# CHARGING FEE FOR *KAFĀLAH* AND ITS CONTEMPORARY APPLICATION: A CRITICAL ANALYSIS FROM ISLAMIC PERSPECTIVE

**BY**

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# ABSTRACT

Over the last decade Islamic banking has been growing rapidly as they are able to provide practical alternative products to the conventional one. Both Islamic and conventional banks issue a Letter of Guarantee (LG) to facilitate different projects that are in dire need of capitals. In fact, the conventional banks issue LG based on interest unlike Islamic Banks. However, some Islamic banks do charge fee for LG based on *kafālah* mechanism which may be regarded as a back door to *ribā*. The main purpose of this research is to provide critical analysis on the legality of charging fees for LG from Islamic perspective and to furnish viable alternatives to *kafālah* principle. This study sets about the conceptual framework of *kafālah* (guarantee) and its historical background briefly. Moreover, the concept of LG in conventional bank is analyzed and its practical manifestation in the Islamic bank is critically evaluated. In addition, the research suggests the model of guarantee products in Islamic banking that represent *mushārakah*, *muḍārabah* and *wakālah* as replicates of the *kafālah* model by taking cognizance of the views expressed by scholars of the past and the present regarding fee for such products in general and to LG in particular. Furthermore, it highlights the obstacles in the application of alternative models and explores the feasible solution to overcome these obstacles as well.

# خلاصة البحث

شهدت المصرفية الاسلامية تطورا ملحوظاً خلال العقود الآخيرة وذلك لما تقدمه من خدمات مثالية كبديل للبنوك التقليدية، حيثيعمل كل منهما على إصدر خطاب الضمان لتسهيل تمويل المشاريع المختلفة ذات الحاجة لرأس المال. عملياً تصدر البنوك التقليدية خطاب الضمان على أساس سعر الفائدة. وعلى النقيض في البنوك الاسلامية لا مجال لسعر الفائدة. ومع ذلك فإن بعض المصارف الاسلامية تأخذ أجراً مقابل خطاب الضمان على أساس مبدأ الكفالة وذك قد يعتبر حيلة أو خدعة تقود إلى الربا. والهدف الرئيسي من هذه الرسالة هو المناقشة و التحليل النقدي لمشروعية أخذ الأجر على خطاب الضمان ، ومن ثم إقتراح أمثل البدائل لمبدأ الكفالة. وقد انتهجت الدراسة مبدأ الكفالة من حيث المفهوم والمضمون بالرجوع للخلفية التاريخية والشرعية بإيجاز. كما اعتمدت الدراسة مبدأ الضمان القانوني المستخدم في أنظمة البنوك التقليدية ومن ثم تقييم كفاءة كُلٍ منهما على حدة. هذا بجانب إقتراح بعض النماذج التي تحل محل الكفالة وهي: المشاركة والمضاربة والوكالة مع الأخذ بآراء السابقين والمعاصرين من علماء المسلمين حول القضية المنشودة. وعلى ذات الصعيد الوقوف على بعض العقبات التي تحد من تطبيق النماذج المقترحة والحلول الممكنة لتخطى هذه العقبات.

# APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science in Islamic Banking and Finance.

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Hikmatullah Babu Sahib
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This research paper was submitted to the IIUM Institute of Islamic Banking and Finance (IIiBF) and is accepted as a fulfillment of the requirement for the degree of Master of Science in Islamic Banking and Finance.

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Dean, IIUM Institute of Islamic Banking and Finance

# DECLARATION

I hereby declare that this research paper is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for my other degrees at IIUM or other institutions.

Mahmoud Hassen Hussen

Signature …… Date ……...

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# DECLARATION OF COPYRIGHT AND AFFIRMATION OF FAIR USE OF UNPUBLISHED RESEARCH



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Affirmed by Mahmoud Hassen Hussen

…… ……. ……..

Signature Date

# DEDICATION

For

This research paper is dedicated to my family especially to my wonderful mother, Jamila Khalid (Raḥmatullahi ʻAlayhā) who passed away when I was first year under graduate student, for her endless love and unconditional support, and to my father, al-Hajj Hassan Hussen, *Ago* who taught me civilized manners in ascetic lives. I can never repay that!

