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HAWASSA UNIVERSITY

COLLEGE OF LAW AND GOVERNANCE STUDIES

SCHOOL OF LAW GRADUATE PROGRAM

DEPARTEMENT OF COMMERCIAL LAW

**THE LEGAL FRAME WORK OF INTEREST FREE MICROFINANCE
INSTITUTIONS IN ETHIOPIA: A COMPARLATIVE STUDY**

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HAWASSA UNIVERSTIY, HAWASSA, ETHIOPIA

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As members of the Board of Examiners of the final Masters degree open defense, we certify that we have read and evaluated the thesis prepared by Abduelsemed Bedewi, have read and evaluated his thesis titled “ THE LEGAL FRAME WORK OF INTEREST FREE MICROFINANCE INSTITUTIONS IN ETHIOPIA: COMPARLATIVE STUDY” to certify that the thesis has been accepted in partial fulfillment of the requirement for degree master.

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DECLARATION

I, Abdulsemed Bedewi, hereby declare that this research, titled "The Legal Framework of Interest-Free Microfinance Institutions in Ethiopia: A Comparative Study," is my own original work that has never been presented or submitted to any institution. Furthermore, I have acknowledged that all sources used have been properly cited in the references.

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Signature: _____

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ABSTRACT

This study endeavors to examine the legal regulations governing interest-free microfinance institutions in Ethiopia with comparisons of Sudan, Egypt, and Malaysia. The research method employed is comparative doctrinal legal research design, which involves scrutinizing secondary data sources such as black and white documents. The qualitative data was analyzed using content analytical techniques that were consistent with the study's objectives. The findings of this study revealed that Ethiopia's legal framework for interest-free microfinance institutions has significant gaps and differences when compared to Egypt, Sudan, and Malaysia.

These differences include the specificity of regulations, variations in regulatory oversight and licensing requirements, and the legal basis for interest-free microfinance. Malaysia stands out with its dedicated legal framework for Islamic finance principles. Addressing these gaps would involve considering broader legal frameworks, enhancing regulatory oversight, and aligning with international standards. By doing this, Ethiopia can strengthen its legal framework for interest-free microfinance institutions, promoting access to financial services and local economic growth. Therefore, the legislative structure of interest-free microfinance institutions in Ethiopia exhibits gaps and weaknesses when compared to Sudan, Egypt, and Malaysia. These gaps include the lack of specificity in regulations, variations in regulatory oversight effectiveness and capacity, differences in licensing requirements, and a narrower legal basis. These gaps can pose challenges for interest-free microfinance institutions in terms of compliance, clarity, supervision, and consumer protection. To address these weaknesses, Ethiopia should consider enhancing regulatory capacity, aligning with international standards, promoting collaboration, and expanding the scope of the legal framework. Furthermore, Ethiopia can establish a more robust and effective legal framework that promotes the development and growth of interest-free micro-finance institutions, thereby contributing to financial inclusion and long-term economic progress. Furthermore; it's suggested that National Bank of Ethiopia revise its means of supervising/regulating operations related to free-interest-based micro-financing optimizing outreach effectiveness hence promoting successful establishment/development thereof.

Key Words: Legal And Regulatory Frameworks: If-MFI, Ethiopia

ACRONYMS

ICD: International Cooperation Development

ICCIA: Islamic Chamber of Commerce, Industry and Agriculture

IF-MFI: Interest free micro finance institutions

IFSB: Islamic Finance Service Board

IGAD: Intergovernmental Authority for Development

IMFI: Islamic Micro-Finance Industry

KCB: Kenya Commercial Bank

MAISA: Mit-Ghamr Islamic Saving Association

MIX: Microfinance Information Exchange Market

MFI: Microfinance Institutions

NBE: National Bank of Ethiopia

IBM: Islamic Bank of Malesia

OIC: Organization of Islamic countries

PASED: Port of Sudan Association for Small Enterprise Development

PFC: Pilgrim Fund Corporation

PFMA: Public Finance Management Act

SACCA: Savings, Credit and Cooperative Associations

SME: Small and Medium Enterprise

SRD: Strategic Roundtable Discussion

CHAPTER ONE

INTRODUCTIONS

1.1 Backgrounds of the Study

Interest-free microfinance, also known as Islamic microfinance, is a financial service that operates according to Shariah or interest-free principles. It refrains from collecting interest in favor of adhering to Islamic financial concepts including profit-sharing and moral investing techniques.¹ Low-income people and underprivileged communities can receive financial services from microfinance organizations (MFIs), such as savings, credit, insurance, and remittances. These services are especially provided interest-free by MFIs.²

Interest free micro - finance is critical to the goal of financial inclusion because it provides access to financial services to those who are denied access to traditional banking. By allowing low-income individuals, especially those residing in rural areas, to save, borrow, and take part in income-generating endeavors, it promotes economic engagement and inclusivity.³

Additionally, one effective tool for lowering poverty is interest-free microlending. It enhances living standards, reduces poverty risk, and produces income for impoverished individuals and communities by assisting in the creation or expansion of small businesses. Furthermore, interest free micro lending encourages entrepreneurship and enhances the growth of small and medium sized enterprises (SMEs), thereby promoting social and economic advancement.⁴

¹ Abedifar P Ebrahim, Molyneux P, and Tarazi A, 'Islamic banking and finance: Recent empirical literature and directions for future research' (2015) 29 (4) *Journal of Economic Surveys*, 637-670

² Ahmed H, and Khan T, *Islamic Microfinance: An Emerging Market Niche* (World Development, 2016) 80

³ Fanta A. A, and Mubarik Y. A, 'The Impact of Microfinance on Financial Inclusion: Evidence from Ethiopia' (2020) , 21(2) *Journal of African Business*, 191-212

⁴ International Finance Corporation, 'Islamic Microfinance in Africa: Opportunities and Challenges': <[https://www.ifc.org/wps/wcm/connect/industry_ext_content/ifc_external_corporate_site/financial+institutions/re sources/publications/islamic+microfinance+in+africa](https://www.ifc.org/wps/wcm/connect/industry_ext_content/ifc_external_corporate_site/financial+institutions/re+sources/publications/islamic+microfinance+in+africa)> accessed 6 November 2023

As a result, communities and individuals gain from increased employment opportunities, economic expansion, and general improvements in social welfare.

Interest-free microfinance offers important chances to combat financial exclusion and advance economic growth in African nations. There's an opportunity to close the gap in financial services and take advantage of this market potential because there's a big number of unbanked people. Furthermore, interest-free microfinance is a more acceptable and approachable financial option since it conforms to the cultural and religious norms of many African communities.⁵

African countries, on the other hand, are having difficulty building and implementing sufficient legal and regulatory frameworks for interest-free microfinance. These frameworks must assure compliance with Shariah principles, consumer protection, and financial stability while taking into consideration the special characteristics and requirements of Islamic finance.⁶ Strengthening capacity efforts are also critical in overcoming difficulties like as product creation, risk management, governance, and financial literacy. These issues can be effectively handled by strengthening the capacities of interest-free microfinance institutions, regulatory bodies, and other stakeholders.⁷

The aim of this research is to examine the legal and regulatory framework that governs interest-free microfinance in Ethiopia, as well as to compare Malaysia, Egypt, and Sudan. The study will use empirical research to analyze the effectiveness of the current framework in fostering financial inclusion, consumer protection, and financial stability. It will also look at Ethiopia's special prospects and difficulties, relying on the experiences of the selected countries.

