore it would involve us in facing in two directions. We should not only have to sue you, but also to sue the issuing bank in order to cover the possibility that you might be right. We cannot afford to pay on those terms."

Merchant: "All right. I am quite confident that the issuing bank and my buyer will be content that you should pay, particularly since the documents are in fact in order. You pay me and if the issuing bank refuses to reimburse you for the same reason that you are unwilling to pay, we will repay you on demand and then sue you. But we do not think that this will happen."

Bank: "We agree. Here is the money 'under reserve.'"[448]

In highlighting what actions the bank may take as a reaction to non-conforming documents, Article 14 (f) of UCP 500 asserts: "If the remitting bank draws the attention of the issuing bank and/or confirming bank, if any, to any discrepancy(ies) in the document(s) or advises such banks that it has paid, incurred a deferred payment undertaking, accepted draft(s) or negotiated under reserve or against indemnity[449] in respect of such discrepancy(ies), the issuing bank and/or confirming bank, if any, shall not be thereby relieved from any of their obligations under any provision of this article. Such reserve or indemnity concerns only the relations between the remitting bank and party towards whom the reserve was made, or from whom, or on whose behalf, the indemnity was obtained."[450]

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[448] (1983) 2 WLR 841 (Court of Appeal) at 854-855.

[449] In an explanation of the meaning of indemnity, Mugasha said "[a] contract of indemnity is ... where one party undertakes to keep another harmless against loss; that is, to make good any loss suffered by that other". A Mugasha, Letters of Credit and Bank Guarantees (The Federation Press, Sydney 2003) 14.

[450] UCP500 Article 14(f).

However, UCP 600 differs from the previous UCP as it did not refer to payment 'under reserve' or 'against indemnity'. UCP 600 in its Article 16 asserts that:

a. When a nominated bank acting on its nomination, a confirming bank, if any, or the issuing bank determines that a presentation does not comply, it may refuse to honour or negotiate.

b. When an issuing bank determines that a presentation does not comply, it may in its sole judgment approach the applicant for a waiver of the discrepancies. This does not, however, extend the period mentioned in sub-article 14 (b).[451]

Therefore, taking a different position from UCP 500, UCP 600 mentions two actions the bank can take: refusing payment or asking the buyer for a waiver. The reason that the UCP 600 did not talk about payment 'under reserve' or 'against indemnity' which was mentioned in Article 14 (f) UCP 500 was because the UCP 600 Drafting Group "felt that this sub-article dealt with situation subject to an agreement between a nominated bank and the beneficiary and was not an essential part of the UCP".[452]

While the UCP 600 refers to the 'asking for a waiver' option, the bank is not under obligation to seek the buyer's waiver. Nor is the bank required to accept the waiver granted by the buyer. The Commentary on UCP 600

[451] UCP600 Article 16.
[452] International Chamber of Commerce, Commentary on UCP 600 (ICC Publication No. 680, International Chamber of Commerce, Publications Department, France 2007) 74.

asserts: "[t]here is no rule in the UCP that requires the issuing bank to seek waiver of the discrepancies from the applicant".[453]

The Bank's Failure to Comply

If the bank fails to comply with the instructions given by the UCP in handling discrepancies, the bank will be precluded from raising any objection regarding the non-compliance of the documents. Article 14 (e) UCP 500 asserts: "If the Issuing Bank and/or Confirming Bank, if any, fails to act in accordance with the provisions of this Article and/or fails to hold the documents at the disposal of, or return them to the presenter, the Issuing Bank and/or Confirming Bank, if any, shall be precluded from claiming that the documents are not in compliance with the terms and conditions of the Credit".[454] This rule was retained by UCP 600 as it stated in Article 16 (e):

"If an issuing bank or a confirming bank fails to act in accordance with the provisions of this article, it shall be precluded from claiming that the documents do not constitute a complying presentation".[455] The case of Bayerische Vereinsbank Aktiengesellschaft v. National Bank of Pakistan[456] illustrates how the bank's failure to comply with the rejection procedures set forth in the UCP resulted in the bank being precluded from claiming that the documents do not comply with the credit. In this case, when the issuing bank received the documents from the confirming bank, the issuing

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[453] International Chamber of Commerce, Commentary on UCP 600 (ICC Publication No. 680, International Chamber of Commerce, Publications Department, France 2007) 72.
[454] UCP500 Article 14.
[455] UCP600 Article 16.
[456] Bayerische Vereinsbank Aktiengesellschaft v. National Bank of Pakistan [1997] 1 Lloyd's Rep 59.

bank immediately passed them to the applicant without examining them. Subsequently, based on the discrepancies found by the applicant, the issuing bank rejected the documents.[457] The court found that the issuing bank in this case was acting like 'a postbox' in handling the documents. Mance LJ said: "I find that the defendants [issuing bank] did act effectively as no more than a postbox, both when they received the documents and passed them on to Suhail Jute [applicant] and when they received Suhail Jute's letter and passed it on to the plaintiffs [confirming bank]".[458] The court asserted that had the issuing bank examined the documents and then only consulted the applicant for waiver of discrepancies, the process would have been done quicker. But because the bank forwarded the documents to the applicant to examine them, the examination process took longer than it should be. Therefore, the court found that the issuing bank was in breach of the requirement that the bank should act within "reasonable time" and "without a delay".[459] As a result, the court held that the issuing bank should be precluded from raising claim that the documents were not in compliance with the credit.[460]

Documents are to be read together

It is not required that every single document contain all the information or conditions specified in the credit. However, it is sufficient if the set of documents if read together provide the required information or conditions.

[457] [1997] 1 Lloyd's Rep 59 at 61.
[458] [1997] 1 Lloyd's Rep 59 at 69.
[459] [1997] 1 Lloyd's Rep 59 at 69.
[460] [1997] 1 Lloyd's Rep 59 at 70.

In Midland Bank Ltd v. Seymour[461], for the purpose of importing feathers from Hong Kong, Seymour contracted Taiyo Trading Company. To secure payment of the goods, Midland Bank opened an irrevocable letter of credit in favour of the sellers, who managed to tender the documents and obtain payment from the bank after fraudulently shipping rubbish. The documents tendered by the sellers, though if they were read individually did not contain all descriptions of the goods that had been specified in the credit, the whole set of the documents if they were read together provided sufficient information. While the credit instructions specified that the goods should be "Hong Kong duck feathers – 85 per cent clean; 12 bales each weighing about 190 lbs.", the bill of lading tendered by the sellers says "12 bales, Hong Kong duck feathers". However if the documents are read together, they provide the whole descriptions. The buyer refused to reimburse the bank, claiming that the bank had paid against non-conforming documents. The buyer contended that the bill of lading did not contain complete descriptions of the goods specified in the credit. [462]

In its judgment, the court held that the bank had properly executed its undertaking because it was enough that the documents, if read together as whole set, contain all specifications and it was not necessarily for every piece of the documents to include the whole information, unless the credit explicitly specified that each document should contain all details. The court made it clear that "[t]here would therefore have been, as I think, no

[461] Midland Bank Ltd v. Seymour (1955) 2 Lloyd's Rep 147.
[462] (1955) 2 Lloyd's Rep 147 at 151.

difficulty in Mr. Seymour having specified, if he wanted to, that the bill of lading should contain full description".[463]

Reasonable Care in Examining Documents

In examining the documents, the bank is only required is to exercise reasonable care, which Jack has defined:

"reasonable care is simply the care that would be exercised in the particular circumstances by a bank competent to handle documentary credit transactions". [464]

The current UCP does not refer to the 'reasonable care' standard. However the UCP 500 asserts that: "Banks must examine all documents stipulated in the credit with reasonable care, to ascertain whether or not they appear, on their face to be in compliance with the terms and conditions of the Credit".[465]

It has been suggested that the 'reasonable care' standard still has its effect despite being absent in the UCP 600, as it was pointed out:

"Although the references to "reasonable care" in the old Art.13(a) of the UCP 500 have disappeared in the UCP 600, the commonly held view is that it is unlikely that this will affect what was in any event a restatement of the common law position".[466]

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[463] Midland Bank Ltd v. Seymour (1955) 2 Lloyd's Rep 147 at 153.
[464] R Jack, A Malek and D Quest, Documentary Credits (Third edn, Butterworths, UK 2001) 713.
[465] UCP500 Article 13 (a).
[466] M Isaacs and M Barnett, 'International Trade Finance - Letters of Credit, UCP 600 and Examination of Documents' [2007] JIBLR.

The common law position towards 'reasonable care' can be found in Gian Singh & Co Ltd v. Banque de l'Indochine.[467] In this case, upon the instructions of Gian Singh & Co Ltd (customer), the Bank of Banque de l'Indochine opened an irrevocable letter of credit in favour of Thai Lung Ship Machine Manufactory of Taiwan for the purchase of a fishing vessel. One of the credit conditions was the presentation of "a certificate signed by Balwant Singh holder of Malaysian Passport E. 13276 certifying that the vessel had been built according to specifications and is in fit and proper condition to sail".[468] After shipping a 14-year-old fishing vessel instead of a new one, the beneficiary presented the documents under the credit including the required certificate but with a forged signature and a forged passport of Balwant Singh.[469] The bank accepted the documents and after paying the beneficiary, debited the customer's account for that payment. Dissatisfied with the bank's performance, the customer brought action against the bank claiming that the bank had wrongfully debited the customer's account. The court found that the bank had exercised its duty in examining the documents with reasonable care to ensure that the documents had complied with the credit and therefore the bank was entitled to repayment. Lord Diplock asserted that:

"The fact that a document presented by the beneficiary under a documentary credit, which otherwise conforms to the requirements of the credit, is in fact a forgery does not, of itself, prevent the issuing bank from recovering from its customer moneys paid under the credit. The duty of the

[467] Gian Singh & Co Ltd v. Banque de l'Indochine (1974) 2 WLR 1 (Judicial Committee of the Privy Council).
[468] (1974) 2 WLR 1 (Judicial Committee of the Privy Council) at 10.
[469] (1974) 2 WLR 1 (Judicial Committee of the Privy Council) at 4.

issuing bank, which it may perform either by itself, or by its agent, the notifying bank, is to examine documents with reasonable care to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit". [470]

Time for examination

The reasonable time for examining the documents by the bank was determined by the UCP 500 to be within seven days of receiving the documents. Art. 13(b) UCP 500 asserts:

"The Issuing Bank, the Confirming Bank, if any, or a National Bank acting on their behalf, shall each have a reasonable time, not to exceed seven banking days following the day of receipt of the documents, to examine the documents and determine whether to take up or to refuse the documents and to inform the party from which it received the documents accordingly".[471] However, this time was reduced by the new UCP to five working days. In the language of Article 14 (b) UCP 600:

"A nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank shall each have a maximum of five banking days following the day of presentation to determine if a presentation is complying. This period is not curtailed or otherwise affected by the occurrence on or after the date of presentation of any expiry date or last day for presentation". [472]

The specific time limits contained in UCP 500 and UCP 600 was inspired by the decision of the Court of Appeal in Bankers Trust Co. v. State Bank

[470] (1974) 2 WLR 1 (Judicial Committee of the Privy Council) at 11.
[471] Art. 13(b) UCP 500.
[472] Art. 14 (b) UCP 600.

of India.[473] In this case, for the purchase of 22,000 tonnes of steel plates by Harlow and Jones Ltd (the buyers) , the issuing bank, Bankers Trust Co., opened an irrevocable letter of credit in favour of Steel Authority of India (the sellers). The credit, which was subject to the UCP (1983 Revision), was confirmed by State Bank of India. When the documents were tendered, the confirming bank accepted the documents and paid the beneficiary the same day the confirming bank received them and the issuing bank immediately reimbursed the confirming bank as the issuing bank was under obligation to do so even before it examined the documents. Subsequently, the documents were sent to the issuing bank which examined them for three days. The documents were then sent to the customer who held the documents for another three days to examine them. After eight working days from receiving the documents, the issuing bank sent a notice of rejection to the confirming bank which alleged that this period of time exceeded the reasonable time rule set out by the UCP.

This case has been dealt with by the court in light of Article 16 of the UCP 1983 Revision, which stated that:

"(c) The issuing bank shall have a reasonable time in which to examine the documents and to determine as above whether to take up or to refuse the documents.

(d) If the issuing bank decides to refuse the documents, it must give notice to that effect without delay…

(e) If the issuing bank fails to act in accordance with the provisions of paragraph (c) and (d) of this article and/or fails to hold the documents at

[473] Banker's Trust Co v. State Bank of India (1991) 2 Lloyd's Rep 443 (Court of Appeal).

the disposal of, or to return them to, the presenter, the issuing bank shall be precluded from claiming that the documents are not in accordance with the terms and conditions of the credit".[474]

Therefore, the issue that the court was trying to resolve in this case was whether the issuing bank by taking eight working days had examined the documents within a reasonable time and whether this period should include the time for the customer to examine the documents.

In determining the reasonable time in any circumstances, the court pointed out that the following factors should be considered:

"it may be that one or more of the documents presented is in a foreign language in which none of the bank's staff is versed; or the technical nature of other documents may require an explanation from an expert...Other circumstances which will no doubt be taken into account in determining what is a reasonable time, are the complication of the transaction, the number and complexity of the documents involved and, for example, the fact that the documents are being considered by the staff of a large bank at a busy financial centre".[475]

After considering evidence provided by banking experts suggesting that the average time for examining the documents would take from two to three working days, the court found that the issuing bank had exceeded the reasonable time in examining the documents. Lloyd LJ stated:

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[474] Article 16 UCP (1983 Revision).

[475] Banker's Trust Co v. State Bank of India (1991) 2 Lloyd's Rep 443 (Court of Appeal) at 455.

