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Practical application of *Kafalah* in Islamic banking in Malaysia

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Abstract

Purpose – The purpose of this paper is to explore the application of *Kafalah* in the practice of Islamic banking in Malaysia generally and ascertain applicable rules governing the application under relevant legislations and *Shariah*. The study also aims to examine the legislations in the light of *Shariah* provisions governing *Kafalah* and propose amendments.

Design/methodology/approach – This is a qualitative research where primary data sources mainly legislations and secondary sources comprising of articles and books on the subject of *Kafalah* were examined. It is an exploratory legal research that primarily focuses on library studies and adopts doctrinal approach for content analysis of data from the identified sources.

Findings – *Kafalah* is widely used in Islamic banking in Malaysia with primary or secondary application in structuring such products/services as personal guarantee, bank guarantee, Islamic credit card among others. The substantive law applicable to *Kafalah* in Islamic banking in Malaysia is the Contracts Act 1950 as decided cases indicate. However, provisions of the Act are at variance with rules of *Shariah* applicable to *Kafalah* on absolution of guaranteed debtor, multiple guarantors' liability towards guaranteed sum as well as recourse and recovery from principal debtor.

Research limitations/implications – This research explored the practice of *Kafalah* in Islamic banking under Malaysian legal framework based on the available literature. The research does not embody an empirical evaluation.

Originality/value – This research suggests, with respect to the identified issues, an amendment to the Act for clarification as follows: that recourse and recovery from principal debtor is only where creditor has requested guarantor to settle outstanding debt, that presence of surety does not absolve principal debtor from his original liability and that multiple guarantors stand as having equal responsibility towards guaranteed amount. The research findings will assist policy and law makers to harmonize the relevant laws with the *Shariah* to facilitate sustainable development of Islamic banking.

Keywords Application, Islamic banking, *Kafalah*, Malaysia, Guarantee

Paper type Research paper

1. Introduction

Kafalah or guarantee is a concept that is widely used in Islamic banking. As a form of guarantee that secures obligations in financial transactions, it is not only a concept that protects banks from default risk (where a bank stands as a beneficiary) but also used to give

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protection to third parties and save them from possible risks arising because of default of payment or discharging an obligation, which a customer promised to fulfil (where the bank is the guarantor). Accordingly, it is not an overstatement to say that *kafalah* is versatile in its modern usage and provides benefit to both banks and customers, depending on the way the concept are used. Guarantee is a means by which conventional financial institutions, particularly banks, ensure that their debtors' liabilities will be met as and when due. For customers or clients, a guarantee enables them to obtain financing and acquire items they desire or capital for investment. Financial institutions historically are averse to being unsecured creditors, i.e. granting financial facilities or services to a debtor without collateral (Schich, 2013). As such, collateral used to be and till date remains a better guarantee for one to obtain financial facilities or loans in conventional banking. However, in Islamic banking, with the Islamic concept of *kafalah*, a guarantee can be obtained not necessarily with a collateral in the actual sense of the term but on a contractual assurance by a third-party institutions or persons of means (Baele *et al.*, 2014). For the workability of this, there strict rules of *Shariah* among other regulatory requirements that must be satisfied by an eligible party.

The objective of this research study is to find out the application of *Kafalah* in Islamic banking in Malaysia generally. In addition, the research seeks to ascertain applicable rules governing the application of *Kafalah* under relevant legislations, in this regard the Malaysian Contracts Act, 1950, as well as rules *Shariah* on the subject matter. The research would examine relevant laws on guarantee and/or *Kafalah* in the light of the *Shariah* provisions governing the same. In the final analysis, proposal is made for amendments on certain provisions of the Contracts Act. These objectives are premised on the following questions, which the research would seek to answer ultimately:

Q1. What are the provisions of the Malaysian law on guarantee as applicable to Islamic banking?

Q2. How are those provisions in tune with the rules of *Shariah* governing *Kafalah*?

Malaysia is an Islamic finance jurisdiction in the world that believably has an advanced legal and regulatory framework for Islamic banking resulting from series of impactful researches. Nonetheless, a survey of the available literature reveals a very few works on *Kafalah* application in Malaysian Islamic banking practice and none so far on legal issues in application under relevant Malaysian law and the *Shariah*. A research gap is thus identified to exist here and this research is the first attempt to address the gap from the perspectives of law and *Shariah*. It is thus anticipated that this research would be *significant* by identifying and addressing the legal issues in applying *Kafalah* in Islamic banking to fill the gap and add a twist in the available literature.

This paper is divided into five parts. Followed by the Introduction, Section 2 deals with the methodology. Section 3 provides a review of relevant literature and discusses the definition of *Kafalah*, types of *Kafalah*, the concept of guarantee under the Malaysian Contracts Act 1950 and application of *Kafalah* in Islamic banking generally. Section 4 highlights the research findings and discussion thereon, and Section 5 provides the research conclusion and recommendations.