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# LIST OF ABBREVIATIONS

| | |
|---|---|
| BIMB | Bank Islam Malaysia Berhad |
| IBF Net | Islamic Business and Finance Network |
| IBG | Islamic Bank Guarantee |
| IDB | Islamic Development Bank |
| IFIs | Islamic Financial Institutions |
| ISRA | International *Sharī'ah* Research Academy for Islamic Finance |
| LC | Letter of Credit |
| LG | Letter of Guarantee |
| OIC | Organization of Islamic Cooperation |
| SAC | *Sharī'ah* Advisory Council |
| SC | Securities Commissions |
| SCM | Securities Commissions Malaysia |
| SLC | Stand-By Letter of Credit |

# CHAPTER ONE

# INTRODUCTION

## 1.1 BACKGROUND OF STUDY

Islamic banking industries have been growing rapidly globally as they are able to provide alternative products and services to their customers based on Islamic principles and values. Letter of Guarantee (LG) is one of the most popular services which Islamic banks have been providing in the areas of international trade, construction, project related finance and other activities using the *kafālah* principle. In fact, almost all Islamic banks charge for these services (Obaidullah, 2008).

However, despite the rapid growth of Islamic financial institutions that provide such products and services, it is worth noting that the extent to which these products and services are *sharīʿah*-compliant is yet to be comprehensively elaborated. It has been noted that the practice of guarantee fee is criticized and has been categorized as controversial issue among the *sharīʿah s*cholars. Therefore this research aims to examine the issue of charging fee for guarantee in general and its application in particular in Islamic banking industries. Furthermore, this study is undertaken in order to observe the constraints and challenges which the banks face in implementing these products as there are no alternative. Finally the researcher will attempt to provide feasible solutions and recommendations. Readers will find the term "*kafālah*" and "guarantee" as well as "surety" are used quite liberally and perhaps interchangeably due to their seeming similarities in their usages.

## 1.2 STATEMENT OF PROBLEM

Islamic banking is similar to its conventional counterpart in terms of offering LG services in the areas of international trade and cross-border project. The underlying concept used in Islamic banking is the contract of *kafālah*. The classical jurists have unanimously agreed that *kafālah* is a voluntary service that demands no charge whatsoever, though some contemporary jurists differ on the ground that there is no explicit evidence in both primary and secondary texts that prohibit charging fee for *kafālah*, since *kafālah* has become a necessity especially in international trade where the seller and the buyer do not know each other, nor the payment of the price by the purchaser cannot be done simultaneously with the supply of the goods.

Thus, in the process of issuing guarantee, almost all Islamic banks tend to charge a service fee when issuing LG, even though some *sharīʿah* scholars are of the opinion that this practice is against Islamic law (ISRA, 2012). In passing, there is no disagreement on the issue that an Islamic bank charges fee to cover the expenses incurred. By analyzing the aforementioned points of view of both classical and contemporary jurists, the researcher tends to find out the basis or rather the origins of the rulings for both the proponents and the opponents among the jurists with regards to charging fee for *kafālah* and to critically examine the degree of necessity required for that as argued by some contemporary scholars.

## 1.3 RESEARCH OBJECTIVES

The primary purpose of this study is to find out whether charging fee for *kafālah* is permissible or not. In addition, the research intends to achieve the additional objectives which include:-

a) Finding out the views and opinions of Muslim jurists regarding the issue of charging fee for LG.

b) Examining whether *kafālah* is considered a voluntary service or otherwise.

c) Investigating whether the current practices of Islamic Bank Guarantee (IBG) is in line with *sharīʿah* principles.

d) Critically analyzing the validity of charging of guarantee fee on the grounds of necessity or *ḍarūrah*.

e) Coming up with recommendations and suggestions in order to achieve the objective of *sharīʿah* in this regard.

## 1.4 RESEARCH QUESTIONS

The main research question of this study is what is the origin of the ruling of charging fee for *kafālah*? The secondary questions are as follows:

a) What are the Muslim jurists' views regarding the issue of charging of guarantee fee in general?

b) Is the current practice of Islamic banking with regard to charging fee for LG conforms to the origins of the ruling in *sharīʿah*?

c) Is guaranteeing merely a voluntary service?

d) Is charging fee for LG considered a necessity?

e) What are the possible recommendations and suggestions needed to fulfill the aim of *sharīʿah* in this area?

## 1.5 MOTIVATIONS OF RESEARCH

There are several factors that motivated the researcher to select this issue for study. The main reason is the overwhelming significance of guarantee in modern economic activities and especially in the domain of export and import. In addition, almost all Islamic banking industries charge service fee for the LG based on the principle of *kafālah* even though classical scholars mentioned that it should be free of charge.

## 1.6 SCOPE AND RESEARCH METHOD

This study focuses on the issue of charging fee for guarantee in terms of its legality and to review relevant literatures so as to ascertain the position of classical and contemporary scholars regarding the issue at hand and its contemporary application in Islamic banking industries. As the researcher is constrained by time and focus, the research will emphasize on IBG by examining and analyzing the issue critically from Islamic perspective. However, the finding of the study can be applied on other similar applications.

