PRINCIPLE OF STRICT COMPLIANCE IN LETTER OF CREDIT: A COMPARATIVE STUDY FROM LEGAL AND SHARIAH PERSPECTIVE

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ABSTRACT

Letter of credit (LC) is a payment mechanism which is used to facilitate trade. One of the fundamental principles that govern the LC operation is principle of strict compliance. This principle indicates that in order to be paid; seller’s documents must strictly comply with the LCs’ requirement. This practice seems peculiar to the inherent nature of the contract of sale where the goods are customarily considered to be the only “factor” in making a payment. On the other hand, in LC transaction, banks are confined to handling financial and papers only, as provided by the UCP, “Bank deals with documents only”. Accordingly, payment for the goods is not honored upon compliance of the goods sold but it is paid on compliance of seller’s documents. Likewise, it is established that commercial banks worldwide, including Malaysian banks, adopt the same approach in dealing with documents in Islamic LC. The aim of this paper is to look at this practice which is originally conventional, from Shariah’s perspective. In order to determine the permissibility of stipulating such condition (a condition that payment in LC is honoured only upon compliance of documents) from Shariah’s point of view, it is imperative to study the position of Islamic law relating to freedom of stipulating condition in sale contracts. Among other things, this paper discusses the origin of the principle of strict compliance in LC transactions and the rationale of its application. Furthermore, it highlights Shariah issues in the principle of strict compliance in LC. Last but not least, it focuses on the views of the Muslim jurists in the issue of freedom of stipulating condition in sales contract. It is only by looking into the basic principles highlighted by the Muslim jurists on this issue; the permissibility of strict compliance principle can be ascertained.

Field of Research: Letter of credit, principle of strict compliance, legal perspective, Shariah perspective.
1. INTRODUCTION

LC is known as the most famous and secured method of payment in international trade. It comes into existence once the seller and buyer agreed to use LC as a mechanism of payment in their underlying sale contract. Both seller and buyer are representing by the banks as a reliable paymaster. An issuing bank represents the buyer in issuing LC while a confirming bank acts on behalf of the seller which confirmed the issuance of the LC. In order to claim payment, the seller should present to the confirming bank, documents which strictly complied with LC requirement. Any discrepancies in seller’s documentary presentation may triggers non-compliance and the seller does not entitle to receive payment. Thus, in order to honour payments in LC transactions, the bank adopts principle of strict compliance where the documents tendered by the seller must appear to be in strict compliance with the LC requirements. Any error, ambiguity or discrepancy in the seller’s documents will discharge the bank from its undertaking to pay.

Premised on this principle, LC becomes a distinctive method of payment as payment is based on compliance of documents presented by the seller instead of compliance of goods delivered by the buyer under the underlying sale contract. Due to this peculiar characteristic, LC is treated as a special contract and is totally separated from the contract of sale. Generally, the contract encapsulated under LC is that the payment must be based on the basis of strict compliance with the terms and conditions of LC.

The aim of this paper is to look at this practice which is originally conventional, from Shariah’s perspective. Among other things, this paper discusses the origin of the principle of strict compliance in LC transactions and the rationale of its application. Furthermore, it highlights Shariah issues in the principle of strict compliance in LC. Last but not least, it focuses on the views of the Muslim jurists in the issue of freedom of stipulating condition in sales contract. It is only by looking into the basic principles highlighted by the Muslim jurists on this issue; the permissibility of strict compliance principle can be ascertained.

2. PRINCIPLE OF STRICT COMPLIANCE – BACKGROUND

The principle of strict compliance is fundamental to the integrity of LC as a primary obligation. (Dolan, 2009). The issue of strict compliance comes into the picture during the process of checking documents in LC transactions. The bank is the only party in the transaction chain that determines whether or not the presentation complies with the terms and conditions of the LC based on the International Standard Banking Practice (ISBP) and the Uniform Customs and Practice for Documentary Credits (UCP). These guidelines are the standard interpretation, within which the bank must exercise its reasonable judgment, in ascertaining compliance of the documents.

Significantly, the UCP provides relevant provisions relating to documents presented by the seller under LC transaction. Obviously, the requirement of strict compliance is highlighted by Article 18(c) relating to the description of the goods in a commercial invoice. It states:
“The description of the goods, services or performance in a commercial invoice must correspond with that appearing in the credit.”

