

**DA AFGHANISTAN BANK  
(CENTRAL BANK OF AFGHANISTAN)**  
**Product Outline: Export Letter of Credit Negotiation  
(Receivables Financing)**

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***Product Outline: Export Letter of Credit Negotiation  
(Receivables Financing)***

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 – EXPORT LETTER OF  
CREDIT NEGOTIATION (RECIEVABLES FINANCING)**

**PART A: PREAMBLE**

**1 Background**

- 1.1. This product outline for an Export Letter of Credit Negotiation (Receivables 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 Export Letter of Credit Negotiation (Receivables 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 Export Letter of Credit Negotiation (Receivables 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 Export Letter of Credit Negotiation (Receivables Financing) products.

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- 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 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, Product Outlines or circulars that Da Afghanistan Bank (“DAB”) may issue from time to time.

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**PART B: PRODUCT OUTLINE – EXPORT LETTER OF CREDIT  
NEGOTIATION (RECEIVABLES FINANCING)**

**3 Product Outline Structure - Export Letter of Credit Negotiation  
(Receivables Financing)**

- 3.1. The underlying Shariah-compliant contract: Bay' Al-Dayn BI Al-Sila' structure for a true sale without recourse situation.
- 3.2. **Product Description:** The documents under Export Letters of Credit ("LC"), for Letters of Credit issued by the Bank's partnered banks, with who it has Trade Limits and, available at their counters with sight tenors can be discounted to avail instant finance by presenting a clean set of export documents under the Letter of Credit.
- 3.3. This would be effectively free the Bank's customers working capital limits and improve their customer's funding cost while mitigating country and issuing bank risk.
- 3.4. **Who are the sellers and buyers of the Trade receivables?**
  - 3.4.1. Sellers of the Export LC are Bank customers (exporters) and the buyer of the LC - Sight is the Bank.
  - 3.4.2. Seller sends the goods under Sight LC to an importer and requires financing against documents submitted to the Bank.
  - 3.4.3. In this case, the Bank will be the Advising Bank (as it is acting for the exporter). In conventional terms the word 'Negotiation' means giving value/money against documents. The financed amount is settled upon receipt of funds from the issuing bank (the importer's bank) which is generally 10 to 15 days.
- 3.5. **When is the debt established?**

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- 3.5.1. The debt established after submission of the shipping documents to the Bank by the exporter (the Bank's customer) which evidences delivery of goods or shipping of goods to the buyer (importer).
- 3.5.2. In short, the exporter approaches the Bank with an LC issued by a bank known to the Bank and the Bank will buy the LC from the exporter at an agreed discount. Once the LC is paid by the issuing bank (the importer's bank) the Bank will keep 100% of the funds received.
- 3.6. The Wakala contract is in relation to the provision of procedural services i.e. examination of documents whereas the Kafalah contract is the provision of institutional guarantee/undertaking to pay to the importer (as the guaranteed) in favour of the seller/exporter (beneficiary) on condition that the exporter/seller present documents for the goods conforming to the instructions.

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

- 4.1. The Bay al-Dayn Bi al-Sila' structure has been approved by a number of Shariah Supervisory Boards in the past. Indeed, the Islamic Academy of Fiqh has allowed the sale of debt for a commodity at any price to be agreed by the parties. Source: International Fiqh Academy Resolution No. 158 (17/7) in its 17th session held in 2006.
- 4.2. What constitutes eligible receivables as set out in the Export Letter of Credit presented by the Customer of the Bank for Negotiation is set out in **Appendix 1** hereto.
- 4.3. If the Bank has any queries on whether an asset, the subject matter of a Letter of Credit, is an eligible receivable, it is to seek the advice of its Shariah Board before negotiating the Letter of Credit.
- 4.4. Reference can be made to Cash Financing Product Outline for details on the use of a Commodity Broker Platform and general concepts surrounding the Commodity Murabaha structure.
- 4.5. **Servicing:** Pursuant to the terms of the Master Receivables Purchase Agreement, the Seller (the Bank Customer) shall collect the purchased

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receivables as agent for the Purchaser (the Bank) under the principle of a Wakala, provided that the Purchaser may terminate such servicing arrangements in respect of any purchased receivable or the portfolio of purchased receivables at any time in its sole discretion. The Seller shall transfer collections to the Purchaser on a monthly basis. All decisions concerning collection of the Sold Commercial Receivables, including but not limited to, notification of the sale of the receivables, consents to payment delays, waivers of payments, extensions of payment terms and negotiating settlements of outstanding amounts, will be at the sole election of the Purchaser.