"I am bound to regard a period of eight working days for examining these documents and determining whether to accept them or not as much too long".[476]

The court further decided that the reasonable time should not be extended to allow the customer to examine the documents. Lloyd LJ asserted:

"A reasonable time for the bank to examine the documents cannot be extended by a further period of time to enable the costumer to examine the documents".[477]

Non-Documentary Conditions

If the credit includes conditions that are non-documentary in its nature, the bank should ignore them. UCP 500 13 (c) asserted that:

"If a credit contains without stating the document(s) to be presented in compliance therewith, banks will deem such conditions as not stated and will disregard them".[478] Equally, this rule was restated in the new UCP as it says:

"If a credit contains a condition without stipulating the document to indicate compliance with the condition, banks will deem such condition as not stated and will disregard it".[479] In addition, the UCC provides the same rule as it states in Section 5-108 (g) that "[i]f an undertaking constituting a letter of credit under Section 5-102(a)(10) contains nondocumentary

[476] (1991) 2 Lloyd's Rep 443 (Court of Appeal) at 449.
[477] (1991) 2 Lloyd's Rep 443 (Court of Appeal) at 449.
[478] UCP 500 13 (c).
[479] UCP 600 14 (h).

conditions, an issuer shall disregard the nondocumentary conditions and treat them as if they were not stated".[480]

Example of such conditions can be found in Gian Singh & Co Ltd v. Banque de l'Indochine.[481] In this case, the credit required the presentation of "a certificate that signed by Balwant Singh holder of Malaysian Passport E. 13276".[482] The court found this was a non-documentary condition and the bank was not required to adhere to it. The court stated that:

"The instant case differs from the ordinary case in that there was a special requirement that the signature on the certificate should be that of a person called Balwant Singh, and that that person should also be the holder of Malaysian passport no. E. 13276. This requirement imposed upon the bank the additional duty to take reasonable care to see that the signature on the certificate appeared to correspond with the signature on an additional document presented by the beneficiary which, on the face of it, appeared to be a Malaysian passport no. E. 13276 issued in the name of Balwant Singh" [483] Banque v. JH Rayner[484] provides another example of the non-documentary conditions. In this case, under the heading 'Special Conditions', the credit required that 'Shipment to be effected on vessel belonging to shipping company that member of an International Shipping Conference'. Donaldson MR in the Court of Appeal asserted: "This is an unfortunate condition to include in a documentary credit, because it breaks the first rule of such a transaction, namely, that the parties are dealing in

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[480] UCC 5-108 (g).
[481] Gian Singh & Co Ltd v. Banque de l'Indochine (1974) 2 WLR 1 (Judicial Committee of the Privy Council).
[482] (1974) 2 WLR 1 (Judicial Committee of the Privy Council) at 10.
[483] (1974) 2 WLR 1 (Judicial Committee of the Privy Council) at 11.
[484] Banque De L'Indochine ET DE Suez SA v. JH Rayner (Mincing Lane) Ltd (1983) 2 WLR 841 (Court of Appeal).

documents, not facts. The condition required a state of fact to exist. What the letter of credit should have done was to call for a specific document which was acceptable to the buyer and his bank evidencing the fact that the vessel was owned by a member of a conference. It did not do so and as, accordingly, the confirming bank had to be satisfied of the fact, it was entitled to call for any evidence establishing that fact. All sorts of interesting questions could have arisen as to what evidence could have been called for and what would have been the position if, contrary to that evidence, the vessel was not owned by a conference member. In fact it was so owned and merchants produced the evidence required by the bank before the expiry of the credit. Accordingly no such questions arise".[485]

Ambiguity

In letter of credit transactions, ambiguity can be found in two situations. The first situation is ambiguity in the credit instructions, and the second one is ambiguity in the presentation. If the bank finds ambiguity in the credit instructions, the bank has to ask the applicant for clarification.[486] However, if that was not possible, then if the bank acts in a reasonable manner, the bank is protected. In Commercial Banking Co of Sydney Ltd v. Jalsard Pty Ltd, Lord Diplock said:

"...where the banker's instructions from his customer are ambiguous or unclear he commits no breach of his contract with the buyer if he has construed them in a reasonable sense, even though upon the closer

[485] Banque De L'Indochine ET DE Suez SA v. JH Rayner (Mincing Lane) Ltd (1983) 2 WLR 841 (Court of Appeal) at 855.
[486] L D'Arcy, C Murray and Barbara, Schmitthoff's Export Trade, The Law and Practice of International Trade (Tenth edn, Sweet & Maxwell, London 2000) 177.

consideration which can be given to questions of construction in an action in a court of law, it is possible to say that some other meaning is to be preferred".[487]

As to the second situation, if there is ambiguity in the presentation, in principle, this presentation is considered as a non-conforming presentation, but the bank can arrange with the beneficiary to pay under reserve.[488] However, if the documents, despite the ambiguity, are in a state that could be read and understood properly, the bank should accept this presentation. That is why the Banking Commission of the ICC remarked that "the banks could not act like robots, but had to check each case individually and use their judgment".[489]

Consistency

If the tendered documents are inconsistent with one another, these documents will be deemed to be non-conforming documents. Article 13(a) UCP 500 states:

"Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in compliance with the terms and conditions of the Credit."[490] The issue of consistency was tackled by the court in Bank Melli Iran v. Barclays Bank.[491] In this case,

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[487] Commercial Banking Co of Sydney Ltd v. Jalsard Pty Ltd [1973] A.C. 279. To clarify this issue, Jack outlined that:
"Where the terms of the credit are ambiguous in the sense that it is unclear what I called for, or unclear whether A or B is called for, a bank may be entitled to act on its own interpretation of the terms provided that it is reasonable" R Jack, A Malek and D Quest, Documentary Credits (Third edn, Butterworths, UK 2001)182.
[488] L D'Arcy, C Murray and Barbara, Schmitthoff's Export Trade, The Law and Practice of International Trade (Tenth edn, Sweet & Maxwell, London 2000) 179.
[489] Opinions of the ICC Banking Commission (1980-1981), Publication No 399.
[490] Article 13(a) UCP 500.
[491] Bank Melli Iran v. Barclays Bank DCO (1951) 2 Lloyd's Rep 367.

Bank Melli Iran has issued a letter of credit to secure a payment for the purchase of 100 Chevrolet trucks, and the credit was confirmed by Barclays Bank. The credit required the submission of documents certifying the shipment of 'sixty new Chevrolet trucks'. When the Chevrolet trucks were shipped to the buyer, the seller tendered the documents to Barclays Bank for payment. The documents included an invoice, which described the trucks as 'in new condition'. It also included a certificate that described the trucks as 'new, good, Chevrolet M6 4X4 trucks'. Among the documents was also a delivery order describing the trucks as 'new (hyphen) good'. Barclays Bank accepted the documents and made payment to the beneficiary and debited Bank Melli's account. Challenging the action of Barclays Bank, Bank Melli claimed that Barclays Bank wrongfully made payment against documents that did not conform to the credit mandate.[492] The court held that the tender was bad as the descriptions of the goods in the submitted documents were inconsistent.[493] McNair LJ asserted:

"On the other hand, I consider that the document is clearly defective in two respects:

(1) The description of the trucks as "new (comma) good" may clearly connote something different from the description "new". It may have a special trade meaning in relation to motor vehicles. It is sufficient to say that it is not the same.

(2) But the more important defect, in my judgement, is that the certificate does not purport to relate to any specific trucks; the trucks as to which the

[492] Bank Melli Iran v. Barclays Bank DCO (1951) 2 Lloyd's Rep 367 at 372.
[493] (1951) 2 Lloyd's Rep 367 at 375.

certificate is given are not identified as the trucks covered by the invoice or a fortiori by the delivery order, which did not come into existence until some five or six weeks after the date of the certificate".[494]

Nevertheless, because Bank Melli has ratified the actions of its agent, Barclays Bank, the court found that Barclays Bank was entitled to be reimbursed.[495]

However, the concept of consistency was replaced in the new UCP with the concept of 'not conflict with' as it states:

"Data in a document, when read in context with the credit, the document itself and international standard banking practice, need not be identical to, but must not conflict with, data in that document, any other stipulated document or the credit".[496] The ICC explained the reason behind this departure from the previous terminology:

"Over the years, the approach by banks to documents that may be deemed to be inconsistent with one another has been proved, in many cases to be subject to misuse due to a misinterpretation of the rule. When inconsistencies encompassed issues including simple typing and grammatical errors, banks frequently cited a significant number of discrepancies. However, calling many of these discrepancies was often unwarranted. The drafting group believed that this concept needed to be changed and felt that the phrase specifying that data must not "conflict with" would be a much narrower and more preferable concept than one stating "document which appear on their face to be inconsistent with" and would require banks to make a decision based on the compliance of the

[494] Bank Melli Iran v. Barclays Bank DCO (1951) 2 Lloyd's Rep 367 at 375.
[495] (1951) 2 Lloyd's Rep 367 at 377.
[496] Article 14 (d) UCP 600.

data itself. The drafting group believes this will result in a reduction of discrepancies. Consequently, this new standard does not require a mirror image of data".[497]

Linkage of the documents

The linkage of documents means that each document should relate to the same goods.[498] In essence, "they must each identify the same parcel of goods".[499]

The linkage of documents was one of the issues tackled in Banque De L'Indochine ET DE Suez SA v. JH Rayner.[500] In this case, the confirming bank rejected the beneficiary's presentation for discrepancies found in the documents. One of these discrepancies was the lack of linkage between the documents. Under number 4 in the list of the discrepancies the bank mentioned:

"Certificates of weight, quality, packing and certificates of origin and EUR1 certificates cannot be related to remaining documents or to letter of credit".[501]

Emphasising the importance of linkage of the documents, Parker LJ stated:

"I have no doubt that as long as the documents can be plainly seen to be linked with each other, are not inconsistent with each other or with the terms of the credit, do not call for enquiry and between them state all that

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[497] International Chamber of Commerce, Commentary on UCP 600 (ICC Publication No. 680, International Chamber of Commerce, Publications Department, France 2007) 64.
[498] L D'Arcy, C Murray and Barbara, Schmitthoff's Export Trade, The Law and Practice of International Trade (Tenth edn, Sweet & Maxwell, London 2000) 184.
[499] M Bridge, The International Sale of Goods (Second edn, Oxford University Press, New York, USA 2007) 278.
[500] Banque De L'Indochine ET DE Suez SA v. JH Rayner (Mincing Lane) Ltd (1983) 2 WLR 841 (Court of Appeal).
[501] (1983) 2 WLR 841 (Court of Appeal) at 843.

is required in the credit, the beneficiary is entitled to be paid".[502] The court agreed with the confirming bank that the documents submitted by the beneficiary lacked linkage and should therefore be considered discrepant. Parker LJ stated:

"I do not consider that the documents are on their face consistent with each other. It is accepted that they are in any event not on their face linked with each other and they do not show E.U.R. certificates as to the required quantity".[503]

The legal and commercial significance of the Documents

In examining the documents, the bank should not be concerned about the commercial or the legal significance of the documents, even if it appears that the documents do not have any commercial or legal consequences. The bank's sole concern is the compliance of the documents to the credit and it does not matter to the bank how material are the discrepancies to the parties.[504] On the same basis, the bank is not liable for the genuineness or the legal effect of the documents. Art 34 UCP 600, which is taken almost literally from Art 15 UCP 500, states:

"Banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document, or for the general or particular conditions stipulated in a document or superimposed thereon; nor does it assume any liability or responsibility for

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[502] Banque De L'Indochine ET DE Suez SA v. JH Rayner (Mincing Lane) Ltd (1983) 2 WLR 841 (Court of Appeal) at 850.
[503] (1983) 2 WLR 841 (Court of Appeal) at 851.
[504] R Jack, A Malek and D Quest, Documentary Credits (Third edn, Butterworths, UK 2001)171, A Mugasha, Letters of Credit and Bank Guarantees (The Federation Press, Sydney 2003) 128.

the description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods, services or other performance represented by any document, or for the good faith or acts or omissions, solvency, performance or standing of the consignor, the carrier, the forwarder, the consignee or the insurer of the goods or any other person".[505]

The Standard for Strict Compliance

While the strict compliance is a well established rule, the standard that banks should follow to determine the compliance and the discrepancy of the documents is far from being clear. The UCP 500 states that:

"Banks must examine all documents stipulated in the credit with reasonable care, to ascertain whether or not they appear, on their face to be in compliance with the terms and conditions of the Credit. Compliance of the stipulated documents on their face with the terms and conditions of the Credit, shall be determined by international standard banking practice as reflected in these Articles. Documents which appear on their face to be inconsistent with one another will be considered as not appearing on their face to be in compliance with the terms and conditions of the Credit".[506]

However, this rule does not provide guidelines to solve the issue of the extent which the documents should be in compliance with the credit.

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[505] Art 34 UCP 600. The language of 15 UCP 500 is very close to the new article. It reads: "Banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any documents(s), or for the general and/or particular conditions stipulated in the document(s) or superimposed thereon; nor do they assume any liability or responsibility for the description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods represented by any document(s), or for the good faith or act and/or omissions, solvency, performance or standing of the consignors, the carriers, the forwarders, the consignees or the insurers of the goods, or any other person whomsoever".

[506] UCP500 Article 13 (a).

Regrettably, this issue was not solved in the new UCP either. Under Article 2 UCP 600, the complying presentation is defined as:

"a presentation that is in accordance with

- the terms and conditions of the credit,
- the applicable provisions of these rules and
- international standard banking practice".[507]

In another position, in an attempt to provide more assistance in determining the compliance of the documents, UCP 600 asserted:

"Data in a document, when read in context with the credit, the document itself and international standard banking practice, need not be identical to, but must not conflict with, data in that document, any other stipulated document or the credit."[508]

However, this rule has failed to establish an objective standard that the bank and the court can follow to decide if the documents pass the test of strict compliance.[509]

Likewise, the UCC shared the UCP position in lacking an objective standard to be followed. UCC Section 5-109 (2) asserts:

"An issuer must examine documents with care so as to ascertain that on their face they appear to comply with the terms of the credit but unless otherwise agreed assumes no liability or responsibility for the genuineness, falsification or effect of any document which appears on such examination to be regular on its face".[510] Here, while it gave direction that the

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[507] UCP600 Article 2.
[508] UCP600 Article 14 (d).
[509] K Roane, 'Hanil Bank v. PT. Bank Negara Indonesia (Persero): Continuing the Quandary of Documentary Compliance Under International Letter of Credit' (2004) 41 Hous L Rev 1053.
[510] UCC Section 5-109 (2) (Rev. 1995).

documents should be examined with care to ensure that they comply with the credit; the UCC did not provide any objective test to carry out the examination and determine the compliance of the documents.

What makes the matter even worse is that the absence of an objective standard has led to confusion in the court's approach to the issue of non-compliance. That is why the judicial decisions in several occasions seem to be in conflict with each other regarding whether the discrepancy in the presentation is a trivial one and therefore the presentation should be accepted or that the discrepancy should be considered as a material one which should result in the rejection of the presentation. For example, the American court in Beyene v. Irving Trust Co.[511] considered the misspelling of the name of the buyer, Sofan, in the bill of lading, which was mistakenly listed as Soran, as a material discrepancy. The court held that failure to comply literally with the credit was sufficient to relieve the bank of its duty to honour the credit. However, the court highlighted that the decision would be different "where the name intended is unmistakably clear despite what is obviously a typographical error, as might be the case if, for example, "Smith" were misspelled "Smithh"".[512]

A similar approach can be found in the American case Hanil Bank v. PT. Bank Negara Indonesia (PERSERO).[513] In this case, Bank Negara (BNI), an Indonesian bank with an agency in New York, opened a letter of credit (subject to UCP 500) on the instruction of PT. Kodeco Electronics Indonesia in favour of Sun Jun Electronics Co. Ltd. The name of the beneficiary was mistakenly written on the credit as Sun Jin instead of Sun

[511] Beyene v. Irving Trust Co (1985) 762 F 2d 4.
[512] (1985) 762 F 2d 4 at 5.
[513] Hanil Bank v. PT. Bank Negara Indon. (Persero) (2000) 41 UCC Rep Serv 2d 618.