As this study is a qualitative type in nature, the researcher will primarily rely on library works such as text books, theses, journals, magazines and other documents related to the subject. Through comparative and analytical methods, works of classical and contemporary scholars will be studied extensively. Besides, inductive and deductive method will be applied to examine and scrutinize the views and evidences of both classical and contemporary Muslim scholars on the issue of charging fee for guarantee in general and for bank LG in particular.

## 1.7 SIGNIFICANCE OF THE STUDY

The significance of this study lies on the fact that the area of *kafālah* is a new field in Islamic financial institutions and the extensive research pertaining to the issue of LG is rarely discussed and critically analyzed, especially from Islamic perspective. Even though some *sharīʿah* scholars have highlighted the issue of charging fee for guarantee in general, to the best of the researcher's knowledge, none of them has gone in greater depth to study the issue concerning IBG. Perhaps they might have viewed it as trivial but it causes unjust income which is another form of *ribā* as well as raising big question on the validity of the contract.

The researcher therefore, believes that this research is a meaningful contribution in this area and will produce new insight into the *sharīʿah*-compliant products and services. Besides, it will assist policy makers and judges by adding to their theoretical knowledge and will also serve as a base for future research.

# CHAPTER TWO

# LITERATURE REVIEW

## 2.1 INTRODUCTION

There is a clear and considerable need for comprehensive study and critical analysis of the issue of charging fee for *kafālah* (guarantee) and more specifically for IBG as a significant contract in the field of international import-export trade which facilitates the expansion of markets for goods and services. Therefore, the researcher attempts to find out whether charging fee for guarantee is permissible or otherwise, and examines the current practice of IBG in the light of *sharīʿah* principles. The research endeavors to provide sound recommendations and suggestions. It is very important to pursue this study in order to clear some ambiguities surrounding the issue of charging fee by banks. As such it is pertinent to review available literature on this issue despite the fact that the existing literature on this issue is very limited. Even though *kafālah* principle is a well-known mechanism in Islamic law of contract, there is no much scholarly literature on its contemporary applications in Islamic banking industries, especially in English medium. This could be due to the recent formal introduction of Islamic banking system in most part of the world. However, the researcher has endeavored to search for the most relevant materials that contain the views of prominent classical and contemporary Muslim scholars pertaining to charging fee for guarantee and the issuance of bank LG.

## 2.2 CONCEPTUAL FRAMEWOK OF *KAFĀLAH* (GUARANTEE)

### 2.2.1 Definition

The term guarantee has many nomenclatures in Arabic, namely, *kafālah*, *himālah*, *ḍamānah* and *zaʿāmah*. Although they are used interchangeably at different times, to mean one and the same, nevertheless, it is noticed that there are slight differences between them which makes them unique from one another. The prominent Shāfiʻī scholar, Al-Māwardī identifies *kafālah* as a guarantee between parties or individuals. *Himālah* is used to describe the situation related to *diyyah* (blood money), whereas *damānah* is used in relation to debts, while *zaʿāmah* is significantly used in guaranteeing large amount of money (Al-Zuhaylī, 2007).

It should be noted that throughout the Noble Qur'ān, the word *kafālah* is not mentioned in relation to guarantee which is derived from the root verb "K-F-L" but its corresponding word is "*zaʻīm"* which is derived from the root verb "Z-ʻ-M" meaning guarantor. This can be found in Qur'ān (12:72), where he, Prophet Yūsuf said: "we had lost the (golden) bowl of the King and for him who produces it is (the reward of) a camel load and I will be the *zaʻīm* (the guarantor) for it". In passing, the history indicates that the contract of guarantee has been used in human history since a very early age (Al-Sālūs, 1986).

However, the word *Kafālah* is mentioned in the Qur'ān with reference to various other meanings, if we observe in the story of Āl-ʻImrān, for instance, *the word kaffalahā is used in referring to upbringing, meaning that Zakariyyā took the responsibility of upbringing Mary, the mother of Prophet ʿĪsā* (Qur'ān, 3:38).

The term *kafālah*, in Islamic jurisprudence has a specific meaning which literally means responsibility or surety-ship and technically it means the conjoining of the guarantor's liability to that of the guarantee, in a way the responsibility of the

original bearer is established as a joint liability (SCM, 2009). In other words, it is used widely as supporting and complimenting of commercial contracts, when one party does not have confidence in dealing with another in terms of comprehensive identity, credibility or not sure about integrity of the person, for instance, the third party becomes the guarantor who stands as collateral to the other party in order to assure that the consideration or subject matter will be received.