2. Methodology

This is a qualitative research where primary data sources mainly legislations and secondary sources comprising of articles and books were examine (Mayer, 2015) on the subject of *Kafalah*. It is an exploratory legal research that primarily focuses on library studies and adopts doctrinal approach for content analysis of data from the identified sources. In view of

the doctrinal nature of the research, data for it were drawn from the provisions of statutory laws, mainly the Contract Act 1950, as well as case laws or decisions handed down by courts on the subject matter of guarantee and *Kafalah*, journal articles and textbooks (Hutchinson, 2015). Likewise, provisions on *Kafalah* from *Shariah* sources including the holy Quran and hadith were appropriately consulted. These data sources were fetched and accessed library and largely on academic and professional databases including LexisNexis, HeinOnline, Scopus, Web of Science and Google Scholars among others. All data were documented and content analysis was carried out via careful study of the documents (Cownie and Bradney, 2013).

3. Literature review

3.1 Definition of Kafalah

The literal meaning of *Kafalah* is responsibility or suretyship and it has been defined by different Islamic scholars of the different Islamic schools of law. The Hanafis define *Kafalah* as making a guaranteed person's liability a joint liability of the guaranteed and guarantor at the time of demanding compensation. Meanwhile, the Malikis, Shafi'is and Hanbalis scholars define *Kafalah* as the conjoining of a guarantor's liability to that of the guaranteed *(*Al-Zuhayli, 2003). Technically, *Kafalah* is an obligation added to existing ones with reference to a claim or a demand for something where one party agrees to discharge the liability of a third-party if the third-party defaults in fulfilling their obligation (Rahim *et al.*, 2015; Ramli *et al.*, 2014). According to Bank Negara Malaysia (2018), "*Kafalah* refers to a contract where the guarantor conjoins the guaranteed party in assuming the latter's specified liability"[1]. This definition is for all intent and purpose the formal one under the Malaysian legal system and in the context of Islamic finance generally. The definition appears to embody aspects of all the juristic definitions.

Functionally, *Kafalah* is a contract whereby the guarantor will guarantee the performance, action and undertaking to beneficiary. The guarantor will underwrite any claim and obligation that should be fulfilled by the guaranteed party. A *Kafalah* is a permissible in contract of exchange like in contract of sale (Usmani, 2015). More often than not, in Islamic banking, the contract of *kafalah* can normally be used as a secondary contract (Mustafa and Najeeb, 2018), for instance in bank guarantee (BG) where the primary contract could be based on deferred sale of an asset and to secure the future payments owing to the bank. Here, the bank may request the customer to furnish a guarantor as a security contract. Nonetheless, the application of *Kafalah* is not limited to being a secondary contract only, it can be a primary contract as well (Alwi *et al.*, 2016). As a primary contract, it can also be used in an instance where the product itself is giving *Kafalah* such as shipping guarantee or standby letter of credit[2].

Kafalah contract is permissible based on proofs available in the Quran, Sunnah and juristic consensus (Al-Zuhayli, 2003). "They said: We miss the great beaker of the king; for him who produces it, is (the reward of) a camel load; I will be his *za'im*". [Quran 12:72]. It is said that, according to Ibn Abbas, *za'im* as stated in this verse is another word for guarantor or *kafil* (Al-Zuhayli, 2003). There is consensus among Muslim jurists that *Kafalah* is a valid contract as it assists creditors secure their right and avoid harm from debtor (Mansuri, 2010). A *Kafalah* arrangement needs to fulfil the following requirements as its tenets: guarantor (*Kafil*), beneficiary (*Makful lahu*), object of the guarantee contract (*Makful*) and the contract language (*Sighah* i.e. *Ijab* [offer] and *Qabul* [acceptance])[3]. According to Al-Zuhayli (2003), for Abu Hanifah and Muhammad, a *Kafalah* contract is built on the guarantor's offer and the debtor's acceptance while for Abu Yusuf and the majority of the scholars, they maintain that it is built on offer alone. The modes of *Kafalah* can be

unrestricted or restricted by description, suspended or pending a condition or deferred to a future time (Al-Zuhayli, 2003). It should be note that *Shariah* spells out a limitation in the application of *kafalah* as a secondary contract. Thus, it is impermissible to stipulate in trust contracts such as in agency (*wakalah*) contract that a personal guarantee or pledge of security shall be produced. In that instance, stipulating such a condition will tantamount to contravening the nature of trust contracts except where such contracts are used to cover cases of negligence, misconduct or breach of contract (Usmani, 2015). This rule is applicable to *wadiah* contracts, *amanah* contracts, *musharakah*, *mudharabah*, *wakalah* and lease contract where the leased asset is in trust with lessor (Usmani, 2015).

