

EXAMINING THE PRACTICE OF THE INTERNATIONAL TRADE IN ISLAMIC FINANCIAL INSTITUTIONS, IN SRILANKA

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Abstract

International trade is an important sector in the economy that has great influence in the countries' economic growth and developments. Islamic financial Institutions as like conventional institutions play vital role to finance for international trade. The modes of financing are different depends on variants services that are included such as financing for exporters, importers and producers. This research has been carried out in order to identify the possible application of Islamic international trade financing by Sri Lankan IFIs. This is a qualitative study whereby the data were collected from both primary and secondary sources. Primary data were collected through direct interview and discussion. Secondary data were gathered from journal articles, other research papers, books, annual reports of banks, and official websites of IFIs LOLC AL-Falah and PLC Al-Safa. Kalmunai branches of both IFIs were selected as sample of this study. The operational procedures and Shari'ah contracts involved in the processes of international trade are identified. Further, the study has found some challenges in the practice and the recommendation are provided to rectify those issues.

Keyword: International trade, export, import, LC (Letter of Credit), challenges

Introduction

Trade plays an important role in the economy. Started many thousand year ago as a barter exchange, where one thing was exchanged into another, trade now is a vital element of our societies. With current development of economy and technology trade has evolved into a very unique system whereby people and companies do trading domestically and internationally. The trade volume has become so large that companies are unable to support their own operations. That is why they are looking for ways to finance the trade. This is where the banks start playing an important role. Islamic banks which operates to provide compliant financial solutions offer financing for local and international trade. Sri Lanka is also one of the non-Islamic state which enables the establishment of Islamic banks and Islamic financial institutions (IFIs). There are more than fifteen IFIs operate in Sri Lanka inclusive of fully fledged IFIs and the Islamic windows under conventional financial institutions (IFN News. 2016). All IFIs provide financial facilities for international trade as like conventional banks do. However, the contract and

procedures should be different between conventional and IFIs whereby IFIs have strictly follow the rules in all transactions. Therefore, this paper is to discuss the processes of international trade in IFIs.

Research problem

Islam as way of life has given clear guidance in every aspects of life. For the economic life of the human being Islam has encouraged the trade and business. The prophet (PBUH) also was a good trader and has given many examples and paths to do business. Scholars in the field of Fiqh al Muamalah has identified the detail set of rules and regulations for the trade. However, due to expansion of business environment and the application of modern financing techniques especially in the international trade, it is important to elaborate how Islamic banks are deal with international trade. This issue has been taken as research problem for this study.

Research objectives

This paper aims to discuss the following objectives:

- To explain procedures of international trade in Islamic banking in Sri Lanka.
- To identify the contract and sub contract in international trade financing in IFIs.
- To identify the challenges faced by Islamic banking in Sri Lanka while practicing the International trade.

Research questions

Based on the above objectives the following research questions are developed:

1. What are procedures of international trade in Islamic banking in Sri Lanka?
2. What are the contracts and sub contracts used in international trade?
3. What are the challenges faced by Islamic banking in Sri Lanka while practicing the international trade?

Methodology

This is a field based research to explore the processes of International trade in IFIs in Sri Lanka and to identify the issues and challenges. As an exploratory study, the researchers have applied the qualitative research method. The data collected for this study are both primary and secondary sources. Primary data were collected through direct interview and discussion. Secondary data were gathered from journal articles, other research papers, books, annual reports of banks, and official websites if IFIs.

‘LOLC AL-Falah’ which is an Islamic window of non-state LOLC group and People’s leasing AL-Safa which is an Islamic window of state leasing company were selected as sample for this study to represent IFIs in both private and government sectors.

Literature review

International trade is a trade agreement where import or export are take place. All the nations involve in this type of trading activity. It helps to develop their country in many ways. In Islamic point of view it is a trade and it should be accomplished all the required rules of sale to be validated. Ibnu Kahldun said: “Increasing one’s capital by buying merchandise and attempting to sell it for a price higher than its purchase price, either by waiting for market fluctuations or by transporting the merchandise to a country where that particular merchandise is more in demand and brings higher prices, or by selling for a high price to be paid in a future date”. (Ahmed El-Asker and Rodney Wilson 2006)

However, there are number of stages are involved in the modern practice of international trade such as intermediaries for both importer and exporter, opening of L/C, shipment, insurance and financing. To make enable those stages according to , each IFIs have different contracts agreements especially for the financing. In Sri Lanka IFIs use Musawama or Murabahah, or Musharakah.

