The Application of Shari'ah Contract in Islamic Financing Guarantee Schemes of Credit Guarantee Corporation (CGC)

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Abstract

Islamic financing is regarded as one of the financing alternatives that enterprises may utilize to fund their business. This financing type is characterized as free from *riba* and is based on illiquid assets which create real assets and inventories. The aim of this conceptual paper is to highlight the Shari'ah contract of *al Kafalah* that is used by Credit Guarantee Corporation (CGC) to attach to its Islamic financing guarantee scheme offered to business enterprises. *Kafalah refers* to an obligation to pay in the event the principal debtor is unable to honour his obligation. Through this Shari'ah contract, the CGC has indeed paved a new way of financing enterprises which are keen on having *halal* financing to fund their business activities. Most importantly, this addition of *halal* financing has accelerated the growth of Islamic finance in Malaysia.

Keywords: Al Kafalah, Islamic financing guarantee scheme, Credit Guarantee Corporation

Introduction

Islam is a way of life that covers all human activities from family life, social, political and economic activities to international relations. All these spheres of activity come within the jurisprudence of Islamic law. The Holy Qur'an and the Sunnah of the Rasulullah (pbuh) provide the general principles covering economic and commercial rules as well as ethics. The emphasis is on justice, fairness and mutual consent between parties in business dealings. This is indeed very essential to Islam as it comes to improve the system of life as a whole. This includes improving the spiritual development of the individual, and resolving the socio-economic structure of society by moving it towards social justice. The latter is normally based on the concept of cooperation and brotherhood. Today, the world is witnessing active movement by the Islamic world to reconstruct political, social and economic activities in accordance with Islamic teaching. As for the economic aspect, Muslims assert that an economic system based on the principles of Islamic law is feasible even though the Islam religion already existed 14 centuries ago. The establishment of Islamic banking system, Islamic financial institutions and Islamic businesses is a major landmark of this movement.
The objective of this paper is to delve into the Shari'ah concept of *al Kafalah*, as one of the Shari'ah contracts attached to Islamic business transactions. To what extend is the practicality of this Shari'ah contract being attached to the Islamic financing guarantee scheme of Credit Guarantee Corporation (CGC).

Islamic Financial System: a brief outlook

In order to ensure that Islamic financial institutions are offering better alternative financing and services to the people, the International Association of Islamic Banks in 1977 has outlined the objectives of Islamic banks, as follows;

- To carry out banking activities and services in accordance with Islamic principles that are free from *riba* (usury) and exploitation;
- To mobilize and consolidate resources in the economy through the development of the individual; saving awareness; and
- To direct funds into investment activities that serve to fulfil the objectives of economic and social development of Islamic nations.

Thus, the above objectives indicate that the Islamic banking and financial system is not only confined to the elimination of *riba* in banking operations, but is also directed to achieve the socio-economic objectives of an Islamic system. In this regard, M. Fahim Khan (1995) asserted that the objective of Islamic banks is "to promote, foster and develop the application of Islamic principles, law and tradition in their transactions be it financial, banking and related business affairs, and to promote investment companies, enterprises and related concerns to engage in business activities that are acceptable and consistent with Islamic principles, law and traditions" (Fahim Khan, 1995). What are the characteristics of Islamic Banking and Finance that have made them different from their conventional counterpart? Mirakhor (1995) and many other Muslim scholars have discussed at length about the salient features of Islamic finance, which can be explained under the following four elements:

Transactions based on valid contract

In essence, the main contract in the Islamic commercial law is the contract of sale. In fact, the general theory of contract and most other contracts are based on this sale contract. A valid contract should include the basic elements and conditions of the Islamic law of contract, that is, the contracting parties have attained legal capacities; the offer and acceptance have been on mutual consent between the contracting parties; and the subject matter of the contract must exist, is lawful and can be delivered. The Islamic banks and other Islamic financial institutions have to abide by the Islamic law and the civil law of a particular country when the transactions they indulge in involve Islamic financial products and services. Doing the above ensures the sanctity of the contract and the welfare of the parties involved to be safeguarded.