Jun and the beneficiary has never requested the amendment of that mistake. After accepting the beneficiary's presentation, Hanil Bank, which was a Korean bank with also an agency in New York, paid against the documents.[514] Seeking reimbursement, Hanil forwarded the documents to the issuing bank, BNI, which rejected the tender on four discrepancies. The most material one was that the letter of credit "identifies the beneficiary as Sun Jin Electronics Co. Ltd. instead of Sun Jun Electronics Co. Ltd".[515] Hanil Bank brought an action against BNI "for breach of contract, breach of the Uniform Customs and Practice for Documentary Credits (1993 Revision) International Chamber of Commerce Publication No. 500 (the "UCP"), unjust enrichment, and breach of an implied covenant of good faith and fair dealing".[516] The court found that the misspelling of the beneficiary's name was a material discrepancy and the issuing bank was right in rejecting the documents.[517] While Bank Negara contended that this case should be treated as in Beyene v. Irving Trust[518] where the court found that the misspelling of the name of the party was a material discrepancy, Hanil Bank argued that this case is distinguishable from the Beyene case as in that case the beneficiary made the mistake while in the present case the mistake was done by the issuing bank.[519] However, the court rejected Hanil's argument relying on Mutual Export Corp. v. Westpac Banking Corp.[520], where the error in the expiry date of the credit was made by the issuing bank and it was held that it was the beneficiary's

[514] Hanil Bank v. PT. Bank Negara Indon. (Persero) (2000) 41 UCC Rep Serv 2d 618.
[515] (2000) 41 UCC Rep Serv 2d 618.
[516] (2000) 41 UCC Rep Serv 2d 618.
[517] (2000) 41 UCC Rep Serv 2d 618.
[518] Beyene v. Irving Trust Co (1985) 762 F 2d 4.
[519] Hanil Bank v. PT. Bank Negara Indon. (Persero) (2000) 41 UCC Rep Serv 2d 618.
[520] Mutual Export Corp. v. Westpac Banking Corp (1993) 983 F 2d 420.

responsibility to notice any error that might affect the proper functioning of the credit. Accordingly, the court in the present case explained that it was the duty of the beneficiary to inspect the credit and ensure that it did not contain mistakes; otherwise the beneficiary would be "responsible for any negligent failure to discover that the credit does not achieve the desired commercial ends".[521] The court further added that Hanil Bank by accepting to negotiate a credit that contained such a mistake had assumed the risk associated with its action. The court concluded that, as in the Beyene case, the mistake in the name of the beneficiary in the present case could not immediately be recognised as a typographical error and therefore that was a material discrepancy and the bank was entitled to reject the documents.[522] While the above cases represent a rigid application of the strict compliance rule, the following cases adopt a more flexible approach. In the English case Kredietbank Antwerp v. Midland Bank Plc[523], the tender under the credit was rejected by the issuing bank based on several discrepancies. One of these discrepancies was that the credit required the tender of a "draft survey report issued by Griffith Inspectorate at port of loading" but the seller tendered a draft survey report signed on behalf of Daniel C Griffith (Holland) BV, which was a 'member of the worldwide inspectorate group'. The Court of Appeal held that this discrepancy was a trivial one. Evans LJ further added: "the requirement of strict compliance is not equivalent to a test of exact literal compliance in all circumstances and as regards all documents. To some extent, therefore, the banker must exercise his own judgment whether the requirement is satisfied by the documents presented

[521] Hanil Bank v. PT. Bank Negara Indon. (Persero) (2000) 41 UCC Rep Serv 2d 618.
[522] (2000) 41 UCC Rep Serv 2d 618.
[523] Kredietbank Antwerp v. Midland Bank Plc [1999] CLC 1108 (Court of Appeal).

to him".[524] The court acknowledged the difficulty in distinguishing between trivial discrepancies and the discrepancies that entitle the bank to reject the documents. The court said:

"the distinction between 'trivial' discrepancies and those which require the bank to reject the documents tendered (subject to further express instructions from the customer) is not always easy to draw".[525] In an American case, New Braunfels National Bank v. Odiorne[526], the beneficiary sued the issuing bank for refusing to pay under the credit. The bank claimed that its refusal was because the documents tendered by the beneficiary were defective. The court, in recognising the importance of maintaining the existence of the strict compliance principle, asserted that:

"maintaining the integrity of the strict compliance rule is important to the continued usefulness of letters of credit as a commercial tool".[527] Nevertheless, the court found that the issuing bank had failed to adopt the proper application of the principle of strict compliance as the discrepancy was of a typographical or clerical nature. Therefore, the bank was wrong in rejecting the beneficiary's presentation. [528] Equally, the American court in Tosco v. FDIC[529] found that the draft drawn under the credit which contained "l" instead of "L" in the word "Letter" and "No." instead of "Number" should not be considered as a bad tender and therefore should not be rejected for lack of compliance.[530] The same approach was

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[524] Kredietbank Antwerp v. Midland Bank Plc [1999] CLC 1108 (Court of Appeal) at 1112.
[525] [1999] CLC 1108 (Court of Appeal) at 1111.
[526] New Braunfels Nat'l Bank v. Odiorne (1989) 780 SW 2d 313.
[527] (1989) 780 SW 2d 313 at 316.
[528] (1989) 780 SW 2d 313 at 320.
[529] Tosco Corp. v. FDIC (1983) 723 F 2d 1242 (6th Cir).
[530] (1983) 723 F 2d 1242 (6th Cir) at 1249.

embraced by the American court in Voest-Alpine Trading USA Corp v. Bank of China.[531] This case involved the agreement between Jiangyin Foreign Trade, a Chinese company and Voest-Alpine Trading USA Corporation on the sale of 1,000 metric tons of styrene monomer. The parties also agreed that the payment was to be made by means of irrevocable letter of credit which was opened by the Bank of China for the amount of $ 1.2 million. When the seller tendered the documents under the credit, the Bank of China rejected the tender alleging several discrepancies. One of these discrepancies was that the beneficiary's name was written in the document different from the way it was written in the credit. The name was supposed to be "Voest-Alpine USA Trading Corp.", but it was written in the documents as "Voest-Alpine Trading Corp".[532] The court found that this was a trivial discrepancy and asserted that "[a] common sense, case-by-case approach would permit minor deviations of a typographical nature because such a letter-for-letter correspondence between the letter of credit and the presentation documents is virtually impossible".[533]

The above judicial applications of strict compliance rule illustrate a striking lack of clear objective standard which resulted in inconsistency in the courts' approach toward this issue.

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[531] Voest-Alpine Trading USA Corp. v. Bank of China (2000) 167 F. Supp. 2d 940.
[532] (2000) 167 F. Supp. 2d 940 at 942.
[533] (2000) 167 F. Supp. 2d 940 at 947. In addition, Paker LJ remarkably says: "I also accept, as did Mr. Saville, that Lord Sumner's statement cannot be taken as requiring rigid meticulous fulfilment of precise wording in all cases. Some margin must and can be allowed, but it is slight, and banks will be at risk in most cases where there is less than strict compliance". Banque De L'Indochine ET DE Suez SA v. JH Rayner (Mincing Lane) Ltd (1983) 2 WLR 841 (Court of Appeal) at 850.

Conclusion

The letter of credit plays a vital role in financing international trade. Under the letter of credit mechanism, international trade is carried out in a more efficient and secure way. The letter of credit does not only assure the seller of payment as soon as the commodities are shipped and proper documents are presented to the bank, but also assures the buyer that no money is advanced to the seller unless the commodities are shipped and conforming documents are provided.

For letters of credit to achieve this objective, two fundamental principles have to be observed: the strict compliance and the autonomy of the credit. This chapter has examined the strict compliance principle which dictates that the seller will not get paid unless strict compliance to the credit has been taken place.

The purpose of this principle is mainly to provide protection to the applicant/buyer against improper performance of the seller/beneficiary.

In determining whether the documents conform to the credit, the bank should examine the documents on their face with reasonable care. The bank should not go beyond the provided documents and the legal and commercial significance of the documents should not be the bank's concern.

The examination of the documents has to be undertaken by the bank within a reasonable time. While, under the UCP 500, this reasonable time should not exceed seven working days; under the new UCP, it has been reduced to five working days.

Upon examining the beneficiary's presentation, if the bank finds this presentation to be in strict compliance with the credit, the bank has to accept the presentation. However, if the presentation does not strictly comply with the credit, the bank has a duty toward its customer not to accept the presentation. Accordingly, if the bank rejects conforming documents, the bank is liable to the beneficiary for wrongful dishonour, and if the bank pays against non-conforming documents the bank is liable to the applicant for breaching its duty.

Refusing the documents is one of the actions the bank can resort to when receiving non-conforming document. This action was taken by the bank in Soproma SPA v. Marine & Animal By-Products[534] where the court held that the bank was right in rejecting the beneficiary's tender because it was defective. The other action the bank might take is to pay the beneficiary under reserve. In this kind of arrangement, the bank and the beneficiary would agree that the bank would pay on the condition that if the documents are rejected by the issuing bank or the buyer, the beneficiary is going to reimburse the bank for the amount that the bank had paid under reserve. In addition to these two actions, the bank, if finds any discrepancies in the documents, can pay against indemnity or ask the buyer for a waiver.

According to Article 37 (c) UCP 500 and Article 14 (e) UCP 600, it is acceptable that if the documents are read together to provide all the information and is not required that every single document should contain

[534] Soproma SPA v. Marine & Animal By-Products [1966] 1 Lloyd's Rep 367.

all the specifications. This rule was also asserted by the court in Midland Bank Ltd v. Seymour.[535]

However, the linkage of the documents is required, which means that each of the documents should relate to the same goods. The consistency of the documents is also required as inconsistent documents are considered to be non-conforming and they should be rejected by the bank.

While it is well understood that the doctrine of strict compliance does not require the documents to be a mirror image, the question that are yet to be resolved is to what extent these documents have to conform to the credit. Neither the UCP in its previous and new version nor the UCC provide any objective standard to serve as guidelines in this matter. This lack of an objective standard led to confusion in the bank's examination of the documents and inconsistencies in the courts' treatment of the non-compliance issue. While some courts, such as in Beyene v. Irving Trust Co[536] and Hanil Bank v. PT. Bank Negara Indonesia (PERSERO)[537] would consider documents that contain trivial discrepancies to be non-complying documents and therefore should be rejected, other courts such as the courts in Kredietbank Antwerp v. Midland Bank Plc[538], Tosco v. FDIC[539] , and Voest-Alpine Trading USA Corp v. Bank of China[540] would take the view that documents containing trivial discrepancies should be accepted as these discrepancies would not affect the core compliance of the documents.

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[535] Midland Bank Ltd v. Seymour (1955) 2 Lloyd's Rep 147.
[536] Beyene v. Irving Trust Co (1985) 762 F 2d 4.
[537] Hanil Bank v. PT. Bank Negara Indon. (Persero) (2000) 41 UCC Rep Serv 2d 618.
[538] Kredietbank Antwerp v. Midland Bank Plc [1999] CLC 1108 (Court of Appeal).
[539] Tosco Corp. v. FDIC (1983) 723 F 2d 1242 (6th Cir).
[540] Voest-Alpine Trading USA Corp. v. Bank of China (2000) 167 F. Supp. 2d 940.

Sixth Chapter: The Autonomy Doctrine and the Fraud Exception

Introduction

The autonomy doctrine, or what is sometimes referred to as the independent principle, simply means that the letter of credit transaction is separate from the underlying sale of goods agreement or any other agreements.[541] In essence, apart from the credit transaction, the bank is in no way involved in the sale agreement or any other agreements initiated between seller and buyer. When presented with the right documents, the bank has to fulfil its obligations under the credit regardless any disputes between the parties and regardless the insolvency or the objection of the applicant.[542]

The UCP 500 refers to the autonomy doctrine in Article 3(a)[543], which is echoed in Article 4(a) UCP 600:

"A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned with or bound by such contract, even if any reference whatsoever to it is included in the credit. Consequently, the undertaking of a bank to honour, to negotiate or to fulfil any other obligation under the credit is not subject to claims or defences by the applicant resulting from its relationships with the issuing bank or the beneficiary".[544]

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[541] L D'Arcy, C Murray and Barbara, Schmitthoff's Export Trade, The Law and Practice of International Trade (Tenth edn, Sweet & Maxwell, London 2000)172-174.

[542] A Ward, 'The Liability of Banks in Documentary Credit Transactions Under English Law' (1998) 13 (12) JIBL 387.

[543] With a very slight difference from Article 4(a) UCP 600, Article 3(a) UCP 500 reads: "Credits, by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the Credit. Consequently, the undertaking of a bank to pay, accept and pay Draft(s) or negotiate and/or to fulfil any other obligation under the Credit, is not subject to claims or defences by the Applicant resulting from his relationships with the Issuing Bank or Beneficiary".

[544] Article 4(a) UCP 600.