Musawama is meant for normal sale transaction while Murabahah is a type of sale where by the seller disclose the cost and the profit he added in the cost. (Taqi Usmani 2000)

Rosmavani and Akhtar (2009) there is no specific definition for Islamic LC. It is mentioned as “documentary credit “in AAOFI standard defined L/C as ‘a written undertaking by a bank (known as the issuer) given to the seller (beneficiary) as per the buyer’s (applicant or orderer) instruction or is issued by the bank for its own use, undertaking to pay up to a specified amount (in cash or through acceptance or discounting of a bill of exchange), within certain period of time, on condition that the seller present document for the good conforming to the instructions.” (Rosmavani and Akhtar (2009)

Financing for International Trade

Financing solutions for international trade have been suggested by various researches where each of them pointed out suitable compliant contract for financing along with the challenges there are in.

Chuah reported that alternatively, parties can adopt a clause subjecting the contract to a set of expressed terms and conditions compliant with Islamic principles, such as a code of industry practice adopted by Islamic banks, or a specific set of rules established by an individual Islamic bank This can cause problems for the Islamic financiers seeking to secure the business of more orthodox Islamic traders, and their stakeholders, who are unhappy to see Islamic law being treated as less than binding legal rules which should be accorded the same recognition as the law of a sovereign. (Chuah, 2006)

The early Arab Traders were used Partnership as a tool for international trade which later approved by Prophet (Sal). They had mutual insurance system to protect traders (Ahmed El-Ashker, Rodney Wilson, 2006). Financing modes are known to be based on three principle sharing, sale and leasing. these modes are mostly use for the international trade financing in their business.in the International trade sharing modes based on the Mudarabah and the Musharakah basis. At the same time sale mode are using the

Murabahah contract for international trade and lease base contract also involved the international trading. (Monzer khaf, 1999)

Islamic financial institutions have developed various modes that help in expanding their market share in international trade. While discussing the trade of Islamic banks, it is argued that conventional banking theory emphasis that more the financially strong customers, the greater opportunities will be for trade but in case of Islamic banking, this theory is not necessarily true (Muhammad Bilal 2016)

Muhammad Bilal in his research has identified some modes of financial instrument. Those are mostly used for international trade such as Murabahah, Salam, Istisna, Mudarabah, Musharakah, and Diminishing Musharakah. Following are explain the functions of those contract.

If Musharakah has been applied in international trade, the importer may himself purchased the remaining quantity of importer items on the market rate of the agreed price between the parties on the date of sale, entering the contract with the exporter to finance and share export proceeds with pre agreed percentage.

Diminishing Musharakah also suitable for international trade financing. Diminishing Musharakah means the financier (IB) and client jointly own an asset or property. The financiers share is divided into small units and client gradually purchase which decreases the financiers share and increase clients share. Ultimately, client will become sole owner of the asset. The client pays rent on the financier's share of investment which gradually decreases and ends up with sole ownership of asset by the client.

If Murabahah has been applied for financing international trade, the financier purchased the commodity for the client on his demand by himself or by its agent. Bank can appoint client himself as his agent. The ownership of the commodity remains with financier for a while, so all risk goes to financier. Some Islamic financial institutions (IFIs) use Salam sale for financing. Salam is a type of debt mode of financing which is contract between the supplier of the goods (Exporter) and purchaser (Importer) in which vendor (Exporter) take the responsibility to provide specific items on some agreed future date in exchange of money fully paid in advance. (Muhammad Bilal 2016). Above mentioned kind of the contract are mainly operated by the IFIs to offer financing for the international trade.

