Time Value of Money in Islamic Perspective and the Practice in Islamic Banking Implications

Nurrachmi, Rininta and Fathia , Mia and Mad-ahdin, Ashanee and Radenarmad, Ninasrin and Akhtar , Rulia

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TIME VALUE OF MONEY IN ISLAMIC PERSPECTIVE AND THE PRACTICE IN ISLAMIC BANKING IMPLICATIONS

SUBMIT TO

ASSOC. PROF. DR. SALINA HJ KASSIM

PREPARED BY

1. MIA	**FATHIA**	**MATRICS NO. G0827756**
2. ASHANEE	**MAD-AHDIN**	**MATRICS NO. G0915660**
3. NINASRIN	**RADENARMAD**	**MATRICS NO. G0923508**
4. RULIA	**AKHTAR**	**MATRICS NO.G0923876**
5. RININTA	**NURRACHMI**	**MATRICS NO.G1015702**

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ABSTRACT

Time Value of money is a fundamental financial theory and a basic element in the monetary system. This concept serves as the foundation for all other notions in finance. It impacts consumer finance, business finance, and government finance. Basically the Conventional Time value of money results from the concept of interest that prohibited in Islamic principle. Moreover, there are several basic principles that caused the Conventional theory views "Money" and "commodity" differs and compares with the principle as defined by Islam. This leads the time valuation of money in Islamic Perspective is totally different from the conventional. The objective of this study is to discuss the concept of Time Value of Money in Islamic Perspective and its advantages. The paper attempts to analyze the difference between the concept of Time in Islamic and Conventional Perspective. Furthermore, we are going to highlight how Islamic Banks applied the concept of Time Value of Money in Islamic View to their implications in the practice. In addition, this study observed the practical issues and challenges in applying the concept of Time Value of Money in some financial products which are Murabahah, Istisna and Salam.

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND

The time value of money serves as the foundation for all other notions in finance. It impacts consumer finance, business finance, and government finance. However, the Conventional Time value of money results from the concept of interest that prohibited in Islamic principle. There are several basic principles that caused the Conventional theory views “Money” and “commodity” differs and compares with the principle as defined by Islam. Since the Islamic banking and finance practice emerged in the 1960s and 1970s. It came out with a new system which differed from conventional finance interest-based system. In the earlier time of its emergence, Islamic banking and financial system was deemed to be a weird system, since the system offers new view and thought. Actually, the illegitimate of interest-based system in Shari’ah perspective have been ascertained since fifteenth centuries ago. The interest-based system should not arise. The existence of the interest-based system was caused by the west hegemony. But today, after years past by, the Islamic banking and finance system has grown rapidly. It has already been accepted by the public and become a part of the international financial system.

As mentioned before, the interest-based system (riba) was practiced on conventional system. This system has been declared as haram from Shariah point of view (Al Quran: 3: 130). As a replacement, Islamic banking and finance institution introduced several interest-free systems that accommodate the banking and financing needs of the Muslim population. Some of these systems are Murabahah, Mudarabah, Musharakah, Ijarah, Bai’ Al Inah, Al Ijarah Muntahiah Bi Tamlik, Bai’ Bi Thaman Ajil. But, the doubts regarding their Shari’ah compliance are still extant. One of the reasons that bring about these doubts is the practice of Time Value of Money in several interest-free systems on the Islamic banking and finance institution. The Conventional Time value of Money is similar with riba, in term of all deferred exchange transactions. While, the time value of money is not rule out in Islamic legal financial theory and practice, as long as it is not part of lending relationship in which it is claimed as a predetermined value (Ahmad and Hassan, 2004). Therefore, the interest-free systems that applied in Islamic banking and finance institutions have to be reviewed, especially in the part of system having time value of money application on the underlying contracts.

1.2 OBJECTIVE OF THE STUDY

The primary objective of this study is to discuss the concept of Time Value of Money in Islamic Perspective and attempt to highlight how Islamic Banks applied this concept to the practice in their implications. As the secondary aim of this paper, we attempt to achieve this formulated objective:

1. To distinguish the Concept of Time Value of Money between Islamic and Conventional Perspectives

2. To enlighten the advantages of Time Value of Money in Islamic perspective.

3. To observe the issuance of Time Value of Money in Islamic banks and their implication.

1.3 RESEARCH QUESTIONS

This study will specifically attempt to answer the following research question:

1. What is the concept of Time Value of Money in Islamic Perspective?

2. What is the difference between Islamic and Conventional in the concept of Time Value of Money?

3. What are the advantages of Time Value of Money in Islamic Perspective?

4. How do the Islamic Banks apply the concept of Time Value of Money in their implication?

1.4 ORGANIZATION OF STUDY

This study will be divided into four chapters. The structure of the study is as follow: Chapter 1 provides a brief introduction of the study which states about the background of the study, objective of the study, research question and organization of study. Chapter 2 consists of an explanation of Fundamental analysis of Time Value of Money which Comparison between Conventional and Islamic Perspective. Also discuss the Islamic view for Time Value of Money and The Advantages of Time Value of Money in Islamic Perspective. Chapter 3 describes the sample of product in Islamic Banks and investigates the \issues and challenges in choosing products. Chapter 5 represents the conclusion, limitation of study and provides suggestions for future research.

CHAPTER 2

TIME VALUE OF MONEY: CONVENTIONAL VERSUS ISLAMIC PERSPECTIVES

2.1 INTRODUCTION

Riba in deferred exchanges of two similar commodities is dealt within the Qur'an. Qur'an says, "if you repent (from riba) then your capital sums are for you, deal not unjustly, and you shall not be dealt with unjustly" (al-Baqarah, 2:279). Deferred exchanges normally result in credits and loans. The verse indicates that there would be no riba if the creditors retrieve only the principal amount from their debtors. That means, whatever commodity is the subject of deferred exchange that commodity shall be returned in the original amount irrespective of the period of indebtedness and any amount charged above the principal would be riba. Money is treated as a commodity in exchange transactions because gold and silver were money during the advent of Islam.