Prohibition of riba

The most important principle of Islamic banking and financial transactions that differentiate them from the conventional banking and financial system is the element of *riba*. Although *Riba* is mentioned in the Qur'an and the Sunnah, the Qur'an does not provide specific definition for this offence simply because it is well known and has no ambiguity in its meaning to the Arab people (Taqi Usmani, 1998). In the modern Islamic literature, *riba* and interest have been used interchangeably and being treated synonymously. In principle, *riba* can be defined as an increase or additional charge over and above the principle amount of a debt. In this regard, the debt that has been created, originated from a sale transaction or loan transaction – conditionally as per time or period. *Riba* constitutes an unjustified increase in capital, thereafter earning that is gained with no appropriate effort or without any counter value. It should be noted that the prohibition of *riba* does not mean that capital or money has no price in the Islamic economy. Most importantly, the Qur'an asserts that *"Allah has permitted trade and forbidden riba* (Surah al Baqarah, verse 275) which means the remuneration for capital used as one of the factors of production in trading activities in indeed profit.

Asset-backed Financing

Another crucial principle of Islamic financing is that it is an asset-backed financing. Unlike conventional financial institutions, financing in Islam is based on illiquid assets which create real assets and inventories (Taqi Usmani, 1998). In the conventional system of financing, the banks and financial institutions deal with money and monetary papers only. However, in Islam, money is not recognized as the subject matter of a trade transaction. Next, Islamic banks do not transact on credit basis. They neither borrow nor lend money on the basis of interest, whether the underlying fundamental is fixed, floating, prepaid, deferred or in any other form. In other words, money is not considered a commodity that demands a price and this money giving birth to more money. Money has been used as a means rather than as a medium when transacting business, and it is also used to measure the efficiency of doing business through the use of "rate of return on investment" (Yahia Abdul Rahman, 2010). Hence, in Islam, money has no intrinsic value and it is only used as a medium of exchange. Therefore, any profit that is earned as a result of dealing in money is regarded as interest, which is prohibited.

Risk Bearing and Profit-Sharing Financing Techniques

In essence, the basic principle of Islamic financing is based on profit sharing and risk sharing instead of a fixed rate of interest basis. In this regard, the relationship between Islamic banks and their customers is not that of a creditor and a debtor as in the conventional banks. Instead, the relationship is between a partner and an investor, or profit and loss sharing between owners of capital (*rab al-mal*) and fund managers or investors (*mudarib*) by applying the Islamic contracts of *mudarabah* and *musharakah.* In fact, in the case of financing, Islamic banks do not offer cash loans as in conventional banks, but operate on a trading basis. This means Islamic banks buy the goods needed by their customers and then sell them to their customers at a profit agreed by the customers. The payment by customer will be either ready cash or by way of deferred payment basis via the contracts of *murabahah, bay‘ bithaman ajil, bay‘ salam* and *ijarah wa al-iqtina’*.The reason for the principle of no profit sharing without risk sharing (*al-ghunm bi al-ghurm*) is that earning profit is legitimized by way of engaging in an economic venture and contributing to the economy. This feature has indeed distinguished Islamic economics and finance from their conventional counterpart. The operating manner reflects a different understanding of the value of capital and the entrepreneur.

Al Kafalah: Islamic Model of Financing

Al-Kafalah is a contract of guarantee offered by a person to the owner of an asset, whom has placed or deposited his asset with a third party. Hence, any subsequent claim by the owner must be accountable by the guarantor and the 3rd party. In fact, there are several other names for *al-Kafalah* depending on the nature of items involved to be secured or collateral by the guarantor. For instance, *Kafalah* itself denotes a guarantee for future obligations involving human beings such as bailing. The bailing manner gives assurance for the attendance of the accused criminals to the court for judgement. Meanwhile, *al-Dhamanah* represents a guarantee for future obligations involving property. This includes debt obligation, the return of borrowed property, the delivery of products, payment for purchase of products or services, or the security of goods.

When Islamic finance is concerned, *al-Kafalah* implies an obligation to pay in the event that the principal debtor is unable to undertake his or her obligation. In short, it is a guarantee that the bank would be liable to transfer the responsibility to the third party. Unlike, *al-Hiwalah, al-Kafalah* would not release the principal debtor because it is only an obligation in addition to the existing obligation.The permissibility of *al Kafalah* is contained in the Quranic verse, hadith of the Prophet (pbuh) and *ijma*'. Surah Yusuf verse 72 stated

the following. They answered, “We miss the King’s goblet; and he who produces it shall receive a camel–load [of grain as a reward!” And (the herald added: “I pledge myself to this (promise)!” In the *Hadith*, the Prophet (pbuh) said, “The Guarantor is the debtor”. In another *Hadith*, Salamah Al-Akwa’ narrated that the Prophet (pbuh was presented with a corpse of a man to be prayed upon (before the burial). He (pbuh)) asked, “Did he leave anything?” They answered, “Nothing at all”! He (pbuh) asked: “Does he owe anything?” They answered, “Yes indeed, he owed 2 gold Dinars”. He said, “You proceed with the funeral prayer for your friend (without me)” then Abu Qatadah said, “O the messenger of Allah, I will be the guarantor (for the repayment) of the 2 Dinars”. After that, the Prophet (pbuh) performed the funeral prayer for him. The Islamic scholars had unanimously agreed on the legitimacy of the *al-kafalah* in principle. There are some differences in the details, though as it is a necessity in the society to remove some hardship and difficulties on the part of the creditors (Wahbah al Zuhayli, 1997). The Concept of *al Kafalah* or Guarantee in the CGC’s Islamic Financing Scheme