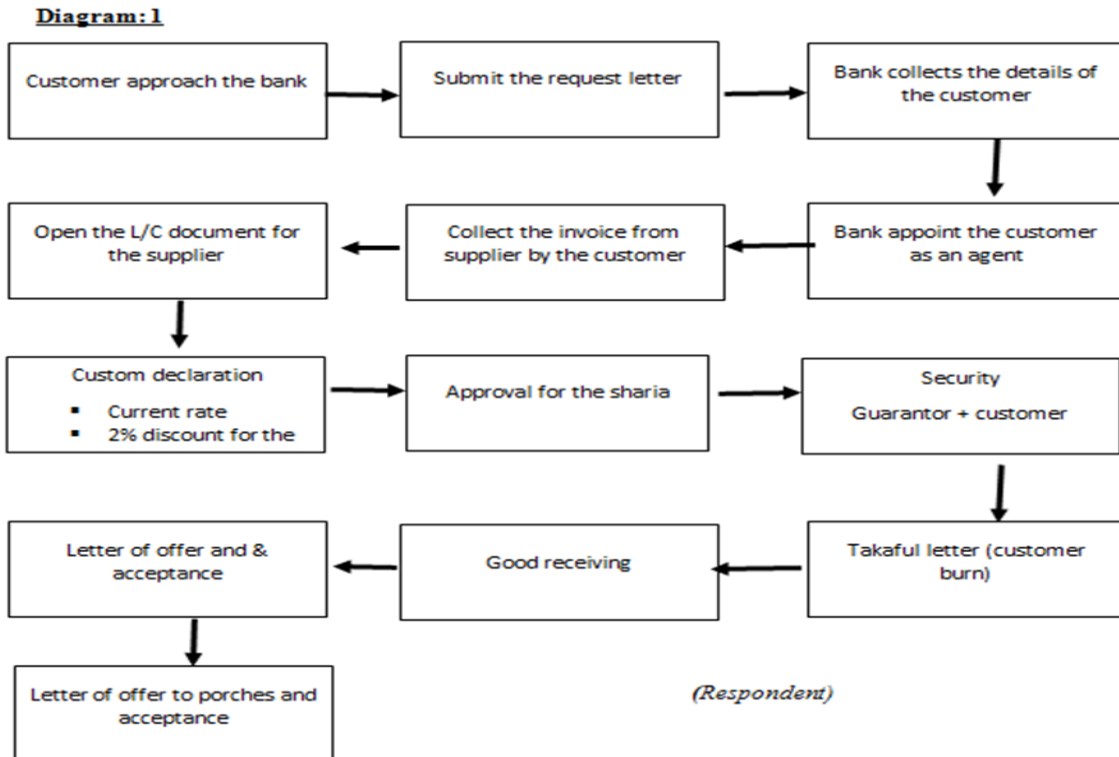
Letter of Credit (L/C) is an important ingredient in international trade financing. Rosmawani and Akhtar zaitie have reported in their research explain that the L/C is an instrument of payment in international trade and this facility is offered not only by Islamic bank but also by conventional banks. Islamic L/C which consists of Murabahah, wakalah and Musharakah as the insurance of Islamic L/C based on these three concept .

Islamic trade financing is can't effective without certain fundamental requirement such as, availability of the good warehousing facilities. Those functions are run basis of Murabahah, Musharakah and

Mudarabah. In order for Islamic trade financing to be effective and to have significant impact on the international trading. (Saaid Ali.A.E , 2013)