Therefore, if the debt is in the form of money then the lenders are entitled to receive only the amount lent. Otherwise, riba will take place. It is obvious therefore, that riba in deferred transactions is nothing but a charge for the period of indebtedness. In the economics literature, this charge is also called a time value of money that represents a rental for the use of money for a certain period. That is why interest representing time value of money stands prohibited. This position is confirmed from the verse "if the debtor is in a difficulty then grant him time till it is easy for him to pay" (al-Baqarah, 2:280). Therefore, one must conclude that, according to the Qur'an, time value of money is riba. An analysis of the contemporary Islamic banking practices shows that time value of money is a part of all financing transactions.

2.2 THE DEFNITION OF MONEY FROM CONVENTIONAL AND ISLAMIC PERSPECTIVES

2.2.1 CONVENTIONAL PERSPECTIVE

In order to understand more on Time value of money relationship with riba, it is crucial to develop a basic understanding on money. According to Ikass (2009), the conventional perspective, money can be seen as:

1. Money is a commodity and is used to obtain other goods.

2. Widely Marketable as it is highly in demand and valued good. Thus, it is sure that it can be used anytime and anywhere

3. It can be transport easily. Money is made to make human life easier therefore to make sure that it is convenience is important.

4. Relatively scarce as it is high in demand and high in value, which means it holds a high value in small quantities.

5. Money is relatively imperishable. It is durable and can be use for future purchases.

6. Easy to store

7. Easily divisible

8. Money lasts forever.

9. All units of money are similar, meaning to say that it is easy to distinguish and estimate the value of the money.

2.2.2 ISLAMIC PERSPECTIVE

As for the Islamic perspective, Mohsin (2009) and Meera (2002) found that:

1. Money has no intrinsic value, meaning to say that it cannot be utilized in direct fulfillment of human needs. Money to Islam can only be used to acquire goods or services. It is not a commodity which can e utilized directly without exchanging it for some other things.

2. All units of money of the same denomination are 100 percent equal to each other.

3. In commodity, the transactions of sale and purchase are affected on an identified and specific commodity.

4. Money is a medium of exchange. It is a way to define a value of a thing, but not to itself.

5. Money has standard of value which measures the relative different goods and services

2.3 ISLAMIC VIEW FOR TIME VALUE OF MONEY

2.3.1 THE CONCEPT OF TIME VALUE OF MONEY IN ISLAMIC PERSPECTIVE

Time Value of money is a fundamental financial theory and a basic element in the monetary system. The time valuation of money in Islamic Perspective is totally different from the conventional since Islam defined money that differs from conventional system. Concept of money basically in Islamic perspective is not similar to Conventional. Islam defines money as the medium of exchange and unit of account and not store of value (Ahmad and Hassan, 2004). No function at all that Money performs by itself unless when it is exchanged with asset or to buy services that makes money become useful. Moreover, during the Prophet's time, the main purpose of using money is as a substitution of barter trade system (the exchange between goods) to maintain the economic stability. Furthermore, money has worthless in itself due to money unable to produce by itself and it will be productive only when it is jointed with other resources. From the Shari'ah scholars' view, money is considered as a capital when it combines with other resources to carry out the productive activity like Mudarabah and Musharakah that lenders do not share only profit but also loss. In addition, Islam banned to increase more money by lending out due to it leads to element of interest that prohibited in Islam (Khan, 1991).

According to Imam al-Ghazali in Ihya Ulumiddin, he said that creation of Dirhams and Dinars or money is one of the God's Blessings. The important function of Money is to serve and facilitate the exchange transactions and it is not an objective in itself. Treating money as a commodity like trading money contradicts the Shari'ah principle and brings more harm than benefit to the commodity, i.e. promotes inflation and creates the injustice to the society. Moreover, the consequence of financial transactions as treating money as commodity unable to not linked to real economy. This means that it prevents people from undertaking real economic activities. In addition, when person can create more money via lending by the concept of interest, it easily receives money without taking skills and knowledge. This leads the society is full of greed, speculation and immorality (Saadallah, 1994).

For the concept of time value of money is Islamic perspective, Islam recognized the concept of positive time preference. All consumption and production activities take time and to calculate the time value of money based on the real time that used for the activities as we known as ex post in modern economics. Time is considered as a valuable economic resource that can be explain into two main position (Batcha, 2009)

1. Opportunity cost of postponing current consumption current consumption brings more satisfaction than future consumption. Thus, compensation should be made for utility forgone today

2. Opportunity cost of not being able to invest funds in productive activity. Owner of funds gives up possibility of earning a positive return on funds

Moreover, the concept of positive time preferences is supported by majority of jurists. They agreed that prices for cash sale and credit sale can be varied, for example the view of Grand Mufti of Saudi Arabia has permitted the installment sale wherein the credit price could be higher than the cash price. In Islam view, both time and place have impact on time value of money as we can see from the contract of Salam that support positive time preference: price paid in advance for future delivery of goods is less than cash and carry price. Furthermore, for the borrowing transaction in Islam encourages people to pay their debts well which are Incremental amount purely voluntary as a token of gratitude and Incremental amount denotes Islam's acknowledgement of positive time preference (Ayub, 2004).

