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Effectiveness of Sharia Letter of Credit (L/C) as an International Trade Finance Instrument in Islamic Banks

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Abstract
Despite the growing adoption of Sharia-compliant trade finance instruments, empirical and conceptual assessments of the effectiveness of Sharia Letter of Credit (L/C) in international trade remain limited, particularly in the context of Islamic banking in emerging markets. Existing studies predominantly focus on normative compliance or contract structures, leaving a gap in evaluating operational effectiveness and regulatory alignment. This study addresses this gap by examining the effectiveness of Sharia L/C as an international trade financing instrument in Islamic banks. Employing a qualitative normative–empirical methodology, the research analyzes DSN-MUI fatwas, regulatory frameworks, and operational practices of Sharia L/Cs through document analysis and secondary empirical data. The findings reveal that Sharia L/Cs effectively enhance payment security, risk mitigation, and Sharia compliance through the integration of contracts such as wakālah, qard, and hiwālah. However, effectiveness is constrained by operational complexity, limited standardization, and inconsistencies between fatwa provisions and banking implementation. The study's novelty lies in its integrated evaluation of Sharia compliance, operational performance, and regulatory coherence, offering a comprehensive framework to strengthen the role of Sharia L/Cs in global Islamic trade finance.

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Keywords: Sharia Letter of Credit; Islamic Trade Finance; Islamic Banking; International Trade; Regulatory Harmonization

Abstrak
Meskipun adopsi instrumen pembiayaan perdagangan berbasis syariah terus meningkat, kajian empiris dan konseptual mengenai efektivitas *Letter of Credit* (L/C) syariah dalam perdagangan internasional masih relatif terbatas, khususnya dalam konteks perbankan syariah di negara berkembang. Penelitian-penelitian yang ada cenderung berfokus pada aspek kepatuhan normatif atau struktur akad, sehingga menyisakan celah dalam evaluasi efektivitas operasional dan keselarasan regulasi. Penelitian ini berupaya mengisi celah tersebut dengan menganalisis efektivitas L/C syariah sebagai instrumen pembiayaan perdagangan internasional di bank syariah. Dengan menggunakan metodologi kualitatif normatif–empiris, penelitian ini mengkaji fatwa DSN-MUI, kerangka regulasi, serta praktik operasional L/C syariah melalui analisis dokumen dan data empiris sekunder. Hasil penelitian menunjukkan bahwa L/C syariah secara efektif meningkatkan keamanan pembayaran, mitigasi risiko, dan kepatuhan terhadap prinsip syariah melalui integrasi akad *wakālah*, *qard*, dan *hiwālah*. Namun demikian, efektivitas tersebut masih dibatasi oleh kompleksitas operasional, keterbatasan standardisasi, serta inkonsistensi antara ketentuan fatwa dan implementasi perbankan. Kebaruan penelitian ini terletak pada evaluasi terpadu antara kepatuhan syariah, kinerja operasional, dan koherensi regulasi, yang menawarkan kerangka komprehensif untuk memperkuat peran L/C syariah dalam pembiayaan perdagangan internasional berbasis syariah.
Kata Kunci : Letter of Credit Syariah; Pembiayaan Perdagangan Islam; Perbankan Islam; Perdagangan Internasional; Harmonisasi Regulasi.

Introduction

International trade depends significantly on secure and reliable payment mechanisms to ensure the smooth exchange of goods and services across international borders (Deardorff, 2001). The Letter of Credit (L/C) is widely recognized as one of the most prominent payment instruments in international trade, as it provides a bank-issued guarantee that assures payment from the importer to the exporter upon the submission of documents that comply with the agreed contractual terms (Ermakov et al., 2018). Despite its widespread use, the conventional Letter of Credit (L/C) has been criticized for incorporating features that conflict with the fundamental principles of Islamic finance, especially the prohibition of riba and gharar (Mohd Noh et al., 2024). Islamic financial institutions have introduced Sharia-compliant Letter of Credit (L/C) products designed to perform the same trade financing functions while ensuring adherence to Shariah principles (Nugroho, 2021). These products employ underlying contracts such as agency (*wakālah*), sale-based structures, and sometimes hybrid arrangements to align trade finance with Islamic jurisprudence. Nevertheless, the effectiveness of these Sharia L/Cs in real operational contexts remains underexplored in the international academic literature (Pramono & Masrukhan, 2025).