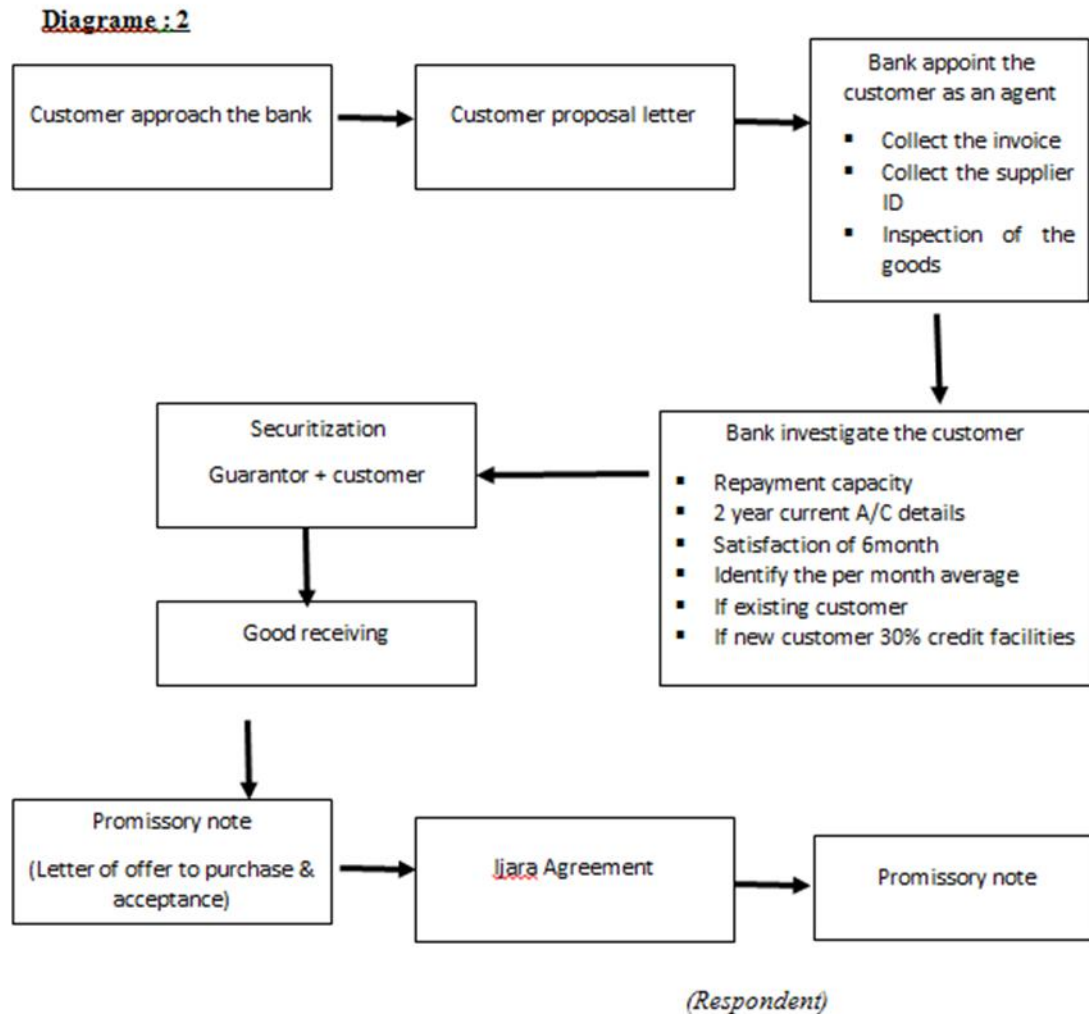
Analysis

Based on the first objective in our research to explain procedures of international trade in Islamic banking in Sri Lanka, both banks are almost same procedure, following diagram will explain that statement.



According to the diagram -1 LOLC Al-Falaah financial institution following well-planned procedure to deal an international trade as an intermediate bank under this contract the Musawama agreement. There are thirteen steps in their procured. The first to third steps are show that according to this point the customer who want to doing an international trade, he approach the bank and submit the request letter about the goods.

Then bank will collect the details of the customer to identify the capacity of him for the repayment. After that L/C document will be opened by the bank for the supplier. They get the sharia approval at the same time 9th and 10th steps are show that separate guarantor agreement, takaful letter also assign by them .At the ending 3 steps are declare that goods purchasing through the Musawama contract. Then agreement will terminate.



The diagram -2 explain that the peoples leasing AL-Safa financial institution following procedure have nine steps in there international trading. According to the diagram -2 the first step & second step are show that customer approach and proposal letter of customer. Then third step show how bank will appoint the customer as an agent. He collects the invoice and infests of the goods. Then bank will investigate the customer according to the investigation if the bank sates with the customer.

Then the fifth step of the bank is to request the customer to bring a guarantee for his payment. In this case they done the separate guarantee agreement. Then good will receiving to the port, the promissory note will be assigning by bank and customer. After that the good sell to the customer based on the Murabahah contract or Ijara contract.

As for our second objective, the both IFIs used different main contracts & sub contracts for the international trade. LOLC Al-Falah use Musawama as a main contract while Wakala, Wa'd, Takaful and kafalah are being used as subcontracts. At the beginning of the contract, the IFI appoint the customer as an agent for purchase the good whereby the customer will act as agent of IFI in order to purchase the required goods and the unilateral promises are taken place to exercise the trade financing

properly. Based on the promise made by the customer, the kafalah agreement also will be signed for the purpose of the stability of the customer's payment. As well as the takaful agreement will be adopted here to insure the goods in the ship. Finally, they deal Letter of offer & acceptance note based on Musawama agreement which is the main contract in this financing.

