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RETURN ON THE LETTER OF GUARANTEE: ISSUES AND NEW PROPOSALS IN STRUCTURING THE PRODUCT

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ABSTRACT

The paper aims at discussing the issues surrounding earning of return on Letters of Guarantee (LG) issued under *kafālah* by Islamic banks and to propose alternative ways of structuring it by *sharī'ah* compliant Islamic banks. The paper proposes structuring LG as a service contract under *wakālah* or as a reputation-based partnership. Letter of guarantee can be issued as a service contract and the Islamic Bank can charge service fees commensurate with the direct and indirect costs of issuing the cover. The paper further proposed that an Islamic Bank and a client (prospective guaranteed) can set up a reputation-based partnership for an underlining project where the Islamic Bank contributes through the issuance of the LG with profit sharing agreed upon and losses borne proportionate to capital contribution. The paper contributes to Islamic bank practice in the financial intermediation role by providing an instrument for such banks to meet unique needs of their clients with financial solutions fulfilling the dual needs of financial intermediation and *sharī'ah* compliance.

JEL Classification: G21, Z12, E44

Key words: Letter of guarantee, *Mushārakah* (Partnership), *Wakālah* (agency), Earning of a return

1. INTRODUCTION

Islamic finance continues to see significant growth over its 40-year existence with US$ 1.81 trillion in global assets as at 2014 with an annual growth rate of almost 10% over 2013 total. Islamic finance assets are forecasted to reach USD 3.25 trillion by 2020 out of which total banking assets will be USD 2.6 trillion (Thompson Reuters, 2016). This mega trend in Islamic finance is recognized by many stakeholders in the global finance industry and some describe it as shifting from "a very esoteric asset class to one that's more… global" (The Economist, 2014). This shows the acceptability of the Islamic banking model in the world especially in the Middle East, North Africa and Asia.

Islamic Banks (IBs) in playing the role of financial intermediaries are expected to provide various products to support customer financial needs. Many IB patrons are more concerned with the products and services on offer than with the constraint of *sharī'ah*, but Islamic finance has evolved with more sophistication to appeal on both fronts and some customers choose IBs not out of sheer piety but "purely as a value proposition" (The Economist, 2014). Islamic finance contracts help in responding to the IB customer needs. Exchange, Sharing and Contributory contracts with various derivatives and combinations of these contracts are identified as the classes of contracts used by IBs and their clients (Kahf, 2015). Due to the non-static nature of economic phenomenon, IBs are always challenged to come out with new products to meet changing financial needs.

The sophistication and competition in financial markets are increasingly challenging and IBs have to respond by enhancing their ability to exploit the opportunities presented (Iqbal, Ahmad and Khan, 1998). They need not be limited to only the classical modes of Islamic finance contracts which were relevant in those societies many years ago but need to develop new products with the guidance of the classical contracts to meet current realities (Iqbal, Ahmad and Khan, 1998). Coming out with new products that will withstand the bifurcated scrutiny of *sharī'ah* and financial intermediation has never been easy, given that, by its very nature, *sharī'ah* is open to different interpretations and views by various scholars and that Islamic finance products derive their authenticity from *sharī'ah* (ISRA, 2011).

Kafālah contract has been the center of controversy in product innovation in Islamic finance. While the majority of *sharī'ah* scholars are against it as practiced by many IBs (Islamic Fiqh Academy of the OIC (resolution number 12(12/2), 1985) some contemporary scholars permit it (Hammad, 1997). The permissibility or otherwise is not on the product validity itself but the earning of a return in the underlying *kafālah* contract. Significant majority of *sharī'ah* scholars opined that a fee cannot be charged in a contract whose nature is benevolent such as *kafālah*. However, a dissenting institutional view was adopted by The Sharī'ah Advisory Committee of Bank Negara Malaysia arguing that it is difficult at present to get a guarantee free of charge (BNM, n.d.).

To reconcile this dissenting view, the Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI) recommended that the fee charged should be the actual or expected cost of issuing a letter of guarantee (LG) under a *kafālah* contract (AAOIFI, 2000). The question regarding this recommendation is how practically IBs as financial intermediaries will be compensated to take the risk of providing guarantees to their clients. Also, looking at the importance of *kafālah* as a financial tool in the development of the entire gamut of Islamic finance value proposition, there has to be an effort by *sharī'ah* scholars and Islamic finance experts to respond to this important financial tool. Therefore, this paper aims at responding to this issue by undertaking an explorative study of issues surrounding the *kafālah* contract and attempt to find the way forward on LGs from the *sharī'ah* and Islamic finance scholar perspective.

Broadly this research aims at exploring the issues surrounding the LG contract with respect to earning of returns but specifically its aims are:

1. To find out how LG contract is structured in IBs.
2. To study the issue surrounding return on LG under *Kafālah* by IBs.
3. To explore the arguments against and in favor of return on LG by IBs.
4. To propose alternative ways of structuring an LG by IBs that is *Sharī'ah* compliant.

Accordingly in addition to the introduction and conclusion, this paper will have two other sections. Section two discusses the return in Islamic finance and how it applies to LGs, section three looks at the way forward by proposing a new way of structuring an LG by IBs that is more *sharī'ah* complaint.

2. RETURN IN ISLAMIC FINANCE AND ITS APPLICATION TO LG

2.1 CONDITIONS OF EARNING IN ISLAMIC FINANCE

Sharī'ah has put forward a set of criteria for earning. The fundamental justification for earning in Islamic finance is ownership of an asset (Kahf, 2015). Ownership of an asset comes with both risk and return and therefore the only way to earn in *sharī'ah* is to own an asset with inherent bearing of risk of loss as well as profit (Ayub, 2008). When there is an actual increment in a property the owner of the property is entitled to the earnings. It is worth mentioning that taking risk alone does not justify earning in Islamic finance as there are *sharī'ah* qualifying conditions for an earning asset that must be met as well (Kahf, 2015). In other words, owning an asset alone is not enough to justify earnings as certain further conditions must be met according to *sharī'ah* before a return can be deserved. These conditions are: (a) the asset must be able to generate an intrinsic utility or increment by itself, (b) there must be actual increment, (c) the asset must pass a moral test, and (4) the contract related to earning must also pass a similar moral test (Kahf, 2015). These criteria make the monumental difference between earning in Islamic finance and conventional finance.

Islamic economics places much emphasis on socio-economic justice with the belief that all resources in the world belong to Allah and humankind is only acting as trustees as far as properties are concerned (Ayub, 2008). Ownership by man is therefore seen as a trigger for seeking permission from God to use the resources. In the Al-Qur'ān (24:33), it reads "… and give them from *māl* of Allah, which He gave to you." This is why the ownership of a property alone is not enough to earn legitimately in *sharī'ah*. The means of acquiring and generating an increment must be real, moral and up to the *sharī'ah* standards. Accordingly, in as much as one cannot earn without owning an asset one cannot also earn by selling an asset one does not own (Ahmed, 2010). These provisions derive from the principle of realism in Islamic finance.

