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Financial Risk Management: It's Implications and Compliance with Shari'ah Standards

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Financial Risk Management: It's Implications and Compliance with Shari'ah Standards

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Abstract

Financial Risk Management (FRM) is an integral to ensuring financial stability and sustainability in both conventional and Islamic finance systems. This article explores the definitions and foundations of Financial Risk Management (FRM), focusing on its implications and compliance with Shari'ah standards. Illustrative, conventional FRM relies heavily on risk-transfer mechanisms such as derivatives, while Islamic finance emphasizes on ethical principles, including the prohibition of Riba (interest), Gharar (excessive uncertainty), and Maysir (gambling). These principles promote risk-sharing, fairness, and asset-backed transactions, aligning financial practices with Islamic ethical values. The study reviews international FRM standards, such as those proposed and evaluates their compatibility with Islamic finance. Shari'ah standards, particularly those outlined by AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions), provide a structured approach to managing financial risks in compliance with Islamic jurisprudence. The research also examines the historical roots of risk management in pre-Islamic Arabia, where mutual cooperation and risk-sharing laid the foundation for modern Islamic financial practices. Drawing on Quranic verses and Prophetic traditions, the article highlights the Shari'ah-based foundations of FRM, showcasing how principles of justice, trust, and shared responsibility are embedded in Islamic finance. This study contributes that Islamic Shari'ah has not only allows mitigating future risk but emphasizes on the following of best principles for FRM laid down in the Qur'an and Sunnah of the Prophet (PBUH).

Keywords: Financial Risk Management, Shari'ah Standards, Islamic Finance, Riba, Gharar, Qimar, AAOIFI, Quran, Sunnah, Pre-Islamic Arabia, Takaful, Sukuk.

A. Introduction

Financial Risk Management (FRM) is an integral to ensuring financial stability and sustainability in both conventional and Islamic finance systems. This article explores the definitions and foundations of Financial Risk Management (FRM), focusing on its implications and compliance with Shari'ah standards. Illustrative, conventional FRM relies heavily on risk-transfer mechanisms such as derivatives, while Islamic finance emphasizes on ethical principles, including the prohibition of Riba (interest), Gharar (excessive uncertainty), and Maysir (gambling). These principles promote risk-sharing, fairness, and asset-backed transactions, aligning financial practices with Islamic ethical values. The study reviews international FRM standards, such as those proposed and evaluates their compatibility with

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Islamic finance. Shari'ah standards, particularly those outlined by AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions), provide a structured approach to managing financial risks in compliance with Islamic jurisprudence. The research also examines the historical roots of risk management in pre-Islamic Arabia, where mutual cooperation and risk-sharing laid the foundation for modern Islamic financial practices. Drawing on Quranic verses and Prophetic traditions, the article highlights the Shari'ah-based foundations of FRM, showcasing how principles of justice, trust, and shared responsibility are embedded in Islamic finance. This study contributes that Islamic Shari'ah has not only allows mitigating future risk but emphasizes on the following of best principles for FRM laid down in the Qur'an and Sunnah of the Prophet (PBUH).

Background of the Topic

Financial Risk Management (FRM) has become an integral aspect of modern financial systems, ensuring stability, sustainability, and the minimization of the adverse financial impacts. Traditional FRM focuses on identifying, evaluating, and mitigating risks such as market volatility, credit defaults, liquidity shortages, and operational disruptions. These practices are designed to safeguard organizations from financial shocks and enhance long-term performance. In the context of Islamic finance, FRM takes on a unique form due to the requirement for compliance with Shari'ah principles, which governs all aspects of life, including economic activities, and prohibits unethical practices such as Riba (Interest), Gharar (Uncertainty) and Maysir (Gambling). Riba (interest) means earning through predetermined interest are forbidden, Gharar (excessive uncertainty) means engaging in ambiguous or speculative contracts is impermissible; while Maysir (gambling) means speculative activities akin to gambling are prohibited. Substitute, Shari'ah-compliant financial systems promote equity-based transactions (e.g., *Musharakah, Mudarabah*), asset-backed financing (e.g., *Ijarah, Murabaha*), and risk-sharing mechanisms. This distinction necessitates unique risk management strategies that align with ethical, religious, and legal standards while maintaining financial viability. As Islamic finance grows globally, especially in regions like the Middle East, Southeast Asia, and parts of Europe, the need to develop vigorous FRM strategies within the framework of Shari'ah compliance has gained prominence. However, it also poses challenges, such as the development of innovative instruments, Shari'ah governance, and standardization across jurisdictions. The study of FRM in the context of Shari'ah compliance is essential for integrating traditional risk management approaches with Islamic financial ethics, contributing to a stable, inclusive, and ethical financial system. There are number of research papers written, but this aspect is very less discussed in the context of Islamic principles of Risk management while highlighting its compliance with Islamic Shari'ah. In this article, foundations of Financial Risk Management in the context of Islamic Shari'ah will be explored. It will also be highlighted whether the Holy Qur'an and Sunnah of the Holy Prophet (PBUH) provide us guidance regarding Risk Management.