⁵ World Bank, 'Financial Inclusion criteria in East Africa': <https://databank.worldbank.org/source/financial-inclusion-data>> accessed 3 November 2023

⁶ Harvard University Center For International Development, *Islamic Finance and Entrepreneurship: Challenges And Opportunities Ahead* (Entrepreneurial Finance Lab Research Initiative, 2021) <<https://www.cid.harvard.edu/eflr>> accessed 7 November 2023

⁷ Munwar I and Philip M, 'Thirty Years of Islamic Banking in Africa: History, Performance, and Prospects' (2016) 19(1) *Islamic Economics Research Center of King Abdulaziz University*, 37-39

1.2 Problem of the Statements

According to related to the implementation current study, problem researcher states that there is a gap in knowledge of Islamic microfinance laws and regulations in Ethiopia. While there have been some recent empirical studies conducted in African countries and locally in Ethiopia, these studies did not thoroughly address the specific gaps in implementing Islamic microfinance laws and regulations in Ethiopia. As well as provide a result, there is need to close this gap in knowledge and thorough insight into the challenges and opportunities in implementing Islamic microfinance in Ethiopia.

*Abdi, S. et al. undertook a recent empirical study titled "Challenges and Opportunities of Islamic Microfinance in African Countries: A Comparative Study" to analyze the challenges and potential of Islamic microfinance in various African countries. The study investigated aspects such as legal frameworks, cultural relevance, and capacity building, but it did not particularly address the application of Islamic microfinance rules and regulations in Ethiopia. This study provides useful insights into the broader African setting, but does not address the specific information vacuum in the Ethiopian situation.*⁸

And very few countries in the IGAD region, including Ethiopia, are familiar with it. Nonetheless, data from global organizations such as the World Bank (WB) and the International Monetary Fund (IMF), as well as studies conducted in participating nations, indicate that there is a strong market for IFsMF products because there are few providers of this service and low levels of financial inclusion among Muslims who observe their religion.⁹

In a paper titled "Assessing the Current Status of Islamic Microfinance in Ethiopia: A Case Study of Derdewa and Afara Microfinance Institution," Tadesse, A. et al. conducted a local empirical investigation to determine how Islamic microfinance is currently performing in Ethiopia. Products, risk, and financial literacy were among the topics covered in the survey. The application of Islamic microfinance rules and regulations in Ethiopia, however, was not well examined. As such, there is a knowledge vacuum on the unique obstacles and prospects associated with Ethiopia's legal and regulatory environment.¹⁰

⁸ Abdi S, 'Challenges and Opportunities of Islamic Microfinance in African Countries: A Comparative Analysis' (2020) 16(3) Journal of Islamic Economics, Banking and Finance, 567-586

⁹ International Monetary Fund, (IMF Multi Country Reports, 2021) See the Ethiopian part in the report, 345

¹⁰Tadesse A, 'Assessing the Current Status of Islamic Microfinance in Ethiopia: A Case Study of Dire Dawa Microfinance Institution' (2021) 29(2) Ethiopian Journal of Economics, 123-140

The following is the current knowledge gap about Ethiopia's implementation of Islamic microfinance laws and regulations: The existing information vacuum concerns the potential and difficulties unique to Ethiopia's application of Islamic microfinance legislation and regulations. Because of the high interest rates or noncompliance with sharia, many communities, particularly in Ethiopia, steer clear of traditional microloans. Due to higher interest rates resulting from their religious convictions and a lack of appropriate legal or regulatory frameworks that meet their demands, the impoverished Muslim population also shuns traditional financial institutions in Ethiopia.¹¹

This entails assessing how well the current legislative and regulatory system ensures consumer protection, financial stability, and adherence to Shariah values.¹² The knowledge of the peculiarities and prerequisites of Islamic financing in Ethiopian contexts, as well as the demands of regulatory bodies and interest-free microfinance institutions to enhance their ability, are other gaps.

I fill the gap: To address this information gap, the current paper conducts a thorough empirical examination of Ethiopia's implementation of Islamic microfinance rules and regulations. In addition to making recommendations for improving the legal and regulatory framework, it will look at the opportunities and challenges specific to the Ethiopian environment. The study will address gaps in knowledge in consumer protection, financial stability, interest-free or Shariah principles, and the specifics of Islamic finance in Ethiopia.

The knowledge of the peculiarities and prerequisites of Islamic financing in Ethiopian contexts, as well as the demands of regulatory bodies and interest-free microfinance institutions to enhance their ability, are other gaps.

It will also pinpoint the areas in which Ethiopian regulatory agencies and interest-free microfinance institutions require capacity-building. The project will close this information gap and advance our awareness of the unique difficulties and possibilities associated with introducing Islamic microfinance in Ethiopia.

¹¹ Harvard University Center For International Development (n 6)

¹² Munwar I and Philip M (n 7)

1.1 Research Questions

The study aims to answer the following research questions:

1. What are the key elements of the legal and regulatory framework governing interest-free microfinance in Ethiopia?
2. How does Ethiopia's legal and regulatory framework for interest-free microfinance compare with Malaysia, Egypt, and Sudan?
3. What are the strengths and weaknesses of Ethiopia's legal and regulatory framework in Ethiopia in promoting the growth and development of interest-free microfinance?
4. What can we learn from the experiences of Malaysia, Egypt, and Sudan in implementing their legal and regulatory frameworks for interest-free microfinance?

1.2 Objective of the Study

1.4.1 General Research Objective:

The study's general research objective is to analyze and compare the legal and regulatory framework governing interest-free microfinance in Ethiopia with those of Malaysia, Egypt, and Sudan.

1.4.2 Specific Objectives:

The study's specific objectives include the following:

1. To examine the components and characteristics of the legal and regulatory framework governing interest-free microfinance in Ethiopia.

2. To compare the legal and regulatory framework for interest-free microfinance in Ethiopia with that of Malaysia, Egypt, and Sudan, taking into account similarities and differences.
3. To assess the strengths and weaknesses of the legal and regulatory framework in Ethiopia in promoting the growth and development of interest-free microfinance.
4. To identify and analyze the lessons that can be learned from the experiences of Malaysia, Egypt, and Sudan in implementing their legal and regulatory frameworks for interest-free microfinance.

Achieving these goals will enable the study to provide insights into Ethiopia's legal and regulatory framework for interest-free microfinance, as well as the extent to which it promotes financial inclusion and economic growth. The report makes recommendations for policy and looks at other countries' experiences to improve Ethiopia's legal and regulatory framework.

1.3 Significance of the Study

The study is extremely important for microfinance institutions (MFIs) operating in Ethiopia. The research will shed important light on the potential and difficulties faced by MFIs by analyzing the legal and regulatory environment around interest-free microlending. Making educated judgments about product development, risk management, and governance will be made possible by their increased understanding of the regulatory environment. The study's conclusions will help MFIs that provide interest-free microlending services run more sustainably and improve their business practices.

Importance for Entrepreneurs: Ethiopian entrepreneurs should pay special attention to this report. The study's goal is to provide insights into the availability and accessibility of interest-free financing solutions for businesses by assessing the implementation of Islamic microfinance rules and regulations. As a result, business owners seeking capital will be able to access appropriate financial services and make informed decisions. The results of the study will support Ethiopian entrepreneurship's expansion and advancement, especially in fields that adhere to Islamic financial norms; microlending services with no interest.