The above provision expressly maintains the requirement of strict compliance in commercial invoice where it should comply with the terms and conditions of LC. Similarly, the reflection of strict compliance was developed in 1927 by Lord Sumner in the case of *Equitable Trust v Dawson Partners.* His Lordship highlights:

“In LC transactions, there is no room for the documents which are almost the same or which will do just as well.” (Lord Sumner, 1926).

Thus, a document which contains a nearly similar description to those required by the credit and bears the same function could not be accepted as a substitution and should be rejected.

The rationale of the principle of strict compliance is evidently to protect the customer that is the buyer. (Sarna, 1986) Due to the impossibility to witness the existence of physical goods, the document is the only security for the buyer to prove that his goods have been properly delivered as mutually agreed. Thus, it is essential that the documents contain the true description of the goods. Otherwise, the buyer has a right to instruct the bank to reject documents which is deemed to be non-compliant. The bank could not, in any situation, exceed its mandate authorized by the said guidelines, that is, to only pay upon compliance of the seller’s documents. If the bank pays despite knowing of the discrepancies, the bank will have to bear the risk of wrongful honour and will have no recourse against the payment made.

Another rationale of upholding the application of strict compliance in LC transactions is based on the principle that banks are not experts in goods and industries. In most cases, the bank does not even know what kinds of goods are transacted between the seller and the buyer. This is consistent with the principle that the bank is looking only for apparent conformity and is not required to look beyond the face of the documents.

The common discrepancies reported by the previous survey reports (SITPRO, 2003) are those relating to incorrect descriptions of goods on documents, absence of endorsement by the authorities, incorrect spelling of the names of parties, and documents which have not been properly signed or prepared in compliance with the credit requirements. Other common causes of discrepancies highlighted by one of the experts are discrepancies due to the bad practice of exporters, lack of training, fabrication by issuing banks upon request from the so-called VIP applicants who refuse to take up the goods if the price is not as expected. (T.O Lee, 2006). There is also a case where discrepancies are purposely created in order to delay payment where the applicant does not have enough money to pay the goods and the issuing bank is also not willing to advance payment. (Bergami, 2007). Other causes which contribute to the high rate of discrepancies are bankers are not adequately trained. In addition, there are no adequate financial resources to provide them with the effective training conducted by professional trainers.
3. Principle of Strict Compliance and Shariah Perspective

Similar to conventional LCs, Islamic LC is also governed by the principle of strict compliance which indicates that in order to be paid; seller’s documents must strictly comply with the LCs’ requirement. All commercial banks worldwide, including Malaysian banks, adopt the same approach in dealing with documents in Islamic LC. Thus, principle of strict compliance stands as a condition for payment. In other words, payment is absolutely depends on documentary compliance. The issue that arises here is whether such practice is permissible from Shariah perspective.

In order to determine the permissibility of stipulating such condition (a condition that payment in LC is effected only upon compliance of documents) from Shariah’s perspective, it is imperative to study the position of Islamic law relating to freedom of stipulating condition in contracts. It is only by looking into the basic principles highlighted by the Muslim jurists on this issue; the permissibility of strict compliance principle can be ascertained.

3.1 Freedom of stipulating conditions in contracts: different juristic views

Obviously, the Muslim jurists have different views on the permissibility of stipulating conditions in contracts. Thus, the requirement of strict compliance or to stipulate a condition that the documents must be in strict compliance with LC’s requirements before effecting payment triggers diverse opinions among the Muslim jurists. Basically, their approaches on the freedom of stipulation of condition in contract can be divided into liberal, moderate and strict views. (Zaidan, 2003).

A liberal approach is established by Ibn Taymiyyah and his disciple Ibn Qayyim who were prominent Hanbali scholars. Freedom to stipulate condition is considered as a general rule in Islamic law as the former states: It is a basic rule of Islamic law that the contracting parties can make whatever stipulations they deem fit for regulating their contractual relationship. The law will intervene only in a few and exceptional cases to invalidate such stipulation. In other words, it is validity rather than invalidity of stipulation which is the general rule in Islamic law. (Ibn Taymiyyah, 2006).