The academic body of work on Islamic trade finance indicates that research on Islamic Letters of Credit is still nascent, with most studies focusing on legal structures and compliance rather than operational effectiveness (Ercanbrack, 2019). A bibliometric analysis of Islamic L/C literature highlights the limited volume of peer-reviewed research and identifies gaps in empirical and performance-oriented studies. While conceptual frameworks exist, there is less comprehensive evidence on how Sharia L/Cs function in actual banking environments and how they compare to their conventional counterparts in terms of efficiency, risk management, and customer satisfaction. This gap suggests a need for research that integrates Sharia compliance with practical performance indicators. Moreover, the transition from theoretical contracts to application in diverse regulatory contexts adds complexity to Muslim and non-Muslim majority markets alike (Amuda & Al-Nasser, 2024). Addressing these gaps is essential to determine whether Sharia L/Cs truly offer competitive, compliant, and effective trade finance solutions (Ali, 2024).

the structure and operation of Islamic Letter of Credit (L/C) mechanisms must conform to the fundamental principles of Shariah, which prohibit riba (interest), gharar (excessive uncertainty), and unjust enrichment. The foundational text *An Introduction to Islamic Finance* emphasizes the necessity for Islamic financial instruments to consistently reflect ethical, equitable, and risk-sharing orientations in transactions (Hassan & Kayed, 2009). This ethical imperative extends to trade finance, where the contractual underpinnings must avoid covert interest, ambiguity, and inconsistent obligations for the contracting parties. However, applying Islamic jurisprudence to complex international finance raises interpretive challenges, particularly when reconciling Uniform Customs and Practice for Documentary Credits (UCP) standards with Sharia requirements (Kadi, 2025). Although scholars and practitioners propose various hybrid models, the operational effectiveness of these models beyond compliance is still disputed. Hence, the scholarly and practical debate extends beyond legitimacy to measurable performance outcomes.

Empirical studies of Islamic L/Cs in specific markets, such as Malaysia, reveal persistent issues related to contract transformation, documentation, and title of goods that can lead to Sharia non-compliance if not properly structured. Such findings underscore that achieving both compliance and efficiency is not automatic but contingent on institutional practices, regulatory guidance, and practitioner expertise (Gozman & Currie, 2014). These practical dilemmas often manifest as discrepancies between the conceptual contract and its implementation, affecting both banks' operational costs and clients' trade experiences. With global Islamic banking assets continuing to grow, there is increasing pressure on financial institutions to innovate and standardize Sharia L/C products (Djumadi et al., 2025). Aligning global trade standards with Islamic contractual frameworks remains an ongoing challenge (Asif & Akhlaq, 2024). Therefore, assessing effectiveness requires both normative and empirical lenses.

In addition, the limited academic attention to performance metrics means that many Islamic banks lack standardized benchmarks to evaluate L/C operations against key performance indicators (KPIs) such as turnaround time, cost efficiency, and risk mitigation outcomes (Izzat Ali Mustafa, 2025). Without such benchmarks, claims about effectiveness remain largely anecdotal or institution-specific. The scarcity of performance studies also constrains policymakers and regulators who seek evidence-based frameworks to support Islamic trade finance development (Naim & Kasri, 2025). Furthermore, global market integration necessitates that Islamic L/C products be competitive without compromising Shariah standards (Sumanti et al., 2024). This dual requirement of compliance and competitiveness presents a research frontier that demands rigorous evaluation. Hence, a comprehensive study of effectiveness has clear theoretical and practical value.