It is noticed that in the theory of exchange, sale contracts can only be undertaken on specific commodities or rights that can be delivered in reality such as physical goods, property's usufructs and intellectual rights. Selling or earning on what you do not own is unrealistic and amounts to injustice. It is worth mentioning that there is recognized exception to this rule where sale can be effected in the realm of "sale on description," "sale on sample" and "sale with deferred delivery known as *salam* contract." In all these types of sale the ability of delivery 'under normal conditions' must exist at the time of contract. This means that such exceptional contract may be undertaken only on commodities/rights whose existence in the market at the day of delivery is not questionable at arm's length. Furthermore, when sale on description is undertaken, earning from it by reselling the purchased items cannot be legitimized before factually taking delivery. This means while purchase/sale on description is allowed in order to facilitate market interaction earning on description is never accepted.

In summary, to be able to earn in Islamic finance, there must be ownership of an asset with incremental utility. Owning an asset entails an inherent risk, meaning that the asset can reduce or increase, appreciate or decline in value to which the owner is entitled. In other words, entitlement and risk (*al-ghunm* and *al-ghurm*) are inseparable two facets of ownership. When the asset increases in value, then the asset owner is entitled to the increment and the reverse holds. This entitlement is further scrutinized in the context of *sharīʻah* permissibility where certain criteria set by *sharīʻah* will validate or otherwise the return from ownership. Thus you own, bear ownership risk, pass *sharīʻah* earning criteria and then you earn a return legitimately.

2.2 *KAFĀLAH* AND LGS

Kafālah is one of the age-old transactions evolved by man to bridge the gap that may exist in financial dealings as a result of the parties' lack of confidence in one another. Traditionally, the most important objective of a *kafālah* contract is its role in strengthening a debt or potential debt by ensuring that there is a reduction in the default risk of the guaranteed. Every rational creditor is concerned with the assurance from the debtor that debts incurred will be paid when they are due and *kafālah* comes handy in giving this assurance to the creditor. From the angle of the beneficiary it is seen as an instrument of risk mitigation and risk management and if looked from this context it is akin to collateral (Kahf, 2015).

From the side of the guarantor or the IB issuing a *kafālah*, the contract brings to force an added burden or risk for which it has to make enough provision. This is usually met by allocating funds, capital and collateral requisition from clients before the issuance of a *kafālah* (Kahf, 2015). The guaranteed uses *kafālah* as a tool to strengthen its creditworthiness. It is able to attract funding to finance a project hitherto unable to be acquired without the support of the *kafālah*, especially an LG in respect of international trade and execution of contracts. That is why LG is the most widely-used form of *kafālah* in Islamic banking practices in this modern era (Kahf, 2015).

LG is usually issued by a bank for a specific purpose for instance the performance of a task or repayment of a loan and so on (Lee and Detta, 2007). The client of the issuing bank may be a contractor with a company or government entity and the LG then serves the purpose of guaranteeing the contractual financial obligations of the client in respect of the contractual relationship with the government or company (Kahf, 2015). It is clear that whereas LG is usually issued by a bank, a *kafālah* on the other hand can be issued by financial or non-financial institutions because a *kafālah* contract is undertaken in regard of the performance of a certain act, financial or otherwise, failure of which causes a financial liability to fall on the guarantor (Bakar, 2008).

Indeed, LGs have become an essential component of most or all contemporary economic relationships that are of any substantial value. International trade, construction projects, maintenance contracts, goods and material supply contracts all normally require one form or another of LGs. The form an LG takes is indicated by the nature of contractual relationships created between its three parties. An LG can be used to enhance a tender bidding, contract performance, advanced payment, payment for consignment under a contract, loan repayment, and guarantee for payment of contract value in total and so on (Ilie, 2015). The different forms that LG can take are explained in Table 1.

TABLE 1
Forms of LGs Used in IB

Form of LG	Usual Customer	Description/Objective	Coverage
Performance LG	Project contractors	LGs issued in respect of performance of a specific contract. This type of LG is usually required by beneficiaries to guarantee the financial effects of failure to execute a contract according to its conditions and time frame	High collateral, cash margin, often with client's revenue collection
Liability or Maintenance Bond	Contractors	Applies after the completion of a contract. It is issued by the Islamic bank on behalf of the client/contractor to assure the beneficiary that the contractor will assume the responsibility of any malfunction or other required maintenances for a period following contract completion.	Collateral, Cash margins

TABLE 1 (*continued*)

Form of LG	Usual Customer	Description/Objective	Coverage
Tender/Bid Bond	Contractors and Suppliers	This is usually a requirement in responding to an invitation to bid for contracts by government, public and private companies alike. Projects such road construction, construction works, building or provision of goods and services usually require this. The LG of the successful bidder is retained until after signing the contract and then substituted by other kinds of LGs. If the successful bidder fails to sign the contract or submit its requirements, the tender LG may be cashed or exercised by the beneficiary	Collateral, Cash margins
Shipping LG	Importers	This is normally given on the request of a client or an importer to a bank to cover goods to be delivered by a shipping company with the guarantee for the shipping company to deliver the goods in case goods arrive before documents	Collateral, Cash margins
Advance Payment LG	Contractors	This is common in contracts that provide for contractors to receive advance payments to start their work. There is usually a requirement of an LG to cover this advance payment. Advance payments are typically deducted from bills of the contractor overtime and accordingly this kind of LG would have a clause to reduce the guarantee by matching reduced amounts of the advance payments.	Collateral, Cash margins

TABLE 1 (*continued*)

Form of LG	Usual Customer	Description/Objective	Coverage
Customs Bond	Importers	LG issued by a bank to a client for the benefit of customs authority for the anticipated amount of taxes on goods imported/exported by the client. It allows freeing of the goods from customs on condition of delaying the payment of the due taxes for a few months by the importer/exporter. The bank must pay the customs authority at a fixed date without delay if client fails to pay the levied duties.	Collateral
Payment Undertaking LG	Merchants, Creditors	This LG is issued by the bank to guarantee its client as a guarantee of payment owing to the beneficiary on a particular date. It commonly represents the exact amount and maturity of the outstanding payment required by the bank's client to the beneficiary.	Cash margin
Miscellaneous LGs	Students, Litigants, Job, Contractors	Other needs of clients on varied grounds may require a bank to issue an LG. These can take the form of scholarships for students with the bond to serve beneficiaries after graduation, fine payments subject to court clearance, maintenance warranty period after a job is completed, and so on. The text, amount and maturity of such LGs are usually dictated by the beneficiary depending on their objective and banks issue them against appropriate securities or collateral	Collaterals, cash margins

Source: Kahf, 2015.