Therefore, the idea of Islamic Time Value of Money is providing of funds should be compensated for foregoing current consumption or opportunity to earn a positive return on investments. However, this compensation cannot be contractually predetermined because there is no certainty in any outcome. Nowadays the Application that offered by Islamic Bank has applied this concept, for example, Profit loss sharing concept or Mudarabah transaction that capital provider (Rabb-mal) has to a share of venture's profits because he has given up current consumption or ability to invest funds elsewhere. In short, although the Shari'ah principles do not provide clearly of consideration and ruling of the ideal of time value of money, its concept is positive time preference that based on real sector that is business and trade of goods not in exchange of monetary values and loans or debts and Shari'ah scholars allow any incremental in a loan give to cover the price of a commodity in any sale contract to be paid at the future date (Ahmad and Hassan, 2004).

2.3.2 TIME VALUE OF MONEY AND ITS PERSPECTIVE IN ISLAMIC FINANCE

Study had shown that time has an economic value. This happens when all consumption and production activities take place within a given time. As such, time is known to be a valuable economic resource and a point of reference. For example, a lecturer may earn a minimum of RM300, while other lecturers with the same qualification would earn as much as RM 6, 000. By doing so, the lecturer had chosen to improve his self-worth and wealth. And if he had chosen not to lecture, then he had lost the opportunity to increase his earning (Mohsin, 2009).

Time value of money is an important cornerstone of modern finance as earlier mentioned. In basic terms, it means that money has its own time value. RM 2,000 today is not the same as RM 2,000 after a year (Mohsin, 2009). A rational individual would prefer the former than the latter. The basic fundamental reason behind this are that, first, a cash flow of RM 2,000 now to an individual implies that he can purchase and consumer goods and services worth the amount now, while RM2,000 in a years time would mean that he has to wait until then before he could consume. The sacrifice involved in the postponement of consuming the money requires the individual to be ³compensated´ for ³waiting´(Mohsin, 2009). Arguably, concern on consumption in the ³future´ always hit individuals just as hard as their concern towards current consumption.

Moreover, if an individual consciously saves either for the rainy day or to finance specific needs in the future, such future consumption if often more important than the present consumption. And of course, one must realize that saving for the rainy day occurs only when one has started out on one's current needs (Mohsin, 2009).Another argument put forward which favors the time value of money concept is that it holds greater merit. Furthermore, it asserts that an individual would prefer RM 2,000 now over tomorrow since he would have the alternative to invest this amount now and earn are turn immediately. As for this rate of return, it is known in conventional finance as rate of interest (Rosly, 2005).An Islamic perspective, Time value of money does exist. The return available to the individual saver does not always have to be related to riba-based transaction. As example, the return available on the next best permissible´ investment which is from trade or others would constitutes time value of money in Islamic finance (Mohsin, 2009).

The concept of time value of money in the context of Shari'ah is also established from the fact that Shariah prohibits mutual exchanges of gold, silver or monetary values except when it is done simultaneously. This is because a person can take benefit from the use of a currency which has been received and has not been given counter value from which the other party would benefit from (Ayub, 2007).The fact that Islam forbids riba does not mean that it is against the concept of positive-time preference (PTP). Indeed, Islam does recognize PTP as evident in the statements of the Prophet (pbuh), ³Virtuous are they who pay back their debt as well´ (Rosly, 2005).Within the context of Islamic finance, the Shari'ah prohibits the mutual exchange of gold, silver, or monetary values except when it is done simultaneously and equally (Hassan,2004). The reasoning behind this is that Islam does not allow people to profit from using a currency that they have received before being given its counter-value, whereby a situation of which the other party could take advantage of the other. Furthermore, time valuation is possible only when goods are traded, not when exchanging monetary values and loans or debts (Hassan, 2004).

Thus, in Islam, recognizing PTP does not imply awarding a contractual increase on the principal loan. Any increase from an Islamic financing (qard) can only be stated on maturity and not up front as normally practiced in interest-bearing financing contracts. The increment, which is voluntary, is set by the debtor. In contract, the increment from riba financing is contractual and set by the creditor (Rosly, 2005). On the basis of the above rationale, an overwhelming majority of Islamic economics believe that economic agents in an Islamic economy will have a positive time preference and there will be indicators available in the economy to approximate the rates of their time preferences, generally determined by the preference in an Islamic economy, as made in a number of studies on investment behavior in the Islamic perspective (Ayub, 2007). Having deliberated previously on the TVM, the next section considers what the scholars have said on the concept regarding their agreement or differences.

2.4 FUNDAMENTAL ANALYSIS OF TIME VALUE OF MONEY: COMPARISON BETWEEN CONVENTIONAL AND ISLAMIC PERSPECTIVE

Unlike conventional banking based on interest-bearing loans, funds invested in an Islamic bank are used essentially for trade. There is no room for ambiguity in Islam "every loan that draws a gain is riba."

Many people question whether Islamic finance differs meaningfully from conventional finance. Outwardly, in form, many structures do bear a similarity in various respects. The present day operating environment is a conventional one--, from market structuring and dynamics, to rate benchmarks and circulation of money, to regulatory controls as well. However, the way these two types of finances function with respect to core defining parameters is very different. Many things look the same but are in essence differ in fundamental perspectives.