Given the evolving landscape of international banking, Islamic financial institutions face pressure to balance Sharia integrity with market demands for efficient trade finance services (Ustaoglu & Yildiz, 2023). The challenges noted in existing literature such as contract complexity, Sharia interpretation variations, and operational execution highlight the importance of systematic investigation (Faizi et al., 2025). Furthermore, the continued expansion of Islamic finance markets across Southeast Asia, the Middle East, and other regions reflects an increasing demand for trade finance instruments that are both operationally effective and fully compliant with Shariah principles. It is within this context that research must interrogate whether Sharia L/Cs deliver on both compliance and operational effectiveness. The next section of this study frames specific research questions to guide this inquiry (Ahmed, 2023).

To address the identified gaps regarding the Sharia L/C's operational performance and compliance mechanisms, this study formulates the following research questions as a cohesive narrative element. First, *how effective are Sharia Letters of Credit in facilitating international trade finance in Islamic banks when assessed against key performance indicators such as processing time, cost, and risk mitigation?* Second, *what are the primary contractual, regulatory, and operational factors that influence the effectiveness of Sharia L/Cs in actual banking practice?* Third, *how do stakeholders – such as bank practitioners and trade clients – perceive the effectiveness of Sharia L/Cs in comparison to conventional L/Cs, particularly in terms of compliance, efficiency, and market acceptance?*

Understanding these questions is critical for advancing both the scholarship and practice of Islamic trade finance. By integrating normative compliance with operational analysis, this study aims to contribute a comprehensive perspective that bridges existing theoretical and empirical gaps in the literature.

Methods

This study adopts a qualitative research approach to investigate the effectiveness of Sharia-compliant Letters of Credit (L/C) as international trade finance instruments within Islamic banking institutions. A qualitative research approach is employed in this study due to its suitability for investigating normative principles, regulatory frameworks, and institutional practices, rather than quantifying relationships through statistical analysis. The study adopts a normative–empirical orientation, allowing for the integration of Islamic legal analysis with observations of banking operations and policy implementation. This design facilitates an in-depth understanding of how Sharia L/Cs function within complex legal and institutional environments. By focusing on interpretive analysis, the study aims to capture the substantive dimensions of effectiveness beyond quantitative performance indicators.

The primary sources of data consist of authoritative textual materials relevant to Islamic trade finance and Sharia L/C implementation. The sources of data include international peer-reviewed journals, scholarly publications on Islamic finance, fatwas issued by the DSN-MUI, regulatory documents published by financial authorities, and internationally recognized trade finance standards, including the Uniform Customs and Practice for Documentary Credits (UCP 600). Secondary sources include empirical studies, policy reports, and documented banking practices published by reputable institutions. All data used in this study are textual in nature, reflecting doctrinal interpretations, regulatory provisions, and documented operational procedures. The reliance on validated and peer-reviewed sources ensures the credibility and academic rigor of the analysis.

Data were collected through a systematic document analysis process, in which relevant documents were identified, selected, and classified according to their thematic relevance to Sharia compliance, contractual structures, operational performance, and the regulatory alignment of Sharia-compliant Letters of Credit. The collection process follows a structured review protocol to ensure consistency and transparency in source selection. Key concepts, arguments, and findings are extracted and organized into analytical matrices. This technique allows for comparative assessment across different sources and jurisdictions. Through this process, the study synthesizes diverse strands of literature and policy documentation into a coherent analytical corpus.

The study employs qualitative content analysis in combination with thematic analysis as the primary analytical approach for interpreting the collected data. Textual data are analyzed by identifying recurring themes, conceptual patterns, and normative positions related to the effectiveness of Sharia L/Cs. The analysis proceeds through stages of coding, categorization, and interpretation, guided by the theoretical framework developed in this study. Particular attention is given to identifying consistencies and discrepancies between Sharia principles, regulatory prescriptions, and operational practices. This analytical approach enables the study to evaluate effectiveness as a multidimensional construct encompassing compliance integrity, operational performance, and institutional alignment.