Likewise, this doctrine was a point of concern in the UCC where it provided:

"Rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or non-performance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary".[545]

Moreover, the primary concern of the parties in the letter of credit transactions is the documents and not the goods. Article 4 of UCP 500 asserts that "[i]n Credit operations all parties concerned deal with documents, and not with goods, services and/or other performances to which the documents may relate."[546] Restating the same rule in a more simplified form, UCP 600 Article 5 provides:

"Banks deal with documents and not with goods, services or performance to which the documents may relate".[547]

The main purpose of this doctrine is to prevent the applicant or any other parties from restraining the bank from carrying out its obligations.[548] Therefore, the bank cannot use the seller's breach of sale contract as a defence for not paying under the credit. Hence, the shipment of unsatisfactory quality goods should not affect the performance of the letter

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[545] UCC Section 5-103 (d).
[546] Article 4 UCP 500.
[547] Article 5 UCP 600.
[548] A Ward, 'The Liability of Banks in Documentary Credit Transactions Under English Law' (1998) 13 (12) JIBL 387.

of credit and should not give the buyer the right to instruct the bank to stop payment under the credit.[549]

The Doctrine of Autonomy in Common Law

The courts have explicitly addressed the principle of autonomy in several cases. In Power Cuber International Ltd v. National Bank of Kuwait, a distributing firm based in Kuwait, Hammoudeh & Al Fulaij, opened an irrevocable letter of credit in favour of an American exporter, Power Cuber International, for machinery to be shipped from the U.S. to Kuwait. The letter of credit was issued by the National Bank of Kuwait, which was incorporated in Kuwait and had a registered office in London. Hammoudeh

[549] L Sealy and R Hooley, Commercial Law (Fourth edn, Oxford University Press, USA 2009) 865. On the Autonomy Principle, see also R Jack, A Malek and D Quest, Documentary Credits (Third edn, Butterworths, UK 2001) 285, A Mugasha, Letters of Credit and Bank Guarantees (The Federation Press, Sydney 2003) 136, J Dolan, The Law of Letters of Credit, Commercial and Standby Credits (Warren, Gorham & Lamont, 1996) 3-17, R Goode, Commercial Law (Third edn, Penguin Books, London 2004) 971, P Gillies and G Moens, International Trade and Business: Law, Policy and Ethics (Cavendish Publishing, Australia 1998) 409, M Bridge, The International Sale of Goods (Second edn, Oxford University Press, New York, USA 2007) 296, M Kurkela, Letters of Credit and Bank Guarantees Under International Trade Law (Oxford University Press, New York, USA 2007) 102, X Gao, The Fraud Rule in the Law of Letters of Credit, A Comparative Study (Kluwer Law International, Netherlands 2002) 23, J Dolan, 'Letters of Credit: A Comparison of UCP 500 and the New U.S. Article 5'[1999] JBL 521, D Dann, 'Confirming Bank Liability in Letter of Credit Transactions: Whose Bank is It Anyway?' (1983) 51 Fordham L Rev 1219, G McLaughlin, 'Letters of Credit and Illegal Contracts: The Limits of the Independence Principle' (1989) 49 Ohio St LJ 1197, D Howard, 'The Application of Compulsory Joinder, Intervention, Impleader and Attachment to Letter of Credit Litigation' (1984) 52 Fordham L Rev 957, R D'Ascenzo, 'The Supreme Court of Ohio's Decision in Mid-America Tire, INC. v. PTZ Trading LTD., and the Weakening of the Independence' (2004) 32 Cap UL Rev 1097, EP Ellinger, 'The Autonomy of Letters of Credit After the American Accord' (1983) 11 ABLR 118, M Williams, 'Documentary Credits and Fraud: English and Chinese Law Compared '[2004] JBL 155, J Ulph, 'The UCP 600: Documentary Credits in the 21st Century'[2007] JBL 355, R Hooley, 'Fraud and Letters of Credit Part 1' (2003) 3 JIBFL 91, H Bennett, 'Performance Bonds and The Principle of Autonomy'[1994] JBL 574, J Wood, 'Drafting Letters of Credit: Basic Issues Under Article 5 of The Uniform Commercial Code, UCP 600, and ISP98' (2008) 125 Banking LJ 103, R Sappideen, 'International Commercial Letters of Credit: Balancing the Rights of Buyers and Sellers in Insolvency'[2006] JBL 133, J Head, 'How Letters of Credit Operate in International Commercial Transactions: An Introduction to UCP' (2008) 77 JKSBA 16, J Arkins, 'Snow White v. Frost White: The New Cold War in Banking Law' (2000) 15 (2) JIBL 30, M Moses, 'Letters of Credit and the Insolvent Applicant: A Recipe for Bad Faith Dishonor' (2005) 57 Ala L Rev 31 & D Regal, 'Basic Principles of Letters of Credit, What Lawyers Need to Know about UCC Article 5 - Letters of Credit ' (2002) 832 PLI/Comm 13.

managed to obtain an order issued by a Kuwaiti court and upheld by the Court of Appeal banning the National Bank from paying under the credit.[550] The plaintiff, Power Cuber, sued the National Bank of Kuwait in the High Court in England for defaulting on payment under the credit, and the Court found for the plaintiff. When the case was brought to the attention of the Court of Appeal in England, it agreed with the High Court that the Kuwaiti courts had no power over the letter of credit, and the governing law for such a transaction should be the law of North Carolina because it was the law to which the contract had "its closest and most real connection"[551]; therefore the National Bank of Kuwait was under obligation to fulfil its promise to make payment under the credit. The Court made it clear that if a court in any countries would be allowed to interfere in a bank's obligation to make payment on the letter of credit because of a dispute that took place between the parties, such interference would undermine the true nature of the letter of credit as being independent from any transactions or disputes. Consequently, it would undermine the reputation of the letter of credit for being a secure and effective means of payment in international trade.[552] Lord Denning said that the bank should make payment under the letter of credit regardless of any disputes between the parties, and this obligation should "apply not only to confirmed credits but also to irrevocable credits".[553] He added that "[t]he buyer may say that the goods are not up to contract. Nevertheless the bank must honour its

[550] Power Curber International Ltd v. National Bank of Kuwait , [1981] 2 W.L.R. 1233 (Court of Appeal) at 1236.
[551] [1981] 2 W.L.R. 1233 (Court of Appeal) at 1240.
[552] [1981] 2 W.L.R. 1233 (Court of Appeal) at 1241.
[553] [1981] 2 W.L.R. 1233 (Court of Appeal) at 1241.

obligations. The buyer may say that he has a cross-claim in a large amount. Still the bank must honour its obligations".[554]

Sharing the same view, Griffiths LJ expressed the view that "[t]he bankers' promise to pay the seller is wholly independent of the underlying contract of sale between the seller and buyer, or of any contractual dispute that may arise between them".[555]

In another case, namely, Hamzeh Malas & Sons v. British Imex Industries Ltd, the plaintiffs attempted to prevent the defendants from obtaining payment under the credit claiming that the defendants shipped worthless goods. However the court refused to grant an injunction and declared that "the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as whether the goods are up to contract or not".[556] The Court further added that "[a]n elaborate commercial system has been built up on the footing that bankers' confirmed credits are of that character, and, in my judgment, it would be wrong for this court in the present case to interfere with that established practice".[557]

Illustration of the Autonomy Principle

The following example illustrates the autonomy principle in a typical letter of credit transaction:

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[554] Power Curber International Ltd v. National Bank of Kuwait [1981] 2 W.L.R. 1233 (Court of Appeal) at 1241.
[555] [1981] 2 W.L.R. 1233 (Court of Appeal) at 1243.
[556] Hamzeh Malas & Sons v. British Imex Industries Ltd [1958] 2 QB 127 (Court of Appeal).
[557] [1958] 2 QB 127 (Court of Appeal).

A Nigerian corporation needs to purchase steel from the U.S. It approaches a U.S. manufacture and agrees to purchase 100,000 tons of steel for $1,000,000. Because there is no previous relationship between the buyer and the seller, they both agree that the buyer would open an irrevocable letter of credit in the seller's favour. In that letter of credit, the buyer's bank, which issues the letter of credit, promises to pay $1,000,000 upon receiving specific documents to prove that the seller has shipped the steel and it is according to the conditions of the credit. When the American seller ships the goods to Nigeria, the seller would present to the bank the required documents and obtain payment.

Therefore, in a typical international commercial transaction, there are three distinctive contracts. The first is the sale of goods contract, which is agreed between the buyer and the seller. The second is the contract between the applicant and the bank to issue a letter of credit. The third contract is the letter of credit itself, which is issued by the applicant's bank to undertake payment responsibility to the beneficiary upon receiving complying documents. According to the autonomy principle, this third contract, the letter of credit, even though it exists as a result of the two other contracts, is a totally independent contract and should be isolated from the other contracts.

The Importance of the Autonomy Principle

Observing the importance of the autonomy principle in protecting the letter of credit mechanism, McLaughlin remarks:

"As with negotiable instruments, the independence principle, or the principle of autonomy as it is sometimes called, gives the letter of credit its unique qualities as a swift, certain, flexible and economically efficient payment mechanism and contributes to its widespread acceptance in the international marketplace. It would not be an exaggeration to say that without the independence principle, the letter of credit would cease to be a useful mechanism and as a result would soon cease to be."[558] In addition, the autonomy principle aims at protecting the beneficiary by providing assurance of payment. In an international transaction, the beneficiary, until he gets paid for the goods, bears the risks that the buyer may become insolvent, delay or refuse payment, or attempt to obtain a price reduction claiming that the goods are defective. Using the letter of credit mechanism, these risks are eliminated or minimised and the autonomy principle, which is a critical feature of the letter of credit serves in making the bank under obligation to pay the seller despite disputes that may develop over the buyer's insolvency or the quality or price of the goods. Moreover, "in the typical case, the [autonomy] principle protects the seller-beneficiary by assuring that he will be the stakeholder of the proceeds of the letter of credit during any subsequent litigation over the quality or price of the goods or the creditworthiness of the buyer."[559]

[558] G McLaughlin, 'Exploring Boundaries: A Legal and Structural Analysis of the Independence Principle of Letter of Credit Law' (2002) 119 Banking LJ 501.
[559] G McLaughlin, 'Letters of Credit and Illegal Contracts: The Limits of the Independence Principle' (1989) 49 Ohio St LJ 1197 at 1209.

How the Autonomy Principle Functions[560]

To fully understand the function and the effect of the autonomy principle, the following scenarios can be considered

First Scenario

This is an international trade transaction that contains three contracts. In this transaction, the seller is a Brazilian company involved in a contractual relationship to sell coffee to an American company. The American company (the buyer) agrees to pay for the goods by means of issuing an irrevocable letter of credit. This is the first contract which is the sale of goods contract agreed between buyer and the seller. The buyer approaches its bank (the issuing bank) requesting the opening of an irrevocable letter of credit in favour of the Brazilian seller. By filling in the letter of credit application form and accepting its terms, the American buyer enters into a contract with the bank by which the buyer agrees to reimburse the bank when the bank pays the seller. The bank, if accepting the application, agrees to issue a letter of credit and pay the seller when presented with specified documents. This is the second contract. The third contract exists when the bank issues the letter of credit in favour of the beneficiary, the Brazilian seller, promising to make payment against conforming documents.

Therefore, in this scenario, there are three contracts. The first is the sale of goods contract. This contract, which is between the Brazilian seller and the American buyer, deals with the issues of quality and quantity of the goods,

[560] G McLaughlin, 'Exploring Boundaries: A Legal and Structural Analysis of the Independence Principle of Letter of Credit Law' (2002) 119 Banking LJ 501 at 506.

the price of the goods, the place of delivery, warrantees, and other issues of a mercantile nature. The second contract is the one between the American buyer and the bank in which the buyer agrees to be bound to the terms of the letter of credit application, including the reimbursement of the bank; and the bank agrees to issue the credit in favour of the Brazilian seller. The third contract is the letter of credit itself, which does not deal with the goods but whose primary concern is the documents and the compliance of the documents with the terms of the credit. The main function then of the autonomy principle is to isolate the third contract, the letter of credit, from the other contracts in the transaction.

When the Brazilian seller ships the coffee and presents conforming documents requesting the bank to make payment under the credit, the American buyer learns that the seller shipped an inferior quality of coffee different from the quality contracted for. The buyer informs the bank that it has substantial evidence to support the fact that the seller shipped an inferior quality of coffee and requests the bank to reject the seller's presentation for payment.

What the seller did, if it can be proven, is a breach of the warranty of quality in the sale of goods contract; however, based on the autonomy principle, which isolates the letter of credit from the underlying sale of goods contract, the bank cannot refuse making payment when presented with conforming documents, and hence, the bank should honour its obligations under the credit regardless of the breach of warranty. The American seller, however, is able to bring an action against the Brazilian

seller under the sale of goods contract, and this kind of dispute would be treated separately from the letter of credit obligations.

Second Scenario

This scenario addresses the impact of the autonomy principle in isolating the letter of credit from the contract between the buyer and the issuing bank. To use the above characters again, the Brazilian seller shipped the coffee and presented conforming documents to the bank for payment. However, it came to the bank's knowledge that the American buyer is facing a financial crisis and it is most likely that the buyer will not be able to reimburse the bank or can only do so after a substantial delay. The implication of the autonomy principle here means that the bank cannot refuse payment under the credit because of the insolvency of the buyer, and thus, the bank has to fulfil its obligations regardless of the financial status of the buyer.

Third Scenario

In the first scenario, the Brazilian seller in order to obtain its money had to present conforming documents to the issuing bank. However, in this scenario, the Brazilian seller stipulates the involvement of a confirming bank in the credit transaction. This arrangement means that the documents are to be presented to and payment is to be obtained through this confirming bank. In credit transactions, the involvement of a confirming bank, which is located in the seller's own country, will ensure a more secure and a faster means of payment. Moreover, in case of disputes, the

Brazilian seller does not have to struggle with a foreign bank, but can deal with a local Brazilian bank.

The transaction in this scenario creates two new contracts. The first contract is the one between the issuing bank and the confirming bank in which the issuing bank undertakes to reimburse the confirming bank when the later advances payment to the Brazilian seller under the credit. The second contract is the contract between the confirming bank and the seller. In this contract, the confirming bank becomes under an obligation to honour the Brazilian seller's draw when presented with conforming documents.

In this scenario, the American buyer learns that the Brazilian seller has shipped an inferior quality of coffee and then approaches the confirming bank in an attempt to persuade it not to pay the seller because of the breach of the warranty in the sale of goods contract. Does the autonomy principle protect the confirmer against disputes that may arise from other transactions, specially, the sale of goods contract?

The UCP in its 500 and 600 revisions does not address this question. In addition, the UCC in Section 5-103 (d) does not mention the confirmer at all. It asserts that "[r]ights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary".[561] However, the official comments to UCC

[561] UCC Section 5-103 (d).

Section 5-107 extend the language of the code to also cover the confirmer wherever the code applies to the issuer. The official comments pointed out that "the terms 'confirmer' and 'confirmation' should be read into [Article 5] wherever the terms 'issuer' and 'letter of credit' appear".[562] Therefore, if the terms 'issuer' and 'letter of credit' in UCC Section 5-103 (d) are replaced with the terms 'confirmer' and 'confirmation', the text would read as follows:

"[r]ights and obligations of a confirmer to a beneficiary or a nominated person under a confirmation are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the confirmation arises or which underlies it...".

Based on this understanding of the language of the UCC, the arm of the autonomy principle should be expanded to protect the confirmer from any disputes arising between the seller and the buyer, thus, if the seller presents strictly complying documents, the confirmer is under an obligation to honour the seller's draw despite any disputes between the seller and the buyer. On the same token, the issuer is under an obligation to reimburse the confirmer regardless of any disputes between the parties.

As a result of this analysis, based on the autonomy principle, the American buyer cannot restrain the confirming bank from honouring its obligation because of the Brazilian seller's breach of the underlying sale of goods contract.

[562] Official comment 1 to UCC Section 5-107.

