

International Trade under Islamic Banking

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Abstract
The crucial area of this study is to identify the international trade under Islamic banking using data of period 2000-2014. Islamic banking is growing with very fast speed in Pakistan. In Dec. 2011, Islamic Banking Industry Assets reached to 641 Billion Pak Rupees and growing with the pace of more than 30 percent every year. There are two modes of financial instrument, namely; debt creating such as Murabahah, Salam and Istisna, and non-debt creating such as Mudarabah Musharakah, and Diminishing Musharakah. This research work will elaborate the working of these financial instruments along with their support in international trade.
Keywords: international trade, Islamic banks, conventional banks, imports, exports
JEL CLASSIFICATION: B23; R28

Introduction

Now a day, the whole world becomes a global village and distance has become vanished due to the advancement of communication and transportation means. No country can survive without involving into trade activities with the rest of the countries in the world. Trade comprises of two sections; exports and imports. Exports are the major source of foreign reserves for most of the developing countries including Pakistan. Islamic banking also plays significant role in the trade of Pakistan as in many Islamic countries. The total exports financed by Islamic banks have crossed USD 12 billion but still a lot of efforts are required to accelerate the inflows of foreign exchange in Pakistan. The whole process of exports and imports is quite technical and a lot of expertise are required because minor error may cause discrepancy and hassle. All the trade is going on through the process of UNIFORM CUSTOM AND PRACTICES (522). To facilitate the exports of Pakistan, State Bank had introduced a scheme with the name of "**Export Refinance**" in 1973. The purpose was to provide concessionary finance to exporters for the promotion of exports of traditional and newly emerged commodities. Subsequently, the scope of scheme was enlarged to include all manufactured goods. In 1977, the scheme was divided into two part I and Part II. Under part I, finance is allowed on case to case basis and under part II, finance is allowed on revolving basis up to the 50% of the exports realized in previous year. The exporter is required to avail the double proceeds from the amount financed during the current year. If exporter is unable to achieve his target, non/short performance fine will be imposed by SBP. Previously, this scheme only provides incentives to direct exporters but latterly, the scheme was revised to facilitate small, medium, emerging and indirect exporters to avail the benefits. The main theme of this study is to investigate the Shari'ah compliance financing modes offered by Islamic banks and their working to support the importer/exporter/producer in international trade. The research objective is to elaborate the Islamic banks role in international trade of Pakistan including full-fledged as well as Islamic banking division of conventional banks.

LITERATURE REIW:

Ajaz Ahmad and Laura Thaut (2008) trade and commerce played a vital role in the expansion of Islam. During the early Islamic history, the structure of economic relations varied significantly from the current economic era. The early Muslims were not only involved in trade but they also went to distant lands for the purpose of business. In fact, Islam reached East and West Africa, Asia and Europe through merchants.

Zamir Iqbal reported in his research that all the pioneer references trading activities confirming to Islamic Shari'ah developed under the umbrella of either interest free or Islamic banking. However, describing Islamic financial system simply as interest free does not provide complete picture of the system. Undoubtedly, prohibition of interest is the soul of the Islamic financial system but it is supported by the principles of risk sharing, individual rights and duties, property rights and sanctity of the contract. Islamic banking system also equally emphasis on the ethical, moral, social and religious dimensions to enhance equality and fairness for the goodness of overall society. Furthermore, Islamic financial system is not limited to banking but covers capital formation and its markets, and all types of financial intermediations.

Monzer Kahf, (1999) Trade finance is to be based on three principles; sharing, sales and lease. Sharing modes of finance is of two types, full equity sharing and non-voting equity financing. In sale modes, IB purchases the goods on behalf of the customer and sells them on deferred payment. In lease mode of finance, IB purchased the equipment and leased to the ordered usually under Ijarah Wa Iqtina or Diminishing Lease.

Monzer Kahf (1999) while taking the birds eye view, we come to know that practices of certain kind of banking activities go back as early as 1200 years ago in the famous muslim cities Baghdad, Damascus, Fez and Cordoba. The people of these cities are familiar with the use of cheques and current account at that time. The major mode of finance was Musharakah which was used not only for Mediterranean trade but also for Indians and Scandinavians traders through Arab Caravans.

In the current era, Islamic financial institutions have developed various modes that help in expanding their market share in international trade. Islamic banks have a great opportunity to finance the trade between Muslim countries as well as with the rest of the World. 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. The efficient performance of Islamic banks is due to wisely use of capital in financing the trade. Similarly, conventional banks perform well in monopolistic market while Islamic banks are better managed in competitive market (A.G. Awan, 2009).

