

**DA AFGHANISTAN BANK**  
**(CENTRAL BANK OF AFGHANISTAN)**  
**Product Outline: Letter of Guarantee (Trade Financing)**

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Accountable Executive & Custodian	Islamic Banking Division
Policy Owner	Head of Islamic Banking Division

Approved by DAB Governor:	Date .....	DAB Board Secretary .....
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**ISLAMIC REPUBLIC OF AFGHANISTAN**

**DA AFGHANISTAN BANK, PRODUCT OUTLINE – LETTER OF  
GUARANTEE (TRADE FINANCING)**

**PART A: PREAMBLE**

**1 Background**

- 1.1. This product outline for a Letter of Guarantee (Trade Financing) (hereinafter referred to as “the Product Outline”) is issued by the Da Afghanistan Bank (hereinafter referred to as “DAB”) which shall be adopted and become the guiding principles for Islamic Financial Institutions, Financial Institutions operating with an Islamic Window and Financial Institutions operating with an Islamic Unit (collectively referred to as “the Bank”) in the Islamic Republic of Afghanistan offering Islamic financial products.
- 1.2. This Product Outline is intended to:
- i) Enable Banks to develop their own Letter of Guarantee (Trade Financing) products using this Product outline as a baseline for the product development process; and
  - ii) Illustrate to the Bank global best practices in adopting the Product Outline.
- 1.3. The objectives of this Product Outline are to:
- 1.3.1. Facilitate the development of Letter of Guarantee (Trade Financing) products in Banks in the Islamic Republic of Afghanistan; and
  - 1.3.2. Establish a precedent Product Outline that the Banks shall use when developing and operationalising their Letter of Guarantee (Trade Financing) products.
- 1.4. Any particular exemption to any of the provisions as provided herein shall only be permitted via a formal application being submitted by the Bank after prior consultation with its Shariah Board (hereinafter referred to as “the Shariah

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Board”), to the Shariah Supervisory Board of DAB (hereinafter referred to as “the SSB”) outlining the reasons and justifications for such requests.

- 1.5. If any new or additional guidelines on the Product Outline are to be adopted, the Shariah Board of the Banks shall always be consulted first before the adoption of same.

## **2 Legal Provision**

- 2.1. This Product Outline is issued pursuant to Article 2.2 of the Afghanistan Bank Law gazetted on 12/17/2003 (corresponding to 30/10/1382) in relation to the powers of DAB to regulate and supervise Banks in the Islamic Republic of Afghanistan and any amendments thereto.
- 2.2. This Product Outline shall be read together with the following manuals/guidelines:
  - 2.2.1. National Shariah Governance Framework;
  - 2.2.2. Shariah Review Manual;
  - 2.2.3. Shariah Compliance Manual;
  - 2.2.4. Guidelines on Ibra;
  - 2.2.5. Guidelines on Late Payment Charges; and
  - 2.2.6. Other relevant regulations guidelines or circulars that Da Afghanistan Bank (“DAB”) may issue from time to time.

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**PART B: PRODUCT OUTLINE – LETTER OF GUARANTEE (TRADE FINANCING)**

**3 Product Outline Structure – Letter of Guarantee**

- 3.1. Proposed underlying contracts: Kafalah and Master Commodity Murabaha Agreement.
- 3.2. Product Description
- 3.3. A guarantee is a written undertaking issued by a bank in favor of the receiver of the goods or services (the client/customer), whereby it pledges to make certain payments on behalf of its client, if the latter fails to make a payment or to carry out specific functions in terms of the commercial contract. The bank's commitment is legally independent of the underlying commercial contract.
- 3.4. A guarantee (bond or surety-ship, as it is sometimes called) supports commercial contracts by providing trading partners with the flexibility to reduce credit and Performance risk. It is a supplementary agreement or form of collateral or security relating to a specific transaction, for example:
- a) Seller may not be able to assess a buyer's ability to pay for goods or a service rendered and wants protection against non-payment; and
  - b) The buyer questions the seller's financial capability, resources and ability to perform under the commercial contract and needs protection against non-Performance.
- 3.5. Types of Guarantees
- a) Payment Guarantees
  - b) Performance Guarantees
  - c) Bid Bond Guarantees
  - d) Advance Payment Guarantees
  - e) Retention Bond
  - f) Warranty / Maintenance Bonds
  - g) Financial Guarantee (only for Sharia compliant financing)
  - h) Labor Guarantee

