General Council for Islamic Banks and Financial Institutions

المجلس العام للبنوك والمؤسسات المالية الإسلامية

CIBAFI

ISSUE 8 • July 2018

CIBAFI BRIEFING

Islamic Trade Finance: Back to the Roots

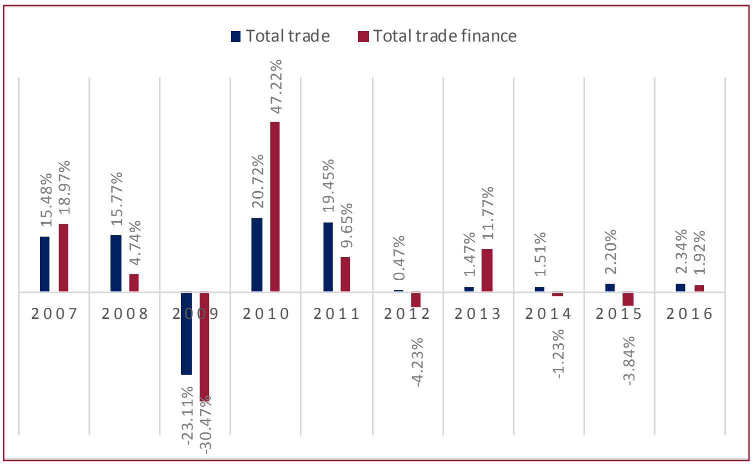
CIBAFI is pleased to present its eighth "CIBAFI Briefing", which aims to inform its members and others on recent trends in Islamic Trade Finance, as well as increase awareness among the stakeholders of the Islamic finance industry. Moreover, it explores challenges, opportunities, and ongoing structural changes in the Islamic trade finance market which may affect its future development.

Background: Introduction and Importance

Trade finance is defined as a specific area of finance that examines underlying international trade transactions. Islamic trade finance consists of providing Shariah-compliant export and import financing tools. These are financial solutions and guarantees which facilitate transactions between buyers and sellers of goods and services. Conventional Trade Finance revolves around products such as credit or payment guarantees. Direct cash payments finance only a small portion of international trade (estimation 20%). The largest share of trade transactions are conventionally financed either by open credit arrangements (estimation 45%) or by a bank intermediary (estimation 35%).

Globally, the volume of the trade finance industry is estimated to be US$12.3 trillion in 2016, and is expected to grow at a compound annual growth rate (CAGR) of 3.77% from 2016 to 2020. In the past decade, world trade finance increased until the global financial crisis (GFC) and reported a decline in 2008.

Figure 1: Global growth rate estimation in trade and trade finance (%), 2007-2016



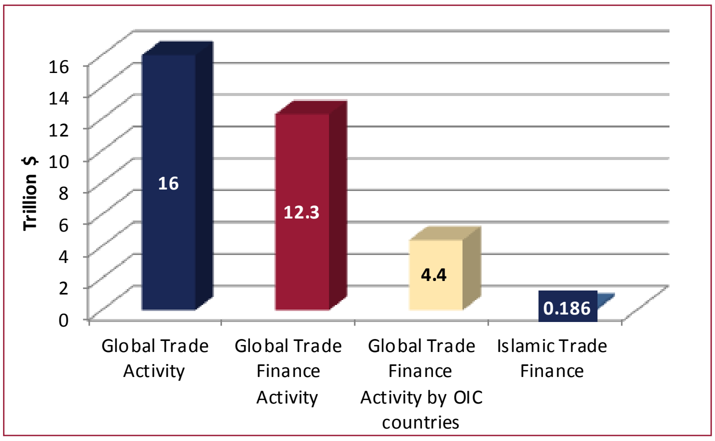
Source: CIBAFI, Delta Metrics (2015)

Global financial crises have reduced confidence in the conventional credit system and emphasized the position of Islamic financing around the world as a suitable system.

Currently, many Islamic trade finance arrangements are available in the market to facilitate pre- and post-shipping trade and to provide working capital to mitigate the risks of trading stakeholders. Islamic trade finance currently represents a small part of the global trade finance market. However, the sector is growing continually, and its share in 2016 was about US$186 billion.