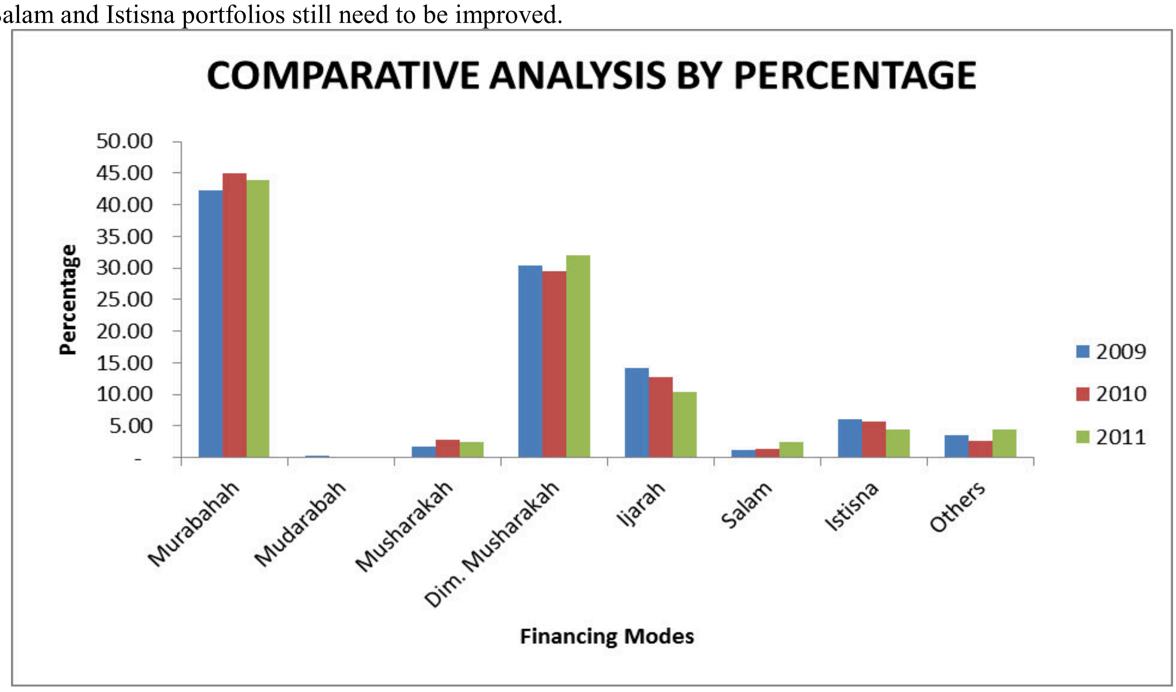
Abdullah (2004) has explained various methods of Islamic trade financing after the introduction of Islamic Shari'ah laws governing in Sudan in 1984. He highlighted the difference between Musharakah and Mudarabah which are important modes of financing since long. Two fundamental problems are discussed in his research, double burden of failure, where borrower's project fails and depletion of lender's capital by inflation. He suggested that Musharakah financing is the solution to overcome these problems.

Anjum Saddiqui (2008) had discussed various risks faced by Islamic banks while trade financing. Like the conventional banks, Islamic banks also face credit risk. In profit sharing modes of financing (Musharakah and Mudarabah), such risk is greater due to non-payment of banks share by the lender entrepreneur. This situation arises just because of asymmetric information available. In this case, borrower have detailed inside information about the project and its profitability as compared to banks. While under other contracts such as Murabahah, rate of return is prefixed and such risks are being avoided. However, credit risk arises only in the form of counterparty risk due to nonperformance of the trading partner.

RESEARCH METHODOLOGY:

The research was used to collect the data from the financial statement of the full-fledged Islamic Banks as well as conventional banks that have Islamic banking units. Financial Statement and statistical reports of the State Bank of Pakistan was also used to collect data. Other source of data is internationally published journals, financial and statistical reports of Islamic development bank, IMF and World Bank reports and research papers on Islamic banks. The two modes of financing that have been used to finance the trade activities both domestic and global level are debt creating and non debt creating modes (Khan, 1999; Haroon and Shenmugam, 2001). Islamic modes of financing are unique in nature as debt related financing results from real commodity purchase and sale operations instead of exchange of money for interest bearing debt. The whole idea behind Profit & Loss Sharing is seen as an innovation and it brings several merits for the banking industry, thus benefiting the whole community (Faisal Naseem, 2004).