The Fraud Exception[563]

While the autonomy of the letter of credit is an essential feature of letter of credit transactions, this principle is not free from limitations.[564] An

[563] For Fraud Exception, see L D'Arcy, C Murray and Barbara, Schmitthoff's Export Trade, The Law and Practice of International Trade (Tenth edn, Sweet & Maxwell, London 2000) 210, A Mugasha, Letters of Credit and Bank Guarantees (The Federation Press, Sydney 2003) 137, J Dolan, The Law of Letters of Credit, Commercial and Standby Credits (Warren, Gorham & Lamont, 1996) 3-178, R Goode, Commercial Law (Third edn, Penguin Books, London 2004) 991, P Gillies and G Moens, International Trade and Business: Law, Policy and Ethics (Cavendish Publishing, Australia 1998) 412, M Bridge, The International Sale of Goods (Second edn, Oxford University Press, New York, USA 2007) 302, R Jack, A Malek and D Quest, Documentary Credits (Third edn, Butterworths, UK 2001) 287, M Kurkela, Letters of Credit and Bank Guarantees Under International Trade Law (Oxford University Press, New York, USA 2007) 173, X Gao, The Fraud Rule in the Law of Letters of Credit, A Comparative Study (Kluwer Law International, Netherlands 2002), R Buckley and X Gao, 'The Development of the Fruad Rule in Letter of Credit Law: The Journey So Far and the Road Ahead' (2002) 23 U Pa J Int'l Econ L 663, R Ryan, 'U.C.C. Article 5 Symposium: Who Should Be Immune From the "Fraud in the Transaction" Defense in a Letter of Credit'[1990] 56 Brooklyn L Rev 119, J Dolan, 'Letters of Credit: A Comparison of UCP 500 and the New U.S. Article 5'[1999] JBL 521, M Blodgett and D Mayer, 'International Letters of Credit: Arbitral Alternatives to Litigating Fraud' (1998) 35 Am Bus LJ 443, G McLaughlin, 'Letters of Credit and Illegal Contracts: The Limits of the Independence Principle' (1989) 49 Ohio St LJ 1197, D Howard, 'The Application of Compulsory Joinder, Intervention, Impleader and Attachment to Letter of Credit Litigation' (1984) 52 Fordham L Rev 957, G McLaughlin, 'Exploring Boundaries: A Legal and Structural Analysis of the Independence Principle of Letter of Credit Law' (2002) 119 Banking LJ 501, EP Ellinger, 'The Autonomy of Letters of Credit After the American Accord' (1983) 11 ABLR 118, LC Cansler, 'International Letters of Credit - The American Accord Case - Fraud Exception Limited' (1982) 17 Tex Int'l LJ 229, R Goode, 'Reflections on Letters of Credit - I'[1980] JBL 291, R Bulger, 'Letters of Credit: A Question of Honor' (1984) 16 NYUJ INt'l L & Pol 799, J Blackman, 'Letters of Credit and Bankers' Acceptances, Judicial Intervention' (1988) 450 PLI/Comm 559, R D'Ascenzo, 'The Supreme Court of Ohio's Decision in Mid-America Tire, INC. v. PTZ Trading LTD., and the Weakening of the Independence' (2004) 32 Cap UL Rev 1097, R Rendell, 'Fraud and Injunctive Relief' (1990) 56 Brook L Rev 111, J Lah, 'Mid-America Tire, INC. v. PTZ Trading LTD.' (2003) 29 Ohio NUL Rev 749, G Smith, 'Irrevocable Letters of Credit and Third Party Fraud: The American Accord' (1983) 24 Va J Int'l L 55, , 'Fraud in the Transaction: Enjoining Letters of Credit During the Iraninan Revolution' (1980) 93 Harv L Rev 992S Leacock, 'Fraud in the International Transaction: Enjoining Payment of Letters of Credit in International Transactions' (1984) 17 Vand J Transnat'l L 885, X Gao, 'The Fraud Rule in Law of Letters of Credit in the P.R.C.' (2007) 41 Int'l Law 1067, S Paterson and A Johnson, 'Fraud and documentary credits' [2001] JIBL 37, R Hooley, 'Fraud and Letters of Credit Part 2' (2003) 4 JIBFL 132, M Williams, 'Documentary Credits and Fraud: English and Chinese Law Compared '[2004] JBL 155, Y Demir-Araz, 'International Trade, Maritime Fraud and Documentary Credits'[2002] Int TLR 128, EP Ellinger, 'Developments in Banking Law'[2000] JBL 618, Montague and T Goddard, 'In Practice - Letters of Credit - Some Recent Decisions on Fraud, Injunctions and Construction' (1999) 1 (5) Finance and Credit Law, C Proctor, 'Confirmed Letters of Credit - A New Twist' (2000) 4 JIBFL 109, J Ulph, 'The UCP 600: Documentary Credits in the 21st Century' [2007] JBL 355, R Hooley, 'Fraud and Letters of Credit Part 1' (2003) 3 JIBFL 91 & C Johnson, 'Letter of Credit: Fraud Exception/Rule of Documentary Compliance'[1987] JIBL 52.

[564] There are several exceptions to the Autonomy Principle, but fraud is the most important exception. Nullity (or non-existence of the underlying contract), illegality (or

important limitation to the autonomy principle is the fraud exception[565], which despite the fact that it is not mentioned in the UCP; it is well recognised in common law and also by the UCC.

UCC Article 5 Section 5-109 tackles the issue of fraud by providing that:

"(a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant:

1- the issuer shall honor the presentation, if honor is demanded by

i. a nominated person who has given value in good faith and without notice of forgery or material fraud,

ii. a confirmer who has honored its confirmation in good faith,

iii. a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or

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violation of public policy), and insolvency of the issuing bank or the beneficiary are examples of such exceptions. For more on these exceptions, see: A Mugasha, Letters of Credit and Bank Guarantees (The Federation Press, Sydney 2003) 183-195, M Kurkela, Letters of Credit and Bank Guarantees Under International Trade Law (Oxford University Press, New York, USA 2007) 198-206.

[565] Jack mentioned four situations where fraud or the allegation of fraud affects the credit transaction: "(1) Where documents have been presented but the paying bank has refused to pay, and is being sued by the beneficiary/ seller and is resisting payment on the ground of fraud. (2) Where the paying bank has not yet paid and the applicant for the credit desires to prevent it paying, or to prevent the beneficiary / seller from presenting documents, because the applicant believes that the beneficiary / seller is fraudulent. (3) Where the paying bank has paid but the applicant is resisting reimbursement on the ground that the bank should not have paid because of fraud. (4) Where the paying bank has paid and recovery of the payment is sought by it from the beneficiary/seller on the ground that the presentation of documents involved fraud". R Jack, A Malek and D Quest, Documentary Credits (Third edn, Butterworths, UK 2001) 257.

iv. an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; and

2- the issuer, acting in good faith, may honor or dishonor the presentation in any other case". [566]

The leading case on the fraud exception is Sztejn v. J. Henry Schroder Banking Corporation.[567] In this case, the plaintiff entered into an agreement to purchase a specified quantity of bristles from Transea, an Indian seller. In order to pay for the goods, J. Henry Schroder Banking Corporation, upon the plaintiff's request, issued an irrevocable letter of credit in favour of Transea. Instead of sending the described bristles, the seller has shipped cowhair, rubbish and worthless goods and presented fraudulent documents to the Chartered Bank at Cawnpore, India. Along with the documents, the seller submitted a draft, which the seller drew under the credit to the order of the Chartered Bank. Upon receiving the documents, the Chartered Bank delivered them and the draft to Schroder Bank (the issuing bank). The plaintiff filed a lawsuit attempting to restrain the bank from making payment.

First, the court acknowledged the establishment and the importance of the independence of the letter of credit from the underlying sale contract. It also emphasised that the bank should only be concerned with documents and "[i]t would be a most unfortunate interference with business transactions if a bank before honouring drafts drawn upon it was obliged or

[566] UCC Section 5-109.
[567] Sztejn v. J. Henry Schroder Banking Corporation, (1941) 31 NYS 2d 631.

even allowed to go behind the documents, at the request of the buyer and enter into controversies between the buyer and the seller regarding the quality of the merchandise shipped."[568] However, the court asserted that this principle cannot be utilised to protect a fraudulent seller. The court thus established the fraud exception when it declared that "where the seller's fraud has been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller".[569]

The court further denied the bank's claim that Chartered Bank was a holder of the draft in a due course and insisted that it was "a mere agent for collection for the account of the seller charged with fraud". Therefore, the Chartered Bank was not protected against the fraud allegations.[570]

Fraud Exception and the United City Merchants

In the UK, the case of United City Merchants v. Royal Bank of Canada[571] is the keystone in the fraud exception. Due to the importance of this case in shaping the fraud rules in the UK, considerable attention is given to this case.

The Facts

In this case, Glass Fibres, an English company entered into a contractual relationship with Vitrorefuerzos SA (Vitro), a Peruvian company involved in the business of manufacturing glass fibres. The parties agreed that Glass Fibres would sell Vitro equipment needed for the production of glass

[568] Sztejn v. J. Henry Schroder Banking Corporation, (1941) 31 NYS 2d 631 at 633.
[569] (1941) 31 NYS 2d 631 at 634.
[570] (1941) 31 NYS 2d 631 at 635.
[571] United City Merchants Ltd v. Royal Bank of Canada [1983] 1 A.C 168 (HL).

fibres. The equipment was to be paid for by an irrevocable letter of credit which Vitro managed to arrange with Banco, a Peruvian bank. On March 30, 1976, Glass Fibres was notified of the opening of an irrevocable letter of credit by the Royal Bank of Canada through its branch in London.[572]

On July 22, 1976, Glass Fibres assigned to United City Merchants "their rights, entitlements and benefits due under the letter of credit" and the bank was informed of such assignment. Glass Fibres temporarily stored the goods at Beck & Pollitzer, which was instructed by Glass Fibres to deliver the goods whenever M.C.K. Freight Ltd., the freight forwarding agent for Glass Fibres, acquired them.[573] On Dec. 2, Glass Fibres sent a letter to Mr. Nancollis who worked for M.C.K. telling him about the terms the bill of lading had to comply with, including the requirement that the goods had to be on board on or before Oct 15. By sending a telex, Mr. Nacoliss passed these instructions to Mr. Baker, an employee of E.H. Mundy & Co. (Freight Agencies) Ltd., which was the loading brokers for Prudential Lines, the carriers. The bill of lading then was prepared by Baker.[574] On Dec. 9, the goods reached the United States Lines' quay at Felixstwoe. The goods were loaded on board the American Accord, a vessel of the United States Lines, on Dec. 16. Instead of stating the true date on the bill of lading as Dec. 16, Baker, without the seller's knowledge, altered the date to read Dec. 15 to meet the bill of lading requirement. When presented with the documents, the bank rejected them for a number of reasons. The most material one was the false statement of the date of the bill of lading. The plaintiffs sued the bank for wrongfully dishonouring the presentation.

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[572] United City Merchants Ltd v. Royal Bank of Canada [1979] 1 Lloyd's Rep 267 at 269.
[573] [1979] 1 Lloyd's Rep 267 at 270.
[574] [1979] 1 Lloyd's Rep 267 at 269.

The Trial Court[575]

After citing several cases along with the UCP, the trial court maintained that both the principle of autonomy and the fraud exception are well established in English law. The court asserted that "[t]he above short summary of some of the more important English cases suggests that where the documents tendered comply with the requirements of the letter of credit [,] the bank has no option but to pay except in the case of fraud". Branding what Baker did as fraud and "false representation", the trial judge held that Baker altered the date with the knowledge that "the correct date was a matter of importance in relation to a letter of credit". However, the court expressed the view that neither Baker nor his company was acting on behalf of the beneficiary; hence, the beneficiary did not perpetrate fraud in presenting the bills of lading. The court, therefore, concluded that the plaintiffs were 'entitled to succeed'.[576]

The trial court distinguished this case from Sztejn v. Schroder,[577] which was approved by the Court of Appeal in Edward Owen v. Barclays Bankcase,[578] as in Sztejn the fraud was committed by the seller while in this case the seller has no knowledge of the fraud.

Court of Appeal[579]

The Court of Appeal disagreed with the trial court and found that the bank was correct in refusing to honour the credit. Opposing the view of distinguishing fraud committed without the beneficiary's knowledge from

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[575] United City Merchants Ltd v. Royal Bank of Canada [1979] 1 Lloyd's Rep 267 at 269.
[576] [1979] 1 Lloyd's Rep 267 at 278.
[577] Sztejn v. J. Henry Schroder Banking Corporation, (1941) 31 NYS 2d 631.
[578] Edward Owen Engineering Ltd v. Barclays Bank [1978] 1 All ER 976.
[579] United City Merchants Ltd v. Royal Bank of Canada [1981] 1 Lloyd's Rep 604 (Court of Appeal).

fraud committed by the beneficiary or with the beneficiary's knowledge, Stephenson LJ asserted that "[i]f a document false in the sense that it is forged by a person other than the beneficiary can entitle a bank to refuse payment, I see no reason why a document in any way false to the knowledge of a person other than the beneficiary should not have the same effect."[580] He added that in circumstances where fraud is known to the bank, the bank should not accept the document. In this situation, "the bank owes no duty to the beneficiary to pay and.....owes a duty to the customer not to pay."[581] In his opinion, it does not matter "whether the falsity of the document amounts to clearly established fraud or only points to fraud". In addition, it does not matter "whether a bank is bound to its customer to refuse payment or only entitled to refuse payment". [582]

Ackner LJ also backed the bank's position saying that when "the bank knows that a bill of lading has been fraudulently completed by a third party, it must treat that as a nonconforming document in the same way as if it knew that the seller was party to the fraud."[583] Warning that the bank's financial security would be at jeopardy if the bank were forced to accept false documents, Ackner LJ states "[a] banker cannot be compelled to honour a credit unless all the conditions precedent have been performed, and he ought to not to be under an obligation to accept or pay against documents which he knows to be waste paper. To hold otherwise would be to deprive the banker of that security for his advances, which is a cardinal

[580] [1981] 1 Lloyd's Rep 604 (Court of Appeal) at 623.
[581] [1981] 1 Lloyd's Rep 604 (Court of Appeal) at 623.
[582] [1981] 1 Lloyd's Rep 604 (Court of Appeal) at 623.
[583] [1981] 1 Lloyd's Rep 604 (Court of Appeal) at 628.

feature of the process of financing carried out by means of the credit."[584] Ackner LJ highlighted also that a forged document is not acceptable because it is not valid. He asserted that "the buyer, unless otherwise agreed, cannot be deemed to have authorised the banker to pay against documents which are known to be forged....If the documents are forged, then obviously they are not valid. The buyer's instructions to the banker must be construed as requiring the acceptance of valid documents only, and the banker's promise to the seller must be similarly construed".[585] Ackner LJ further argued that it is the bank's duty to honour its obligations when it is presented with conforming documents, believing that these documents are genuine. However, the bank cannot pay against a document the bank knows it is not genuine even if that document appears to be conforming. A document that is not genuine should be considered as a non-conforming document regardless of its origin. He stated that "The banker's authority or mandate is to pay against genuine documents and that is what the bank has undertaken to do. It is the character of the document, not its origin, that must decide whether or not it is a "conforming" document, that is a document which complies with the terms of the credit".[586]

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[584] United City Merchants Ltd v. Royal Bank of Canada [1981] 1 Lloyd's Rep 604 (Court of Appeal) at 628.
[585] [1981] 1 Lloyd's Rep 604 (Court of Appeal) at 628.
[586] United City Merchants Ltd v. Royal Bank of Canada [1981] 1 Lloyd's Rep 604 (Court of Appeal) at 628. On the same grounds, Griffiths L.J. arguably asked "[w]as the bank wrong to refuse payment in these circumstances?" He then replied by explaining that "[i]t seems to me that it would be a strange rule that required a bank to refuse payment if the document correctly showed the date of shipment as Dec. 16, yet obliged the bank to make payment if it knew that the document falsely showed the date of shipment as Dec. 15 and that the true date was Dec 16". Griffiths L.J. also pointed out that these documents are very critical for the security of the bank's funds and therefore the bank should not accept forged document. He said "[w]hat is the position if the bank is presented with documents that appear on their face to be in order but which the bank knows to be forgeries? The

House of Lords

The case was then pursued in the House of Lords, which reversed the decision of the Court of Appeal and found for the beneficiary. The decision of the House of Lords was delivered by Lord Diplock, who began his opinion by referring to the principle of autonomy and describing the separate, though related, contracts that involve in the whole transaction of the letter of credit. Lord Diplock stated:

"It is trite law that there are four autonomous though interconnected contractual relationships involved. (1) The underlying contract for the sale of goods, to which the only parties are the buyer and the seller; (2) the contract between the buyer and the issuing bank under which the latter agrees to issue the credit and either itself or through a confirming bank...(3) if payment to be made through a confirming bank the contract between the issuing and confirming bank...and (4) the contract between the confirming bank and the seller.....Again, it is trite law that in contract (4), with which alone the instant appeal is directly concerned, the parties to it, the seller and the confirming bank, "deal in documents and not in goods," as Article 8 of the Uniform Customs [and Practice for Documentary Credits (1974)] puts it". [587]

Then, Lord Diplock outlined the limitation of this principle by the fraud exception saying, "[t]o this general statement of principle.....there is one established exception: that is, where the seller, for the purpose of drawing

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bank takes the documents as its security for payment. It is not obliged to take worthless documents. If the bank knows that the documents are forgeries it must refuse to accept them". United City Merchants Ltd v. Royal Bank of Canada [1981] 1 Lloyd's Rep 604 (Court of Appeal) at 632.

