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Service Based Contracts Used in Islamic Finance: A Comparison of Hawalah, Wakalah, and Kafalah

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Abstract

This paper aims to examine the use of service based contracts in Islamic Finance, namely Wakalah, Hawalah and Kafalah. These contracts, though considered secondary to primary contracts such as Musharakah and Mudarabah, are a crucial part of the foundation of Islamic Finance. The differences in each contract will be explained as well as issues on regulations, practices and procedures. Despite the fact that these concepts are widely adopted in Islamic financial products and services, little work has been done in examining the differences and applications in financial institutions. In this paper, the basic principles and rules of service based contracts will be discussed with special reference to their application in modern banking system.

Paper type: Viewpoint

Keywords: Hiwalah, Hawalah, Wakalah, Kafalah, Islamic Finance, Service Based contracts, Islamic Banking, Shariah Compliant Financial Products

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1. Introduction

The fundamental aim of Islamic finance is to fulfil the teaching of Holy Quran and the prohibition of interest (riba) is of particular importance in the Islamic financial system. More specifically, exploitative contracts based on riba or unfair contracts based on risk are prohibited according to Islamic law (Shariah). Instead of giving and relying on financial security that promises a guaranteed return, all parties in a shariah-compliant financial transaction share the profit and the risk of making financial losses (Zaher and Hassan, 2001).

According to Thomson Reuters (2015), the global Islamic funds are conservatively projected to grow by 5.05% per annum for the next five years to reach USD77 billion in value by 2019. This suggests that Islamic finance has so much potential given the right plan and opportunity alongside to conventional banking. Islamic finance has its own strength and unique products suitable to the market, but it is only legit with proper Shariah adherence.

Islamic *Muamalat* can be divided into three main categories, namely, Trading Contracts such as *bay' murabahah*, Contracts of Profit Sharing such as *musharakah* and lastly service based contracts which is what we will discuss in this paper. There are three main types of service based contracts we will discuss in this paper and they are *wakalah, kafalah* and *hawalah.* These concepts are widely adopted in Islamic finance products (Bank Negara Malaysia, 2006).

Service based contracts are one of the least researched areas of Islamic finance despite most Islamic Banks and finance institutions provide these three contracts as part of their services. This paper aims to address the gap in previous research in relation to service based contracts, by looking at the differences between *wakalah*, *kafalah* and *hawalah* and how it is applied in reality, with special reference to Islamic banking transaction. In the next section, we compare and contract these service based contracts regarding their definition, legality, and conditions. This is followed by a presentation of the applications of these service based contracts in financial institutions. The final section sums up the main points and outlines managerial implications for Islamic finance institutions.

2. A comparison between Hawalah, Wakalah, and Kafalah

There are various legally recognised forms of financing contracts in Islam, and Hawalah, wakalah, and kafalah are three most commonly used concepts in modern Islamic banking. To a great extent, hawalah resembles kafalah and wakalah (Saleem, 2012) since these contracts involve transfer of risk and control. The main difference between hawalah and kafalah is that the principal debtor is released from the debt under hawalah contract whereas kafalah is not (Saleem, 2012).

Table 1 gives a comparison of hawalah, wakalah and kafalah which is based on various resources, including academic publications and industry reports published by professional bodies. These three service based contracts compared and contrasted according to three main features: definition, legality and condition from each contract.