We begin with basic principles. One is interest-based money lending while the other operates like a trading house. What allows this difference? Two core principles lie at the centre, elimination of Riba and Gharar. Any Islamic transaction needs to assess these two things first. Keeping in mind the definition given in Hadith, one can discuss time value of money and the workings of present day Islamic banks. For this, we would have to look at the differences in ways in which modern capitalist theory views 'money' and 'commodity' from the principles defined by Islam. Different views have been expressed about the conventional time value of money from the point of view Islamic in the following figure

CONVENTIONAL PERSPECTIVES	**ISLAMIC PERSPECTIVES**
Money is a commodity besides medium of exchange and store of value. Therefore, it can be sold at a price higher than its face value and it can also be rented out.	Money is not a commodity though it is used as a medium of exchange and store of value. Therefore, it cannot be sold at a price higher than its face value or rented out
Time value is the basis for charging interest on capital.	Profit on trade of goods or charging on providing service is the basis for earning profit

Time Value of Money in Islamic Perspective and the Practice in Islamic Banking Implications

Interest is charged even in case the organization suffers losses by using bank's funds. Therefore, it is not based on profit and loss sharing.	Islamic bank operates based on profit and loss sharing. In case, the businessperson has suffered losses, the bank will share these losses based on the mode of finance used (Mudharaba, Musharakah).
While disbursing cash finance, running finance or working capital finance, no agreement for exchange of goods & services is made.	The execution of agreements for the exchange of goods & services is necessary, while disbursing funds under Murabaha, Salam &Istisnaa contracts.
Conventional banks use money as a commodity, which leads to inflation.	Islamic banking tends to create link with the real sectors of the economic system by using trade related activities. Since, the money is linked with the real assets therefore it contributes directly in the economic development.

2.5 THE ADVANTAGE OF TIME VALUE OF MONEY IN ISLAMIC PERSPECTIVE

As the concept of time valuation is possible only in business and trade of goods not in exchange of monetary values and loans or debts. Therefore, no time value can be added to the principal of a loan, or a debt after it is created or the liability of the purchaser stipulated. The important conclusion view in Islam is time value of money is acceptable in respect of the pricing of assets and their usufruct, it is not acceptable with regard to any addition to the principal of loans or debts. Valuation of credit period based on value of the goods value of the goods or their usufruct is different from the conventional concepts of 'opportunity cost' or the 'time value' (Ayub, 2004). Thus, the time value of money in Islamic view represents the advantages to the economy and society which are

- **Fulfill the human need directly**

The time valuation of money in Islamic principle differs from the conventional theory as money and commodities have different characteristics, i.e. money has no intrinsic value but it is only a unit of value or medium of exchange so it is unable to fulfill the human needs by itself unless convert to the commodity. Thus, commodity can fulfill human needs directly and can be different quality while money has no differential quality in the sense of the new note of RM 100 is exactly equal in value and quality to an old note of RM 100. Also commodities are transacted or sold by pinpointing the commodity in questions or at least by giving certain specifications. Since a commodity is known to possess an intrinsic value and quality, the owner of such a commodity is allowed to sell it at whatever price the buyer and himself mutually agree on, provided the seller does not commit a fraud but is subjected to the forces of demand and supply. This would hold true even if the price is mutually agreed upon is higher than the prevailing market price (Hassan, 2010). Therefore, the Islamic view that based on the concept of real price of commodity and usufruct can fulfill the need of human due to it is according to the real situation in the practice.

- **Enhance the economic productivity**

Since its concept based on the real sector of the economic activities, it encourages people for working and trading. This leads the improvement and enhances the ability in competition. Moreover, these economics activities increase the level of real productivity of the system and develop the national economy for achieving the high level of economic growth and the standard of living (Meera and Larbani, 2004).

- **The stability of National Economy and society**

Furthermore, it lead the stability to the country's economy because when all economics activities mainly from real sector, it prevents the affect of fluctuation and recession that originates from the greed and speculation. It also reduces the socio-economic problems that happened when applying the conventional time value of money to the system such as the collapse of the system, the default of loan payment, economic crisis and injustice (Meera and Larbani, 2004).

CHAPTER 3

THE SAMPLE OF PRODUCTS IN ISLALMIC BANKS

3.1 INTRODUCTION

This chapter represents the sample of products in Islamic Banks that applied the concept of Time Value of money in Islamic Perspectives. The chapter is divided into two sections. The first section discusses the sample of product in Islamic Banks, while the second section provides the issues and challenges of these products.

3.2 THE SAMPLE OF PRODUCTS IN ISLALMIC BANKS

3.2.1 MURABAHAH FINANCING INSTRUMENT

It originally signified only the price determination method, called a cost-plus-profit or markup sale, in which the seller or trader revealed his or her cost and the two parties negotiated a profit margin to add to the cost as compensation for the trader's work. However, given the recent growth of the modern Islamic finance industry and the desire to create instruments that are parallel with conventional banks' products, Murabahah has evolved to mean both a sale whose price is determined on a cost-plus basis and that is financed on credit, or bay' al-muajjil. Additionally, in modern times, the trader's role as financier has been taken over by banks.

It occurred when a client wants to buy something and the seller also wants to sell it, however he does not have the case sought by the seller. Under this arrangement, the bank also discloses the information on its costs and profit margin to the buyer. But it does not materially affect the actual exchange. Thus, one may as well not insist on these requirements. The payment by the client may be in lump sum or in installments.

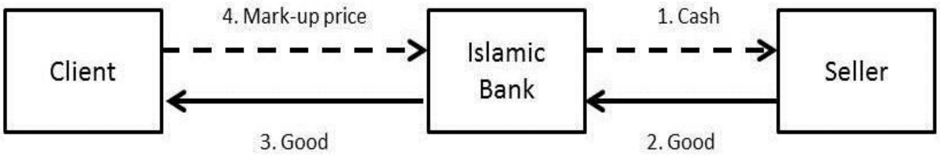

Figure: Murabahah Transaction

Murabahah transaction takes place between three parties: the seller of the product, the client (customer or purchaser of the product), and the Islamic bank as depicted in the above figure. Murabahah works in the following steps:

1. Bank buys the goods that the client want to buy from the supplier and pay cash to the supplier
2. Supplier then deliver the good to the bank
3. Bank may appoint supplier as agent to deliver the good to the client after the bank sell the goods to the client on Murabahah basis which is cost plus profit on deferred basis.
4. The client will pay the bank the mark-up price that they have agreed before within the pre-agreed period

