

CHAPTER II

THEORETICAL FRAMEWORK

A. Baitul Maal figure

1. History of Baitul Maal wa Tamwil

The development of Shariah banking system in Indonesia has stated from 1992, by establishment of bank muamalat Indonesia (BMI) since then the development of Shariah banking keep growing rapidly up until now, Even though the Idea of Islamic banking development has been started in early 1980's in Bandung was known as baitul maal wa tamwil Salman and in Jakarta as cooperation Shariah known as koperasi ridho gusti. From these two experiment MUI initiate for Islamic bank development in their annual meeting in 1990's. and then in 1992, the development of BMT rise under ikatan cendikiawan Muslim Indonesia (ICMI) which lead by B.J Habibie. During the early development of BMT which is built by ICMI, BMT only concern for collecting the zakah fund from the employee whether its belong to the government or the private company who hire the employee.

Since the monetary crisis in 1997 BMT begin to know as the alternative for the Indonesian economic restoration which shift BMT become financial provider for small medium enterprises under Shariah laws.

Currently, BMT become more popular after the awakening of Muslim in Indonesia to find a new economy alternative model which can support the development of small enterprises and micro business. The needs of the people toward a financial

system and Shariah banking are natural since the majority of Indonesia citizen are Muslims. In 2000, Lembaga-Lembaga Ekonomi Keuangan Syariah (LEKS) emerging which consist of bank umum Syariah 131 unit with total asset Rp 2.584.240 million or equal to 0,25% from the total market share from the general commercial bank.and then followed by 81 Bank Perkreditan Rakyat Syariah (BPRS) and also followed by emerging of 1300 BMT and a Syariah mutual fund (PT. Danareksa) and an Islamic Multifinance which is known as BNI-Faisal Islamic Finance (Arifin, 2000).

The revolutionary invention which is done by Prophet SAW is the establishment of a wealth saving institution known as Baitul Maal. What was done by prophet SAW is a process of revenue collection and expenditure which is transparent which has the goal of what we called now welfare oriented (Ridwan, Manajemen Bank Syariah, 2003).

Baitul Maal which is founded by prophet SAW has no official form so the flexibility was so high and almost not having any bureaucracy. This is keep happening until the age of Abu Bakar caliphate, where can be said that there is no any significant different in Baitul Maal Management. Until the caliphate of Umar Ibn Khattab, since the territory of Islam was expanding, so the fund which is managed by Baitul Maal was increasing together with the wide of Islamic territory. This situation makes the caliphate Umar to make an administration and accounting which can manage the development (Ridwan, 2004)

2. Understanding of BMT

Baitul Mal comes from Arabic term bait which has meaning a house, and al-mal which has meaning wealth. So basically as linguistic understanding, Baitul maal would have a meaning house which collecting or keeping the wealth. From among the Islamic financial institution, BMT is an Islamic institution which is built on the basis of Shariah or Islamic creed which its nature are populist (kerakyatan) since it was built from people and for the people.

From the amount BMT is Islamic financial which is the widest spread compared from the other Islamic financial institution since BMT has more customer which is still in middle class or working in small medium enterprises.

The existence of BMT in Indonesia has the legal standing which is protected by Indonesia law which is acknowledged regarding its status or its mechanism. The law of BMT itself derived from certain Islamic legal source which can be understanding as following (Arifin, 2000)

a. Noble Quran

Baitul Mal Wattamwil (BMT) in Islamic law can be taken from the source of general law in the noble Quran since this kind of Muamalah did not mention particularly in the noble Quran. So the concept of BMT is more general and its law was taken or derived from the general laws in muamalah as Islamic teaching.

b. Sunnah (Prophetic tradition)

every attempt to seek the pleasure of Allah must be an act based on Islamic creed, as Muslim the main reference of the law must be the noble Quran and sunnah of the prophet SAW, hence the BMT also using the very same resource since in

BMT using contract which is agreement in a business which must be trusted by the dealers.

c. Ijma' (the opinion of righteous predecessor)

Other from the Quran and Sunnah, ijma' or the consensus of righteous predecessor from the companions of the prophet SAW or scholar of Islam. Ijma' is necessary since the development of Islam is keep growing. Just like Al-Qur'an and Sunnah, Ijma' can be used as Islamic legal source as a basis for Baitul Mal Wattamwil.