Table 1: A comparison between Hawalah, Wakalah, and Kafalah

	Hawalah	**Wakalah**	**Kafalah**
Definition	Hawalah means "change" or "transfer" and usually refers to the transfer of debt from original debtor to the legal personality. Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI) Shariah Standard No. 7 define Hawalah as transfer of a debt liability from the transferor to the payer. The effect of Hawalah is that the creditor can no longer claim debt from original debtor since the claim should be made against the new debtor named in Hawalah contract (Al-Zuhayli, 2003).	Wakalah refers to a contract in which a party (muwakkil) authorizes another party as his agent (wakil) to perform a particular task, in matters that may be delegated, either voluntarily or with imposition of a fee (Bank Negara Malaysia, 2015). AAOIFI (2010) Shariah Standard No. 23 defines Wakalah as "the act of one party delegating the other to act on its behalf on what can be a subject matter of delegation."	Kafalah is an Arabic word for responsibility, amenability or suretyship. It often refers to an act of someone adding himself to another person, and making himself liable to perform the responsibility, together with the person. According to AAOIFI Shariah Standard No. 5, kafalah are guarantees that are intended to secure obligations and protect amount of debts, either from being uncollectible or from being in default (AAIOFI, 2010). Ibn Al-Qudamah defines kafalah as a conjoining of the guarantor's liability to the liability of the guaranteed. Thus, the debt would be established on both of them (Al-Zuhayli, 2003).
Legality	The hadith reported by Al-Bayhaqi, in which the Prophet ﷺ have said: "*Delinquency of rich debtors is a form of transgression, so if one of you has his debt transferred to a rich person, let him accept the transfer of debt*" (Narrated by Ahmad and the author of six books of Hadith as well as Ibn Shaybah and Al-Tabarani in his *'Awsat* on the authority of Abu Hurayrah). Al-Zuhayli (2003) recorded that majority of the jurist view this Hadith that it is preferred to accept the transfer of debt, since it is not an obligation.	The evidence of permissibility is derived from the text in Al-Quran hadith and ijma'. One of the text is "… *so send one of you with this silver coin of yours to the city and let him look to which is the best of food and bring you provision from it* …." (Surah Al-Kahf, verse 19) From the ijma' the jurists agreed that wakalah is permissible and recommended based on ta'awun concept (helping each other)	Kafalah can be seen in the Sunnah of the Prophet Muhammad S.A.W., where Abu Qatadah asked the Prophet to pray for a man to whom he (Abu Qatadah) had been a guarantor for a debt (Al Bukhari, Al-Jami' Al Sahih, 3/94). In more recent times, AAOIFI Shariah Standard No.5 has stated that guarantees are allowed with regards to contracts of exchange and also contracts of property.

Condition	According to Hanafis as reported by Al-Zuhayli (2003), there are five (5) conditions pertaining to the transfer of debt. 1. The language of the contract must be intended for offer and acceptance to transfer debt, and it can be in oral or in written form. 2. The principal debtor must be of eligible person to enter into contract and freely consent to the transfer of debt, meaning no coercion involved because coercion invalidate the transfer. 3. The creditor must have the same criteria of the principal debtor but with additional condition which is issuance of acceptance by creditor in order to signify recognition of the transfer. 4. The transferee must fulfil similar conditions like the creditor just now. 5. The debt must be fungible debt and should be binding. When such debt complied with the two conditions, the debt is eligible to be transferred. There are other opinions with regard to the conditions of Hawalah contract, but the author mainly highlights the opinion from the Hanafis.	There are four (4) conditions pertaining to the basis of wakalah contract. (Bank Negara Malaysia, 2015) 1. The muwakkil shall authorize a specific wakil and notify him of his appointment. 2. The Wakil (Bank) agent (wakil) to perform a particular task, in matters that may be delegated, either voluntarily or with imposition of a fee 3. Subject matter in wakalah contract should be known to agent and it is not permissible to delegate someone to perform unknown thing. 4. Offer and acceptance may be expressed verbally or by appropriate documentation or by any other methods accepted by customary business practice which does not contravene the Shariah principles.	In Kafalah there are four (4) basic rules and conditions the parties must adhere to (Al-Zuhayli, 2003; Badri & Bouheraoua, 2013; Dusuki, 2011). 1. Guarantor who is of sound mind, has legal capacity and willingly give his consent and agreement to the contract. 2. Debtor, he does not need to have legal capacity and can even be a minor, insane person or a bankrupt. 3. Creditor who must be known to all parties. 4. Guaranteed object or asset. This asset must be an actual asset that is possible to collect from the guarantor. It should be an asset that can be legally owned and sold should the debtor fail to fulfil his obligations.