This indicates that Ibn Taymiyyah treats all stipulations of condition as valid in Islamic law. The contracting parties have a freedom to include whatever stipulations which are suitable to their contracts and the law reserves its interference except in certain exceptional situations. (Abdallah I, 1980). Ibn Taymiyyah’s view is supported by various authorities derived from Quran, Hadith and reasoning. In Quran, Allah (SWT) says:

O you who believe! Fulfill you contracts. (Al-Maidah 5:1).

The above verse signifies that Allah has commanded to fulfill the undertakings or conditions agreed in the contract absolutely. Thus, contracting parties are conferred with full freedom to create whatever undertakings and stipulations. Furthermore, it reflects that the contracting parties are free to stipulate whatever conditions that they
may deem fit for serving their interests, (Abdallah I, 1980) otherwise Allah would not have asked us to fulfil something which is not allowed in the first place, as Allah (SWT) says:

Whereas Allah has permitted sale and forbidden *riba*. (al-Baqarah 2: 275).

Therefore, Allah allows us to be involved in any kinds of transaction except those involving *riba*. Consequently, people are free to make stipulations and regulate contracts in the way that suits them best as Allah (SWT) says:

O you who believe! Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent. And do not kill yourselves (nor kill one another). Surely, Allah is Most Merciful to you. (Annisa’ 4:29).

Based on the above verse, Ibn Taymiyyah held that Allah permits us to make any contracts and stipulations provided that they are based on mutual consent. Once consent is freely given, validity of a stipulation cannot be questioned unless the contrary is proved or a stipulation is prohibited by the law. In addition, Ibn Taymiyyah relied on the *Hadith* of the Prophet (PBUH) when He says:

Muslims are bound by their conditions except a condition which allows what is prohibited or prohibits what is lawful. (Al-Tirmizi)

The above *Hadith* signifies that by analogy, every stipulation which does not contradict principles and beneficial to people is valid and lawful. Apart from the above authorities from *Quran* and *Hadith*, Ibn Taymiyyah relied on the following maxim:

Everything is permitted in transactions as long as there is no an obvious texts or general provision of the *Shariah* that nullifies it. (Al-Jawziyyah, 1991).

The above maxim shows that any stipulation in a contract which is not prohibited by the *Shariah* is acceptable. Therefore, as far as the issue of stipulating conditions in contract is concerned, Ibn Taymiyyah’s approach reflected that the contractual parties are free to stipulate whatever conditions which they may deem fit for their interests (Abdallah I, 1980) and any stipulations of condition is valid as long as there is no involvement of interest and uncertainties. Last but not least, Ibn Taymiyyah held that mutual consent of both contracting parties is the most important criteria for the validity of the condition in contract. (Ibn Qudamah, 2001, Ibn Taymiyyah, 1994).

Based on the above mentioned authorities, the contracting parties are allowed to make any stipulation in accordance to their wishes provided that the stipulation is not against the express injunction of *Quran*, *Hadith*, *ijma* and *qiyas*. (Ibn Taymiyyah, 1976, Zaidan, 2003). Since there is no verse in *Quran* that prohibits the making of stipulations, the contracting parties are allowed to make any stipulations for their business due to the fact that this is part of the ordinary activities.

On the other hand, a moderate view is established by Jumhr consisting of Hanafis, Shafiis, Malikis and the early Hanbalis. According to the Jumhr, there is no requirement for specific textual authority for permissibility of
condition in contract. Furthermore, they do not consider that freedom to make stipulation as the general rule in Islamic law. In addition, Jumhur incline to take restrictive view to the freedom of contracting parties to make stipulations and at the same time, they have broadened the exceptions for those restrictions. (Zaidan, 2003).

In contrast to Ibn Taymiyyah’s and Jumhur views, a strict approach was established by the Zahiris who totally prohibit stipulation of conditions in contract. Ibn Hazm, one of the Zahiris’ scholars, opposed to treating the validity of stipulations as a general rule and upheld that it is the invalidity of stipulations which should be treated as such. (Ibn Hazm, 1980) In addition, the Zahiris highlight that Allah (SWT) has prescribed contractual obligations and procedures of executing a contract. Therefore, human being has no authority to interfere in matters which have been outlined by the Quran and Hadith. Thus, a stipulation of conditions which is not described by the Shariah is nullified. To support their opinion, Zahiris have referred to the following verse of the Quran where Allah (SWT) says:

And who disobeyed Allah and His Messenger and transgressed His limits, He will make him enter fire, where such will dwell forever. (Al-Baqarah 2: 1999).

