



From Madinah to Modern Markets: Reclaiming Prophetic Foundations of Risk Management in Islamic Finance

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Risk management is central to the functioning of any financial system, yet its ethical orientation determines whether it contributes to social stability or economic disruption. Islamic finance presents itself as a value-based alternative to conventional finance, grounding its principles in the Quran and the Sunnah. Despite this claim, contemporary Islamic financial institutions often rely heavily on conventional risk management frameworks with limited substantive integration of Prophetic principles. This paper explores financial risk management during the Prophetic era, particularly in the State of Madinah, and examines its relevance for contemporary Islamic financial practices. Using a qualitative and analytical methodology based on classical Seerah literature, authentic Hadith collections, Qur'anic guidance, and modern Islamic finance scholarship, the study demonstrates that risk management in the Prophetic era was ethical, institutional, and socially embedded. The findings reveal that risk was managed through risk sharing, transparency, moral accountability, and social welfare mechanisms rather than technical complexity. The paper argues that reconnecting Islamic finance with these foundational principles can enhance its credibility, resilience, and socio-economic impact.

Keywords: Financial risk management, Prophetic era, Islamic finance, Seerah, Madinah state, ethical finance

1. Introduction

Risk is an inherent element of all economic activity, and the way it is managed reflects the moral and institutional priorities of a financial system. Modern financial systems employ sophisticated tools to measure, hedge, and transfer risk, yet recurring financial crises reveal deep structural weaknesses rooted in excessive speculation, moral detachment, and unequal risk distribution. Islamic finance emerged as an alternative paradigm that promised ethical conduct, justice, and shared responsibility. However,



critics argue that contemporary Islamic finance frequently mirrors conventional finance in structure while differing mainly in contractual form.

This concern necessitates a return to the original Islamic economic model established during the lifetime of Prophet Muhammad ﷺ. The State of Madinah represents a historically grounded example in which economic life was regulated through divine guidance, moral norms, and pragmatic governance. Rather than denying risk, the Prophetic model acknowledged it as a natural feature of economic life and managed it through fairness, cooperation, and accountability. This paper examines financial risk management practices in the Prophetic era and explores their relevance for addressing contemporary Islamic financial challenges.

Islamic finance emerged as an alternative framework that claims to promote ethical conduct, social justice, and shared responsibility. It emphasizes fairness, transparency, and real economic engagement while discouraging exploitation and excessive uncertainty. However, critics increasingly argue that contemporary Islamic finance often mirrors conventional financial practices in substance, differing mainly in contractual form. This concern highlights the need to revisit the original Islamic economic model established during the lifetime of Prophet Muhammad ﷺ.

The State of Madinah offers a historically grounded example of an economy regulated by divine guidance, ethical norms, and practical governance. The Prophetic model did not deny the existence of risk, nor did it attempt to eliminate uncertainty entirely. Instead, it acknowledged risk as a natural aspect of economic life and managed it through justice, cooperation, documentation, moral accountability, and social solidarity. This paper seeks to examine that model and explore its relevance for contemporary Islamic financial risk management.

2. Financial Risk from an Islamic Perspective

In Islamic economic thought, risk is inseparably linked with responsibility and ownership. Islam does not prohibit risk taking; instead, it regulates risk by connecting the right to profit with the obligation to bear potential loss. This principle is encapsulated in the legal maxim *al ghunm bil ghurm*, which establishes that gain is justified only when accompanied by risk and liability.¹ This understanding contrasts sharply with conventional finance, where risk is often traded, transferred, or externalized without direct connection to real economic activity.

The Quran emphasizes fairness and mutual consent in financial dealings. Allah states:

يَا أَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا أَمْوَالَكُمْ بَيْنَكُمْ بِالْبَاطِلِ إِلَّا أَنْ تَكُونَ تِجَارَةً عَنْ تَرَاضٍ مِّنْكُمْ²

This verse establishes that legitimate financial transactions must be based on consent, transparency, and lawful means. It implicitly discourages unjust risk shifting and exploitative practices. During the Prophetic era, financial transactions were grounded in real trade and tangible assets, ensuring that risk remained tied to productive economic activity rather than speculative behaviour.

Another important Qur'anic principle related to risk management is documentation and clarity in financial contracts. The longest verse of the Quran instructs believers to record debt transactions clearly and to appoint witnesses.