Significance of the Study

Exploring Financial Risk Management (FRM) within the framework of Shari'ah compliance is highly significant due to its relevance to finance, ethics, and Islamic economic systems. The IFSB's ***Islamic Financial Services Industry Stability Report 2024*** reveals that the global Islamic finance industry experienced steady growth in 2023, with total assets reaching

USD 3.38 trillion.[1] Shari'ah-compliant financial systems emphasize ethics, equity, and shared responsibility, bridging the gap between risk management and moral accountability. Islamic financial institutions (IFIs) face unique risks due to their reliance on profit-and-loss sharing contracts, asset-backed transactions, and the prohibition of derivatives[2], requiring tailored frameworks for effective risk management. By increasing stakeholder confidence through morally aligned financial solutions, Shari'ah-compliant FRM fosters trust and long-term engagement. This research contributes to developing standardized guidelines, promoting operational efficiency, reducing systemic risks, and enhancing resilience against financial crises. Its findings can guide policymakers and regulators in crafting governance structures that align financial prudence with Shari'ah compliance, ensuring sustainable and robust Islamic financial systems.

Objectives of the Study

The study aims to explore and analyze Financial Risk Management (FRM) practices within the framework of Shari'ah principles, addressing the unique challenges faced by Islamic financial institutions (IFIs). It seeks to identify and examine various financial risks, such as credit, market, operational, and liquidity risks, and assess the impact of Islamic finance principles like profit-and-loss sharing and asset-backed financing on risk exposure. The study evaluates the implications of inadequate risk management on the stability and growth of IFIs while investigating the role of effective FRM in enhancing stakeholder trust and competitiveness. It explores how Shari'ah principles shape risk management frameworks, identifies challenges in ensuring compliance, and examines tools and strategies like Takaful and Sukuk etc. for mitigating risks. Additionally, the research assesses governance and regulatory frameworks, focusing on the role of Shari'ah standards such as AAOIFI, in aligning financial prudence with Shari'ah compliance.

Review of the Relevant Literature

The literature on Financial Risk Management (FRM) within Shari'ah compliance highlights its ethical and practical foundations in Islamic finance. Chapra (2000) and Siddiqi (2006) emphasize risk-sharing and transparency, contrasting these with conventional risk-transfer methods. Usmani (2002) elaborates on the prohibitions of ***riba*** (interest), ***gharar*** (uncertainty), and ***maysir*** (gambling) shaping risk practices. Iqbal (2008) classifies risks in Islamic finance, while Ahmed et al. (2010) address liquidity challenges and the scarcity of Shari'ah-compliant tools. Mitigation strategies, including ***Sukuk*** and ***Takaful***, are explored by Khan and Bhatti (2008), with Archer and Haron (2013) proposing Shari'ah-compliant governance frameworks. Governance challenges are detailed by Hassan and Lewis (2007) and Rosly (2010), emphasizing harmonized standards. Sole (2007) and Dusuki (2011) identify the need for innovation and global alignment in risk instruments. Comparative analyses, such as Iqbal and Mirakhor (2011), stress the resilience of Islamic finance during crises, while Ali (2013) advocates for ethical alternatives to derivatives. Despite progress,

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[1] Islamic Financial Services Board. *Islamic Financial Services Industry Stability Report 2024* (Kuala Lumpur: Islamic Financial Services Board, 2024). P 8

[2] Derivatives are financial instruments whose value is derived from the performance of an underlying asset, index, or benchmark. These underlying assets can include stocks, bonds, commodities, currencies, interest rates, or market indices. Derivatives are commonly used for hedging risks, speculation, and arbitrage.

gaps remain in standardization and regulatory frameworks, calling for further research to ensure effective, ethical FRM in Islamic finance.

Research Gap

The review of relevant literature reveals several research gaps in the domain of Financial Risk Management (FRM) and its compliance with Shari'ah standards. One of prominent gaps lies in the lack of standardization across jurisdictions, as variations in Shari'ah interpretations hinder the development of unified FRM frameworks for Islamic financial institutions (IFIs). Apart from all other gaps, this research will explore the Shari'ah Implications and Compliance of Financial Risk Management (FRM), which can be opted by Islamic Financial Institutions (IFIs) and get rid of conventional methods of FRM in financial dealings.

Research Methodology

The research methodology for this study adopts a mixed-methods approach to comprehensively explore Financial Risk Management (FRM) practices and their compliance with Shari'ah standards. It integrates qualitative and quantitative methods to provide a balanced analysis. Qualitative data is gathered through an extensive review of primary and secondary sources, including Shari'ah principles from the Qur'an and Hadith, regulatory guidelines from bodies like AAOIFI and IFSB[3], and relevant academic literature.

B. Discussion

Financial Risk Management

The etymology of the word "risk" traces back to the late Middle French word "Risque, which is derived from the Italian "Risico" or "Rischio", both meaning "danger" or "hazard." The Italian term likely originated from the Latin "Risicum", a variant of "Resecare", meaning "to cut off" or "to sever," signifying the act of avoiding potential harm or danger.[4] There is no single definition of risk. Because, Economists, behavioral scientists, risk theorists, statisticians, and actuaries each have their own concept of risk. However, risk historically has been defined in terms of uncertainty. Based on this concept, risk is defined as uncertainty concerning the occurrence of a loss. In the Risk Management Guide 73 (2002) states that an effect may be positive, negative, or a deviation from the expected. These three types of events can be related to risks as opportunity, hazard or uncertainty. The guide mentions that risk is often described by an event, a change in circumstances, a consequence, or a combination of these and how they may affect the achievement of objectives.[5]

The term risk is an ambiguous and has different meanings; in the past, risk managers generally considered only pure loss exposures faced by the firm. However, new forms of risk management are emerging that consider both pure and speculative loss exposures. These risks are usually divided into categories such as operational, financial, legal compliance,

[3] IFSB stands for the Islamic Financial Services Board. It is an international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry. The IFSB develops global prudential standards and guidelines for various sectors, including Islamic banking, Islamic insurance, and Islamic capital markets, ensuring their alignment with Shari'ah principles while addressing financial risks and regulatory requirements.

