



**THE POSSIBILITY OF APPLICATION OF ISP98
AS A GOVERNING RULE OF A BANK
GUARANTEE ISSUED BY AN ISLAMIC BANK**

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1. Introduction

Bank guarantees can be issued not only by a conventional bank but also by an Islamic bank. The issuance of bank guarantees can be subject to national laws and/or international customs and practices. For Islamic banks, the issuance of bank guarantees must also be in accordance with the principles of Islamic Law. In conventional bank practice, it is common for a bank to prefer the application of the latter rules in the context of a cross-border transaction, because this provides more certainty, uniformity and efficiency since all of the parties refer to the similar rules. Under those circumstances, this dissertation aims to discuss about the possibility of applying the international standard practices towards to govern bank guarantees by Islamic banks.

This research will examine and review the compatibility of the provisions of International Standby Practices 1998, International Chamber of Commerce Publication No.590 (“ISP98”) with Islamic Law principles and the applicability of ISP98 as a governing rule to a bank guarantee issued by an Islamic bank. ISP98 embodies one of the most widely used unified set of rules in international banking usage and practice relating to bank guarantees. These rules set out comprehensive, detailed and technical procedures for standby letters of credits and similar undertakings, including demand guarantees.

In this dissertation, the term bank guarantee either in singular or plural form encompasses the independent bank guarantees, which are also often known as demand guarantees and standby letters of credit. This terminology will be used throughout this dissertation. However, the specific reference to demand guarantee or standby letter of credit will be made when required.

This dissertation will firstly establish the general theory of bank guarantees in international practice. It will then be followed by a discussion of the legal devices by which the essential characteristics of a conventional bank guarantee can be mimicked under Islamic law in order to assess the compatibility of the provisions of ISP98 with the principles of Islamic Law.

By using ISP98, Islamic banks could improve their competitiveness in the issuance of bank guarantees for cross-border transactions. Moreover, the parties involved thereby avoid any potential disputes arising from the interpretation of the terms and conditions of the bank guarantee. Furthermore, the reference to ISP98 will provide a greater degree of certainty to the parties in international transactions because such a rule is customarily also used by majority conventional banks in the world.

2. Bank Guarantee in International Practice

Demand guarantee and standby letter of credit are independent legal instrument emerged around 1960s-1970s.¹ There is no equal theory in the existing legal theory which can explain the nature of this product. These products are different with the concept of traditional guarantee (accessory guarantee) which exist in common law, civil law systems and in Islamic Law.

In brief, guarantee in traditional sense could be defined defined as an undertaking to answer for another's default.² It is dependent and accessory in nature. If the principal debtor's obligation does not exist under the underlying contract, the guarantor's obligation towards the guaranteed object will also be void.

In contrast, a bank guarantee basically is an independent undertaking from a bank as a guarantor to the beneficiary (of the bank guarantee) up to certain amount of money, within the stipulated period, by tendering the complying documents required by the terms and conditions of the bank guarantee.³ It is a primary or direct undertaking so that the promise will be enforceable whether or not that of the underlying contract is enforceable.⁴ Moreover, the claimed amount will not be measured from the underlying contract but subject to the amount determined in the guarantee.

Such bank guarantee originates from practice to accommodate the need of industry and the international trade. It provide certainty, reassurance and confidence in the transaction between the parties involved, in particular for cross-border transaction in

¹ Roeland F. Bertrams, *Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions* (4 rev ed Kluwer Law International 2013) 1.

² Ewan McKendrick (ed), *Goode on Commercial Law*, (4th ed , Penguin Books: London, 2010) 878.

³ From Preface to International Standby Practices (ISP98) (ICC Publication No.590) and definition of demand guarantee in Uniform Rules for Demand Guarantees (URDG).

⁴ Michelle Kelly-Louw, Michelle Kelly-Louw, 'Selective Legal Aspects of Bank Demand Guarantees' (Doctor of Laws thesis, University of South Africa 2008) 35. , accessed 1 June 2015.

which the parties involved are separate. Initially, this is an alternative or cash reinsurance for the security of non-performance event of the party who owes services or performance to its counterparty.⁵

As mentioned above, there are two widely-known forms of bank guarantee in international practice ie demand guarantee being developed in Europe and standby letter of credit which originated from the US. No major gap exists between them because of their equivalent main function as security and legal nature, notably the independent principle and the documentary nature of the conditions of payment. They only differ in practice and terminology.⁶ In fact, courts have applied standby letter of credit law to the bank demand guarantee⁷ and scholars are in general agreement that the same law should apply to them.⁸

Now, standby letters of credit is extensively used across the globe even it is developed in the US.⁹ Its use is also reported to have increased significantly occurs even in Europe, the bastion of the first demand guarantee.¹⁰ The issuance of guarantees in favor of US Companies and in Latin America and the Far East countries which are influenced by American banking practices adopted the term and technique of standby letters of credit.¹¹ Also, the conservative estimation reveals that the volume of the

⁵ S H Humoud, *Islamic Banking : The Adaptation of Banking Practice to Conform with Islamic Law*, (Arabian Information Ltd 1986), 163. See also Bertrams (n1), 261.

⁶ Because of its origin, the technique of the standby letter of credit is more closely aligned to the commercial letter of credit than is the guarantee. See Bertrams (n1), 8 .

⁷ J F Dolan 'Analysing Bank Drafted Standby Letter of Credit Rules, the International Standby Practice (ISP98)' (2000) 14 *Wayne Law Review* 1865, 1873.

⁸ *Ibid.*

⁹ Preface of ISP98 and James E. Byrne, *International Standby Practices (ISP98)* (ICC Publication No.590) : Versatile Rules For Modern Practice (Part 1 of 2) in *Documentary Credit World* Vol.16 No.9, October 2012 <http://www.iccwbo.org/Data/Documents/Banking/ISP98-Article_J-Byrne/ > accessed 1 June 2015

¹⁰ James E. Byrne, 1998. "New rules for standby letters of credit: The International Standby Practices/ISP98." *Business Credit* 100, no. 5: 32.

¹¹ Bertrams (n1), 7

standby issuance by non-American banks is equal and could exceed that of the American banks.¹²

The perceptible difference between demand guarantee and standby letter of credit is that standby letters of credit are usually drafted in the form of a letter of credit.¹³ However, this fact does not hinder the intention of the parties to apply International ISP98 for a demand guarantee or Uniform Rules for Demand Guarantees ('URDG') for a standby letter of credit. Despite that ISP98¹⁴ and URDG¹⁵ provide model forms, the governed parties are not bound to use these models.¹⁶ Additionally, regardless of the name used for bank guarantee, the denomination is not determinative whether the undertaking operates as either a standby letter of credit or a demand guarantee.¹⁷ A thorough examination should be carried out towards the undertaking itself rather than the formal title used. As long as the text of bank guarantees fulfill the minimum requirement set out in either rules and it does not infringe the prevalent national law, banks can issue the requested bank guarantee irrespective of its form or name.¹⁸ The familiarity to the practice rules and the method of payment arguably are the main motive of choosing the preferred rules.

2.1 Key Elements of Bank Guarantees

Further, what distinguishes bank guarantees with the traditional guarantee are their cardinal characteristics namely the independent principle and documentary conditions

¹² Byrne (n10).

¹³ (344 See De Ly *op cit* note 13 at 833). As cited in Kelly-Louw (n 4), 83.

¹⁴ Model forms of standby letter of credit can be accessed in this link <<http://iiblp.org/resources/isp-forms/>> accessed 1 July 2015.

¹⁵ The model forms of demand guarantee are available as appendix in the URDG.

¹⁶ Even some multinational companies usually have their own template bank guarantee text because they use bank guarantees against their counterpart for regular basis. In their template, they assure that they have the same terms and conditions for all services provider they engage.

¹⁷ See definition of demand guarantee in URDG758 and Rule 1.01 of ISP98. Scopes of both standby letter of credit and demand guarantee contend the words " however named or described". It shows the importance of the substance of bank guarantee over the form. What may cause distinction between a standby letter of credit and demand guarantee form is the method of payment.

¹⁸ The minimum requirements are set out in Article 3 of the URDG and Rule 3 of ISP98.

of payment. These notions are closely related. They pausibly constitute the success of the widespread use of bank guarantees in international trade practice.

Such principle lies at the core of a bank guarantee. Such bank guarantee is independent in respect of three relationships among the applicant, the bank or the guarantor and the beneficiary.

In regard to the relationship between the bank or guarantor and the beneficiary, it means that the relationship does not depend on the mandate or reimbursement agreement between bank and the applicant and the underlying contract between the applicant and the beneficiary. The guaranteed amount of money will be paid to the beneficiary provided that the beneficiary complies with all requirements specified in the terms and condition of the guarantee. As a result, the bank cannot refuse to pay and raise any defence with regard to the underlying relationship in the way an accessory guarantor can do.¹⁹

Next, the notion of independence applies between the relationship of bank and the applicant. In this case, the right of the bank for reimbursement from the applicant and the obligation of applicant to reimburse the claimed amount is not affected by the rights and obligations, or defences against compensation as measured by and originating from the underlying contract as the traditional guarantee does. The bank cannot be involved or exposed to the dispute regarding underlying contract.²⁰

Another vital features of the bank guarantees is documentary conditions of payment. Bank will solely pay if the beneficiary satisfies all the terms and condition prescribed in the bank guarantee. Although the paramount function of the bank guarantee is to provide security for non-performance of financial and non-financial obligations of the applicant²¹, the bank only concerns with documents and the question whether the document tendered appear on its face to conform with the terms and conditions of the

¹⁹ Bertrams (n 1) 203.

²⁰ Bertrams (n 1) 204.

²¹ Bertrams (n 1) 13.

bank guarantee. It does not have any obligation to further investigate and verify the fact of default within the documents.