Theoretically and practically, Islamic banks have focused both on the Islamic modes of financing and their ability to perform financial intermediation catering to the needs of the people who decide to have a *riba* free transaction. In this regard, the Islamic banks also have to ensure that the modes of financing are compatible not only in terms of the Shari’ah ruling, but also to the banking regulations. Hence, it is necessary for the bank to pay attention to the risks that are associated with the financing, particularly credit risk. Credit risk is related to the capability of the debtor to repay at the time scheduled for repayment and in accordance with the conditions specified in the contract. If the debtor failed to observe his obligation, and the implication is a loss to the creditor; this constitutes a risk for the bank. In fact, conventional banks face credit risk in almost all of their operations simply because the nature of the relationship between a debtor and a creditor. Islamic banks also face this form of risk in most of the modes or contracts of financing such as *murabahah*, *istisna*’, or even in equity financing. In equity financing, for instance, the credit risk exists in two ways. First, in the case of negligence, the entrepreneur is liable to guarantee the capital; this is a debt liability. Secondly, when the capital of *mudarabah* or *musharakah* is employed is involved in a deferred sale, the capital owner (*rabb al-mal*), particularly the bank bears an indirect credit risk. This risk is associated with the ability of the counter party to repay. Additionally, *Bay’ al Salam* also gives rise to a commodity debt rather than a cash debt. Despite this nature, this mode of financing also involves credit risk (Elgari, 2003). As far as the banking system is concerned, strict regulations for giving credit are based among others on the credit-worthiness of the client or borrower, his ability to perform his obligations within the specified time period, the financial reputation of the client and his credit history, financial standing, ability to provide a collateral and most importantly is the ability of the client to pay. Such strict regulations have offered opportunities for potential SMEs to offer financing as well. Commercial banks usually adopt 5Cs as a way of assessing a borrower’s application for funds. The 5Cs include character, capacity, capital, condition and collateral. Hence, lending to small enterprises has been seen as a risky business for banks. This situation has prompted the CGC to offer an additional channel for small enterprises to gain access to credit facilities within the formal financial structure. CGC’s main objective is to assist marginal, but potentially viable small and medium scale enterprises (SMEs), particularly those enterprises without collateral, or those with inadequate collateral and track record, to obtain financing from financial institutions. The first scheme offered by CGC was in year 1973 in which it was conventional based financing known as General Guarantee Scheme (GGS). CGC’s first Islamic financing guarantee scheme was introduced to the market in year 1997. It was known then as Interest-Free Banking Scheme (IFBS). It is indeed true that with the various products of Islamic financing available in the market, this has in fact opened a new dimension of

financing for the SMEs in Malaysia. Such products were introduced to fulfil the needs and the nature of the economic activities. Simultaneously the valued offering was also to assist the entrepreneurs to meet their financial needs at the various stages of their business cycle.
Table 1 illustrates the various Islamic financing guarantee schemes that have been offered and adapted in order to meet the varying needs of the client and to be competitive in the market.

Table 1: The Islamic Financing Guarantee Schemes offered by the CGC

No	Name of the Schemes	Year introduced
1	Interest-Free Banking Scheme (IFBS)	1997
2	Islamic Banking Guarantee Scheme (IBGS)	2003
3	Direct Access Guarantee Scheme-Islamic (DAGS-i)	2005
4	Credit Enhancer-i Scheme (ENHANCER -i)	2008
5	Bumiputera Entrepreneur Project Fund-i (TabungProjekUsahawanBumiputera-i, TPUB-i)	2009
6	SmallBiz Express Scheme-i (SBE-i)	2010
7	BizMula-i scheme	2014

How does the system work?