3. Application of Service Based Contracts

3.1. Hawalah

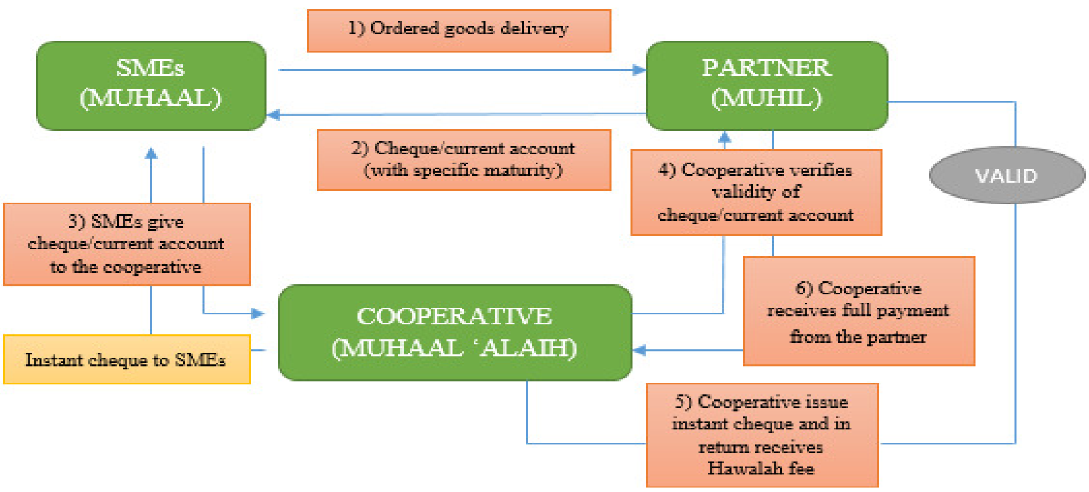
The contract of Hawalah is commonly used in contemporary banking, namely bill of exchange, promissory note, cheque or overdraft (Al Raisi et al., 2016; Kureshi and Hayat, 2014). It refers to transfer of debts from the transferor or the original debtor to the payer (Accounting and Auditing Organization for Islamic Financial Institutions, 2010).

3.1.1. Propindo Islamic Cooperative

One notable example of Hawalah-based financing can be found in Propindo Islamic Cooperative, Indonesia. It can be utilised in the trading sector involving Islamic Financial Institutions (IFI), especially Islamic microfinance institution. Hawalah-based financing has been introduced by Cooperative, an independent Islamic cooperative pioneered by a group of small traders in Jakarta Indonesia (Dewi and Kasri, 2011). In relation to that the Cooperative aim to provide additional working capital for their Small Medium Enterprise (SMEs) members because the SMEs usually receive payment within 1-3 months for the goods' supplied. At the same time, the SME requires sufficient working capital in order to continue productions while waiting for the payment from the partner. This situation creates additional burden for SME in maintaining their business sustainability. Therefore, Hawalah-based financing is provided by the Cooperative to counter the problem.

Basically this mechanism involve three parties: the partner is principal debtor, the Cooperative is the transferee, and SME is the creditor. The scene starts when debt created between the partner (principal debtor) and SME (creditor). Hawalah take place when SME transfer their debt to the cooperative. The cooperative then provides cash, based on the SME receivables values, and later collect the receivables from the partners (SME trading partner). Thus, the cooperative acts as a third party that takes over the SME's receivables and provides 'quick cash' for working capital for the SME. In return, cooperative receives hawalah fee from the SME. A clear illustration of the transaction can be seen in Figure 1.

Figure 1: The transaction flow of Hawalah-based financing



Source: Dewi and Kasri (2011: 11)

The above figure shows transaction flow of Hawalah-based financing works between the three parties involved and the explanation is as follow:

1) SME supply particular goods to the partner.

2) After checking quality and quantity of the ordered goods, the partner issues term payment cheque that can be cashed within a particular period.

3) The SME pass the current account to the Cooperative.

4) SME will then check the originality and validity of the financial instrument issued.

5) The Cooperative issues cheque that can be disbursed and used by the SME as working capital. In return, it receives fee (ujrah) from the service provided based on agreements with the SME.

3.1.2. Shariah issues based on the structure

The Shariah issue that can be identified is that the risk of non-compliance arises as there is lack of clarity in defining and setting percentage of fee proposed in the transaction. While it is allowed to take some fee, strict Shariah position requires this fee to be justified with the real costs to deliver the service (Dewi and Kasri, 2011). It is possible that clients may take advantage of this condition and delaying payments to the banks.