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- 3.6. The Letter of Guarantee (LG) is subject to the proviso that it will only be used for Shariah compliant goods and contractual terms (which shall exclude any receipt of payment or interest) excluding debt and receivables as well as any refinancing of an asset. A non-exhaustive list of same is attached hereto at **Appendix 1**.
- 3.7. The Master Commodity Murabaha Agreement will be entered into by the customer and the Bank when granting the facility. The Customer will appoint the Bank its agent to execute the schedules of the Master Commodity Agreement in the event of default. The Bank will utilise the proceeds of the on-sale to settle its claim against the customer under the Letter of Guarantee and the Bank shall be entitled to its principal and profit as it accrues in accordance with the Master Commodity Murabaha Agreement. For more details on Commodity Murabaha please see the Product Outline, Cash Financing / Working Capital Finance.
- 3.8. The Commodity Murabaha contract is supplementary to the Guarantee or Kafalah as Commodity Murabaha is only needed to manage the risk of repayment by the principal debtor after the guarantor has made the payment to the guaranteed party/beneficiary and it is not essential to Kafalah.

#### **4 Concept and Basic Conditions**

- 4.1. There are a number the key conditions that have to be complied with for a Kafalah contract to be in line with the prevailing Shariah principles:
- 4.1.1. The Kafalah must be for a specified amount in an agreed currency, or where the conversion rate has been pre-agreed.
- 4.1.2. The terms of the Kafalah must be clear and concise.
- 4.1.3. The Bank may charge a fee for issuing a Kafalah.
- 4.1.4. The sale must be instant and absolute. Thus, a sale attributed to a future date or a sale contingent on a future event is void.

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- 4.1.5. The Bank may take security to cover its liability (the face value of the guarantee) from the customer. This can take the form of cash or cash equivalents.
- 4.1.6. Where security posted by the customer is not Shariah-compliant at the outset or becomes non-compliant, the Bank may still accept /continue to hold same. In this instance the bank shall be appointed as agent of the customer to dispose of the non-compliant assets in the event of default. The Bank shall apply all monies raised by the disposal of such assets towards the customer's liability to it and any costs and expenses incurred by the Bank directly linked to the customer's default.
- 4.1.7. The Bank's preference should be for Shariah-compliant securities wherever possible.
- 4.1.8. The Bank may, where the security offered is cash, invest same in accordance with a Mudarabah partnership.

## **5 Process flow Letter of Guarantee**

- 5.1. If the customer defaults, bank will need to pay the guaranteed amount and customer now owes the Bank. Kafalah is akin to qard so there should not be any additional amount apart from the guaranteed amount to be paid by the customer to the bank.

### **5.2. Process flow:**

- 5.2.1. The Customer will request that the bank issue a Letter of Guarantee (LG). The LG will be based on the kafalah contract for a fee (normally 0.15% of the sum guaranteed – pricing a matter for each Bank) (this fee will be in the Schedule of Tariffs for the respective Bank) in favour of the beneficiary on behalf of the customer. The customer may need to give some collateral to the bank as per approved terms and the customer shall deposit the Security Deposit LG with the Bank; The Security Deposit LG will vary from customer to customer together with the Bank and market practice. For some customers as per the Credit approval terms Security