Trade finance is considered a means for achieving development objectives and is one of the key growth drivers for the financial sector. It is also a major supplier of economic growth in many countries due to the direct benefits of trade finance on economic growth and development.

Figure 2: Trade, Trade finance and Islamic Trade Finance Activity (2016)



Source: CIBAFI, WTO, ICD

The Role of International Trade Finance Organizations and Multilateral Development Banks (MDBs) in Establishing an Appropriate Trade Finance Environment

World trade size is about 80% dependent on trade finance. However, the gap in trade finance remains large, particularly in developing countries, with global unmet demand estimated at about US$1.5 trillion. According to the ICC Survey, "Rethinking & Trade Finance Report" (2017), 61% of surveyed banks (comprising 255 responses from 98 jurisdictions) perceive that there is more demand than supply for trade finance. According to the same survey, banks across all regions report that multilateral development banks (MDBs) are helpful in fulfilling the demand.

The World Trade Organization (WTO) is encouraging the renewal and enhancement of the networks and links between stakeholders involved in the trade finance marketplace in order to keep trade finance flowing and mitigate decreases. Additionally, the WTO is determining where the gaps are in trade finance markets, and how to fill the gaps with policy measures. It also provides a useful forum for trade finance stakeholders' concerns to be expressed.

MDBs are very active in expanding international trade, advancing trade policy and determining the agenda of international trade. While the majority of MDBs were initially unwilling to finance international trade, assuming that their role should be restricted to trade infrastructure and social sector financing, the Islamic Development Bank (IsDB) has since 1977 financed international trade operations. However, the trade finance gap and the consensus on international trade's importance for economic growth and sustainable development led the MDBs to become involved in the development of trade finance activities. Since 2008, ITFC (International Islamic Trade Finance Corporation) has inherited IsDB's trade related activities. It provided more than US$40.2 billion Shariah-compliant financing to its member countries from the date of its commencement. ITFC advances policies to advocate for the adoption and implementation of policy options to achieve the Sustainable Development Goals (SDGs) and more inclusive international trade. It's expanding and diversifying its trade finance activities as it's launching in 2018 the first Islamic finance-compatible sovereign energy fund (ICC Global Survey 2018).

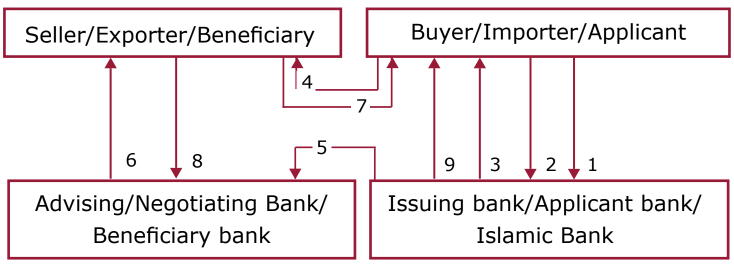
Table 1: Some advantages of international trade organizations for different stakeholders

Improve local banking centres through training / awareness programmes on mutual trading / regional arrangements.
Enhance trade infrastructure through, for example, the development of Shariah and investment advisory services through established training centres geared towards trade exporters, importers, and workers.
Collaborate with strategic partners in order to create further awareness and to promote trade financing solutions and domestic and strategic products in different regions.
Facilitate trade activities by supporting finance-centred liquidity to the sector and to the real economy within the trade transactions themselves.
Diversify the supply of exported products with their networking opportunities.
Monitor problems and maintain a closer dialogue with regulators to improve trade finance policies and facilitate socio-economic development.
Adopt norms and international market standards and mitigate administrative procedures in international trade.
Develop specific funding instruments with SMEs' needs in mind.