[587] United City Merchants Ltd v. Royal Bank of Canada [1983] 1 A.C 168 (HL) at 182-183.

on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material misrepresentations of fact that to his knowledge are untrue." [588]

However, Lord Diplock rejected the Court of Appeal's opinion that the change of date undermined the validity of the document. He took the view that "[t]he bill of lading with the wrong date of loading placed on it by the carrier's agent was far from being a nullity. It was a valid transferable receipt for the goods giving the holder a right to claim them at their destination, Callao, and was evidence of the terms of the contract under which they were being carried."[589] Lord Diplock also held that the seller has no knowledge of the fraud; therefore the fraud exception did not apply in this case. [590]

Criticisms of the House of Lords' Decision

The decision of the House of Lords has met with several criticisms. The following is a discussion of those criticisms.

One of the criticisms is that the House of Lords failed to explain why the agent of the shipping company was not an agent of the seller. According to this criticism, the House of Lords' opinion would lead to a disturbing consequence of obliging the bank to pay against conforming documents even if the bank knows that the agent had replaced the goods with rubbish and that would undermine the fraud exception. This criticism suggests that

[588] [1983] 1 A.C 168 (HL) at 183.
[589] [1983] 1 A.C 168 (HL) at 188.
[590] [1983] 1 A.C 168 (HL) at 188.

the agent of the shipping company is also an agent of the seller and the seller should be held responsible for the action of that agent.[591]

Another criticism looks at which of the two parties, namely, the seller and the buyer has a much closer attachment to the person who committed the fraud. It is obvious that the seller has a much closer connection to the shipping agent. Accordingly, although both parties were innocent, if any of these parties has to bear the harm, the seller was the party that should sustain the loss rather than the buyer. According to this criticism, it is odd to make the buyer the party who should be sacrificed, while allowing the party that is more closely attached to the shipping agent to escape, simply because the seller was not aware of the fraud.[592] Therefore, "to say that the beneficiary has a right to payment against even forged documents if he is not party to the forgery finds no justification in the terms of the letter of credit or in the provisions of the UCP and has the effect of extending to beneficiaries the benefit of a rule designed exclusively to safeguard the banks".[593]

A third criticism is that allowing the seller to escape the liability of fraud committed by a third party would provide a fraudulent seller an opportunity to take advantage of this rule by arranging a fraud with a third party and making it appear as if it happened without the seller's knowledge.[594]

Fourth, the House of Lords overlooked the principle of strict compliance. This principle dictates that all the conditions of the credit have to be

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[591] D Zacks, 'The American Accord'[1986] Int'l Bank L 166 at 176.
[592] [1986] Int'l Bank L 166 at 176.
[593] R Goode, Commercial Law (Third edn, Penguin Books, London 2004) 996.
[594] X Gao, The Fraud Rule in the Law of Letters of Credit, A Comparative Study (Kluwer Law International, Netherlands 2002) 133.

strictly complied with before the seller is entitled to be paid.[595] Had the House of Lords considered this principle, it would have found that the seller was not entitled to be paid because one of the credit conditions had not been met. The credit specified that the goods should be on board the ship on or before 15 Dec. but that boarding did not happen until the 16 Dec. This inconformity should entitle the bank to dishonour the presentation. The decision of the House of Lords is inconsistent with this principle, and according to this criticism "[i]t is disturbing that whilst a document stating the true loading date could have been rejected by the bank in light of the doctrine of strict compliance, a document in which the loading date was fraudulently misrepresented by its maker constituted a valid tender in the beneficiary's hands".[596] It is also argued that "[t]he House of Lords decision leaves banks in an anomalous position. Under a documentary credit, a confirming bank has a duty to honour conforming documents. After American Accord, banks must honour a credit and accept fraudulently completed documents, unless they were fraudulently completed by the seller-beneficiary".[597]

The fifth criticism is that an important purpose the letter of credit mechanism meant to furnish is to reduce the international trade risks by allocating each risk to the party that is most capable of dealing with it. Although in most cases the parties that engage in the letter of credit transaction are aware of the risks that associated with this kind of

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[595] The Principle of Strict Compliance has been examined in the previous chapter.
[596] AG Guest (editor), Benjamin's Sale of goods (Seventh edn, Sweet & Maxwell, London 2006) 1715.
[597] L.C. Cansler, 'International Letters of Credit – The American Accord Case – Fraud Exception Limited' (1982) 17 Texas Int'l LJ 229, 240).

transaction, it is not at all acceptable to legally force a party to accept the risk of taking fraudulent documents.[598]

Finally, the sixth criticism is that what matters the most in letters of credit transactions, which was compromised by the House of Lords' decision, is the genuineness of the documents, not their origin or the identity of the perpetrator. The parties here are dealing with documents so it is very critical that the documents be genuine regardless of their origin.[599] That is why Article 4 of UCP insists that "all parties concerned deal with documents, and not with goods, services or performances to which the documents may relate."[600] It is also argued that "a forged document is a nullity or, at least, is not genuine regardless of the identity of the perpetrator of the forgery, and the issuer ought not to pay once it becomes aware of the forgery. Whether the beneficiary is not a party to the fraud or acts in good faith is irrelevant; it is not entitled to payment if it tenders noncomplying (forged) documents".[601] Moreover, several old cases, English as well as American, have emphasised that the documents being genuine should be the decisive point in letter of credit transactions. In Old Colony Trust Co v. Lawyers' Title and Bank Trust Co[602] the American court held that the bank was right in its refusal to honour a warehouse receipt which was fraudulent, stating:

"when the issuer of a letter of credit knows that a document, though correct in form, is, in point of fact, false or illegal, he cannot be called upon to

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[598] Goode, 'Reflections on Letters of Credit – I' [1980] JBL 291 at 294.
[599] X Gao, The Fraud Rule in the Law of Letters of Credit, A Comparative Study (Kluwer Law International, Netherlands 2002) 129.
[600] UCP 500 Article 4.
[601] A Mugasha, Letters of Credit and Bank Guarantees (The Federation Press, Sydney 2003) 146.
[602] Old Colony Trust Co v. Lawyers' Title and Bank Trust Co (1924) 297 F 152.

recognise such a document as complying with the terms of a letter of credit".[603] In addition, the American court in Maurice O'Meara Co v. National Park Bank[604] stated that "the bank's obligation was to pay sight drafts when prescribed if accompanied by genuine documents specified in the letter of credit".[605] Emphasising the same concept, the court in Sztejn v. J. Henry Schroder Banking Corporation[606] asserted that "the application of this doctrine presupposes that the documents accompanying the draft are genuine and conform in terms to the requirements of a letter of credit".[607] Similarly, the English court in Edward Owen Engineering Ltd v. Barclays Bank[608] maintained that the bank has no right to honour the presentation when it knows that the documents are not genuine or there is a fraudulent request for the money. The court stated that "the bank ought not to pay under the credit if it knows the documents are forged or that the request for payment is made fraudulently in circumstances when there is no right to payment."[609] On the same grounds, the court in Etablissment Esefka International Anstall v. Central Bank of Nigeria[610] established that the bank would have a good defence against any liability that arises as a consequence of fraudulent documents. The court declared "[t]he document ought to be correct and valid in respect of each parcel. If that condition is broken by forged or fraudulent documents being presented in respect of

[603] (1924) 297 F 152 at 158.
[604] Maurice O'Meara Co v. National Park Bank, (1925) 146 NE 636.
[605] (1925) 146 NE 636 at 639.
[606] Sztejn v. J. Henry Schroder Banking Corporation, (1941) 31 NYS 2d 631.
[607] (1941) 31 NYS 2d 631 at 634.
[608] Edward Owen Engineering Ltd v. Barclays Bank [1978] 1 All ER 976.
[609] Edward Owen Engineering Ltd v. Barclays Bank [1978] 1 All ER 976 at 982.
[610] Etablissment Esefka International Anstall v. Central Bank of Nigeria [1979] 1 Lloyd's Rep 445.

any parcel – the defendant [the bank] have a defence in point of law against being liable in respect of that parcel".[611]

According to this last criticism, all the above cases serve to convey the message that what it matters the most is the documents being genuine. The House of Lords weighed the notion of the fraud being perpetrated without the beneficiary's knowledge on the account of a much more important concept, namely, the genuineness of the documents. Letters of credit will not be able to maintain their purpose unless the documents are genuine. Forged or fraudulent documents are useless. Additionally, without genuine documents, the interest of the parties cannot be protected leading to the collapse of an important instrument in financing international trade.[612]

Fraud vs. Forgery

Although the words 'fraud' and 'forgery' are different in their meaning, the courts do not make any distinction in treating them for the purpose of the fraud rule. However, "it has been suggested that a document is false [forgery] if it misrepresents that goods were shipped while none was in fact shipped. On the other hand, a document is fraudulent which correctly describe goods but no goods were actually shipped".[613] Therefore, an example of 'forgery' could be found in the American Accord[614] case where the loading broker altered the shipping date. On the other hand, in the case

[611] [1979] 1 Lloyd's Rep 445 at 447.
[612] X Gao, The Fraud Rule in the Law of Letters of Credit, A Comparative Study (Kluwer Law International, Netherlands 2002) 130-131.
[613] A Mugasha, Letters of Credit and Bank Guarantees (The Federation Press, Sydney 2003) 142.
[614] United City Merchants Ltd v. Royal Bank of Canada [1983] 1 A.C 168.

of Sztejn v j Henry Schroder[615] where the beneficiary shipped worthless goods, that instance might be considered fraud.

When fraud must be established to the bank

This matter is considered through examining two different situations:

The first situation is where the bank has already paid against the documents. The general rule is that if the bank accepted the presentation and paid, the bank is entitled to be reimbursed. Therefore, for a fraud allegation to be considered by the bank, it has to be established before the bank makes payment under the credit. The court in United Trading Corpn SA v Allied Arab Bank Ltd[616] asserts that:

"It seems to us clear that, where payment has in fact been made, the bank's knowledge that the demand made by the beneficiary on the performance bond was fraudulent must exist prior to the actual payment to the beneficiary and that its knowledge at that date must be proved. Accordingly, if all a plaintiff can establish is such knowledge after payment, then he has failed to establish his cause of action. The bank would not have been in breach of any duty in making the payment without the requisite knowledge. We doubt that this is really open to contest".[617]

The second situation is where the bank has not made payment yet and is refusing to make payment on the grounds that there is fraud in the transaction. Later, the bank realised that it was mistaken and the transaction was clean from fraud. The question is if after the payment time has elapsed and new evidence backs up the fraud allegation, can the bank

[615] Sztejn v. J. Henry Schroder Banking Corporation, (1941) 31 NYS 2d 631.
[616] United Trading Corpn SA v Allied Arab Bank Ltd [1985] 2 Lloyd's Rep 554.
[617] United Trading Corpn SA v Allied Arab Bank Ltd [1985] 2 Lloyd's Rep 554 at 560.

then use this evidence at the court to justify the bank's refusal to pay or should the court reject this evidence, reasoning that such evidence should be presented before the payment time elapsed? The court in Balfour Beatty Civil Engineering v Technical & General Guarantee Co Ltd[618] held that relying on such evidence in the bank's defence is not acceptable. However, this decision has been criticised on the grounds that by refusing this established evidence, the court is giving the fraudulent beneficiary a chance to obtain payment and escape fraud. According to this view, the proper rule would be to allow such evidence. The problem with this suggested rule is that "a bank might abuse such a rule by declining payment in a borderline fraud case, taking a chance that further material will come to light before trial. Of course it is then taking a risk with its reputation as well as its liability and it is doubtless for that reason that the reported cases mostly concern attempts by applicants to restrain payment rather than attempts by banks to avoid payment".[619]

The Standard for Fraud: Material Representation

The English courts have adopted a very rigid standard for the fraud exception. As a result, there are very few cases where the fraud exception has been applied as it is very difficult to establish fraud. In an attempt to set forth a standard for fraud, the court in United City Merchants (Investments) Ltd v. Royal Bank of Canada stated:

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[618] Balfour Beatty Civil Engineering v Technical & General Guarantee Co Ltd (1999) 68 Con LR 180.
[619] R Jack, A Malek and D Quest, Documentary Credits (Third edn, Butterworths, UK 2001) 282.

"To this general statement of principle as to the contractual obligations of the confirming bank to the seller, there is one established exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue". [620]

Explaining the meaning of 'material representation', the court added:

"material to the price of the goods to which the documents relate would fetch on sale if, failing reimbursement by the buyer, the bank should be driven to realise its security..". [621]

Contrary to this court's view regarding 'material representation', Jack provides a different opinion:

"It is suggested that this must be material to the bank's duty to pay, so that if the document stated the truth the bank would be obliged to and entitled to reject the documents."[622] Providing examples of this definition, Jack added "[F]or example, if the bill of lading and invoice in the Sztejn case had stated that the shipment consisted of 'cowhair and rubbish purporting to be bristles', they would not have conformed. And, in the United City Merchants case itself, if the bill of lading had had the correct dated of shipment, it would have been outside the credit period". [623]

Therefore, according to the court's understanding of the meaning of 'material representation', the predating of the bill of lading to meet the credit condition would not be considered material because it does not

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[620] United City Merchants Ltd v. Royal Bank of Canada [1983] 1 A.C 168 (HL) at 183.
[621] [1983] 1 A.C 168 (HL) at 183.
[622] R Jack, A Malek and D Quest, Documentary Credits 266.
[623] R Jack, A Malek and D Quest, Documentary Credits 266.

affect the real value of the goods. However, under the definition provided by Jack, the predating of the bill of lading should be material because if the document had stated the true date, the bank would have been obliged to reject it.[624]

Under the U.S law, if material fraud has been perpetrated by the beneficiary, the issuing bank has the right to honour or dishonour the credit as long as the bank is acting in good faith. UCC Section 5-109 (a) states:

"If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant:

1- the issuer shall honor the presentation, if honor is demanded by...