2.2 Rules of the International Chamber of Commerce

The importance of the harmonisation and unification of practice rules emerge from the international characteristic of the modern commerce. As the interaction involve multiple parties in different countries, those parties are in need of certainty in absence of an effective international law regime. For that reason, it is indispensable to have private rules of practice to order their collective behaviour in international transaction. These rules subsequently should be given currency and credibility by endorsement of recognized national or international use organisations and worldwide use.²²

Since demand guarantees and standby letters of credit emanate from the need of the merchant in cross-border transaction, general sources of law for them can be found often in international banking practice and usages. In the development of the law, it can be observed through the rules issued by International Chamber of Commerce (ICC).²³ One of the most critical function of ICC is to harmonise international trade practices through uniform rules and trade terms incorporated into contracts, and through the publication of guides devoted to specific fields of activity or specific problems areas.²⁴

Uniform Custom Practice (UCP), URDG758 and ISP98 are three widely used rules that are pertinent to the discussion of bank guarantees.²⁵ These rules technically are

²² J E Byrne (edited by J G Barnes), *The Official Commentary on the International Standby Practices* (Institute of International Banking Law & Practice Inc: Montgomery Village, 1998) 8.

²³ ICC is an international, non-governmental business organisation consisting of thousands of member companies and associations from over 130 countries and it is the only representative body that speaks with authority on behalf of enterprises from all sectors in every part of the world. More about ICC can be accessed in this link < <http://www.iccwbo.org> > accessed 2 July 2015.

²⁴ *Ibid.*

²⁵ UCP and URDG were initiated by the ICC. Meanwhile, ISP98 was initiated by the American Institute of International Banking Law and Practice and endorsed by ICC. See also Bertrams (n1), 28-30 and Kelly-Louw (n 4), 114-115.

not law, neither a statute nor a code.²⁶ They are voluntary rules or a set of standard terms that can only take force if the parties incorporate them into their contract. To the extent that such incorporation is not inconsistent with domestic legislation applicable to the bank guarantees, courts will normally uphold provisions of the UCP, URDG, URCG or the ISP98, where specifically incorporated into the guarantee.²⁷ Hence, the success of the rules will depend on whether the international business players are willing to embrace them in practice.

The oldest rules provided for standby letter of credit under ICC rules is UCP which generally used for documentary credits.²⁸ Some issues that are vital in a standby letter of credit context are not addressed at all in the UCP²⁹ because the rule originally is prepared for commercial letter of credit.³⁰ For many years, the UCP were the only set of rules that could govern standby letters of credit. However, that was only until 1992 when the ICC published URDG,³¹ which is applicable specifically to demand guarantees³² and can also be applied to standby letters of credit. Later, a separate set of rules, the ISP98, came into operation on 1 January 1999. In spite of that, the ambit of standby does not only cover standby letter of credit but also other similar independent undertakings³³ for instance demand guarantees regardless there is URDG

²⁶ See Van Niekerk and Schulze *op cit* note 2 at 275. As cited in Kelly-Louw (n 4) 101.

²⁷ Kelly-Louw (n 4) 133.

²⁸ Provisions relating standby letter of credit was officially set out in UCP 400 (1983 edition). R. Goode, 'Abstract Payment Undertakings And The Rules of International Chamber of Commerce' (1994-1995) 39 St. Louis U. L.J. 725. See also Kelly-Louw (n 4) 96-98.

²⁹ A standby letter of credit and commercial letter of credit has different function even it has similar legal characteristic ie autonomy principle and documentary credit. A commercial letter of credit is a method of payment under a contract of sale, while standby letter of credit is a standby payment method in case of default under some underlying transaction. See also Kelly-Louw (n 4) 81-82 and 103

³⁰ Byrne (n 10).

³¹ Kelly-Louw (n 4) 104.

³² Kelly-Louw (n 4) 110-114 and Bertrams (n 1) 28-30.

³³ Rule 1.01 of ISP98.

which specifically rules this type of bank guarantee. URDG and ISP98 have no material difference in approach.³⁴

Today, standby letters of credit can be governed by the UCP, URDG or the ISP98. In addition to these rules, it is also possible that the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit³⁵ can apply to standby letters of credit.³⁶ Nevertheless, ISP98 is more preferable for the issue of standby letter of credit since it has come into effect in 1999³⁷

2.3 The position of the ISP98 against mandatory law

The discussion in this matter is confined to the ISP98 as the focal point of our analysis. The ISP98 were designed to be compatible with the United Nations Convention on Independent Guarantees and Stand-by Letter of Credit (which represents a useful and practical formulation of basic standby and independent guarantee law) and also with local law, whether statutory or judicial, and to embody standby letter of credit practice under that law.³⁸

Since the rules are not issued by a state government and the compliance against them is voluntary, their position supplement the national law which is applicable to the

³⁴ Byrne (n 22), 2.

³⁵ UN Convention on Independent Guarantees and Standby Letter of Credit came into force on 1 January 2000. (UNCITRAL Convention). It will apply (1) where the place of business of the guarantor/issuer at which the undertaking is issued is in a contracting state or (2) the rules of private law lead to the application of the law of a contracting state, unless the undertaking excludes its application. Once a country ratifies it, it becomes its official regulation as a part of its national law. The Convention, in addition to being essentially consistent with the solutions found in the rules of practice, supplements their operation by dealing with issues beyond the scope of such rules such as the question of fraudulent or unfair demands for payment and judicial remedies available in such instances.

See Kelly-Louw (n 4) 124-127 and UN Convention on Independent Guarantees and Standby Letter of Credit.

³⁶ Preface to the ISP98.

³⁷ DCW Feature 'LC Practice Trends: International Standby Practices (ISP98) and Uniform Rules for Demand Guarantees (URDG)' (September 2004) 8 *Documentary Credit World* at 17–23). As cited in Kelly-Louw (n 4), 104.

³⁸ Preface to the ISP98 and Rule 1.02(a) of ISP98.

bank guarantees. The applicable national law could be the law of a country that covers the domicile of the issuing bank or any other agreed national law.³⁹

3. The Development of Islamic Finance

3.1 The Basic Concept of Islamic Finance Transaction

Islamic finance transaction is classified as muamalat in the realm of Islamic Law. It encompasses any legal action or dealing resulted from interaction among people which is not in the ambit of ibadat or worship.⁴⁰ For this reason, muamalat provides more leeway for Muslim jurist to develop new law and devise new product or transaction to promote and achieve social justice.⁴¹ However, this freedom should be used in the framework in Islamic Law.

Any commercial dealing in Islamic finance should be subject to the prohibition set out in the Islamic Law. Any transaction may not involve riba (usury, excessive interest), speculation or gharar (a notion encompassing excessive or avoidable risk, deceptive ambiguity, and risk shifting). The transaction considered involving haram activities (religiously forbidden) and unethical behaviour are also prohibited. Profit-sharing and risk-sharing are promoted by the Law. All of these restrictions in general is promote the objective of Islamic Law ie the establishment of social justice and equity in society, the promotion of social security, mutual help and solidarity and the promotion of cooperation in matters of goodness and prohibition of evil deeds and actions.⁴² This is the ideal theory of Islamic finance transaction.

³⁹ The choice of the governing law will be subject to the national banking policy of the country where the issuing bank is located.

⁴⁰ John L. Esposito (ed), "Muamalat." In *The Oxford Dictionary of Islam*, Oxford Islamic Studies Online, <<http://www.oxfordislamicstudies.com/article/opr/t125/e1564>> accessed 2 August 2015.

⁴¹ Ibrahim Warde, *Islamic Finance in the Global Economy* (Second Edition, Edinburgh University Press 2012), 39.

⁴² Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons, Ltd, West Sussex 2007), 24.

3.2 The Evolution of Islamic Finance

The principles and structures of Islamic finance receive an acknowledgement from the conventional economy circumstances after. It could survive the financial collapse better than the conventional sector.⁴³ These conditions encourage Islamic finance institutions to innovate their product even majority of it conceivably still replicates the conventional finance product. It could not be said that it is wrong at all to resemble conventional finance. It would be acceptable so long as it is in compliance with not only formal requirement of Islamic law for the pertinent structure but also the objectives of Islamic Law. The conventional financial product could be the departure point to modify or even create a new product. However, in certain cases, there is some debatable dispensation related to the circumvention of some prohibition under Islamic Law by invoking the principle of *darura* (dire necessity) and *maslaha mursalaha* (public welfare).⁴⁴

The changing circumstances could be accommodated in the modern practice of Islamic finance through *maslaha mursala*. Scholars use this notion to formulate the specific rules in contrary with or outside the rules from Al-Qur'an and Sunna by taking into account the common good of the society.⁴⁵

Further, the assessment of the product compliance within the sphere of Islamic finance becomes the burden of sharia supervisory board, senior management and the board of directors within the Islamic financial institution.⁴⁶ Sharia Supervisory Board must ensure the legal compliance of the prospective product towards the principles of

⁴³ Warde (n 41) 89.

⁴⁴ Dr. Abdulazeem Abozaid and Dr. Asyraf Wajdi Dusuki, 'The Challenges of Realizing Maqasid al-Shari'ah in Islamic Banking and Finance'. A paper presented at the IIUM International Conference on Islamic Banking and Finance: 'Research and Development: The Bridge between Ideals and Realities' organized by IIUM Institute of Islamic Banking and Finance, Kuala Lumpur, 23rd – 25th April 2007.

< <http://www.kantakji.com/media/6132/w239.pdf> > accessed 2 June 2015

⁴⁵ Knut S.Vikor, *Between God and the Sultan : A History of Islamic Law* (C. Hurst & Company, London 2012), 69.

⁴⁶ Ahmed, Habib, 'Maqasid al-Shariah and Islamic financial products : a framework for assessment', (2011) ISRA International Journal of Islamic Finance 3(1) 149.

Islamic Law. As a result, the Board has the responsibility to give fatwa. Fatwa in this context could be defined as the legal opinion of the Board with regard to the current issues on banking practices forwarded to them by the bank.⁴⁷ This device could foster the development of contemporary Islamic banking practice.