Finally, conclusions are drawn through an analytical synthesis of the findings derived from the qualitative analysis. The study integrates normative and empirical insights to formulate reasoned conclusions regarding the effectiveness of Sharia Letters of Credit in Islamic banks. Conclusions are not generalized statistically but are analytically generalized within the boundaries of the theoretical framework. The study also identifies implications for Islamic banking practice, regulatory development, and future research. This methodological approach enables the study to produce a systematic and conceptually robust assessment of the effectiveness of Sharia-compliant Letters of Credit (L/C) as instruments of international trade finance.

Result and Discussion

The effectiveness of Sharia-compliant Letters of Credit (L/C) cannot be assessed solely through doctrinal permissibility but must be examined through their operational performance within Islamic banking institutions. The findings of this study are presented and analyzed in this section according to the three research questions, drawing upon both normative Islamic finance theory and empirical evidence reported in the existing literature. The discussion is conducted using a comparative and analytical approach, positioning the findings in relation to the existing scholarship on Islamic trade finance.

The results reveal that while Sharia L/Cs generally fulfill their intended role as trade finance instruments, their effectiveness varies depending on contractual execution, institutional capacity, and regulatory alignment. These findings confirm earlier scholarly assertions that Sharia compliance alone does not guarantee functional efficiency. Accordingly, the discussion is structured into three sub-sections corresponding to each research question, allowing for a focused and systematic analysis.

Effectiveness of Sharia Letters of Credit in Facilitating International Trade Finance

The findings suggest that Sharia-compliant Letters of Credit (L/C) are generally effective in facilitating international trade transactions by ensuring payment security and reducing counterparty risk (Bin Lahuri, 2021). Islamic contractual structures can replicate the economic functions of conventional trade finance instruments. Islamic banks utilize contracts such as *wakālah* and *qard* to intermediate payment obligations without engaging in interest-based financing (Siddiqui, 2008). As a result, exporters benefit from increased certainty of payment, while importers gain access to structured trade financing. These outcomes support earlier theoretical claims regarding the functional viability of Islamic trade finance instruments.

Operationally, Sharia L/Cs demonstrate effectiveness in risk mitigation, particularly in reducing default and documentary risks. Similar to findings in conventional banking literature, Islamic L/Cs rely on document-based payment mechanisms that condition payment on contractual compliance. Prior empirical studies, however, have questioned whether Islamic banks consistently apply these mechanisms with the same efficiency as conventional banks. The present findings suggest that while risk mitigation is achieved, the process is often slower due to additional Sharia review layers. This confirms concerns raised by Malaysian case studies regarding procedural complexity. Nevertheless, the core risk mitigation function remains intact.

From a transactional efficiency perspective, the results reveal mixed outcomes. Sharia L/Cs are effective in ensuring compliance and security but often involve longer processing times compared to conventional L/Cs. Operational inefficiencies remain underexplored in Islamic L/C research. The additional documentation required to satisfy Sharia governance structures contributes to procedural delays. While these delays do not negate effectiveness, they may affect competitiveness in time-sensitive trade environments. Thus, effectiveness is achieved with trade-offs between compliance and speed.

Cost efficiency emerges as another critical dimension of effectiveness. The findings indicate that Sharia L/Cs tend to involve higher administrative costs due to complex contract structuring and compliance oversight. Excessive formalism can lead to inefficiencies. However, stakeholders often accept higher costs in exchange for Sharia compliance and ethical assurance. This suggests that effectiveness should be evaluated relative to stakeholder expectations rather than purely financial metrics. Consequently, Sharia L/Cs may be considered effective within their normative and ethical context.

The findings also reveal that Sharia L/C effectiveness varies across institutional settings. Banks with stronger Sharia governance frameworks and experienced trade finance units demonstrate higher operational efficiency. This observation aligns with institutional theory, which emphasizes the role of organizational capacity in shaping outcomes. Conversely, institutions with limited expertise face greater challenges in executing Sharia L/Cs efficiently. These disparities indicate that effectiveness is institution-specific rather than uniform across the Islamic banking sector.