In practice, the customer requests an IB, for instance, for a guarantee credit line. The bank processes the application and if it is satisfied that the customer is of good credit standing, it will extend letter of guarantee facility to the customer by means of an offer letter (BIMB, 1994).

2.3 RETURN ON LGS

In conventional banking, fees are imposed for the guarantee services provided by banks and in Malaysia some IBs charge fees on the issuance of LGs (Teoh, 2008). This practice has become a contentious issue among *sharīʻah* scholars. This is based on the fact that the *kafālah* contract is considered as a *tabarruʻ* contract by many classical Muslims jurists which should not be used as an earning vehicle.

Both conventional and Islamic banks allocate quite significant resources for funding LGs. For instance, Qatar National Bank (QNB), the biggest bank by assets in Qatar has about 9% of its total credit exposure devoted to LGs in 2015. This is translated to 23% of total off-balance sheet returns and 3% of total interest income (QNB Annual report, 2015). A similar observation is seen with regard to IBs. For the same year, return on LGs constituted 13% of Qatar Islamic Bank's (QIB) fees and commission income and about 4% of distributable profit of the Bank with commensurate exposure of 11% of total credit exposure of the banking book (QIB Annual report, 2015). This shows that LGs serve an important financial objective for clients of both bank types and points out the need to address this issue by creating a more *sharīʻah* compliant instrument to meet IB client needs.

In this subsection we will undertake critical review of the arguments for and against earning return on LGs and in section three we suggest what we believe to be *sharīʻah*-compliant solutions.

2.3.1 ARGUMENTS AGAINST EARNING RETURN ON LGS

Charging fees on LG implies that IBs may profit from the issuance of *kafālah*. Ibn Qudāmah reports in the literature that all the four schools of *fiqh* hold the view that it is unlawful for the guarantor to charge for the issuance of a *kafālah* (Ibn Qudāmah, 1983). They all articulated a number of reasons for reaching this conclusion. Hanafi's reflection is that the central ingredient of the contract is an act of *tabarruʻ* (Ahmad, 2000). Al-Imām Al-Shāfiʻī argued that if a fee is charged by the guarantor on issuing a *kafālah*, then the contract form of *tabarruʻ*

associated with *kafālah* is lost or rather changed into a *mu'āwaḍah* (exchange) contract (Hammad, 1997). It was further argued that this is tantamount to consuming other people's property unjustly if a fee is charged on a *kafālah* looking at the nature of its contract as there is no exchange of goods or services (Mohd Noor and Haron, 2011). This argument is refuted by some scholars who explained that commitment by an IB is equivalent to providing services which entitles the IB to charge a fee (Hammad, 1997). Other jurists have also opined that charging fees for a guarantee will also lead to *gharār* (uncertainty), which is prohibited in Islam (Hammad, 1997). *Kafālah* is classified in the category of contractual guarantee from the angle of the contracts' objective. While it is *tabarru'* at the start of the contract, it turns into *mu'āwaḍah* at the completion stage because there is an involvement of *tabādul al-ḥuqūq* (two way transfer of rights) (Al-Zarqā, 2004).

The Fiqh Academy of the Organization of Islamic Cooperation (OIC), expressly ruled that:

> Firstly, it is not permitted to charge a fee for issuing a letter of guarantee (in which, customarily, the amount and the period of guarantee are considered) whether it is with or without cover. Secondly, the administrative expenses for issuing a letter of guarantee of both kinds are permissible in *Sharī'ah*, provided they do not exceed actual expenses for services of the same kind. In the event a partial or total cover is presented, it is permissible to take into account, when estimate of expenses is determined, the possible effort which may be required to materialize (liquidate) the cover. (Islamic Fiqh Academy of the OIC, 2000).

AAOIFI takes a similar stance to that of the OIC Fiqh Academy; they also stated that it is not permissible to take fee for issuing an LG; only administrative expenses incurred at arm's length in issuing the LG can be claimed from the IB customer.

It is evident that though the prohibition on fees relies on the *ḥadīth* of the Prophet (peace be upon him) the conditions now may be different from those of his time. The difficulty with the guarantee as argued by some is that there is no underlining asset behind the risk the bank is taking and it seems to possess the extreme case of uncertainty without ownership of asset. These arguments mean that, apart from the issue of *kafālah* being a gratuitous contract, the fundamental ingredient of ownership in justifying earning is missing if one looks at the *kafālah's* current structure, no matter the reasons advanced for fee charging. This is because if an IB charges a fee on just issuing a guarantee, what is the object of the transaction as far as ownership is concerned? It is unclear if the commitment taken by the IB regarded as service qualifies to be treated under *Kafālah* to justify earnings. So even though the bank may justify fee charging from the angle of impact on bank capital adequacy as well as the impracticality of issuing LG for free, the structure fails to pass the realism principle of ownership to warrant a legitimate earning.

2.3.2 ARGUMENTS IN FAVOR OF EARNING RETURN ON LGS

It is clear that the *kafālah* in classical *fiqh* is seen as a pure help especially the personal *kafālah*. LGs, as practiced today, are seen as pure business transactions which form part of the tools needed for business execution and come with a cost. Some contemporary *sharī'ah* jurists deemed the LG fee permissible. One such scholar, c Hammad, opined that an LG can take either of the following types of commitments:

1. A commitment by the guarantor to settle the debt but in the end, the debtor settles it himself. The guarantor is entitled to a fee in exchange for the given commitment.
2. A commitment by the guarantor to settle the debt, and the guarantor settles the debt of the debtor but he actually owes the debtor the same amount of debt. Both parties are cleared of their respective obligations. Then an automatic set-off of debt occurs (*muqāṣṣah*). Thus, the guarantor may get a fee for the given commitment.
3. A commitment by the guarantor to settle the debt of the debtor and the guarantor settles that debt but also having debt to the debtor with lesser amount than the debt paid to the creditor. Here, the guarantor is also entitled to a fee for the commitment given when the debtor quickly settles the amount paid by the guarantor to the creditor on the grounds of giving a service for which a return is permissible.
4. A commitment by the guarantor to settle the debt and when the guarantor settles it for the debtor without having debt owed to the debtor; the guarantor is entitled to a fee for this kind of commitment too.
5. A commitment by the guarantor to settle the debt of the debtor; the guarantor is not entitled to a fee for the commitment if the debtor does not quickly settle the amount

paid by the guarantor to his creditor as it became like a loan or a long term loan.