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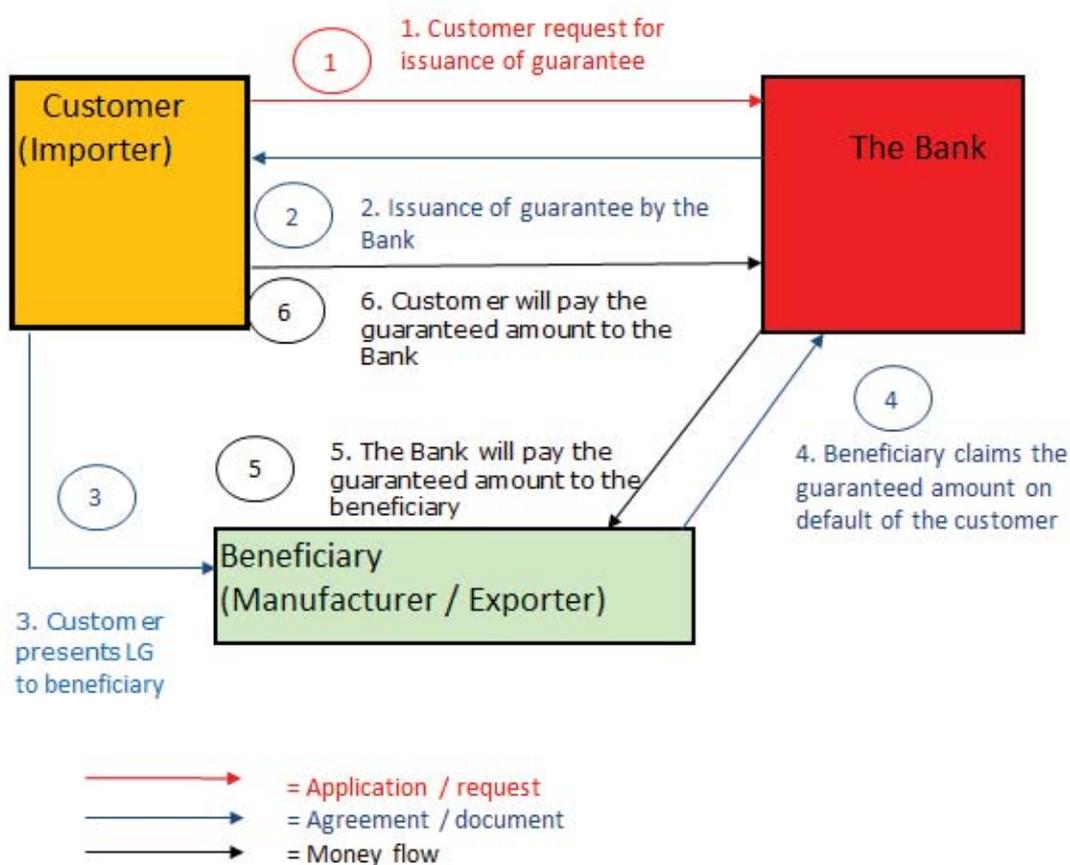
Deposit funds need to be held until the guarantee reversal. The customer will pay the LG issuance charges;

- 5.2.1.1. The quantum of a Security Deposit on the LG (if any) shall be decided on a customer to customer basis and also the Bank and market practice. It is suggested that for new Bank customers as per the Credit approval terms Security Deposit funds need to be held until the guarantee reversal.
- 5.2.1.2. The guarantee is normally reversed only after 1 month after expiry of same and upon reversal the security is released.
- 5.2.2. Upon compliance with all conditions precedent by the customer, the Bank will issue the LG.
- 5.3. The customer will present the Letter of Guarantee to the beneficiary of the guarantee;
- 5.4. If customer defaults, beneficiary will claim on the guarantee from the bank within the period specified in the LG for the guaranteed amount if the customer fails to fulfil his obligation.
- 5.5. Bank will pay the guaranteed amount to the beneficiary and recover the sum paid from the collateral of the customer;
- 5.6. Customer will pay the bank for the guaranteed amount paid out to the beneficiary.
- 5.7. The process of Guarantee Reversal (example):
  - 5.7.1. Guarantee due date fixed at 1st Jan 2015
  - 5.7.2. Any claim that comes to bank before this date must be reviewed and then if ok, paid by the bank.
  - 5.7.3. If no claims are received until 1st of Jan 2015. This means that the guarantee should expire.
  - 5.7.4. Bank waits 30 days – a cushion in case there are disputes or claims in the process of coming over via post etc.
  - 5.7.5. Usually Banks nominate agents in other countries. E.g. Indonesia. Guarantee claim submitted on the 15th of Jan at the nominated bank in Indonesia. The Bank aware of it on 7th of Feb. The Bank must, if it is a valid claim, honour this claim.

