ABSTRACT

Risk mitigation is one of the key elements in trade financing. The use of documents represents one of the main techniques by banks in managing risks in trade financing. These documents play an important role in financing, insuring, and guaranteeing the banking operations. Islamic finance, on the other hand, utilizes various asset-based contracts. Islamic financial institutions in Malaysia tend to reconcile, using a combination of these contracts, to replicate the conventional banking techniques. These can be at odds with the conventional trade financing concept that “banks deal with documents and not with goods”. Hence, the undertakings may raise concerns regarding Shari’ah suitability. This chapter examines the challenges faced in the usage of documents covering all risk including Shari’ah risk management in Islamic trade financing.
INTRODUCTION

International trade has been an on-going activity since civilizations formed across lands remote from each other. The significance of distance translates into a substantial risk factor differentiating it from normal trade. Not all merchants had the capacity to undertake such endeavours, and for those who could, not all had enough capital or funding to do so. Hence, financing from other parties to the travelling merchant enabled commerce to materialize. In modern international trade, banks have become the intermediaries that facilitate the business of exporting and importing.

For Malaysia, the existence of dual banking system compounds matters as the conventional financial system has been long-established in the country and thus, is more influential. Due to this, the current trade financing techniques are often derived from the conventional banking as Islamic banking is simply duplicating the products as to achieve the same goal resulted from both industries are competing in the same market. This chapter highlights some of the Shari’ah issues and challenges which come about when handling documentation in the context of risk mitigation. The methods used in conventional trade financing will be introduced first, followed by the concepts used in Islamic Finance for the equivalent objective will be explained. After that, the issues arising from this will be put forward. At the end of this chapter, concepts which could be further developed in the future will be put forth.

OBJECTIVE OF RESEARCH

The objectives of this chapter are:

- To investigate current trading practices in Islamic Finance
- To analyse and discuss areas of concern with regards to Shari’ah and its compliance
- To bring forward available solutions as well as suggest practical ways to overcome these issues

With the awareness of such issues and challenges faced by traders and financial practitioners, it is hoped that better practices and procedures will be developed in the future to avoid or even solve them.

This chapter uses a qualitative approach based on evaluation of reported sources such as central bank’s report and readily available research papers, as well as primary resources consists of interviews with experts in the field. Issues being discussed in this chapter mainly concentrate on those within the current Islamic Finance practice in Malaysia which may differ in some concepts and practices from other jurisdictions such as in the Gulf Cooperation Council (GCC) states.

This chapter focuses on issues which have not been widely discussed in today’s literature regarding the handling of documents but do not include risk management strategies such as forward or future contracts and hedging techniques. Structured trade financing is also not thoroughly discussed as it is not considered pure trade but rather a product consists of combination of different concepts. For example, tolling involves financing the processing of raw materials into semi-finished or finished products. Hence, it is considered a combination of trading of raw material and working capital financing.