Hence, the contracting parties cannot make any stipulation unless the making of such stipulation is expressly sanctioned by law. In the Hadith, the Prophet (PBUH) says:

Whoever did a thing which is not according to our instruction is rejected. (Sahih al-Bukhari)

In another Hadith, the Prophet (PBUH) says:

What happened to the people that they impose conditions which are not in the Book of Allah, whatever the condition is not included in the Book of Allah is nullified and though they make hundred conditions. (Sahih al-Bukhari).

Therefore, it is not permissible to stipulate any conditions to a contract, except those which are laid down by the Quran and Hadith. (Ibn Hazm, 2001). All conditions stipulated by contracting parties are void in the absence of textual authority or consensus of opinions authorising it. (Ibn Hazm, 1980).

3.2 Types of condition in contract according to Muslim Jurists and principle of strict compliance in LC: a comparison

It seems that there is no unanimous agreement among the Muslim jurists in the classifications of types of stipulation of condition in contract. Hanafis categorise stipulations of condition into three (3) types, which consist of shart sahih (valid stipulation), shart fasil (irregular or voidable stipulation) and shart batil (void stipulation); (al-Shawkani, 1994) whereas Jumhur (Malikis, Shafi’is and Hanbalis) divides into two categories only that is shart sahih and shart batil. (al-Zuhayli, 1984). According to Jumhur, shart sahih means a condition which fulfils the entire requirement for a valid contract whereas shart batil is a condition which does not fulfil the requirement for a valid contract. (al-Zuhayli, 1984). On the other hand, Hanafis have specified the scope of shart sahih to a stipulation which is either inherent to the nature of contract; (al-Zuhayli, 1981; Zaydan, 2003) appropriate to the contract, established by custom or expressly sanctioned by law. (Abdallah I, 1980; Zaidan, 2003).
The first type of *shart sahih* as classified by Hanafis is a stipulation of a condition inherent to the nature of contract since those stipulations are implied condition to the nature of contract. (al-Kasani, 2000). For instance, a condition that a buyer will acquire ownership if he buys the goods or a seller will be paid if he sells the goods. In LC context, condition which requires the seller to fulfill several documents in strict compliance to obtain payment is a condition inherent and customary to the nature of contract. This signifies that the seller is agreed to transfer the ownership of the goods to the buyer. The issuance of the LC by the issuing bank in the first place, indicates that the buyer agreed to purchase, pay for the goods, take delivery and accept ownership of the goods from the seller. Therefore, it is valid, since the benefits are implied to the contracts regardless of the existence of such stipulation. (Abdallah I, 1980).

The second type of *shart sahih* recognised by the Hanafis is a condition which is appropriate to the contract. It refers to the stipulation of a clause which is not primary to the contract terms but is appropriate and complies with its basic demand. (Oussama, 1998). It includes a stipulation by the seller that the buyer shall provide a surety (*kafil*) who can guarantee the payment of the price; a stipulation by the seller that the buyer shall give collateral (*rahn*) before he is allowed to take the goods and a stipulation by the seller that the buyer shall pay the price to the seller’s creditor. (al-Shakwani, 1994; al-Sarakhsi, 1986). In LC transaction, the issuing bank is said to be the surety or a party that provides a guarantee of payment to the seller, provided that the seller complies with all the terms and conditions of the LC. The seller is assured by an irrevocable payment instrument which cannot be revoked without the consent of the seller. The seller may request for a standby LC to serve as security where the seller can claim damages in the event the buyer fail to fulfill his obligation under the contract.