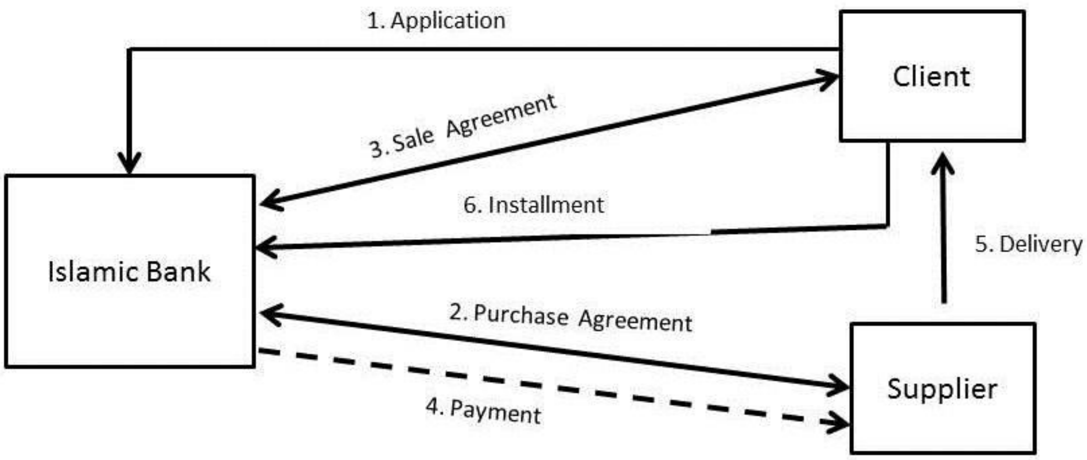

Figure: Working of Transaction of Murabahah

The figure shows the working transaction in Murabahan. The step will be explain as follows :

1. The client make an application to the Islamic Bank
2. There is a purchase agreement between the supplier and the Islamic Bank.
3. There is a sale agreement between the client and the Islamic Bank
4. Islamic Bank make a payment to the supplier
5. Supplier make a delivery to the client
6. The client pay the installment to the Islamic Bank

Murabahah also has several conditions. First, a Murabahah contract has to be based on the sale of an asset and cannot be used to finance other expenses such as the payment of wages or accounts payable. Additionally, in the case of default by the consumer, the Islamic bank only has a right to the product, and no additional mark-up or penalty may be charged. The Islamic Bank may, however, ask for collateral in the case of default by the consumer. Lastly, the markup rate that is charged by the Islamic bank is determined by the type of product financed, type of collateral, creditworthiness of the consumer, and the length of time for payment deferral.

Suppose Yusuf wants to buy a computer from Ruqayyah's Electronics. He chooses a computer and asks for a price quote. Ruqayyah's Electronics quotes the price of the computer at $1500. Yusuf then contacts Bank A and promises to buy the computer from the bank, with an agreed-upon markup, if the bank first purchases the computer from Ruqayyah's Electronics. Bank A agrees and purchases the computer from Ruqayyah's Electronics, paying the full $1500. Bank A sends Yusuf as its agent to Ruqayyah's Electronics to pick up the computer. Bank A and Yusuf then enter into Murabahah contract. Bank A indicates the cost of the product to Yusuf as $1500. The two then negotiate a 5 percent mark-up for the services provided, arriving at a total cost of $1575. Yusuf agrees to pay Bank A in installments, paying $175 per month for 9 months.

3.2.2 SALAM FINANCING INSTRUMENT

Bai' Salam involves advance payment to a party for delivery of a thing in future. It applies to the case in which things come into the possession of the seller due to his being their producer or towards discharging his occupational functions, for instance a wholesaler acquiring goods from a manufacturer and supplying them to the retailers. Other than helping farmers who need money to grow their crops and to feed their family up to the time of harvest, the purpose of Salam is to aid the traders for import and export business.

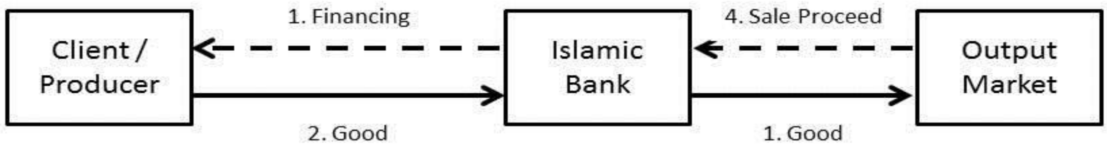

Figure : Salam Transaction

In Salam transaction there are there parties involved, Output market, Islamic Bank and Client / Producer. The above figure will be explained as follows:

1. Islamic Bank will give financing to producer to cover his expenses and enter Salam contract with the promise to get the good later
2. Producer will deliver the goods to Islamic Bank
3. Islamic Bank will deliver and sell goods at output market
4. Islamic Bank will then get the sale proceed