2- the issuer, acting in good faith, may honor or dishonor the presentation in any other case." [625]

In an attempt to explain the meaning of 'material fraud', the official comments on UCC Section 5-109 express the opinion that "a fraud is material if it is significant to the participant in the underlying transaction."[626] An example of that would be if the seller shipped 5 barrels

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[624] Jack added: "it is not sufficient for the bank merely to prove that there is material which would lead a reasonable banker to infer fraud by the beneficiary. The civil burden of proof is generally proof on the balance of probabilities. But 'the degree depends on the subject matter. A civil court when considering a charge of fraud will naturally require for itself a higher degree of probability than that which it would require when asking if negligence is established." R Jack, A Malek and D Quest, Documentary Credits (Third edn, Butterworths, UK 2001) 273.

[625] UCC Section 5-109 (a).

[626] Official comment 1 to UCC Section 5-109.

instead of 1000, but it would not be material if the seller shipped 999 barrels instead of 1000.[627]

With regard to the beneficiary's intention, neither the UCC nor its official comments provide that the beneficiary's intention has to be proved to activate the fraud exception.

The bank's position with regard to allegations of fraud

In principle, the bank is not required to and should not investigate the allegation of fraud. According to Turkiye Is Bankasi AS v. Bank of China[628] "It is simply not for a bank to make enquiries about the allegations that are being made by one side against the other. If one side wishes to establish that a demand is fraudulent it must put the irrefutable evidence in front of the bank. It must not simply make allegations and expect the bank to check whether those allegations are founded or not".[629] However, where allegation of fraud is brought to the bank's attention, the bank's reaction differs according to the following situations:

1- If there is only an allegation brought in front of the bank without established evidence that fraud has been committed, the bank has to honour the presentation and ignore the fraud allegation.[630] In Discount Records Ltd. v. Barclays Bank Ltd,[631] Megarry LJ asserted:

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[627] Official comment 1 to UCC Section 5-109.
[628] Turkiye Is Bankasi AS v Bank of China [1996] 2 Lloyd's Rep 611.
[629] [1996] 2 Lloyd's Rep 611at 617.
[630] L D'Arcy, C Murray and Barbara, Schmitthoff's Export Trade, The Law and Practice of International Trade (Tenth edn, Sweet & Maxwell, London 2000) 211.
[631] Discount Records Ltd v Barclays Bank Ltd [1975] 1 WLR 315.

"I would be slow to interfere with bankers' irrevocable credits, and not least in the sphere of international banking, unless a sufficiently grave cause is shown".[632]

2- If the bank knows of the fraud but without solid evidence that the seller has knowledge of the fraud, the bank also must make payment.[633]

3- If there is established evidence in front of the bank that fraud has been committed with the seller's knowledge, then the bank is under an obligation not to pay the beneficiary. If the bank in this situation pays, the bank will lose its right for reimbursement.[634] Professor Goode summarises where a bank has a duty to its customer to refuse payment under the credit. According to him, this can be found in the following situations:

"(a) the documents tendered do not on their face conform to the credit,

(b) the person presenting the documents is not the party entitled to payment,

(c) the issue of the letter of credit was induced by fraud or misrepresentation,

(d) there is other established fraud, whether in relation to the credit or the underlying sales transaction,

(e) by the governing law or the law of the place where the credit is due to be honoured, it would be illegal to do so, or

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[632] [1975] 1 WLR 315 at 320. See also Etablissements Esefka International Anstalt v. Central Bank of Nigeria [1979] 1 Lloyd's Rep (Court of Appeal) 455 & Tukan Timber Ltd v. Barclays Bank plc [1987] 1 Llodyd's Rep 171.

[633] United City Merchants Ltd v. Royal Bank of Canada [1983] 1 A.C 168 (HL) & L D'Arcy, C Murray and Barbara, Schmitthoff's Export Trade, The Law and Practice of International Trade (Tenth edn, Sweet & Maxwell, London 2000) 211.

[634] [1983] 1 A.C 168 (HL), L D'Arcy, C Murray and Barbara, Schmitthoff's Export Trade, The Law and Practice of International Trade (Tenth edn, Sweet & Maxwell, London 2000) 211 & R Jack, A Malek and D Quest, Documentary Credits (Third edn, Butterworths, UK 2001) 275.

(f) the credit was issued to support an underlying transaction which to the knowledge of the bank was either unlawful in itself or lawful in the making but entered into for an unlawful purpose". [635]

[635] R Goode, Commercial Law (Third edn, Penguin Books, London 2004) 990.

Injunctions[636]

From a buyer's perspective, the injunction is a device that the buyer can resort to in the situation of fraud. When all attempts to convince the bank of the fraud have failed, the buyer can apply to the court for injunction to restrain the bank from making payment.

From a bank's perspective, the injunction is a protection. The bank, when confronted with a fraud allegation, can request the buyer to apply to the court for an injunction. If the court accepts the application and grants an injunction, this action would keep the bank's reputation intact, as the bank would escape from being the one who made the decision of dishonouring the credit which might harm its financial reputation. On the other hand, if the court refuses to grant an injunction, that action would also provide relief to the bank, namely, the fraud allegation was not accepted by the court, and the court's action thus provides protections to the bank against

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[636] See R Bulger, 'Letters of Credit: A Question of Honor' (1984) 16 NYUJ INt'l L & Pol 799, O Wilson, 'Letters of Credit: Injunctions Against Honor' (1985) 356 PLI/Comm 169, J Blackman, 'Letters of Credit and Bankers' Acceptances, Judicial Intervention' (1988) 450 PLI/Comm 559, R D'Ascenzo, 'The Supreme Court of Ohio's Decision in Mid-America Tire, INC. v. PTZ Trading LTD., and the Weakening of the Independence' (2004) 32 Cap UL Rev 1097, R Rendell, 'Fraud and Injunctive Relief' (1990) 56 Brook L Rev 111, M Blodgett and D Mayer, 'International Letters of Credit: Arbitral Alternatives to Litigating Fraud' (1998) 35 Am Bus LJ 443, J Lah, 'Mid-America Tire, INC. v. PTZ Trading LTD.' (2003) 29 Ohio NUL Rev 749, G Smith, 'Irrevocable Letters of Credit and Third Party Fraud: The American Accord' (1983) 24 Va J Int'l L 55, S Leacock, 'Fraud in the International Transaction: Enjoining Payment of Letters of Credit in International Transactions' (1984) 17 Vand J Transnat'l L 885, 'Fraud in the Transaction: Enjoining Letters of Credit During the Iraninan Revolution' (1980) 93 Harv L Rev 992, R Wasserman, 'Equity Renewed: Preliminary Injunctions to Secure Potential Money Judgments' (1992) 67 Wash L Rev 257, D Laycock, 'The Death of the Irreparable Injury Rule' (1990) 103 Harv L Rev 687, M Williams, 'Documentary Credits and Fraud: English and Chinese Law Compared '[2004] JBL 155, Y Demir-Araz, 'International Trade, Maritime Fraud and Documentary Credits'[2002] Int TLR 128, H Govind, 'India: Principles for Grant of Injunction against Bank Guarantee'[1996] IBFL 10, EP Ellinger, 'Developments in Banking Law'[2000] JBL 618, J Goodliffe, 'Court of Appeal Restrains the Making of a Demand on a Bond'[1995] JIBL 405, D Montague and T Goddard, 'In Practice - Letters of Credit - Some Recent Decisions on Fraud, Injunctions and Construction' (1999) 1 (5) Finance and Credit Law , J Ulph, 'The UCP 600: Documentary Credits in the 21st Century'[2007] JBL 355 & A Mugasha, 'Enjoining the Beneficiary's Claim on a Letter of Credit or Bank Guarantee'[2004] JBL 515.

claims that the bank has wrongfully honoured the beneficiary's presentation.[637]

However, the court in Bolivinter Oil SA v Chase Manhattan Bank[638] warned that injunctions might have harmful consequences not only for the bank but also for the letter of credit itself. The court observed that "by obtaining an injunction restraining the bank from honouring that undertaking, he will undermine what is the bank's greatest asset, however large and rich it may be, namely its reputation for financial and contractual probity. Furthermore, if this happens at all frequently, the value of the irrevocable letters of credit and performance bonds and guarantees will be undermined".[639]

The Tests for Injunction Relief

The court will not grant injunction relief unless the applicant is able to satisfy two conditions, namely, the knowledge of the bank of the fraud, and that there is an established balance of convenience in favour of the injunction.

1- Knowledge of the bank

To succeed in the application for injunction, the applicant has to be able to show to the court that the bank has knowledge of the fraud. In R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd, Kerr LJ maintained:

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[637] R Jack, A Malek and D Quest, Documentary Credits (Third edn, Butterworths, UK 2001) 275.
[638] Bolivinter Oil SA v Chase Manhattan Bank [1984] 1 Lloyd's Rep 251 (Court of Appeal).
[639] [1984] 1 Lloyd's Rep 251 (Court of Appeal) at 256.

"It is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by banks. They are the life-blood of international commerce. Such obligations are regarded as collateral to the underlying rights and obligations between the merchants at either end of the banking chain. Except possibly in [1] clear case of fraud of which [2] the banks have notice, the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration".[640]

In addition, in Bolivinter Oil SA v Chase Manhattan Bank, the court pointed out:

"Judges who are asked, often at short notice and ex parte, to issue an injunction restraining payment by a bank under an irrevocable letter of credit or performance bond or guarantee should ask whether there is any challenge to the validity of the letter, bond or guarantee itself. If there is not or if the challenge is not substantial, prima facie no injunction should be granted and the bank should be left free to honour its contractual obligation, although restrictions may well be imposed upon the freedom of the beneficiary to deal with the money after he has received it.

The wholly exceptional case where an injunction may be granted is where it is proved that the bank knows that any demand for payment already made or which may thereafter be made will clearly be fraudulent. But the evidence must be clear, both as to the fact of fraud and as to the bank's knowledge".[641]

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[640] R.D. Harbottle (Merchantile) Ltd, v. National Westminster Bank Ltd, [1978] QB 146 at 155.

[641] Bolivinter Oil SA v Chase Manhattan Bank [1984] 1 Lloyd's Rep 251 (Court of Appeal) at 257.

2- Balance of convenience[642]

Before the court is willing to grant an injunction, the court has to be convinced that the balance of convenience favours granting the injunction. That means that the remedy which would be otherwise obtained through damages is not going to be sufficient. In addition, the court should be satisfied that the harm that granting the injunction would cause the bank is not going to be greater than the harm the applicant would sustain if the injunction is not granted. The balance of convenience issue was tackled in Harbottle (Mercantile) Ltd v. National Westminster where the court pointed out:

"The plaintiffs then still face what seems to me to be an insuperable difficulty. They are seeking to prevent the bank from paying and debiting their account. It must then follow that if the bank pays and debits the plaintiff's account, it is either entitled to do so or not entitled to do so. To do so would either be in accordance with the bank's contract, then the plaintiffs have no cause of action against the bank and, as it seems to me, no possible basis for an injunction against it. Alternatively, if the threatened payment is in breach of contract...the plaintiffs would have good claims for damages against the bank. In that event the injunctions would be inappropriate, because they interfere with the bank's obligations to the [confirming bank], because they might cause greater damage to the bank than the plaintiffs could pay on their undertaking as to damages and because the plaintiffs would then have an adequate remedy in damages.

[642] See R Jack, A Malek and D Quest, Documentary Credits (Third edn, Butterworths, UK 2001) 293, S Paterson and A Johnson, 'Fraud and documentary credits'[2001] JIBL 37, H Bennett, 'Performance bonds and the principle of autonomy'[1994] JBL 574, P Howcroft, 'Performance bonds - the tide turns against the banks'[1990] JIBL 17 & R Hooley, 'Fraud and Letters of Credit Part 2' (2003) 4 JIBFL 132.

The balance of convenience would in that event be hopelessly weighted against the plaintiffs".[643]

[643] R.D. Harbottle (Merchantile) Ltd. v. National Westminster Bank Ltd, [1978] QB 146 at 155.

Conclusion

For letters of credit to function properly, the adequate application of two fundamental principles; namely, strict compliance and autonomy of the credit, have to be observed. While the principle of strict compliance has been examined in the previous chapter, this chapter tackled the principle of autonomy of the credit, which aims at keeping the credit transaction separate from any other transactions, so the bank would be able to undertake its obligations without interference as one court maintained that "[t]he bankers' promise to pay the seller is wholly independent of the underlying contract of sale between the seller and buyer, or of any contractual dispute that may arise between them."[644] Under this principle, the parties involved in letter of credit transactions are only concerned with the documents and not the goods.

Therefore, based on the autonomy principle, the seller will not be able to stop the bank from honouring the credit for disputes that arise out of the underlying sale of goods contract, such as the seller's shipping of an inferior quality of goods. Moreover, the autonomy principle separates the relationship between the applicant and the bank from the credit. Therefore, the insolvency of the applicant, for example, should not affect the bank's obligations under the credit.

However, the autonomy principle will not function soundly where material fraud has been established as the court in Sztejn v. J. Henry Schroder Banking Corporation said: "where the seller's fraud has been presented for payment, the principle of the independence of the bank's obligation under

[644] [1981] 2 W.L.R. 1233 (Court of Appeal) at 1243.

the letter of credit should not be extended to protect the unscrupulous seller". [645]

To a great extent, the rule of fraud exception has been shaped by the decision of the House of Lords in United City Merchants v. Royal Bank of Canada,[646] despite the criticisms that have been cited against that decision. The standard of fraud set out by the court in United City Merchants is that there should be 'material presentation', defined by the court as: "material to the price of the goods to which the documents relate would fetch on sale if, failing reimbursement by the buyer, the bank should be driven to realise its security...". [647]

The time for establishing fraud is before the bank makes payment; otherwise, allegations of fraud will not be considered. However, a bank's reaction to fraud allegations differs according to the situation. If there is no established evidence of fraud, the bank should accept the presentation and honour the credit. Likewise, if the knowledge of the seller cannot be proved with established evidence, the bank has to accept the presentation and make payment. However, in a situation where there is established evidence that fraud has been perpetrated with the knowledge of the seller, the bank should not make payment.