BMT is an organization which runs in social movement, its role can be can be reflected from the Baitul Maal which has the function same as Lembaga amil zakat (LAZ) due to this ability and also BMT encouraged to be able become professional LAZ to collect the funds of zakah, infaq, charity, wakaf and another source of social funds. While the role of business can be derived from the definition of Baitul maal wa tamwil (Ridwan, 2004).

3. BMT products

In the operational of BMT, the investor invests their money in BMT without the intention to gain the interest but to earn the return from the profit loss sharing. The product of shariah financing institution for fund collection (MUI, 2003).

a. Product of funds collection

1) Wadiah Clearing

Wadiah Clearing is a saving product which can withdraw at any time. The funds of customer kept in BMT and can be managed by BMT. Anytime customer can withdraw and deserve to have a bonus from the profit for the fund utilization

by BMT. The amount of bonus not settled in the beginning but rather from the policy of BMT. Even though the nominal of profit adjusted to be as always competitive. (MUI D, 2000)

2) Mudharabah saving

The funds which saved by the customer will be managed by BMT to gain profit. the profit which will be given to customer according to the deal which made by the customer. Customer as shihibul maal while the Shariah financial institution as mudharib (MUI, 2000)

3) Mudharabah fixed deposit

BMT freed to deal any kind of business and to expands it which is not against the Shariah. BMT freed to manage the funds (Mudharabah Mutlaqah). The role of BMT as mudharib while the customer as shahibul maal. Even though there are customers who have the initiation to invest in the certain business. The customer giving the limit the usage of funds for the type of business and a certain place. This kind of deal called as Mudharabah Muqayyadah. In the financing activity , BMT using profit loss sharing scheme for equity financing and investment according to profit from trading (Bay') mechanism as the fulfillment of the debt financing needs (Arifin,1999)

B. Profit Financing

1. Murabaha

Murabaha is an Islamic form of asset financing and has a fixed term and a predetermined profit. In a Murabaha the bank buys a specific asset that the customer wants, and it sells to the customer at the buying price plus a profit at a rate agreed at the time of entering into the contract

BMT buys goods which desired by the customer and then sell them to the customer plus markup price as profit. BMT must tell the customer honestly the real price plus necessary cost. Customer pay the goods in the certain period of time which have been agreed (MUI, 2000)

2. Musharaka

Musharaka is a contract whereby the bank and a customer agree to combine their financial resources for the establishment or running of a business or project, or for undertaking any type of business activities. The two parties agree to manage the project in accordance with the terms of the contract. The profit or loss will be apportioned between the parties base on their participation in the invested capital. There are two types of Musharaka Contracts; Permanent Musharaka being by contributing a share of the capital and Diminishing Musharaka being the long term financing.

Musyarakah financing is a contract of cooperation between two parties or more in a certain business, Where every party have the contribution in the fund with the agreement that profit and loss will be bear together according to the agreement (MUI, 2003).

3. Istisna

Istisna is an Islamic form of financing used to finance construction and industrial projects, such as the construction of buildings and so on. The unique feature of Istisna is that it allows the selling of an asset that does not exist at the time of the contract. The payment can be in immediate cash or may be in the form of deferred payments.

Bai' al-istishna is a contract of trading in the form of the order of certain manufacturing goods and certain criteria and the conditions which is agreed between one who order or buyer(mustashni') and seller(shani) (MUI, 2003).

4. Ijara

The Bank leases movable and immovable assets to its customers, with the option that the customer may or may not own the leased asset at the end of the term of the lease as per the agreement signed between the two parties.

Ijarah is a contract which can transfer ownership right regarding goods and services in a certain period of time by the payment of leasing as rent or wage, without transferring the ownership (MUI, 2003).

5. Salam

Salam in the definition jurists a sale of a commodity whose delivery will be at a future date for a cash price. It is a financial transaction in which price is advanced in cash to the seller who abides the delivery of a commodity of determined specification on a definite due date. The deferred is the commodity sold and described (on liability) and the immediate is the price. Salam sale is suitable to finance agricultural operations. Thus, the bank renders great services to the farmers in their way to achieving their production target.