4. Bank Guarantee from the Perspective of Islamic Law

The development of the Islamic finance encourages Islamic banks to compete with the conventional financial institution in the market. It should also provide the product that can cater to the needs of its existing and prospective customers. Islamic banks offer various product to the market. As previously observed, some of its products resemble the products offered by conventional banking. One of the products is letter of guarantee which is also known as bank guarantee. The main requirement of issuing the guarantee is the subject matter of the underlying contract is not prohibited by the principles of Islamic Law. This product can be classified as complementary products of banking which would fulfill the additional needs of the customer of the provision of security or guarantee. It is not the main product of a bank. It is a supporting product offered to mitigate and allocate the risk of the beneficiary of the guarantee. This product plays a vital role in infrastructure project which involves multiple parties in multiple countries.

The concept of bank guarantee as issued by conventional banks is not known under the classical theory of Islamic Law. It has special feature distinguishing it with the concept of traditional guarantee.⁴⁸ It has the combination of characteristic between documentary credit and traditional guarantee. It functions as guarantee but the legal characteristic is similar with documentary credits. Both products have been acknowledged in AAOIFI⁴⁹ Sharia Standard ('Sharia Standard'). Guarantee and

⁴⁷ Suhaimi AB Rahman, 'The Classical Islamic Law of Guarantee and Its Application in Modern Islamic Banking', (Doctor of Laws thesis, Department of Law University of Wales Aberystwyth, 2005), 203.

⁴⁸ Please see Section 2.1.

⁴⁹ Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is a Bahrain based not-for-profit organization that was established to maintain and promote Shariah standards for Islamic financial institutions, participants and the overall industry. The Sharia Standard of AAOIFI could be considered as ijthad in modern era. It attempts to streamline and rationalize the product of

commercial letter of credit are widely used in Islamic finance and commercial transaction. However, the Sharia Standard specified only for bank guarantee is not available.

In view of the above, the following sections will discuss the classical theory of Islamic guarantee and its contemporary application particularly to observe to what extent the classical theory can be used to devise the Islamic version of bank guarantees.

4.1 Classical Theory of Islamic Guarantee

The classical theory of guarantee in Islamic Law could be used as the departure point of analysing the further development of Islamic guarantee in modern economy system. Various terminologies are used in Islamic Law to refer to the term guarantee such as kafala, daman, hamala and za'ama.⁵⁰ These terms can be found in the primary sources of the Islamic Law. The first two terms are the commonest.⁵¹ Kafala will be used over this study as an equivalent to Islamic guarantee.

The purpose of kafala is slightly different with the conventional guarantee. In addition to secure future obligations, kafala operates as an Islamic device to provide assistance to the people in need particularly in the context of loan transaction.⁵² Kafala is considered a righteous act performed by the guarantor, for which Allah will give the reward.⁵³

Islamic financial institutions. Further information regarding AAOIFI can be accessed in <http://www.aaofii.com>.

⁵⁰ Averroes as cited in Nicholas HD Foster 'The Islamic Law of Guarantees.' (2001) 16 (2) *Arab Law Quarterly* 133, 138.

⁵¹ Foster (n 50)138 and Rahman (n 47) 60.

⁵² Rahman (n 48) 63-64.

⁵³ Wahbah Al-Zuhayli, *Financial Transactions In Islamic Jurisprudence* (Mahmoud A. El-Gamal (ed.) Muhammad S. Eissa (rev) Vol.2, Second Edition, Dar Al-Fikr, Damascus 2003) 6.

4.1.1 Legality of kafala

The practice of kafala has been existed before Islam comes.⁵⁴ They were then refashioned and developed in accordance with the principles of Islamic Law.⁵⁵ Al-Qur'an as the first primary sources of Islamic Law has confirmed the practices in several occasions. Firstly, Surah Yusuf verse 72: "For the one who produces it (the King's breaker) is the reward of a camel's load and I will be his Za'im." ⁵⁶ In this context, Za'im has similar meaning with Kafil, ie guarantor.⁵⁷ Another translation translates Za'im as responsible.⁵⁸ This verse reflects the other term of kafala ie za'im which could be defined as responsible. Secondly, Surah An-Nahl verse 91: "And fulfill the covenant of Allah when you have taken it, [O believers], and do not break oaths after their confirmation while you have made Allah , over you, a witness. Indeed, Allah knows what you do." ⁵⁹The word "kafil" as the root of kafala is used. ⁶⁰

Further, the authority on kafala can be found in *Sunnah* of the Prophet (pbuh). The definition of *Sunnah* is the saying, the action done and/or approved by the Prophet (pbuh)⁶¹. Sunna is narrated in *Hadith*. In practice, both terms are used interchangeably to refer to the conduct of the Prophet (pbuh)⁶² The following hadith is reported by Al-Bukhari⁶³ in his Sahih. ⁶⁴

⁵⁴ Rahman (n 47) 60 and Foster (n 50) 139.

⁵⁵ Rahman (n 47) 60.

⁵⁶ Zuhayli (n 53) 5.

⁵⁷ The interpretation of Ibnu Abbas. *Ibid*.

⁵⁸ Translation from Qur'an Saheeh International : They said, "We are missing the measure of the king. And for he who produces it is [the reward of] a camel's load, and I am responsible for it."

⁵⁹ *The Qur'an : English Meaning and Notes Saheeh International* (Al Muntada Al Islami Trust : 2001) 258.

⁶⁰ Foster (n 50) 139.

⁶¹ Ayub (n 42) 22.

⁶² Further about Sunnah can be read in Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (The Islamic Text Society, Cambridge 2003), 64.

⁶³ Al-Bukhari is one of the well-known narrator of Hadith of the Prophet Muhammad (pbuh). All of his narrations are sahih (has the highest authority). Muslims refer to his works after Al-Qur'an. More about him can be accessed in the following link:

The Prophet (pbuh) was reported to have gone for the funeral of a man to pray for his soul. He asked those present at the funeral: “did he leave any wealth?”, they replied “No.” He asked further, “did he die with any debts outstanding?”, they replied “yes, he owed two Dinār” (in some narrations three Dinār). The Prophet (pbuh) was about to leave when he said “then pray on your companion.” Abu Qatādah interceded and said: “I guarantee his debt, Oh Messenger of Allah” and the Prophet (pbuh) then pray on his soul.

In this hadith, Abu Qatadah took role as a guarantor for the debt of the deceased man. Further, in another hadith narrated by Abu Dawud, Al-Tirmidhi and Ibn Hibban, the Prophet (pbuh) was reported to have said: “the guarantor (al-za‘im) is a debtor.”⁶⁵ These two hadiths could establish the practice of guarantee in Islamic Law and set out its legal principles that the guarantor’s responsibility is co-extensive with the principal debtor’s responsibility.

Next, the pertinent other sources of Islamic Law is ijma. It could be defined as a consensus of opinion from Muslim scholars.⁶⁶ Ijma could be viewed as a means to validate the effort of the scholars to find solutions of problems of which Al-Qur’an and Sunna have not prescribed a specific law for it. In this context, the consensus among Muslim jurists confirm the permissibility of the guarantee due to the dire need of such contract. Jurists unanimously agree that the guarantee contract is legal although they have different opinion of the details of its rulings.⁶⁷ Such guarantee is regarded as protection to the debtor and assurance of repayment for the creditor.⁶⁸

Robson, J.: "al-Bukhārī, Muḥammad b. Ismā‘īl." *Encyclopaedia of Islam, Second Edition*. Edited by: P. Bearman, Th. Bianquis, C.E. Bosworth, E. van Donzel, W.P. Heinrichs. Brill Online, 2015. [Reference](#). Queen Mary, University of London. 01 August 2015

<http://referenceworks.brillonline.com/entries/encyclopaedia-of-islam-2/al-bukhari-muhammad-b-ismail-SIM_1510> accessed 1 August 2015

⁶⁴ Zuhayli (n 53), 5.

⁶⁵ *Ibid.*

⁶⁶ Kamali (n 62) 228-263.

⁶⁷ Zuhayli (n 53) 5.

⁶⁸ Abdulqadir Ibrahim Abikan, ‘Contract of Kafalah (Guarantee): A Veritable Product of Islamic Finance?’ (2008) *University of Ilroin Law Journal* 3 and 4 199, 202.

In view of the above, the sources of law for kafala can be found not only in Al-Qur'an and Sunnah but also in ijma.⁶⁹ Following the modern era, the legal sources could be more extensive. It might also contain the works of classical jurist ie the legal rules which can be inferred from classical manuals, fatwa and court decisions in modern practice.⁷⁰

4.1.2 Essential characteristic of kafala

(i) Gratuitous contract

In the early days of Islam, kafala is regarded as a gratuitous contract or a contract that requires no consideration.⁷¹ The guarantee in Islam is developed from the principle of *ta'awun* (mutual assistance). The relevant sources of law for kafala do not explicitly mention about this tenet. However, the justification of this notion of gratuitousness can be inferred from several occurrences reflected in the verses of Al-Qur'an and hadiths.⁷²

According to Nicholas Foster⁷³, this characteristic differentiates the concept of guarantee in Islamic Law with the other legal system. In other words, kafala applies liberality principle. Further, he argues that it results the lack of protection towards the guarantor.⁷⁴ However, his proposition could be challenged because arguably the basic principle of and the circumstances of the guarantee concept in Islamic Law are dissimilar with the modern law of guarantee.

In the contemporary practice, this liberality notion gives rise to the issue of permissibility of charging a fee towards kafala. Due to its gratuitous nature, the imposition of fee for kafala might be considered *riba*. Further discussion about this

⁶⁹ Further about the sources of Islamic Law can be read in Kamali (n 62).

⁷⁰ Rahman (n 47) 64.

⁷¹ *Ibid.*, 54 .

⁷² The details can be read in Rahman (n 47) 54 and 60-62.

⁷³ Two other characters which are similar to other modern legal system are personal nature of kafala and accessory nature of kafala obligation. Foster (n50) 142.