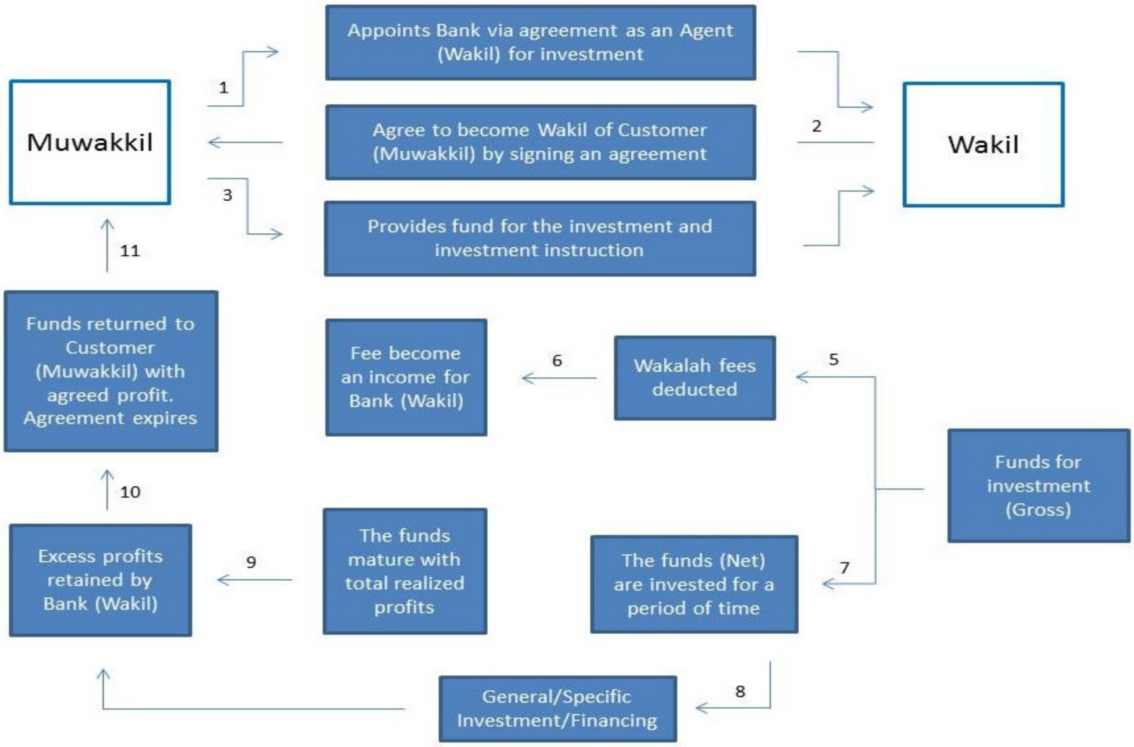
3.2. Wakalah

Wakalah is an agency contract, where the account holder (principal) appoints an Islamic finance institution (agent) to carry out investment activities. Al-Bashir and Al-Amine (2013: 132) claims that wakalah "*allows a much more efficient recycling of short-term liquidity in the Islamic banking system*". Islamic banks and financial institutions offer wakalah contracts in many different forms, including letter of credit (Maldives Islamic Bank, 2011), Islamic monetary certificate (Ismal, 2011), Islamic bonds (Al-Bashir and Al-Amine, 2013; Furqani, 2013), term deposit (Ismail et al., 2016), and Islamic insurance (Nahar, 2015).

3.2.1. The application of Wakalah in Banks

In wakalah contracts, the actual profit is distributed according to the profit ratio agreed upfront (Bank Negara Malaysia, 2015). Bank (Wakil) is able to specify expected return from customers' deposit by investing into selected instrument for an agreed wakil fee. The Wakil will then make the investment to generate a return, which is carried out for and on behalf of the customers (Muwakkil). The Muwakkil specifies the returns expected from the investment, and Wakil is required to source an investment to achieve the expected returns, after deducting the wakil fees. Any profits exceeding the agreed returns will be retained by the Wakil as additional incentive. Like any other investment, in case of default, the Muwakkil shall bear all risks and losses except those risks and losses resulting from the Wakil's misconduct or negligence. The structure of Wakalah deposit is shown in figure 2.