[4] Oxford English Dictionary. "Risk." Accessed November 16, 2024. https://www.oed.com.

[5] Hopkin, Paul. Fundamentals of Risk Management: Understanding, Evaluating and Implementing Effective Risk Management. 4th ed (London: Kogan Page,2017), p 16

information, personnel and enterprise risk management. [6] In the modern context, risk management is the process of identifying, assessing, and controlling threats to an organization's capital and earnings. These risks stem from a variety of sources, including financial uncertainties, legal liabilities, strategic management errors, accidents, and natural disasters. A successful risk management program helps an organization consider the full range of risks it faces. Besides, Risk management also examines the relationship between risks and the cascading impact they could have on an organization's strategic goals.[7] Also, in an organizational context, Risk is usually defined as anything that can impact the fulfilment of corporate objectives. However, corporate objectives are usually not fully stated by most organizations. [8] However, in the economics and finance literature, authors often make a distinction between risk and uncertainty. The term "risk" is often used in situations where the probability of possible outcomes can be estimated with some accuracy, while "uncertainty" is used in situations where such probabilities cannot be estimated. [9]

Financial Risk Management

The above lines have defined various aspects of the term "Risk", such as operational, financial, legal compliance, information, personnel and enterprise risk management. However, in the context of financial risk management, there are several types of risks that organizations must identify and mitigate. Elucidation, these risks are including; Credit risk which refers to the possibility that a borrower will default on their obligations, leading to financial losses. Market risk involves the potential for losses due to fluctuations in market variables, such as interest rates, equity prices, or commodity prices. Operational risk arises from failures in internal processes, systems, or human error, which can disrupt operations and lead to losses. Liquidity risk refers to the inability of an organization to meet its short-term financial obligations due to an imbalance between its liquid assets and liabilities. Legal and regulatory risk stems from the potential for financial loss due to changes in laws or regulations that affect the business. Reputational risk is the potential for damage to a company's public image, which could lead to a loss of customers or investors. Finally, systemic risk refers to the risk of collapse or failure of the entire financial system due to the interconnectedness of financial institutions or markets. All of these risks need to be carefully managed to ensure financial stability and long-term success. [10] In short, the Financial Risk Management (FRM) is the process of identifying, assessing, and mitigating risks that could adversely impact an organization's financial health. John C. Hull explains FRM as using various tools and techniques to minimize the potential impact of market, credit, liquidity, and operational risks on an organization. [11] *Explicatory, the FRM in Islamic finance refers to*

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[6] George E. Rejda, Michael J. McNamara, Principlas of Risk Management and Insurance (Tokyo: Pearson Publishers, nd), p 44

[7] Kloman, H. Felix. "A Brief History of Risk Management." In Enterprise Risk Management: Today's Leading Research and Best Practices for Tomorrow's Executives, edited by John Fraser and Betty Simkins (New Jersey: John Wiley & Sons, Inc. nd), 19-29.

[8] Hopkin, Paul. Fundamentals of Risk Management: Understanding, Evaluating and Implementing Effective Risk Management. 4th ed (London: Kogan Page,2017), p 17

[9] Knight, Frank H. *Risk, Uncertainty, and Profit*. (Boston: Houghton Mifflin, 1921), 233.

[10] Horcher, Tonya J. Boen. Essentials of Financial Risk Management. (Hoboken, NJ: John Wiley & Sons, 2005), 46.

[11] Hull, John C. Risk Management and Financial Institutions. 5th ed. (Hoboken, NJ: John Wiley & Sons, 2018),

managing financial risks in alignment with Shari'ah principles, avoiding Riba (interest), Gharar (uncertainty), and Maysir (gambling). Mr. M. Iqbal emphasizes that Islamic FRM centers on ethical financial practices, risk-sharing mechanisms, and asset-backed financing to ensure both compliance and stability.[12]

International Standards of Risk Management

There are numerous Standards of Risk Management recognized at international level. Descriptive, ISO 31000, Risk Management Guidelines: It is a widely recognized international standard that provides principles, frameworks, and processes for effective risk management applicable to any organization. It emphasizes integration, customization, and continuous improvement in managing risks. ISO 31000 is an adaptable to diverse industries and organizational scales, making it a cornerstone of modern risk management practices. [13] The COSO ERM Framework: It is the Committee of Sponsoring Organizations of the Treadway Commission (COSO) developed the Enterprise Risk Management (ERM) framework. This standard focuses on strategically managing risks to achieve organizational objectives. It emphasizes governance, strategy alignment, and performance metrics as key elements for embedding risk management into decision-making processes.[14] Basel Accords (I, II, III), the Basel Accords, issued by the Basel Committee on Banking Supervision[15], set regulatory standards for managing credit, market, and operational risks in financial institutions. Basel III emphasizes enhancing capital adequacy and liquidity requirements to mitigate systemic risks. These accords have profoundly influenced global banking practices, ensuring financial stability and resilience during crises. [16] Solvency II Directive: It is a European Union regulatory framework for insurance companies, which emphasizes risk-based capital requirements, governance, and disclosure standards, providing a comprehensive approach to ensuring solvency and financial resilience. Its principles align capital adequacy with an insurer's risk profile, ensuring stability in the face of market fluctuations. [17]

The Shari'ah Standards for Islamic Finance (AAOIFI)

Apart from Conventional International Standards, Muslim World, under the umbrella of OIC, has also established Islamic International Standards. Explicatory, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is a leading international

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[12] Iqbal, Zamir, and Abbas Mirakhor. An Introduction to Islamic Finance: Theory and Practice. 2nd ed. (Singapore: John Wiley & Sons (Asia), 2011.