Bai' as-Salam is a trading by using order mechanism and the payment is done in advance by certain conditions. the payment must be done during the contract or when the contract agreed. And the delivery of goods base on the contract which has been agreed with certain quantity and quality (MUI, 2003)

6. Mudaraba

The term Mudaraba refers to a contract between two parties in which one party supplies capital to the other party for the purpose of engaging in a business activity with the understanding that any profits will be shared in a mutually agreed upon. Losses, on the other hand, are the sole responsibility of the provider of the capital. Mudaraba is also known as Qirad and Muqarada. This type of business venture serves the interest of the capital owner and the Mudarib (agent). The rate of return is quite uncertain and the cost of capital is also uncertain. Hence, there is a perfect correlation between the cost of capital and rate of return on capital.

Mudharabah financing is cooperation contract between two parties where the first party (Shahibul maal) provide all the necessary capital while the other managing the capital and profit of the business divided base on the agreement in the contract (MUI, 2003)

C. Non-profit Financing

BMT also have product which is not run base on profit oriented named Qard-al-Hassan, according to Iqbal(2015) Qard-al-Hassan is a loan mentioned in the Qur'an as "beautiful" (Hassan), probably because in all the verses in which this loan is

mentioned, it is stipulated that it is made directly to Allah (SWT) and not to the recipient (see, for example, Chapter 64, verse 1, other relevant verses are 2:245; 5:12; 57:11; 57:18; 73:20). It is a voluntary loan, without any expectation by the creditor of any return on the principal. In addition, while the debtor is obligated to return the principal, the creditor, of his own free will, does not press the debtor for an exact timing of its return. Allah (SWT) promises multiple returns to the “beautiful loan.”

Qard Hassan has been mentioned in the Sunnah. Prophet Muhammed says: "Whoever relieves a Muslim of a burden from the burdens of the world, Allah will relieve him of a burden from the burdens on the Day of Judgement. And whoever helps ease a difficult in the world, Allah will grant him ease from a difficulty in the world and in the Hereafter. And whoever covers (the faults of) a Muslim, Allah will cover (his faults) for him in the world and the Hereafter. And Allah is engaged in helping the worshipper as long as the worshipper is engaged in helping his brother." (tirmidhi, 1930)

D. Hedging in Conventional and Shariah View

Hedging is one of the new instruments which have been designed to fulfill modern financial needs of both individuals and businesses. It is an approach to risk management that uses financial instruments to neutralize the systematic risks of price changes or cash flows (Cusatis & Thomas, 2005).

Hedges are investments made to minimize or remove the risk of another investment. It is used to minimize exposure to business risks, at the same time allowing a business to gain profit from investment activities. Hedging is closely associated with the use of derivatives as financial instruments to minimize losses of a financial or

business investment. A Derivative is simply a financial instrument or asset that derives its value from the value of an underlying asset. The most common instruments are forwards, futures and options. (Mohamad, 2008)

Hedging can be referred to as one of the risk management approaches that aims to reduce risk while limiting the probability of losses inflicted due to the instability of commodity prices, currency values or securities. Subsequently, hedging can determine that the selling price sealed with the buyers will not affect the projected gains as those holding positions in the liquidity market will strive to reduce those risks in the futures market. Considering almost all the researchers agree with the statement that the concept of hedging is to manage and reduce risk, then it can be concluded that this concept is most appropriate (Ahmad & Ab. Halim, 2014).

Hedge funds have been put at the heart of a serious argument among Islamic scholars over whether their practices – particularly short-selling – can be complied with prohibitions on riba or paying interest and on gharar (uncertainty) sales and excessive speculation. It is difficult to separate hedge funds from speculation and while many scholars accept the need for risk management and hedging, the financial tools applied are often the same. Is the challenge for scholars to assess the shariah compliance of the strategy is hedge funds investing for profit and hedging or is it pure speculation and gambling? (Mackintosh & Oakley, 2008)

In the world of Islamic finance, some expert gives their dedication to creating a brand new system which is originally used in a conventional way in order to establish full shariah compliance. The view of Islamic hedge is clear permissible as long as there

is certainty during the contract. It is completely not permissible to do gambling or pure speculation by running an uncertain business.

E. Salam as Islamic hedging

1. Definition of Salam Contract as Forward Contract

A forward contract is a non-standardized contract between two parties to buy or sell an asset at a specified future time at a price agreed today. This is in contrast to a spot contract, which is an agreement to buy or sell an asset today. The party agreeing to buy the underlying asset in the future assumes a long position, and the party agreeing to sell the asset in the future assumes a short position. The price agreed upon is called the delivery price, which is equal to the forward price at the time the contract enters into. The difference between the spot and the forward price is the forward premium or forward discount; generally considered by the purchasing party as a profit or loss. The value of a forward position at maturity depends on the relationship between the delivery price and the underlying price at that time. (Zahan & Kenett, 2011).