يَا أَيُّهَا الَّذِينَ آمَنُوا إِذَا تَدَايَنْتُمْ بِدَيْنٍ إِلَىٰ أَجَلٍ مُّسَمًّى فَاكْتُبُوهُ وَلْيَكْتُب بَيْنَكُمْ كَاتِبٌ بِالْعَدْلِ وَلَا يَأْبَ كَاتِبٌ أَنْ يَكْتُبَ كَمَا عَلَّمَهُ اللَّهُ فَلْيَكْتُبْ وَلْيُمْلِلِ الَّذِي عَلَيْهِ الْحَقُّ وَلْيَتَّقِ اللَّهَ رَبَّهُ وَلَا يَبْخَسَ مِنْهُ شَيْئًا فَإِنْ كَانَ الَّذِي عَلَيْهِ الْحَقُّ سَفِيحًا أَوْ ضَعِيفًا أَوْ لَا يَسْتَطِيعُ أَنْ يُمِلَّ هُوَ فَلْيُمْلِلْ وَلِيُّهُ بِالْعَدْلِ وَاسْتَشْهِدُوا شَهِيدَيْنِ مِنْ رِّجَالِكُمْ فَإِنْ لَمْ يَكُونَا رَجُلَيْنِ فَرَجُلٌ وَامْرَأَتَانِ مِمَّن تَرْضَوْنَ مِنَ الشُّهَدَاءِ أَنْ تَضِلَّ إِحْدَاهُمَا فَتُذَكَّرَ إِحْدَاهُمَا الْأُخْرَىٰ وَلَا يَأْبَ الشُّهَدَاءُ إِذَا مَا دُعُوا وَلَا تَسْأَمُوا أَنْ تَكْتُبُوهُ صَغِيرًا أَوْ كَبِيرًا إِلَىٰ أَجَلِهِ ذَلِكُمْ أَقْسَطُ عِنْدَ اللَّهِ وَأَقْوَمُ لِلشَّهَادَةِ وَأَدْنَىٰ أَلَّا تَرْتَابُوا إِلَّا أَنْ تَكُونَ تِجَارَةً حَاضِرَةً تُدِيرُونَهَا بَيْنَكُمْ فَلَيْسَ عَلَيْكُمْ جُنَاحٌ أَلَّا تَكْتُبُوهَا وَأَشْهِدُوا إِذَا تَبَايَعْتُمْ وَلَا يُضَارَ كَاتِبٌ وَلَا شَهِيدٌ وَإِنْ تَفَعَّلُوا فَإِنَّهُ فُسُوقٌ بِكُمْ وَاتَّقُوا اللَّهَ وَيُعَلِّمُكُمُ اللَّهُ وَاللَّهُ بِكُلِّ شَيْءٍ عَلِيمٌ³

From this perspective, risk in Islam is not a commodity to be sold or transferred without real economic involvement. Instead, it is a moral responsibility that accompanies ownership and participation in productive activity. This approach distinguishes Islamic risk management from conventional finance, where risk is often detached from real assets and traded through complex financial instruments.

For example, banks might sell complex derivatives or credit default swaps where they earn money from risk itself rather than from producing goods or services. In contrast, Islamic finance links profit directly to productive effort. If someone invests in a business, both the investor and the entrepreneur share the profits and losses. This ensures that risk is real, tangible, and fairly distributed, rather than being transferred to someone else who has no involvement in the underlying activity.

3. Risk Management Practices in the Prophetic Era

The Prophetic era provides rich historical evidence of practical risk management embedded in daily economic life. Trade partnerships such as *mudarabah* were commonly practiced, allowing capital providers and entrepreneurs to share profits and

losses according to agreed ratios. This structure distributed financial risk fairly and protected weaker parties from exploitation. The Prophet Muhammad ﷺ approved such partnerships, provided they were based on transparency and trust⁴.

Market regulation in Madinah further illustrates proactive risk mitigation. The Prophet ﷺ emphasized honesty in trade, accurate measurement, and full disclosure. He stated:

مَنْ عَشَّ فَلَيْسَ مِنَّا⁵

This Hadith establishes a clear prohibition of deception, reducing informational asymmetry and protecting market participants from hidden risks. The Quran similarly commands:

وَأَوْفُوا الْكَيْلَ وَالْمِيزَانَ بِالْقِسْطِ⁶

Such guidance fostered market stability by discouraging fraudulent behaviour and unjust enrichment.