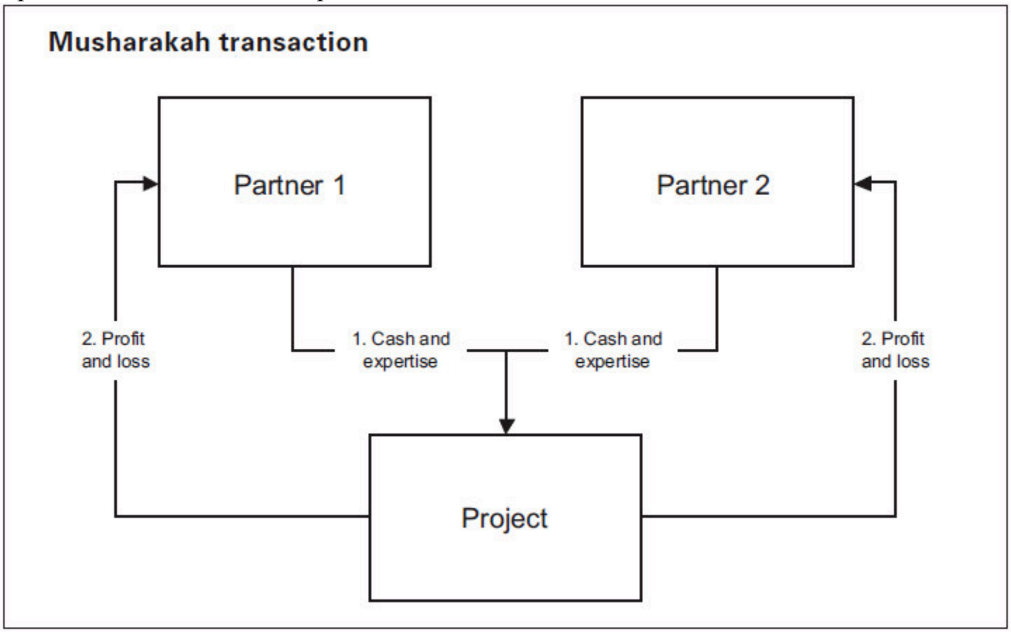
Islamic banks provide wide range or Shari'ah compliance products and services. Murabaha is a dominating mode of finance and similarly, Ijarah, Salam, Istisna Musharakah, Diminishing Musharakah and Export Refinance Scheme have also depicting significant share in financing foreign trade. However, Mudarabah, Salam and Istisna portfolios still need to be improved.



It has already been discussed in introduction phase that pace of growth of Islamic banks in Pakistan remains more than 30% every year from its evaluation. Now Islamic banking comprises about 7.8% share of the overall banking industry and last year growth is 34%.