The view of fee permissibility is shared by some *Sharī'ah* Advisory Council members of Bank Negara Malaysia (Syed Alwi, Ibrahim and Sawari, 2014). They came to this position by adducing evidence to support their claims. To start with, one argument is that a *tabarru'* contract is metamorphosed into a *mu'āwaḍah* (exchange) contract insofar as the contracting parties reached an agreement to that effect. According to this view, LG should be treated as an exchange contract not a *tabarru'* because the guarantor expends resources and the guaranteed benefits by making a profit from the business venture. Also, the guarantor is seen to put in an effort and commits funds in the issuance of the LG and thus it is considered a service rendered to the guaranteed. Therefore, these arguments hold that the guarantor is entitled to earn a return from exchanging resources and efforts with the guarantee's business for which the LG was issued (Hammad, 1997). Contrary to the view that *kafālah* contract does not provide any benefit which warrants a charge as in *wadī'ah/wakālah,* Nazih Hammad holds the view that similar to *wadī'ah* and *wakālah*, "there are such benefits derived in *kafālah* as in the other contracts and therefore it can be the subject matter of monetary reward in exchange" and cites jurists' views on the following reasons to justify his position:

1. It is permissible to charge fees in *wadī'ah* for a commitment for safekeeping although there may be no efforts involved in the safekeeping of the items.
2. Maliki school jurists have allowed taking fee for various permissible commitments, although the subject matter is outside the realm of financial transactions but still relevant in this context. A case in point is, a wife may pay fee to her husband for his commitment to not practice polygamy or a husband paying some fee for his wife not to remarry after he passes away. The prohibition here does not bar them from breaching the commitment but they stand to lose the earned fee. This means that it is acceptable to take a fee in exchange for a commitment, i.e. considering commitment as a kind of priceable and exchangeable thing (1984).

Ahmed (1997) refuted the above by stating that, the aforementioned (*wakālah* and *wadī'ah*) can be benevolent contracts but when attached with returns (such as *kafālah* with a fee), are considered to be transformed into a different contract with different legal nature and consequences. For example, *hibah al-thawāb* is not a real *hibah.* The misunderstanding lies in its terminology by calling it *hibah* (because it is actually a *mu'āwaḍah* contract), and it is not regarded as an act of *tabarru'* (donation). Consequently, these conversions will result in lending or giving a loan for a fee which is nothing other than *ribā.*

The impulse of the argument is that once it is determined that the LG issuance is likened to providing services to the client, then charging fee on it will be allowed as it becomes like *wakālah* and *wadī'ah bi ajr*. This is relevant considering the fact that offering an LG to a client may also include setting aside financial resources for it. In other words, it is not a finance transaction but a sale of a capital-cum-effort based service such as *wakālah bi ajr*.

Similarly, compensating the wife not to remarry from a husband or compensating husband not to take a second wife without consent of the first wife is also refuted. The argument is that, in the case of the promises not to remarry or not to take a second wife without the consent of the first wife, the compensation is related to dropping a right (*isqāṭ al-ḥaq*) where the payment by the husband or by the wife is in respect of not breaking the promise. The wife can of course get remarried when the husband passes away and the husband can have a second wife without consent of his first wife. On the other hand, in *kafālah* a commitment is made; this is not like dropping a right (Ahmed, 1997).

Others also argue on the perspective of *maṣlaḥah* (public interest) as a justification for charging fee on LG saying that LG provision is a necessity for societal well-being. According to Al-Zuḥailī (1997), a fee can be charged by a guarantor on issuing an LG based on the public good and necessity. Looking at the importance of LGs in business transactions and the fact that in some cases it is difficult to get a perfect substitute for it in some jurisdictions, it may be appropriate to concur with this position. For instance, in a country where the law requires that a prospective contractor has to provide an LG as part of the bidding process and at the same time the banking regulation provides that the guarantor has to make provision for the LG in respect of working capital, it will be justifiable based on *maṣlaḥah* for the guarantor to charge a fee to enable provision of the service.

Both the OIC Fiqh Academy and the AAOIFI argue that an IB can charge depending on whether it is secured or unsecured. A fee is charged on the basis of *wakālah* (agency) by the

IB when the LG is fully covered by the guaranteed (the client deposits some money in the IB which can be used to settle the debt if the client defaults) because as an agent the IB manages funds for the principal (the client). The fee is therefore in respect of the agency services but not the guarantee (Al-Zuḥailī, 1997). On the other hand, if the LG is unsecured or is only partially covered by the customer, IB will act merely as a guarantor and is thus prohibited from charging fees on the LG itself. In this instance, permissibility of charging fees is related to only the banking costs in respect of the LG issuance. The banking costs here are explained as the out-of-pocket costs relating to LG such as information collection, cost-benefit analyses for the relevant projects, and the costs of collection and payment of relevant amounts (Al-Zuḥailī, 1997). Al-Zuḥailī (1997) was quick to add that an IB cannot charge disproportionate high fees for issuing an LG since the fundamental principle remains that it is under a LG contract which is a gratuitous contract.

3. THE WAY FORWARD

In this section we will discuss how IBs may structure LG contract that will be more acceptable to *sharīʻah* and practically implementable within the context of financial intermediation. The section specifically presents how IBs can provide LG, firstly as a service within the ambit of *wakālah* and secondly through a reputation-based *mushārakah*-cum-*kafālah*. The *sharīʻah* compliance, structure, modalities and risks with regard to structuring this product are discussed.

3.1 THE WAY FORWARD IN HANDLING RETURNS IN LG

The differing positions of *sharīʻah* jurists on the permissibility of returns on LG reflect Islamic Banking practices especially in Malaysia regarding how banks structure this financial instrument. In Malaysia, out of twelve IBs studied, 50% use the percentage of LG cover method issued by the Malaysia Banks Association (ABM), 40% use actual cost method; while 10% use their own calculation based on percentage of exposure for the LG (Syed Alwi, Ibrahim and Sawari, 2014).

In practice, the reasons offered for charging are based on the views of the scholars who agree on the permissibility of charging fees. Some practitioners argue that one of the reasons banks charge fees stems from the fact that *sharīʻah* committees do not consider the contract of LG as a *tabarruʻ* contract. For example, if a customer wants to conduct business and asks the bank to issue an LG for him, there is no element of gratuity involved as this is pure business. They argue that the nature of issuing a guarantee for business purposes differs from that of a loan. As the LG is not a loan, charging a fee is not equivalent to *ribā* (Syed Alwi, Ibrahim and Sawari, 2014). But the product authenticity is not in the name but the reality behind the name. In essence, the LG can be issued but to follow this explanation, it may not be classified as *kafālah*. Another reason practitioners give is the fact that IBs charge fees based on percentage because of the high amount of risk assumed by the bank. And this usually involves more work and prudence. The argument is that the bank undertakes a liability, called a contingent liability when a guarantee is issued and liability implies risk (Syed Alwi, Ibrahim and Sawari, 2014).