[13] Hubbard, Douglas W. The Failure of Risk Management: Why It's Broken and How to Fix It. 2nd ed. (Hoboken, NJ: John Wiley & Sons, 2020), 45–48.

[14] Hopkin, Paul. Fundamentals of Risk Management: Understanding, Evaluating, and Implementing Effective Risk Management. 5th ed (London: Kogan Page, 2018), 153–157.

[15]It is an international body that sets global standards for the regulation and supervision of banks to enhance financial stability and reduce systemic risks. It was established in 1974 by the central bank governors of the G10 countries, following financial disruptions caused by the collapse of several banks, including Backhaus Herstatt in Germany

[16] Hull, John C. Risk Management and Financial Institutions. 5th ed (Hoboken, NJ: John Wiley & Sons, 2018), 341–345.

[17] Sweeting, Paul. Financial Enterprise Risk Management (Cambridge: Cambridge University Press, 2011), 189–192

standard-setting body established in 1991, dedicated to the development and harmonization of Shari'ah-compliant financial practices. Headquartered in Bahrain, AAOIFI issues comprehensive standards covering Shari'ah principles, accounting, auditing, ethics, and governance for Islamic financial institutions (IFIs). These standards aim to ensure the consistency, transparency, and credibility of Islamic finance operations globally. With over 100 member countries, AAOIFI plays a vital role in bridging traditional financial practices with Shari'ah principles, providing guidance for products such as Sukuk, Takaful, and Islamic banking while addressing contemporary challenges in the industry.[18]

Shariah Principles of Financial Risk Management

Islam is, no doubt, a complete and perfect guide for humanity till the day of Judgment, which guides in every sphere of life. Elucidatory, Finance is one of the foremost and important field of human society. Obviously, it also provides complete, perfect and most beneficial guidelines in this field. The primary sources of Islam, The Holy Qur'an and Hadiths of the Prophet (PBUH), has provided sufficient teaching and financial principles. In this context, majority of financial dealings and transactions are lawful except three main elements such as Riba, Gharar and Maysir. These three are extremely harmful not only to an individual but for the whole society. That's why, Islam has strictly prohibited them in the financial dealings and transactions. A brief introduction of these elements is as below:

Prohibition of Riba (Usury)

The Qur'an categorically prohibits Riba, which refers to any predetermined interest on loans. This prohibition is grounded in the belief that usury exploits borrowers and exacerbates financial inequities. Instead of earning profit through exploitation, the Qur'an encourages a model where financial gains arise from legitimate business activities and partnerships.[19]

"يَا أَيُّهَا الَّذِينَ آمَنُوا اتَّقُوا اللَّهَ وَذَرُوا مَا بَقِيَ مِنَ الرِّبَا إِن كُنتُم مُّؤْمِنِينَ"[20]

> *O you who have believed, fear Allah and give up what remains [due to you] of interest, if you should be believers."*

This directive promotes risk-sharing rather than risk-transfer, encouraging parties to engage in investments where profits and losses are shared, thus fostering a fairer economic environment.

Maysir (Gambling)

Maysir involves financial transactions where gains or losses depend purely on chance, which is strictly prohibited in Islam. This principle discourages speculative activities in financial markets, including trading in derivatives or excessive reliance on uncertain future outcomes. Islamic financial instruments must be based on tangible assets or real economic activities to avoid Qimar.[21]

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[18] Iqbal, Zamir, and Abbas Mirakhor. An Introduction to Islamic Finance: Theory and Practice. 2nd ed (Singapore: John Wiley & Sons, 2011), 213–216.
[19] Usmani, Muhammad Taqi. An Introduction to Islamic Finance (Karachi: Maktaba Ma'ariful Quran, 2002), 19–23.
[20] Al Bagara 2: 278
[21] El-Gamal, Mahmoud A. Islamic Finance: Law, Economics, and Practice (Cambridge: Cambridge University Press, 2006), 58–61.

Gharar (Excessive Uncertainty)

Gharar signifies uncertainty or ambiguity in the terms or conditions of a contract, leading to potential disputes or exploitation. It is prohibited in Islamic finance to ensure transparency and fairness in transactions. Contracts must be clear, with known quantities, prices, and deliverables, avoiding speculative elements. For instance, insurance is often replaced with Takaful to align with Shari'ah principles.[22]

Emphasis on Fairness and Honesty

The Qur'an places great emphasis on integrity and transparency in financial transactions. It encourages individuals to engage in fair trade, warning against deceptive practices and fraud. The ethical conduct outlined in these verses helps mitigate risks associated with dishonesty and misrepresentation.

وَأَوفُوا الْكَيْلَ وَالْمِيزَانَ بِالْقِسْطِ [23]

"And give full measure and weight in justice."