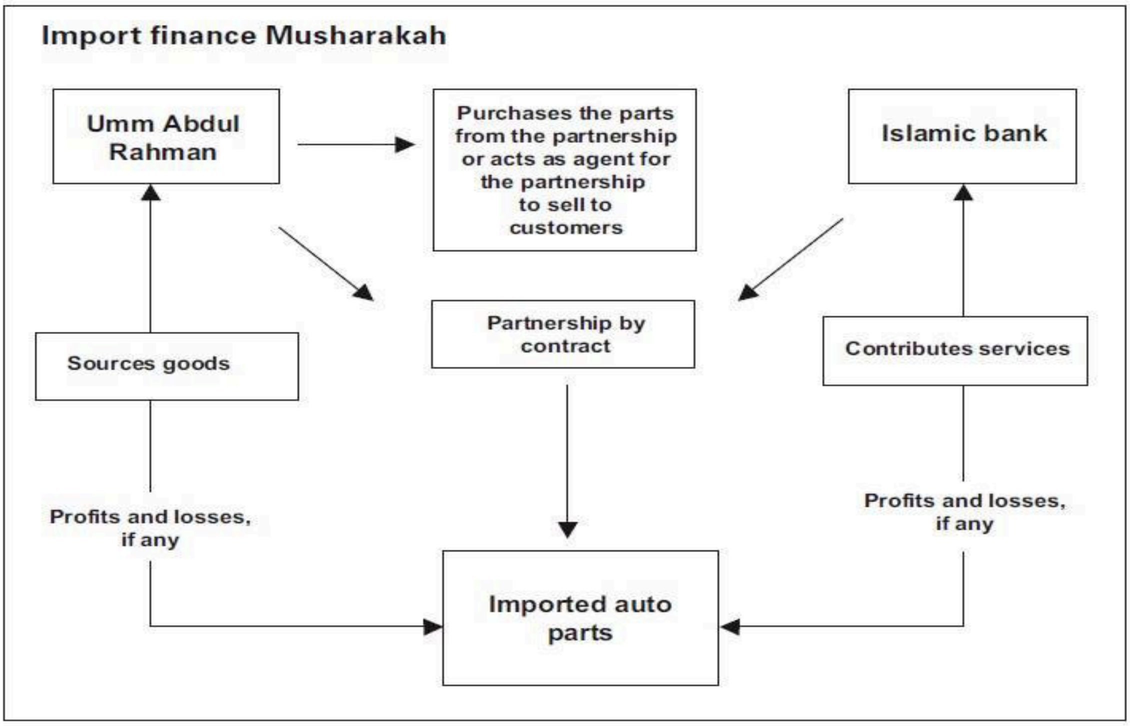
MUSHARAKAH

Musharakah does not appreciate a fixed rate of return. Islam has discouraged the interest as financing mode because of unjust attribute either to the creditor or debtor. If the debtor suffers losses, it is unjust on the part of creditor to demand fixed rate of return; and if debtor generates high profits, it is injustice to the creditor to provide him small portion of profit. No doubt, Musharakah as a universal mode of financing may include number of practical issues in its full implementation.



Source: Islamic Banking: A Guide for Small and Medium-Sized Enterprises

The most important issue of the Musharakah agreement is the nature of capital invested. All jurists are agreed that money can be pooled up as capital but there are variations on the issue of making commodities as capital, The Musharakah can be restricted to an agreed term, if the imported goods are not sold in the market up to the expiry of term, 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. If the prices are pre-agreed, the bank cannot compel the importer to purchase the goods.