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5.7.6. After the expiration of the 30 day cushion the guarantee is reversed. It is now null and void.



5.8. The above steps constitute a single LG transaction by the customer.

## 6 Suggested Documentation for Letter of Guarantee

6.1. The legal documentation for the Product will depend on the actual structure to be adopted by the Bank and the Bank's internal policies and procedures as advised by the respective Bank's legal counsel.

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- 6.2. The following is the suggested documentation that the Bank may use to deliver the Product Outline deliverable:
- 6.2.1. Request for Letter of Guarantee facility from the customer to be approved by the Bank's Shariah Board.
  - 6.2.2. Islamic Trade Finance Facility letter
  - 6.2.3. Board resolution of customer to apply for Letter of Guarantee
  - 6.2.4. Request to amend LG application to be approved by the Bank's Shariah Board.
  - 6.2.5. Security documentation to be approved by the Bank's Shariah Board including:
    - 6.2.5.1. Master Commodity Murabaha Agreement
    - 6.2.5.2. Agency Agreement;
    - 6.2.5.3. Other agreements as relevant from time to time.

## **7 Suggested Accounting Entries for Letter of Guarantee**

- 7.1. A guarantee is a written undertaking issued by a bank in favour of the receiver of goods or services; whereby the bank pledges to make certain payment on behalf of its client, if the client fails to:
- 7.1.1 Make a payment, or
  - 7.1.2 Carry out specific functions in terms of commercial contract
- 7.2. Guarantee is based on Kafalah concept
- 7.3. The following are suggested accounting entries. Actual accounting entries shall be determined by the Bank and approved by the Bank's Shariah Board.
- 7.3.1. Bank issues Letter of Guarantee (LG) based on customer request

The Bank approves customer's request and issues guarantee for a certain amount in favour of the Beneficiary

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OFF BALANCE SHEET (Contingency)

<u>GL Account Number</u>	<u>Subs. Account Number</u>	<u>Account Particulars</u>	<u>Debit/Credit</u>
		Guarantee Kafalah -Customer	Debit
		Guarantee Kafalah -Bank Liability	Credit

7.3.2. Letter of Guarantee (LG) fee charged to customer

ON BALANCE SHEET

<u>GL Account Number</u>	<u>Subs. Account Number</u>	<u>Account Particulars</u>	<u>Debit/Credit</u>
		Customer Current AC	Debit
		Guarantee Fee (P/L)	Credit

7.3.3. If no Guarantee is presented by due date

If no guarantee is presented by due date, then bank will wait for 30 days and reverse the guarantee as it becomes expired.

OFF BALANCE SHEET (Contingency Reversal)

<u>GL Account Number</u>	<u>Subs. Account Number</u>	<u>Account Particulars</u>	<u>Debit/Credit</u>
		Guarantee Kafalah -Bank Liability	Debit
		Guarantee Kafalah -Customer	Credit

7.3.4. If Guarantee is presented by due date

If guarantee is presented by due date, then bank has to pay the guaranteed amount to the beneficiary and record receivable from customer. Off balance sheet contingency will be reversed.

OFF BALANCE SHEET (Contingency Reversal)

<u>GL Account Number</u>	<u>Subs. Account Number</u>	<u>Account Particulars</u>	<u>Debit/Credit</u>
		Guarantee Kafalah -Bank Liability	Debit
		Guarantee Kafalah -Customer	Credit

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ON BALANCE SHEET

<u>GL Account Number</u>	<u>Subs. Account Number</u>	<u>Account Particulars</u>	<u>Debit/Credit</u>
		Accounts Receivable- Customer	Debit
		Bank/Nostro	Credit

7.4. In case of default, Commodity Murabaha structure would be used (where same has been previously executed) and the same entries would be passed.