Furthermore, the third type of *shart sahih* accepted by Hanafis is a stipulation of condition which is established by the custom of a place. (al-Kasani, 2000) Hence, a transaction contains a stipulation which is common practice or established custom is permissible. (al-Kasani, 2000; al-Sarakhsi 1986). This is based on the authority of the Prophet (PBUH) where he bought a camel from Jabir Ibn Abdullah with a condition that Jabir shall ride and deliver the horse to Madinah. (al-Sarakhsi 1986). Therefore, it is permissible for a buyer to put a condition to a seller that the seller shall promise to repair the sold goods (such as watch, radio, motor car, washing machine and fridge) within a prescribed time (al-Zuhayli, 2003). However, it should be noted that this kind of stipulation should be applied with cautious for a trivial departure from the identifiable customs is illegal and affects the validity of contract. (Oussama, 1998). In LC context, it is common for the buyer to request for pre-inspection and request for additional documents such as certificate of quality or certificate of origin apart from bill of lading, invoice and certificate of insurance to ensure goods fulfill the conditions as described in the sale contract.

Last but not least, the fourth type of *shart sahih* recognised by Hanafis is a stipulation which is clearly prescribed by Islamic law such as stipulation for right of option for three days. This is established by the Hadith of the Prophet (PBUH) when He says:

> If you trade, then say: “no wheedle” and I have an option for three days.
Furthermore, Hanafis refers to *shart fasid* (irregular or voidable) as a stipulation that confers an additional advantage, (which would not have otherwise been obtained under the prescribed effects of the contract), on one of the contracting parties or the subject matter of the contract or a third party. (al-Kasani, 2000) In relation to this kind of stipulation, Hanafis did not recognise its validity based on the principle that there must be a consideration of every stipulated condition. (al-Sarakhsi, 1986) The examples are illustrated as follows:

If a man buys an item on the condition that the vendor carries it to his house; or if he buys wheat on the condition that the vendor grinds it; or if he buys a cloth on the condition that the vendor tailors it; then all these contracts are void. (al-Syaibani, d. 1804).

In LC transaction, there is no such situation as all the duties and liabilities of the seller and buyer are clearly provided by the International Commercial Terms (INCOTERMS). INCOTERMS gives the contractual parties’ duties such as delivery of goods, distribution of costs, risks, procurement of cargo insurance and contract of carriage. For instance, in a contract which used CIF (Cost, insurance, freight) terms, it is already prescribed by the INCOTERMS that a seller is under a duty to arrange for a contract for the carriage, procure for the cargo insurance and ensure delivery to the final destination in the country of the buyer. If the buyer wishes to arrange for the carriage, he cannot amend the CIF term but choose another term, FOB (free on board). Therefore, as far as seller and buyer relationship is concerned, there is no issue of stipulation or condition which confers an additional advantage on one of the contracting parties since duties and rights for both parties are clearly laid down by INCOTERMS.

Thus, a stipulation which benefits one of the contracting parties renders the contract irregular according to the Hanafis. In contrast, it is considered as valid by Malikis and Hanbalis and void by Shafi’is. (Ibn Rush 1975; Ibn Taymiyyah, 2006; Abdallah I, 1980). However, it should be noted that the rule mentioned by Hanafis confined only to contract of exchange where the existence of such condition is detrimental to such contract as fairness should equally be served to both contracting parties.(Zaidan, 2003). Accordingly, it is not applicable to charitable or gratuitous contracts.

Moreover, Hanafis define a void stipulation as those which do not fall under any of the categories of a valid stipulation and at the same time do not confer any additional advantage to any person.(Zaydan, 2003). For example, a stipulation by the seller that the buyer shall not re-sell the goods, a stipulation by the seller of a house that the buyer shall destroy it and a stipulation by the seller that the buyer shall not use the property sold.

On the other hand, Malikis refer to void stipulation as those stipulations which are contrary to the inherent nature of the contract and render the price uncertain, while Hanbalis refer to those stipulations which contrary to the inherent of the contract and violate the rule of law. (Abdallah I, 1980).

The similar approach to the Hanafis is demonstrated by the Shafi’is.(Abdallah I, 1980). It is observed that the only difference between these two schools is that, Shafi’is do not absolutely recognise the validity of stipulations sanctioned by custom. (al-Zarkashi, 2000). Apart from that, the approaches of these two schools are the same.
Generally, the Malikis allow all conditions stipulated in a contract as long as there is no element of *riba* and *gharar*, (Ibn Rushd, 1975) based on the *Hadith* where the Prophet (PBUH) says:

> The Muslims are on their conditions except the condition which forbid the permissible thing or permit the forbidden thing. (al-Tirmizi).