By mandating honesty in trade, these teachings reduce the likelihood of disputes and foster trust among parties, essential elements for successful financial transactions.

Mutual Support and Cooperation

The Qur'an advocates for cooperation and mutual assistance, particularly in financial dealings. This principle aligns with the idea of collective risk management, where community members support each other in times of need, sharing the burdens of financial challenges.

"وَتَعَاوَنُوا عَلَى الْبِرِّوَالتَّقْوَى[24] "

"And cooperate in righteousness and piety."

This verse underscores the importance of community cohesion in managing financial risks, as individuals come together to support one another and ensure the well-being of the community.

Foundations of FRM in Pre-Islamic Arabia

Financial Risk Management has deep basis in the history especially in Islamic history. If we have glance at Pre and Post Islamic history, we would find numerous examples related to risk and financial risk management. There a number of precedents of financial risk management in pre followed by post Islamic history. Few of them are briefly mentioned in the lines below:

'Aaqilah (عاقلہ)

The 'Aqilah is a traditional concept in Islamic law referring to a group of paternal male relatives or tribal members who collectively assume financial responsibility for paying blood money (Diyah) in cases of accidental killing or injury. Rooted in Hadith and practiced during the time of Prophet Muhammad (PBUH), the system emphasizes communal solidarity and collective responsibility, ensuring that the financial burden does not fall solely on the individual responsible. The 'Aqilah promotes unity, risk-sharing, and mutual support within

[22] Iqbal, Zamir, and Abbas Mirakhor. An Introduction to Islamic Finance: Theory and Practice. 2nd ed (Singapore: John Wiley & Sons 2011), 73–76.
[23] Bani Israil 17: 35
[24] Al Maidah 5: 2

families or tribes. In modern contexts, the principles of the 'Aqilah have influenced Islamic insurance systems like Takaful, adapting communal responsibility to contemporary needs.[25]

Contract of Alliance (عقد موالات)

The Contract of Alliance in Islamic jurisprudence refers to an agreement between two parties for mutual support and shared responsibilities. This contract often involves commitments such as legal representation, financial aid, or even sharing liabilities like blood money (Diyah) in cases of accidental harm. Rooted in pre-Islamic Arab customs, this practice was refined and regulated by Islamic law to ensure justice and fairness. The Prophet Muhammad (PBUH) acknowledged such alliances, emphasizing their role in fostering social cooperation and collective responsibility.[26] This demonstrates an early form of risk management by establishing networks of support, ensuring that members of the community look after one another's welfare.

Qasamah (قسامہ)

The term Qasamah is an Islamic legal concept used to resolve cases of unintentional homicide or murder when there is insufficient evidence or witnesses. The process involves the accused or their family members taking an oath (qasm) to either deny or confirm their involvement in the crime. If the accused denies the crime, the victim’s family may demand an oath from the accused or their relatives, swearing by God's name to assert their innocence. This oath-based procedure aims to provide justice when there is a lack of clear proof.[27] This system promotes community accountability and risk-sharing, ensuring that collective justice is served while also protecting individuals from wrongful accusations.

Guarantee of Road Safety (ضمان خطرالطریق)

The concept of Guarantee of Road Safety in Islamic law refers to the responsibility of ensuring the safety and protection of individuals while traveling on public roads. Rooted in Islamic teachings on justice, safety, and preventing harm, it emphasizes the obligation of both authorities and the community to take necessary precautions. Authorities are responsible for maintaining safe infrastructure, while the community must ensure that roads are free from hazards and risks. The principle aligns with the broader Islamic maxim of "*no harm and no reciprocating harm*" which underscores the importance of protecting life and property. This was a way to mitigate risks and transfer responsibility among traders.[28] This practice reflects a systematic approach to managing commercial risks and emphasizes communal solidarity in the face of potential dangers.

[25] Bukhari, Muhammad bin Ismail, al Jami’ al Sahih (Riadh: Darussalam, 1999), Kitab al Diyat, Bab al Diyat, Hadith: 6898

[26] Ibn Qayyim al-Jawziyyah, *Ahkam Ahl al-Dhimmah*, ed. Subhi al-Salih (Beirut: Dar al-‘Ilm li’l-Malayin, 1961), vol. 1, 235.

[27] Ibn Abidin, Muhammad Amin. *Radd al-Muhtar ala al-Durr al-Mukhtar*. 2nd ed (Beirut: Dar al-Fikr, 2000), 5/ 389.

[28] Ibn Qayyim al-Jawziyyah, *Ahkam Ahl al-Dhimmah*, ed. Yusuf al-Bakri and Shakir al-Arna'ut (Beirut: Dar al-Kutub al- ‘Ilmiyyah, 1997), vol. 2, 451.

Guarantee of Accountability (ضمان الدرک)

The Guarantee of Accountability in Islamic law refers to the principle that individuals or parties are held responsible for the harm or damage they cause. This concept ensures that people are accountable for their actions and that the consequences, whether financial, civil, or criminal, are appropriately addressed. It promotes social justice by ensuring that those who cause harm, whether intentionally or unintentionally, compensate the victims or face the consequences. This principle encourages individuals to act responsibly, knowing that they will be held liable for their actions. [29] This principle highlights the importance of accountability in commercial transactions, mitigating financial risks through guarantees.