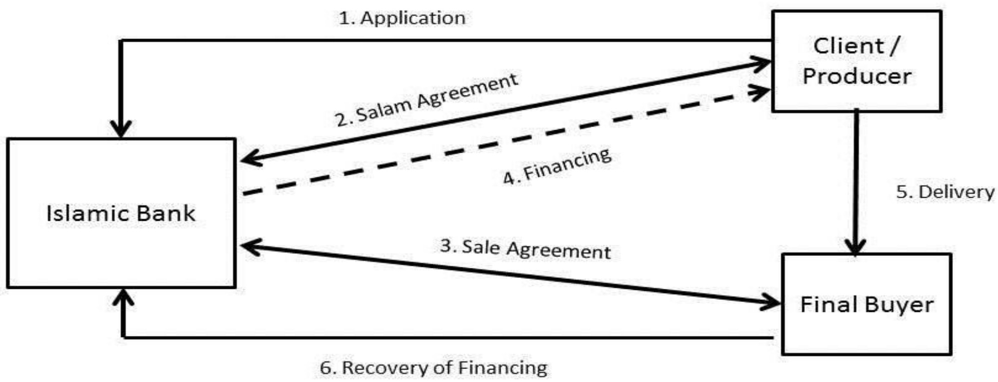

Figure: The Working Transaction of Salam Financing

The figure depicts the working transaction in Salam. The process will be explain as follows:

1. The client/producer make an application to the Islamic Bank
2. There is a Salam agreement between the client/producer and the Islamic Bank
3. There is a sale agreement between final buyer and the Islamic Bank
4. Islamic Bank make a financing to the client/producer
5. Client / Producer make a delivery to the Final buyer
6. The client pay the installment to the Islamic Bank

Under Salam, it is lawful for traders to sell the goods in advance so that after receiving their cash price, they can easily undertake the aforesaid business. Salam is beneficial to the buyer because the price in Salam is lower than the price in spot sales. Further, in Salam, the seller of the goods must be its producer or manufacturer.

The agreement should be explicitly mentioned on the following matters :

1. The quality and the quantity of the thing being sold
2. The price and the payment matters
3. Delivery matters such as time and place of delivery and how that might take effect.

For instance, Yusof is a farmer who has his own vineyard. He grows two varieties of grapes which are Malacca and Cardinal in the area of two acres. This later period, he faces financial problem which make him lack in spending. Hence, he needs money to undertake his business and to feed his family up until the time of harvest. Therefore, he decides to apply financing by the Islamic bank.

The Working of Salam Contract for Yusof :

1. Yusof executes a Salam contract to sell a specified amount of grapes in advance for RM 20.000 to bank A. The grapes are to be delivered on 1 July 2012.
2. Bank A pays RM 20.000 on a spot basis to Yusof and also stipulates from where to take delivery on 1 July 2012
3. The grapes are delivered to bank A on 1 July 2012.
4. Bank A sells grapes in the output market at profit. (That is, Bank A make the contract with merchant B in which merchant B will purchase grapes from bank A for RM30.000 on 1 July 2012. When Yusof supply the specified grapes to bank A on the agreed delivery date, bank A informs merchant B to execute the sale and take delivery.)

3.2.3 ISTISNA FINANCING INSTRUMENT

An Istisna contract is a sale in which the customer asks the seller to manufacture a specific product for purchase. Both parties agree on a price and specifications for the product to be manufactured. If the product does not conform to those specifications when it is delivered to the customer, he or she may retract the contract. The two parties have flexibility when deciding payment timing and mode: the price can be paid in a lump sum at the time of the contract, in a lump sum in the future, or over installments. This mode of financing is usually used for aircraft manufacture, equipment installation at factories, construction, etc.

Istisna and bay' al-salam are both exceptions to the general rule for sale contracts that the subject of the sale must exist at the time of the sale. However, four differences between istisna and bay' al-salam contracts exist. First, the purchased good in an istisna contract must be manufactured, while it does not have to be in a bay' al-salam contract. Also, buyers in istisna contracts are not required to pay the full price immediately upon signing the contract, as they are in bay' al-salam contracts. Additionally, an istisna contract can be canceled by either side before the seller begins manufacturing, while a bay' al-salam contract can only be canceled with the consent of both parties. Finally, the seller is given flexibility regarding time of delivery in an istisna contract, while time of delivery must be specified exactly in a bay' al-salam contract.

Suppose Southwest Airlines wants to buy a new 737 aircraft from Boeing. Assuming Boeing does not already have any premade 737 aircraft, Southwest and Boeing enter into an istisna contract. The two parties agree to a price of $45 million with a deferred lump sum payment and specifications regarding the airplane. Boeing delivers the airplane to Southwest within a specified range of dates. Southwest is satisfied with the quality and specifications of the aircraft and pays Boeing $45 million at an agreed-upon date in the future.

3.3 ISSUES AND CHALLENGES

Undeniable, Islamic banking system become more and more interested by many people around the world after global financial crisis, not only Muslim but also Non-Muslim. No doubt, it is the only system that can overcome and have no effect from such crisis. However, there are still many problems which occur in operating and practicing under the system that many Islamic scholars concerned. Therefore, in this particular point, this paper tries to discuss issues that arise in those three modes of Islamic financing as mention earlier and highlight how Islamic bank face such critical challenge.

3.3.1 MURABAHAH FINANCING INSTRUMENT

Murabahah in its classical form may not give rise to many Shari'ah issues as legal rulings related to its application have been laid down clearly and comprehensively by past jurist. However, murabahah in its modern structure which is a form of combined contracts may result in many issues.

In the issue of rebate in the event of a default, classical jurists argued that the murabahah contract is one of the trust-based contracts in which everything should be disclosed including the cost price and the mode of payment of the first sale. For example' if someone bought a commodity through a murabahah contract which was concluded on a deferred payment basis , he must disclose to his customer(second buyer) that he has purchased the commodity on a deferred payment basis .If not, he is said to have committed a betrayal because a murabahah contract involves the time value of money which must be taken into account as it is recognized by the shariah, The time value of money in this regard entails the deferment earns a portion in the price of a murabahah contract, Hence, jurists stipulated that an increment in the price of a murabahah contract is due to assingnig monetary value to deferment. As such, the question that arises from this is whether the bank must give a rebate to the customer in the event of default, and whether to give for early settlement, or not. This is because, in both cases, the deferment which constitutes the basis for increment in a murabahah contract is no longer enjoyed by the customer since he has to settle the debt on a spot basis.