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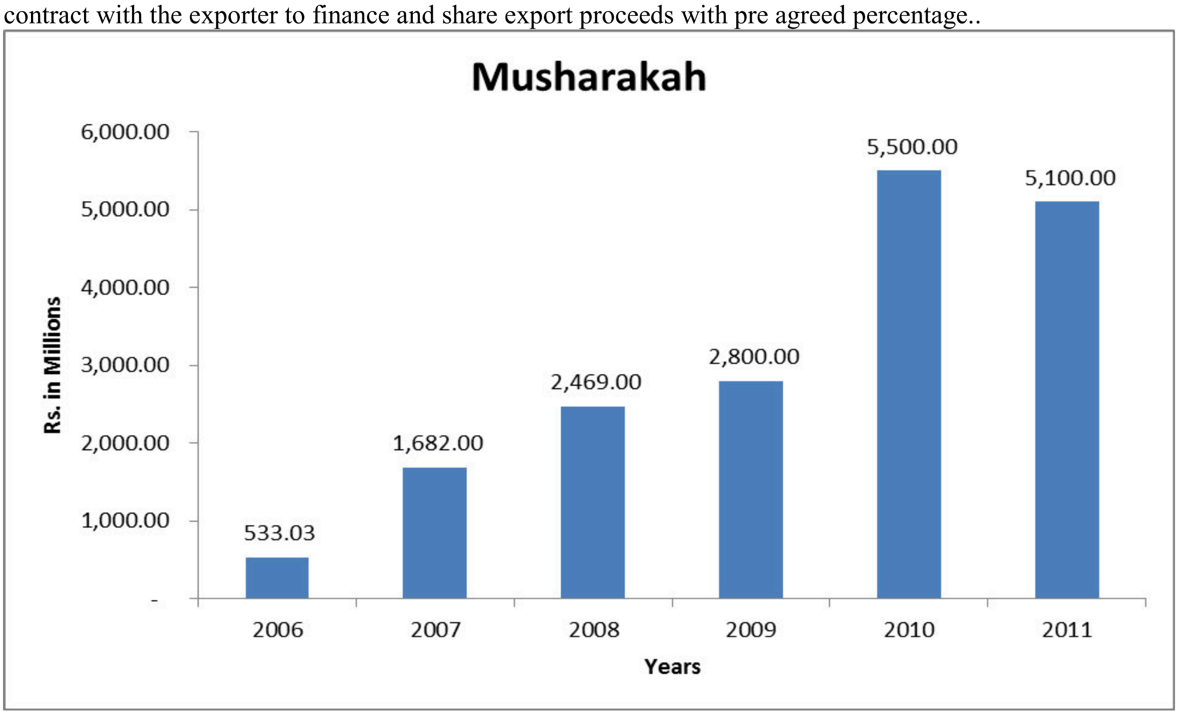
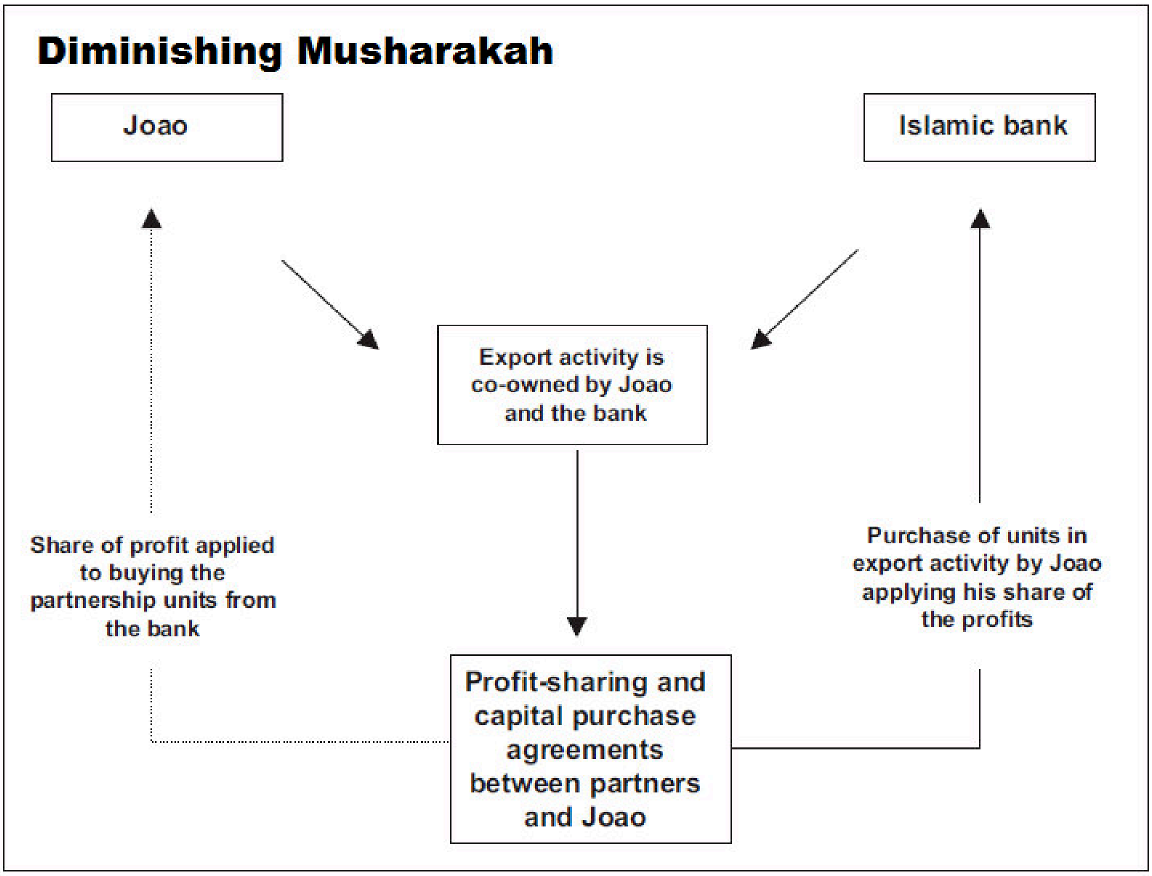
Similarly, Musharakah mode of financing will be used even more in case of export financing. The exporter has specific order from importer abroad. The prices of the goods are well known by the exporter as well as financier thus to calculate the actual profit very easily. Islamic bank as financier may enter into Musharakah contract with the exporter to finance and share export proceeds with pre agreed percentage..



As it has already been explain that Islamic banks are not fully interested to finance the trade activities by using Musharakah mode due to facing of risk on the philosophy of Profit and Loss sharing. That is way, this mode does not contribute significant role in the overall trade. Islamic banks utilize Musharakah up to some extent as financing mode since the start of operations of Islamic banking in Pakistan.