Classically, majority of Islamic jurists had always considered it unlawful to charge a fee for a guarantee (Al-Zuhayli, 2003). These include Hanafi, Shafi'i, Maliki and also Hanbali jurists. This is because of the fact that *kafalah* used to be a contract based on *tabarru*', an Islamic social welfare concept for donation or gratuitous grant, for which no reward or any gain is required from the person to whom such a donation, grant or rather assistance is rendered (Maali and Atmeh, 2015; Ali *et al.*, 2014). However, where it is associated with a fee imposed by a guarantor for personal guarantee and/or financial in business, it becomes a commercial contract, which is allowable [Bank Negara Malaysia (BNM), 2018]. Therefore, the guarantor can claim expenses actually incurred during the period of a personal guarantee (Usmani, 2015). There are two types of personal guarantee (Usmani, 2015); that is recourse guarantee and non-recourse guarantee. A recourse guarantee is where the guarantor has the right of recourse to the debtor and the guarantee is offered at the request or with the consent of the debtor. A non-recourse guarantee is offered voluntarily by a third party without the debtor's request or consent.

3.2 Types of Kafalah

Kafalah is classified under two heads such as *Kafalah bi al-Nafs* (Physical Guarantee) and *Kafalah bi al mal* (Financial Guarantee). (International Shari'ah Research Academy for Islamic Finance, 2012).

(1) *Kafalah bi al-Nafs* (Physical Guarantee): This is a type of *Kafalah* in which the guarantee brings someone to the particular authority. In suretyship for a person the guarantor is assuming the responsibility to make sure the presence of the principal in a lawsuit, where the principal owes the creditor. The guarantor is required only to make sure the presence of the person. He is not liable to settle the debt on behalf of the principal. If the principal dies the guarantor is not bound to pay on his behalf. This is because the guarantee given is for the presence of the principal and not for the settlement of his debt.

(2) *Kafalah bi al-mal* (financial Guarantee): *kafalah* for the property can be both for the settlement of a debt (*dain*) or a guarantee that a certain specific thing (*ain*) would be returned [Bank Negara Malaysia (BNM), 2018]. In this case, guarantor is not freed from liability even though the creditor or the owner of the thing dies. The heirs of the creditor or the owner of the thing can demand that the guarantor settle the debt or return the thing. *Kafalah bi al-mal* can be divided into three types as follows:

- *Kafalah bi al-dayn*: Guarantee of repayment of another party's loan obligation;
- *Kafalah bi al-ayn*/*kafalah bi al-taslim*: Guarantee of payment for an item or a guarantee of delivery in a transaction; and

- *Kafalah bi al-darak*: Guarantee, which ensures a specific asset is free from any encumbrances in the case a certain transaction involves the transfer of titles of rights.

3.3 Concept of guarantee under Malaysian Contracts Act 1950

In Malaysia, *Kafalah* generally to be applied in accordance with the principles of guarantee as codified in the Contracts Act, 1950. However, for specific application of guarantee or *Kafalah* in Islamic finance, the Act is applicable alongside Bank of Negara's *Kafalah* Policy Document 2018. The policy document is a regulatory instrument meant to guide the application of *Kafalah* in the operation of all Islamic financial institutions. As such, it is important to understand the provisions of the Contract Act 1950 on guarantee in line with the policy document to comprehend the application of guarantee and/or *Kafalah* to Islamic banking in the country. The Contracts Act, 1950 is the principal legislation governing contractual rules and obligations and covers guarantees. It should accordingly be noted that whatever the Act provides in that regard would be applicable to Islamic banking too.

Under Part 8 of the Contracts Act, 1950 entitled "Indemnity and Guarantee", the roles of surety, creditor and debtor are stipulated in principle but without detailed regulations. One of the issues regarding *Kafalah* is the charging fee on the issuance of BG. This however, has not been legislated upon in Malaysia. Consequently, the fee varies from bank to bank in accordance with direction of their respective *Shariah* Committees. Section 79 of the Contracts Act provides definition of important terms related to guarantee whereby a "contract of guarantee" is defined as a contract to perform the promise or discharge the liability of a third person in case of his default. The person who gives the guarantee is called the "surety", the person in respect of which default the guarantee is given is called the "principal debtor" and the person to whom the guarantee is given is called the "creditor". Furthermore, "a guarantee may be either oral or written". In relation to consideration for guarantee, Section 80 of Act states that "anything arising, or any promise made for the benefit of the principal debtor may be a sufficient consideration to the surety for giving the guarantee".