Implications for Policymakers: The study has important ramifications for Ethiopian policymakers. Through a comparative analysis of Ethiopia's interest-free microfinance legislative and regulatory environment with those of Malaysia, Egypt, and Sudan, this study will offer important insights into best practices and international lessons learned. This will assist legislators in developing laws and policies that effectively promote the growth and advancement of interest-free microlending in Ethiopia. The study's findings will help to establish a regulatory framework that promotes financial inclusion and economic growth.

Academic significance: This study is significant because it will add to existing knowledge about interest-free microfinance in Ethiopia. By comparing Ethiopia's legal and regulatory frameworks with those of Malaysia, Egypt, and Sudan, scholars will gain a clearer understanding of the unique challenges and opportunities faced in Ethiopia. The results will add to the academic research and literature on Islamic microfinance, serving as a valuable reference for future investigations and enriching the scholarly conversation on financial inclusion and economic development.

1.4 Scope of the Study

The study focused on the legal and regulatory framework governing interest-free microfinance in Ethiopia, and included a comparative analysis with Malaysia, Egypt, and Sudan. It specifically examined the policies, laws, regulations, and guidelines relevant to interest-free microfinance within these countries. The geographical scope was intentionally limited to these regions, employing meta-analyses to draw insights.

In exploring interest-free microfinance, the study delved into its conceptual aspects, including the principles and practices associated with Islamic finance. Key components of the legal and regulatory framework were analyzed, such as licensing requirements, governance structures, consumer protection measures, and risk management guidelines. Additionally, the study addressed the roles of financial intermediaries, including microfinance institutions and regulatory authorities, in the effective implementation of these frameworks.

Using a qualitative legal doctrinal research approach, the study conducted a thorough review of existing literature, including academic articles, reports, and policy documents. This review examines the legal and regulatory landscape of interest-free microfinance in Ethiopia and comparator countries. A systematic approach was used to conduct a comparative analysis of the

legal and regulatory frameworks, identifying both similarities and differences based on a thorough examination of relevant documents. The research was motivated by the need to fill a knowledge gap regarding Ethiopia's legal and regulatory framework for interest-free microfinance. By comparing Ethiopia's framework with those of Malaysia, Egypt, and Sudan, the study sought to highlight best practices and lessons learned that could inform policy recommendations for strengthening Ethiopia's legal and regulatory environment. The findings aim to contribute to financial inclusion, economic development, and the growth of interest-free microfinance in Ethiopia. Moreover, the study offers valuable insights for microfinance institutions, entrepreneurs, policymakers, and academics engaged in the field of interest-free microfinance.

1.5 Methodology

1.7.1 Research Design

The investigation utilized a doctrinal comparative legal research design. The framework governing interest-free microfinance was one of the legal systems whose laws were compared for comparative law. Utilizing a qualitative method, the objective was to determine and quantify the parallels and discrepancies among these statutes.

1.7.2 Data Collection Tool

To gather the data and information required for the investigation, secondary sources were reviewed. Regulatory agencies, research groups, government agencies, funding agencies, and academic journals were among these sources. Comparing Ethiopia's interest-free microfinance system against those of Malaysia, Egypt, and Sudan was the main goal of the research.

1.7.3 Data Analysis Methods

The study used approaches for analyzing qualitative data. In order to conduct the study, qualitative data from doctrinal sources, legal decrees, proclamations, policy papers, and empirical literature from Ethiopia, Sudan, Egypt, and Malaysia were examined. The data was organized using content analysis to align with the study's objectives. To produce significant results, the data was further classified and examined using analytical techniques consistent with the study's objectives.

1.6 Limitations of the Study

Minimal Study limitation: The comparative analysis of interest-free microfinance legal and regulatory frameworks in Ethiopia, Malaysia, Egypt, and Sudan was one of the study's main limitations. The study excluded other nations with distinct legislative frameworks and strategies for interest-free microlending. Consequently, it's possible that the conclusions and suggestions don't apply to nations that aren't included by the research.

Conceptual Scope Restrictions: A further drawback of the research was its limited conceptual breadth, which mainly concentrated on the legal and regulatory dimensions of interest-free microfinance. Not enough research was done on other crucial elements, such as the socioeconomic effect, cultural influences, and technical developments. This hindered the thorough comprehension of interest-free microfinance and its possible consequences.

Constraints on Gathering Data from Interviews: The study only used secondary sources, including reports, scholarly papers, and policy documents. Further insights and viewpoints may have been obtained by primary data gathering via interviews with pertinent stakeholders, including microfinance institutions, regulatory bodies, and business owners. One of the study's limitations is that primary data was not collected via interviews.

The study attempted to offer a thorough analysis within the constraints of the data that was available in order to make up for the aforementioned shortcomings. The study examined the legal and regulatory systems of the chosen nations in depth, employing qualitative data analysis methods. The research sought to give important insights into law and the legal framework of interest by carefully reviewing the body of available literature.no-cost microloans.

1.7 Organization of the Study

The thesis is divided into five sections. The first chapter covered the issue statement, research questions, study purpose and importance, study scope, methodology, and limitations. Chapter 2 includes a review of relevant literature, while Chapter 3 provides an overview of IFMI and its rules. Chapter 4 describes the data analysis and interpretation process, while Chapter 5 presents the results and suggestions.

CHAPTER TWO

REVIEW OF LITERATURE

2.1 Theoretical concept Interest free Microfinance

Financing services that do not allow interest payments or receipts, excessive uncertainty, gambling, or funding of activities deemed detrimental to society are referred to as interest-free financing.¹³ On the contrary, the International Monetary Fund states that a commercial transaction should have a legitimate economic goal and that neither side should engage in excessive speculation or exploitation of the other.¹⁴ Many academics have suggested interest-free microfinance (IFMFI) as a substitute for traditional microfinance to address the needs of marginalized groups that are under banked and unbanked, as well as those who are chronically impoverished, penniless, and unfortunate.¹⁵

The primary goals of interest-free microfinance include the following: control over ownership, equal opportunity, and income growth, functional distribution of income, poverty alleviation, and malpractice prevention.¹⁶ Several countries, including the United States and the United Kingdom, introduced interest-free financial services between the early 1990s and the 2020s. Interest-free microfinance organizations have been in operation in numerous Asian and Middle Eastern countries since the early 1970s.¹⁷

After conducting comparative analysis, Reshid and Ejaze¹⁸ concluded that, in comparison to their counterparts in interest-based microfinance systems, interest-free microfinance is more successful in helping the core poor and achieving the goal of poverty reduction. The Modi, Patel and Patel,¹⁹ highlighted the unique characteristics of interest-free microfinance and its ability to reach

¹³ Abu Joudeh B, 'Exploring the Potential for Profit-loss Sharing Models in Islamic Microfinance' (Wharton Undergraduate Research, Social Impact Research Experience (SIRE) 2011), 12

¹⁴ International Monetary Fund, 'Interest Free Microfinance Approach to Scaling up the Economic Life of Vulnerable People with HIV/AIDS in the Muslim Society' (2020) 59(3) *Journal of Religion and Health*, 1327-1343 <https://doi.org/10.1007/s10943-019-00832-8> accessed 7 November 2023

