Charging Fee for Guarantee in the Islamic Credit Guarantee Scheme by Credit Guarantee Corporation Malaysia Berhad: An Analysis from the Shari'ah Perspective.

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OBJECTIVES

1. To study the application of letter of guarantee in Malaysian Credit Guarantee Corporation Malaysia Berhad (CGC).

2. To analyze the underlying Shariah principle of the guarantee letter, i.e. kafalah or daman (guarantee).

3. To scrutinize the legality and validity of the practice of charging fee for guarantee from the Shari'ah perspective.

INTRODUCTION

Malaysian Credit Guarantee Corporation Malaysia Berhad (CGC)

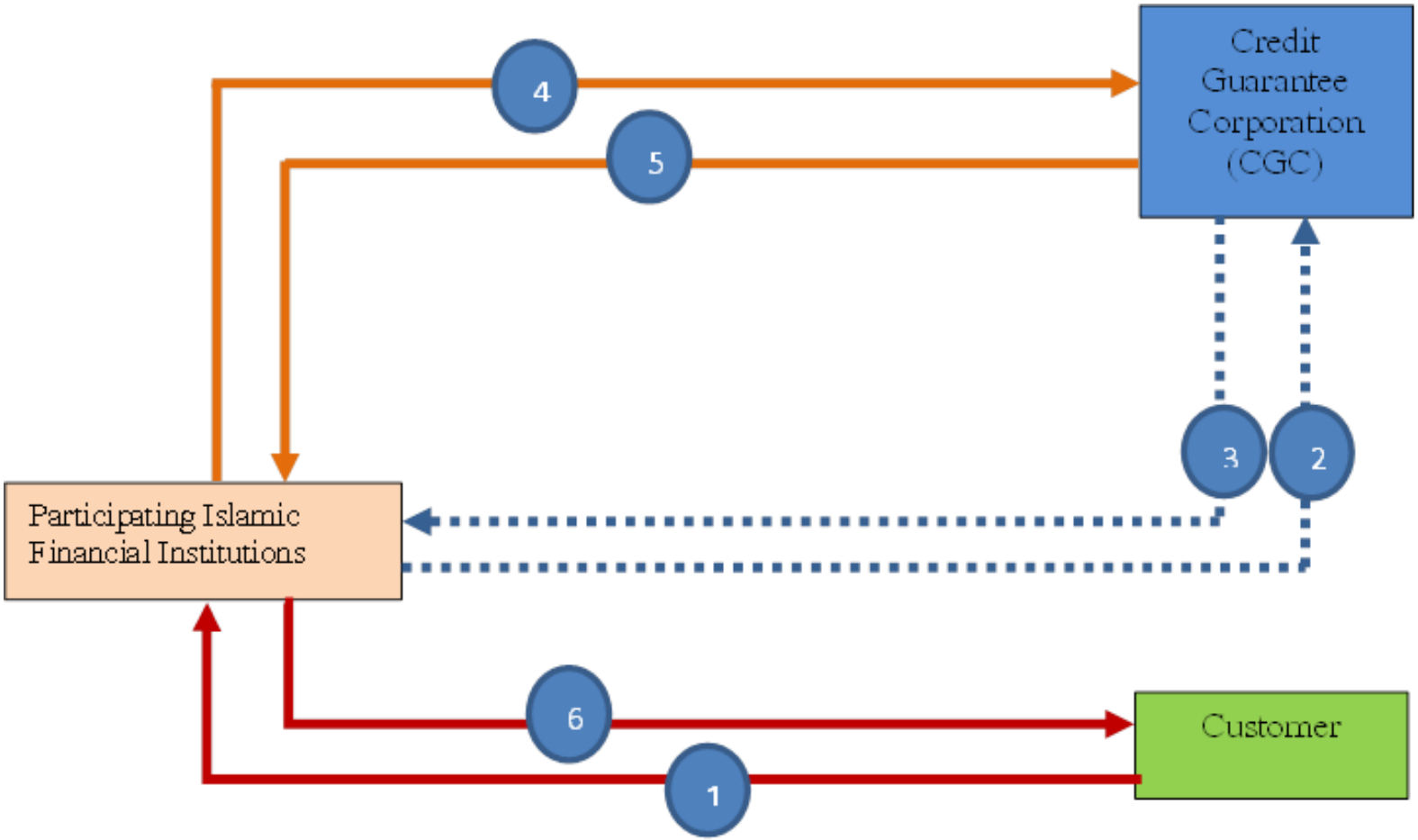
- initiated by a Malaysian Government as to assist small and medium-sized enterprises (SMEs)
- providing them a liquidity guarantee to get access to financing from Islamic financial institutions (IFIs)

A letter of guarantee is an indemnity letter issued by a guarantor to guarantee the payment obligation should the guaranteed party fail to fulfil its contractual obligations.