DIMINISHING MUSHARAKAH

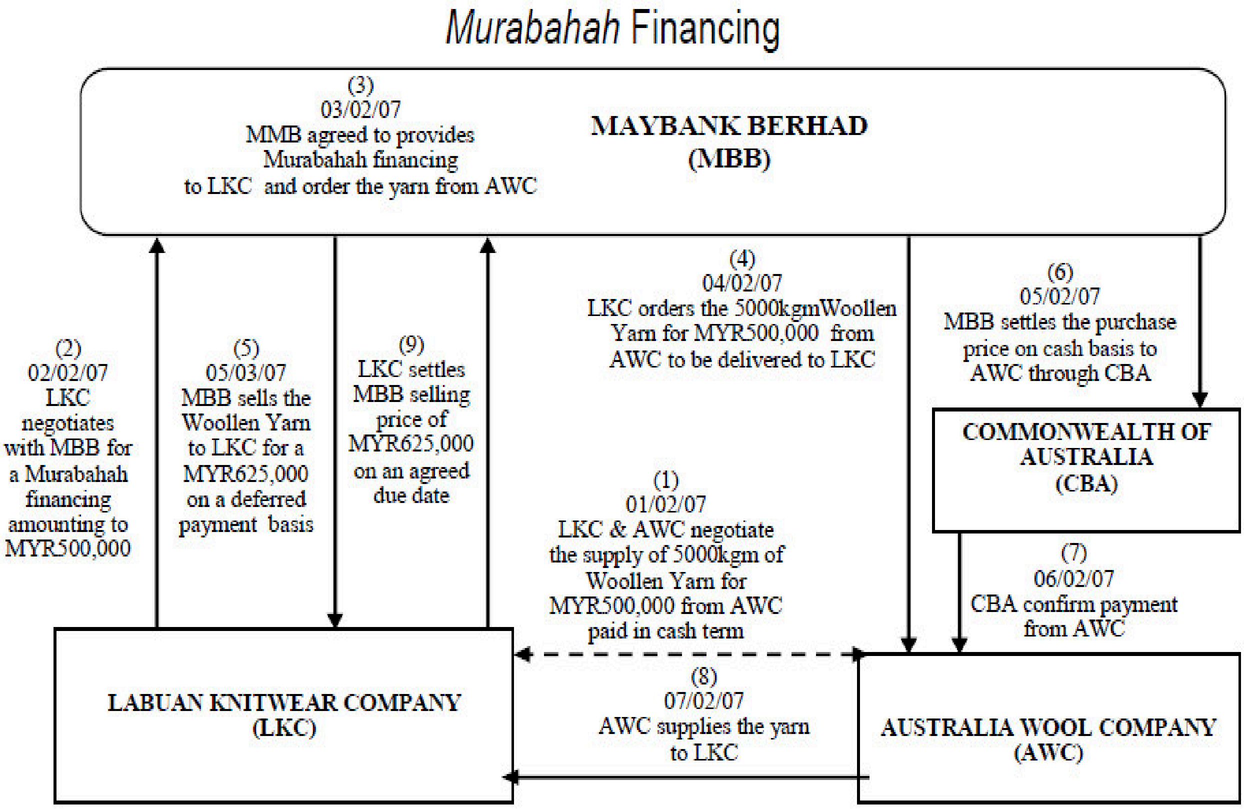
Diminishing Musharakah means the financer (IB) and client jointly own an asset or property. The financer's share is divided into small units and client gradually purchase which decreases the financer's share and increase client's share. Ultimately, client will become sole owner of the asset. The client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



Source: Islamic Banking: A Guide for Small and Medium-Sized Enterprises

MURABAHAH

Shfiq-ur-Rahman, (2009) has briefly elaborate Murabahah as a mode of finance adopted in exceptional case by IBs where Musharakah and Mudarabah cannot be restored. It is a BAY' UL MU'AJJAL having agreed profit on cost. The financer 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 financer for a while, so all risk goes to financer.



Source: May Bank Berhad

The one issue regarding the Murabaha is different prices cash and credit sales which look to be indifferent for interest charged by the conventional bank against lending. The answer to this issue is, (a) capitalist do not differentiate between money and commodity. Money is not directly consumable and is only the means of exchange.

Imports

Trade department of various banks in Pakistan utilize Murabahah mode to finance the customer by letter of credit. Imports are reported on "**I Form**" having 4 copies and its original copy goes to SBP after a month in SBP reporting.

Letter of Credit Murabahah

- ✓ CBD contacts the customer and offer Murabahah products. The client after acceptance, agree on the terms and conditions of the Murabahah facility.
- ✓ Client and bank execute the MMFA and agency agreement. Under this contract, client is appointed as an agent of the bank for the purchase of various commodities.
- ✓ Client sends the LC opening documents to the Trade Finance Department (TF). After the verification of available limit, TF Department obtains the necessary approvals from CBD and opens the LC in clients favor.