¹⁵ Ismail A. G and Elzahi A, *Regulation and Supervision of Islamic Microfinance* (International Islamic University, 1stedn 2015)

¹⁶ Khaleequzzaman M, *Islamic Microfinance: Outreach and Sustainability* (A Research Paper Presented at IIUM International Conference on Islamic Banking and Finance 2007), 23-25

¹⁷ Khandker S. R, 'Microfinance and Poverty: Evidence Using Panel Data from Bangladesh' (2015) 19 (2) *The World Bank Economic Review*, 263-286 <<https://doi.org/10.1093/wber/lhi008>> accessed 7 November 2023

¹⁸ Rashid A. G, and Ejaz L, 'Interest Free Micro Credit Loans: Pakistani Female Entrepreneurs' (2019) 10(3) *Journal of Islamic Marketing*, 860-873 <https://doi.org/10.1108/JIMA-04-2018-0071>> accessed 7 November 2023

¹⁹ Modi A, Patel K. J, and Patel K. M, 'Impact of Microfinance Services on Rural Women Empowerment: An Empirical Study' (2014) 16(11) *Journal of Business and Management*, 1-8 <<https://doi.org/10.9790/487X-161136875>>

underprivileged individuals in isolated rural villages and farmer's communities by offering minor financial services.²⁰

According to Rokhman²¹ interest-free micro lending companies made an effort to build their social capital by demonstrating harmony and confidence between themselves and their clients. It encourages recipients to share risks, which would foster a spirit of cooperation and teamwork within the micro lending system. Women in rural communities acquire the ability to bargain, resist violence against women, and make decisions for themselves and their families by receiving more financial independence through a range of interest-free microfinance programs. Its methods closely examined how interest-free microloans play a crucial role in empowering rural women.²²

2.2 Interest-Free Microfinance (IFM) Models

Understanding the characteristics of the current institutions that are in operation in different nations is crucial for any discussion on the benefits of IFM institutions over IFBs. IFMIs may be broadly classified into three categories: profit-based, charity-based, and hybrids of the two.²³

In a similar way to IFBs, profit-based IFMIs provide services. Micro-musharakah (joint venture), mudarabah (profit sharing), salam/istisna (advance payment sale), and ijara (rental) are the services they mostly provide. Making money is their main goal in selling these goods. This strategy is used in several nations to offer IFM services by traditional banks, full-fledged IFBs, and conventional microfinance organizations.

The charity-based IFMIs are mission-based institutions, which apply zakah (a religious obligation of capable Muslims to assist the poor), *sadaqa* (donation), *waqf* (endowment) and *qard hasan* (loan) as a source of fund for their transactions.²⁴

Serving as a go-between for charitable donations and the underprivileged, their goal is not to earn a profit. Composite establishments, which provide both services concurrently, fall into the third type. For those who are economically inactive and persistently impoverished, they provide

²⁰ Jan Sofi Fuzia, 'Financing Microenterprises: Creating a Potential Value-Based Hybrid Model for Islamic Microfinance' (2013) 2(2) International Journal of Management and Business Research, 108-122

²¹ Rokhman W, 'The Effect of Islamic Microfinance on Poverty Alleviation: Study in Indonesia' (2013) 11(2) Economic Review: Journal of Economics and Business, 21-30

²² Larios Hernández G. J, 'Block Chain Entrepreneurship Opportunity in the Practices of the Unbanked' (2017) 60(6) BusHoriz, 865–874 <<https://doi.org/10.1016/j.bushor.2017.07.012>> accessed 7 November 2023

²³ Ghouse G, Aslam A, Bhatti M. I, Role of Islamic Banking During COVID-19 on Political and Financial Events: Application of Impulse Indicator Saturation (2021) 13(21) Sustainability, 116–119 <<https://doi.org/10.3390/su132111619>> accessed 7 November 2023

²⁴ *ibid*

charity-based services. To help clients become financially active and able to utilize the profit-based services and goods, they provide training and consulting services.

2.1.1 Building Sustainable Business Models

There are currently no recognized performance standards for interest-free microfinance business models, and they are presently under development. But two areas stand out as being especially crucial: risk management and operational efficiency.²⁵

The provision of affordable financial services to the poor is dependent on operational efficiency. Managing minor transactions is expensive, so MFIs must think outside the box to reduce costs. In an ijara or murabaha transaction, the money provider buys a good (such inventory or equipment) and then marks it up for resale or lease to the consumer. Discounts on wholesale pricing might be advantageous for interest-free microfinance,²⁶ However, there are significant costs associated with purchasing, selling, leasing, and maintaining a good (such as a sewing machine), which are frequently passed on to customers. By requiring the end user to look for and identify the required product, several institutions have managed to reduce the expenses associated with murabaha transactions. For the purpose of cutting expenses and providing their customers with more enticing prices, these establishments have to think about creating innovative methods and procedures also.²⁷

- Risk management: Risk management is another critical component of developing sustainable institutions. Conventional microfinance has established a set of best practices for managing credit risk, and MFIs have superior portfolio quality. Instead of using collateral to obtain loans, conventional MFIs often depend on peer pressure and stringent collection procedures. These methods must to be modified to adhere to the no-interest and risk-sharing tenets that are fundamental to Islamic banking. Some argue, for instance, that in addition to peer pressure, there should be emphasis placed on religious community pressure and calls to religious responsibility.²⁸
- The Veracity Question: Despite the overwhelming evidence of market demand for interest-free microloans, satisfying this need necessitates low-income customers feeling confident that the

²⁵ *ibid*, p67

²⁶ *ibid*, p78-79

²⁷ Meyer J, 'Outreach and Performance of Microfinance Institutions: The Importance of Portfolio Yield' (2019) 51(27) *Appl Econ*, 2945–2962

²⁸ Mirzaei A, Saad M, and Emrouznejad A, 'Bank Stock Performance During the COVID-19 Crisis: Does Efficiency Explain Why Islamic Banks Fared Relatively Better?' (2022) 314(2) *Ann Oper Res*, 1–39

items they are receiving are truly Islamic. Critics of Islamic financial products argue that the prices of some items marketed as Sharia-compliant are too similar to those of mainstream products. Institutions that offer murabaha, for instance, may conceal interest charges under the pretense of a cost markup or administrative fee.²⁹

There is a belief that interest-free microfinance is simply conventional finance "rebranded" and does not truly embody Islamic principles. So, in order for Interest-Free Microfinance to reach its full potential, low-income populations—who frequently seek religious guidance from local leaders—must be convinced that these financing products are legitimate. Further research is required to.³⁰

- Encourage religious leaders, particularly those serving impoverished populations, to share their experiences with Sharia compliance in microfinance products. Cooperate with local religious leaders to educate low-income populations about how financial products adhere to Islamic law. Increase collaboration between Sharia and financial experts on product authenticity.³¹
- Capacity Building: To fully utilize Islamic microfinance, capacity building at all levels is required. To create a framework for transparency in the global interest-free microfinance industry, the Islamic Development Bank and organizations that establish interest-free financial standards (such as the IFSB or the AAOIFI) should consider developing global financial reporting standards tailored to the microfinance sector. This infrastructure would include comprehensive disclosure requirements for accounting principles in interest-free microfinance, pricing strategies, financial audits, and rating services.³²