The Islamic wisdom with regard to *kafālah* is to promote the spirit of brotherhood, unity and mutual co-operation among its *ummāh* (Abdurrahman, 2009). Islam always encourages cooperation in acts of righteousness and piety (Qur'ān, 5: 2)

### 2.2.2 Basis of *Kafālah*

The legality of *kafālah* is considered as a matter that has been agreed upon by unanimity since the time of the companions. Its basis is found in the Qur'ān, the Sunnah and the consensus of the Muslim jurists. As highlighted above, the story of Prophet Yusuf, who stood as a guarantor for a reward to whoever could return the King's bowl of measure, can be among the strongest evidence.

A tradition of the Prophet further declares the legitimacy of *kafālah*, where it is narrated that the Prophet attended the funeral of a man to pray for his soul. He asked those who were present at the funeral: "Did he leave any wealth? To which they replied: "No". He asked further: "Did he die with any debts outstanding?" and they replied: "Yes", he owed two dinars". The Prophet was about to leave when he said: "Then pray on your companion". At this point, Abū Qatādah said: "I guarantee his debt, O! Messenger of Allah" and the Prophet then prayed for his soul (Al-Bukhārī, vol. 3, p.56). In another narration, the Prophet was reported to have said: "The guarantor is responsible for (paying) the thing he guaranteed" (Ahmad, vol.5, p.267).

The validity and legal effect of *kafālah* (guarantee) contract is also established by way of unanimous consensus among Muslim scholars based on the various authorities from both the Qur'ān and the Prophetic traditions. This is due to the great need for such contracts in financial dealings as it facilitates protection to the debtors and assurance and confidence about repayment to the creditors. Furthermore, it makes dealing in loan simple and safer for both parties (Muhammad, 2001).

## 2.3 HISTORICAL BACKGROUND OF *KAFĀLAH*

*Kafālah* or guarantee has been considered as a form of security for peace and future obligations in the primitive ages. It was not only utilized in social agreements within communities but it included commercial transactions. The institution of guarantee[1] developed hand in hand with the progress of humanity. The civilizations that prospered in Mesopotamia, Greece, Rome and Medieval England shaped the rules and the progress regarding the institution of guarantee. Islam that came as a new force after the collapse of all the above civilizations adopted the institution of guarantee and tailored it to suit and conform its *sharīʿah*.

### 2.3.1 The Origin of Guarantee

In record, *kafālah* shows that this institution is not a recent practice within human communities. In fact it was known since the medieval times when the fruits of civilization started to spread all over the world. Guarantee did emerge due to causative factors that are found in the human need. Therefore, the needs that guarantee was meant to meet and fulfil were conditioned by time, place, local

[1] The word guarantee is originally a French word- "*garantie*" the word was derived from the Frankish word *garant* which is a derivation from the word 'warrant" It connotes support. See Kevin Patrick Mcguiness, *The Law of Guarantee*, p. 21, 1986.

environment and racial characteristics. Since man is considered as sociable, it has been one of the factors that led to the emergence of guarantee. Thus there are various maxims that explain why men can't live on their own but has to mingle with others (Hewitson, 1927). Thus the fabric of human cooperation was worthy and of significance. As a result of this fundamental act, the principle of reciprocity emerged and everyone had a moral obligation to support others. It is also believed that the institution of guarantee was born from this process. Thus guarantee was regarded as important during the primitive epoch, since it provided source of security to those in dire need. Guarantee can also be regarded as personal security to secure the unforeseeable risks. In a nutshell guarantee is dispensable and security for future uncertainties.

### 2.3.2 Practice of Guarantee during the Primitive Era

It is seen that the institution of guarantee was first used in warfare. It was established with an aim of securing peace within the primitive communities. There were no defined rules and regulations governing the life and relationship of those primitive people. Men had instincts of self-defence from all hazards and if possible they had to take other people's property and lives. Therefore retaliation was common between them (Hewitson, 1927). However it was at this point that a mechanism was brought up to end this brutal life and thus guarantee became a tool of peace and reconciliation. Guarantee was essential in securing good behaviour among people through the submission of guarantors as hostages (Bell, 1804). As a result, the role of guarantee in a society was developed and applied which was further extended to cover future obligations.