The problems in murabahah indeed have several points but, in order to see clearly, we will observe what scholar and practitioners give criticism about main issues in murabahah. A number of scholars and practitioners have criticized murabahah for two main reasons. First, they view the markup as a disguised form of interest, especially since the markup rate currently used by most Islamic banks is tied to the prevailing interest rate in the market, such as the London Interbank Offered Rate (LIBOR). Second, murabahah does not fulfill the mission of Islamic banking, namely to justly share risk between the lender and the borrower.

In response to the first criticism, scholars have declared that the profit margin is acceptable according to Shariah due to several differences between murabahah and conventional loans. First, in a murabahah sale, because the bank must own the product for some period of time after purchasing it before reselling it to the customer, it exposes itself to the risk that the product will be harmed or destroyed, the product's value will fluctuate, or that the seller will change his or her mind before buying the product from the bank. However, banks effectively avoid this risk by making the period of time between the purchase and the resale minutes or even seconds. Therefore, banks do not truly take any ownership risks. Second, scholars argue that a profit margin is acceptable because it compensates the lender for the service it is providing. If the bank were to purchase and take possession of a good before reselling it to the customer, no one would dispute that the bank is providing a service to the customer. However, as this presents many operational challenges, banks most often appoint the customer as its agent to take possession of the good. Though the bank provides a smaller service in this case, it is arguably still a service that should be compensated. Third, scholars argue markup is lawful because it compensates the bank for the opportunity cost of not having those same funds available to it. That is the Shariah does allow for compensation for the time value of money for sales contracts but not for loans. Since a murabahah is a sales contract, scholars argue compensation for the time value of money is lawful.

In response to the second criticism, scholars stress that murabahah is not the primary or preferred method for financing trade and sales, though it is allowed. Rather, profit and loss sharing financing methods such as PLS musharakah and PLS mudarabah are preferred. This preference, however, has not resulted in a proportionally higher number of PLS contracts. In the early years of modern Islamic finance, murabahah was used as a temporary instrument for ease and convenience while scholars tried to develop risk sharing instruments that could serve the same purpose. However, rather than disappearing, the importance of murabahah instruments has grown, and murabahah has become the dominant mode of financing. Islamic banks use murabahah contracts for about 80 percent of their investments while PLS mudarabah contracts account for less than 5 percent.(Iqbal,Z.& Mirakhor,A,2007)

As a result of this disproportionately high number of murabahah contracts, scholars have suggested a number of ways for banks to reduce their reliance on these contracts. First, some have suggested altering murabahah contracts in order to eliminate distortions or abuses of the contract's original intention. Second, others have suggested that banks change their markup methods to represent the amount of service the bank has actually provided rather than a percentage of the total value of the product, which is often similar to prevailing interest rates. Scholars should continue to alter the terms of murabahah contracts in the future in order to return to instruments that truly share risk and reward, which is a basic principle of Islamic finance.

3.3.2 SALAM FINANCING INSTRUMENT

It is evident from the foregoing discussion that Shariah allowed Salam to fulfill the needs of farmers and traders, therefore, it is basically a mode of financing for small farmers and traders. The mode of financing can be used by modern banks and financial institution, especially to finance the agricultural sector. As pointed out earlier, the price in Salam may be fixed at a lower rate than the price of those commodities delivered at the spot. In this way, the difference between the two prices may be a valid profit for the banks or financial institutions. In order to ensure that the seller shall deliver the commodity on the agreed date, they also can ask him to furnish a security, which may be in the form of a guarantee or in the form of mortgage or hypothecation. In case of default in delivery, the guarantor may be asked to deliver the same commodity by purchasing it from the market, or to recover the price advanced by him. The only problem in Salam that may agitate the modern banks and financial institutions today is that they will receive certain commodities from their clients, and will not receive money. Being conversant with dealing in money only, it seems to be cumbersome for them to receive different commodities from different client and to sell them in the market. They cannot sell those commodities before they are actually delivered to them, because it is prohibited in Shari'ah.

But whenever we talk about the Islamic modes of financing, one basic point should never be ignored. The point is that the concept of the financial institutions dealing in money only is foreign to Islamic Shari'ah. If these institutions want to earn a halal profit, they shall have to deal in commodities in one way or the other, because no profit is allowed in Shari'ah on advancing loans only. Therefore, the establishment of an Islamic economy requires a basic change in the approach and in the outlook of the financial institutions. They shall have to establish a special cell for dealing in commodities. If such a special cell is established, it should not be difficult to purchase commodities through Salam and to sell in spot markets. However, there are two other ways of benefiting from the contract of Salam.

First, after purchasing a commodity by way of Salam, the financial institutions may sell them through a parallel contract of Salam for the same date of delivery. The period of Salam in the second (parallel) transaction being shorter, the price may be a little higher than the price of the first transaction, and the difference between the two prices shall be the profit earned by the institution. The shorter the period of Salam, the higher the price, and the greater the profit. In this way the institutions may manage their short term financing portfolios.

Second, if a parallel contract of Salam is not feasible for one reason or another, they can enter into a promise to sell the commodity to a third party on the date of the delivery. Being merely a promise, and not the actual sale, their buyers will not have to pay the price in advance. Therefore, a higher price may be fixed and as soon as the commodity is received by the institution, it will be sold to the third party on a pre-agreed price, according to the terms of the promise.

A third option is sometimes proposed that at the date of the delivery, the commodity be sold back to the seller on a higher price. But this suggestion is not in line with the dictates of Shariah. It is never permitted by the Shariah that the purchased commodity be sold back to the seller before taking its delivery, and if it is done on a higher price it will tantamount to riba which is totally prohibited. Therefore, this proposal is not acceptable at all.