2. The Nature of the Risk

Dacorogna(2011) noted the identification of emerging risks using internal and external sources and central information gathering. A global pandemic can be one of the examples of emerging risk. Business continuity planning, hedging, and options can be the control measures to mitigate risk.

Ibu Taymiah more than 670 years ago acknowledged a dual form of risk. ‘The first form of risk that arises due to the nature of the transaction is value adding and wealth creating activities. While the second form of risk is that of gambling;

this implies eating wealth for nothing. It is prohibited in Islam. This risk is referred as ‘zero-sum’ activity, where, there is no additional wealth is created’ (Kenett, 2011).

Therefore, the resolution about decreasing or hedging risk is recommended as long as it is conducted in a manner that is compliant with Sharia. Hence, the question that comes to mind is if risk arising from zero-sum games is not allowed, would hedging using zero-sum games, where the loss of one party is the gain of the other. This condition is applicable on both the conventional and Islamic derivatives regardless of their purposes; for risk mitigation or speculation. Theoretically, derivatives are supposed to distribute risk among market participants in accordance with their ability to assume them. If such distribution is achieved, each party will be better off, this improving deficiency and productivity. If the initial motive in using derivatives is mainly for hedging purposes, then any gain accrued from this process may trigger other purposes for income generation.

3. Understanding of Salam Contract

The nature and Conditions of bay’ al-Salam, Bay’ al Salam is Islamic contract which allowed the seller to achieve advance payment hence the price is determine fixed in advance, this feature has a big influence in price certainty and stability for the seller in this particular case farmers.

Bay’ al Salam allowed in Islam by certain conditions to ensure the real contract of Bay’ al Salam there are some mandatory conditions of Bay’ as Salam, which can be summarized by Al-Shamrani (2014) in the following points:

- a. In Bay' as Salam, it is necessary to the validity of the contract that the buyer pays the price in full in advance to the seller at the time of effecting the contract; otherwise, the contract will be void.
- b. The object of exchange must be fungible, of quality and clearly defined physically and quantitatively as to the size, volume and color.
- c. Bay' al Salam only deals with goods as long as the goods are fungible. Gold and silver are not allowed in this contract because these are regarded as monetary value exchanges, while the aim of Bay' al Salam is to meet the needs of farmers – who require money in order to grow their crops – and of traders for import and export businesses.
- d. In terms of the delivery of the goods the exact date and place of delivery must be specified in the contract, because the time of delivery is an essential part of this contract.
- e. It must be ensured that the goods are able to be delivered when they are due.
- f. The customer (buyer) cannot enjoy ownership rights over the purchased commodities before taking possession of them.
- g. The goods of the Bay' al Salam contract should remain in the market for the day of the contract up to the date of delivery.

4. Benefit of Hedging Price in Bay' as Salam

in Bay' al Salam there are features which are only can be found in this particular contract, one of them are the determination of price in advance, the Bay' al Salam has several benefit of hedging in forward selling

- a. Helping farmers By utilization of the feature of Bay' al Salam which allowed the advanced payment in the fixed price so hopefully this feature can help farmers to have a more competitive price since the risk which bears by farmers are not only during the cultivating period but also even after harvesting period and then continued to marketing. Bay' al Salam has the advantage which is applicable

for both interests, for buyer and seller especially for farmers who used to suffer for bearing too much risk during cultivating until selling.

- b. Make distinctions with conventional banks. This product not only implements Salam as a mode of financing with less risk. But it also fulfills the Islamic banks function as a communal institution to help the farmers. Unlike the conventional banking institutions, the main purpose of Islamic banking is not to maximize profit. It has a social function to help the poor who is really in need of money (Muneeza, 2013)
- c. Eliminating *riba*, Obaidullah (1999) says that our analysis reveals that there is no possibility of earning *riba* with this kind of contracting. The requirement of spot settlement of obligations of at least one party imposes a natural curb on speculation though the room for speculation is greater than under the first form of contracting. The requirement amounts to the imposition of a hundred percent margin which, in all probability, would drive away the uninformed speculator from the market. This should force the speculator to be a little surer of his expectations by being more informed.
- d. Creating a win-win solution, Banks can offer this instrument either with the help of middlemen who have insightful knowledge about the local area or they can take up the process as a new subsidiary. The ultimate objective of the proposed models is to develop such a system that can result in a win-win situation for both banks and farmers (Hilmy, 2013).