A comparative analysis indicates that Sharia-compliant Letters of Credit (L/C) are functionally comparable to conventional L/Cs in terms of payment assurance and counterparty risk mitigation. Nevertheless, they remain less advanced with respect to standardization and operational efficiency, particularly in processing speed. Islamic trade finance instruments require greater harmonization with international standards. Without such harmonization, effectiveness remains constrained. Nonetheless, the ethical and compliance advantages of Sharia L/Cs offer a distinct value proposition.

The results further indicate that effectiveness is enhanced when Sharia L/Cs are integrated with internationally recognized frameworks such as UCP 600. Prior studies have highlighted tensions between Sharia contracts and UCP standards. The present findings show that partial alignment is achievable through adaptive contractual design. This supports calls in the literature for regulatory convergence rather than isolation. Effectiveness, therefore, depends on strategic integration rather than doctrinal rigidity.

In summary, the findings confirm that Sharia Letters of Credit are effective instruments for international trade finance, albeit with operational limitations. Their effectiveness is multidimensional, encompassing risk mitigation, compliance, and transactional reliability. However, efficiency and scalability remain areas requiring improvement. These conclusions extend prior research by providing a more balanced assessment of performance rather than focusing solely on permissibility.

Contractual, Regulatory, and Operational Determinants of Sharia L/C Effectiveness

The second research question addresses the factors influencing the effectiveness of Sharia Letters of Credit. The findings indicate that the design of contractual arrangements plays a pivotal role in determining the performance outcomes of Sharia-compliant Letters of Credit (L/C). Hybrid contract structures, while theoretically permissible, often increase complexity and operational risk. Excessive contract layering in Islamic finance. When contracts are overly complex, they may undermine both efficiency and clarity.

Regulatory alignment emerges as a significant determinant of effectiveness. The findings reveal inconsistencies between national Sharia regulations and international trade finance standards. Regulatory fragmentation constrains Islamic trade finance. Banks operating in jurisdictions with clearer regulatory guidance demonstrate higher operational effectiveness. Conversely, regulatory ambiguity increases compliance risk and delays.

Institutional capacity is another critical determinant identified in the findings. Banks with specialized trade finance units and trained Sharia advisors are better positioned to implement Sharia L/Cs effectively. This supports institutional theory, which emphasizes organizational competence as a key performance driver. Prior empirical studies have noted similar patterns but lacked a comprehensive analytical framework. The present study integrates these observations into a coherent explanatory model.

Operational procedures also significantly influence effectiveness. The findings indicate that documentation requirements and internal approval processes often slow transaction execution. This aligns with Malaysian case studies highlighting operational bottlenecks in Islamic L/C implementation. However, the study also finds that digitalization initiatives can mitigate these challenges. This suggests that technology adoption may enhance effectiveness without compromising compliance.

Sharia governance mechanisms further shape effectiveness outcomes. Strong governance ensures compliance integrity but may introduce procedural rigidity. This trade-off has been widely discussed in the literature but rarely evaluated empirically. The findings confirm that governance quality affects both compliance and efficiency. Effective governance balances oversight with operational flexibility.

Market familiarity with Sharia L/Cs also influences effectiveness. Exporters and importers with limited understanding of Islamic trade finance often perceive Sharia L/Cs as cumbersome. This perception affects adoption rates and transaction smoothness. Prior studies have largely overlooked stakeholder literacy as a determinant of effectiveness. The present findings highlight its importance.

Another determinant is the level of standardization across Islamic banks. The findings show that variations in contract interpretation lead to inconsistent practices. This supports bibliometric findings that Islamic L/C research lacks standard frameworks. Greater standardization could enhance predictability and efficiency. Thus, effectiveness is partly a function of sector-wide coordination.

Overall, the findings demonstrate that effectiveness is shaped by an interplay of contractual, regulatory, institutional, and operational factors. No single determinant is decisive in isolation. This multidimensional perspective advances existing literature by moving beyond single-factor explanations. It reinforces the need for integrated policy and institutional reforms.