Same sub contracts are needed employed by the PLC Al Safa except Murabahah which is the main contract. Additionally, in Al Safa, if the customer may use Ijara also as sub contract depends on the type of goods. The IFIs will deal promissory agreement with customer whereby the IFI promise that to sell the goods to the customer and customer will promise that to purchase. Finally, they deal letter of offer & acceptance using the main contract such as Murabahah or Musawma agreement.

Challenges of International Trade in Islamic Banks

The researchers have identified some issues and challenges in the Islamic international trade financing in Sri Lanka. These challenges can be categorized as operational challenges and Shariah issues. These obstacles continuously effect the smooth function of international trade financing.

Operational Challenges.

- Recovering the money is Main challenge face by the bank. To achieve better Islamic trade financing need to development system of recovering the money but in our country it is lack system to IFI. They should need to develop highly efficient and effective trade related recovering money system.
- The business performance of international trade to be determined by the level of the country regulations relating to labour wages, fiscal policies, and fixed rate by the central bank of Sri Lanka, monetary policies impacting inflation and uncertainty.
- In Sri Lanka there is no regulatory system that govern IFIs especially. Therefore, the industry face regulatory challenges while practicing international trade activities.
- The basic transaction in International trading is not an ordinary hand to hand deal but a forward transaction. Here the customer may get many barriers until getting the ordered good. Thus, IFIs face exchange rate challenges in the practice of international trade. There is no adequate Shariah compliant forward contracts in the country to mitigate the risk in the international trade.

Issues of International Trade

- Islamic financing method for international trade has developed using number of contract in a single transaction. It creates different opinions among the scholars on the acceptability of those arrangements. Sometime it creates confusion one contracts seem like conditions for other contracts.

- There is common criticism among the public that most of the procedures are same with conventional environments. It has brought serious confusion both system are same but the name is the only difference.
- Business of the international trading there are many risk involved such as, insurance, transport, deliver of the good. Usually IFIs do not like to burn the risk because their mainly target the profit earning way of Islamic financing system. Therefore, IFIs also indirectly transfer risk. Such insurance. In international trading, Islamic financing rule clearly determined the insurance will burn by the IFIs but here they escape from this risk.
- Accepting the delay delivery and unable to delivery is the one of the issue in international trade business. When IFI unexpectedly faced this situation, they can't say absolutely customer can accept the delay delivery and unable to delivery. In this case customer can frustrated with this Islamic banking system. This is also main issue related to international trading.

Conclusions and Recommendations

The study carried out under the topic of application of international trade in IFIs in Sri Lanka. LOLC and PLC Islamic financial institution which are sample of this study clearly mentioned in the interview that they face some issues and challenges at the procedure and agreement while using Islamic contracts in the international trade activities in Sri Lanka. In this regard, the researchers have identified the method of application Islamic contracts towards international trade in Sri Lanka and found some issues and challenge. The operational challenges are mainly related to the regulations and unavailability of proper Shariah complaint forex contracts. Therefore, countries where Islamic finance is in practice should develop Islamic legal and regulatory system to encourage promoting Sariah based trade financing system. IFIs collectively take effort to bring any regulation which will ease Islamic international trade financing. The IFIs need to exert more efforts and implement reasonable measures to attract more external financial resources to improve Islamic trade financing infrastructure that lead to economic growth. In our country IFI need to develop appropriate exchange trade policies for better Islamic trade financing climate. Islamic banks need to establish Islamic trade related institutions to support Islamic trade financing in general to support their international business.

Therefore, IFIs should need to develop highly efficient and effective trade related recovering money system and should tide their polies for international trading. Further, IFIs must try to offer the product without intermingling many contracts into a single contract with the guidance of their respective Shari'ah board. To overcome challenges of non-delivery, IFI should ensure the delivery of the goods and the need maintain personal contact between the trading partners during the all stages of transaction the other parties participate in international trade. Last but not least, there is great necessity to IFIs to show the clarity and transparent in the agreements and other procedure of international trade business in order to make awareness to the public by way of arranging awareness programs, advertising at newspapers and social media and by issuing handbills.

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