There is a specific requirement by many regulators regarding how LGs issued by Islamic banks should be treated with respect to capital adequacy. Islamic Financial Services Board (IFSB) standards and by far Basel 2 require that Islamic banks should make provision of tier 1 capital of 20% on all the risk-weighted liabilities of letters of guarantee issued. This means that the issuance of an LG by an IB has a huge impact on the available capital that the bank holds and can use for profit-making activities. Since it is a profit-making venture, it is understandable that the bank will look at the opportunity cost of issuing the LG. In a case where the bank cannot make returns from the LG issuance, then it will not be motivated to do so. For instance, if a bank issues an LG of USD 1 million, this LG will eat into its capital and issuing five of such will be equal to financing of USD 1 million business of similar risk weight by the bank. This demonstrates that IBs are practically constrained when it comes to LG issuance without earning a return by nature of the risk involved and the current banking system regulatory environment. Given this regulatory constraint coupled with the desire to profit from depositor funds, the IB will prefer to finance a *murābaḥah* business than issue LGs without returns.

No matter how compelling, these justifications for charging LG fees are far from being convincing if you put them strictly to the litmus test of the fundamental principle of earning in Islamic finance. Earning is not prohibited because of the presence of *ribā* or whether it is allowed because of the presence of an exchange contract or whether there is contingent liability impacting on the risk taking of an IB. The cardinal principle in Islamic finance is earning by owning an asset. In this instance, what does the IB own to justify the return on the LG? Arguing from the angle of risk even makes a fee on an LG worse than *ribā*. Why? Because in *ribā* there is a mute asset (debt) as an object of the contract but in an LG there is absolutely nothing owned to make incremental gains.

A few options have been proposed by some scholars on the way forward in dealing with LG with respect to fee charging. When the LG is fully secured through cash, other near liquid properties, real assets or any collateral, it can be under *wakālah* with the bank acting as an agent in managing the funds for the guaranteed under a *wakālah* contract thus allowing the bank to charge agency fee on the transaction as mentioned earlier (Islamic Fiqh Academy of the OIC, 2000). On the other hand, when the LG is partially covered, a *wakālah* contract applies to the covered portion while *kafālah* contract applies to the uncovered part. Thus, an IB can charge fee based on the *wakālah* contract for the covered portion (Kahf, 2015). In a scenario where the LG is completely uncovered by the guaranteed, it is impermissible to charge a fee on the LG since the relationship between guarantor and guaranteed in respect of the indebtedness, should it arise because of the latter's failure, creates a creditor-debtor relationship.

Let us go back to issuing LG under *wakālah* and shed more light on it. Al-Zuḥailī (1997) opined that an IB can charge a fee as an agent only to cover the transaction-related banking cost. He defined the banking cost to include cost related to information gathering, analyzing cost-benefit related to the project in question and the cost with respect to collection and payment for the relevant amount.

Islamic banks provide various services on the basis of *wakālah bi ajr* such as investments and fund management. It may not be out of place to say that if an LG is considered as a "service" which the IB client needs to enable his or her business dealings, then IBs can step in to provide this as a service. In this regard the LG is seen as a tool entrepreneurs require for facilitating business.

The object of an agency contract can be any type of financial contract and dealings that can be performed personally once it does not violate the *sharī'ah*. In bidding for a construction contract for instance, the prospectus may require that a prospective bidder should submit an LG. The securing of the LG is part of the project cost without which the project cannot proceed. There is no substitute for it in some jurisdictions. In this context, the client falls on the IB. The bank carries out its assessment of the project including cost benefit analysis and then charges the client for providing that service. Now, the interest here is the justification of the charge on the LG for this service which will probably be linked with the market rate for this service. It will be useful to reconsider Al-Zuḥailī's definition of banking cost discussed above. He included the need to look at the cost-benefit analyses for issuing the LG on the project in question. This can be done from both the client and bank perspectives. Of course, the client's project analysis will be informed by the kind of project and how it stands to add value to the real economy and other host of considerations without losing sight of the costs the IB incurs in terms of capital allocation for this liability and market study of its prospective client's business.

Service charge here is construed to be the effort expensed in the process leading up to issuance of the LG but not the mechanical process of issuing the LG which has the notion of loan with possibility of *ribā*. The LG is seen as service the client needs in order to carry out the business for which it is issued. With regard to the fees, the amount payable in agency contract should be known, whether in lump sum or as a share of a specific amount of income. It is also allowed to define the remuneration to be known in the future and can also be linked with a benchmark (AAOIFI, 2010).

3.2 STRUCTURING LG THROUGH MUSHĀRAKAH

Another proposal advanced by some scholars on the way forward in structuring *kafālah* which will meet the dual requirement of *sharī'ah* and IBs intermediation role inculcates the principles of *mushārakah* (partnership) (Kahf, 2015).

Looking at the nature of partnership where partners guarantee each other to the extent of their capital contribution in the partnership, there is an idea of *ḍamān* or *kafālah* and this is well established by many scholars within the OIC Fiqh Academy. Also in *sharīkah al-wujūh* (partnership between reputed persons), it is not uncommon to have a partner on the basis of their reputation or good credit standing. The Hanafi and Hanbali Schools professed that a partner may offer *ḍamān* as a contribution to a partnership and qualify as a no capital partner (Kahf, 2015).

The argument advanced is that this type of partnership was used in different times and places which was not objected to and this provides proof that it constitutes a type of business for which partnerships may be established (Al-Zuḥailī, 1997).

Partnership (*sharīkah*) can take the form of co-ownership *(sharīkah al-milk)* or contractual (*sharīkah al-'aqd*) known as *mushārakah*. Unlike contractual partnership where there is shared objective and management, there is no common objective and management in co-ownership partnership. By its nature, when issued on *sharīkah* basis the LG will be taking the form of partnership between the IB and client as contractual partnership.

In a contractual partnership, the contract allows the partners equal rights and obligations whether in a limited or unlimited partnership. With limited partnership (*sharīkah al-'inān*), Ibn Al-Mundhir stated that this form of partnership is where the partners share the capital, as well as profits and losses (Al-Zuḥailī, 1997). Partnership capital can be in cash or in kind as Al-Imām Mālik holds the view that liquidity is not a condition in validating partnership capital (Usmani, 2002).

