

CONTRACT OF *KAFĀLAH* (GUARANTEE) IN ISLAMIC FINANCE: EXTENDING THE FRONTIERS OF ISLAMIC LAW

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ABSTRACT

In the traditional application of kafālah (guarantee) agreement under the Islamic law, the kāfil (guarantor) is not expected to make profit from offering to guarantee. However, in the contemporary Islamic financing, a huge volume of national and transnational transactions are built around kafālah in form of bank guarantee, standby letter of credit and shipping guarantee. The Islamic financial institutions have thus redesigned the traditional concept to take advantage of the robust return, like their conventional counterparts, accruable from kafālah transactions. This raises fundamental question of possible infraction of the Shariah or contrivance of legal device (hiyal) to permit the impermissible. This paper therefore, conducts a study of the traditional concept of kafālah with a view to examining the possible contrivance in and/or infraction of Shariah in the process of its redesign and application. The goal is to screen the product for Shariah compliance and the methodology adopted is qualitative. It concludes that rather being a contrivance of Islamic traditional precept the practice is an ingenious extension of the frontiers of Islamic law to the contemporary needs.

Keywords: *kafālah, frontiers, Islamic finance, law*

INTRODUCTION

Kafālah is one of the age-long transactions evolved by man to bridge the gap that may exist in financial dealings as a result of the parties' lack of confidence,

suspicion and lack of detailed knowledge of one another on the one hand. On the other hand, it gives assurance that a particular person would discharge his obligation in certain relationships without being constrained for lack of such assurance. The longevity of the usage of the contract is evidenced, as will be shown hereunder, by the age of the event in the story of Prophet Yūsuf which has remained the main proof of its validation in Islamic law. Islam adopted *kafālah* and encourage its practice in reversal of the negative perception, informed by peoples experience, in which it was held. The perception is expressed in a way that a guarantee is immediately followed by the guarantor blaming himself and being blamed by others, then he regrets his act when demanded to pay on behalf of the guaranteed party, and he finally loses some of his property (al-Zuhayli, 2003: 6). Islam therefore adopts the product within a legal framework that makes it adaptable to new transactions of different era.

The reemergence of institutionalized Islamic financing in the last four decades and its continued development has occasioned a reengineering of the traditional financial contracts including *kafālah*, to suit, especially, the contemporary banking and finance. Other similar financial instruments adapted include *mushārah* (partnership), *muḍārabah* (sleeping partnership), *salām* or *salaf* (advance purchase), *ijārah* (lease), *ju'ālah* (reward or commission transactions), *muzārah* (share cropping) and *musāqāh* (irrigation).

This paper therefore, conducts a study of the traditional concept of *kafālah* with a view to examining the possible contrivance in and/or infraction of Shariah in the process of its redesign and application by Islamic financial institutions (Saiful Azhar Rosly & Mahmood Sanusi, 2001: 274-275).¹ The research is conducted in five parts. Following this introduction, part two looked into the definition of the instrument under the Islamic law tracing its legality to the two primary sources of Shariah (*Qur'ān* and *sunnah*) and *ijmā'*. Part three examines the types of *kafālah* along with the juristic views on its development. Part four of the work looks into the justification for charging fees for *kafālah* vis-à-vis its contemporary application by Islamic financial institutions and the work is concluded in part five.

DEFINITIONS AND LEGALITY OF *KAFĀLAH*

In this section, both literal and juristic definitions of *kafālah* as well as its validating sources of Islamic law relating thereto are considered.

¹ This is necessary in the light of heavy criticism attracted by some of the products devised by Islamic financial institutions like *bay' al-'inah* (buy back sale) popularly used in Malaysia on the understanding that it is allowed by Shāfi'ī school of law.

1. Definitions

In its literal usage, *kafālah* means surety, bail, guarantee, responsibility or amenability (Khan, 2003: 335; Ibn Rushd, 2006: 355).² It was in this literal sense that Allah SWT used the term in the holy *Qur'ān* where He says:

فَنَقَّبَلَهَا رَبُّهَا بِقَبُولٍ حَسَنٍ وَأَنْبَتَهَا نَبَاتًا حَسَنًا وَكَفَّلَهَا زَكَرِيَّا

“...so, her Lord (Allah SWT) accepted her with goodly acceptance. He made her grow in a good manner and put her under the care of Zakariyya (Zechariah)....”

(Surah Alī-‘Imrān, 3: 37)

The term *kafālah* as used in the verse was a reference to the upbringing of Maryam the mother of Prophet ‘Isā AS under the responsibility of Prophet Zakariyya. In this same manner, Prophet Muhammad SAW used the term where he was reported to have said that:

سَهْلُ بْنُ سَعْدٍ عَنِ النَّبِيِّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ قَالَ أَنَا وَكَافِلُ الْيَتِيمِ فِي الْجَنَّةِ هَكَذَا وَقَالَ بِأَصْبَعَيْهِ السَّبَّابَةِ وَالْوُسْطَى عَنِ

Sahl Ibn Sa’d narated: The Prophet, peace and blessings be upon him, said: “I and the person who looks after an orphan and provides for him, will be in paradise like this,” putting his index and middle fingers together...”³

Reference to *kāfil al-yatīm* (lit. guarantor of orphan) in the above *ḥadīth* was used literally to mean guarantor of good welfare of orphan. Legally, the term guarantee is defined as the conjoining of the guarantor’s *dhimma* (faculty by which a person bears liabilities) to that of the guaranteed in a way that the debt or other responsibility of the original bearer is established as a joint liability of the two of them (Ibn Qudāmah: 1983: 70). The contract provides an assurance that an obligation or liability of the guaranteed party will be fulfilled. It may relate to a person (*kafālah al-nafs*), finance (*kafālah bi al-māl*) or performance of an act (*kafālah wajh*) (Bank Negara Malaysia (BNM), 2015: 6) *kafālah* relating to a person involves the production of the person for whom the *kafālah* (bail) has been given. *Kafālah* relating to finance implies an obligation. *Kafālah* relating to an act or performance ensure the

² It is also call *hamalah*, *ḍamānah* and *za‘amah*.