## 8 Risks Associated With the Product Outline

8.1. **Credit Risk:** Credit Risk of the customer. Bank to use prudent risk management tools to ensure that only good credits are approved for the Letter of Guarantee product. Bank may require additional security from customer as collateral for the financing. In addition, some Banks require a 110% cash deposit in to be lodged in order to issue a Letter of Guarantee. The Bank must have a robust credit risk team to offer this product or it may suffer losses.

8.2. **Market Risk:** There may be Market risk due to the particular nature of the imported assets (especially automobiles). The Market risk of the imported asset may adversely affect the cash-flow position of the customer and may lead to a default in payment when they had anticipated paying for the goods out of cash flow. Suggest that the Bank has a financing cap for various industries prone to market risk (e.g. automobile dealers) as part of its credit policy.

### 8.3. Operational Risk:

8.3.1. **Process risk:** Strong Know Your Customer ("KYC") controls, complete Management Information System of the transactions and daily logs will reduce the processing risk.

8.3.2. **Documentation risk:** Relationship Manager to ensure that complete documents are obtained from the customer. To include correct corporate governance documentation.

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- 8.3.3. **Loss of security documents:** Central Operations will ensure safe keeping of the documents under dual custody in a fire proof cabinet. The complete details will be entered in the lodgement register.
- 8.3.4. **KYC and Money laundering risk:** Business unit to ensure compliance with all requirements in the money laundering prevention, local regulations concerning KYC and account opening procedures.
- 8.4. **Compliance Risk:** Compliance department to ensure that necessary Central Bank regulations are communicated to appropriate divisions for implementation.
- 8.5. **Shariah Risk:** The implications of Shariah non-compliance and risks associated with the Bank's fiduciary responsibilities towards different fund providers would expose the Bank to fund providers' withdrawals, loss of income or voiding of contracts. This in turn could lead to a diminished reputation and / or the limitation of further business opportunities for Bank in this sector. Shariah compliance is critical to the Bank's Islamic operations and such compliance must permeate throughout the organisation.
- 8.6. Shariah compliance is the highest priority in relation to all other identified risks concerning this product.
- 8.7. **Specific Risk Matrix**

	<b>RISK ASSOCIATED</b>	<b>RISK ELEMENTS</b>	<b>MITIGATING FACTORS</b>
i	Market risk (price risk)	<ul style="list-style-type: none"> <li>Different types of assets and markets contribute to volatility in the prices of the imported assets.</li> </ul>	<ul style="list-style-type: none"> <li>Bank should highlight the specific market risk factors corresponding to each asset and market. The Bank should ensure that it has not provided letters of guarantee to customers primarily for the same asset class. E.g. agricultural machinery.</li> </ul>
		<ul style="list-style-type: none"> <li>Competitive</li> </ul>	<ul style="list-style-type: none"> <li>Bank must offer competitive</li> </ul>

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		threats from other financial institutions who market the similar products	fees, enhancing quality service and pricing capability when financing letters of guarantee. Thus, this would attract customer to engage in the product or services offered by the bank.
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ii	Credit risk	<ul style="list-style-type: none"> <li>• Credit risk in the case of Over The Counter (OTC) transactions</li> </ul>	<ul style="list-style-type: none"> <li>• Bank may manage the credit risk by putting in place appropriate credit policies, applying Takaful coverage (if available), and authorizing the limits prior to entering into Letter of Guarantee transaction.</li> </ul>
iii	Liquidity risk	<ul style="list-style-type: none"> <li>• Customer defaults in payment.</li> </ul>	<ul style="list-style-type: none"> <li>• To reduce defaults in payment when same is due, banks may impose a late payment penalty (this must comply with the DAB Guidelines on Late Payment Charges).</li> </ul>
		<ul style="list-style-type: none"> <li>• Measuring rate of return risk</li> </ul>	<ul style="list-style-type: none"> <li>• The estimation of cash flows is one of the key features of measuring rate of return risk. Hence, the bank should review regularly the behavioural maturity, underlying assumptions and parameters of the letters of credit it issues. Therefore, the strategy is to match the sources of funds to the uses of funds.</li> </ul>
v	Operational risk	<ul style="list-style-type: none"> <li>• Delivery of imported assets</li> </ul>	<ul style="list-style-type: none"> <li>• Bank needs to monitor the arrival of imported assets or conditions of the letter of</li> </ul>