⁷⁴ *Ibid.*

issue will be observed in the section about the contemporaneous application of Islamic guarantee.

(ii) Secondary obligation

The obligation of the guarantee is accessory in nature.⁷⁵ It means that the guarantor obligation emerges because of the obligation of the principal debtor from the underlying contract between himself and the creditor. The guarantee is dependent to its underlying contract. As a result, if the principal obligation is discharged, the guarantor should also be discharged because the guaranteed obligation is not exist any longer.

In the modern economy system, the bank attempts to cater to the need of business people. The opposite concept of the traditional guarantee is introduced ie the independent notion from the underlying contract. This doctrine becomes the challenge of the Muslim jurist and the sharia supervisory board to observe the adaptation of the kafala concept.

(iii) Co-extensiveness

Furthermore, another key tenet of the Islamic guarantee is the notion of co-extensiveness. It means that the liability of the guarantor must not exceed the liability of the principal debtor.⁷⁶ The guarantor should not be liable of any obligation that the principal debtor does not undertake. The guarantor is given the freedom of contract whether to guarantee part or the whole amount of the guarantee.

4.1.3 Validity of kafala

Islamic guarantee is regarded as a non-commutative contract or Aqd Ghair Mu'awadha ('*Tabarru*') in which the donor transfers ownership of property to a party without consideration.⁷⁷ The term of contract (aqd) in the classical Islamic Law also encompasses unilateral declaration, in addition to a mutual agreement such as sales or

⁷⁵ Foster (n 50) 141.

⁷⁶ Foster (n 50) 146.

⁷⁷ Ayub (n 42) 125.

lease.⁷⁸ Kafala is considered an enforceable contract, not a mere declaration although it is gratuitous in nature.⁷⁹

4.1.4 Other Related Issues

(i) Right of the guarantor to seek reimbursement from the principal debtor

The basis for the reimbursement is the obligation of the principal debtor exists and the debt owed by the debtor to the guarantor dues to the debt payment. With regard to the right of reimbursement, if the guarantor offers the guarantee voluntarily, not by the request of the debtor, the guarantor is not entitled for reimbursement. Meanwhile, the guarantor can ask for reimbursement if the demand for guarantee comes from the principal debtor. In addition, such right can only be claimed if the guarantor has paid the debt because the right is established through the lending and ownership transfer.⁸⁰

(ii) Right of the creditor for seeking the claim payment by the guarantor

The standard opinion of the classical jurist of which is applied in modern practices in some Islamic countries is the creditor has the right to choose whether claiming the payment to the principal debtor or the guarantor when default occurs regardless of the condition of the principal debtor.⁸¹ However, according to Maliki opinion, the guarantor should call upon the principal debtor first unless the principal debtor is proven to be insolvent or it is impossible to ask for repayment from the principal.⁸² The creditor should not be given the first call upon the guarantor because the basic purpose of kafala is to ensure repayment for the creditor.⁸³ In the contemporary application of kafala for an uncovered bank guarantee, the Maliki's opinion could be

⁷⁸ *Ibid.*, 104.

⁷⁹ According to the classical works of all madhabs, it is confirmed that the majority of jurist considered gratuitous arrangements as valid contract. Shaikh' Ali al-Khafif, *Ahkamal-Mu'amalatal-Shar'iah*, p.205(n.d.) as cited in Rahman (n 47), 103.

⁸⁰ Zuhayli (n 53) 28.

⁸¹ Rahman (n 47) 165-166.

⁸² 'Abdul Rahman al-jaziri, *Kitab Al-Fiqh 'Ala Madhahib al-Arba'ah*, vol.3, p.239. As cited in Rahman (n 47) 165).

⁸³ Zuhayli (n 53) 26.

used as the justification that the claim should be addressed directly to the guarantor or the bank.⁸⁴

4.2 Contemporary Applications of Islamic Guarantee by Islamic Financial Institutions

In the present economic system, kafalah is widely used. Its aim is not only to guarantee debt but also performance of a particular act. In this context, kafala principle is applied as the basis to issue a bank guarantee in some Islamic banks.⁸⁵ Other banks prefer not use this structure⁸⁶ arguably to accommodate the application of the autonomy principle and due to the ongoing debate about the permissibility of charging a fee to any kafala-based product.

Bank guarantees are issued by Islamic banks for the purpose of among others tender guarantee, performance guarantee, and warranty guarantee. Most of these guarantees arguably deal with huge amount of financing transaction. Kafala cannot be implemented rigorously and might need modification in this regard because the circumstances plausibly are different with the classical theory. The user of bank guarantees are companies instead of an individual. All the parties involved have the knowledge on the transaction they carry out. They usually use this for modern transaction involving great amount of financing such as the construction of infrastructure. In addition, the function of the bank guarantees is not only to secure future obligation but also as an intermediary and cash reassurance to provide certainty, reassurance and confidence in the transaction between the parties involved.

⁸⁴ Fatwa No. 14 Shari'ah Supervisory Board of Faysal Islamic Bank of Sudan in Rahman (n 47), 285-290.

⁸⁵ Bank Islam <<http://www.bankislam.com.my/en/Pages/BankGuarantee-i.aspx?tabs=1>>, Maybank <<http://www.maybank2u.com.my/Islamic/en/business/trade/bank-guarantee-i.page?>>, SME Bank <<http://smebank.com.my/wp-content/uploads/2013/12/PDS-30092013-KFLH-ENG.pdf>>, Exim Bank Malaysia <<http://www.arbift.com/islamic-banking/trade-finance/trade-finance/letter-of-guarantee>>, Al Masraf Islamic Banking <<http://www.arbift.com/islamic-banking/trade-finance/trade-finance/letter-of-guarantee>>, Bank Muamalat <<http://www.bankmuamalat.co.id/layanan/bank-garansi#.VboUfZNViko>>, Bank Mega Syariah <<http://www.megasyariah.co.id/#.funding-content2=product-and-services/financing/bank-garansi>> accessed on 1 August 2015.

⁸⁶ Faisal bank website: <<http://www.faisalbank.com.eg/FIB/english/personal-services/letters-of-guarantee.html>> accessed 1 August 2015.

They use bank guarantees to provide swift payment in the event of default by the applicant.

Considering the above, to what extent kafala could be applied by an Islamic bank to resemble a bank guarantee issued by a conventional bank will be discussed in the subsequent section.

4.2.1 The Application of kafala for issuing bank guarantees

(i) Independent principle

The application of this independent notion towards bank guarantees with kafalah structure could be an issue under certain circumstances if an Islamic bank uses an international standard practice. Kafala is secondary in nature, dependent and co-extensive to the underlying contract, whereas all of the pertinent standard practices are designated for independent guarantees or undertaking.⁸⁷ From the research, the literature on kafala and an Islamic bank guarantee rarely discuss about the application of the independent principle in international practice towards them. It is possibly because the application of such principle depends on the Islamic transaction structure approved by the Sharia supervisory board of each Islamic bank. In addition, the jurists have more concern about the fee imposed for the guarantee issuance due to its relation with the prohibition of riba. However, although the debate on this issue arguably does not take much attention as the debate on such fee,⁸⁸ it is important to understand the realization of this percept. The independent principle is the key characteristic of a bank guarantee which makes its use popular in international practice.

⁸⁷ The key characteristic of a bank guarantee issued under URDG or ISP98 is the independent nature of the guarantee. This precept is what makes this guarantee is used in international trade.

⁸⁸ Mohd Bahroddin Badri and DR. Said Bouhreaou 'Fatwa in Islamic Finance: Charging Fee on Letter of Guarantee – Is It Permissible?' International Shari'ah Research Academy for Islamic Finance (ISRA) and Bloomberg Monthly Bulletin (February 2014) 1.

<<http://ifikr.isra.my/documents/10180/16168/isra-bloomberg-feb-2014-fatwa.pdf>> accessed 30 July 2015.

Independent principle of a bank guarantee from the bank's standpoint is related to the documentary conditions of payment⁸⁹ agreed by the applicant and the beneficiary. The manifestation of this precept is the duty of bank to examine the compliance and the conformity of the documents presented on its face against the terms of conditions of the guarantee.⁹⁰ The bank does not need to assess further about the veracity of the presentation against the underlying contract. The bank will rely on the occurrence of non-performance obligation by receiving the document presented.

Kafala can accommodate this practice so long as there is a strong evidence of default because the right to claim of the creditor arises when the default occurs under the classical theory. The creditor or in this case the beneficiary could submit a written demand submitted accompanied by an undisputed statement of default. In this context, a statement of default from the beneficiary and signed by the applicant, or a proof of default issued by a third party appointed by the applicant and the beneficiary or a court or arbitral decision on the dispute should be acceptable. Nevertheless, a simple demand without any statement of default whether integrated with the demand or not will not satisfy the requirement of kafala because it is unclear whether the default has occurred. A problem could happen in the implementation of the independent precept if the beneficiary fulfills all the conditions of payment but there is an ongoing dispute on the underlying transaction with regard to the non-performing obligation. Consequently, under kafala structure, the bank as the guarantor may not pay the beneficiary's claim until it is evident that the dispute has occurred.

Further, independent notion from the applicant's side affect the right of the bank for reimbursement arising from the mandate or instruction of the applicant. The bank can exercise its right towards the applicant irrespective of any dispute regarding the underlying contract. It is because basically the bank only performs its instruction to pay the claim in favor of the beneficiary provided that all the terms and conditions in the bank guarantee are fulfilled. This interpretation is closely connected to the

⁸⁹ In general, the conditions of payment could be one of the following: (i) a simple written demand without a proof of default, a written demand with a statement of default (ii) from a beneficiary, or (iii) evidenced by third party document or (iv) evidenced by a court or arbitral decision. Bertrams (n 1) 45-46.

⁹⁰ Bertrams (n 1) 83.

examination duty of the bank. Under classical theory of kafala, the guarantor has the duty to ensure that the default is absent from the dispute of the underlying agreement. In the modern context, the bank may only be reimbursed if the bank has paid the claim of the beneficiary and assured about the occurrence of default. How the bank is assured about the default is by examining the strong evidence of default as discussed in the preceding paragraph.