³ Muḥammad Ibn Ismā‘il al-Bukhārī (1987), *Ṣaḥīḥ al-Bukhārī*, vol. 8, ‘Bāb Fadlu man Ya’ul al-Yatim’, *ḥadīth* no. 34, Beirut: Dār al-Fikr, 23.

performance of a certain act, the failure of which may render the surety liable and responsible.

One important point to be stressed is that *kafālah*, unlike *hiwālah* (transfer of debt), would not release the principal debtor in whose favor the contract is concluded because *kafālah* is only an obligation in addition to the existing obligation. While the guarantee agreement establishes a joint liability of both the guarantor and the guaranteed, it does not increase the creditor's right to the original debt. This is because once the debt is claimed from either of them, no claim can be laid on the other and a discharge of one of them from liability for performance exonerates the other.⁴

2. Legality of *Kafālah*

Contract of guarantee finds its bases from the *Qur'ān*, *sunnah* and consensus of Muslim jurists. In the *Qur'ān* the event of Prophet Yūsuf and his brothers where the former feigned the loss of the King's measure and stood guarantor for a reward for whoever retrieve it gave validity to the contract under the Islamic law. The relevant of *Qur'ān* portion provides:

قَالُوا نَفَقَدْ فُتِنَ صُورَاعَ الْمَلِكِ وَلِمَنْ جَاءَ بِهِ حِمْلُ بَعِيرٍ وَأَنَا بِهِ زَعِيمٌ ﴿٧٢﴾

They said: "We have lost the (golden) bowl of the king and for him who produces it is (the reward of) a camel load; and I will be bound by it..."

(Surah Yūsuf, 12: 72)

The word *za'im* used in the verse signifying being bound by obligation was said to have been interpreted by Ibn 'Abbās to mean *kafīl* i.e. guarantor. Imam al-Razī in his exegeses of *Qur'ān* also interpreted the verse as a basis for *kafālah* contract especially as it was confirmed by the later practice and saying of the Prophet but made exception of the subject of the guarantee in the verse, which was to reward a return of a purported stolen item (al-Razī, 1981: 179-180).

In further validation of the contract, the Prophet SAW was reported in a *ḥadīth* narrated by Jābir to have gone for the funeral of a man to pray for his soul. He asked those present at the funeral:

⁴ Bakar, D. (2008), "Contracts in Islamic Commerce and their Application in Modern Islamic Financial System," *Iqtisad Al-Islami Khalifa Institute*, http://islamic-world.net/economics/contract_03.htm, accessed 1 April 2010.

“..did he leave any wealth?”, they replied “No.” He asked further, “did he die with any debts outstanding?”, they replied “yes, he owed two *dinār*” (in some narrations three *dinār*). The Prophet SAW was about to leave when he said “then pray on your companion.” Abū Qatādah al-Anṣārī interceded and said: “I guarantee his debt, Oh Messenger of Allah SWT” and the Prophet SAW then pray on his soul...”⁵

In another tradition, the Prophet SAW was reported to have said:

“The guarantor (*al-za‘im*) is a debtor.”⁶

The Muslim jurists are also unanimous on validating contract of guarantee because it is essential for a flow of commercial dealings as it gives protection to the debtor and assurance and confidence about repayment to the creditor (Shabir, 2001: 94). In financial transactions, guarantee is intended to secure obligations and protect amount of debts from being uncollectible or from being in default. It takes the form of written documents, attestations, personal guarantees, pledges, cheques and promissory notes. Guarantee is effective in contract of exchange, like contract of sale or contracts of rights, e.g. right of intellectual property but it does not affect the validity of the original contract in which it is required. More than one guarantee may also be contained in one contract, as in incorporation of personal pledge with the pledge of security in the same contract (AAOIFI, 2002: 57).

THE JURISTIC VIEWS ON THE DEVELOPMENT OF *KAFĀLAH*

Having agreed generally on the legality of *kafālah* contract, many juristic ink have flown in the expression of divergent views of Muslim scholars on the nitty-gritty of especially its composition, conditions for its validity, knowledge of the guaranteed liability and exoneration of its principal bearer.

a) Composition of Contract of Guarantee

Majority of the Muslim jurists comprising of Mālikī, Ḥanbalī, Shāfi‘ī and some views in Ḥanafī schools agreed on four components of a contract of guarantee. These are: (a) *al-Kāfil* (the guarantor) with capacity to transact in

⁵ al-Bukhārī (1987), *Ṣaḥīḥ al-Bukhārī*, vol. 3, “Kitāb al-Ḥawālah,” Beirūt: Dār al-Fikr, no. *ḥadīth* 492, 276.