In Section 81, it is stipulated that the liability of surety is co-extensive with that of the principal debtor unless it is otherwise provided by the contract. This shows that the creditor has the right to seek payment from either the debtor or guarantor when the payment is due. However, such case is typically not found in practice as banks avoid risking indefinite liability beyond the guarantee amount. A reported Islamic banking case where Section 81 of the Contracts Act, 1950 was cited is Bank Kerjasama Rakyat Malaysia Bhd v. Sea Oil Mill (1979) Sdn Bhd and Anor (2010) 1 CLJ 793. In this case, the issue was whether guarantor could again raise issues decided by the High Court against borrower. On appeal, it was held that the second respondent's liability as the guarantor for the first respondent also remains by virtue of Section 81 of the Contracts Act, 1950. This is because the agreement in this case had provision for the liability of the surety in co-extensive with the principal debtor.

Moreover, according to Section 84 of the Act, when a surety is dead, the guarantee shall be revoked unless there is any contrary condition on the guarantee. According to Section 85, in case of joint guarantee made by more than two sureties, the creditor's right on the guarantee is not affected by any contract made between the joint sureties. Section 87 states that in case that the principal debtor is released from his liabilities by any act or omission of the creditor, the surety shall be discharged from the liability. The surety shall be discharged when creditor compounds with, gives time to or agrees not to sue principal debtor according

(Section 88). However, when the creditor makes agreement with third party to give time to principal debtor, the surety is not discharged (Section 89).

In 2009, the Bank Negara Malaysia (BNM) set up a Law Harmonisation Committee to review existing laws to ensure that they are compatible with and adaptive to *Shariah* requirements in Islamic finance transactions. The Law Harmonisation Committee Report released in 2013 stated that the provisions of Contracts Act, 1950 on guarantee are in line with the principles of *Shariah* although deliberations were only made on the recourse element of guarantee.

3.4 Application of Kafalah in Islamic banking

Kafalah is mostly applied as supplementary contract in combination with others to structure different products. It can also be a primary contract and the subject of main transaction[4]. The application of contract of *Kafalah* in Islamic banking can notably be found in three instances (Hassan, 2011). The first instance is for the third-party guarantee for the financing amount where the customer is required by the bank to appoint a guarantor to ensure payment of the financing. The second instance is for the third-party guarantee in *mudharabah* and *musharakah* contracts where the guarantor is guaranteeing the parties in cases of negligence. However, in this case, the guarantor is not allowed to guarantee the capital or profit as it is against the principle of *mudharabah or musharakah*. The third instance is BG based on *Kafalah* where the bank agrees to discharge the liability of a third party in the case of default by such third party.

In the modern banking context, *Kafalah* services provided by Islamic banks are mainly Shipping Guarantee and BG, which are offered by conventional banks as well. Though the purpose and function of the guarantees offered by Islamic banks and conventional banks are same, but the conditions and method of charging fee are different. Islamic shipping guarantee (ISG) is usually issued by a bank that provides a customer with LC *Murabahah* and the function of ISG is basically same as the Conventional shipping guarantee (CSG), which enables the port releases the goods in the case that customer has not received original Bill of Lading, but he wants to avoid any demurrage charge. However, it is found that the liability of ISG is different from CSG that some of Islamic banks does not specify the guarantee period and amount on the guarantee while CSG specifies them as the Islamic banks does not want to shift the responsibility to the shipping company in the case that guarantee period is expired and the goods arrive too late or lost. However, it is also controversial to issue the guarantee without expiry date and guarantee amount as it is containing an element of *gharar* (uncertainty) to make the bank exposed to the risk of unlimited guarantee (Syed Alwi *et al.*, 2015). The majority of the jurists allow the debt guaranteed by the guarantor to be unspecified and as such known and unknown amounts can be guaranteed under *Kafalah (*Al-Zuhayli, 2003).

In terms of BG, some jurists argue that it is unlawful to charge fees for BG as it is a form of *tabarru'* contract while others insist that charging a fee for guarantee is permissible as it is one of the services banks provide that contains costs and risks. Among contemporary scholars who allow charging fee for guarantee are Sheikh Yusuf al-Qaradawi, Sheikh Nazih Hamad, Sheikh Abdullah Mani' and Malaysian scholars at *Shariah* advisory council (SAC) of BNM. It is permissible to convert a *tabarru'* (donation-based contract) to a mu'awadhah-based contract (commercial exchange contract) with the consents of the contracting parties (Hamad, 2001). A guarantor deserves a good reward from the guaranteed person similar to his contribution for the guaranteed person or even more as long as the debt is settled immediately (Hamad, 2001). According to him it is like a hibah (a gift) when expected with a

reward (Hamad, 2001). According to Al-Zuhayli (2003), fee paying is allowed only when there is a necessary or general need for the guarantee, and the debtor cannot find any other guarantor who is not charging a fee. This seems to be realistic in the modern context of Islamic commercial dealings, especially when the guarantee is established institutionally and not by an individual. The author maintained that guaranteeing agencies often involves some clerical costs for providing guarantee and as such, these agencies giving guarantee may charge fees accordingly, but excessive costs must not be charged.