Compared to the Hanafis, the Malikis provide a broader sphere for valid stipulations. (Abdallah I, 1980). The Malikis recognise a stipulation inherent to the nature of contract or prescribed effect to the contract, a stipulation established by custom and a stipulation that confers a due advantage on one of the contracting parties or a third party. (Abdallah I, 1980). Accordingly, the Malikis allow the stipulation of a condition that a seller can stay at his house for some time after selling it to the buyer. (Abdallah I, 1980).

Based on the Muslim jurists’ opinions discussed above, it is observed that the most liberal approach pertaining to the issue of stipulation of condition in contract is established by Ibn Taymiyyah from the Hanbalis. (Ibn Qudamah, 1990, al-Zarqa, 1967). In relation to this, it is claimed that the Hanbalis’ view in matters pertaining to “freedom to make stipulation” resembles to civil law. (al-Zuhayli, 2003) The liberal approach of Ibn Taymiyyah is obvious when they recognise a stipulation that confers an undue advantage to a contracting party or a third party. However, similar to Malikis, the Hanbalis reject a stipulation which contradicts the inherent effects of the contract. (Ibn Qudamah, 1990). Moreover, the Hanbalis did not recognise any condition that violates the law or a condition which is contrary to the *Hadith* of the Prophet (PBUH). (Ibn Qudamah, 1990) In short, Ibn Taymiyyah maintains that any stipulation which is not contrary to a rule of law is valid.

In relation to this view, it is interesting to analyse Article 1 of UCP 600 which reads:

> …they are binding on all parties thereto unless expressly modified or excluded by the credit.

This article permits modification to the conditions of an LC which is mutually agreed to by all the trading parties. When it is read in the context of Islamic LC whether it is on *wakalah*, *murabahah* and *musharakah* LC, the buyer in particular, could state a condition, for example:

> Invoice must be signed by the buyer’s authorise signatory(ies) and verified by the issuing bank to certify goods are received in good condition and order before payment is affected.

This modification or additional condition would serve as an additional guarantee to the buyer that he received the goods in the manner described by the sale contract and free from any defect or fraud. The seller on the other hand, would not be deprived of his payment as LC represents irrevocable undertaking of the bank to make payment upon compliance of documents. Having this condition expressly stated, no banks are required to lay their hands on the goods or ‘deal’ with the goods. In other words, it complies with the requirement of Article 5 of UCP 600.  

Furthermore, it strictly complies with the *Shariah* principle as the concept of equity and fairness in trade is firmly upheld. Besides having an assurance of payment against presentation of documents, the seller is also confined to fair trade with no room to fabricate fraud or delivering substandard goods to the buyer. The bank, being appointed
as an agent will act in accordance with the instruction provided for by the buyer to honour the payment to the seller as agreed, which is payment against compliance of documents.

The Hanafis’ views provide a comprehensive guidance in freedom of stipulation of contract which could be conveniently accommodated by business trade community. In addition, Shafi’is approach seems quite rigid since any stipulation which does not confer a fair advantage to contracting parties is not permitted.

At the same time, the Malikis’ view is deemed to fulfill the objective of the Shariah since they allow all conditions as long as there are no elements of riba and gharar. In addition, they recognise any stipulations which are not contrary to Quran, Hadith, ijma’, or qiyas. (al-Zuhayli 2003) This approach is in line with peoples’ needs and interests and is suitable with the current development.

On the other hand, the Zahiris’ view seems too narrow since they have forbidden all types of conditions which are not mentioned in the Quran and Hadith. This approach is obviously inappropriate for current practice as these two primary sources only specifically outlined the prohibited things without specifying what are permissible. It is also claimed that the authorities referred to by the Zahiris School which restrict the freedom of stipulation of condition is applicable only to matters pertaining to ibadah (worship) and not mu’amalah (transaction). Moreover, it is argued that the Zahiris’ reference to the Hadith of the Prophet (PBUH) which forbids the stipulation of conditions that are not in the book of Allah, could not be applied generally since it is confined to those conditions which contradict a rule of law. (Ibn Taymiyyah, 1976). Thus, due to the rigidity of the Zahiris’ view, it is not appropriate to be applied in ascertaining the validity of the stipulation in LC transactions as this view seems to not support trade development. Otherwise, all new economic and trade activities which consist of various conditions unknown to the early jurists will not be accepted.