CGC acts as a guarantor for the enterprise on the financing amount approved by the IFI.

A certain amount of fee is charged to the SMEs

Table 1: Modus Operandi of Islamic Credit Guarantee Scheme



Source: Credit Guarantee Corporation Malaysia Berhad (2013)

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1. A customer approaches any participating Islamic Financial Institution (IFI) for a financing facility.

2. The participating IFI submits the application for a Letter of Guarantee to the CGC.

3. The CGC conducts a thorough credit evaluation before notifying the participating IFI whether the application is approved or not. For the successful application, the CGC issues Notification of Guarantee Approval (NGA) and a pro forma Letter of Guarantee (LG) to the IFI.

4. The customer pays the guarantee fee and requests the CGC to issue the LG via the IFI.

5. The CGC issues the Letter of Guarantee to the customer via the participating IFI. 6. The IFI disburses the financing amount to the customer.

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The guarantee rate for the unsecured portion ranges from 0.75% to 4% per annum and the secured portion ranges from 0.5% to 3.2% per annum.

Juristic views on the ruling of charging fee for a guarantee.

First Group; Charging fee for a Guarantee Impermissible	Second Group; Charging fee for a Guarantee Permissible
• -Islamic Fiqh Academy of the Organisation of Islamic Cooperation (IFA-OIC) disagree with the imposition of a fee for a guarantee • - Majority of Muslim jurists; Hanafi, Shafi'i, Maliki and Hanbali Schools, are of the opinion that charging a fee on *kafalah bi al-mal* (guarantee of wealth) is not permitted.	• Shari'ah Advisory Council of Central Bank Of Malaysia resolves that charging a fee for a guarantee is allowed. • Some contemporary scholars stand on its permissibility. E.g Shaykh Nazih Hammad, Shaykh Nizam Ya'qubi etc.

First view: It is not permissible to charge fee for a guarantee

It leads to a breach of the Islamic legal maxim: كل قرض جر به نفعا فهو ربا:

"any loan that begets benefit for the lender is **riba** (usury)."

If the guaranteed party fails to repay the loan, the guarantor is obliged to pay the guaranteed amount on his behalf to the third party.

When the guaranteed party is indebted to the guarantor the fee over and above the debt principal is deemed as *ribā*.

The basic objective of a guarantee contract is to provide help through **generosity and benevolence**. A designate fee on a contract based on generosity and help revamp its essential nature.

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Islamic Legal maxim: يستحق الربح إما بالمال أو بالعمل أو بالضمان

"The justification of profit is either through effort, or capital invested, or risk/liability assumed."

The entitlement to fee/compensation is based on work or capital, and *kafalah* or *daman* is neither capital nor work.

Receiving money from such transactions would be considered as consumption of the wealth of others wrongfully.

Second view: It is permissible to take a fee for guarantee

Risk factor: i.e., the guaranteed might fail to repay what he owes; the guarantor in this situation has the responsibilities to fulfil the obligations due to him.

According to the Islamic legal maxim "*al-kharaj bi al-daman*" (benefit goes with liability), anyone who undertakes the obligation for a thing is entitled to benefit therefrom. Hence, the benefit obtained is considered as the compensation for the liability.

Letters of guarantee consist the meaning of *daman* and *kafalah* since they contain a commitment for the beneficiary. Besides that they also comprise the meaning of *wakalah* (agency contract) since the procedures contained in the letter of guarantee and delivery of the document is performed by the issuing bank on behalf of the individual.