According to BNM's Concept Paper of *Kafalah*, clauses 17.1 and 17.2 allows banks in Malaysia to charge a fee on *Kafalah* and the methods of charging fee can either be an agreed fixed amount or a percentage of the guaranteed amount. Under such requirement, the methods of charging fee vary from banks to banks according to their interpretations. Currently, out of twelve major Islamic banks in Malaysia, six banks are imposing fee the same way as conventional banks while the others are charging either the actual cost for the issuance or based on their own formula (Syed Alwi *et al.*, 2014).

4. Findings and discussion

4.1 Use of Kafalah in Islamic banking in Malaysia

By Section 2 of Islamic Financial Services Act (IFSA) 2013, *Kafalah* falls within the provision of finance whereby it enables to guarantee liability, obligation or duty of any person. *Kafalah* contract is widely used in Islamic banking in Malaysia. It is used not only in corporate financing but in retail and trade financing as well. The use of *Kafalah* is frequently found in the form of personal guarantee and BG. Also, it is found in Islamic credit cards and is found in Islamic deposit insurance systems by Perbadanan Isurans Deposit Malaysia (PIDM).

To comprehend the types of products offered by Islamic banks using *kafalah,* products offered by a sample of four Islamic banks in Malaysia are studied. These banks been selected for being prominent in terms of clientele and/or customer base, innovative and wide-ranging products, as well as market goodwill in the Malaysian Islamic banking industry. It is found that Islamic banks in Malaysia uses *Kafalah* as a primary contract to structure products and it also used as a secondary contract that is combined with other contracts to secure the future payments owed by the customer to the bank. This type of guarantee is required by all the 16 Islamic banks operating in the country. However, it is imperative to state that for equity contracts (musharakah and mudarabah), only performance guarantee is required so as to secure the partner in case of negligence as this contract is based on trust. Section 18 of *Shariah* standards and operational requirements of BNM states that each party in this case can provide a collateral and the guarantor should be an independent third party. Moreover, it also states that the guarantee shall be executed in a separate contract and shall be used to cover any loss or depletion of the capital. According to INCEIF (2006), in ijarah contracts, both financial and performance guarantee is acceptable and applicable in the Islamic banks. When an Islamic bank leases out an equipment or any other item to its customer, it is permitted for the bank to take any kind of permissible guarantee to secure the rental payment (financial guarantee) and against negligent use of the leased item (performance guarantee).

For BG, mostly known as BG-i in Malaysia, Islamic banks act as a guarantor of its customer by providing letter of guarantee to the customer undertaking to fulfil the obligation of the customer when the customer defaults. The type of BG offered by Islamic banks differs from one bank to another as shown in Table I below.

The Table I (above) provide the types of BG offered by four Islamic banks of Malaysia. The information is extracted from the official websites of the respective banks. According to Table I, all the four Islamic banks studied provides tender guarantee, performance guarantee and guarantee for advance payment. Only two banks provide guarantee in lieu of security deposits or supply guarantee. Guarantee for exemption of custom duties, guarantee for maintaining ledger accounts, guarantee for honouring of cheques and custom bond are provided by one bank only. It is found that all types of BG stated in Table I are provided by Bank Muamalat. CIMB Islamic provides four types while Bank Islam and Maybank Islam provide three types only.

It is essential to note that the application of *Kafalah* in Malaysia, is governed by the Contracts Act, 1950 as the principal substantive law in this regard. Substantive laws are those laws, which deal with the specific subject in a detailed manner. So, in Malaysia, if a contract is entered between two parties, irrespective of the nature of the contract, the Contracts Act, 1950 would be applicable. When it comes to Islamic banking, federal legislations dealing with commercial matters are applicable. For example, in Islamic banking products where land is the subject matter, then National Land Code 1965 shall be applicable. When dealing with Islamic banking agreements, the provisions of Contracts Act, 1950 shall be followed. In the case of Bank Kerjasama Rakyat Malaysia Bhd v. Sea Oil Mill (1979) Sdn Bhd and Anor (2010) 1 CLJ 793, Section 81 of the Contracts Act, 1950 used. The issue in this case was whether guarantor could again raise issues decided by High Court against borrower, though the judgment against the borrower was upheld by the Court of Appeal. On appeal, it was held that the second respondent's liability as the guarantor for the first respondent also remains by virtue of Section 81 of the Contracts Act, 1950. This is because the agreement in this case makes provision for the liability of the surety as co-extensive with that of the principal debtor.