Thus, the views of Ibn Taymiyyah, Ibn Qayyim and the Jumhurs (Hanafis, Malikis and Shafi’is) are preferable since they have been presented within a moderate to liberal approach in stipulating conditions, supported by reliable authorities. In addition, Jumhurs’ view is practical in the sense that the contracting parties are permitted to stipulate conditions with certain exceptions. (Ibn Taymiyyah, 2001). This approach serves the needs of business activities and the trade community. Last but not least, it confers flexibility and encourages the development of trade business.

3.3 Permissibility of the stipulation of documentary compliance in LC: harmonisation of principle of strict compliance with Shariah principles.

Therefore, to confirm the permissibility of the stipulation of documentary compliance in LC, it should refer to the aim of LC to facilitate trade between seller and buyer. Consequently, the principle of strict compliance should be applied in line with the aim of facilitating trade. The above discussion on the freedom of stipulation of condition in contract generally revealed that Islam does not prohibit the application of any rules which are by nature Conventional and non-Shariah base provided that its application is not contradictory to Shariah principles. Thus, the stipulation that the seller’s documents must be in strict compliance before making payment in LC is not contrary to Shariah principle since it is considered as a condition established by custom which has been practiced and
universally accepted worldwide. This practice of strict compliance originated by custom and developed by time since
the payment by using LC is a new trade activity which consists of various forms and conditions that was unknown to
the early jurists. Furthermore, the strict compliance is an appropriate and complies with the basic demand, as long
as there is no element of riba and gharar or any elements prohibited by Shariah.

However, it should be noted that Islam emphasises on the concept of fairness and justice in all dealings. Any kind of
arrangement must be fair to both contracting parties and must not contain any element of bias or unfair advantage
to one party or grants unjust enrichment to the other party. Thus, it should be noted that, generally this practice is
not contrary to Islamic principles provided that both contracting parties; the seller and the buyer have agreed
upfront to abide by such an arrangement and it is made based on mutual consent.

In relation to this, it is highlighted that Shariah also gives leeway for any of the contracting parties to cancel any
stipulation of contract based on mutual consent through the concept of iqalah. Iqalah is defined as “termination of
contract by mutual consent of the parties in case one of them is regretful and wants to turn away from the
contract.” (al-Zuhayli, 1984). The permissibility of iqalah is based on the Hadith of the Prophet (PBUH) who is
reported to have said:

Whoever discharges a regretful person of his undertaking, Allah (SWT) will remove his obstacles in
the hereafter. (Sunan Abu Daud).

Therefore, with regards to LC contract, should the seller found that it is inconvenient for him to fulfill any condition
pertaining to documents required by the buyer, he may ask the buyer to waive such kind of condition.

Generally, it could be viewed that the UCP as a whole is complied with Shariah requirement of justice and fairness
as far as the right of both seller and buyer are concerned. The UCP 600 is a clear set of rules that do not consider
defect of the goods as a reason for ‘non-compliance.’ This position gives the fraudulent seller a perfect vehicle to
accomplish his task by delivering fraudulent goods and presenting the compliant documents. By relying on the
principle of “banks deal with documents” only, the fraudulent seller may easily get his payment. The position in such
case is unfair to the innocent buyer since he has to pay and get nothing worth for his goods. Moreover, the seller is
the only party who should complete the process of collating and presenting the documents called for in an LC and
the buyer has no direct or indirect role in the said process. It is a general rule that ‘seller’s presentation’ is the
ultimate consideration for payment by banks. Therefore, it is solely the basis on which banks determine whether or
not the payment is to be honoured.

Thus, the application of strict compliance should at the first stage observe Shariah requirements of justice and
fairness, otherwise the application may be deemed not in harmony with Shariah principles. This can be supported
by the Hadith where the Prophet (PBUH) says:

The Muslims are on their conditions except the condition which forbid the permissible thing or
permit the forbidden thing. (Sunan al-Tirmizi).
Accordingly, any constraints or hardship caused by the discrepancy arising out of the strict literal compliance approach should be avoided since Islam encourages convenience in doing business transactions. The Prophet (PBUH) says:

Harm may neither be inflicted nor reciprocated (in Islam),(Muwatta, 1990).