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			guarantee and ensure payment is made promptly to the advising bank by the customer.
		<ul style="list-style-type: none"> <li>• Shariah non-compliance risk</li> </ul>	<ul style="list-style-type: none"> <li>• To avoid any potential risk arising from the transaction (i.e. non-compliance with Shariah requirements), the Bank should have adequate controls to ensure validity of the contract which may include, <i>inter alia</i>: <ul style="list-style-type: none"> <li>(a) a proper process for screening the assets / activity the subject matter of the guarantee is a Shariah-compliant asset / activity; and</li> <li>(b) checking on transaction flows which are endorsed by the respective Shariah Board of the bank;</li> </ul> </li> </ul>

## 9 Common Mistakes

- 9.1. Failure to ensure that Fatwa issued by the Bank's Shariah Board for the Product before offering to clients. Shariah secretariat to confirm with Business Units that the product may be offered to customers.
- 9.2. Inadequate or non-existent documentation – this may render the transaction void *ab initio*.
- 9.3. Incorrect document process flow – this may render the transaction void *ab initio*.
- 9.4. See common mistakes for Cash financing as this relates to the payment side of the Letter of Guarantee in the event of default. Bank to ensure that customer signs Master Commodity Murabaha Agreement in advance of issuing the LG

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- 9.5. Failure to exactly describe the asset or activity in the Letter of Guarantee documentation.
- 9.6. Providing a Letter of Guarantee for a non-compliant asset / or non-compliant business activities.

## **10 Custodian of the Product Outline**

- 10.1. This Product Outline shall be under the safe custody of the Islamic Banking Division (“IBD”) of DAB. Any changes to this Product Outline shall be made by the IBD with prior consultation with the SSB, as reviewed by the DAB Executive Board and upon approval by DAB Supreme Council. A copy of the amended Product Outline shall be made available to all stakeholders and SSB members for reference and implementation.
- 10.2. Banks may further refine the Product Outline to suit their particular structure and policies. Such amendments shall be approved by the Bank’s Shariah Board. The Bank’s Shariah Department/Islamic Banking Department/Unit will have custody over the Bank’s Product Outline for trade finance products.

## **11 Effective Date of the Product Outline**

The Effective date of this Product Outline is the \_\_\_\_\_ day of \_\_\_\_\_ 20\_\_\_\_

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**12 Appendix 1: Islamic Trade Finance Prohibitions sample – to be approved by the SSB.**

No.	Prohibitions	Notes
<b>Food and beverage related</b>		
1	Alcoholic beverages	
2	Pork poultry or any pig-related items	
3	Non-halal poultry i.e. slaughtered not according to the Islamic prescribed methods	
4	Tobacco-related products	
5	Any other intoxicated or drug-oriented items (other than those approved for medical purposes by certificated practitioners)	
<b>Gambling related items</b>		
6	Casino/ any lottery slot machines or similar in nature	
7	Any other items that may reasonably be known to be used for gambling purposes	
<b>Obscene nature</b>		
8	Pornography or adult-oriented materials	
9	Items used for prostitution/ immoral activities	
	Any item that is likely to be used for purposes contradictory to the Shariah or not directly for the good of the people (vague category)	Not a total prohibition/ could be permissible provided that there are sufficient inquiries which have been conducted to ascertain its purpose of usage
10	E.g. Arms and ammunition	
<b>Miscellaneous (non-exhaustive list)</b>		
11	Any other items which an Islamic expert may deem it to be or likely to be used against the principles of Shariah.	Such as items that are harmful in nature etc.