In the case of *Arab-Malaysian Merchant Bank Berhad v. Foreswood Industries Sdn Bhd and 4 Ors,* [2007] 1 LNS 539, Sections 92 and 94 of the Contracts Act, 1950 were referred to. In this case, the plaintiff agreed by a letter of offer to grant to the first defendant a Bai' Bithaman Ajil (deferred payment sale) facility of RM5.0 million for financing the purchase of machinery and equipment for the first defendant. The second, third and the fifth defendants who were guarantors to the facility provided relied on Sections 92 and 94 of the Contracts Act, 1950 to prove that they have discharged their liability to the plaintiff. In this case, nothing more was done by the plaintiff until the first defendant received from the plaintiff a

Table I.
Types of bank guarantees offered by Islamic banks in Malaysia

Type of guarantee	Bank Muamalat	Maybank Islamic	CIMB Islamic	Bank Islam
Tender guarantee	√	√	√	√
Performance guarantee	√	√	√	√
Guarantee for advance payment	√	√	√	√
Guarantee in lieu of security deposits or Supply guarantee	√	–	√	–
Guarantee for exemption of custom duties	√	–	–	–
Guarantee for maintaining ledger accounts	√	–	–	–
Guarantee for honouring of cheques	√	–	–	–
Custom bond	√	–		–

Source: Information extracted from the official websites of the banks

statutory notice of demand to pay the plaintiff the judgment sum within 20 days, failing which a winding up petition may be filed against the first defendant. The statutory notice expired, but the plaintiff did not and has not filed any winding up petition against the 1st defendant. Instead, the plaintiff appointed a receiver and manager over the first defendant by a notice in Form 59 on 15.08.2002. The second, third and fifth defendants contended that the plaintiff owed them a duty of care to act prudently and take all reasonable steps to recover any amount owing from the first defendant. The second, third and fifth defendants claimed that the plaintiff was in breach of its duty of care in failing to take any action upon the alleged default of the first defendant which occurred more than four years ago and as a result they have suffered loss as a result of the impairment or diminution in value of the assets of the first defendant. They relied on Sections 92 and 94 of the Contracts Act, 1950 and contended that they have successfully discharged the liability owed to the plaintiff. As a result, it is unjust and inequitable for the plaintiff to prosecute its claim against the second, third and fifth defendants who are merely guarantors because of laches and delays on the part of the plaintiff. The court in this case allowed the appeal of the appellants on the ground that there is a fit and proper case for full trial and could not be disposed-off summarily.

4.2 Modus operandi of Kafalah in Islamic banking

In demonstrating the *modus operandi* of *kafalah*, its practical application in personal guarantee and BG, Islamic credit card and Islamic deposit insurance system is discussed here.

4.2.1 Personal guarantee. Personal guarantee is where *Kafalah* is usually being used in Islamic banking. In obtaining any type of Islamic banking facility from the bank, a customer will be requested to provide a personal guarantor to secure the payment of financing. In the event of default of the financing facility by the customer, both the customer (principal debtor) and the guarantor will be jointly held liable to pay the creditor and the creditor has the right of recourse against both the customer and the guarantor without absolving the liability from the customer. Personal guarantee can be obtained by the bank when it deems required with or without other securities like charge.

4.2.2 Bank guarantee. BG is obtained for different purposes such as performance guarantee, tender guarantee and guarantee for sub-contracts. The BG contract is made between the bank and another party where the bank agrees to discharge the liability of its customers in case of default or failure of the customer to fulfil its obligation as per the conditions of the guarantee. The effect of this is that, if the customer defaults, the bank is obliged to pay the agreed amount of money to the third party.

For example, BG-i is provided by Maybank Islamic. It is stated in the official website of Maybank Islamic that it is a guarantee by the bank on customer's behalf to ensure that the customer's liabilities will be met and it is issued under the *Shariah* contract of Kafalah. The types of guarantees provided are tender guarantee/bid bond, performance guarantee, advance payment guarantee and warranty maintenance guarantee.

4.2.3 Guarantee in Islamic credit card. Credit cards are also structured using the concept of *Kafalah*. In this type of credit card, the bank operates as the card issuer who guarantees all the obligation to pay for the transactions that occurs between the customer and the merchant or cash withdrawals made by the customer from other banks. The bank in this case charges a fee for the services offered and this fee is determined in advance upon the conclusion of the contract and the term of the contract is fixed.

4.2.4 Guarantee in Islamic deposit insurance system. Kafalah with a fee (*Kafalah bil ujr*) is implemented in Islamic deposit insurance scheme as applied by PIDM. The purpose of this insurance scheme is to provide *takaful* coverage and protection for depositors against

the loss of their deposits placed with the bank if the bank is unable to meet the customer's demand. In this scheme, the Islamic banks pay a fee to PIDM as annual premiums as a consideration to the guarantee provided by PIDM. PIDM will provide reimbursement to depositors in case of loss. The permissibility of this product using *Kafalah* with fee has been endorsed by the SAC of BNM it its 80th meeting on 7th January 2009.