From Islamic perspectives, the substantial compliance rather than strict literal compliance seems to be in line with Shariah principles since it provides fair dealing when it comes to discrepancy. Thus, documents which substantially complied with LC requirement must be accepted as a good presentation. Minor discrepancies or trivial mistakes in documents which do not affect the LC transaction should not be a basis to disqualify the seller from receiving payment. In addition, it should be noted that Islam places an important consideration on goods and payment where payment for value of the goods must be made as agreed, as long as the goods are not haram (illegal) by nature, and that they are not to be used in any prohibited activity.

Furthermore, the principle of strict compliance where payment undertaking depends totally on the seller’s documents is also not properly suit to be applied in murabahah LC. In fact, it is the goods that should take priority since in the murabahah sale, it is not the documents but the existence of the goods is the most important criteria for a valid sale contract. Thus, this principle of strict compliance should be meticulously applied and it is not hundred percent appropriate to govern Islamic LC transaction. Furthermore, the goods are fundamental in LC issued under murabahah since a sale contract must not be signed unless the existence of the goods is ascertained. Therefore, the goods represent the bottom line to determine validity of the contract. In short, the new UCP 600 limits the depth of examination of documents by banks and provides leniency in resolving issues on discrepant documents where the trading parties, namely the buyer and the seller, equally have some binding say on how the discrepant documents should be dealt with. Generally, as far as ‘compliance’ is concerned, the new UCP 600 can be said to encourage fair and equitable trade.

4. Conclusion

It is fundamental that the seller’s documents must be in strict compliance with the credit to secure payment. This is the basic principle in LC operations where ‘documents match payment’ is purely based on compliance of documents with the terms and conditions of the LC. Wider strict compliance as suggested by the new UCP 600 does not mean that the data content in any documents could go ‘unmatched’. Generally, it only widens the scope of compliance where data in any document may differ expressly with one another but should not contradict each other. This is in line with the different purposes and functions of each document where the express wording contained in any one document may slightly differ with the expressed wording in other documents. This new approach of compliance is seen to ensure smoother payment under the LC rather than looking for discrepancies and rejecting such discrepant documents during the process of document examination.
In Islamic LC transaction, the principle of strict compliance is firmly intact similar to the conventional method where banks are only concerned with the compliance documents and has no connection with the sale of goods contract. On the other hand, the principle of strict literal compliance is seemed as not properly compatible to Shariah requirement of fair and justice whereas substantial compliance is more justifiable.

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1 ISBP is issued in January 2003, reflected the best practices used by banks in determining compliance of stipulated documents under LC. Its function is to serve as a guideline to practitioners dealing with documentary compliance.
2 The UCP is a body of Articles which regulate the implementation and operation of LC. The latest version is the UCP 600 which has been implemented from 1st July 2007. Even though UCP has no force of law, it has been applied in almost transaction involving LC.
3 See, articles 14(d), 14(e) and 14(j).
4 (1926) 25 LIL Rep 90; In this case, LC called for a certificate to be signed by experts, the bank paid against a document signed by only one expert. The bank was not entitled to reimbursement.
6 See, article 34, UCP 600.
7 “Banks deal with documents and not with goods, services or performance to which the documents may relate.”
8 In matters pertaining to ibadah, it is necessary to have Shar'ah explicit text but in muamalah including contractual issues, it needs no Shariah explicit text to explain its validity. It is sufficient as long as it is not prohibited by the Shariah. This is based on the principle that “everything is permissible until contrary is proved,” see, Al-Zarqa, Mustafa Ahmad, al-Madkhal al-Fiqh al-Amm, Dar al-Fikr, Damascus, 1967, at 481.
9 See, Article 16, UCP 600.
References


Al-Baqarah 2: 275

Al-Baqarah 2: 1999

Al-Maidah 5: 1

An-Nisa’ 4: 29


Uniform Custom and Practice for Documentary Credit (UCP) 600. (ICC Publication No 600), (2007).