The above-mentioned precedents of Financial Risk Management illustrate a sophisticated understanding of risk management in early Islamic society. These practices not only reflect communal responsibility and ethical conduct but also provide a framework for ensuring mutual support and accountability. Such principles can be foundational in contemporary discussions on risk management, demonstrating the relevance of Islamic teachings in modern contexts. Integrating these historical practices into contemporary frameworks can enrich the discourse on risk management in both Islamic jurisprudence and global contexts.

Shariah Foundations of FRM in the Holy Qur'an

Risk management is a vital concept that spans various aspects of life, from personal safety to financial dealings. The Holy Qur'an offers numerous guidelines that emphasize the importance of mitigating risks and ensuring safety in both personal and communal affairs. This research explores several verses that illustrate the principles of risk management as presented in the Qur'an.

Prophet Joseph's (PBUH) Strategic Vision

In Surah Yusuf, Allah Almighty describes how Prophet Yusuf (PBUH) was given the ability to interpret dreams, which allowed him to foresee a coming famine. He advised the Pharaoh to store surplus grain during the years of abundance:

إِنَّكَ أَنْتَ الْعَلِيمُ الْحَكِيمُ"[30]

Indeed, you are the All-Knowing, the All-Wise.

فَسَتَسْتَخْرِجُونَ مَا تَحْصُدُونَ إِلَّا قَلِيلًا مِمَّا تَأْكُلُونَ"[31]

And you will harvest what you sow, except for a little of what you will eat.

سَبْعٌ شِدَادٌ يَأْكُلْنَ مَا قَلَّتُمْ"[32]

Seven years of severe famine will consume what you have saved for them.

Joseph's foresight and strategic planning illustrate the importance of preparing for potential risks, particularly in resource management.

Strategy of Ammar ibn Yasir (R.A)

The verse refers to Ammar ibn Yasir (R.A), who faced threats to his life due to his faith. The Qur'an allows for the preservation of life, even under duress:

مَن كَفَرَ بِاللَّهِ مِن بَعْدِ إِيمَانِهِ إِلَّا مَن أُكْرِهَ وَقَلْبُهُ مُطْمَئِنٌّ بِالْإِيمَانِ"[33]

[29] Ibn Abidin, Muhammad Amin. *Radd al-Muhtar ala al-Durr al-Mukhtar*. 2nd ed. Beirut: Dar al-Fikr, 2000, vol. 4, 218.
[30] Al Yusuf 12: 43
[31] Al Yusuf 12: 47
[32] Al Yusuf 12: 49

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"Whoever disbelieves in Allah after his faith except for one who is forced while his heart is secure in faith.

This verse emphasizes the importance of safeguarding one's life and the acceptability of temporary measures to mitigate risks in the face of persecution.

Strategy of Prayer in Times of Fear

The Qur'an prescribes prayers even during times of fear, ensuring that spiritual connection remains intact:

وَلاَ تَهِنُوا فِي ابْتِغَاءِ الْقَوْمِ"[34]

And do not weaken in pursuing the enemy.

This highlights the significance of maintaining spiritual resilience as a form of psychological risk management.

Preventive Measures by Prophet Yaqoob (PBUH) about His Sons

Prophet Jacob instructed his sons to enter through different gates to avoid attracting attention:

وَلَا تَدْخُلُوا مِن بَابٍ وَاحِدٍ"[35]

And do not enter from one gate.

This demonstrates the practice of taking preventive measures to mitigate risks associated with envy and jealousy.

Weaponry Strategy and Risk Management

The Qur'an advises the believers to be ready and prepared for confrontation by keeping weapons:

وَأَعِدُّوا لَهُم مَّا اسْتَطَعْتُم مِّن قُوَّةٍ"[36]

And prepare against them whatever you are able of power.

This verse underscores the necessity of being equipped to face potential threats.

Contracts to Mitigate Risks

The Qur'an discusses the importance of documenting debts to avoid disputes:

يَا أَيُّهَا الَّذِينَ آمَنُوا إِذَا تَدَايَنتُم بِدَيْنٍ إِلَىٰ أَجَلٍ مُّسَمًّى"[37]

O you who have believed, when you contract a debt for a specified term..."

This verse emphasizes the need for clear agreements to minimize financial risks.

The Importance of Consultation

The commandment of consultation is one of the strategies to avoid risk or gain profit. The Holy Qur'an has mentioned this order of the Allah Almighty in these words:

" وَشَاوِرْهُمْ فِي الْأَمْرِ "[38]

And consult them in the matter."

Seeking counsel from others before making decisions is essential in mitigating risks, as it promotes collective wisdom.

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[33] Al Nahal 16: 106
[34] Al Nisa' 4: 104
[35] Al Yusuf 12: 67
[36] Al Anfal 8: 60
[37] Al Baqarah 2: 282
[38] Al Imran 3: 59

Protection of Life

The Holy Qur'an emphasizes the responsibility of individuals to protect their lives and those around them:

يَا أَيُّهَا الَّذِينَ آمَنُوا عَلَيْكُمْ أَنفُسَكُمْ"[39]

O you who have believed, upon you are yourselves.

This stresses individual responsibility in safeguarding life, which is a fundamental aspect of risk management.

Confrontation with Armed Enemies

The Qur'an advocates for standing firm in the face of adversaries:

فَإِنْ خِفْتُمْ مِنْهُمْ فَارْتَابُوا "[40]

If you fear them, then take precautions.

This illustrates the necessity of being vigilant and prepared for conflict.