⁶ Abū Dāwud (1984), *Sunan Abū Dāwud*, vol. 3, Beirūt: Dār al-Fikr, no. *ḥadīth* 3343, 247.

his own property, (b) a right susceptible to representation, (c) the form (offer by the guarantor) and (d) *al-Makfūl 'anhu* (the guaranteed party), who bears the liability originally, dead or alive (Ibn Juzayy, n.d.: 325). According to Shabir (2001: 94), the major area of difference between this group and the minority group comprising of Abū Ḥanifah and his disciple, Muḥammad, is in the form of the contract where the latter insist that an offer by a guarantor must be accepted by the guaranteed. The majority is contented with only the offer as constituting the contract relying on the fact that the *ḥadīth* of Jabir cited above was not anticipatory of acceptance from the deceased debtor. This view seems to be more convincing.

b) Conditions for the Validity of *Kafālah* Contract

Several conditions are stipulated for the validity of *kafālah* contract. The conditions relate to the guarantor, the guaranteed party, object of the guarantee and details of the language of guarantee contract. As for the guarantor, Muslim jurists are unanimous on the requirement that he must have legal capacity⁷ to enter into gratuitous contract relating to his property and must as well be free from restriction to enter into the contract. These two conditions exclude a child and an insane as well as a slave from being guarantors. However, these conditions are extended by Mālikī jurists by further excluding a woman from guaranteeing a liability that covers more than 1/3 of her property without the consent of her husband (al-Zuhayli, 2003: 16).

Divergent views emerged as to the conditions to be satisfied by the guaranteed party. Abū Ḥanifah excludes a bankrupt deceased person from eligibility to guarantee as according to him, all liabilities on the juristic personality of a deceased person must have perished with his death. However, his two disciples, Abu Yusuf and Muhammad and jurists of Mālikī and Shāfi'ī schools viewed differently. They relied on the *ḥadīth* of Jabir to insist that the debt of a deceased person whose estate cannot repay his debt can be guaranteed. Shāfi'ī and Ḥanbalī jurists also held contrary views to Ḥanafīs insistence that a debtor to be guaranteed must be known to the guarantor. This, the former said, is unnecessary since the debtor's acceptance is not required to

⁷ The legal capacity of a person, from Shariah perspective, is defined as capacity to assume rights and responsibilities; and capacity to give legal effect to his action. Among the important conditions are that the person must possess sound mind and the capacity to distinguish between what is harmful or beneficial to one's interests. Legal capacity of a legal entity is defined as eligibility of an entity to acquire rights and assume responsibilities, see BNM, *Kafālah Concept Paper* paragraph 13.2, 9.

form the contract and guarantee as a charitable act can be directed to anyone (Ibn Qudāmah, 1983: 537).

Bank Negara Malaysia (2015: 10) summarized the object of guarantee as comprising the following:

- a) A financial liability or obligation of the guaranteed party that is already established or that will be established in the future;
- b) Performance of a certain act by the guaranteed party;
- c) Fulfillment of an obligation by the guaranteed party; or
- d) A combination of any or all of the above.

Jurists are unanimous that a financial debt must be a valid and binding one to be guaranteed. This excludes non-debts like the ransom to be paid by a slave given the option of freeing himself and alimony payment by a husband of a divorcee before the option of enfranchisement is made or before the alimony is agreed upon respectively (al-Zuhayli, 2003: 17).

The majority of Muslim jurists, comprising of Ḥanafī, Mālikī and Ḥanbalī jurists also opined that the object of financial guarantee must be such that can be retrieved from the guarantor. This invalidates a guarantee to receive physical punishment because receipt of physical punishment cannot be done in proxy. This position placed reliance on the *ḥadīth* reported by Bayhaqī and quoted by al-Saywasī (n.d.: 187) where the Prophet SAW was reported to have said:

لا كفالة في حد

*“There is no guarantee for a physical punishment (ḥadd).”*⁸

Their position was further fortified by the contradiction that exists between the objective of guarantee, that is, to certify and assure the creditor’s right and the convention of the jurists seeking to avoid the infliction of physical punishment by looking for grounds to doubt the need to inflict penalties. The Ḥanafīs however understand this impermissibility as to avoid forcing a guarantor from producing one. Thus, a voluntary guarantee of presence by the accused person is valid (al-Kasānī, 1986: 8).

Finally on the object of guarantee, it is the view of the Ḥanafīs that it must be an established liability borne by the debtor. Thus, non-fungibles held as a possession of trust cannot be object of guarantee. It is not permissible to stipulate in trust (financing) contracts like agency contracts or contract of deposit that a personal guarantee or pledge be produced, because such a

⁸ al-Bayhaqī (1994), *Sunan Bayhaqī al-Kubra*, vol. 6, “Bāb: Mā Jā’a fī al-Kafālah bi badan mā ‘alayh Ḥaq,” Makkah: Maktabah Dār al-Bāz, 77.

stipulation is against the nature of the contract, unless it is intended to mitigate risk arising from cases of misconduct, negligence or breach of contract (Ibn Qudāmah, 1983: 536-539). This position is more stringent in *mushārah* (partnership) (Muhammad Akram Khan, 2003: 136)⁹ and *muḍārah* (profit sharing) (Muhammad Akram Khan, 2003: 129)¹⁰ contracts since the partner or the manager in these contracts cannot be asked to guarantee the capital or to promise a guaranteed return. This is more so as the contract cannot be marked or operated as guaranteed investments.

c) Knowledge of the Guaranteed Liability

Majority of the Muslim jurists comprising Ḥanafī, Mālikī and Shāfi‘ī jurists are of the view that it is not necessary for a guarantor to know the amount or the extent of the liability he is guaranteeing. This according to them is because the contract of guarantee is a voluntary gratuitous contract meant to facilitate transactions and as a result accommodates ignorance of the object (al-Ramlī, nd.: 26). The Shāfi‘īs extend the permissibility of guarantee of an unknown object to guaranteeing the safety of the route through which the objects would be transported.