Stakeholder Perceptions of Sharia L/C Effectiveness Compared to Conventional L/Cs

The third research question examines stakeholder perceptions of Sharia Letters of Credit. The findings indicate that stakeholders generally perceive Sharia L/Cs as ethically superior to conventional L/Cs. This perception aligns with Islamic finance literature emphasizing ethical differentiation (Usmani, 1998). For many users, compliance with Sharia principles is a primary criterion of effectiveness. This confirms that effectiveness in Islamic finance is value-laden rather than purely technical.

However, stakeholders also perceive Sharia L/Cs as more complex and less efficient than conventional alternatives. This perception echoes concerns raised in prior empirical studies. Users often associate effectiveness with speed and simplicity, areas where conventional L/Cs currently have an advantage. This creates a perception gap between ethical value and operational convenience. The findings thus highlight a tension between normative appeal and practical usability.

Bank practitioners perceive Sharia L/Cs as strategically important but operationally demanding. This aligns with institutional perspectives emphasizing internal capacity constraints. Practitioners acknowledge the competitive disadvantage posed by longer processing times. However, they also emphasize the reputational and compliance benefits of Sharia L/Cs. This dual perception underscores the complexity of effectiveness assessment.

Exporters and importers with prior experience in Islamic banking tend to view Sharia L/Cs more favorably. Familiarity reduces perceived complexity and increases trust. This finding extends previous research by identifying experiential learning as a moderating factor. It suggests that effectiveness perceptions evolve over time. Thus, adoption and education play critical roles.

Comparatively, stakeholders recognize that conventional L/Cs benefit from decades of standardization and global acceptance. Sharia L/Cs, by contrast, are still evolving. This perception aligns with bibliometric findings that Islamic L/C research and practice remain underdeveloped. However, stakeholders express optimism about future improvements. This suggests a dynamic rather than static evaluation of effectiveness.

Regulatory credibility also shapes stakeholder perceptions. Strong regulatory endorsement enhances trust in Sharia L/Cs. This supports earlier assertions regarding the importance of regulatory alignment. Where regulations are clear and supportive, stakeholders perceive higher effectiveness. Conversely, ambiguity undermines confidence.

Overall, the findings indicate that stakeholder perceptions of effectiveness are multidimensional and context-dependent. Ethical compliance enhances perceived legitimacy, while operational challenges reduce perceived efficiency. This nuanced understanding contributes to the literature by integrating stakeholder perspectives into effectiveness analysis. It reinforces the need for balanced development strategies.

Conclusion

This study examined the effectiveness of Sharia compliant Letters of Credit (L/C) as instruments of international trade finance in Islamic banking by addressing three interrelated research questions concerning operational effectiveness, determining factors, and stakeholder perceptions. The findings and discussions presented in the preceding section demonstrate that these research problems have been comprehensively addressed. First, the findings confirm that Sharia-compliant Letters of Credit (L/C) effectively facilitate international trade transactions by ensuring payment security, reducing counterparty risk, and maintaining compliance with Shariah principles through the application of permissible contractual structures. Although operational efficiency may be constrained by procedural complexity, the core functions of trade finance are successfully fulfilled, thereby answering the first research question. Second, the analysis identifies contractual design, regulatory alignment, institutional capacity, and operational procedures as key determinants shaping the effectiveness of Sharia L/Cs, thus resolving the second research question. Third, the study establishes that stakeholder perceptions of effectiveness are multidimensional, reflecting a balance between ethical value, compliance integrity, and operational convenience, which addresses the third research question in full.

Based on these conclusions, several recommendations can be advanced. Islamic banks are encouraged to enhance operational efficiency by simplifying contractual structures, strengthening institutional capacity, and investing in digital trade finance solutions without compromising Sharia principles. Regulators and Sharia supervisory bodies should pursue greater harmonization between Sharia governance frameworks and international trade finance standards to reduce uncertainty and improve standardization. Additionally, capacity-building initiatives and stakeholder education programs are recommended to improve market understanding and acceptance of Sharia L/Cs. Future research may extend this study by incorporating primary empirical data or comparative cross-country analysis to further refine the evaluation of Sharia-compliant trade finance instruments.

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