# The issue of charging a service fee for providing guarantee (kafalah) in Islamic finance

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**Abstract**

This article studies the issue of charging fees for *kafalah* services from the Shariah perspective and concludes that Islamic financial institutions may offer such services to their clients on pure commercial terms through *al-wakalah bi al-istithmar* arrangements (investment agency contracts).

**Keywords**: kafalah, al-wakalah bi al-istithmar, bank guarantee, ta'widh

## Introduction

In today's modern commercial world, a guarantor (financial institution, bank, etc.) usually does not provide a guarantee service or kafalah[1] in favor of a borrower for free, rather he charges a considerable fee for such service. Almost all of the classical Islamic jurisprudence sources state that the guarantee is a voluntary action and that such service is not paid for[2]. Kafalah is an Arabic word for responsibility, amenability or suretyship. It often refers to an act of someone adding himself to another person, and making himself liable to perform the responsibility, together with the person. According to AAOIFI Shariah Standard Standard No.5, kafalah are guarantees that are intended to secure obligations and protect amount of debts, either from being uncollectable or from being in default.

The guarantor may charge a fee to cover the costs of paperwork at most, however, the guarantee service basically is considered an unpaid voluntary deed. The reason for this prohibition is that if a person lends to another person, it is not permissible to repay the loan with interest, because the interest received is usury. The guarantor, that is, a person providing guarantee is more pertinent to this prohibition because he would have demanded an overpayment amount without paying the loan. He only assumes a guarantee liability that he will repay the required amount on behalf of a borrower if he is unable to pay. If the lender can't receive an extra fee while providing cash loan, how come a guarantor without lending money but only providing guarantee can charge this extra fee?

Suppose that party A has borrowed $100 from party B, who demanded a guarantor from party A. If party C, the third party, says to party A, "I will pay off $100 to party B right now, but you will repay $120 to me at a later date", this additional $20 would undoubtedly constitute usury. Now party D goes to party A and says "I will act as

your guarantor, but you will have to pay me $20 for this service". If we allow party D to charge a service fee for his guarantee, it would imply that party C can't charge $20 despite his immediate repayment of the debt, and party D can charge $20 despite the fact that he has simply promised to pay only when party A is unable to pay the debt. From the above it becomes clear that parties are not treated fairly. Therefore, the classical Muslim scholars have forbidden to charge a guarantee fee so that both party C and party D have equal standing.

However, some modern scholars look at this problem from the different standpoint. According to them, the issue of guarantee has become an inevitable necessity of our times. It is especially difficult to deliver products and make payments simultaneously in international trade transactions where neither a seller nor a buyer knows each other. There arises a need for an intermediary party who can guarantee the payment. Arranging for guarantors willing to provide a free service has become nowadays an impossible task. Taking into account the given current situation, some modern scholars are in the view differing from that of classical Muslim jurists. They say that the prohibition of the guarantee fee is not based on a clear evidence from Qur'an or Sunnah of the Prophet (peace and blessings be upon him). It is a judgment issued through the logical reasoning as a consequence of usury or as companions of usury. The traditional guarantee structures were very simple in their nature. They also say that in today's commercial business a guarantor conducts detailed research and makes a lot of paperwork, so these circumstances should be considered when forbidding the fee to be charged for guarantee services. This issue still needs to be further explored and discussed in a larger forum of Shariah scholars and Islamic finance experts. It is worthwhile to note that it is not permissible for Islamic financial institutions to charge or pay for guarantee services until such a forum is convened and a firm decision is made. They may charge or pay a certain amount to cover the costs incurred during the process of providing a guarantee service[3].

Despite the above-mentioned Shariah views, Islamic banks of our time charge their customers on a commercial basis fess for the guarantee services they provide. In order to bring the provision of these services in line with Shariah, an Islamic bank deals with the client not only on the basis of a guarantee agreement, but also in addition to the guarantee agreement cooperates with him based on *al-wakalah bi al-istithmar* structure. Before getting acquainted with the guarantee (kafalah) instrument issued on the basis of *al-wakalah bi al-istithmar*, we will study some of the instruments used in the traditional banking practice.

**Bank Guarantee**

A seller who sells goods on credit or foreign partner under an export-import contract may require the client to arrange for a third party as a guarantor who shall guarantee the client's debt obligation. If the customer fails to pay on time, the seller will recover the guaranteed amount from this guarantor.