Through supporting established institutions in scaling up and funding trial projects experimenting with different business models, foreign donor agencies may significantly contribute to increasing access to financing at the micro and institutional levels in low-income and Muslim nations. The development of operational tools and manuals (such as those

²⁹ *ibid*

³⁰ Treleaven P, Brown R.G, and Yang D, 'Block Chain Technology in Finance' (2017) 50(9) *Wang R*, 14–17

³¹ Xu M, Chen X, and Kou G A, 'Systematic Review of Block Chain' (2019) 5(27) *Financ Innov*, 2–14 <<https://doi.org/10.1186/s40854-019-0147-z>>

³² Lin Z and Luo H, 'Block Chain, Bank Credit, and SME Financing' (2018) 15(7) *Qual Quant*, 12–33 <<https://doi.org/10.1007/s11135-018-0806-6>>

created by Deutsche Gesellschaft für Technische Zusammenarbeit for use in Indonesia) should be one way to further train managers and staff in Interest-Free Microfinance.³³

Variety of Products: Murabaha (cost plus markup sale) products are a major component of Interest-Free Microfinance. But impoverished individuals have different demands when it comes to money; for many, savings or housing goods may be more pressing. More consumers of Interest-Free Microfinance would have better access to capital thanks to the creative creation of a variety of Sharia-compliant goods and services.³⁴

Making Use of Islamic Funds and Zakat: In the Muslim world, microfinance, whether Islamic or not, is still regarded as a charitable endeavor rather than a commercial one. As a result, zakat—money given in accordance with the Muslim obligation to pay alms—is increasingly being seen as a source of funding in the context of Islamic microfinance. In fact, zakat funds seem perfectly adapted to assist Islamic microfinance, considering the fundamental tenet of Islamic finance—that is, the promotion of the welfare of the society. But a mostly charitable approach is not always the ideal one for growing a sizable and long-lasting industry; instead, more dependable, profit-driven funding sources must to be looked for.³⁵

2.3 Interest free Microfinance: An Emerging Market Niche

A new market segment known as "interest-free microfinance" has emerged as a result of certain microfinance institutions (MFIs) stepping in to serve low-income consumers who desire goods based on interest-free financial principles. Additionally, it symbolizes the union of interest-free microfinance and traditional microfinance, two sectors that are both expanding quickly.³⁶ It has the ability to meet unmet demand as well as integrate the principles of interest-free finance—which prioritize helping the less fortunate—with microfinance, which gives the underprivileged access to credit. Millions of impoverished people who presently refuse microloans because of their higher interest rates and religious beliefs may be able to obtain financial access if this potential is

³³ Conoscenti M, Vetrò A, and Martin J.C.D, 'Block Chain for the Internet of Things: A Systematic Literature Review' (Paper presented at the 2016 IEEE/ACS 13th International Conference of Computer Systems and Applications (AICCSA), UK 2016)

³⁴ Düdler B, and Ross O, 'Timber Tracking: Reducing the Complexity of Due Diligence by Using Block Chain Technology' (2017) Available at SSRN 3015219 <https://ssrn.com/abstract=31383>/Cong L. W, and He Z, 'Block Chain Disruption and Smart Contracts' (2018) London, 82 <<https://ssrn.com/abstract=31383>>

³⁵ Larios Hernández G. J, (n 22)

³⁶ Kayed R. N, and Hassan M. K, 'The Global Financial Crisis and Islamic Finance' (2011) 53(50) Thunderbird Int Bus Rev

realized.³⁷

The field of interest-free microfinance is very young, and new business models are constantly developing. The IMF gathered data on over 125 organizations and spoke with experts from 19 Muslim nations for a 2022 worldwide assessment on interest-free microfinance. According to the poll and a synthesis of other data, interest-free microfinance accounts for less than 0.5 percent of all microfinance outreach globally, with an estimated total reach of only 380,000 consumers. The majority of the world's supply of interest-free microfinance (80% of total outreach) comes from a small number of countries, with Indonesia, Bangladesh, and Afghanistan ranking first through third.³⁸

Still, there is a significant market for interest-free microlending solutions. Results from surveys conducted in Syria, Jordan, and Algeria, for instance, show that 20–40% of participants refuse to use traditional microloans due to religious principles. This Focus Note outlines the current situation of the Islamic microfinance industry and points out potential roadblocks to its expansion. The primary audience for this introduction to interest-free microfinance is the donor community and other prospective newcomers to the market.³⁹

2.4 Principles of Interest free Microfinance

Free of interest The foundational idea of microfinance is the general prohibition of activities seen to be unfair loan rates for low-income individuals or for Muslim cultures in order to promote the welfare of the populace. The Islamic financial system is best known for its strict prohibition on offering or accepting any predefined rate of return on financial transactions. Most experts think there should be no interest. This is based on two fundamental principles.⁴⁰

Money has inherent value; it is not an asset in and of itself and can only grow in value when combined with other resources to engage in worthwhile endeavors. As a result, money cannot increase in value over time or be bought and sold like a commodity. Instead, money is supported by assets.⁴¹

³⁷Sakti A, 'Proposing New Islamic Microfinance Model for Sustainable Islamic Microfinance Institution in Islamic Finance and Sustainable Development' (2021) Palgrave Macmillan, 349–378

³⁸ Kabra N, Bhattacharya P, Tanwar S, and Tyagi S, 'Mudra Chain: Block Chain-based Framework for Automated Cheque Clearance in Financial Institutions' (2020) 102 *Futur Gener Comput Syst*, 574–587

³⁹ Ghouse G, Aslam A, and Bhatti M. I, (n 23)

⁴⁰García Corral F. J, Cordero García J. A, and others, 'A Bibliometric Review of Crypto Currencies: How Have They Grown?' (2022) 8(2) *Financ Innov*, 2–32 <<https://doi.org/10.1186/s40854-021-00306-5>>

⁴¹ Verberne J, *How Can Block Chain Serve Society?* (Paper presented at the World Economic Forum, Greece 2018)

Fund suppliers need to assume some of the company risk: fund suppliers are investors, not debtors, who usually receive a fixed rate of return; investors share both the risks and the benefits of their investment. On the other hand, interest-free microfinance goes beyond outlawing interest-based transactions.⁴² The following are some essential financial concepts:

Important implication: Every financial transaction must be linked, either directly or indirectly, to an actual economic activity. To put it another way, transactions must be backed by assets, and investments can only be made in tangible, long-term assets. Because financial speculating is prohibited by this, practices like short selling are considered transgressive.⁴³

Investment activities: Funding cannot be provided for any activities that are judged to be in violation of Sharia law, including those that involve the creation of WMDs, the use of alcohol or pork, and gambling. Sharia, in general, forbids funding any endeavor deemed detrimental to society at large. **No contractual exploitation:** All agreements must be mutually agreed upon and have precise terms and conditions. A thorough understanding of the item or service being purchased or sold is also required of all parties involved. Sharia-based financial contracts are designed using a vast body of jurisprudence.

Finally, the most well-known interest-free finance scholars in the industry agree on the basic financial principles mentioned above; however, because there is no central Sharia finance authority, opinions on how these principles should be applied to the development and expansion of interest-free microfinance products may differ. Scholars must complete several years of training before they are qualified to issue financial rulings.⁴⁴

2.5 Interest free Microfinance Demand

Interest-free Microfinance programs have been very successful in Muslim-majority countries. The Grameen Bank, founded by Nobel Prize laureate Mohammed Yunus, was one of the first microfinance initiatives, beginning in Bangladesh. Approximately 44% of traditional microfinance clients worldwide reside in Muslim countries, including Pakistan and Indonesia.