Guardianship of Orphans

The Qur'an mandates the careful management of an orphan's wealth to prevent exploitation:

وَلاَ تَقْرَبُوا مَالَ الْيَتِيمِ إِلَّا بِالَّتِي هِيَ أَحْسَنُ"[41]

And do not approach the orphan's property except in a way that is best.

This serves as a guideline for risk management concerning the financial rights of vulnerable individuals. The Holy Qur'an provides a comprehensive framework for risk management that encompasses personal, social, and financial dimensions. By adhering to these principles, believers can navigate the complexities of life while minimizing potential risks. Each of the discussed verses offers valuable insights into proactive measures, emphasizing the importance of foresight, preparation, and ethical conduct in managing risks effectively.

Shariah Foundations of FRM in the Hadiths

The holy Prophet (PBUH) has also guided His Ummah to mitigate risk and future hazards. There are numerous traditions that testify that the Prophet (PBUH) had allowed to manage risks but complying with Shari'ah principles of finance mentioned in the above lines. Elucidatory, the Prophet Muhammad (PBUH) discouraged practices involving excessive uncertainty (Gharar), deceit, and exploitation, which are core considerations in risk management.

Prohibition of Gharar (Uncertainty)

The Prophet (PBUH) prohibited excessive uncertainty (Gharar) in contracts, emphasizing the need for clarity and specificity in financial agreements. This prohibition is critical for effective risk management, as it encourages all parties involved to fully understand the terms and conditions of their agreements.

نَهَى رَسُولُ اللَّهِ صلى الله عليه وسلم عَنِ الْبَيْعِ الْغَرَرِ[42]

"The Messenger of Allah (PBUH) prohibited sales that involve excessive uncertainty."

[39] Al Maida 5: 105
[40] Al Nisa 4: 104
[41] Al Nisa 4: 5
[42] Ibn e Majah, Muhammad bin Yazeed, al Sunan, Kitab al Tijarat, Bab al Nahyi 'Aan Bai' al Hasat wa 'Aan Bai' al Ghara, Hadith: 2194

By minimizing uncertainty, this teaching helps to mitigate the risks associated with ambiguity and confusion in financial transactions.

Promoting ethical business conduct

The Sunnah emphasizes the importance of ethical conduct in trade. The Prophet (PBUH) set a precedent for fairness in financial dealings, which is vital for maintaining trust and integrity in economic activities.

"الْبَيِّعَانِ بِالْخِيَارِ مَا لَمْ يَتَفَرَّقَا[43]"

The buyers and sellers have the option to cancel or confirm the sale as long as they have not separated."

This principle encourages parties to be fully aware of the risks involved in a transaction, thereby promoting informed decision-making and reducing the chances of disputes.

Community Responsibility

The Sunnah also highlights the importance of supporting one another, especially during times of financial hardship. The Prophet (PBUH) emphasized the significance of mutual assistance and cooperation among community members.

لا يُؤْمِنُ أَحَدُكُمْ حَتَّى يُحِبَّ لِأَخِيهِ مَا يُحِبُّ لِنَفْسِهِ[44]

None of you truly believes until he loves for his brother what he loves for himself."

Taking Action and Trusting Allah

This hadith underscores the importance of taking initiative and putting in effort, while trusting that Allah will guide and facilitate the path according to His wisdom. It encourages individuals to act with determination, knowing that success in their efforts is ultimately determined by Allah's will. The verse reflects a balance between personal responsibility and reliance on divine guidance.

عَنْ عَلِيٍّ، قَالَ كُنَّا جُلُوسًا عِنْدَ النَّبِيِّ. صلى الله عليه وسلم. وَبِيَدِهِ عُودٌ فَنَكَتَ فِي الأَرْضِ ثُمَّ رَفَعَ رَأْسَهُ فَقَالَ " مَا مِنْكُمْ مِنْ أَحَدٍ إِلاَّ وَقَدْ كُتِبَ مَقْعَدُهُ مِنَ الْجَنَّةِ وَمَقْعَدُهُ مِنَ النَّارِ " . قِيلَ يَا رَسُولَ اللَّهِ أَفَلاَ نَتَّكِلُ قَالَ " لاَ اعْمَلُوا وَلاَ تَتَّكِلُوا فَكُلٌّ مُيَسَّرٌ لِمَا خُلِقَ لَهُ " [45]

It was narrated that 'Ali said: "We were sitting with the Prophet (PBUH) and he had a stick in his hand. He scratched in the ground with it, then raised his head and said: 'There is no one among you but his place in Paradise or Hell has already been decreed.' He was asked: 'O Messenger of Allah, should we not then rely upon that?' He said: 'No, strive and do not rely upon that, for it will be made easy for each person to do that for which he was created.

Avoiding Harm

It is a key principle in Islamic ethics, emphasizing the importance of preventing actions that may cause damage or distress to others. This concept is rooted in the idea that one should avoid both direct harm and harm through negligence, ensuring that actions are in line with

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[43] Bukhari, Muhammad bin Isma'il, al Jami' al Sahih, Kitab al Buyu', Bab al Bai'an bil Khiyar Ma Lam Yatafarraqa', Hadith: 2111

[44] Bukhari, Muhammad bin Isma'il, al Jami' al Sahih, Kitab al Iman, Bāb min al-īmān an yuḥibba li-akhi-hi mā yuḥibbu li-nafsi-hi, Hadith: 13

[45] Ibn e Majah, Muhammad bin Yazeed, al Sunan, Kitab al Sunnah, Bab fy al Qadr, Hadith: 78

justice, fairness, and compassion. The Prophet Muhammad (PBUH) advised that neither harm should be inflicted upon others, nor should harm be tolerated, reflecting a commitment to the well-being of individuals and society as a whole.