- e. Changing paradigm of common understanding of Salam viewed merely as risky business, as in all Islamic products, instruments involving Salam contracts should embody all the principles and requirements both in form and spirit of the shariah. Thus, shariah screening, rather than being viewed as an extra risk, is to act as impediments to bad investment decisions and hence provide investors with a more superior set of risk management tools (Mohamad, 2008).
- f. As risk management tool, Bay' al Salam would also enable the participants to manage risk. At the same time, the requirement of settlement from one end would dampen the tendency of many participants to seek a complete transfer of perceived risk and encourage them to make a realistic assessment of the actual risk. (Muhammad & Chong, 2007).

F. Previous Studies

1. And also the research by Roziq , Hisyamudin, & Purnamawati, (2014). By using qualitative explorative research in Jember regency the researchers found that no Salam contract found in Islamic financing institution for the cassava farmers, tempe businessman, cassava chips, and cassava flour. The problem which is faced by respondents is the lack of capitals, the difficulty of marketing after harvest, the low quality of cassava during raining season, fail of harvesting. While the problems of Islamic financial institution for Salam contract which faced are the lack of capital to pay in advance, the capital loss risk, farmers moral hazard for selling to the other party when the price are appreciating.

2. Research made by Adi (2013) The result of research shown that the profit which is generated from agricultural business in Bogor district is profitable according to this research almost 50% of farmers willing to give selling price at the margin more than 10% for the buyer, this can be considered as profitable industry in Shariah financing industry. Hence the percentage of margin around 10% -15% but in order to achieve the prosperity for both of party researcher suggesting to took 12,5% by the maximum length of financing 6 months.
3. And also, research by Hassan (2012) by using descriptive and qualitative research is conducted and focuses on two main groups of banking customer's users and nonusers of Islamic banking and also an informal interview with managers of some banks. A survey questionnaire was developed that subsequently get a response from 120 respondents. After the through study of a body of knowledge, we find that there is a significant relationship between Islamic banking and agriculture sector. Islamic banking is providing easy terms of financing like *Ijarah*, Diminishing *Musharaka*, *Murabaha*, Salam and Bay' al Salam and similarly providing different types of working capital like *Murabaha*, *Musawamah*, *Salam*, *Muzara'a*. These terms of financing increase the asset ownership, yield and income of farmers. Islamic banking is not providing any financing for the irrigation system and farmers are facing the problem of credit standing and the problem of collateral.
4. Hilmy (2013) in his research by using qualitative method by analyzing data collected through in-depth interviews with several people¹in Islamic banking industry and the people in agricultural sectors, site - visit to the agriculture business and field research as well as library research to find out the current process of

agricultural finance and to the marketing system of their crops the researcher has interviewed the farmers and the rice mill owners. To identify the reasons behind unimplementation of Salam, the researcher has interviewed the Islamic bankers. To know the products offered by the Islamic financial institutions in Sri Lanka the researcher has read the annual reports of the companies and the country report like KPMG. Salam is a trade-based instrument, and against advance full payment, thus, the farmers, as well as the institution, can get good profits on it. Exploring the agriculture related problems and hurdles faced by farmers can help in the proper application of this instrument. The above discussion shows that farmers hardly afford to purchase the inputs on cash. Even it's tough enough for them to meet personal consumption expenses from farm income. Thus, banks should take care before proceeding Salam instrument to reduce risks large-scale willful defaults

5. The research made by Ab. Aziz & Yusoff (2014) stated that risk and uncertainty are inherent in agro projects and commodity supply chains. Given the pervasiveness of risks, farmers, agro-entrepreneurs, international agencies, and banking institutions are increasingly seeking effective and sustainable strategies and approaches to mitigate, transfer, or cope with these inherent risks. The methodology of this paper is through quantitative research based on questionnaires to identify patterns of agro-entrepreneurs in facing various types of risks. There are several risks which have been encountered by agro-entrepreneurs in agriculture projects and require them to finance their projects using Shariah-compliant financing and banking products. From this research, it shows that majority of respondents are willing to continue their agro projects even though they had to encounter various

risks, and had some knowledge or experience about the advantage and disadvantages of those risks. In addition, local Islamic banking institutions should take these risks into consideration in providing monetary funds to the agro-entrepreneurs in order to ensure the funds could accommodate the loss from the effect of those risks and support agro projects.