- 4.6. The Bank may opt to have the Bank's customer assign the Letter of Credit to it (subject to the terms of the Letter of Credit including the consent of the issuer) and take payment of same directly from the issuing bank.
- 4.7. Bank to ensure that any monies paid by the issuing bank are paid into an account held by the customer with it and the Bank may place a lien against the account for the face amount of the letter of credit.
- 4.8. **Service fee:** The purchase price for each sold receivable is the fair market value of such receivable at the time of purchase (reflecting that the Seller will continue to collect and otherwise service all sold receivables on and after the date of the sale).

## **5 Process flow Export Letter of Credit Negotiation- (Receivables Financing) utilising Bay al-dayn Bi al-Sila' contract.**

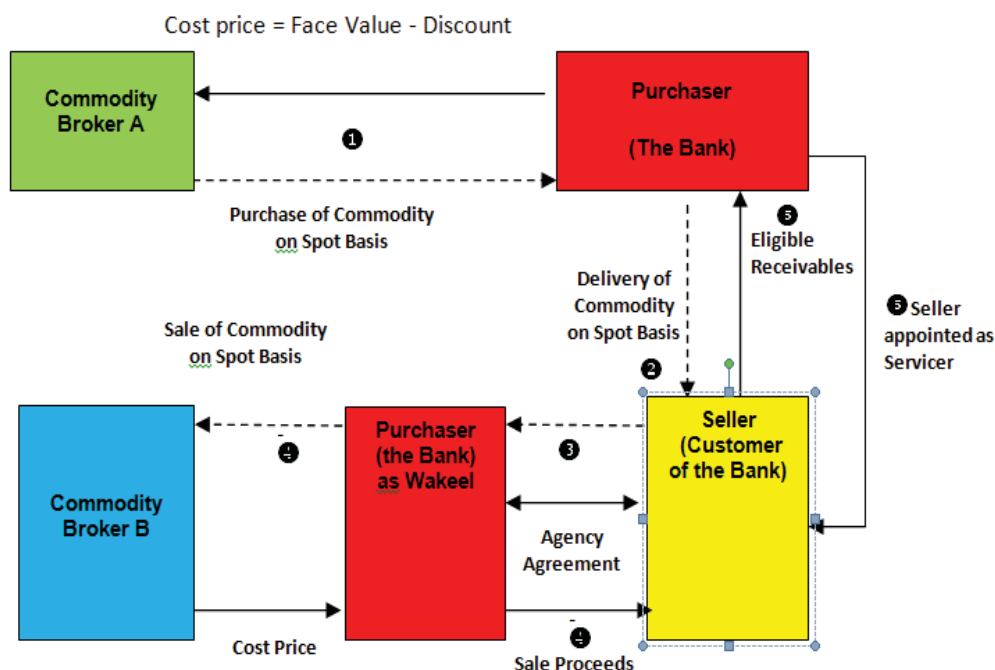
- 5.1. The Seller (Bank Customer) will provide the Purchaser (the Bank) with details of the eligible receivables it wishes to sell. Provided that the conditions precedent and eligibility criteria set out in the purchase agreement are met, the Purchaser will then advise the Seller which eligible receivables it agrees to accept and shall procure Shariah compliant commodities from a third party commodity broker ("Commodity Broker A") on a spot basis valued at an equivalent value to the eligible receivables less the Discount (the "Cost Price"). The Cost Price will reflect the price of the commodities.

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- 5.2. The Purchaser will immediately exchange the commodities with the Seller as payment for the eligible receivables.
- 5.3. The Seller will appoint the Purchaser as its agent, under an Agency Agreement in order to sell the commodities to a second commodity broker ("Commodity Broker B") on a spot basis at the Cost Price. The Seller shall pay a fee to the Purchaser for this service.
- 5.4. The Purchaser shall sell the Commodities (as agent of the Seller) to Commodity Broker B and will remit the Cost Price to Seller.
- 5.5. The Seller will collect the receivables as the agent of the Purchaser and send same to the Purchaser as they are collected.

**The structure**



- 5.6. The above steps constitute a single Export Letter of Credit Negotiation transaction by the customer with the Bank.