4.3 Problems detected in the application of Kafalah to Islamic banking in Malaysia

In this part of the paper, the problems detected in the application of *Kafalah* to Islamic banking will be analysed using the Contracts Act, 1950, *Kafalah* concept paper of BNM and the Mejelle law. The Mejelle was the civil code of the Ottoman Empire and is considered to be the first attempt at codification of a *Shariah*-based law.

4.3.1 Absolution of guaranteed debtor. Section 81 of the Contracts Act, 1950 allows the release of the debtor when payment is due where the creditor can either seek payment from the debtor or the guarantor. According to Section 16.6 of BNM's Concept Paper, it is stipulated that the creditor may claim his rights from the guaranteed party and/or the guarantor. The claim can either be for the full amount of the liability from either of them or a part of the liability from the guaranteed party and the other part from the guarantor(s). Furthermore, Section 16.7 gives the guarantor the right to impose a condition that the creditor shall first claim from the guaranteed debtor and will only claim from the guarantor if the guaranteed party is unable to settle his liability.

In the Mejelle law, Article 644 states "the person claiming under the guarantee has the option of claiming either against the guarantor or against the principal debtor". The creditor may claim first from the debtor and then from the guarantor or from both simultaneously. Nevertheless, the guarantor also has the right to include in the contract the specific condition that the creditor can claim his rights from the guarantor only if the debtor fails to fulfil the obligations. Furthermore, Article 662 assures that the extrication of the principal debtor from the liability brings about the release of the guarantor. However, vice versa of the order of release is not the supported as imposed in Article 661.

From a *Shariah* point of view, by releasing the principal debtor from his debt to the surety, the nature of the *Kafalah* contract is changed and will be treated as a transfer of debt (*hawalah*) instead. According to Article 648 of the Mejelle, if there is a condition in the contract of guarantee that exculpates the principal debtor, the contract is transformed into a transfer of debt. Hence, the presence of surety does not absolve the principal debtor from his original liability since guarantee is only meant to ensure payment whether from the debtor or guarantor.

4.3.2 Multiple guarantors. Note the ruling in the case of Bank Kerjasama Rakyat (M) Bhd v. Flavour Right Sdn Bhd and Ors (2012) MLJU 1003, where multiple guarantors were involved, and the court held that the fourth defendant was not held liable as he has been discharged as a guarantor for the first defendant in June 2010.

In *Shariah,* it is provided that when there is only one guarantor of the debt, full payment of the liability should be sought from him when the principal debtor fails to pay the debt. However, when there is more than one guarantor in a single obligation, each of them should pay an equal share of the guaranteed amount as long as none of them had in turn guaranteed the other (Al-Zuhayli, 2003).

This is similar to the conventional guarantee as provided by the Malaysian Contracts Act, 1950. Section 99 says that:

> [. . .] where two or more persons are co-sureties for the same debt or duty, either jointly or severally, and whether under the same or different contracts, and whether with or without the knowledge of each other, the co-sureties, in the absence of any contract to the contrary, are liable,

as between themselves, to pay each an equal share of the whole debt, or of that part of it which remains unpaid by the principal debtor.

The fair principle of contribution is that if one of the multiple guarantors pays the whole debtor or even more than his proportion, he is entitled to recover it from his co-guarantors whether the obligation was joint or joint and several (Abu Backer, 2005). The provision of Section 99 was applied in the case of *Wong Kim Swee v. Wong Chee Mun and Ors* (1984) 2MLJ 221 where it was made clear that if any of the co-sureties had paid the creditor, thus discharging the debt, then the others were equally liable to contribute to the sum paid towards that discharge.

In situation like this, Suhaimi Ab Rahman (2005) argued for the classical doctrine of the Malikis to be an alternative resolution, such that the creditor or bank can only sue the guarantor after exhausting the recourse from the principal debtor first. The initial purpose of guarantees is to support the debtor and provide a safety net to the creditor in having a second source of funds in case of a default. However, if the principal debtor is readily available and sufficient to set off his debt, then the guarantor should not have to be burdened.

Similarly, according to Article 647 of the Mejelle law, if there are several guarantors of one debt who have become guarantor for such debt separately, action may be taken against any one of them for the whole amount of the debt. If they become guarantors at one and the same time, action shall be taken against each one for his share of the debt but if they have also each guaranteed the amount to be paid by the others, each of them is liable for the whole amount of the debt. The Concept Paper of BNM also allows multiple guarantors in a debt contract with requirement that the contracting parties agree to the specific terms of the guarantee as stipulated in clause 16.12. Hence, the section in the Concept Paper and Contracts Act shall be maintained as it is.