Nevertheless, if Islamic banks do not apply autonomy principle for the issuance of their bank guarantees, they could not compete with the conventional product. It is what makes this product is used in the international trade practice. With the position of various parties in various countries, from commercial side it is quite difficult if any default occurs and the beneficiary cannot be reimbursed promptly. There is no assurance for the beneficiary to receive payment. Dispute between parties in multiple countries could spend much time and money. Even after the dispute has been resolved, the parties may find difficulties in enforcing some of the court or arbitral decision in the real situation.

In light the above, in the modern application of kafala for bank guarantees, the bank and its Sharia supervisory board should consider the application and the implementation of this principle if they intend to apply any international standard practices rules ie ISP98 or URDG758. Kafala concept in bank guarantee is compatible with the autonomy principle only in certain circumstances. The consequence of the application of kafala for a bank guarantee is the bank may not respond to the claim of the beneficiary until the dispute between parties in the underlying contract is resolved. This consequence may undermine the main purpose and benefit of the bank guarantee in international practice. In light of these, Islamic banks may use marsala mursalaha as justification to modify and adapt the kafala structure to resemble this beneficial element of a bank guarantee issued by a conventional bank. Also, they may devise other possible structures of Islamic Law to accommodate this objective. Nevertheless, they should also reckon with maqasid al-sharia in observing the possibilities.

(ii) Sources of fund and fee

The debate among jurists with regard to kafala is not whether the issuance of bank guarantees by Islamic banks is acceptable but about whether charging a fee on

guarantee services is permissible.⁹¹ The issue of fee imposition on such guarantee is closely related to the discussion of *riba* prohibition. The permissibility could be determined by the scheme of guarantee issuance and the interpretation of the source of Islamic Law. What becomes a problem here is the charging of compensation or remuneration in addition to the actual cost incurred by the bank.

The opponents of such imposition argue that *kafala* under the classical theory is a non-profit contract in nature and has an objective to help people in need. No justification from Qur'an and Sunna reveals that it is allowed to charge a fee on *kafala*. Moreover, once the guarantor pays the claim of the creditor, the guarantor becomes a new creditor of the debtor. Under this circumstance, the payment of fee charged earlier over the debt repayment could be deemed as *riba*.⁹² AAOIFI⁹³ and the Organization of Islamic Cooperation (OIC) Islamic Fiqh Academy are the opponents of this view. Imposition of a fee for guarantee is permissible so long as only to cover actual cost incurred such as legal, documentation, administration and stamp duty regardless of the type of bank guarantees. The element of profit could not be justified for any kind of bank guarantee.

On the other hand, the proponents of the imposition have the following arguments to validate their views. Firstly, no prohibition of charging fee on a guarantee can be found in Qur'an and Sunna.⁹⁴ *Kafala* practice appears to be originated from the pre-Islamic tradition⁹⁵ The practice arguably was developed in a limited circle of family, friends and neighbour. The guarantee is usually given for the people in severe financial condition so that it could be considered a help and the guarantor most likely would not ask for a fee or commission for a person under a dire need. This

⁹¹ Bouhreaou (n 88) 1 and John R Presley (ed), *A Directory of Islamic Financial Institutions* (Mackays of Chatham Ltd, USA 1988), 30-31.

⁹² An Islamic legal maxim sums this up as any benefit derived from a loan (*qard jarra manfa'ah*) is considered *riba*. Bouhreaou (n 88) 2.

⁹³ AAOIFI Standard No. 5 Guarantee 7/1/2 .

⁹⁴ Bouhreaou (n 88) 1 and Dr. Mohammed Ibrahim M. Adam, 'Some Aspects of Islamic Banks Dealings with Conventional banks Including Suggestions as to Modes of Cooperation' (13 May 2006) <http://dradamlawoffice.com/pdf/some_aspects.pdf> accessed 31 July 2015.

⁹⁵ Foster (n50), 139 and Adam (n 94) 12.

circumstance is totally different with present day situation. A bank guarantee is required for a commercial transaction in which both creditor and debtor have good financial condition. They use the services for the bank as a reliable intermediary. One of the reasons could be the trust issue between them. Instead of having a guarantee from a high profile individual, the creditor prefers a reputable bank to be the guarantor.⁹⁶ Under these circumstances, the proponents of such imposition find their justification. Secondly, they contend that no *riba* or interest is involved in the transaction. The guarantee is regarded as commitment to satisfy the debtor's obligation if any it defaults, not a loan. Creditor debtor relationship will only occur when the creditor claims the bank guarantee. Therefore, the fee is chargeable as the counter value of the commitment.⁹⁷ It could be inferred also from the previous assertion, the function of bank guarantee in modern era could be inferred as a service offered by the bank to facilitate the need of the commercial parties for a trustworthy intermediary⁹⁸ and secured swift payment in the event of default. Hence a service fee is chargeable in addition to the actual administration fee which might be imposed irrespective of the types of bank guarantee.⁹⁹

In light of the above, the prohibition of charging a fee on a guarantee structure based on *kafala* may hamper the product development of Islamic banks. In reality, such prohibition could cause difficulties for the commercial parties to engage a *sharia* compliant trustworthy party as an intermediary of their transaction which may involve great amount of money and risk. As a result, it is likely that any bank is not willing to issue a bank guarantee for a high risk transaction without any chargeable fee. Moreover, the parties engaging in the issuance of an Islamic bank guarantee in general are companies, particularly big and multinational companies or government institution for an international transaction which need the guarantee for a commercial purpose. As a result, the possibility of the failure of reimbursement by the applicant

⁹⁶ Adam (n 94) 12.

⁹⁷ Bouhreaou (n 88) 2.

⁹⁸ The imposition of the fee is the counter value of bank's reputation and the risk attached to the guarantee. *Ibid.*

⁹⁹ The actual administration fee for bank guarantee can be charged for uncovered, partially covered, covered bank guarantee to compensate the fees incurred by the bank for the issuance of a bank guarantee.

could be very slight as long as the bank make a thorough assesment before extending the facilities to the applicant. In addition, the fee paid by the applicant might be regarded as compensation for a commitment or promise of the bank to provide intermediary service because bank may require collateral whether it is full or partially covered. In case of the uncovered bank guarantee, kafala in modern practice may not be implemented per se with regard to the fee issue to accomodate the needs of the society. In fact, majority of muslim countries have agreed unanimously on the imposition of fee on kafala.¹⁰⁰ Moreover, Malaysia, the Gulf Cooperation Council (GCC), Saudi Arabia, Pakistan, Indonesia, and Turkey have offered the guarantee-based product.¹⁰¹ In spite of this fact, the element of the permitted fee or commission towards a bank guarantee needs further observation and comprehensive examination by the Sharia supervisory board of each Islamic bank.

4.2.2 Alternatives structure: application of wakala principle for issuing a bank guarantee

(i) Independent principle

As previously observed, kafala structure cannot adopt the fully concept of the independent principle due to its secondary nature. Certain event cannot be covered by the structure. Alternatively, Islamic banks can issue bank guarantees by applying the wakala structure to overcome this constraint. Wakala¹⁰² is an Islamic version of agency relationship in standard legal term.

¹⁰⁰ Hussein Kureshi and Mohsin Hayat, *Contracts and deals in Islamic finance : a user's guide to cash flows, balance sheets, and capital structures* (John Wiley & Sons, Singapore 2015), 148.

¹⁰¹ *Ibid.*

¹⁰² Mawil Y. Izzu Dien and P. Bearman, Th. Bianquis, C.E. Bosworth, E. van Donzel, W.P. Heinrichs (ed). "Wakāla." *Encyclopaedia of Islam*, Second Edition. Brill Online, 2015. [Reference](http://referenceworks.brillonline.com/entries/encyclopaedia-of-islam-2/wakala-SIM_7830). Queen Mary, University of London. 03 August 2015 <http://referenceworks.brillonline.com/entries/encyclopaedia-of-islam-2/wakala-SIM_7830> accessed 3 August 2015.

More details about wakala can be read in Wahbah Al-Zuhayli, *Financial Transactions In Islamic Jurisprudence* (Mahmoud A. El-Gamal (ed.) Muhammad S. Eissa (rev) Vol.1, Second Edition, Dar Al-Fikr, Damascus 2003), vol. 1, 627-689 .

The independent principle in the framework of Islamic bank guarantees plausibly can work best where Islamic banks apply the concept of wakala.¹⁰³ Any legal action might be the subject matter of wakala so long as the act is not prohibited by Islamic Law. The ambit of the independent precept which cannot be carried out when applying kafala can be accommodated by wakala. The applicant can authorize bank to pay the claim regardless of the occurrence of any dispute on the underlying contract between the applicant and the beneficiary. Indeed, the applicant may only require a simple written demand from the beneficiary although the bank guarantee functions as a performance guarantee. This later practice could not be implemented according to kafala theory because the certainty of default is questionable without any proof of default.

When applying wakala for issuing an Islamic bank guarantee, the bank only executes the mandate given by the applicant. However, the bank has duty to exercise due care and skill towards the document.¹⁰⁴ The applicant acts as the principal and the bank acts as its agent. The applicant deposits the fund in the bank. Subsequently, the bank is instructed to issue bank guarantee provided that the underlying contract of the bank guarantee does not infringe the principles of Islamic Law. The bank in this structure take roles only as the paying agent because the fund used to pay the beneficiary comes from the cash deposit of the beneficiary instead of the fund from the bank like in the kafala structure. Wakala applies for the fully and partially covered bank guarantee.

In responding the claim from the beneficiary, the bank can liquidate and use the cash deposit of the applicant to pay the beneficiary. The relationship between the bank and

¹⁰³ This paper discusses about the application of the autonomy principle in letter of credit. However, it arguably could also be applied to the bank guarantee because both of them have the same legal nature albeit with different function.