Figure 1 shows the flow chart of the modus operandi of the scheme that involves the CGC, borrower, Central Bank, and banks and finance companies, as well as the Ministry of Entrepreneur and Cooperative Development. There are several steps that need to be followed before a guarantee can be awarded to the right applicant. First, the applicant will approach banks or finance companies to apply for a loan. If the collateral that is provided by the applicant is insufficient or if there is any problem that is faced by the applicant when applying for the loan, the applicant will be introduced to the CGC by the banks or finance companies. Next, the banks or finance companies will forward the application to the CGC and at the same time the applicant also needs to send a copy of the application to the CGC. Lastly, a guarantee will be issued by the CGC through the banks or finance companies. Monitoring and supply of funds will be done by the Central Bank for CGC. A report needs to be sent to the Ministry of Entrepreneur and Cooperative Development.

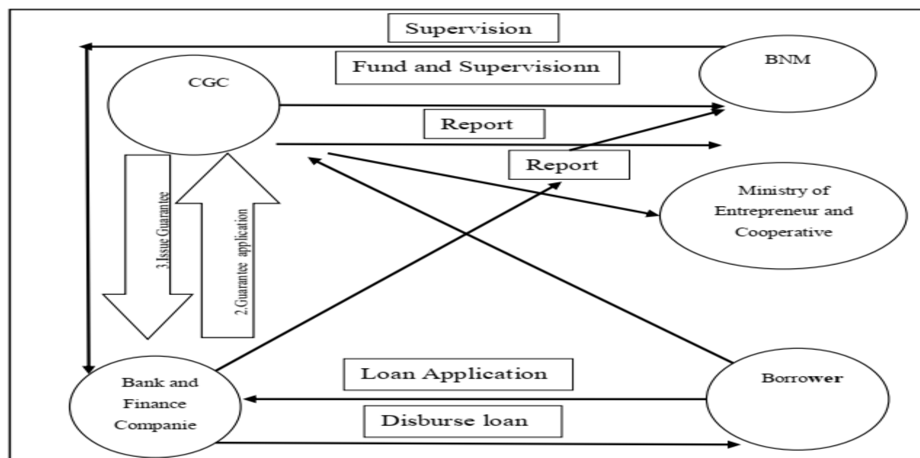

Figure 1 The flow chart of the modus operandi of CGC schemes
(source: http://www.iguarantee.com.my, date of retrieved Mac 2009)

Next, a necessary question is to what extent does the concept of guarantee as being applied by the CGC comply with the Shari'ah?

In this regard, BNM and Shari'ah Advisory Council have produced a resolution on 27th October 2005 which stated that the Islamic guarantee (a guarantee fee is charged) mechanism provided by the CGC to the Islamic financial institutions offering Islamic financing products to customers is permissible, based on the contract of *kafalah*. This is because *Kafalah* signifies a contract that combines a *zimmah* (obligation) of a person and a *zimmah* of another person. As such, majority of Hanafites viewed the *kafalah* as a contract that combines the *zimmah* of a guaranteed person and the *zimmah* of the guarantor in a claim against the self of an individual, debt or an asset. Additionally, from the fiqh perspective, a contract of *kafalah,* in terms of its objective falls under the category of *'uqud al-tauthiqat*. Meanwhile, in terms of its exchange of right (*tabadul al-huquq*) feature, it may be considered as a *tabarru'* initially and a *mu'awadat* at the end of the contract.

The next issue is about the Islamic ruling pertaining to the *ujrah* imposed in a *Kafalah* contract?

There are two views concerning the issue. First, most of the classical scholars are of the view that charging a fee for a guarantee is disallowed. This view is based on the argument that the *kafalah* contract can also be classified as *uqud al-tabarru'*, which is voluntary in nature. As such, the contract does not allow a fee to be charged for the guarantee. The OIC Academy attempted to forbid the charge of *ujrah* for *kafalah* as it may constitute a *qardh* contract with stipulated benefit, and this is forbidden in Shari'ah. Nevertheless, the Academy allows the guarantor to claim for any cost incurred for the purpose of guaranteeing the contract. The same resolution was shared by the AAOIFI Shari'ah Board, which disallows a charge of *ujrah* for *kafalah* or *dhaman.* However, the guarantor is entitled to claim for reimbursement of actual cost incurred as a result of the guarantee. Wahbah (1997) however has a different view when he said that charging an *ujrah* for *dhaman* or *kafalah* is permissible. According to the original rule, it is advisable to offer the guarantee free of charge since the contract of *kafalah* or *dhaman* falls under the category of *aqd al-tabarru*'. However, due to *maslahah* and needs of the community, charging *ujrah* for *dhaman* should be allowed based on the needs of the people. Next, Syeikh Ahmed Ali Abdallah as stated that charging *ujrah* for *dhaman* is permissible. He admitted that the original rule of *dhaman* is *tabarru*', but if the contract has been stipulated with a charge of fee, the requirement must be regarded as valid and enforceable. . Furthermore, he argued that a contract of *dhaman* is a kind of *Istithaq,* and not a kind of *qardh*. Thus, charging *ujrah* for a guarantee service does not fall under the category of forbidden practice simply because a contract of *dhaman* is different from a contract of *qardh*. In this regard, he has backed up his view with an application of *qiyas* on the permissibility of *akhz al-ajr 'ala al-jah* (taking a fee for preserving one's good reputation) and *akhz al-ju'l 'alaruqyahmin al-Quran* (taking a fee as allowed according to a verse in the al-Quran). Furthermore, Hammad (1997) argued that the rule for a charge of *ujrah* to pay for any guarantee service or *kafalah* by the guarantor depends on various circumstances of the guarantor's liability towards the debt. These are categorised as follows:
In any case, if the guarantor does not make any payment for the settlement of debt to the creditor, either because of the debtor has settled the debt or the creditor writes off the debt, the guarantor is allowed to charge *ujrah.*