Figure 2: The transaction flow of Wakalah Deposit



Source: Author's own

3.2.2. Shariah issues based on the structure

The mechanism, basically has fulfilled all the conditions agreed by the scholars and has ensured just and Shari`ah compliant transactions. However, there are some issues that need to be highlighted in this contract. The wakalah contract has been criticised for conflict of interest and it may cause accusation (tuhmah) against an agent (Ismail et al., 2016). The issue exists where the agents act against the interests of their principals (Kareshi and Hayat, 2014). This problem is commonly referred to as an agency problem, which occurs when the objectives of the owner do not coincide with the objectives of their agents.

Furthermore, no physical commodity is required under wakalah contract (Al-Bashir and Al-Amine, 2013). This raises the question of whether wakalah is an efficient governance structure in terms of risk and control.

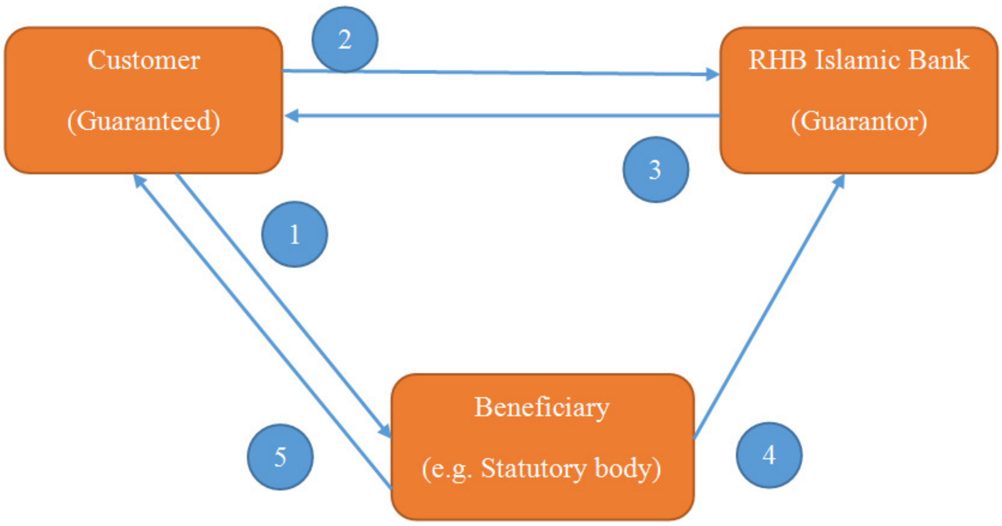
3.3. Kafalah

Kafalah is the guarantee for a loan and all loans must be repaid in due course according to Islamic law. The law allows the lenders to demand some sort of security for the loan in the cases where the borrower fail to repay the loan (Osenim, 2013). As for the Shariah Advisory Council of Bank Negara Malaysia, kalafah is defined as a guaranteed contract on certain asset, usufruct and/or services provided by a guarantor to the parties involved (Bank Negara Malaysia, 2015). In international trade and finance, kafalah plays an important role in facilitating trade across border by which the bank is asked as a guarantor of payment in the international trade transaction. Islamic banks are able to offer bank guarantee, standby letter of credit and shipping guarantee using the concept of kafalah (Bank Negara Malaysia, 2015; Kureshi and Hayat, 2014). Additionally, kafalah can be used to indemnify a third party from financial losses if one party fails to perform its part of the deal. Such application is used in the form of letters of guarantees (Kureshi and Hayat, 2014). In Malaysia, the guarantee facility is not only issued by Islamic banks but also by financial institutions such as Cagamas SRP Berhad and Credit Guarantee Corporation Berhad (Badri and Bouheraoua, 2013).