Ahmad Azam Othman and Rosmawani Che Hashim, "Principle of autonomy in letter of credit (LC)-An overview from legal and Shariah perspective." (2013): 403-418. Conference Proceeding of the 4th International Conference on Business and Economic Research (4th ICBER 2013) at Golden Flower Hotel Bandung, Indonesia 04-05 March 2013 , <http://www.internationalconference.com.my/proceeding/icber2013_proceeding/033_150_4thICBER2013_Proceeding_p0403.pdf> accessed 1 July 2015

¹⁰⁴ Ayub (n 42) 348.

the beneficiary appears in the form of guarantee. However, it is substantially the implementation of the instruction of the applicant by the bank based on wakala .

(ii) Sources of fund and fee

With regard to this structure, the fee should not be an issue as in kafala. The guarantee term in a bank guarantee is merely a denomination in wakala structure. Wakala is not a gratuitous contract.

This bank guarantee product is regarded as a fee-based income product offered by the bank. The bank can charge fee in the basis of *ujrah* or al-ujr.¹⁰⁵ *Ujrah* is a financial compensation for using services. The original term emerges from the practice of *Ijarah* which means lexically “to give something on rent”. In this context, the applicant is regarded as the person who hires the services (*musta’jir*) ie wakala services in the form of the issuance of a bank guarantee, while the bank is the service provider (*ajir*).¹⁰⁶

4.2.3 Types of bank guarantee¹⁰⁷

According to its source of fund, the types of bank guarantees which can be issued by Islamic banks are divided into three types as follows.¹⁰⁸ The classification of such types is closely related to the permissibility of charging a fee towards wakala.

¹⁰⁵ Bank Islam Malaysia Berhad (BIMB), *Islamic Banking Practice from the Practitioner’s Perspective* (BIMB: Kuala Lumpur, 1994), 100-101. As cited in Abikan (n 68), 213.

¹⁰⁶ According to the Islamic jurisprudence, the term ‘*ijarah*’ is used for two different situations. Firstly, it means ‘to employ the services of a person on wages given to him as a consideration for his hired services.’ The second meaning is ‘to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him.’ Source: Republished with the kind permission of Sheikh Muhammad Taqi Usmani, ‘*Ijarah-Introduction*’ <<http://www.islamicbanker.com/education/ijarah-introduction>> accessed 1 August 2015. See also Ayub (n 42) 281 and 495.

¹⁰⁷ Bouhreaou (n 88) 2.

¹⁰⁸ The explanation of the types of bank guarantee are elaborated from the type of letter of guarantee in AAOIFI Shari’a Standard No.5 Article 7/1, Bouhreaou (n 88), 2 and Fatwa No. 14 Shari’ah Supervisory Board of Faysal Islamic Bank of Sudan in Rahman (n 47) 285-290.

4.2.3.1. Uncovered bank guarantee

An uncovered bank guarantee is issued without any cover or backup cash deposit from the applicant. Principle of kafala will apply in this instance. The bank will use its own fund first to pay the claim of the beneficiary. Later, the bank will ask for reimbursement to the applicant. For this reason, the issuance of the bank guarantee uses the credit line extended by the bank provided that the applicant fulfills the credit rating required by the bank. Debt is obviously involved in this issuance.

As noted in earlier discussion about fee under kafala principle, Muslim jurists are debating about the permissibility of charging a fee in exchange of a guarantee.¹⁰⁹ In particular, they argue about the permissibility of an Islamic bank to enjoy remuneration in addition to the actual cost incurred to issue a bank guarantee.¹¹⁰ Majority classical Muslim jurists reject any chargeable fee to the guarantee.¹¹¹ Their main reason is the nature of kafala as a benevolent contract.¹¹² This argument is upheld by AAOIFI with an adaptation about the chargeable actual cost expended by the bank. Meanwhile, the proponents of the proposition question about the different handling between remuneration of an uncovered bank guarantee and a partially covered bank guarantee. For them, it is less sensible that a bank can charge a remuneration for partially covered bank guarantee, while the bank cannot do it similarly for uncovered bank guarantee.¹¹³ They view that the remuneration given as the service charge.

Responding to this debate, ISRA in its bulletin offers a proposed solution.¹¹⁴ The researchers submit that the assessment of the permissibility of fee towards uncovered bank guarantee can be seen from the viewpoint of the applicant or the debtor. From

¹⁰⁹ Bouhreaou (n 88),1 and Adam (n 94), 9.

¹¹⁰ Administrative cost for all types of Islamic bank guarantees are permissible. Bouhreaou (n 88) 2, Rahman (n 47) 285-290 and AAOIFI Shari'a Standard No. 5 Article 7/1/2.

¹¹¹ Bouhreaou (n 88) 1

¹¹² *Ibid.*

¹¹³ Adam (n 94) 11.

¹¹⁴ Bouhreaou (n 88) 2-3.

the classical doctrine, it could be inferred plausibly that the main concern is about the prohibition of riba and the protection of the debtor's position. Under these circumstances, they attempt to accommodate the issues by offering two scenarios for an uncovered bank guarantee. Firstly is the imposition of fee for the applicant that indicates no intention and inability to pay the debt to fulfill the obligation in the due date. For this type, the bank is prohibited to charge any fee over and above the amount of the guarantee. Otherwise, it will be accounted as riba¹¹⁵ because debt relationship between the debtor and the bank has been clearly apparent from the outset. Even, the actual cost could not be charged to the guarantee. Second scenario¹¹⁶ is the applicant or the debtor is viewed as having an ability to pay or fulfill the obligation to the beneficiary on time. The bank can charge over the actual cost in this circumstance. However, if in fact the applicant cannot fulfill its obligation on time to the beneficiary, the bank should pay the due amount to the beneficiary. In this fashion, the indebtedness relationship between the bank and the debtor is exist. Accordingly, the bank can only charge the actual cost on the payment date.

The implementation of the proposal above needs bank's comprehensive examination in assessing the capability of the applicant. Arguably, the credit facility to issue uncovered bank guarantees most likely will only be extended to the loyal customers of the bank of which it has a good track record of them in fulfilling their obligations to the bank. Banks which are non-charitable institutions will take a great risk for the first scenario if no collateral for the bank guarantee is provided either partly or fully. They also expose themselves to the risk of the reimbursement failure by the applicant.

4.2.3.2. Covered bank guarantee

A covered bank guarantee means that the applicant has allocated its fund up to the amount of the bank guarantee in the bank. In other words, it is issued against 100%

¹¹⁵ There are some discussions on the interpretation of riba/usury which can be read in various journal article and Islamic Finance books. The understanding of the Muslim jurists on this issue is very significant because arguably this is what mainly differentiate the Islamic and conventional finance products. Riba reflects the unfairness or inequity in the society.

¹¹⁶ The opinion is adapted by Bank al-Bilad and Nazih Hammad in his book ^[1]Qadaya Fiqhiyyah Mu'asirah fi al-Mal wa al-Iqtisad. Bouhreaou (n 88) 3.

cash deposit or liquid assets.¹¹⁷ Therefore, no debt is involved here between the bank and the applicant. The relationship between the applicant and the bank forms the relationship of an agent with his principal under the principle of wakala.¹¹⁸ The bank merely executes the instructions from the applicant.

As observed above, the fee is chargeable on the basis of the wakalah services provided by the bank.¹¹⁹ It means that the bank can charge not only the actual cost incurred for the issuance of the guarantee¹²⁰ but also the service fee deemed as profit.

4.2.3.3. Partially covered bank guarantee

A partially covered bank guarantee is issued with partial cover from the applicant. The applicant only covers certain proportion of the bank guarantee amount with its fund. In this scheme, wakala will be invoked for the covered part. Meanwhile, the remaining amount will be covered by the credit facility extended by the bank and using kafala structure.¹²¹ The bank will allocate its fund to pay a part of the claim presented by the beneficiary if the applicant fails to perform its obligation.

Charging a fee is justified for the covered part under the principle of wakala¹²² However, it can be challenged because part of the structure is kafala. The proponents of the fee imposition towards kafala principle question about the permissibility of chargeable fee for this product compared to the uncovered bank guarantee. Meanwhile, both of them are in the same role as an intermediary.¹²³ The latter function arguably reflects the modern practice of kafala. In addition, the combination

¹¹⁷ Bouhreaou (n 88) 2.

¹¹⁸ *Ibid.*

¹¹⁹ Please see page 27 and n 106.

¹²⁰ Both covered and uncovered bank guarantees can charge administration fee. AAOIFI Shari'a Standard No. 5 Article 7/1.

¹²¹ Bouhreaou (n 88) 2.

¹²² This opinion^[SEP] is adopted by Al-Rajhi Bank Resolution No.29 and^[SEP] some scholars such as Sheikh Ali Ahmad al-Salus. *Ibid.*

¹²³ Adam (n 94),11.

of kafala and wakala in a transaction could be justified and in accordance with AAOIFI Shariah Standard No.23, Article No. 5/2 because this is not an investment contract and the bank as the agent does not guarantee either profit or principal of an investment.¹²⁴

5. Analysis on the application of ISP98 to govern a bank guarantee issued by an Islamic bank

5.1 Islamic bank guarantee and ISP98

From three regulation applied for bank guarantee¹²⁵, URDG758 issued by ICC for demand guarantee has been explicitly declared as consistent with Islamic banking principles.¹²⁶ It is asserted in the articles in ICC website that URDG758 is in compliance with Islamic Law and it can be applied for the issuance of guarantees for Islamic finance.¹²⁷ It has also been confirmed by the regional members of the Task Force of URDG758.¹²⁸ Further, in 2012, it was reported that the the use of URDG758 in the Middle East (Turkey, Jordan, Egypt) increase ranging from 35% to 50%.¹²⁹

In the development of the bank guarantee in international trade, not only URDG but also ISP98 is used to govern both demand guarantees and standby letters of credits. However, from the research, any statement from ICC and research papers about the compability of ISP98 with Islamic finance-related guarantees could not be found.