Main Shariah-Compliant Trade Finance Solutions

Many Islamic trade finance products and solutions are available in the market. The most commonly used Islamic trade finance instruments are Murabahah, Musharakah, Wakalah, and Kafalah based contracts.

i. Murabahah: The Islamic bank imports goods at the request of the customer and sells the same goods to the customer on a cost plus profit basis. Most of the instruments utilize Murabahah-based solutions such as Letter of Credit (LC), Trust Receipt-i and Accepted Bills-i. The most commonly used Murabahah contract is applied in LC. It can be structured as follows:



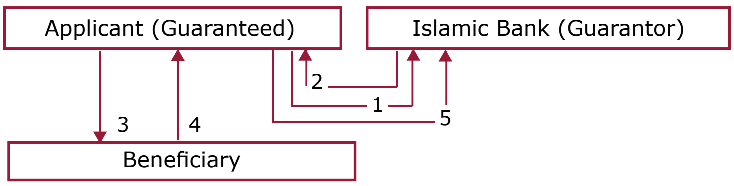
1. Applicant asks the IB to import the goods
2. The applicant promises to buy the specific goods as agreed
3. The IB appoints the applicant as the agent
4. The applicant signs the sale contract with the beneficiary on behalf of the IB
5. The IB releases the LC
6. The Advising bank confirms the LC and informs the beneficiary
7. Exporters deliver the goods, and shipping documents are forwarded to the advising bank after the goods are shipped
8. The exporter claims a payment from the advising bank
9. The IB forwards the payment to the beneficiary through the advising bank. The IB sells the goods to the applicant under the Murabahah contract.

Source: CIBAFI

ii. Musharakah: A Musharakah-based contract can be used in trade finance situations such as export and import transactions. The Islamic bank enters into an agreement with the customer for the sale and purchase of goods whose specifications are provided by the client. The profits or losses arising from the venture are distributed amongst the partners according to a pre-agreed-upon proportion. Like the Murabahah-based LC structure, the applicant negotiates the terms of Musharakah financing, then the bank establishes the LC and pays the advising bank as well as its own share of financing, and then the advising bank releases the documents to the applicant. Customers receive goods and disperse them in the manner agreed upon in the contract.

iii. Wakalah: With this type of contract, the bank works as an agent for a customer such as a purchaser or supplier. Shariah-compliant LC can be based on the principles of Wakalah contract also. The bank is paid fees and commissions for the services provided, unlike a conventional agency contract where interest is paid. In this situation, the bank has only legal and documentational risks. The applicant places a deposit for the full amount of goods, which the bank accepts under the Wadiah (deposit) contract. The bank establishes the LC and remits the payment while requesting the bank to provide facility. The Islamic bank establishes the LC and remits the payment by utilizing the applicant's deposit to the beneficiary and releases the documents to the applicant.

iv. Kafalah: Under this type of contract, loans are guaranteed and all loans must be repaid in due course according to Islamic law. It is defined as a guaranteed contract on certain assets, usufruct (property advantages), and services provided by a guarantor to the involved parties. It plays an important role in facilitating trade across borders. Some Islamic trade finance products are based on Kafalah, such as Islamic Shipping Guarantee (SG-i) and Islamic Bank Guarantee (BG-i).



1. Applicant requests Islamic Shipping Guarantee
2. IB issues the SG-i
3. Applicant presents SG-i to beneficiary
4. Beneficiary relases the goods
5. The applicant redeems the SG-i from beneficiary and returns to IB for cancellation.

Source: CIBAFI

Developments and Trends

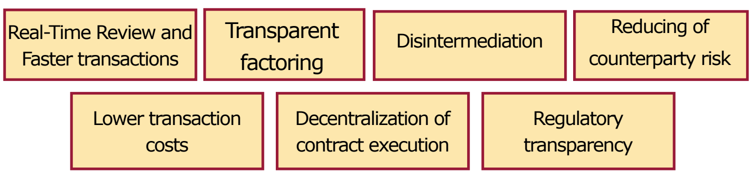
1. Bank Payment Obligations (BPO)

The International Chamber of Commerce recently launched the "Bank Payment Obligation (BPO)" which is an irrevocable document given by a buyer's bank to a supplier's or seller's bank confirming that payment will be completed on an identified date after an electronic data match. It is broadly similar to a letter of credit but is much better suited to paperless transactions. It can thus reduce processing costs, enabling banks to offer a more competitive rate for the BPO transaction. However, it has potential Shariah issues, at least in its standard form. The BPO is stated to be "separate and independent from the underlying trade transaction", and the customer is expected to "acknowledge that the bank has no involvement in, nor is responsible for, the underlying trade transaction". The banks are only involved "with data and not with the commercial contract, documents, or the goods, services or performance to which the data or documents may relate". This may make it difficult to use Murabahah as the relevant Islamic contract on the basis of which banks can derive any income.