Exports

In the export process, the person who wants to export the commodities come to the bank along with his ID card and its copy, chamber of commerce certificate for export registration Number and copy of NTN Number. The application is submitted on "**E Form**" having 4 copies. The bank then verifies the form within 14 days from issuance date of E form. After necessary certification by the bank, exporter submits E form to the custom at the time of shipment. Custom keeps the original copy and remaining three copies are being returned to the exporter, who retains the 4th copy and submit the duplicate and triplicate copy along with shipping documents not later than 14 days of shipment and 21 days of E form certification and 21 days of BL. The bank will forward triplicate copy to the SBP in his monthly reporting. On the receipt of export documents, bank should compare them with relative export form and confirm with all respects and the amount of bill should not less than the value declared on them. When the exporter short ship the portion of the consignment and consequently draws a bill or already prepares an invoice for a quantity less than that declared on the relative export form, he should produce a notice

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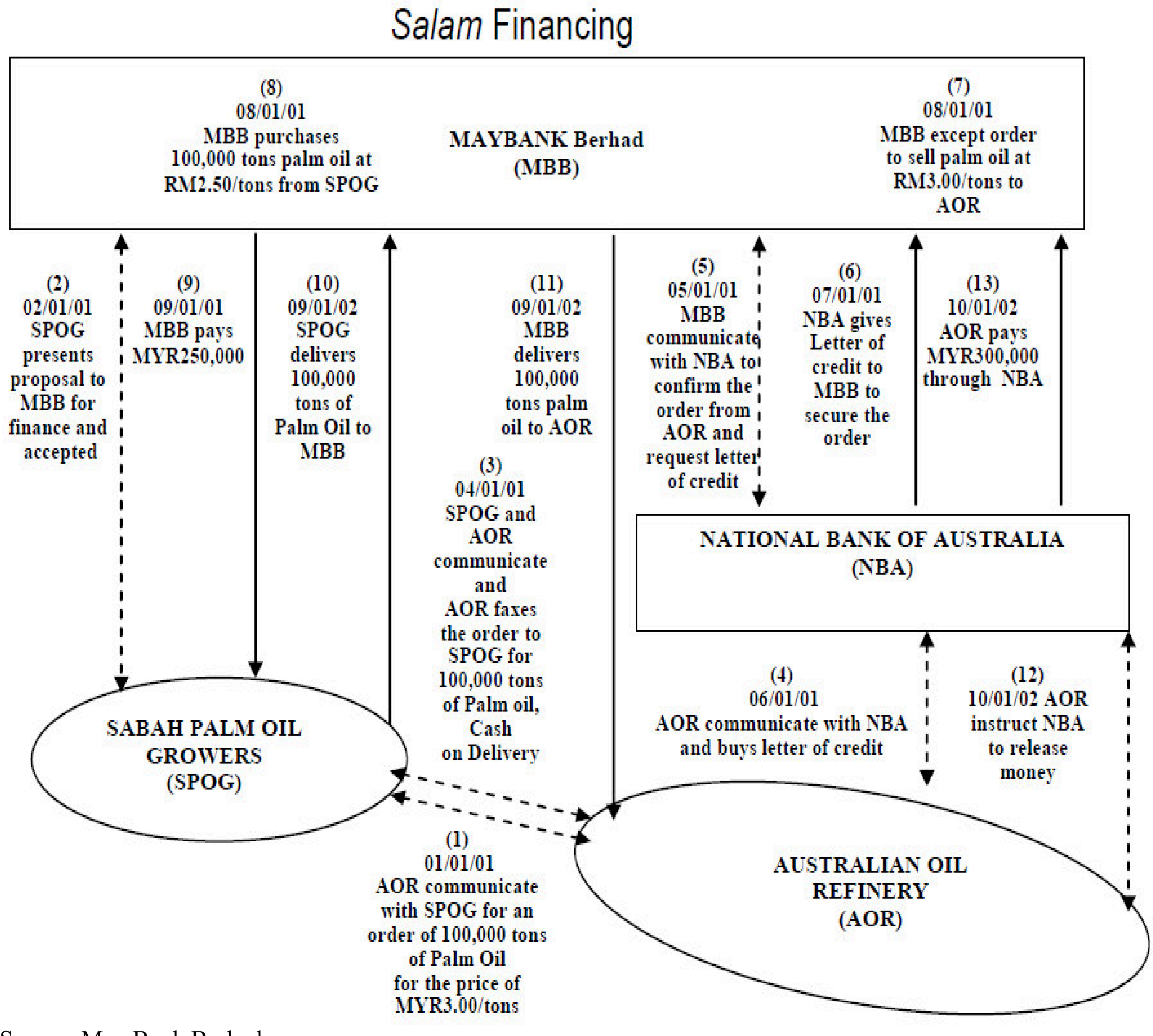
of short shipment on a prescribed form duty certified by the custom with shipping documents. The supporting bank will forward the short shipment notice along with triplicate copy of E form to SBP while reporting the realization of full amount of goods shipped.