According to AAOIFI, *sharīkah al-wujūh* is a partnership based on reputation. This stems from the fact that the subject matter of the partnership is a contingent liability linked to creditworthiness (high reputation). This is the obligation of the partners to settle the payment of the amount of debts created through credit purchases, which forms the liability of the partners. Consequently the parties have to agree on the ratio of liability for which each of the partners is responsible when paying such debts when they occur. When the outcome of the business undertaken is a profit, it is shared according to the pre-agreed terms. In a situation where there is a loss, each partner will bear the loss according to the ratio each partner has pledged in proportion on the total liabilities of the business.

It is worthy of note that *sharīkah al-wujūh* does not prevent any of its partners from injecting capital at any stage of their cooperation. Rather, it implies the possibility of injecting capital by any partner in order to fulfil their committed respective obligations. The same applies to the LG *mushārakah,* where both parties may inject capital as needed at any stage of their respective relationship. This is especially the case in LGs issued for bidding, performance, customs duties and many other business situations.

Drawing from the above, an IB and a prospective guaranteed client can set up a partnership arrangement where the IB contributes through the issuance of an LG with profit sharing agreed which will be well negotiated by the parties. With this arrangement, the IB will issue a partnership LG (*kafālah)* with the opportunity to earn returns from the project or contract. Apparently this kind of partnership can only apply to LG issued with regard to profit making businesses/projects and cannot be issued for personal matters such as guaranteeing an already established debt or students' scholarships. In implementing this kind of LG *mushārakah*, a few considerations must be addressed as discussed in the following paragraphs.

One important consideration is the capital contribution toward the LG. The client approaches the IB with the project and of course will have or intend to make some cash call or in-kind capital toward it. For instance, the client may need to clear goods from the port in advance to avoid demurrage and may need an LG in this regard. The capital contributed will be the cash consideration of the goods of the client. The IB will agree to contribute to this partnership an LG of a given amount based on client credit worthiness and the expected custom fees which will be evaluated by the port authorities. The capital contribution by the IB in this partnership will be the LG (measured by its entailed financial commitment) that will be provided toward the project or transaction.

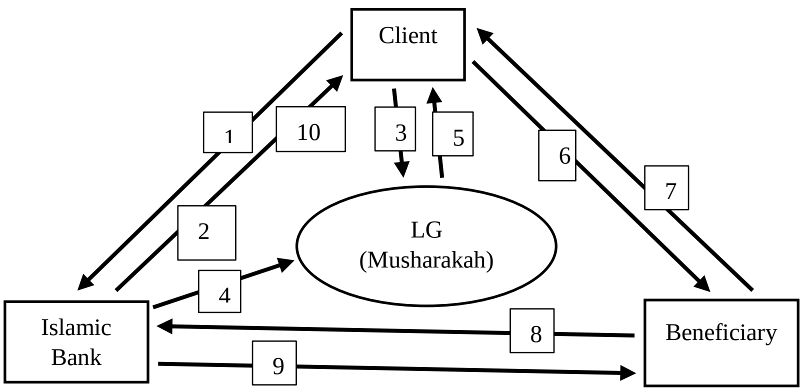
With regard to the ensuing profit, the client and the IB will negotiate the profit sharing formula that will apply when the project yields a profit. For the IB, the profit can be determined with various considerations that will typically drive the rate of return for such projects. The profit can be calculated as a percentage of the total profit but it cannot be a fixed lump amount for either the IB or the client. Also, the contract can put a cap on the maximum profit the IB can make from the project which shall be determined on the basis of prevailing market rate on LGs adjusted by the risk involved in order to achieve realism or balance in the contractual relationship without losing sight of competitiveness. In case the client advances some securities to cover the LG, this can be deducted from the IB contribution at a certain weight before arriving at a final profit. It is important to state that expected profit can be agreed in advance as long it is subject to adjustment once actual profit becomes known.

The risk of the LG can be mitigated by clearly defining cases of failure of the client to fulfil its obligation to the LG beneficiary as most or all of these cases can be described as kinds of negligence and contract violations. Hence the recourse of the bank to the client in case the LG is called for can be assured.

Further, for purposes of clarity it must be mentioned that contribution in LG by the IB does not mean *mushārakah* in all the project's activities and its relationships. It is only in the LG to the extent of what it is for and it being called by the beneficiary in case of client default. This does not mean the IB will not be interested in what the client does. The partnership-based LG as usual has an underlining *wakālah* and it is expected the client conducts the business faithfully and the bank will have at least established this in client profiling prior to creating the partnership.

Figure 1 shows the conceptual framework of the *mushārakah*-based LG. From this figure, it is seen that the client approaches the IB in stage 1 for an LG. The IB then assesses the client in stage 2 and decides whether to go ahead with the request. At stage 3, the IB, when satisfied with the client, will propose a partnership with the client to form a *mushārakah* for the purposes of the client's LG need. The client contributed capital will be determined at this stage. The IB also contributes the LG at stage 4 by agreeing to guarantee the client's performance in the project in question. The client then meets the LG requirement of the project and presents it to the beneficiary in stage 6. The beneficiary then goes ahead to advance dealings with the client at stage 7. If there is a default by the client at stage 8, the beneficiary will notify the IB and the bank will make payment on behalf of the client at stage 9. The bank then, as a result of negligence or contract violation/abuse, pursues collection of the paid amount from the client at stage 10. The LG is terminated on project completion or on recovery of the money paid to the beneficiary.

FIGURE 1
Steps of *Mushārakah* LG



Source: Authors.

3.2.1 MANAGING THE LG *MUSHĀRAKAH*

Just like in any *mushārakah* venture, in an LG issued on reputation-based *mushārakah* each partner is entitled to take part in managing the business. Assuming the IB and the client agrees to form a partnership where the IB issues an LG to help the client purchase goods on credit, the IB has the right to take part in operational management of the business with respect to the qualifying transactions. However, this is not any big issue as the LG contract usually gives right to the bank to interfere in emergency cases to prevent any possible substantial risk. In other words, the partnership agreement (LG issuance) can determine the extent of the IB interference.

A partner is barred from acting against the interest of the partnership or acting in a way that can potentially damage the partnership. For instance a partner cannot unilaterally give out loans from the partnership assets without consent of the other partners. This principle is important in LG issuance as it allows the IB to interfere in case of any moral hazard on the part of the guaranteed client.

Another flexibility of this partnership is the permissibility for the partners to appoint a manager other than any of the partners and pay the person a fixed remuneration to be included in the expenses of the *sharīkah*. This implies that in a situation where the bank does not want to be part of the management of the business or contract for which the LG is issued but is concerned with performance of the business with respect to its engagement, the bank is at liberty to appoint an agent who will represent its interest and is remunerated as such.