The earliest practice of guarantee can be noticed in Genesis whereby Simeon son of Jacob was held in Joseph's custody until his brethren brought Benjamin before him. Simeon was held as a hostage to secure the promise made by the brethren of Joseph who agreed to bring Benjamin before Joseph (Genesis, 42. Qur'ān, 12:78-83). It is worth noting that the practice of guarantee has developed the practice of taking hostages as guarantors were a commonplace. Thus hostages were regarded as a mechanism to observe future obligations. It is reported that during the reign of King Solomon, the practice included debt transactions. The code of Hamurabi (circa 2250) also suggested that a debtor without friends or credit might as well have no choice but to hand over member of family or a slave as hostages whose services to the creditor would reduce the debt (Hewiston, 1927).

The implication of the above practice was, subjecting a guarantor into the power of a creditor. It is observed that, subjecting a guarantor into the power of a creditor is essential for at least two points: a) having an actual possession of a guarantor, 2) establishing creditor's rights over hostages and the people to whom the hostages represent. Therefore, the rudimentary form of subjection became very important as a result the practice of taking security in the form of hostages was a commonplace during the ancient times. During the middle ages, guarantors were held responsible for the wrongdoing of the offender. They were the primary liability of the offender in the sense that they are substitutes of the offenders. This meant that the offenders were no more responsible for their wrongdoing but it was his family, guarantors who shouldered the burden (Hewiston, 1927).

### 2.3.3 Guarantee during the Early Contractual Obligation

The practice of guarantee in the contractual obligation since before 2500 B.C. during the reign of King Sargon 1(circa, 2750B.C.), guarantee was widely used as a mechanism to secure performance of pledges and promises in contractual obligations. The code of Hamurabi shows the significance of guarantee in relation to contractual obligations. This code that was enacted in around 2,250 B.C, 500 years after the reign of King Sargon I, it provided guidelines pertaining the production of hostages as security in debt transactions. During the reign of Solomon, the Hebrews used guarantee to secure the performance of promises in contractual obligations. This practice among the Hebrews can be seen in the Book of Proverbs. For example, the Book of Proverb inter alia mentioned "*He that is surety for a stranger, shall smart for it; and he that hateth suretyship is sure*" (Proverbs: 11:15). "*A man void of understanding striketh hands and becomes surety in the presence of his friend*" (Proverbs 17:18) and "*be not thou one of them that strike hands, or of debts that are surety of debts*" (Proverbs 22:26). During the Babylonian time, the practice of guarantee was extended to the contract of marriage institution. According to Herodotus, a Greek historian, a man could take away a woman who he could have purchased without first presenting a guarantor that he would make her his wife (Morgan, 1927).

In brief, guarantee was utilized as a practical method to secure future obligations like commercial or social transactions. Nevertheless it is noted that most the guarantees in medieval, middle ages and during the Babylonian era, were not in a written form until 670 B.C. From this time (670 B.C), the arrangement took a new written form and can be seen through a tablet which states that: "A loan of silver was made by one *Silim Asur* to *Pudu-Piati*. *Minuhdi–ana-Ili* shall pay the silver to *Silim*

*Asur* if *Pudu-Piati* does not pay it". This arrangement shows that *Minuhdi-ana-ili* became a guarantor of *Pudu-Piati*. In fact it represented the first ever written guarantee in the middle ages (Morgan, 1927).

During the time of the Greeks (400-300 B.C), the significance of guarantee was also realized. In one of the speeches of Demostheness which says: "Against Apaturius, Defendant requested Plaintiff to lend him thirty minas. Plaintiff being on good terms with his banker persuaded him to lend defendant the sum required on Plaintiff's guarantee, while the action was pending the parties agreed to refer matters to a common arbitrator, and each gave surety to the other to secure the performance of the terms of submission". It is suggested that during the Romans time, the guarantee institution underwent massive transformation. The law of guarantee became a technical apparatus and it took the form of contractual obligation (Hewiston, 1927).

Similar to modern practice, the main objective of guarantee during the Romans time was taken to reinforce the existing liability of a principal debtor who is liable to the creditor. A guarantor may as well assume this liability but shall not exceed the existing liability of the principal debtor. The modern doctrines of contribution, reimbursement and subrogation were all practiced by the Romans.

### 2.3.4 Guarantee in Medieval England

It is largely agreed that the foundation of the guarantee in medieval England dates back to early Anglo-Saxon England (c. 449-1066 A.D.). The *borh* is a notable example of guarantee during that period of time where it was widely utilized as a primitive pledging procedure. In relation to the guarantee progress in the primitive ages, the *borh* arrangement was observed to have risen from the need to secure a peaceful life between the people. In fact, it was proposed that the *borh* was the