In banking practice the commercial banks are engaged in providing bank guarantees. Bank Guarantee (BG) is an irrevocable commitment by a bank to pay an agreed sum to the beneficiary in the event that the party requesting to the Guarantee fails to perform its obligations or liability to the beneficiary[4]. According to the bank guarantee, if the client fails to fulfill its obligations for some reason, the issuing bank fulfills its obligations on behalf of the client (for example, pays off his debt to another bank).

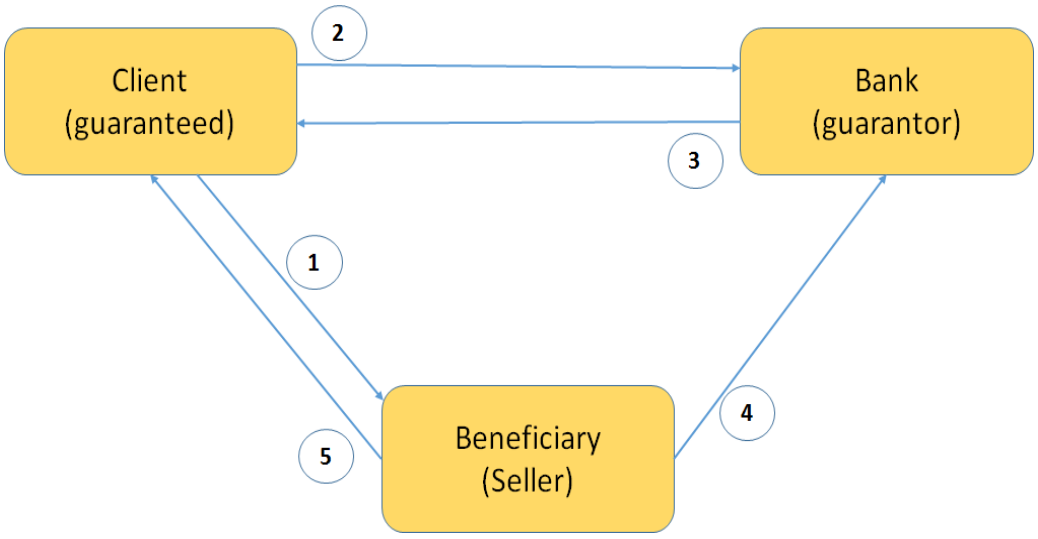
In addition to a bank guarantee, letters of credit may also be used as a guarantee instrument. A Letter of Credit (LC), or "credit letter" is a letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. In the event that the buyer is unable to make a payment on the purchase, the bank will be required to cover the full or remaining amount of the purchase[5].

Circumstances requiring guarantee instruments of banks (examples):

| Client | Type of guarantee |
|---|---|
| Borrower | Bank guarantee serving as collateral for other banks or financial institutions to secure a borrower's default risk |
| Contractor | Bank guarantee aiming to secure the contractual obligations of a contractor participating in major construction projects |
| Foreign trade partner | A guarantee issued to secure the solvency of a trader in front of foreign trade partners |

Let us have a look at how bank guarantee instruments work and are structured by financial institutions.

The structure flow of Bank Guarantees from an Islamic bank:




1. Client enters into a sale-purchase agreement with Seller on a deferred payment basis and assumes certain liability;

2. Client approaches his servicing bank and requests him to issue a guarantee instrument (*e.g. Bank Guarantee*) in favor of Seller (Beneficiary).

3. Based on the client's request Bank issues a *Bank Guarantee* implying "If he fails to pay, I will pay his debt". The bank charges a fee for this service;