2. Supply Chain Finance and Blockchain Technology

"Supply chain finance" is another developing area of banks' trade finance activities, where banks automate documentary processing across the entire supply chain. It has many advantages in trade financing activities, such as reviewing of financial documents in real time and reduction of correspondent banking transaction fees and requirements. Many experts see an opportunity for trade finance to benefit from blockchain technology. Recently, Europe's biggest banks have been shifting their trade finance to blockchain technology. IBM was selected to build a new blockchain system for cross-border trade finance with Deutsche Bank, HSBC, KBC, UniCredit etc. Moreover, blockchain can provide a transparent regulatory environment in enforcement and AML activities.

Figure 3: Some Benefits of Blockchain in Trade Financing



Source: CIBAFI, Deloitte (2017)

3. Digital Trade Financing Platforms

Currently, very few digital Islamic trade finance platforms are available, and the increasing popularity of digital finance tools can help fill the void. They simplify trade finance and would be a great benefit to companies to expand through Islamic trade finance. With the development of Fintech and digital Islamic trade platforms, trade financing becomes more transparent. Additionally, many trade financing processes have been automated to facilitate the handling of shipment of goods, trade instruments, and trade documents. For example, UAE-based Emirates Islamic bank has launched an online Islamic trade finance supply chain platform ("El Trade"). It is an innovative electronic solution that allows the bank's corporate and individual customers to reduce turnaround time and cut costs in an easy and secure way. It provides momentum for Islamic trade finance activities in the UAE and the region.

Challenges and Opportunity Areas in Islamic Trade Financing

Despite its successful development and available opportunities, Islamic trade finance faces a number of different challenges in developed countries and emerging markets. Some challenges are discussed below.

1. Islamic Trade Finance Framework

The efficiency of Islamic trade finance depends on the level of development of the Islamic financial frameworks in respective jurisdictions. Comprehensive Islamic legal frameworks and regulations and the availability of Islamic financing tools are important for Islamic financial development.

The lack of a legal framework and its effective implementation is another trade infrastructure challenge facing Islamic trade finance in many countries. There are some legal and tax implications due to inadequacies of legal and regulatory frameworks. Thus, there is a need for an effective and an inclusive framework which combines accounting standards, corporate governance, and bankruptcy laws in terms of trade finance, in addition to legal standardization.

On the other hand, the existence of an open dialogue with trade finance regulators should ensure that trade and growth considerations are fully reflected in the application of regulations. For example, new and revised rules regarding capital and liquidity requirements under Basel-III may have some implications for trade finance activities, since banks must maintain higher capital reserves against trade finance transactions. International and national regulatory bodies should work to standardize trade facilitation processes in order to eliminate trade barriers and regulatory hindrances.

2. Shariah-Compliant Trade Finance Product Development

Financial engineering is a segment where Islamic banks and IFIs need to deploy the required resources to develop Trade Finance products responding to the fast-changing market dynamics. In fact, they can substantially upgrade their product mix and compete with the interest-based modes of financing by opting for contracts deriving from Musharakah and Mudarabah. Musharakah can be used to finance Export/Import operations through the opening of Letters of Credit and asset trading at a global scale. Diminishing Musharakah is a contract that allows the bank to be involved in an equity-based financing of commodities where the ownership of the asset would be transferred gradually to the partner/client through the successive selling of its shares. Islamic Multilateral Development Organizations have an important role in leading the development of these products since their usual counterparts are governments and leaders from the private sector. Influencing and upgrading the legal framework governing the development of Islamic modes of finance and mainstreaming the usage of these products can be done more efficiently.