6. The research of possibility of application of Salam in Malaysian Islamic banking system, by Muneeza (2013). Stated that In Malaysia, there are various types of Islamic Banking products used. However, Salam has never been used as a mode of financing in the country, though it is utilized for *Sukuk* or Islamic bond. Salam is an exceptional contract in Islamic law, which has been legalized to facilitate the people, especially the poor farmers. It has been stated here that Malaysia is an agricultural nation and farmers here are looking for models to finance their productions and hence the application of Salam contract in Malaysia would be vital. But so far, the Banks are hesitant to use this product because of risk factors. The main objective of this paper is to analyze and formulate a feasible way to implement Salam contract in Malaysia. From the above discussion, it can be safely concluded that Salam contract in Islamic Commercial Laws are the important methods of investment in Islamic banking and can play an important role in economic development. It encourages the demand for agricultural goods to be stabilized and at the same time ease the farmers.
7. Obaidullah (1999) stated that it may be noted that hedging can also be accomplished with Bay' al Salam in currencies. The form of contracting with deferment of obligations of one of the parties to a future date falls between the two

extremes of spot and future contracts. While *Shariah* scholars have divergent views about its permissibility, our analysis reveals that there is no possibility of earning *riba* with this kind of contracting. The requirement of spot settlement of obligations of at least one party imposes a natural curb on speculation, though the room for speculation is greater than under the first form of contracting. The requirement amounts to the imposition of a hundred percent margin which, in all probability, would drive away the uninformed speculator from the market. This should force the speculator to be a little surer of his expectations by being more informed. When speculation is based on information it is not only permissible but desirable too. Bay' al Salam would also enable the participants to manage risk. At the same time, the requirement of settlement from one end would dampen the tendency of many participants to seek a complete transfer of perceived risk and encourage them to make a realistic assessment of the actual risk.

8. The Concept of Hedging in Islamic Financial Transactions by Ahmad & Ab. Halim (2014). Stated that the study finds that the concept of hedging according to Islam is different from the conventional concept of hedging. This means the study has developed a new theory of Islamic hedging. The theory of Islamic hedging must be based on the hadith of *al-kharaj bi al-daman* and fiqh maxim of *al-ghurm bi al-ghurm* approaches. In addition, the objective of Islamic hedging to reduce risk must only be related to real economic activities.
9. Risk management in Islamic banking by Ahmed & Khan (2001) stated that Islamic banks face additional risks due to the nature of their balance sheet and shariah compliance. Non-availability of financial instruments to Islamic banks is a major

hindrance in their way to manage market risks as compared to the conventional banks. While some of the fiqh-related issues have to be resolved by shari'a scholars, setting up of infrastructure institutions needs to be done by the government and regulatory authorities in different countries. Obviously, owing to religious restrictions, the Islamic banks cannot enter the conventional banking market, but the conventional banks are offering the Islamic products simultaneously with their own products. Competition no doubt enhances efficiency and a level playing field is a prerequisite for a healthy competitive environment. A more level playing field for competition between Islamic and conventional banks in this regard cannot be ensured unless the Islamic banks have similar supporting infrastructure institutions. There is a need to introduce a risk management culture in Islamic banks. One way to introduce this culture is to initiate some form of the internal rating system. Specifically, risk weighting of all their assets separately is needed. In the medium and longer run these could evolve into more sophisticated systems. Initiation of such a system can be instrumental in filling the gaps in the risk management system and hence enhancing the rating of these by the regulatory authorities and external credit assessment agencies.

10. Islamic Hedging: Gambling or Risk Management? by Mohamad (2008). Although there is a lack of consensus regarding derivatives and the development of shariah-compliant funds to mimic hedge funds in order to tap the global surplus liquidity especially the Gulf petrodollar, shariah scholars are generally agreeable that hedging is permissible and necessary as a risk management tool. However, there is still considerable debate regarding the kind of instruments that could be shariah-

compliant. This paper looks at the main forms of hedging and examines the debate surrounding the use of derivatives in Islamic financial markets. The paper then looks at alternatives for shariah-compliant hedging mechanisms and in particular examines an Islamic financial derivative of Bay' al Salam that can mimic a short sale in a conventional option, but with potential for becoming a more superior risk management tool.