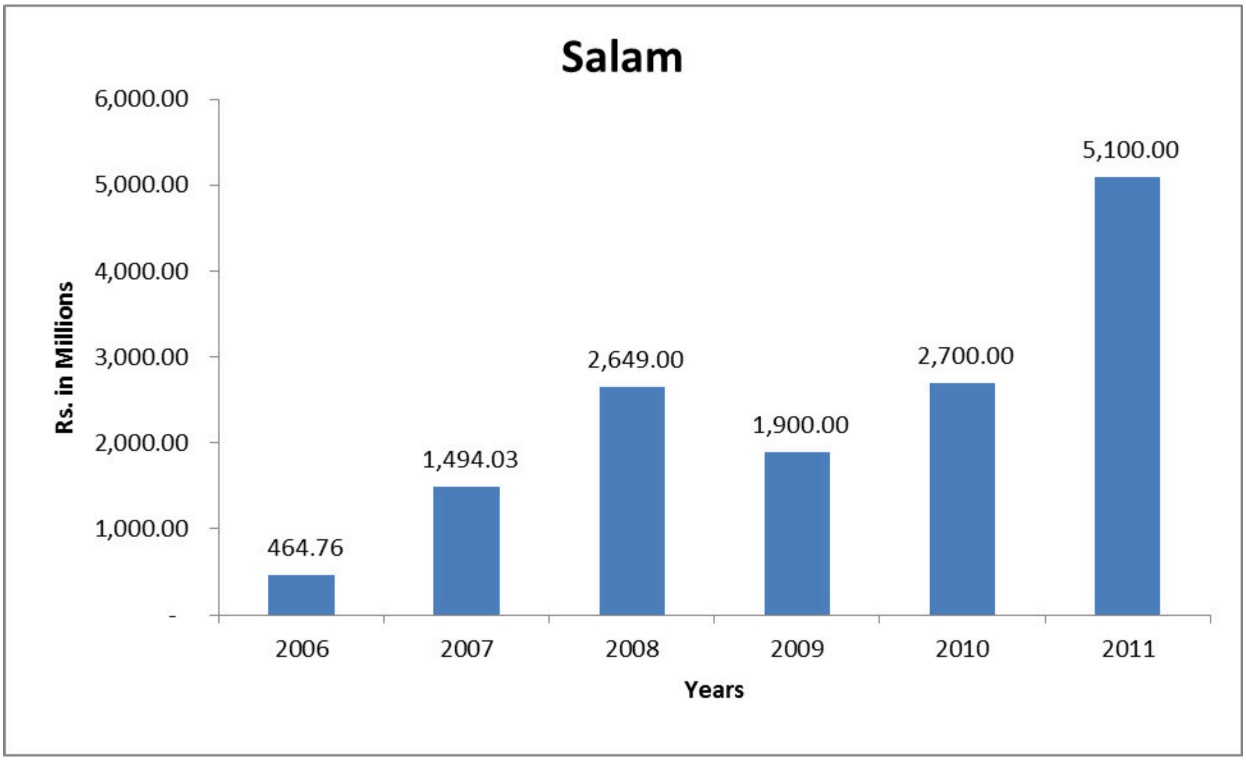
SALAM

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. Salam mode of financing is beneficial for both sellers and purchasers, on the seller side, it is beneficial because it receives the payment against goods in advance and on the buyer side, he obtains the prices generally lower than the spot sales prices.



Source: May Bank Berhad

Islamic banks utilize Salam as financing mode in 2011 comprises 5.1 billion Pak Rs as compare to 2.7 billion in the last year.



In the last year, Salam improves as compared to the previous year and it comprises 5,100.00 Million Pak Rs trade as compare to 2,700.00 Million in the last year 2010 which depicts 88.89 percent tremendous growth and lead to 2.4 percent share in the overall Islamic banking sector financing as compared to 1.40 percent. In istinsa, the exporter requires the funding in order the complete the production.

Conclusion

Now it is the time that Islamic banking and financial institutions resolve to gradually enhance the share of financing on Profit and Loss Basis and reduce the share of financing on the basis of debt creating mode like Murabahah. If Islamic banks and financial institutions are succeeded in practical demonstration of socio-economic justice by enhancing their PLS financing, it will lead tremendous change in the economy. While the dawn of Islamic justice can be visualized where, the fruit of Islamic banking will be available to large number of people leading to overall prosperity in the economy. The growth of Islamic banks in previous few years indicates that the profitability of Islamic banks is less volatile as compared to conventional banks.

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