¹²⁴ Bouhreaou (n 88) 2.

¹²⁵ For the information on other rules please see page 8.

¹²⁶ International Chamber of Commerce, 'ICC Demand Guarantee Rules URDG 758 celebrate two years of rising popularity'(2 July 2012) <<http://www.iccwbo.org/News/Articles/2012/ICC-Demand-Guarantee-Rules-URDG-758-celebrate-two-years-of-rising-popularity/>> accessed 25 July 2015.

¹²⁷ *Ibid.*

¹²⁸ Dr Andrea Hauptmann and Georges Affaki (ed), 'URDG in the world', The URDG Newsletter, an ICC Banking Commission Publication (ICC Task Force on Guarantees, 1 July 2012) <<http://www.iccwbo.org/data/documents/banking/the-urdg-newsletter---1-july-2012,-web-version/>> accessed 25 July 2015.

¹²⁹ *Ibid.*

Given the above, this section will examine whether ISP98 can be used as an alternative rule for Islamic banks to issue bank guarantees. It will be an advantage for such banks if they can apply them. Consequently, they could compete with the other banks and take a role in international trade practice. ISP98 arguably is used by many countries in the world, not only US and US-based banks.

Generally, two key principles of bank guarantees are independent principle and documentary conditions of payment. From the study on the types of bank guarantee, only the covered bank guarantee can accommodate such principle. It is due to the application of wakala structure which arguably is the most flexible structure in Islamic Finance.

Further, such principle may not be able to be invoked for uncovered and partially covered bank guarantees because they use kafala structure. Kafala is secondary obligation in nature¹³⁰ and dependent on the underlying contract. These basic attributes of kafala which distinguishes it with a conventional bank guarantee.

In the preface and Rule 1.06 of ISP98, it is very obvious that the rules are addressed only for the independent undertaking, not for dependent undertaking and accessory guarantee.¹³¹ Their application to the dependent guarantees will cause confusion because the independent notion for independent undertakings is manifested through all the rules in ISP98. As a result, if any user of dependent guarantee use ISP98, they will not gain the optimal benefit from the rules.

In light of the above, the subsequent analysis on ISP98 will be carried out towards the covered bank guarantee¹³². The autonomy principle arguably could work well with this type because wakala structure can be devised flexibly in accord with the need of the applicant. The principal or muwakil (applicant of bank guarantee) and the agent or the wakil (the bank) can agree on the terms and condition of the guarantee including the

¹³⁰ Rahman (n 47) 78.

¹³¹ Preface to ISP98.

¹³² The further explanation of the covered bank guarantee can be seen in Section 4.3.3 (ii).

independence of the undertaking from the underlying contract and documentary requirement of the undertaking. In this fashion, the bank guarantee issued by the Islamic bank can resemble the practice of conventional bank guarantees and could benefit from the independent principle which is the key element of the whole concept of bank guarantee in international trade practice.

In spite of the consistency with the principles of Islamic Law, the use of such covered guarantee has some notable consequences. Initially, the origin of bank guarantee is to replace the function of cash deposit placement (or earnest money) by the exporters or contractor which can be liquidated by the importer or the project owner when a default occurs. However, this method could be viewed as onerous because the applicant has to provide and allocate the funds in advance for a specific project or transaction within particular period of time. Otherwise, they may use this fund for any other purpose. It could affect their liquidity. Therefore, the bank guarantee was created to avoid the disadvantages and preserve the main function of such deposit.¹³³

In covered guarantee structure, the undertaking given by the bank is backed up 100% by the applicant's fund in the form of cash collateral or liquid asset which can be liquidated at any time. In theory, this is similar with the original practice. What makes it difference is the use of the bank as an intermediary to hold the cash deposit. The bank has the function as the trusted third party. The contractors or the exporters as an applicant of bank guarantee must place the cash deposit at the bank before the occurrence of any default. From commercial side, this arrangement could impact on their liquidity position albeit in compliance with Islamic Law. In essence, the bank will not use its own fund when the applicant calls the guarantee. Further, the formality to be complied with Islamic Law can be achieved but the main purpose of the product may not be attained. Bank will withdraw the fund from the applicant's deposit. As a result, there will be no loan arrangement between the bank and the applicant. No restriction of charging a fee to the applicant. The bank and applicant will observe this as an agency relationship which can agree on the separation between the underlying contract and the payment undertaking.

¹³³ Bertrams (n 1) 51.

Such arrangement will be effective for domestic transaction but it may require distinct method for international transaction. In international transaction not only a bank issuer but also an instructing bank are involved. They are most likely located in two different countries. The instructing bank is usually in the same country with the applicant, meanwhile the issuing bank is in the same country with the beneficiary. Another scheme, the issuing bank is in the same country with applicant, meanwhile the bank in the beneficiary's country is only advising the bank guarantee. In theory, following the wakala structure, the applicant's fund should be remitted to the bank which will receive the demand from the beneficiary (the advising bank or the issuing bank) and such fund should be returned if there is no claim until the set period expires. However, this scheme would not be practical for interbank relationship. In practice, banking arrangements between the banks may exist and cover this needs.¹³⁴

5.2 ISP98 from the perspective of Islamic Law

In general, ISP98 rules three important relationships in the issuance of bank guarantee ie the relationship between the applicant and the bank, between the bank and the beneficiary and interbank relationship. The rights and obligations of each party are set out in detail in the rules. This is what distinguishes ISP98 with the other ICC Rules.¹³⁵ Nevertheless, it is arguably also give more benefits to the bank than to the applicant and the beneficiary.¹³⁶

From the approach Islamic Law, any dealing must be carried out fairly and based on social justice. Any arrangement would be acceptable so long as it does not infringe

¹³⁴ Faisal Islamic Bank of Egypt offers two method to issue bank guarantees which are used for international transaction at the request of its correspondent bank ie notification of letter of guarantees (i) with confirmation and (ii) without confirmation. With regard to these schemes, the bank does not require its correspondent bank to transfer the cash cover because of equal treatment rule and the existence of banking arrangement between them.

<http://www.faisalbank.com.eg/FIB/english/personal-services/letters-of-guarantee.html> accessed on 26 July 2015

¹³⁵ Dolan (n 7) 1876.

¹³⁶ Dolan (n 7) 1877.

the objectives of Islamic Law and any other prohibition under Islamic Law mentioned in the earlier discussion. ISP98 will be consistent with Islamic Law to the extent that fairness and justice are manifested in such rules and it does not transgress such prohibition.

5.2.1 The applicant and beneficiary's knowledge about ISP98

The application of ISP98 for a governing rule is voluntary because they are made by a private body, not by a country. For this reason, any party governed by the rules should understand their implementation and implication on their transaction. However, the softcopy of the rules cannot be accessed and downloaded freely from both Institute of International Banking Law & Practice, Inc. (IBLP) & ICC official websites. Any institution or individual who needs them may need to purchase from those institutions. Reproduction of the rules in any forms by any means should obtain written permission of ICC Publishing, or IBLP.¹³⁷ As a consequence, applicant may not receive the copy from the bank, except the bank has the written permission from such institution to disseminate them to its customers. Alternatively, the applicant could purchase it from such institution directly.

From the perspective of Islamic Law, establishment of justice and equity in society is a purpose in any dealing. In this context, the bank issuer, beneficiary and applicant should enjoy the same level of information and knowledge to achieve this objective. For this reason, the bank issuer should ensure that both the applicant and beneficiary has known about the consequence for using ISP98 so that any dispute in the future can be avoided. Subsequently, the peace and security can be maintained.¹³⁸

Bank, of course, has more experiences and more familiar in using ISP98. Meanwhile, it is possible that many of the applicant and beneficiary do not have the copies of ISP98¹³⁹ and not really familiar with the detail of the rules. When agreeing to use

¹³⁷ ISP98 booklet, reprinted in November 2010.

¹³⁸ The establishment of justice and equity in society and the maintenance of peace and security are secondary objectives of Islamic Law according to Muhammad Ayub in Ayub (n 42) 24.

¹³⁹ It is mentioned that from the past experiences, many of applicant and beneficiaries do not have law libraries so that it is most probably they do not have the copy of ISP98. Dolan (n 7) 1878.

ISP98 for the governing rule, they may assume that ISP98 is a collection of standard practice of the industry which is recognized by everyone in general. However, the assumption may not be correct. Some of the provisions may surprise the applicant and the beneficiary. Arguably, such provisions do not give equal treatment to the parties and more favorable to the bank issuer.¹⁴⁰ The following section will study further about such provisions.¹⁴¹

5.2.2 Potential unfair provisions of ISP98

Largely, provisions in ISP98 are operational matters which specify the procedures that banks, applicant and beneficiary should do with regard to the nitty-gritty of the bank guarantee. Some of them do not infringe the concept of Islamic Law but the others may potentially arise some issues. The centre of interest of the analysis is the unfairness treatment among the parties.

(i) Issuer's knowledge of breach

Under Rule 1.06(c)(iv), it is asserted that the issuer's obligation under the bank guarantee does not depend on the issuer's knowledge of the performance or breach of the reimbursement agreement and the underlying contract.¹⁴² It is emphasised by the Official Commentary of ISP98 that the issuer is not in a position to scrutinise or conclude the veracity of the claim against the beneficiary. The issuer's obligation is preserved irrespective of the issuer's knowledge on such performance or breach.¹⁴³ This provision may rise an issue. In one side, this is the implementation of the independent principle that the issuer should pay the beneficiary irrespective of any fraud or illegal action. On the other side, if the fraud or the illegal action is obvious or can easily be proven, the issuer should be able to make any action to preclude the payment, not only shields itself with the autonomy principle. In sum, it seems that this rule may be used by the bank to escape from the responsibility. This does not reflect

¹⁴⁰ Dolan (n 7), 1878

¹⁴¹ More detailed about this can be read in Dolan (n 7). This dissertation elaborates some analysis from it.

¹⁴² Rule 1.06(c)(iv) of ISP98.