3. Shariah Issues and Challenges

There are some Shariah issues and controversies on some trade finance products. Some of the important Shariah issues are as follows:

i. Islamic Trust Receipt (ITR): This is issued by an Islamic bank to the customer based on the concept of a Murabahah contract for financing the purchase of goods. The Islamic bank allows the customer (importer) to get release of the merchandise with the understanding that said customer will make a lump sum payment at a later date. The bank gives an advance sum of money to the seller before the stipulated documents in the form of an advance payment. The time-dependent cost charged to the customer and its profit formula calculation method are both controversial issues among Shariah scholars.

ii. Islamic Shipping Guarantee (SG): This is issued under the Kafalah contract and is an important trade finance solution. Here, the Islamic bank acts as a guarantor on behalf of the buyer/importer to release their goods from the shipping company. The status of Ujrah (fee), the uncertainty of element (gharar), the inexistence of the goods during the execution of contracted liability, and the non-existence of the expiry date of the contract are controversial Shariah issues among scholars. IFIs have different practices with these potential issues.

iii. Islamic Accepted Bills (AB-i): This is a bill with a certain face value issued by an Islamic bank to the customer at a discount. It is used for a Shariah-compliant transaction, and it is based on two concepts: bey'ul dayn (sale of debt) and the Murabahah contract. In this product, sale of debt (bey'ul dayn) is the main controversial issue among scholars in different jurisdictions.

Different fatwas on various Islamic trade finance products in different jurisdictions make Islamic trade finance activities difficult.

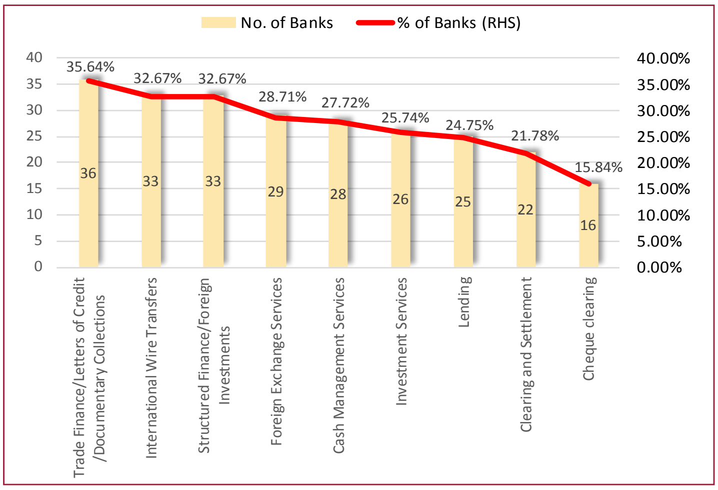
Therefore, standardization of Islamic trade finance solutions with Shariah requirements will help in facilitating Islamic trade finance activities.

4. De-Risking

Another important challenge of Islamic trade finance is de-risking. De-risking consists of financial institutions terminating or restricting business relationships with remittance companies, smaller local banks, and categories of clients in certain regions of the world. CIBAFI Global Islamic Bankers' Survey 2018, with responses from 103 CEOs from 31 countries, found that de-risking changes unfavourably affect trade finance activities, mainly for small banks and their SME (Small and Medium Enterprise) clients around the world. In fact, increased risk-based capital restrictions, the rise of Know Your Customer (KYC) activities, AML and CFT (Anti-Money Laundering and Countering Financing of Terrorism) activities, as well as other regulatory pressures have had an impact on emerging market operations. These have resulted in the withdrawal of some international banks from their relationships with many emerging markets and customers, mainly in correspondent banking relationships (CBRs).

The ICC Global Trade Survey (2016) states that increased costs for KYC and AML activities continue to be a challenge. Moreover, 90% of respondents stated that AML and KYC issues are the leading hindrance to trade finance.