Practices that increased uncertainty and social harm, such as hoarding and artificial price manipulation, were explicitly prohibited. The Prophet ﷺ said:

لَا يَحْتَكِرُ إِلَّا خَاطِرٌ⁷

This Hadith reflects an early form of market intervention aimed at preventing systemic risk and protecting consumers from artificial scarcity.

4. Transparency and Contractual Risk Mitigation

Transparency played a central role in Prophetic risk management. The Quranic directive on documentation provides a comprehensive framework for contractual clarity:

يَا أَيُّهَا الَّذِينَ آمَنُوا إِذَا تَدَايَنْتُمْ بِدِينٍ إِلَىٰ أَجَلٍ مُّسَمًّى فَاكْتُبُوهُ⁸

This verse emphasizes written contracts, witnesses, and fairness, thereby minimizing disputes and legal uncertainty. Such measures functioned as effective tools for mitigating credit and counterparty risk. Unlike modern risk management systems that rely heavily on complex derivatives, the Prophetic model prioritized clarity, simplicity, and mutual understanding.

5. Ethical Foundations of Prophetic Risk Management

Risk management in the Prophetic era was deeply rooted in moral consciousness rather than external enforcement alone. Economic actors were guided by accountability before Allah, which shaped behaviour even in the absence of formal regulation. The Prophet ﷺ stated:

التَّاجِرُ الصَّدُوقُ الْأَمِينُ مَعَ النَّبِيِّينَ وَالصِّدِّيقِينَ وَالشُّهَدَاءِ⁹

This Hadith elevated ethical business conduct to a spiritual rank, encouraging self regulation and trust. The moral internalization of accountability reduced reckless risk taking, fraud, and exploitation. Financial stability was thus achieved through ethical discipline rather than excessive financial engineering.

Unlike many modern financial systems that rely on complex instruments to shift or hide risk, the Prophetic approach focused on simplicity, honesty, and mutual understanding. Agreements were straightforward, terms were clear, and obligations were transparent. This transparency encouraged confidence in trade, allowed even those with limited experience or education to participate, and fostered trust across the community. In essence, transparency was not just a procedural step; it was a moral and social safeguard that reinforced both economic stability and societal cohesion. By ensuring that all parties clearly understood the risks and responsibilities involved, the Prophet ﷺ created an environment in which commerce could thrive safely and ethically.

6. Public Finance and Social Risk Management

At the institutional level, the establishment of Bayt al Mal played a critical role in managing systemic risk. Public revenues from zakat, charity, and other sources were redistributed to support vulnerable members of society. The Quran defines the recipients of zakat as follows:

إِنَّمَا الصَّدَقَاتُ لِلْفُقَرَاءِ وَالْمَسْكِينِ وَالْعَارِمِينَ¹⁰

This mechanism functioned as a social safety net, reducing poverty induced financial shocks and preventing extreme wealth concentration. Scholars such as Ibn Kathir and Ibn Hisham highlight how the Prophetic state ensured economic inclusion and social cohesion through these measures¹¹ [12].

7. Comparative Analysis with Contemporary Islamic Finance

While contemporary Islamic finance claims adherence to Shariah principles, its risk management practices often reveal a gap between form and substance. Many Islamic financial products replicate conventional debt-based structures, shifting risk to clients while institutions secure predictable returns. This practice contradicts the Prophetic principle expressed in the Hadith:

الْخَرَاجُ بِالضَّمَانِ¹³

In contrast, the Prophetic model emphasized genuine risk sharing, real economic activity, and social welfare. Scholars such as Chapra and Usmani argue that abandoning these principles undermines the ethical foundation of Islamic finance and limits its transformative potential^{[14][15]}.

The divergence between the Prophetic model of risk management and modern practices raises important questions about the credibility and resilience of Islamic finance. Many contemporary Islamic financial institutions aim to follow Shariah principles, but in practice, they often replicate conventional banking structures with only minor contractual adjustments. For example, some Islamic banks offer Murabaha-based home financing, where the bank purchases a house and sells it to the client at a marked-up price. Although it is technically Shariah-compliant, the bank bears minimal risk, and the profit is fixed, making it similar to conventional interest-based lending. Another example is Ijara (Islamic leasing), where the bank owns an asset and leases it to the client. While the bank formally assumes ownership, in practice, the client often bears most of the risk, and the transaction becomes a predictable stream of income rather than genuine risk sharing.