Against this background, a valid guarantee may be given for debts, the exact amount of which is unknown. Similarly, a valid guarantee may be given for a debt that will arise in the future. It is however permissible for the guarantor to withdraw such a guarantee before a future debt is actually created, but after notifying the person having interest in the guarantee. This is called a “market (business) guarantee” or “guarantee of contractual obligation” (AAOIFI, 2002: 59).

However, later jurist of the same school insist that a guaranteed object must be known by the guarantor in terms of its amount, characteristics, genus and specification. They opined that contract of guarantee establishes property as

⁹ *Mushārah Lit*: Partnership financing. *Tech*: A financing technique adopted by Islamic banks by which the bank participates in business enterprises by contributing a capital which is mixed with others capital. Profit is shared in pre-agreed ration while loss is borne in the ratio of parties’ contribution to the business capital.

¹⁰ *al-Muḍārah Lit*: Profit sharing financing. *Tech*: A business relationship in which a party (*rabb al-māl*) contributes the capital and the other party (*muḍārib*) entrepreneurship, with a predetermined share of profit while the loss is borne solely by the capital provider except in case of negligence or violation of the terms of the contract by the *muḍārib*.

a liability on the guarantor and like sale; it should exclude ignorance on the established liability (al-Ramlī, n.d.: 403).

d) Exoneration of the *Makfūl ‘Anhu* (Guaranteed Party)

When a debt is guaranteed, majority of the Muslim jurists comprising of Ḥanafī, Shāfi‘ī and Mālikī jurists, are of the view that the guarantee does not exculpate the *makfūl ‘anhu* (guaranteed party) who is the principal debtor, guaranteed from his original liability. To them, guarantee is only meant to assure the payment and to give the creditor option of claiming from either party, except where extrication of the principal debtor is a condition of the guarantee agreement (al-Zuhayli, 2003: 26). Within this majority, jurists of Shāfi‘ī school disallow stipulating such condition which they viewed as contradicting the nature of the contract and seen as more of transforming the contract to *hawalah* (transfer/assignment of debt) (Muhammad Akram Khan, 2003: 192).¹¹ Also, in the exercise of the option of demand of debt, Imam Mālikī prioritized demand from the principal debtor first allowing the demands from the guarantor only when demand from or repayment by the principal debtor has become impossible (Juzayrī, 1998: 286).

Contrary to this majority view, the Zahirī and Imamy schools and few other scholars constituting the minority opined that once a guarantee contract is established, the principal debtor is absolved of his initial liability arguing that the debt is transferred by the agreement to the *dhimma* of the guarantor. Thus, the creditor may not demand his debt from him. They premised their argument on the *ḥadīth* of Abū Jabir where repayment by the deceased guaranteed could not have been anticipated.

Obviously, this argument cannot be sustained in the case of a living guaranteed debtor. The minority’s reliance on the *ḥadīth* of Jābir cannot also stand on the face of the *ḥadīth* where the Prophet was reported by Abū Hurayrah RA to have said:

نفس المؤمن معلقة بدينه حتى يقضى عنه

“The soul of a believer is attached to his debt until it is repaid for him.”¹²

¹¹ *al-Ḥawalah* is an agreement by which a debtor passes on the responsibility of payment of his debt to a third party who also owes the former a debt.

¹² al-Tirmidhī (n.d.), *Sunan al-Tirmidhī*, vol. 3, Beirut: Dār al-Kitāb al-‘Ilmiyyah, no. *ḥadīth* 1078, 389.

This *ḥadīth* was relied upon to fortify the majority's position. It is also arguable that were the deceased in the *ḥadīth* of Jābir RA to be solvent before his death, the debt would have been realized from his estate before distribution to his heirs.

1. Types of *Kafālah*

As would be noticed from the definition above, *kafālah* is of two types i.e. *kafālah bi al-nafs* (physical) and *kafālah bi al-māl* (financial). Physical guarantee or surety-ship for the person is also known as *ḍaman wajh*. This is an assumption of liability for the appearance of the debtor or of his agent in a law suit. Under this guarantee, it is permissible for a person to guarantee the safe delivery of another for a specified period of time. Where this is done, it is the view of the majority of the Muslim jurists that the guarantor is required to deliver the guaranteed person at the end of the specified period and is not responsible for immediate delivery. However, Abū Yūsuf of the Ḥanafī School opined that the guarantor may be required to deliver the guaranteed person at any time and would continue to be so responsible until the expiration of the specified time. This latter view has been said to agree with the common practiced based on custom (al-Zuhayli, 2003: 11).

Financial guarantee on the other hand is a pledge given to a creditor by the guarantor that the debtor will pay his debt, fine or any other personal liability, thereby joining the latter's liability to his. Having established the contract, the creditor is entitled to claim his debt from either the debtor or the guarantor and he has the choice of claiming his right from either of them. However, the guarantor is entitled to arrange the order of liability by stipulating in the contract agreement that the creditor shall first claim the debt from the principal debtor and that the creditor would only have recourse to claim from the guarantor if the principal debtor is unable to discharge his obligation (AAOIFI, 2002:60, clause 3/3).