Figure 4: Products and services affected globally by De-risking



Source: CIBAFI Global Islamic Bankers' Survey (2018). Evaluating Future Impacts: Strategic Thinking, Branding and Financial Technologies

In order to address and close any possible compliance and risk gaps, Islamic banks may increase their levels of transparency, especially where foreign banking relationships are involved, and share up-to-date information with their foreign counterparts, including AML and CFT practices (CIBAFI Briefing (2017), De-risking and Correspondent Banking Relationships).

5. Promoting SMEs through Islamic Trade Finance

In developed countries, SMEs contribute over 50% of the GDP and over 60% of employment. However, in developing countries, SMEs represent only 30% of employment and 17% of the GDP. This conspicuous absence of SMEs in the developing countries is the "missing middle".

SMEs are involved in many trade finance activities locally as well as internationally. They need financing throughout their business process – from the procurement of raw materials, to the production, all the way up to the marketing stage.

According to ICC Global Survey (2014), among the main obstacles limiting SMEs' access to trade finance are (i) the increasing compliance/regulatory burdens and (ii) low country and local bank credit ratings. Generally, over half of trade finance requests by SMEs are rejected in emerging market countries, against just 7% for multinational companies. For this reason, global liquidity tends to be concentrated within the biggest institutions and their clients. Without enhancing sufficient trade finance capabilities for SMEs, opportunities for growth and development may not be fully realized. In developing countries, inadequate financial resources limit the SMEs' export capabilities due to their small banking markets and the lack of connectivity to global financial institutions. To alleviate these challenges, ITFC intervenes in both SMEs financing and technical assistance through integrated trade programmes. ITFC has been able to finance US$ 13 billion of transactions for OIC SMEs and private sector and is currently developing a fully integrated "Global SMEs Development Programme", and has proposed to partner MDBs the creation of a dedicated trade fund for SME.

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Policy Recommendations and Key Findings

- MDBs, Development Agencies, International / Regional Commercial Banks, Local Banks, and Financial Institutions must work together to narrow the Global Trade Finance Gap and provide the necessary resources, expertise, and knowledge.
- De-risking practices significantly affect trade-related transaction and can reduce exports. IFIs can address the challenges of de-risking in a well-coordinated, multifaceted approach, while engaging with regional and international regulatory agencies within an agreed framework in partnership with other bodies, whether Islamic or conventional.
- Islamic finance regulatory bodies and IFIs may adapt their regulations and trade finance products to the constantly changing world. Islamic banks may expand their trade activities with the use of digital trade finance and supply chain finance platforms, blockchain technology, etc.
- Multilateral organizations/banks should increase their trade finance facilitation programmes and bolster the capability of the local banking sector to support trade, as well as make an effort to connect with global banks.
- Efficient international trade financing requires a comprehensive regulatory trade finance framework. Islamic finance regulatory authorities need to build/enhance existing regulatory, legal, and Shariah frameworks to promote trade finance activities.
- Professionals and academics should continue to work together to mitigate Shariah challenges and to develop innovative and flexible Shariah-compliant PLS-based trade finance tools, moving away from dependence on debt-based traditional arrangements to meet the variable financial needs of traders.
- MDBs and specialized institutions for SMEs should scale-up existing trade finance and trade facilitation programmes to provide remedies for geographical hindrances, and to support SMEs by reducing trade barriers.

About CIBAFI

CIBAFI is an international organization established in 2001 and Headquartered in the Kingdom of Bahrain. CIBAFI is affiliated with the Organization of Islamic Cooperation (OIC). CIBAFI represents the Islamic financial services industry globally, defending and promoting its role, consolidating co-operation among its members, and with other institutions with similar interests and objectives. With over 125 members from more than 33 jurisdictions, representing Islamic Banks, market players, international intergovernmental organizations and professional firms, and industry associations, CIBAFI is recognised as a key piece in the international architecture of Islamic finance. In its mission to support Islamic financial services industry by being the leading industry voice advocating regulatory, financial and economic policies that are in the broad interest of our members and that foster the development of the Islamic financial services industry and sound industry practices, CIBAFI is guided by its Strategic Objectives, which are 1. Policy, Regulatory Advocacy, 2. Research and Publications, 3. Awareness and information sharing and 4. Professional Development.

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