Consideration of *daman* as a benevolent act does not make it impermissible to take compensation for it. That is because the pledge that the surety bond entails enhances the value of the contractor's commitments. As such, the guarantee is an honourable act for which charging fee is possible

Commercial *kafalah* (surety). The *kafalah* contract may render the guarantor to undertake the financial obligation. Therefore, "*al-kharaj bi al-daman"* (benefit goes with liability) can be invoked here, especially if the guarantor provides such guarantees as a profession, using them as a means of earning profit.

Nazih Hammad (2001) has cited a number of items of evidence for this view, including the following:

The Hanafi and Hanbali schools permitted profit earned in return for *daman*; they approved *shirkat al-wujuh* (partnership of credit-worthiness),

It is further justified by analogy with *wakalah* (agency contract) and *wadi'ah* (deposit for safekeeping). In the past, people would undertake these functions without charge, as a favour to the beneficiaries;

The Malikis affirm the permissibility of taking compensation for certain types of commitments permitted by the Shari'ah,

Many Maliki scholars are in opinion that under the contract of *kafalah,* a guarantor is allowed to request the creditor to reduce the amount of current debt demanded from the guaranteed party in order for the guarantor to guarantee the rest of the debt at the agreed upon date.

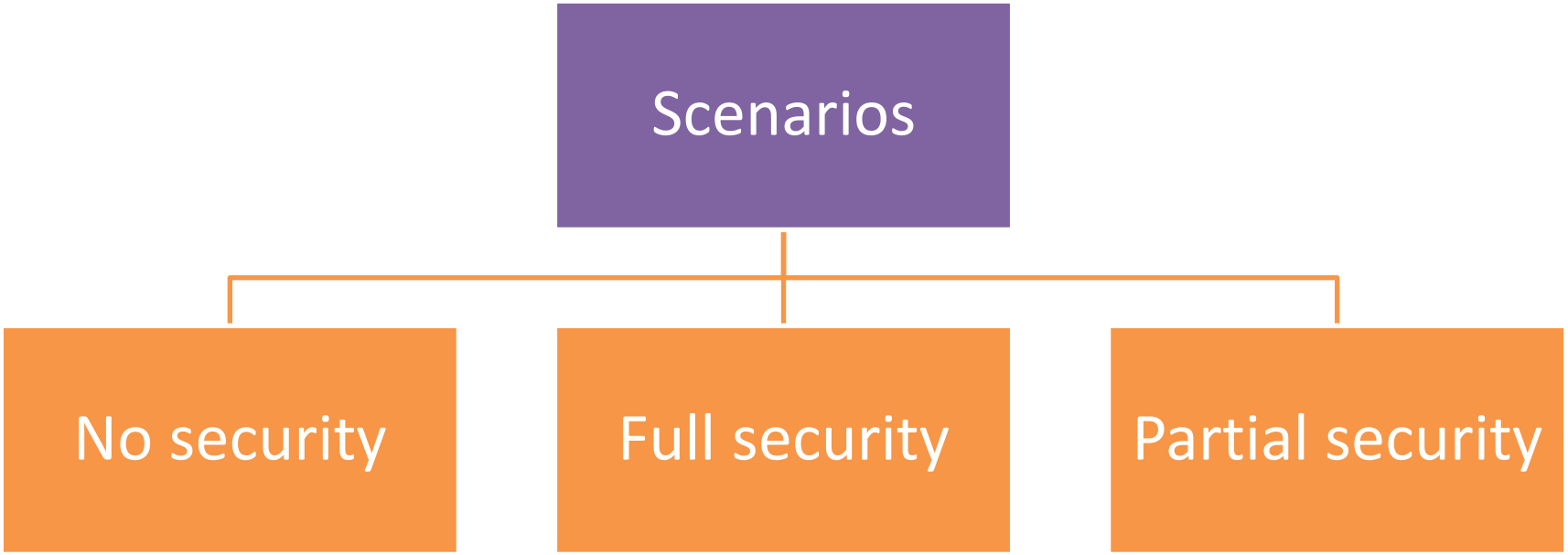
No specific text from the Holy Qur'an or the Sunnah that prohibits taking compensation for a guarantee. There is no other evidence on its prohibition nor is there any harm that would result from permitting it; rather, there is benefit in allowing it.