3.2.2 GUARANTEES IN A REPUTATION-BASED *MUSHĀRAKAH* LG CONTRACT

All partners in a reputation-based *mushārakah* hold the assets of the partnership as a trust. With this implicit trust, no one may be charged a liability or loss outside their capital contribution except when there is breach of contract, misconduct or proven negligence. Negligence in this context can manifest in the cases of (a) non-abiding of the terms and conditions of the contract (b) a partner working against the established conventions of the concerned business; (c) the proven ill-intention of a partner; and (d) any situation in which a partner neglects doing or undoing an action he is expected to undertake.

Profit or capital of any of the partners cannot be guaranteed by the co-partners. Nonetheless, in order to ensure that other partners' conduct is checked against the aforementioned exceptions, a partner can demand that a co-partner provide any security or pledge to cover the likelihood of misconduct and negligence (AAOIFI, 2010). The rationale for granting permission for a party to a partnership to require a guarantee from a co-party as security against cases of misconduct and the like stems from the fact that this requirement does not go against the rules of partnership. In addition, once it is agreed as part of the partnership agreement then it is legitimate as a contractual condition. Also a third-party guarantee is allowed where an independent third party who has no interest in the business may make a promise to guarantee the business in a situation of adverse business outcomes. This is so because the third-party guarantee here does not affect the validity of the contract of *sharīkah* and this is supported by the Islamic Fiqh Academy of OIC (resolution number 30 (5/4), 1988)

Therefore, where an IB issues an LG for a client through a reputation-based partnership and is concerned with the misconduct of the bank client, as a part of its risk management and prudential practices, it can demand acceptable collateral and securities from the client/partner to cater for the risk of misconduct, breach of contract and negligence.

3.2.3 MATURITY OF REPUTATION-BASED *MUSHĀRAKAH*

Any of the partners in a *mushārakah* contract can withdraw their share from the partnership at will as it is fundamentally a non-binding contract. Notwithstanding this, there can be an agreement between the partners on the time frame of the *sharīkah* agreement especially when an interruption by a partner's exit will have a grievous impact on the business. Traditionally *sharīkah* agreement is terminated in any of the following situations:

1. On achieving the specific goal of forming it, the partnership comes to an end with profit shared as agreed and losses borne in respect of the capital contribution by partners. The loss of the IB shall be determined by the amount it cannot recover from the face value of the LG if it ever is called in by the beneficiary.
2. As stated before, a partner can withdraw from a *mushārakah* contract after giving sufficient notice to the other parties without affecting the continuity of the partnership of the remaining partners. This is subject to bearing liability of any damage caused to other partners by the action of the withdrawing one.
3. The death of a partner may also cause termination of partnership although the heirs if they so wish can replace the departed partner with the consent of the remaining partners.
4. In a situation where any of the partners loses the right of ownership or disposition of an asset linked with the partnership, then the partnership may be terminated.

The nature of the maturity of *sharīkah* contracts has implications on the risk of financing and this will be discussed in the ensuing sections.

The need for early termination of *sharīkah* contracts was not considered in the past by jurists as a result of the typical short life and liquidating nature of joint enterprises that took the form of caravan trade (Ayub, 2008). As a result of this, the classical jurists did not see the need to impose any limitations on withdrawal of partners from the *sharīkah*. Latter jurists in the context of business continuity have opined that in the case of a partnership among more than two persons, the contract remains intact even after withdrawal by any partner (Ayub, 2008).

In modern practice, a shareholder of a limited company is unable to withdraw his capital contribution but can sell his stake to another person who may wish to acquire the shares. This is because the business is seen as a separate entity from the owners and is expected to operate into the foreseeable future. In businesses that require long gestation periods and huge capital outlay, termination of the project in between is considered out of the question. It is also allowed for partners to enter into a binding promise for continuity of the partnership for a specified period.

3.2.4 RISK MANAGEMENT OF REPUTATION-BASED LG *MUSHĀRAKAH*

The risk associated with an LG structured through reputation-based *mushārakah* is extremely relevant as this will affect the level of applicability of this instrument in practice. This is even more important considering that equity-based financing which was the main value proposition of some Islamic finance theorists because of its efficiency in resource allocation has remained sluggish in practice given the inherent risk associated with this kind of contract (Iqbal and Ahmad, 2005). Also, from the economic view, equity-driven financing promotes job creation in the economy as the skilled and unskilled labor would be able to offer their services to those with capital in employment and business creation (Mohd Ariffin, Kassim and Razak, 2015).

As a result of the greater complexities arising from the nature of certain specific risks of the profit and loss sharing concept of *mushārakah*, IBs face greater difficulties in recognizing and handling risks as compared with a conventional banks which only assume credit risk (Sundararajan and Errico, 2002; Van Greuning and Iqbal, 2007).[1] The issue of capital guarantee and termination by a partner have significant implication on the risk assessment of all sharing instruments, although the different risks typically faced by IBs are present in this kind of contract, such as credit risk and operational risk.[2] We will focus on equity risk and return (profit) risk as they are most evidently manifested in a *mushārakah* LG.

3.2.4.1 EQUITY RISK OF *MUSHĀRAKAH*-BASED LG

Equity investment risk is generally defined as the risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, in which the finance provider shares in the business risk.

In *mushārakah* contract, the risk profiles of potential *mushārakah* partners are vital considerations in evaluating the level of risk of an investment to undertake at the due diligence stage. Due diligence is part of IIFS fiduciary responsibilities as an investor of Investment Account Holders (IAHs) funds received on a profit-sharing and loss-bearing basis (*muḍārabah*) or the shareholders' funds received on profit and loss sharing basis (*mushārakah*). The risk profiles include the past record of the management team and quality of the business plan, and human resources involved in the business activity.

Risk mitigation may require the investor to take an active role in monitoring the investment, or the use of specific mitigating structures. When an IB holds the position as *mushārakah* partner there is a risk of a counterparty's failure to meet obligations. Wherever there is a proven negligence or misconduct the committed capital in *mushārakah* contract may be transformed to a loan on the *mushārakah*'s managing partner. But where a genuine loss is established the IB is prohibited from imposing any penalty.

When an IB provides financing on the basis of *mushārakah* or *muḍārabah*, it should involve in identifying, measuring, monitoring, reporting and controlling of various risks facing *mushārakah*-based financing. Adequate capital should be held against various risks assumed. With regard to *mushārakah*, the equity exposure can be measured based on the nature of the underlying investments as follows (Usmani, 2002):

(a) For investments held in the trading book, exposure is equal to the fair value; and

(b) For investments held to maturity, exposure is equal to the historical cost less any provisions for impairment.