3.3.3 ISTISNA FINANCING INSTRUMENT

An Istisna' contract is applicable to various industrial productions which can be constructed or manufactured and supervised by specification. For example, an istisna' contract can be employed in housing construction and advanced technology industries, equipment such as aircraft, automobile, ship and factory equipment. In Istisna, since it is not necessary that the price is paid in advance, nor is it necessary that it is paid at the time of the delivery, rather, it may be deferred to any time according to the agreement of the parties, therefore, the time of payment may be fixed in whatever manner they wish. The payment may also be in installments.

On the other hand, it is not necessary that the financier himself construct, for example, the house. He can enter into a parallel contract of Istisna with a third party, or may hire the services of a contractor (other than the client). In both cases, he can calculate his cost and fix the price of Istisna with his client in a manner that may give him a reasonable profit over his cost. The payment of installments by the client may start, in this case, right from the day when the contract of Istisna is signed by the parties, and may continue during the construction of the house and after it is handed over to the client. In order to secure the payments of installments, the financier as a security may keep the title deeds of the house or land, or any other property, until the client pays the last installment.

The financier, in this case, will be responsible for the construction of the house in full conformity with the specifications detailed in the agreement. In case of discrepancy, the financier will undertake such alternation on his own cost as may be necessary for bringing it in harmony with the terms of the contract. In addition, in contemporary application, the another shari'ah issue in an istisna' contract arises in the event the manufacturer fails to deliver the manufactured asset on the date agreed upon' one way that can be exercised to overcome this issue is by allowing the stipulation of a punitive condition upon the manufactured in the event of his failure to deliver the purchased asset at the agreed time. That is as pointed out earlier, it is not necessary in istisna that the time of delivery is fixed. However, the purchaser may fix a maximum time for delivery that means that if the manufacturer delays the delivery after the appointed time, he will not be bound to accept the goods and pay the price.

In order to ensure that the goods will be delivered within the specified period, some modern agreements of this nature contain a penal clause to the effect that in case the manufacturer delays the delivery after the appointed time, he shall be liable to a penalty which shall be calculated on a daily basis. Can such a penal clause be inserted in a contract of istisna according to Shariah? Although the classical jurists seem to be silent about this question while they discuss the contract of istisna, yet they have allowed a similar condition in the case of ijarah. They say, if a person hires the service of a tailor to tailor his clothes, the fee may be variable according to the time of delivery. The hirer may say that he will pay Rs. 100/- in case the tailor prepares the clothes within one day and Rs. 80/- in case he prepares it after two days.

The problems and challenges of Islamic banks cannot be effectively dealt with unless the leadership of Islamic banking becomes truly committed and competent. In a nutshell, it is yet to be substantially proved that Islamic banking offers more efficient and ethical solutions in the contemporary financial world.

CHAPTER 4

CONCLUSION

4.1 CONCLUSION

The time value of money in Islamic perspective is totally different from the conventional one. The return available to the individual saver does not always have to be related to riba-based transaction. The concept of time value of money in the context of Shari'ah is established from the fact that Shari'ah prohibits mutual exchanges of gold, silver or monetary values except when it is done simultaneously. The fact that Islam forbids *riba* does not mean that it is against the concept of positive-time preference (PTP). Furthermore, time valuation is possible only when goods are traded, not when exchanging monetary values and loans or debts (Hassan, 2004). As the concept of time valuation is possible only in business and trade of goods not in exchange of monetary values and loans or debts. Therefore, no time value can be added to the principal of a loan, or a debt after it is created or the liability of the purchaser stipulated. The important conclusion view in Islam is time value of money is acceptable in respect of the pricing of assets and their usufruct, it is not acceptable with regard to any addition to the principal of loans or debts.

Undeniable, Islamic banking system become more and more interested by many people around the world after global financial crisis, not only Muslim but also Non-Muslim. No doubt, it is the only system that can overcome and have no effect from such crisis. However, there are still many problems which occur in operating and practicing under the system that many Islamic scholars concerned. For example, in the Murabahah, Salam and Istisna financing instruments, there are several issues related to the time value of money on Islamic perspective that still debatable. The problems and challenges of Islamic Banks cannot be effectively dealt with unless the leadership of Islamic Banking becomes truly committed and competent. In a nutshell, it is yet to be substantially proved that Islamic banking offers more efficient and ethical solutions in the contemporary financial world.

4.2 LIMITATION OF THE STUDY

The study mainly focuses on the fundamental of Time Value of money in Islamic perspective and how to apply this concept in the Islamic Banking implications, i.e. Murabahah, Istisna and Salam and also discuss their issues and challenges that exist from the applying these products. In fact, there are many products in the Islamic banks for example Mudarabah, Musharakah, Ijarah and so on. In case, discussing in different products may give the different results in discussing how to apply the concept of Time Value of Money in Islamic View. As a result of that, the explanation of their issues and challenges of these products would be different.

4.3 SUGGESTION FOR FUTURE STUDY

The study formulates some suggestion for further research that is as follows:

First, future study may investigate the correlation with the real sector that has not sharpened illustrated. It may describe the government contribution on the Effect of Time Value of Money in Islamic Perspective.

Second, further study may suggest the possible solutions of today's issues and challenges of Murabahah, Istisna and Salam from applied the concept of Time Value of Money has not elaborated on this present paper.

Finally, given this study was conducted on three samples Shari'ah compliance financial products only, the analysis can be further extended to other products and their issues and challenges from applied the concept of Time Value of Money in Islamic view in the today practice such as Mudarabah, Musharakah and Ijarah.

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