Therefore, in consideration of the order of demand, contract of guarantee is divided into two, viz.: recourse and non-recourse guarantee. A recourse guarantee is the type where the guarantor has right to claim back from the principal debtor whatever he uses in the discharge of the latter's liability towards the creditor. To be entitled to the right of recourse, the guarantee must have been created upon the request or with the consent of the principal debtor. Non-recourse guarantee on the other hand is a voluntary guarantee created by the guarantor on behalf of the debtor without asking. In this type, the guarantor cannot claim back anything from the debtor (AAOIFI, 2002: 59, clause 3/1).

2. Modes of *Kafālah*

A guarantee may either be unrestricted, restricted by description, suspended pending a condition or deferred. A guarantee is unrestricted when it is given plainly on the same term as the original debt for which it was created. No new condition or description different from the terms of the original debt is introduced for the convenience of either the guarantor or the principal debtor. The creditor only needs to wait for the debt due date and lay claim to either the debtor or the guarantor.

A restricted guarantee is restricted by its description either as current or deferred guarantees. While a current guarantee operates within the term of the original debt, it is also permitted to restrict the operation of guarantee through deferment to a specified date. It makes no difference whether or not the terms of the deferred guarantee coincide with the terms of deferment of the guaranteed debt. The right of demand remains with the creditor and he has the freedom of contract to enter into different agreement with both the debtor and the guarantor (al-Zuhayli, 2003: 10). On this basis, jurists of the four schools of Islamic jurisprudence allow deferred guarantee of current debt and current guarantee of deferred debt. Where a deferred guarantee is given for a current debt, the implication may be an advantage of the principal debtor or to the guarantor only. If a deferred guarantee is introduced at the initial stage of a current debt contract, the debt automatically becomes deferred. If however, it is given after the conclusion of the contract, the deferment is going to be to the benefit of the guarantor only (al-Zuhayli, 2003: 10).

A guarantee contract can also be suspended on the happening of an event, thereby hanging the liability of the guarantor for the debt until the stipulated event happens. For instance where a guarantor says: "I guarantee the payment of the debt on the due date", he cannot be made answerable for the debt call back before the due date. However, the permissibility of the mode is premised on the requirement that the condition upon which the guarantee is suspended must not contradict the object of the contract of guarantee itself. In other words it must not be such that would make the realization of the debt impracticable. Otherwise, the suspending condition would be nullified and the guarantee would be established as current (al-Kasānī, 1986: 4). In furtherance of this, jurists of Ḥanafī School permit a situation where both physical and financial guarantee are combined in one transaction and one of them is suspended on the other. For instance, where a third party guarantees the production of the debtor at a particular time failing which he agrees to be liable for his debt. Here, the financial guarantee is suspended on the failure to fulfill the physical guarantee

and both are valid so long as the principal debtor acknowledges his initial liability (al-Kasānī, 1986: 4).

A futuristic guarantee is also given a place of validation by the Ḥanafī jurists. In this mode of guarantee, a person guarantees whatever liability another person incurs in the future or whatever the latter consumes or the price of his sale transactions. The only proviso to this mode is that the future event must be such that give rise to the guaranteed right (al-Zuhayli, 2003: 13).

EXTENDING THE FRONTIERS OF ISLAMIC LAW

As mentioned earlier in this work, the concept of *kafālah*, like loan arrangement, is originally gratuitous in nature. However, the significant role it played in the contemporary financial transactions and the prevalence of its use whether as stand-alone product or as complement of other products necessitated the need to structure it in a way to attract benefit to the operators.

1. Charging Fee for *Kafālah*

In its original form, guarantee is a gratuitous charitable contract for which the guarantor expects reward only from Allah SWT for easing the financial inconvenience of his fellow being. He is not entitled to additional payment over the amount he paid as the obligation of the principal debtor. Hammad (1997: 96) posits that majority of the Muslim jurists comprising of the jurists of Ḥanafī, Shāfi‘ī, Mālikī and Ḥanbalī Schools have come up with evidences to support the non-permissibility of taking fee for giving guarantee, some of which are hereunder considered (Hammad, 1997: 96).¹³

Firstly, they argued that the origin of *kafālah* is a charitable voluntary contract and making the guaranteed to pay for its offer would transform it to a contract of exchange and that is not permissible. Secondly, they argued that the Lawgiver places transactions of guarantee, and loan on the same category in their closeness and the way they are known as being only for the sake of Allah SWT and as such taking any remuneration on them is prohibited. Thirdly, they are of the view that financial transaction of exchange is permitted by the law because of the actual exchange of work or property involved. As guarantee is neither work nor property, taking remuneration in its exchange would amount to consuming others wealth in vain or taking bribe. Fourthly, the majority opined that taking a price for offering guarantee has taken the transaction into the realm of *gharar* (uncertainty) sale. And lastly, they held that when a price

¹³ Only Ishāq Ibn Rahawih permits taking fee for the contract.

is agreed on the guarantee given, the guaranteed party would return to the guarantor the amount of the guarantee and the agreed price in addition. This is not permissible because it is tantamount to granting loan which draws benefit, and that is *ribā* (Hammad, 1997: 97-115).