⁴² Handayani W, Hanifa R, and Hudaib M, 'A Bourdieusian Perspective in Exploring the Emergence and Evolution of the Field of Islamic Microfinance in Indonesia' (2018) 9(4) J Islamic Account Bus Res, 482–497. <<https://doi.org/10.1108/jiabr-10-2017-0142>>

⁴³ Dujak D, Sajter D, 'Block Chain Applications in Supply Chain in Supply Network' (2019) SMARTS pringer International Publishing, 21–46. See also Fang F, Ventre C, Basios M and others, 'Crypto Currency Trading: A Comprehensive Survey' (2021) 8(13) Financ Innov, 2–59 <<https://doi.org/10.1186/s40854-021-00321-6>>

⁴⁴ Berns J. P, Shahriar AZM, Unda L. A, 'Delegated Monitoring in Crowd Funded Microfinance: Evidence from Kiva' (2021) 66 J Corp Finance, 101–164 <<https://doi.org/10.1016/j.jcorpfn.2020.101864>>

These nations have thriving microfinance industries. Many Muslim consumers' demands are not met by traditional microfinance programs, though. Islamic financial products are in high demand from both regular banking clients and the impoverished population.⁴⁵

It is true that in many countries, adhering to Sharia law may be more of a cultural than a religious value, and even those who practice less religion may favor interest-free microloans. Interest-free microfinance programs appear to be in high demand, according to several market surveys commissioned by the IFC.⁴⁶

- More than 60% of low-income survey respondents in Gaza and the West Bank prefer interest-free microfinance programs to traditional products. Even if such items are more expensive, more than half of these respondents still choose them.⁴⁷
- According to USAID (2002) and IFC/FINCA (2006) surveys, 24.9 percent and 32 percent of Jordanians are unable to obtain conventional loans due to religious beliefs. According to the IFC/FINCA survey, 18.6% of the respondents cited religious considerations as the primary determinant of their choice to apply for a loan.

According to a 2016 survey, 20.7% of microbusiness owners in Algeria do not request loans, primarily due to their religious beliefs.

- Approximately 40% of Yemen's impoverished people prefer Islamic banking services, regardless of cost. According to a poll conducted in Syria, 43% of respondents said religious beliefs were the most significant barrier to accessing interest-free microfinance. Furthermore, 46 percent of respondents who had never applied for a loan said that their main hesitation was due to their religious beliefs. For religious reasons, about 5% of existing borrowers stated they would not apply for interest-free microloans.⁴⁸

⁴⁵ Berger A. N, Scott Frame W, and Ioannidou V, 'Tests of Ex-ante Versus Ex-post Theories of Collateral Using Private and Public Information' (2011) 100(1) *J Financ Econ*, 85–97 <<https://doi.org/10.1016/j.jfneco.2010.10.014>>

⁴⁶ Churchill S. A, 'Microfinance Financial Sustainability and Outreach: Is there a Trade-of?' (2020) 59(3) *Empirical Econ*, 1329–1350

⁴⁷ Chong F. H. L, 'Enhancing Trust through Digital Islamic Finance and Block Chain Technology' (2021) 13(3) *Qual ResFinance Mark*, 328–341

⁴⁸ Chen Y, and Bellavitis C, 'Block Chain Disruption and Decentralized Finance: The Rise of Decentralized Business Models' (2020) (13) *J Bus Ventur Insights*, 10–51

In addition to the IFC-commissioned research, a 2000 Bank Indonesia survey found that 49% of East Java's rural population believes interest is forbidden and prefers to bank with Sharia-compliant financial institutions. While there exists a segment of the Muslim clientele that uses conventional goods but favors interest-free microfinance ones, there is also a market of impoverished customers who adhere entirely to Islamic transactions.⁴⁹

When Islamic goods become accessible, some traditional microborrowers in Afghanistan, Indonesia, Syria, and Yemen tend to switch over, according to microfinance practitioners in Muslim-majority countries. Anecdotal data, however, indicates that survey participants could, in order to appear pious, vocally declare their preference for Islamic items or, in reality, choose a less expensive conventional product when given the option. The need for Islamic microfinance products appears to exist, but further investigation is required to determine the exact form and scope of this demand as well as how best to supply it economically.⁵⁰

⁴⁹ Ahmad A. U. F, and Rafque Ahmad A. B, 'Islamic Microfinance: The Evidence from Australia' (2019) 25(3) *Humanomics*, 217–235 <<https://doi.org/10.1108/08288660910986946>>

⁵⁰ Adegbite E, Amaeshi K, and Nakajima C, 'Multiple Influences on Corporate Governance Practice in Nigeria: Agents, Strategies, and Implications' (2013) 22(3) *Int Bus Rev*, 524–538

2.5.1 Government Promotion of Interest free Microfinance

Government regulation, for instance, may be very important to the growth of interest-free microfinance, just as it is to the greater interest-free banking sector.

Philippines: Indonesia's government has aggressively promoted interest-free microfinance. In 2002, Bank Indonesia produced a nine-year strategy for the growth of the Islamic finance industry, including assistance for rural banks, as part of its "Blueprint of Islamic Banking Development in Indonesia." Over the previous five years, Indonesia has registered 35 new Islamic rural banks and currently offers a supporting regulatory environment. Additionally, Bank Indonesia is leading the way in capacity building by opening a facility in Medan where Sharia rural bank employees, managers, and directors may receive certification and training on interest-free financing operations.⁵¹

Pakistan: In addition to creating regulations and laws for traditional MFIs, the State Bank of Pakistan created policies in 2007 to facilitate the quick growth of interest-free microfinance. The recommendations outline four different institutional setups that can provide interest-free micro lending: (i) starting your own interest-free micro lending business; (ii) partnering with Islamic banks; (iii) traditional micro lending; and (iv) traditional interest-free micro lending.⁵²

The rules specify what banks and MFIs that provide both conventional and Sharia-compliant products must do in terms of licensing, appointing Sharia advisers to make Sharia compliance decisions, and segregating Islamic product funds (and associated paperwork).⁵³

2.5.2 Banks Downscaling and Expanding Product Line

The fact that Islamic commercial banks are now providing interest-free microfinance services is a positive step for the expansion of Islamic microfinance. For instance, in late 2006, Yemen's Tadhamon Interest-free MFI established a division dedicated to micro and small businesses. Furthermore, a few interest-free MFI want to provide interest-free financial products other than microloans.