3.3.1 The use of Kafalah in RHB Islamic Bank

The practice in Malaysia had shown that Kafalah concept is usually practiced by Islamic Banks in trade financing sector in two products which are bank guarantee-i and shipping guarantee-i (Shahimi, Ismail, and Ahmad, 2006). For this segment, we will be focusing on the bank-guarantee-i product from RHB Islamic Bank (RHB Group, 2016). Figure 3 illustrates how Kafalah is undertaken in a letter of guarantee by RHB Islamic Bank.

Figure 3: The Structure Flow of Islamic Bank Guarantee (IBG) from RHB Islamic Bank



Source: Author’s own

1. Customer enters into a contractual agreement with the beneficiary (e.g. a Statutory Body) to fulfill an obligation.
2. Customer approaches RHB Islamic Bank to request the issuance of Islamic Bank Guarantee (IBG) facility.

3. RHB Islamic Bank issues IBG to the customer, as a surety to discharge the liability of beneficiary in case the customer defaults. In return, a sum amount of fee is charged to the customer.

4. In the event of default by the customer, the beneficiary will claim from RHB Islamic Bank. RHB Islamic Bank makes immediate payment on first demand provided the claim meets all the conditions of the guarantee.

5. If there is no default, the beneficiary will return the IBG to the customer followed by RHB Islamic Bank's cancellation upon maturity.

3.3.2 Shariah issues based on the above structure

In bank guarantee-i, the guarantor (RHB Islamic Bank) charges the customer a certain fee. However, this practice remains a matter of debate among Shariah scholars (Badri and Bouheraoua, 2013). This is because some scholars like Hanafi, Shafie, Maliki and Hambali schools did not permit charging fee for a guarantee due to the nature of the contract (benevolent contract) and in the condition the customer defaulted, the relationship between the guarantor and guaranteed party will change into debtor-creditor, thus, charging a fee will lead to riba.

In contrast, some contemporary scholars like Shaykh Ahmad Ali Abdullah from the OIC International Islamic Fiqh Academy permits charging a fee provided that the guarantee is not in the form of a loan (Qard). Besides that, there is no issue on riba as the commitment provided from the guarantor is considered as counter value following the fiqh maxim – al kharaj bi daman (profit comes with liability). The Shariah Advisory Council of Bank Negara Malaysia has allowed charging fee on letter of guarantee based on this basis.

As a resolution, the stand of the Islamic Fiqh Academy of the Organization of Islamic Cooperation (IFA-OIC) and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is that charging a fee for guarantee is only allowed when it involves the actual cost such as legal fees, documentation, administrative costs and stamp duty.

1. The method used by RHB Islamic Bank in determining the actual cost

RHB Islamic Bank used one of the three methods in charging fees on bank guarantee-i which is by calculating the actual cost (Syed Alwi et al., 2014). Although this method is allowed by AAOIFI, one thing to ponder is how the bank calculates its actual cost. There are always risks that the bank imposed unnecessary fees to increase the profit margin.

2. The guarantee that the customer will pay back to the bank

RHB Islamic bank and some other banks accept collateral or pledge or cash deposits from the customer before agreeing to issue the letter of guarantee to secure the bank's risks. Islamic banks are not exposed to any cash outlays unless their customer defaults on the performance of a certain act (Kureshi and Hayat, 2014).

4. Conclusion

In this paper, we have examined the use of service based contracts in Islamic finance, with a special focus in Malaysia. We have undertaken a comparative analysis of the attributes between hawalah, wakalah, and kafalah. Based on our analysis, it can be concluded that the differences between each contract in terms of rules and regulations, operational method and Shariah views are eminent. We have also analysed the use of these service based contracts in practice.

We have addressed gaps in existing literature on service based contracts, yet our interpretations are still subject to certain limitations. The present paper heavily relies on secondary data and thus it would be fruitful to study longitudinal emerging trends in the service based contracts using empirical data, both quantitative and qualitative. Moreover, future research could investigate the use of service based contracts in emerging economy, and examine whether the cultural and national attributes and their economic development have influenced the use of service based contracts.

To conclude, the expansion and development of the Islamic financial system will largely depend on the liberalisation of capital movements and introduction of innovative shariah compliant financial products (Zaher and Hassan, 2001). In relation to that, problems and challenges associated with Islamic instruments and regulation must be resolved to enhance liquidity and interbank markets.

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