If the applicant fails in convincing the bank of fraud, the applicant has the choice of applying to the court seeking an injunction to prevent the bank from making payment. In addition to the knowledge of the bank of fraud, the applicant would also have to establish to the court that the balance of convenience is in favour of the injunction.

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[645] Sztejn v. J. Henry Schroder Banking Corporation, (1941) 31 NYS 2d 631 at 634.
[646] United City Merchants Ltd v. Royal Bank of Canada [1983] 1 A.C 168 at 183.
[647] [1983] 1 A.C 168 at 183.

Seventh Chapter: The Conclusion

The prohibition of riba is clearly established in the Quran and the Sunnah. Embracing the dominant view that interest is riba, modern Islamic banking aims mainly at providing riba-free financial and banking activities. Therefore, all Islamic financial vehicles are based upon the concepts of partnership, sale or lease.

While mudaraba and musharaka are partnership finance, salam and istisna involve sale finance. In mudaraba, the Islamic bank provides the project fund and the client, the active partner, is in charge of managing the project. In musharaka, the fund for the project is provided by both the bank and the client/partner. The management is usually conducted by the partner. Under salam, there is an advance payment for a product that is going to be available in the future. Istisna is the sale of a manufactured object that is going to be available in the future. The price of the object can be paid at the time of executing the istisna contract or in the future. The Islamic bank also provides ijarah finance in which the bank enters into in a lease contract with the client.

Murabaha, which is a form of sale, is utilised in Islamic banks for financing international trade in conjunction with the letter of credit. The combination of murabaha and letter of credit creates extraordinary relationships between the parties and various kinds of risks that are different than those involved with the conventional letter of credit. The following is a comparison between financing international trade through the murabaha letter of credit and the conventional letter of credit. This comparison will be conducted in light of the two fundamental principles of the letter of credit: strict compliance and the autonomy of the credit with

its fraud exception. This comparison will begin with an outline of the stages that are performed in the murabaha letter of credit and in the conventional letter of credit when financing international trade. Then, the relationships between the parties in both transactions will be examined. Finally, the risks that the parties assume in both transactions will be assessed.

The stages[648]

The first stage of the murabaha letter of credit begins when the customer applies to the bank to finance the purchase of particular goods through murabaha. If the application is approved, the bank and the customer sign a promise-to-purchase agreement. This agreement implies a promise from the bank to carry out the task of purchasing the requested goods from the supplier and selling them to the customer, and also a promise from the customer to purchase the goods from the bank when informed by the bank of the availability of the goods. The bank then attempts to purchase the goods by issuing a letter of credit in favour of the supplier. When the goods are under the bank's ownership, a murabaha sale contract is executed by the bank and the customer. Under such an agreement, the bank sells the goods to the buyer with a profit.

Under the conventional letter of credit transaction, after engaging in a sale contract with an overseas supplier, the customer submits an application to the bank requesting the finance of a sale transaction by means of the letter of credit. Next, the bank issues a letter of credit in favour of the overseas seller. When informed of the opening of the letter of credit, the seller ships

[648] These stages do not include the involvement of the confirming bank as that would make the picture more complicated.

the goods to the buyer/applicant and tenders the required documents to the bank. If the documents are in compliance with the letter of credit, the bank is under obligation to accept the documents and pays the seller/beneficiary. Subsequently, the bank is reimbursed by the buyer.

The relationships between the parties

In the murabaha letter of credit, there is a sale relationship between the customer and the bank, in which the customer is the buyer, and the bank is the seller. While there is no relationship between the customer and the supplier, there are two kinds of relationship between the bank and the supplier. One is the relationship that is created by the issuance of the letter of credit, in which the bank becomes the issuer, and the supplier becomes the beneficiary. The other is the sale of goods relationship, in which, the bank is the buyer, and the supplier is the seller. Therefore, in the murabaha letter of credit, the bank plays several roles; i.e. buyer, seller, and issuer of the credit. The customer plays the role of the buyer and the supplier plays the role of the seller and the beneficiary.

In comparison, under the conventional letter of credit, there is a sale relationship between the customer and the supplier. The customer is the buyer, and the supplier is the seller. In the relationship between the customer and the bank, the customer becomes the applicant and the bank becomes the issuer. Between the bank and the supplier, there is a relationship that is also established as a result of the issuing of a letter of credit, in which the bank is the issuer, and the supplier is the beneficiary.

The risks

These different relationships between the parties in the murabaha letter of credit and in the conventional letter of credit cause different risks that the parties have to bear or attempt to mitigate. The following is an analysis of the various risks associated with both transactions and how the parties may deal with them.

The customer

In both murabaha and conventional letter of credit, the aim of the customer is acquiring goods from an overseas supplier. However, while in the conventional letter of credit, there is a sale of goods contract between the customer and the supplier, in murabaha, there is no relationship that exists between the customer and the supplier. As a result, in the murabaha transaction, if any disputes arise between the customer and the supplier, the customer cannot sue the supplier, since there is no contractual relationship between them. Such a situation becomes even worse for the customer if the Islamic bank adds a clause to its agreement with the customer asserting that the bank is not liable for any damages sustained by the customer as a result of the supplier refusing to sell the goods or delaying in shipping them. Some Islamic banks also stipulate that they are not responsible for any defect found in the goods.

Therefore, the customer is left in a very difficult situation. The customer cannot legally pursue the supplier as there is no privity between the customer and the supplier. Nor can the customer force the bank to deal with the situation because the bank, from the very beginning of the

transaction, avoids being involved in any disputes with the supplier. Thus, the customer may attempt to settle any disputes with the supplier in an unofficial manner. The customer may also seek to persuade the bank, as the party who is in a contractual relationship with the supplier, to sue the supplier or authorise the customer to act on behalf of the bank in dealing with the supplier. In fact, the customer and the bank may consider inserting into their agreement a clause which provides that, in the event of a dispute between the customer and the supplier, the bank will appoint the customer to act on behalf of the bank in resolving such a dispute.

The other risk the customer assumes in the murabaha transaction is the risk that the bank might not conclude the murabaha sale. After signing the promise-to-purchase agreement between the bank and the customer, the next stage is the purchase of the goods by the bank from the overseas supplier. However, the bank may refuse to purchase the goods from the supplier or, after purchasing the goods, may find a more profitable deal and decide not to sell the goods to the customer. Under these circumstances, whether the customer is entitled to damages or not depends on how the promise-to-purchase agreement is perceived. If the promise-to-purchase agreement is considered a binding agreement, then the customer has to be compensated by the bank for any loss incurred because of the bank's refusal to conclude the murabaha sale. If, however, the promise-to-purchase is deemed not to be a binding agreement, the customer will not be entitled to any compensation, since the bank is free to conclude the transaction or not.

In a conventional letter of credit, the customer anticipates the risk that the bank might pay the beneficiary notwithstanding the occurrence of fraud in the transaction. The bank's reaction to fraud allegation in the conventional letter of credit might be different than the bank's reaction to a fraud allegation in the murabaha letter of credit.

Under the letter of credit rules, if an allegation of fraud brought to the bank's attention, the bank would ignore the allegation and make payment as long as there is no established evidence of material fraud. According to the House of Lords in United City Merchant,[649] the bank must pay the beneficiary unless there is established evidence of material fraud and with the knowledge of the beneficiary. Therefore, the bank, in the conventional letter of credit would not consider the issue of fraud unless there is established evidence of material fraud and there is also evidence that the beneficiary is aware of the fraud. If the buyer fails to convince the bank of fraud and cannot prevent the bank from paying the beneficiary under the credit, the buyer might be able to obtain an injunction from the court to stop the bank from making any payment.

However, under the murabaha letter of credit, the bank might act differently. The bank in murabaha letter of credit is the buyer and therefore when the issue of fraud is brought to the bank's attention, the bank before making any payment would attempt to investigate the matter carefully because if it turns out that the bank makes payment while there is material fraud, the bank is the party that would suffer the most. The customer, on the other hand, would not be affected as the customer, who has not

[649] United City Merchants Ltd v. Royal Bank of Canada [1983] 1 A.C 168 (HL) at 183.

purchased the goods yet, will not have to conclude the murabaha contract with the bank where there is fraud in the transaction.

The bank

Under the murabaha transaction, the bank faces the risk that the customer might withdraw from the transaction. In the promise-to-purchase agreement, the customer promises to purchase the goods from the bank when the bank purchases the goods from the supplier. However, when the bank purchases the goods from the supplier, there is a risk that the customer might refuse to conclude the murabaha sale with the bank, in which event the bank will be left with goods that it must then sell to recover its funds. Again, if the promise-to-purchase agreement is based on the view that it is a binding agreement, the bank is entitled to be compensated by the customer for any loss sustained because of the customer's withdrawal. However, if the promise-to-purchase is not a binding agreement, as perceived by some Islamic banks, the bank will not be compensated for any loss.

The other risk is the risk associated with the goods being lost. In the conventional letter of credit, this risk does not exist, as the bank is not concerned with goods but only with documents. However, in the murabaha transaction, as a seller, the bank bears the risk of the goods until the goods are delivered to the customer/buyer. Some Islamic banks mitigate this risk by reducing the time that the goods are in the bank's possession. One way of doing that is to authorise the customer to receive and sell the goods to himself on behalf of the bank. Another way is to appointe the shipper as an

agent to act on behalf of the bank and the customer in receiving the goods and concluding the murabaha sale. Obtaining insurance is also a method that is utilised to deal with the risk of the loss of the goods.

The bank in murabaha transaction also faces the risk that the supplier might ship defective or worthless goods. Under the conventional letter of credit, this risk is borne only by the customer. However, the situation is different in murabaha since the bank is the party that is purchasing the goods from the supplier. To deal with this risk, some Islamic banks insert a clause in the agreement with the customer to protect the bank against this risk, but the effectiveness of this clause is not clear yet.

Under both the murabaha letter of credit and the conventional letter of credit, the bank assumes the risk that it might pay against non-conforming documents. According to the strict compliance principle, if the bank pays against non-conforming documents, the bank is liable to the applicant/buyer. As it has been highlighted in a previous chapter, in Equitable Trust Company,[650] the court held that the bank was not entitled to be reimbursed because the bank paid against non-conforming documents. In that case, the credit required the submission of a certificate signed by experts but the bank accepted a certificate that was signed by only one expert. Therefore, the bank would attempt to examine the documents with reasonable care to avoid paying against non-conforming documents. Nevertheless, the position of the bank with the customer in a murabaha letter of credit transaction is not the same as in a conventional letter of credit transaction. In a conventional letter of credit situation, if the

[650] Equitable Trust Co. of New York v. Dawson Partners Ltd (1927) 27 Ll L Rep 49 (HL).

bank pays against non-conforming documents, the customer may refuse to reimburse the bank or sue the bank for wrongfully honouring the credit. However, in a murabaha letter of credit, the bank is the buyer. The goods are not going to be sold to the customer until they are under the bank's ownership. Therefore, if the goods are not what the customer specified in the application and in the promise-to-purchase agreement, the customer may refuse to conclude the murabaha sale with the bank. To avoid this situation, the bank may be even more careful in examining the documents with the most rigid standard and also more conscientious in inspecting the goods to assure that they meet the customer's specifications. While in conventional letter of credit, when faced with non-conforming documents, the bank may ask the customer for waiver of discrepancies, in murabaha letter of credit, the bank may also be willing to consult the customer before making any decision.

One question that might arise in a murabaha transaction is whether the bank can force the customer to accept goods that differ from those specified by the customer on the grounds that the promise-to-purchase agreement is binding. It is the author's opinion that, even where the promise-to-purchase is binding, the customer would have a legitimate defense that he cannot be forced to accept what he did not agree to in the agreement. The customer in the promise-to-purchase agreement agrees to purchase the specified goods when they are under the bank's ownership. If the bank does not obtain these specified goods, the customer is not obliged to execute a murabaha contract for different goods.

There is also the risk that the bank might refuse to honour a compliant tender of documents. The principle of strict compliance dictates that, if the bank fails to accept complied documents the bank may be liable to the beneficiary. Under the murabaha letter of credit, the likelihood that the bank may reject the documents may be even greater than with the conventional letter of credit, since the bank in the murabaha transaction is the buyer and is therefore concerned not only with the documents but also with the goods. The principle of strict compliance also asserts that the bank should not be concerned with the legal and commercial significance of the documents. While this is manageable under a conventional letter of credit, under the murabaha letter of credit, as the buyer, the bank may be too concerned with the legal and commercial significance of the documents.

The supplier/beneficiary

The supplier/beneficiary is always faced with the risk that the bank might reject his tender under the credit. In light of the lack of an objective standard in examining the documents, this risk might be even greater under the murabaha letter of credit because the bank is expected to apply a very strict standard in examining the documents as the bank is the party who is buying the goods from the supplier.

Therefore, the fact that the bank, in murabaha, is the issuer of the credit and at the same time the buyer of the goods might add more pressure on the beneficiary in preparing the documents under the possibility that the bank might handle the documents too strictly.

According to the principle of autonomy, the credit transaction should be independent from any other transactions, and the parties are dealing with documents and not with goods. However, with the murabaha letter of credit, the bank, being involved in the purchase and the sale of the goods, might find it difficult to comply with this principle. For example, under the conventional letter of credit, if the supplier sends inferior quality goods, the bank would still make payment as long as the supplier provides conforming documents, because the dispute concerns the underlying sale of goods contract and should not, therefore, affect the credit transaction. However, under a murabaha letter of credit, if the supplier ships inferior quality goods, the bank's response may be different. Since the bank is concerned that the customer might refuse to conclude the murabaha sale if the goods do not conform to what the customer had specified, the bank might be inclined to dishonour the supplier/beneficiary's tender.

As a consequence, if the doctrine of autonomy is not applied firmly to separate the two different roles of the bank, suppliers might avoid engaging in transactions that are financed by murabaha.

A possible solution to this problem is to have the letter of credit in a murabaha transaction issued by a bank other than the bank that is involved in the murabaha sale contract with the customer. In such a situation, the stages of the murabaha transaction change slilghtly. The first stage begins as usual with the application by the customer to the bank for a murabaha transaction. The second stage is the signing of the promise-to-purchase agreement by the bank and the customer. The third stage is the issuance of a letter of credit by a different bank in favour of the supplier. Then, when

the goods are under the first bank's ownership, a murabaha contract is conducted between the bank and the customer. Appointing a different bank to act as an issuer of the credit would separate the role of the bank as a buyer/seller in the murabaha transaction from the role of the bank as an issuer of the credit and would, therefore, protect the independence of the credit.

It may be argued that this arrangement might cause a delay to the transaction. For example, if there are discrepancies in the documents, the issuing bank would consult with the buyer, which is the murabaha bank, and the murabaha bank would consult with the customer, which would cause the examination process to take unreasonably long period of time. However, this problem could be overcome by authorising the issuing bank to consult the customer directly and authorising the customer to act on behalf of the murabaha bank in waiving discrepancies.

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