⁵¹Bank of Indonesia, *Statistik Perbankan Syariah (Islamic Banking Statistics)* (Bank Indonesia Direktorat Perbankan Syariah, December 2019)

⁵²Bank of Indonesia, *Statistik Perbankan Syariah (Islamic Banking Statistics)* (Bank Indonesia Direktorat Perbankan Syariah, December 2007b)

⁵³Bank of Indonesia, *Statistik Perbankan Syariah (Islamic Banking Statistics)* (Bank Indonesia Direktorat Perbankan Syariah, November Volume 5, No. 12)

Noor Interest-free MFI and Emirates Post Holding Group announced on January 20, 2008, that they will be forming a firm to provide low-income residents of the United Arab Emirates with banking services that adhere to Sharia law. In addition to microcredit, insurance, debit and credit cards, remittance and currency exchange, and salary payments, the proposed business would offer a broad range of interest-free microfinance products.⁵⁴

2.5.3 Government Regulation Interest Free Microfinance services

The first regulatory environment in which interest-free microfinance programs operated was hazy. But as they grew, they brought with them a number of regulatory issues that different governments have tried to resolve to varying degrees. Promoting Islamic financial services aggressively—even passing laws requiring them—has been one strategy. For instance, in 1984, all of Northern Sudan's banking industry was subject to Sharia-compliant regulatory structures. Establishing a legal, regulated Sharia banking industry alongside its conventional banking system in 1992, rather than replacing it, allowed Indonesia to pioneer new territory in the field of interest-free financing.⁵⁵

Alongside traditional financial services, the development of interest-free microfinance services has been aided by new rules in Pakistan, Malaysia, and Brunei. An alternative regulatory strategy aimed at curbing the expansion of Islamic finance involves the distinct regulation of particular facets of Islamic banking, including Sharia Supervisory Boards (SSBs).⁵⁶

As an illustration, a number of nations (including Kuwait, Jordan, Lebanon, and Thailand) have established regulations pertaining to the qualifications, appointment, and expulsion of members of SSBs, as well as the competency and composition of these bodies.

Though some nations, such as Kuwait and Jordan, may set rules for SSB members to vote with a majority or unanimity, no country is known to govern the Sharia jurisprudence that SSBs use to determine Sharia conformity.⁵⁷

⁵⁴Cong L. W, and He Z, 'Block Chain Disruption and Smart Contracts' (2018) London, 82 <<https://ssrn.com/abstract=31383>>

⁵⁵Grant C. R, Pradata N. E, and Muljosantoso R, *Islamic Finance and Markets* (Indonesia, September 2017) <gettingthedealthrough.com> accessed 28 October 2019

⁵⁶Hassana R, and Hussain M. A, 'Scrutinizing the Malaysian Regulatory Framework on Sharia Advisors for Islamic Financial Institutions' (2013) (2) *Journal of Islamic Finance*, 1. See also Hussain A, and Williams N, *Islamic Finance in Indonesia* (15 June 2016) <clydeco.com> accessed 28 October 2019

⁵⁷Kepli Z, and Yazid M, *The Legal and Regulatory Framework* (Blogger, June 2013)

2.5.4 International Organizations

Organizations worldwide have been established to provide standards for interest-free microfinance services accounting and other areas, along with regulatory bodies paying more attention to these areas.⁵⁸

- The Malaysia-based Islamic Financial Services Board (IFSB) publishes prudential guidelines for Islamic finance. The IFSB has issued guidelines for Islamic banks regarding capital requirements and risk management.
- The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), based in Bahrain, promotes the use of financial reporting standards by Islamic financial institutions.⁵⁹

The multinational Islamic Development Bank (IDB), headquartered in Saudi Arabia, works to alleviate poverty and promote economic growth in its member Islamic countries. The Islamic Solidarity Fund for Development (ISFD) has committed million to developing interest-free microfinance through its Microfinance Support Program (MFSP), promoting poverty reduction initiatives.⁶⁰ These organizations frequently disagree with national regulators (as well as one another) about Sharia norms, while having a common core of Islamic beliefs. AAOIFI requirements are mandated in only a handful of countries and are selectively adopted elsewhere.⁶¹

2.6 The Legal Frame Work of Interest Free Microfinance Institutions in (SSA)

The laws, rules, guidelines, codes of conduct, and other formalities that entities subject to regulation must abide by, together with the organizations or systems established to enforce them, are collectively referred to as a regulatory framework.⁶² Regulation of Interest-Free Microfinance Institutions is the result of the system's need to increase fund mobilization and intermediation in order to promote efficiency in capital distribution, ensure proper risk management, and protect depositors. Member-owned Interest Free Microfinance Institutions must follow laws, regulations, guidelines, rules, and a code of ethics to protect members' money and meet interest-free finance standards.⁶³

⁵⁸ Maysami, Ramin Cooper, and W. Jean Kwon, *An Analysis of Islamic Takaful Insurance—A Cooperative Insurance Mechanism* (2022)

⁵⁹ Frankfurt School of Finance and Management, *Access to Finance Study in Algeria* (Bankakademie International Final Report, July 2022)

⁶⁰ Athmer G, and Bosch E, *Policy Guidelines for Donor Support to Member-owned Financial Institutions in Rural Sub-Saharan Africa* (2013) <<http://www.microfinancegateway.org/p/site/m/template.rc/1.9.63399/>>

⁶¹ Grais, Waifk, and Matteo Pellegrini, 'Corporate Governance in Institutions Offering Islamic Financial Services' (World Bank Policy Research Working Paper 2006) Washington D.C, The World Bank 4052, November)

⁶² Athmer and Bosch (n 60)

⁶³ Islamic Banking and Finance, *Rocked to the Foundations* (Islamic Banking & Finance 2018) Spring16

2.6.1 Reasons for Regulating Member-Owned Interest Free Microfinance Institutions in SSA

- Effective laws are necessary for member-owned Interest Free Microfinance Institutions in South Africa for a number of reasons, some of which are outlined below:
- Regulations allow Member-owned Interest-Free Microfinance Institutions to reach out to financially excluded individuals, including Muslims. Traditional member-owned microfinance institutions charge interest, and non-interest-taking microfinance banks do not offer coverage. It also allows it to draw on funding from donors and/or the government to augment the private capital that member savings have brought in.⁶⁴
- Rules allow the new institution to grow in a correct and orderly manner; Most MIMIs start out as self-help groups to support their members and must find other ways to survive, such evaluating donor funds;
- Regulations establish the framework that permits MIMIs to transition from credit organizations to businesses with a stronger focus on commerce;
- Regulations ensure banking sector stability. Failure can damage the financial sector's confidence, even if MIMI participants, like those in other microfinance sectors, have minimal systemic influence.
- In order to draw in long-term capital, regulations provide the industry credibility and confidence.
- It is imperative that donors and investors possess faith in the processes that the money recipient use. Regulations provide such trust as a result.
- Regulation assures donors and investors that MIMIs are a secure place to place their assets. It also establishes minimum acceptable criteria.