4.3.3 Recourse and recovery from the principal debtor. According to *Shariah*, *Kafalah* contract being a gratuitous contract where the guarantor expects reward only from Allah in return for easing the financial distress of a fellow human being, the guarantor has the right to recover amount he paid to the creditor from the principal debtor. This is also depicted in the provisions of the Contracts Act, 1950, the BNM's Concept Paper and the Mejelle. Section 98 of the Contracts Act, 1950 covers the implied promise to indemnify surety. The guarantor is entitled to recover from the principal debtor whatever sum he has rightfully paid under the guarantee but not the amount, which he has paid wrongfully. At common law, the guarantor has no right of recovering payment if it was made voluntarily.

This is the same as provided by Section 18.1 of the BNM Concept Paper which states that "the guarantor shall have the right of recourse against the guaranteed party notwithstanding the *Kafalah* is given on a voluntary basis" and Section 18.2 such that "the guarantor is only entitled to recourse up to the amount he has paid to the beneficiary as a result of providing the *kafalah*".

The Mejelle law points out in Article 657 that if a person requests another to guarantee a debt, which he owes to some third person and such person agrees, and pays the debt, and wishes to exercise his right of recourse against the debtor, he may do so, in respect to what he has guaranteed and not what he has paid. However, if he has paid a portion of the debt as a result of a settlement with the creditor, he has a right of recourse in respect to that amount only, and not to the whole debt. This shows that in the practice of *kafalah,* the general rule should be that the guarantor has the right to demand compensation from the debtor to the tune of what they have paid to the creditor, given that the guarantee was requested (Muneeza, 2015). Hence, as there are several conditions to this ruling, a comment would be helpful in the Contracts Act, 1950 to the effect where creditor requested a guarantor to settle

an outstanding debt, then recourse and recovery from the principal debtor will be possible. This would provide certainty and fairness to the guarantor.

Having said this, it is essential to note that the Report of Law Harmonization Committee of the Malaysia's Central Bank also deliberated on this issue where it stated that the majority of Islamic jurists (excluding Imam Malik) view that it is acceptable for the creditor to demand recourse from both the debtor and guarantor simultaneously (Rahman, 2005) and that this practice aligns with Section 81 of the Contracts Act, 1950. From the Maliki perspective, the creditor has to exhaust the principal claim from the debtor first before seeking recourse from the guarantor. This is also recognized in Malaysian law under Bankruptcy Act, 1967, sections 2 and 5(3) for only social guarantors. Therefore, the report concluded that the provisions in the common law of guarantee codified in the Contracts Act, 1950 do not impede Islamic finance as the principles stated there are in compliance with Shariah as observed by the majority of scholars. This conclusion of the report implies is that the Contracts Act need not be amended to align it with Shariah as the current Bankruptcy Act, 1967 has adequately addressed the issue of different juristic views.

5. Conclusion

Kafalah is widely used in Islamic banking in Malaysia. Personal guarantee, BG, Islamic credit card and Islamic deposit insurance scheme are structured using the concept. In terms of applicable law applicable to *Kafalah*, it is evident from case law on Islamic banking that the substantive law is the Contracts Act, 1950. The relevant provisions as regard application of *Kafalah* in Islamic banking are those under Part 8, between and/or from Sections 78 to 89. These provisions are to a certain extent in tune with *Shariah* rules on Kafalah. However, three major issues in relation thereto have been identified and discussed in this research. These issues are about absolution of guaranteed debtor; multiple guarantors and recourse and recovery from the principal debtor. The research concludes that the presence of surety does not absolve the principal debtor from his original liability since guarantee is only meant to ensure payment whether from the debtor or guarantor. On having multiple guarantors, it is contended from *Shariah* viewpoint that is not an issue but that such multiple guarantors should stand as having equal responsibility towards guaranteed amount. For recourse and recovery from principal debtor, because of the several applicable conditions from *Shariah* perspective, supplementary comments need to be added in the Contracts Act, 1950 to provide clarification to the effect that where creditor has requested guarantor to settle outstanding debt, then only recourse and recovery from the principal debtor will be possible. These findings and recommendations will assist policy and law makers in bringing about the required changes to the Contract Act 1950 to harmonize some of its provisions on guarantee to be in tune *Shariah* for the purpose of kafalah. This is invaluable to pave way for sustainable development of Islamic banking and finance .

Notes

1. Bank Negara Malaysia, (2018). *Kafalah Policy Document*, Paragraph 8.
2. Bank Negara Malaysia, (2018). *Kafalah Policy Document*, Paragraph 1.3.
3. Bank Negara Malaysia, (2018). *Kafalah Policy Document*, Paragraph 10.
4. Bank Negara Malaysia, (2018). *Kafalah Policy Document*, Paragraph 1.3

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