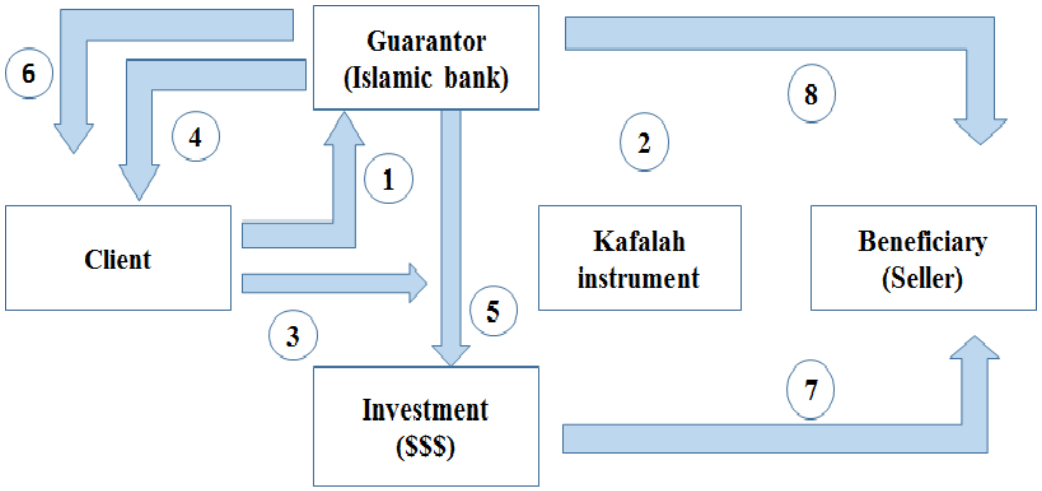
4. If the client defaults on his debt, the beneficiary will approach the bank which has issued the guarantee instrument. If the beneficiary's claim meets all agreed terms, the bank will pay the pre-agreed guaranteed amount to him;

5. If there is no default by the client, the beneficiary will return the guarantee instrument to him upon its maturity[6].

The practice of providing guarantee services by traditional banks is carried out almost in the same way as lending activities. Before it issues the guarantee instrument, the bank carefully studies the credit risk of a concerned client, thoroughly evaluates the feasibility study of his investment plan, and arranges for the execution of necessary transaction agreements and provision of adequate collateral by the client. After the guarantee instrument is issued, the guaranteed amount is reserved within the bank's assets as provision without being diverted to other purposes. For a bank, the guarantee service is the same as the lending service in terms of both its risk profile and cost of capital. In other words, if bank loans on that market are offered at an annual interest rate of 10%, the service fee for *Bank Guarantee* will also be set at an average 10% of the guaranteed amount per annum. Even though the actual cost incurred by a bank to provide the guarantee service accounts for less than 1% of the guaranteed amount, the fee charged for the guarantee service will be determined based on the market value of capital.

**Al-wakalah bi al-istithmar**

In the above paragraphs, we learned the view and suggestion of Islamic scholars on the amount of service fee chargable for guarantee services. According to them, the amount of fees to be charged for guarantee services should not exceed the amount of costs incurred for providing these services. Given that such a restriction may discourage Islamic banks from providing guarantee services, Islamic finance experts suggest that guarantee services be provided on the basis *al-wakalah bi al-istithmar* agreement[7]:




1. Client approaches Islamic Bank to request the issuance of Kafalah instrument in favor of Seller (Beneficiary);
2. Based on kafalah agreement the Islamic bank issues Kafalah instrument;
3. Based on al-wakalah bi al-istithmar (investment agency) agreement the client deposits with the bank money equivalent to a certain portion of the amount of Kafalah instrument;
4. The bank charges a fee for his agency service;
5. The bank invests the deposited money in halal and shariah-compliant businesses (investment holding period = term of kafalah instrument);
6. Profits & dividends from the investments are paid out to the client;
7. If there is default, the bank exits from the investments and proceeds from the investments are partially used to cover the beneficiary's claim;
8. The claim's remaining amount is covered by the bank's own capital;
9. The bank will demand this amount from the client;
10. The bank will make the client to compensate the loss that was caused by his default (In Islamic finance this practice is called ta'widh).

The Fiqh Academy Journal defines it as "Payment of financial compensation or counter-value, which is obligatory as a result of loss caused to others". In the context of Islamic banking and finance, ta'widh can be defined as compensation on the actual loss suffered by the financier or the bank due to late payment by the debtor. Islamic financial institutions may recognize ta'widh as income on the basis that it is charged as compensation for actual loss suffered by the institution[8].

To sum up, Islamic banks can also provide guarantee services on a commercial basis as traditional banks do, and they can profit substantially from these activities. The profit of Islamic banks from guarantee services is gained mainly from agency fees they charge for the management of their clients' investment under al-wakalah bi al-istithmar agreements. Islamic banks may also charge service fees under kafalah agreements; however, these fees unlike those of traditional banks may not be more than the expenses Islamic banks incur in issuing the kafalah instrument. Briefly speaking, fees for kafalah

service shall not be taken as profit rather it shall be viewed as reimbursement of costs relating to kafalah service[9].

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