The view that it is lawful to take a wage for teaching the Qur'an or for being imam; leading the five daily prayers is also applicable to charging a fee for *daman*, especially since it makes them liable for the financial charges that can result from this guarantee.

Shafi'i, Hanbali and Maliki scholars, in one view, allowed the taking of compensation for a service based on reputation.

Allowing compensation for extending a guarantee is in accordance with the establishment of the principle of public interest (*maslahah*) as this will serve the guaranteed party, the beneficiary and the guarantor.

Classification of Guarantee Letter based on the Amount of the Security/Collateral Pledged by the Customer



Takyif Fiqhi (Fiqh Characterization) for the Guarantee Letter

Situation 1 (No Security): A guarantee letter that is not secured by the customer should be considered a *kafalah* contract since *kafalah* . In this case, the guarantor is the bank, the guaranteed is the customer, and the beneficiary of the guarantee is the third party *i.e.* the financing bank. Based on this characterisation, the rulings of *kafalah* apply.

Situation 2 (Full Security): The relationship between the guarantor and the customer is based on *wakalah* (agency) contract. The customer appoints the guarantor to act on its behalf to discharge what is due to the third party. The fee imposed to the customer is for the *wakalah* service.

Situation 3 (Partial Security): The customer deposits a portion of the amount specified in the letter of guarantee with the issuing bank. In this case the relationship between the customer and the issuing bank pertaining to the secured amount is based on *wakalah* whereas the relation for the unsecured portion would be based on *kafalah*.

Findings

Situation 1: The letter of guarantee is completely unsecured .

- If the customer (guaranteed party) indicates, by requesting financing, that he has no intention, or is unable, to pay the guaranteed amount by the due date, in this situation, the CGC (guarantor) is not allowed to charge a fee for the letter of guarantee. This is because the relationship of indebtedness between the guarantor and the guaranteed is obvious and has started from the day of acceptance. Hence, whatever amount charged in addition to the principal guaranteed is deemed as riba (usury). This approach is supported by the majority of Muslim scholars.

Situation 2: The letter of guarantee is fully secured by cash or an asset that is easy to liquidate.

- There is no issue of a loan generating benefit (riba), since the creation of a debt relationship does not exist between the CGC and the customer. In this case the contract of wakalah (agency) applies and fees can be charged. The IFA-OIC (1985), al-Rajhi Resolution No.29, the fatwa issued by al-Azhar (1397 AH) and certain individual scholars take this position.

Situation 3: The letter of guarantee is partially secured

- The contractual relationship between the CGC and the customer is *wakalah* for the secured portion and *kafalah* for the unsecured portion. Charging fee for the wakalah is permitted. This opinion is adopted by Al-Rajhi Bank in Resolution No. 29 and some scholars such as al-Salus.

CONCLUSION

The major concern on issuing a letter of guarantee is the issue of riba that it might rise in the event that the customer (guaranteed party) defaults and becomes indebted to the guarantor.

Riba comes into the picture when the guarantor is presumed to receive the fee imposed earlier over and above the full amount of the debt owed to him.

There is no clear textual evidence from the Qur'an or the Sunnah that prohibits the charging of a fee for a guarantee.

Though the guarantee contract falls under the category of benevolent acts, It does not necessarily mean that charging a fee on such a contract is impermissible even.

A guarantee is different from a *qard* (loan). The issue of riba does not exist in the payment of guarantee since it is regarded as the price for the commitment. A guarantee should not be treated as debt; instead, it should be regarded as a commitment and liability, which is entitled for a fee.

However, if the guarantee creates indebtedness between the guarantor and the customer, due to his default, charging fee is not allowed as it will trigger the issue of riba.

The paper has made its preference with regards to charging fees for the letter of guarantee based on different situations.

- Taking compensation for the guarantee is prohibited if the bank determines prior to issuing the guarantee that the customer (guaranteed party) will be unable to pay the debt.
- If that is not the case, the paper favours the opinion that it is allowed to accept a fee for the guarantee, as long as there is no default by the customer.
- In the event where the customer defaults and the guarantor settle the outstanding amount to the beneficiary, the guaranteed becomes indebted to the guarantor, the guarantor is not allowed to charge any additional fees besides the actual cost incurred.

Thank You