Meanwhile, in a situation where a person requiring guarantee could not find any guarantor who would not take fee for granting same and he is in dire need to have one, he may pay the fee to meet the necessity. Such situation arises when a person is constrained, for instance, by the need to have guarantee to secure his admission into foreign land for the purpose of education or earning a living etc. This permission to pay the fee on the face of necessity is analogous to the jurists' permission of payment for good acts like teaching the *Qur'ān* or other religious acts which should ordinarily be voluntary charitable acts. It also goes with the justification for paying bribe to find out the truth and remove injustice and paying money to enemies to protect the people from their danger. In these cases, the guaranteed would be considered as paying for the benefit he derived for the guarantee (al-Zuhayli, 2003: 39).

2. Contemporary Applications of *Kafālah* by Islamic Financial Institutions (IFIs)

In Islamic financial institutions, *kafālah* (guarantee facilities) refers to contracts or assurance made by the institution to third parties that its customer would fulfill his obligations towards the said third party. In the contract, the financial institution gives an assurance that it would assume the liability of its customer in the event of default or breach of contract entered into by the customer and the third party. It is an undertaking that the financial institution would pay an agreed sum if its customer fails to fulfill his/her obligation under the contract (Bank Islam Malaysia Berhad (BIMB), 1994: 99).

According to paragraph 22.1 of BNM (2015:15, para. 22.1) in the Islamic finance industry, an Islamic financial institution (IFI) may enter into *kafālah* contract in the capacity of a guarantor or beneficiary. In the capacity of a guarantor, the IFI provides a guarantee services to customers through various *kafālah*-based financial products such as bank guarantee, standby letter of credit and shipping guarantee. In the capacity of a beneficiary, the IFI accepts the guarantee provided by a third party for the financing facilities extended. In this wise, it is being used as one of the contracts to supplement various primary Islamic financial products, predominantly for risk mitigation purposes, such as *mushārah* (participatory financing), *muḍārabah* (venture capital participatory financing), *murābahah* (cost-plus financing), *salām* (forward

sale), *istisnā'* (financing for commissioned production), *ijārah* (lease) and *tawarruq* (resale of purchased commodity) (BNM, 2015: 5, para. 1.5).¹⁴

Kafālah is used by the Islamic Financial Institutions (IFIs) to provide guarantee services, such as bank guarantee, standby letter of credit and shipping guarantee.

In practice, the customer requests an Islamic bank, for instance, for a credit line. The bank processes the application and if it is satisfied that the customer is of good credit standing, it will extend letter of guarantee facility to the customer by means of letter of offer. Letter of guarantee is issued in an Islamic bank for the following purposes: Tender guarantee; Performance guarantee; Guarantee for sub-contracts; Custom Bond; Guarantee for exemption of custom duties; Guarantee for maintaining ledger account; and Guarantee in lieu of Security deposit or special guarantee (Khan, 2003: 100).

Where letter of guarantee is to be issued by a financial institution, there must always be a request from the customer. In other words, an institution is not entitled to guarantee financial commitment without right of recourse to the debtor. The only situation where it can decide to be a non-recourse guarantor is when it has been permitted by its Article of Association or by special resolution of the shareholders and investors to make donations or to perform acts of benevolence.

At this juncture, there is the need to examine benevolent loan (*qard ḥasan*), and see if a non-recourse guarantee can qualify to be one of the benevolence acts an Islamic Financial Institution may embark on. A benevolent loan or loan without interest is one of the products of Islamic banks granted on the grounds of compassion to remove the financial distress caused by the absence of sufficient money in the face of dire need of their customers or any other deserving member of the public. However, since banks are profit oriented organizations, its application constitutes a very low percentage of Islamic banks mode of financing. Slight variations exist among different Islamic banks

¹⁴ *Tawarruq* (lit. “turns into silver”) is an Islamic financial sale product which allows clients to raise money quickly and easily, a customer buys an easily saleable asset from an Islamic bank at a marked up price, to be paid at a later date, and quickly sells the asset in the open market, at the same or discounted price, to raise cash, Muhammad Akram Khan, *Islamic Economics*, vol. 24, 182; the product has been condemned as a trick to give or to get an interest-bearing loan, in April 2009, the International Islamic Fiqh Academy of the Organisation of the Islamic Conference, ruled that “organised use” of the *tawarruq* financial instrument was prohibited see Financial Time Lexicon at <http://lexicon.ft.com/Term?term=tawarruq>, accessed on 5 March 2016.

in the use of the mode. The Faisal Islamic Bank of Egypt provides interest-free benevolent loans to the holders of investment and current accounts, in accordance with the conditions laid down by its board of directors. The bank also grants benevolent loans to other individuals under conditions decreed by its board. On the other hand, the Jordan Islamic Bank Law authorizes it to give “benevolent loans” (*qard ḥasan*) for productive purposes in various fields to enable the beneficiaries to start independent lives or to raise their incomes and standard of living.¹⁵

Iranian banks are required to set aside a portion of their resources out of which interest-free loans can be given to (i) small producers, entrepreneurs and farmers who are not able to secure financing of investment or working capital from alternative sources, and (ii) needy customers. It should also be noted that Iranian banks are permitted to charge a minimum service fee to cover the cost of administering these funds (Iran, 1988: 257). In Pakistan, *qard ḥasan* is included in the lending mode of financing. Two important differences are to be noted: (i) No service charge is imposed on *qard ḥasan* loans and (ii) *Qard ḥasan* operations are concentrated in the head office of each bank and branch offices are not permitted to extend these loans which are granted on compassionate grounds. These loans are repayable if and when the borrower is able to pay.