"لَا ضَرَرَ وَلَا ضِرَارَ"[46]

There should be neither harming nor reciprocating harm."

This principle highlights the necessity of avoiding actions that can lead to harm, aligning with risk management practices.

Patience is only at the first strike of calamity

This saying emphasizes that true patience is demonstrated at the initial moment of hardship or distress. It highlights the importance of remaining steadfast and composed when faced with unexpected challenges, as the first reaction often determines one's resilience and faith. The statement encourages individuals to maintain patience and trust in Allah during the early stages of adversity, as this is when emotional strength is most crucial.

"إِنَّمَا الصَّبْرُ عِنْدَ الصَّدْمَةِ الْأُولَى[47]"

Patience is only when one is struck by the first calamity."

This teaches resilience during difficult times, which is vital in managing risks effectively.

Guardian is Responsible for of the Subordinates

This statement highlights the responsibility each individual has in their role, whether as a leader, caregiver, or in any position of authority. It emphasizes that everyone is accountable for the well-being and guidance of those entrusted to them, whether in a family, workplace, or community setting. The message encourages individuals to take responsibility for their actions and the people under their care, ensuring they fulfill their duties with integrity and fairness.

"كُلُّكُمْ رَاعٍ وَكُلُّكُمْ مَسْؤُولٌ عَنْ رَعِيَّتِهِ[48] "

Each of you is a shepherd, and each of you is responsible for his flock."

The teachings of the Quran and Hadith provide a comprehensive approach to risk management, emphasizing ethical decision-making, trust in Allah, and the importance of proactive actions. The Quran encourages individuals to plan and act responsibly, while placing trust in Allah's will, as seen in verses promoting efforts and patience in the face of challenges. The Hadith further reinforces these principles by stressing the avoidance of harm, encouraging ethical business practices, and emphasizing accountability. Together, they establish a framework for managing risks through fairness, integrity, and reliance on divine guidance, ensuring a balance between human effort and trust in Allah's plan.

Conclusion

Financial Risk Management (FRM) refers to the process of identifying, assessing, and mitigating the various risks faced by financial institutions in order to protect their capital and ensure long-term stability. It encompasses both the strategies used to minimize the potential negative impacts of risks such as market volatility, credit risk, and liquidity, as well as the governance and regulatory frameworks that guide these practices. International standards of FRM, such as those set by the Basel Committee on Banking Supervision and the **Accounting**

[46] Ibn e Majah, Muhammad bin Yazeed, al Sunan, Kitab al Ahkam, Bābu: Man Banā fī Ḥaqqihi Mā Yaḍurru Bi-Jārihi, Hadith: 2341

[47] Abū Dāwūd, Sulaymān ibn al-Ash'ath, al-Sunan, Kitāb al-Janāʾiz, Bāb al-Ṣabr ʿInda al-Ṣadmah, Hadith: 3124

[48] Bukhari, Muhammad bin Isma'il, al Jami' al Sahih, Kitab al Ahkam, Bābu Qawli Allāhi Ta'ālā: "Aṭī'ū Allāha wa-Aṭī'ū ar-Rasūla wa-Ulī al-Amri Minkum, Hadith: 7138

and Auditing Organization for Islamic Financial Institutions (AAOIFI), aim to establish uniform practices that enhance global financial stability and ensure resilience against systemic risks. In the context of Islamic finance, Shari'ah standards of FRM provide a moral and ethical framework that aligns risk management practices with Islamic principles. These standards emphasize fairness, transparency, and the avoidance of elements such as Riba (interest), Gharar (excessive uncertainty), and Maysir (gambling), which are prohibited under Shari'ah. Besides, Shari'ah principles of FRM are rooted in values that promote shared responsibility and risk-sharing. Islamic finance encourages partnerships and equity-based transactions, rather than risk-transfer mechanisms seen in conventional finance. The foundations of FRM in pre-Islamic Arabia can be found in practices such as "Aaqila (mutual cooperation and indemnity among tribes), Qasamah (oath-based compensation for unintentional harm), and Aqd al-Mawalat (contract of alliance) etc. which laid the groundwork for the collaborative, risk-sharing principles that are integral to Islamic finance. These precedents emphasized the importance of fairness, mutual support, and accountability, values that are central to modern Shari'ah-compliant risk management. Finally, the foundations of FRM in the Quran and Hadith of Prophet Muhammad (PBUH) provide clear guidelines for ethical risk management. The Quran encourages responsible actions, the avoidance of harm, and the trust in Allah's wisdom in times of uncertainty. The Hadith further emphasizes transparency, fairness in business practices, and the need for individuals to take proactive steps while placing trust in Allah's plan. Together, these teachings offer a comprehensive framework for financial risk management that aligns ethical, financial, and religious principles.

Finding

- Financial Risk Management (FRM) is not only allowed in Islam but is also encouraged.
- The management of future risks is appreciated, with foundations laid in the Quran and Hadith.
- AAOIFI has established comprehensive standards to mitigate risks in accordance with Shari'ah principles.
- Further research should focus on the risks faced by uneducated individuals in society and explore ways to address these risks within the framework of Islamic finance.

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