In contrast, products like Mudarabah (profit-sharing partnerships) and Musharakah (joint venture financing) reflect the Prophetic approach more closely. In these arrangements, both the financier and the entrepreneur share profits and losses according to pre-agreed terms. The risk is tangible, and both parties are incentivized to act ethically and efficiently. Such instruments not only preserve the social and moral objectives of Islamic finance but also strengthen its credibility and resilience. By revisiting these Prophetic principles, contemporary Islamic finance can better fulfill its distinctive identity and social mission while promoting fairness and accountability in economic activity.

8. Lessons for Contemporary Islamic Financial Institutions

Several lessons emerge from the Prophetic approach to risk management. First, genuine risk sharing should be restored as a core objective of Islamic financial products. Second, ethical evaluation must extend beyond contractual legality to include social impact and distributive justice. Third, modern Islamic social finance instruments can draw inspiration from Bayt al Mal to address systemic risks such as poverty and financial exclusion. Integrating moral accountability derived from the Seerah can enhance risk awareness and institutional resilience.

9. Conclusion

Financial risk management in the Prophetic era was far more than a technical or procedural matter. It was a holistic system that combined ethical principles, social responsibility, and practical governance to ensure both individual and societal well-being. Unlike many modern financial systems, which often treat risk as a tradable commodity detached from real economic activity, the Prophetic model anchored risk in tangible trade, productive effort, and shared responsibility. The emphasis was not only on avoiding losses but also on promoting justice, fairness, and moral accountability in every transaction. Prophet Muhammad ﷺ consistently guided the community to engage in trade with honesty, transparency, and mutual consent. As the Quran commands,

“يَا أَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا أَمْوَالِكُمْ بَيْنَكُمْ بِالْبَاطِلِ إِلَّا أَنْ تَكُونَ تِجَارَةً عَنْ تَرَاضٍ مِنْكُمْ”¹⁶

which emphasizes that wealth must be earned through lawful, consensual transactions rather than by exploitation or deceit. This principle reflects the central idea that financial dealings must be ethical at their core, not merely compliant with legal or technical requirements.

The Prophetic approach also addressed systemic and societal risks through institutions such as Bayt al Mal, which redistributed wealth to support the vulnerable, protect the poor, and maintain social stability. By integrating mechanisms for social welfare, the Prophetic model demonstrated that financial risk management is inherently linked to collective responsibility and societal harmony. In addition, the ethical dimension of risk management was reinforced through spiritual accountability. Individuals were guided by the awareness that they are answerable to Allah for their actions, which naturally discouraged fraud, excessive speculation, and exploitation. This combination of ethical, institutional, and practical measures created a resilient financial system that promoted both economic activity and social justice.

Contemporary Islamic finance, while aspiring to follow Shariah principles, often falls short of these holistic standards. Many products, such as Murabaha-based financing or Ijara leases, replicate conventional structures with limited risk sharing, prioritizing predictable profits for institutions over equitable participation. In contrast, instruments like Mudarabah and Musharakah embody the Prophetic model, linking profits to real effort and distributing both risk and reward fairly. Revisiting and incorporating these principles can strengthen the credibility, resilience, and social mission of modern Islamic finance. By emphasizing transparency, ethical conduct, shared responsibility,

and social welfare, contemporary Islamic financial institutions can move beyond mere technical compliance toward a system that genuinely reflects the spirit of Islamic economic ethics.

In conclusion, the lessons from the State of Madinah are timeless. They illustrate that financial stability and economic growth are best achieved when transactions are grounded in ethics, risk is shared responsibly, and the welfare of society is considered alongside individual profit. Modern Islamic finance has a unique opportunity to reconnect with these foundational principles, thereby enhancing its relevance, fostering public trust, and providing an authentic alternative to conventional financial systems. Integrating moral accountability with pragmatic financial practices, as demonstrated in the Prophetic era, can ensure that Islamic finance remains not only a viable economic model but also a powerful instrument for justice, equity, and societal prosperity.

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