Given the facts that Islamic banks also perform social functions of community development therefore, it may rightly be said that non-recourse guarantee would have a place in their operations albeit, it would have to be clearly spelt out as being transacted under benevolence acts. This is more particularly so as it is not permissible to charge any fee on the Account of giving guarantee only. Nonetheless, the fact that the amount usually involved in financial Institutions guarantee on behalf of their customers is huge especially as they involve import guarantee and letter of credit, it will be undesirable for an institution to engage in non-recourse guarantee even if it is otherwise permitted by the Article and the shareholders.

Where a customer is to owe a debt to an Islamic financial institution, it is permissible for the institution to stipulate that the customer provide guarantor or guarantors for the debt but the institution is not obliged to enquire into how a customer obtained a guarantee it produces once the credibility of the guarantee is satisfactory. Just as in the case of general guarantee, it is permitted for Islamic financial institution to fix the duration of a personal guarantee and to set the ceiling on the amount to be guaranteed. The Institution can also restrict the guarantee or put it on condition. This condition can be future event,

¹⁵ Jordan Islamic Banking Law (1978), Article 7-b (1).

like fixing a date at which liability will take effect. Where the date of liability is deferred as in this case, the guarantor, either the institution on behalf of its customer or a third party in respect of its customer's indebtedness towards it, may validly withdraw the guarantee by giving notice to the creditor before the accrual of the obligation guaranteed.¹⁶

Following from the above exposition on charging fee for *kafālah*, it is not ordinarily permissible for an Islamic financial Institution to take any remuneration or commission for providing guarantee to its customers. What an Islamic financial Institution is allowed to take in excess of the amount of the actual obligation is whatever it expended in the course of giving the guarantee. This may include the administrative and all other expenses actually incurred by the institution and a consideration for merely giving the guarantee would not be accommodated. Thus, the amount to be charged as service charge should not exceed what would be charged by other institutions for similar services. Similar charges here are not in comparison with what is charged by conventional banks as the computation of the latter's charges takes into consideration the amount guaranteed and the duration of the guarantee (al-Zuhayli, 2003: 39).

The most frequented guarantee practice in Islamic banks is issuance of letter of credit. Issuance of letter of credit is a traditional banking practice by which the bank's customer (an importer) satisfies the requirements of a corresponding exporter upon the former's request. A bank would issue such letter as a guarantee to pay the foreign exporter for the goods that its customer wishes to buy. Once proof of delivery of the imported goods is produced, the bank pays the exporter the contract price which was ordinarily the obligation of its customer it guaranteed (Al-Salusi, nd.:159). In the conventional banks, the customer is charged interest which comprises its clerical expenses and its profit for providing the services. It makes no difference whether or not the guarantee is fully covered by the customer.

However, since Islamic banks are precluded from charging interest, they practices the contract of guarantee either as issuance of letter of credit through *wakālah* (agency) contract, or *mushārah* (partnership) contract or *murābahah* (cost-plus sale) in addition to the original letter of guarantee discussed above. In the issuance of letter of credit under *wakālah* contract, the bank acts as the agent of its customer who informs it of his requirement of the letter and requests it to provide the facility. When this mode is adopted, the bank requires the customer to place a deposit to the full amount of the price of the goods to be purchased or imported which the bank accepts under the principle of *al-wadī'ah yad ḍamānah* (safe custody deposit). The bank subsequently create the letter of credit, pays the

¹⁶ AAOIFI (2002) 59, clause 3/1/4.

import contract obligations to the negotiating bank using the customer's deposit and releases the documents to the customer. It charges the customer fees and commission for its agency services under the principle of *al-ujr* (fee) (BIMB, 1994: 100-101).

A striking feature of this mode as could be differentiated from a pure guarantee transaction on which an Islamic bank cannot charge an increase relates to the manner of demanding of the contract sum from the customer. Whereas, in a pure guarantee transactions, a guarantor cannot seek the payment of the cost involved in the liability from the guaranteed party until after he might have paid same to the creditor on behalf of the guaranteed party; in the issuance of letter of credit through the medium of *wakālah*, the customer is required to pay the full cost upfront. The bank only acts as a mere trusted intermediary through which the fees are paid and documents exchanged. This is the justification for its taking commission for its services. Also as an agent, the bank is not personally liable for loss that may result from the third party breach in the transaction which is not as a result of its fault or negligence.

This practice does not conflict with the prohibition of combining agency and personal guarantee in one contract at the same time, that is, the same party acting in the capacity of an agent on one hand and as a guarantor on the other hand. The reason for non-permissibility of this combination is its contradiction of the nature of the contracts. Also, a guarantee given by an agent of an investment fund transforms the transaction from agency to an interest-based loan. This is so because a guaranteed investment capital added to the proceeds of the investment is as good as the investment agent taking a loan and repaying it with an additional sum which is *ribā* (interest).¹⁷

Bank Islam Malaysia Berhad issues Letters of Credit (L/C) under the principle of *mushārah* adopting the following method. The customer is required to inform the bank of his letter of credit requirements and negotiate the terms of reference for *mushārah* financing. The customer places with the bank a deposit for his share of the cost of goods imported which the bank accepts under the principle of *al-wadī'ah*.¹⁸ The bank then issues the L/C and pays the proceeds to the negotiating bank utilizing the customer's deposit as well as its own finances, and subsequently releases the documents to the customer. The customer takes possession of the goods and disposes of them in the manner stipulated in the agreement. Profits derived from this operation are shared as agreed (Man, 1988: 76).