¹⁴³ Byrne (n22) 12.

equity between the parties from the point of view of Islamic Law. The beneficiary is afflicted with real threat while the issuer is protected regardless of any occurrence which happens against the underlying contract and the reimbursement agreement.

(ii) Undertaking to honour by issuer and confirmer to beneficiary

Rule 2.01(b) offers the various method of payment for the claim under the bank guarantee.¹⁴⁴ However, with regard to the nature of the function of the bank guarantee, the payment at sight represents the function of the bank guarantee to provide damages for the default. A bank guarantee issued by an Islamic bank needs to reflect social justice for all parties in the dealing. The payment of the claim through mechanism of draft acceptance and deferred payment may delay the fund that should be received by the beneficiary immediately after the issuer honors the claim. Meanwhile, with regard to negotiation, the transaction in this context is not only payment mechanism but also the mechanism to give remedy to the beneficiary so that the negotiation or discounting the payment seems less sensible. The beneficiary suffering from the loss of the non-performing obligations obviously wishes to receive the full amount of the claim immediately to overcome and avoid more losses from the failure.

(iii) Notification of presentation

Pursuant to Rule 3.10, once the bank receives the claim from the beneficiary, the bank does not have any obligation to inform the applicant.¹⁴⁵ This could be based on the independent notion because the bank guarantee is a primary undertaking. An interaction with the applicant with regard to the presentation of the beneficiary should not be required since the demand is documentary in nature. Nothing should be confirmed by the applicant. However, this practice could be regarded as unfair. The notification to the applicant of the receipt and before paying the claim are essential. Since the applicant under the scheme of Islamic Law is the owner of the fund, the applicant should be informed accordingly about its use. Moreover, it also gives opportunity to the applicant to challenge the beneficiary directly if there is any dispute on the underlying contract or fraud allegation.

¹⁴⁴ Rule 2.01 of ISP98 offers three method of payment in addition to sight payment ie by acceptance of a draft, deferred payment, and by negotiation.

¹⁴⁵ Rule 3.10 of ISP98.

(iv) Examination for compliance

Rule 4.01(b) requires the issuer to examine the presentation against the terms and conditions of a bank guarantee and ISP98 rules which are read in the context of standard standby practices.¹⁴⁶ In this matter, the bank issuer may be familiar with the applicable practice but it could be different for the beneficiary. To uphold the fairness between the parties, the beneficiary should be clearly informed on what standard will be used to scrutinise its demand. It will be unjust if the standard standby practice is applied to the parties who are not familiar with.¹⁴⁷ In contrast, pursuant to Rule 1.08(c), it is clear that the issuer is not subject to any law or practice which are not recognized by the issuer. In particular, the issuer is only responsible for the law and practice chosen in the standby and applicable at the place of issuance.¹⁴⁸

(v) Demand

Rule 4.08 requires the beneficiary to submit a written or documentary demand if the bank guarantee text does not mention any particular document to be presented.¹⁴⁹ The beneficiary should be well informed about this provision because it is possible that the beneficiary is not aware of this arrangement. Often, they only take into account the requirement set out in the text. It would be unfair for the beneficiary if the beneficiary does not know the information upfront. The beneficiary may think that only what is stated in the bank guarantee text that should be fulfilled by it.

(vi) Mirror image

With regard to Rule 4.09 (c), the issue is about the instruction in the bank guarantee which requires that the wording of the demand should be “exact” or “identical” with what have been provided in the standby either inside the standby text or in the attached form or exhibit to the standby.¹⁵⁰ It means that the documents should copy

¹⁴⁶ Rule 4.01(b) of ISP98

¹⁴⁷ Dolan (n 7), 1889.

¹⁴⁸ Rule 1.08 of ISP98.

¹⁴⁹ Rule 4.08 of ISP98.

¹⁵⁰ Rule 4.09 (c) of ISP98.

and imitate the specified wording, including typographical errors in spelling, punctuation, spacing and any other writing form including blank lines and spaces. This rule could be used by the issuer to protect and hinder itself from any error or mistake. It could be said that in this matter, the issuer applies the principle of strict compliance instead of substantial compliance. Meanwhile, under Islamic Law, the principle of substantial compliance is upheld to preclude unjust treatment to the parties involved. Moreover, this rule may open the possibility of the bank to reject more demand because of the discrepancy.

(vii) Statement of default

What can be implied from Rules 4.16 and 4.17 are statement of default from the beneficiary is not always required. It could be understood because the purpose of ISP98 is not only for performance guarantee but also the direct standby and financial guarantee.¹⁵¹ Furthermore, for a bank guarantee under Islamic Law, the statement or proof of default is required to align with the main purpose of the guarantee to cover the losses arising from the non-performing obligation. This guarantee is not merely a payment mechanism. The presentation must substantiate that the default has occurred evidenced by the pertinent document. The absence of the proof of default may harm the position of the applicant and open the probability to fraud. Arguably, this notion may be favorable to issuer because the issuer has less responsibility to examine the documents.

(viii) Presentation of discrepant document

Under Rule 5.09, the applicant is given the opportunity to check the documents presented to the issuer after the issuer honours the presentation.¹⁵² However, the applicant could lose its right to object the issuer's honor due to non-complying presentation if the applicant does not provide the notice in a reasonable time. From the issuer's side, this limitation will protect it from uncertainty of objection from the applicant and as the tool for its risk management. However, this could be seen as an inequitable provision if the applicant has not been informed about the limitation of time at the outset of the process.

¹⁵¹ Preface of ISP98 and Rule 1.01(a).

¹⁵² Rule 5.09 of ISP98.

(ix) Refund of reimbursement

Pursuant to Rule 8.03, when a nominated person receive funds for reimbursement in advance before the issuer decide whether it will honor the claim, the nominated person should refund it with interest to the issuer if the issuer dishonors.¹⁵³ This practice clearly violates the prohibition on riba in Islamic Law and is regarded as unjust. In this case, the issuer gains benefits in advancing the reimbursement fund to the nominated person only because of the time period the nominated person hold the fund, not because of the real economy activity the issuer does.

(x) Selling participation

Since the product is a covered bank guarantee, multiple issuer and the practice of syndication may not be an option for the applicant. It would be more practicable for the applicant to transact with only one issuer because the fund is owned by the applicant, not the bank. In addition, the selling of the participation may not be compatible to the principle of Islamic guarantee which is to help debtor and creditor. In conventional transaction, when one of the issuers in syndication sells its participation to other party, the purchaser may take profit from the discounted price of the loan extended to the applicant to pay the beneficiary's demand and the interest charged to such loan. This scheme will be more suitable for conventional practice which involves loan in extending bank guarantee, for the uncovered and partially covered bank guarantees. Accordingly, Rule 10 is not feasible to be applied for the issue of a bank guarantee by an islamic bank.

5.3 The possibility of the use of ISP98

From the above, it could be inferred that not all the rules of ISP98 are compatible with the principles of Islamic Law. They do not manifest the objectives of the Islamic Law which is fairness and social justice. It could be understood because the initial purpose of the drafting only covers the product from conventional financial institutions instead of Islamic institution.¹⁵⁴ Under those circumstances, the spirit of the rules are more

¹⁵³ Rule 8.03 of ISP98. Pursuant to Rules 1.09 and 2.04 of ISP98, a nominated person could be an institution or partnership to advise, receive a presentation, effect a transfer, confirm, pay, etc. In practice, it is manifested in the function of an advising bank (Rule 2.05) and a confirming bank (Rule 1.11.(c)(i)).

¹⁵⁴ The history of the drafting can be read in Dolan (n 7), 1869-1873.

favorable and advantageous to a standby letter of credit issued by conventional finance institution.

More revisions in some parts are required to adjust the rules to the operation of Islamic banking. The issuer must educate the applicant and the beneficiary about the rules applied. This should be done for any private rules to be applied in international trade practice. It is because some users may not be familiar with the details of the rules and not reckon with the technical detail which may harm its position. It would be different with the application of national law in which every citizen of the country is considered aware of the prevailing law and regulation once it is being published. The future drafter of ISP98 revision ICC and IBLP should consider their business interaction with the Islamic countries as the drafter of URDG758 may have already done.

The independent principle from the viewpoint of ISP98 and the general concept of bank guarantee cannot be applied in whole in the transaction involving Islamic bank guarantee although the bank guarantee applies wakala structure as the most flexible structure in Islamic Finance. Further discussion and analysis are required to observe the structure so that not only the bank guarantee is in compliance with Islamic Law in formality but also in substance. The jurists and scholar should find the best structure achieve it so that the product can accommodate the practice on international trade.

6. Conclusion

Some rules in ISP98 are not consistent with the principles of Islamic Law. Unfairness and inequity of the rights and obligations among banks, applicant and beneficiary are potentially infringed by such rules. Moreover, the rule on charge of interest for advance reimbursement fund is also not permissible under Islamic Law. It could be understood because ISP98 is initially prepared for independent undertakings or bank guarantees issued by conventional banks.

In light of the above, some rules may need to be adjusted to be compatible with the principles of Islamic Law. Islamic banks cannot apply the rules as they are. They need to consult with their Sharia supervisory board and seek fatwa about the permissibility of application of ISP98 towards their product. This is important because each Islamic bank may devise the bank guarantee with different structure. They may use other structures permissible under Islamic Law other than kafala and wakala to issue bank guarantee.

Moreover, ICC or any other global Islamic Institution in the future such as AAOIFI should consider issuing international standard practices which can fully accommodate the needs of Muslim countries and parties which are willing to comply with the principles of Islamic Law in performing their commercial transactions.

At last, it is suggested that the further research on the application of independent principle towards the Islamic bank guarantee in various Islamic banks across several Muslim countries to be made. It is significant because this notion lies at the core of the product. It could be a means to look at to what extent the practice of bank guarantee is developed under Islamic Law around the globe, how Muslim jurists and scholars accommodate the commercial needs of Muslim countries but also comply with the principles of Islamic Law.

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