However, if the guarantor settles the debt, while at the same time the guarantor is also indebted to him and the amount of the guarantor's debt is equivalent to the amount he has

paid for the settlement of debt, it is permissible for him to charge the *ujrah.* This is due to the occurrence of *muqasah* between the guarantor and the guaranteed party.

Meanwhile, if the guarantor is in the same situation as in (ii) above, but the amount of guaranteed debt that is paid to the creditor forms part of the amount of debt owed by the guarantor to the guaranteed person, charging an *ujrah* is allowed. However, the guarantor must settle the balance of his debt to the guaranteed person.

Next, if the guarantor settles the debt of the guaranteed person and the guarantor does not owe to the guaranteed person, he or she is allowed to charge a fee for the guarantee provided that the guaranteed person does not delay to refund the guarantor the guaranteed amount paid by the guarantor. Lastly, if the guarantor settles the debt of the guaranteed person and the guarantor has no debt whatsoever owed to the guaranteed person, but the guaranteed person fails to pay the guarantor the guaranteed amount paid by the guarantor within a reasonable time, then the guarantor is not allowed to charge any fee or *ujrah*. This is because the *ujrah* that is charged in this situation is regarded as a *hilah* as in *riba al-nasiah.* In other words, there is deferment settling the debt owed by the guaranteed person to the guarantor.

Therefore, it can be inferred from a *kafalah* contract that a guarantee for a debt is a recognized practice in the Shari'ah law. However, the issue of charging ujrah (fee) for a guarantee service undertaken for a debt remains a debatable issue among the scholars. The different views among them is mainly due to their perception towards the *kafalah* contract as a *tabarru'* in itself. Some of the scholars viewed that if a *kafalah* or *dhaman* is stipulated with a charge of *ujrah*, this constitutes as a practice of *riba*. On the other hand, some of scholars viewed that even though the original rule of a *kafalah* contract is similar to a *tabarru*' contract, this does not hinder the guarantor (kafil) from changing a fee for the service rendered by him or her. This is because at the present time, it is difficult to obtain a service that is free of charge. This opinion is supported by evidences that the features of *kafalah* or *dhaman* are different from the features of *qardh*. Similarly, such fee is not similar to the practice of *riba.*

Thus, the concept of guarantee used by CGC is consistent with the contract of *al kafalah*. It is also consistent with *Dhamanah,* which represents a guarantee for future obligations involving property such as debt obligations, the return of borrowed property, the delivery of products, payment for purchase of products or services, and the security for goods.

Conclusion

It is expected that the Corporation should engage themselves more towards legitimate and lawful businesses which are clear from the elements of *riba* (usury)*, gharar* (uncertainty), *maysir* (gambling) and etc. The role played by CGC can help to expedite the growth of Islamic finance in the country and also in creating more opportunity for enterprises in need of *halal* financing. To the creditor, *al kafalah* has given him a lot of benefits. For example, he could authenticate the loan repayment and ensure that he (the creditor) can get his money back by demanding for payment from the guarantor in the event of default payment by the debtor or pledgor. Furthermore, it allows the creditor to call upon either the debtor or the guarantor to perform the obligation. In this relation, the demand from one will not affect his right to go after the other if the obligation is not fully exercised. As for the debtor, the *al Kafalah* contract brings him benefit in terms of minimizing and spreading his risk because the guarantor by his guarantee has agreed to join his liability to the creditor. In addition, he can convince the creditor to lend him the money since he has somebody to back him up as the

guarantor of the money. Normally, nobody will lend him money if he has nobody guaranteeing to take over his obligation to pay back should he goes on default.

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