

# ISLAMIC “UPAS” LETTERS OF CREDIT

UPAS is the acronym for “Usance Payable at Sight”. From the name, you can deduce that it is a combination of a usance and sight LC.

In a UPAS LC, the beneficiary receives payment on a sight basis, while the applicant enjoys the benefit of the usance facility and reimburses the issuing bank on the maturity date, along with interest covering the out of fund period.

The situation can arise that a beneficiary will not accept usance payment terms even though the materials may be needed urgently by the applicant. Conversely, the applicant may not have surplus or sufficient funds to reimburse the issuing bank if an LC is issued on a sight basis.

What are the possible remedies?

The applicant can consult with its bank and the bank could agree to issue a sight LC with the reimbursement to the issuing bank being delayed through a loan or overdraft facility.

Or, the applicant requests the issuance of a usance LC and the beneficiary can arrange a negotiation or discount of the draft or deferred payment undertaking. Usually, the negotiation/discount fee will be deducted from the proceeds paid to the beneficiary.

It is unlikely that both of these remedies will be acceptable to both the applicant or beneficiary in the circumstances described.

## **UPAS benefits to a Beneficiary**

For the following reasons a beneficiary could agree to accept a UPAS LC:

- The beneficiary will receive payment upon a complying presentation being made to the nominated or issuing bank.
- Reduces “Days Sales Outstanding (DSO)” due to payment “at sight”.
- Increases the marketability of products by providing an applicant with the incentive of extended payment terms as agreed with their own bank.
- Keeps the integrity of the price, as the beneficiary does not need to build in the cost of covering extended payment terms or the negotiation/discounting fees.
- Maintains quality of receivables because payment assurance is still secured through a letter of credit.

## **UPAS benefits to an Applicant**

A UPAS LC is flexible not only for the beneficiary, but also gives some benefits to the applicant, which are enumerated below:

- The interest rate can be lower than that applicable in the country of the applicant i.e., by taking advantage of a lower rate that may be applicable in the country of the beneficiary, by having the nominated bank manage the sight payment process.
- It helps to optimize working capital.
- It enhances Days Payable Outstanding (DPO) by providing extended payment terms.
- It helps to provide an additional source of liquidity.

## **What is an Islamic UPAS LC and how does it work:**

The advantages and disadvantages of the Islamic UPAS LC are the same as a conventional LC, with the exception of the exclusion of an element of interest which is prohibited in Islam.

The UPAS LC arrangement is made through the issuance of a usance LC to facilitate payment to the beneficiary for the documents amount, upon the issuing or nominated bank's receipt of the goods or against the required documents determined to be a "complying presentation". Such funds are procured at the applicant's request under a Sharia compliant arrangement, so that the applicant can settle the reimbursement liability to the issuing bank on the due date, as agreed upon in the transaction documents under the Sharia arrangement/facility, and as approved by the applicant with its bank.

Hence, the UPAS LC is designed to satisfy the needs of both parties, that is, the beneficiary can receive payment at sight, while the applicant can receive the goods on an urgent basis even though financially he is not in a position to pay at sight. The applicant utilises a usance LC facility to enable him to reimburse the issuing bank on a deferred basis.

What will the applicant do to open such a LC?

The applicant will consult with his bank regarding the payment position of the beneficiary and of their own, with a view that the bank in turn will agree to issue a UPAS LC and offer

a facility under a Sharia compliant mode of finance against reimbursement to the issuing bank on a deferred payment basis.

The above structure is proposed as a Sharia alternative to the conventional usance LC, where the beneficiary may/will seek a discounting arrangement with the nominated bank against payment of a discount fee and interest. Also, the Islamic UPAS LC can be seen as an alternative to the conventional practice where the applicant, in the case of a sight LC, may request its bank to pay the beneficiary on a sight basis against interest bearing ODs or any similar arrangement.

#### **UPAS LC Mechanism:**

- Although the beneficiary requires payment at sight, the applicant approaches its bank to open a usance LC.
- The bank issues the usance LC as requested, and sends it to the advising/confirming bank for advising to the beneficiary. The LC will indicate that although the drafts are to be drawn payable at [usance period], the beneficiary is to be paid on a sight basis. The same structure will apply to an LC that is available by deferred payment.
- Beneficiary ships the goods and sends its documents to the nominated or issuing bank.
- In order to meet the beneficiary's payment requirement, a Sharia compliant arrangement is made to allow the payment to the beneficiary immediately upon accepting the documents.
- Funds can be arranged/prepared by granting the applicant a Tawarruq based Murabahah from its bank or any other bank, as the case may be, or under any other Sharia approved structure.

In addition to the above, the following take place:

- A one-off agreement or master agreement is signed between the LC issuing bank and the nominated bank.
- The agreement, in simple words is called a Master Murabahah Agreement, and is completed/valid before the issuance of any LC under this arrangement.
- Pursuant to the Master Murabahah Agreement, and in order to procure funds to the beneficiary, a Murabahah transaction is to be executed by exchanging the Offer and Acceptance between the financing bank/applicant and the issuing bank.
- Although a usance draft will be called for under the LC, the LC will state that the nominated bank or issuing bank will effect payment to the beneficiary on a sight basis.

- For generating the funds for such a transaction, a nominated bank (an Islamic bank) will complete the purchase (finance the purchase) and sale of commodities on behalf of the issuing bank (as an agent of LC Issuing Bank) and the funds so generated from the sale of the commodities will be used to pay the beneficiary on a sight basis.
- Ideally, the Tawwaruq Agreement should be between two Islamic banks i.e., the LC issuing bank and the financing bank are to be Islamic to avoid any fear of Riba. Nevertheless, the agreement can be with a bank other than an Islamic Bank.
- Funds generated are paid to the beneficiary and the purchase of the commodity price (sale price i.e. cost plus profit) is paid by the LC issuing bank in bullet payments, or instalments, normally for 6-12 months until the maturity date of the draft.
- In case of delayed payment by the issuing bank, a certain percentage of the outstanding amount, shall be donated to charity by the issuing bank (but the financing bank cannot charge overdue profit since the finance amount represents the sale of commodities on profit and not on interest).
- There are by-products of this product, i.e., syndication/funded and unfunded risk participation.