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**6 Suggested Documentation for Export Letter of Credit Negotiation.**

- 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.
- 6.2. The following is the suggested documentation that the Bank may use to deliver the Product Outline deliverable:
- 6.2.1. Master Receivables Purchase Agreement to be approved by the Bank's Shariah Board;
  - 6.2.2. On-Sale Agency Agreement to be approved by the Bank's Shariah Board;
  - 6.2.3. Commodity Purchase Letter; This is to separate the sale and purchase of the commodity from the sale and purchase of the receivables. Terms relating to the sale and purchase of commodities are captured herein. To be approved by the Bank's Shariah Board.
  - 6.2.4. Commodity Purchase Letter of Understanding between the Purchaser (the Bank) and Broker A (the Seller) sets out the terms and conditions upon and subject to which the Seller (Broker A) agrees from time to time to enter into transactions for the sale of Commodities to the Purchaser (the Bank).
  - 6.2.5. Commodity Purchase Letter of Understanding between the Seller (the Bank) as Disclosed Agent of the Seller of the Export Letter of Credit (the Bank customer) and Broker B (the Purchaser). This letter sets out the terms and conditions upon and subject to which the Agent (the Bank), acting for and on behalf of the Seller of the Export Letter of Credit (the Bank customer) may agree from time to time to enter into transactions for the sale of Commodities to Broker B who will acquire the Commodities for valuable consideration.
  - 6.2.6. Netting letter to be executed between the Commodity Brokers, the Bank and (ideally) the Bank customer. This is to facilitate the Bank in paying the customer directly on the on sale of the commodities by the Bank (acting as agent for the customer) to Broker B for the eligible trade receivables as outlined in the Export Letter of Credit presented for negotiation.

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6.2.7. The above documentation to be executed once between the Bank, Broker A and Broker B and the customer. The customer will, when presenting Export Letters of Credit for negotiation transact the schedules of the Master Receivables Purchase agreement only.

6.2.8. Bank to ensure that the limits set for the customer and correspondent Bank are not breached.

## 7 Suggested Accounting entries for Export Letter of Credit Negotiation.

- a) *Upon approval of the negotiation facility, the Bank buys inventory of commodity from Broker A*

**DR** Inventory of Commodity

**CR** Bank

- b) *Customer sells the Letter of Credit in **exchange** for the commodity from the Bank (Murabaha Sale)*

**DR** Assets (GL Negotiation of LC) (Principal)

**CR** Inventory of Commodity

## 8 Risks associated with the Product outline

8.1. **Credit Risk:** Credit Risk of the counterparty Bank. Bank to use prudent risk management tools to ensure that only Banks with a good and stable credit rating are approved for the Export Letter of Credit Negotiation product. The Bank must have a robust credit risk team to offer this product or it may suffer losses.

8.2. **Market Risk:** There is no market risk associated with this product.

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**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.

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>Competitive threats from other</li> </ul>	<ul style="list-style-type: none"> <li>Bank must offer competitive fees, enhancing quality service</li> </ul>

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		financial institutions who market the similar products	and pricing capability when negotiating export letters of credit. Thus, this would attract customer to engage in the product or services offered by the bank.
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 for each correspondent bank prior to entering into Export Letter of Credit negotiation transaction.</li> </ul>
iii	Liquidity risk	<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 Export Letters of Credit it negotiates. 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>Settlement risk / Counter-party risk</li> </ul> <p>Exit strategies associated with the imported assets in the event of failure of delivery or goods by the Bank's customer</p>	<ul style="list-style-type: none"> <li>Since the correspondent bank puts a high degree of reliance on the advising bank (the Bank in this case) with regards to the delivery of the imported assets, this may expose the bank to settlement risk.</li> <li>Nevertheless, there might be several events that could lead to failure to deliver the</li> </ul>

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		<p>not to the agreed specifications, which responsibility parties involved for the delivery of the imported assets or for the payment of price.</p>	<p>exported assets by the Bank's customer.</p> <ul style="list-style-type: none"> <li>As only certain events can be protected through obtaining Takaful coverage, adequate assessment of the Bank's customer's ability to honour its obligation (i.e. track record) is crucial to avoid settlement and risk. In view of this, adequate due process on the screening and selection of the Counterparty Bank and the Bank's Customers is highly recommended.</li> </ul>
		<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, inter alia: <ul style="list-style-type: none"> <li>(a) a proper process for screening the assets being exported by the customers via a letter of credit issued by the Importer's bank; and</li> <li>(b) checking on transaction flows which are endorsed by the respective Shariah Board of the bank</li> <li>(c) Particular attention is required in the Bai al Dayn Bil Sila structure to ensure that the exchange of the trade receivables (the Letter of Credit issued by the importer's Bank) takes place after the Bank has acquired</li> </ul> </li> </ul>

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			the commodities from Broker A. (d) The proper process for a Commodity Murabaha must also be followed.
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## 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. Incorrect documentation in the Commodity Murabaha transaction – reference can be made to Cash Financing Product Outline for more details.
- 9.5. Failure to record the discount of the Letter of Credit clearly.
- 9.6. Failure to ensure the Schedules of the Master Receivables Purchase Agreement are executed in the proper sequence.

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## **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.