¹⁷ AAOIFI (2002), 57-58.

¹⁸ *al-Wadī'ah*. Lit. Deposit, trust. Tech.: A contract whereby a person leaves valuables as a trust for safe-keeping, see Khan, *Islamic Economics*, n. 2, 192.

Here too, the transaction is distinguishable from a pure guarantee devoid of additional charges. Both the banks and its customer are partners sharing in the cost of the contract sum in the way they would share the accruing profits in accordance with the agreed term and the ensuing loss according to the percentage of their respective contribution. However, the bank still retains its role as a reliable institution for the assurance of the payment of the contract sum to the creditor (exporter). Going by the ruling that contract of guarantee does not require an acceptance from the guaranteed party, the bank's customer in this case, its position as a guarantor in its dealings with the creditor is not vitiated by either being an agent or partner to the principal debtor.

Another way through which letter of credit is issued especially by Bank Islamic Malaysia is by operation of *murābahah* (cost plus). Here, a customer engaging in either trading or manufacturing may require the purchase of merchandise or raw materials in the course of his business. Apart from the need for a letter of credit, this customer also has no fund to back up his request from the bank. In other words, the guarantee he is requesting is completely uncovered. He therefore requests the bank to purchase or import the goods giving the promise that he would in turn purchase it from the bank negotiating the letter of credit on the principle of *murābahah*. The bank appoint the customer as its agent to purchase the goods on its behalf, establishes the letter of credit and pays the cost of the goods to the negotiating bank using its own fund. The goods are sold to the customer at a sale price made up of its cost and a profit margin under the principle of *al-murābahah*, to be paid on a deferred term (BIMB, 1994: 102-103).

The grey area in this arrangement as is usually experienced in any discussion on *murābahah* are the legality of the arrangement and the binding nature of the promises given by both the customer and the bank to purchase and to buy the ordered goods from each other respectively. As for the legality, the transaction has been held to be valid by Imam Shāfi'ī in his exposition as follows (Imam Shāfi'ī, 2001: 33):

“If an individual shows another, goods and says: buy this and I will give you this much profit in it; and the second man buys it, then the purchase is valid. If the first party said: ‘I will give you this much profit in it, but I retain an option’, then, he may conclude the sale or leave it.”

However, a condition to the validity of the arrangement is assumption of risk by the bank by receiving the purchase item. The appointment of the customer as an agent in the purchase of the ordered item does not exculpate the

bank from being responsible for it before the sale to the customer takes place even while the customer was still acting as the agent.

As for the binding nature of the promises of the bank and the customer, Vogel (1998: 142) quoted Ali (n.d.) as being of the opinion that jurists of Mālikī School recognize such promise as binding ruling that any promise that does not result in permitting that which is forbidden or forbidding that which is permitted is binding. This is more particularly so if the promise has lead another party to undertake a financial obligation as the bank would have done in this case.

Unlike the practice in the conventional banks where some investment deposits are guaranteed, if an Islamic bank manages a transaction on the basis of *muḍārabah* or *mushārahah* or investment agency, it is not permitted for it to guarantee the fluctuation of the currency exchange rate which would ensure that the investors recover their investment share irrespective of the behavior of the currency market. Such guarantee is prohibited because it amounts to the *muḍārib* or the partner or investment agent guaranteeing the capital of other partners or investors.¹⁹

On the whole, where the creditor discharges the guaranteed party from the debt, the bank is also discharged from its liability automatically. But the same position cannot be upheld in a situation where the guarantor is the one discharged, in which case the principal debtor remains indebted. However, if in the course of negotiating the guarantee agreement, the guarantor was able to secure a discount resulting in his paying an amount less than the original debt, the guarantor would only be entitled to the actual amount he paid to the creditor. He cannot make the debtor to pay the discount to him as that would amount to an increase in the amount of the guarantee he paid which is *riba*. The situation would be different if the guarantor settled the debt with a consideration different from the one in which the original debt was designated, in which case he would be entitled to recover whichever is less of the amount of the commodity used in settling the debt or the actual amount of the debt.²⁰

CONCLUSIONS

In the foregoing presentation, attempt has been made to examine the contract of guarantee in its traditional application covering its meaning both literally and juristically, the proof of its legality drawing evidences from the *Qur'ān, sunnah*

¹⁹ AAOIFI (2002), 60, clause 3/3/4.

²⁰ AAOIFI (2002), clause 3/3/2.

and *ijmā'*, differences in the understanding of the Muslim jurists in the course of its development, its types and mode of application and its contemporary application by financial institutions. In the course of the examination, it was established that contract of guarantee is a valid contract under the Islamic law but of its two types, financial guarantee is the one applicable to Islamic financial institutions. Although given prior permission by its Articles and memorandum of Association, an Islamic bank can grant non-recourse guarantee, however by the nature of the customers demand and the amount usually involved, a non-recourse guarantee is undesirable for an Islamic bank as a business going concern. It was shown that it is not traditionally permissible for a guarantor to take remuneration for his offer. However, in the Islamic banking practices, guarantee is offered as an income generating product. The practice is not a contrivance of Islamic traditional precept; rather, it is an ingenious extension of the frontiers of traditional Islamic law concept to the contemporary needs.

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