With LG, a failure could relate to a delay or non-performance in the underlying contract by the contractor covered by the LG. *Mushārakah*-based LG of course will be classified as an investment held to maturity since the business has to go through and the IB can only exit when the contract is performed by the guaranteed partner. But since the contribution of the IB is only the LG, and it does not contribute any funds besides the guarantee except a nominal amount of say US 20, the potential loss is limited to the capital contribution. In other words, no funds out of the IAH's pool is contributed to this *mushārakah*-based LG. Accordingly, there is no equity investment risk involved in this kind of off-balance sheet *mushārakah* although it is a kind of investment held to maturity.

The major risk of *mushārakah*-based LG is the risk of LG being called by the beneficiary. This is so because in *mushārakah* going back to the partner in an instance of loss is not permitted as it will amount to guaranteeing the capital. When there are losses, the IB has no recourse to the partner for the LG amount. In managing this risk, the IB has to do proper assessment of the application to ascertain client creditworthiness to avoid the adverse selection trap. The bank has to have a mechanism for identifying potential risk in this regard. Post-LG issue, the bank has to ensure that the client risk profile is monitored. Thus, risk evolution of the client should be considered. Monitoring to ensure that the client performs the task or business as presented to the bank is essential in risk mitigation. Normal liquidity risk management is applied to ensure that in the unlikely event of the beneficiary calling the LG, the bank will be able to honor its commitment.

Going beyond payment to the beneficiary, the IB should also put a standardized process for recoverability of the funds paid to the beneficiary. The IB can also apply some mitigation processes to respond to the perceived risk of having the LG called by the beneficiary. Two kinds of mitigation can be applied in the *mushārakah* LG: third party guarantee, and proper, extended and clear definition of negligence, misconduct and contract violation or abuse.

A third party guarantee can be sought from the contractor to cater not only for business negligence or non-performance by the partner/contractor to whom an LG is issued but also for normal business loss and any loss caused to the IB as a result of beneficiary calling the LG. The third party guarantor may or may not have recourse to the debtor and the guarantee can be for a fixed period and for a limited amount that covers the issued LG, as long as the third party guarantor receives no consideration from the IB client or the *mushārakah*-based LG.

The contractor's failure to perform its duties toward the LG beneficiary is often caused by negligence, misconduct, violation and abuse of contract on the part of the guaranteed IB customer. In its attempt to cut corners, the client may act in a way that will compromise the project success on the grounds that it can always compromise with the monitoring authority. Incidences of calling the LG by the beneficiary happens usually when the contractor fails or compromises such as lack of performance with the representatives of the beneficiary. The *mushārakah* contract, on whose basis the LG is issued, has to address performance failure as a potential negligence of transgression on the part of the client in order to minimize the probability of the LG being called. The IB can address this by making the client assume liability of non-performance unless it can prove beyond doubt that this was caused by external factors totally unrelated to the client. With this condition, the IB will shift the burden of proof of non-negligence and non-transgression of contract to the client. This is permissible in the Maliki School. Al-Imām Mālik differentiates between common worker (*ajīr ʻām*) and private worker (*ajīr khāṣ*) and opined that within the remit of non-performance, the potentiality is high for a common worker and therefore such worker should be held responsible for negligence unless proven otherwise. This can be carried to cases in which there is special interest of a party to cut corners, reduce cost to increase own profit at the expense of lower performance and high risk of calling the LG (Hassan, 2013).

3.2.4.2 PROFIT RISK

The nature of Partnership LG is such that an important risk that needs to be considered is profit risk. Though equity-based financing may contribute significantly to IBs' income, the exposure to rate of return risk is very high (Mohd Ariffin, Kassim and Abdul Razak, 2015). To recount, the IB provides an LG with anticipation of a share of profit from the underlining project as its remuneration. A number of factors may affect the LG-related project profitability. Market risk, price risk and ownership risk may all be present. With market risk, let us take for instance that the business in question may be dealing in commodities in an unstable market. The market condition may fluctuate due to unforeseen circumstances which may not be favorable to the business. The price risk is also linked to the market risk and this may be seen when the market conditions changed adversely affecting the projected price estimated by the feasibility study. When this happens, it will affect the business bottom line. The last risk type is ownership risk. With this, the risk is recognized for holding the asset for sale for which the business is involved, for example warehouse stockholding. There is possibility of stock destruction by fire, flood or even theft. This exposes the business to loss of profit.

The risk management framework should be able to measure, control, monitor and mitigate these risks. With respect to ownership risk, the IB could ensure that the stockholding risk for instance is transferred through a *takāful*. Market risk can be mitigated by embarking on thorough project feasibility study and also by being selective by minimizing LG issuance for very volatile businesses. The IB may also decide to enter into LG partnership in business where there is off-taker agreement with prospective buyers or one-sided binding promise by a potential buyer to reduce the price risk.

4. CONCLUSION

To conclude, we aimed at discussing the issues surrounding LG issued with focus on earning of return and to propose alternative ways of *sharīʻah* compliant structuring an LG by IB. We proposed new ways of structuring LG as a service under *wakālah bi ajr* or as a reputation-based partnership.

One of the conclusions is that an LG can be issued as a service and the IB can charge service fees commensurate with all the direct and indirect costs of issuing cover for the client. IB provides the LG for the client in trust.

We further proposed that an IB and a client (prospective guaranteed) can set up a reputation-based partnership for an underlining project where the IB contributes through the issuance of the LG with profit sharing agreed upon and losses borne proportionate to capital contribution. When the IB considers the risks associated with this instrument and carefully incorporates them into the risk management practices and the risk mitigation strategies presented in this paper, it will potentially help address the *sharīʻah* serious issues surrounding the current practice of LG by IBs. Thorough feasibility study of qualifying projects is needed coupled with managing profit risk. Selecting projects with less market volatility, that having off-taker agreements and taking Islamic insurance will help reduce the profit risk and risk of LG being called.

The limitation of *mushārakah* LG is that it cannot be used for all kinds of LGs. While it can fit well for all business related LGs such as performance LG, liability or maintenance bond, customs duties and the like, it does not apply for student scholarship and litigation guarantees. However, the latter kinds of LGs are usually less frequent and *wakālah bi ajr* can still be applied to them.

The paper contributes toward better Islamic banking practices in the financial intermediation environment and provides an opportunity for the IBs to meet the client unique needs with financial solutions that meet the dual requirement of financial intermediation and *sharī'ah* compliance.

ENDNOTES

1. We identify the reasons behind IBs reluctance to finance on the basis of profit and loss sharing contracts as:
   (a) Their inherent riskiness and the banks' low appetite for risk.
   (b) The additional monitoring costs associated with such instruments.
   (c) The lack of transparency in markets in the Islamic bank operating environment.
   (d) The reluctance of the banks' depositors to take risk.

2. Credit risk arises when the IB recourse to the partner in cases of negligence, misconduct and violation of contracts but the latter fails to fulfill or when the profit becomes due but the partner fails to distribute it to the IB.

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