2.1.2 Regulatory Frameworks with various regulatory structures in SSA

Several regulatory frameworks are available to govern interest-free microfinance, as it has developed from members' self-help efforts to guarantee their financial inclusivity. These regulatory frameworks might consist of any one of the following, or all of them, depending on what are available in a given nation⁶⁵

⁶⁴ Ashraf Ali, Kabir Hassan M, and William Hippler, 'Performance of Microfinance Institutions in Muslim Countries' (2020) 30 (2) Humanomics, 162-182

⁶⁵ Athmer and Bosch (n 60)

Primary Registrars: In several SSA countries, microfinance institutions are legally recognized as organizations under various statutes. These laws include the "Banking Act," "Private Voluntary Act," "Cooperative Society Act," and "The Money Lenders and Rates Interest Act." Depending on the nation and the available resources, MIMI may fall under any of these laws. Unfortunately, because the majority of them are based on interest-bearing activities, they require additional provisions in order to accommodate the non-interest component of MIMI.⁶⁶

MIMI Network: Financing institutions (MFIs) receive help from various national and international networks. Both formal and MFIs make up these networks. By creating performance standards for best practices and convincing member organizations to adhere to them, these networks have a regulatory function. When members fail to adhere to these established network rules, they typically lose access to the benefits that the network offers them. These advantages include of financial services like grants and guarantees, as well as possibilities for capacity growth and information on training and system deployments.⁶⁷ Additionally, MIMI can create official and informal networks at the local, national, and worldwide levels among like organizations. It can also operate as a regulator by creating best practices and performance criteria that member organizations should strive to meet. These standards should have rewards associated with them, and noncompliance should result in the loss of advantages like implementation of Shariah-related systems and training—which MIMI is well-known for—as well as financial services like grants and guarantees, as with traditional MFIs.⁶⁸

Self-Regulatory Body: This describes an organization that MIMI members established, own, and manage under their supervision. This might be a general association for MIMIs across all nations. These self-regulatory groups will have the responsibility of policing market behavior by developing codes of conduct and other standards for participating organizations. The self-regulatory body's main duty will be to keep an eye on and uphold the established rules. However, as most member institutions often lack the authority to sufficiently discipline misbehaving members, MFI experiences demonstrate that this regulatory framework is not appropriate for prudential oversight.⁶⁹

⁶⁶ *ibid*, 67

⁶⁷ Mohammed Warsame, 'The role of Islamic Finance in enhancing the economic prospects of Kenyan Muslims: An empirical study on Kenyan Islamic Banking Sector' (2015) 13(9) *I J A B E R*, 6885- 6911

⁶⁸ *ibid*, 69-70

⁶⁹ *ibid*, 71-77

Interest-free microfinance can also be regulated by the Apex Institution, another organization. This entails creating a national fund or apex institution that will provide wholesale loans to the local MIMIs. That top institution may be naturally viewed as a type of regulatory framework due to its function as an investor in MIMIs. The soundness of the MIMIs to whom it offers loans will be evaluated and tracked by this organization⁷⁰ Any MIMIs that do not fit the established criteria risk having their loans denied. MIMIs will find it difficult to abide by the loan's terms and conditions as a result. Requirements include a competent Board of Directors, yearly audited financial statements, achieving and maintaining profitability (if necessary), meeting obligations on time, having adequate capital, and adhering to regulatory standards.⁷¹

Delegated Supervision: Under this structure, the government's financial supervisory agency assigns an external body its direct supervisory duty over financial institutions while maintaining oversight and control over the entity. An ultimate regulating body, an umbrella group of MIMI's religious council (or Shariah board), or audit companies may be assigned this responsibility. But before delegated supervision can be properly implemented, a few things need to be made clear. These include, but are not limited to, who pays for the delegation; what would be a workable backup plan in the event that the delegated supervisor's power is withdrawn; and whose authority would be in charge of cleaning up the system in the event that the delegated authority fails. Before using assigned power to oversee MIMI's operations, several crucial concerns need to be resolved.⁷² The majority of SSA nations have their central banks acting as their financial supervisory agency, which means that they are in charge of overseeing banks and other financial institutions, including MFIs. The central banks, however, only exercise non-prudential oversight over loan MFIs and place a greater emphasis on deposit-taking MFIs. Sadly, the majority of MIMIs only assist members with saving; they do not accept deposits from the general public.⁷³ Some central banks use minimum start-up capital for MFIs to limit prudential supervision.⁷⁴ Unfortunately, MIMIs do not meet the minimum start-up capital requirements to be classified as MFIs and subject to central bank supervision. As a result, there aren't enough financial or human

⁷⁰ Hasan Z, 'Regulatory framework of IFMF system in UK, GCC Countries and the UK Kyoto Bulletin of Islamic Area Studies' (2010) 3 (2)

⁷¹ *ibid*, 47

⁷² Bello S, Zubaedy A. G, 'Shari'ah Governance Framework Model for Malaysian Islamic Banking and Finance: A Critical Analysis' (2015) 17(10) IOSR Journal of Business and Management.

⁷³ *ibid*, 243

⁷⁴ Jan Sofi Fuzia, 'Financing Microenterprises: Creating a Potential Value-Based Hybrid Model for Islamic Microfinance' (2013) 2 (2) International Journal of Management and Business Research, 108-122

resources to effectively supervise MIMIs. Central banks could make special provisions for faith-based financial institutions and other MFIs that do not accept deposits or meet minimum start-up capital to monitor their financial activities.⁷⁵

The Interest-Free Finance Advisory Board is a body that regulates financial institutions' interest-free finance activities. Where it operates, it either reports to the central bank or operates independently. This body advises the central bank on interest-free finance issues and Islamic financial activities. They assess the Shariah compliance of financial products and activities offered by interest-free finance institutions and provide appropriate advice.⁷⁶ This body, or a similar one, could be used to regulate the activities of MIMIs, particularly in the area of interest-free finance compliance.⁷⁷

Finally, Member-owned Interest-Free Microfinance is a new self-help group formed by poor Muslims in SSA to ensure financial inclusion for its members. The significance of this initiative is emphasized by the fact that more than 85 percent of the people in this region are unbendable, with a reasonable number of Muslims who will not deal in interest.⁷⁸

As admirable as the concept may appear, leaving it unregulated may be a time bomb for the poor members who put in their meager resources to assist themselves, if it fails.⁷⁹ This necessitates a strong regulatory framework that will not only protect the poor's fund, but will also ensure the success of the good idea. This study examined the operations of the two most commonly used member-owned microfinance organizations by Muslims, saving groups and financial cooperatives, in order to better understand how they operate. It also discussed various regulatory frameworks that are available to regulate this nascent interest-free microfinance in Ethiopia in comparison to Egypt, Sudan, and Malesia.

⁷⁵ Ibid, 108-122

⁷⁶ Frasca Alexandra, *A Further Niche Market: Islamic Microfinance in the Middle East and North Africa* (Center for Middle Eastern Studies and McCombs School of Business, University of Texas at Austin 2018)

⁷⁷ Hassan M. Kabir, Benito Sanchez and Geoffrey Ngene, 'Scales and Technical Efficiencies in Middle East and North African (MENA) Micro Financial Institutions' (2021) 5(2) *International Journal of Islamic and Middle Eastern Finance and Management*, 157-170

⁷⁸ Ashraf, Kabir, and Willima (n 64)

⁷⁹ Chowdhry Sajjad, *Creating an Islamic Microfinance Model-The Missing Dimension* (Dinar Standard, Business Strategies for the Muslim World, 2020) <https://www.academia.edu/776183/Creating_an_Islamic_Microfinance_Model-The_Missing_Dimension>

CHAPTER THREE

INTEREST FREE MICROFINANCE IN ETHIOPIA

In Ethiopia, interest-free micro lending has grown in popularity in recent years. Because many people lack access to traditional financial services and a large proportion of the population lives below the poverty line, interest-free microfinance has emerged as a viable and inclusive alternative. One of the primary drivers of this trend is the growing demand for financial services among underprivileged and economically marginalized populations. To meet the needs of low-income people and small businesses, interest-free microfinance institutions (IFMIs) are bridging this gap by offering easily accessible and reasonably priced financial products and services.⁸⁰

The Ethiopian government recognizes the importance of interest-free microlending in promoting financial inclusion and reducing poverty. So, in order to encourage the expansion and development of IFMIs, favorable laws and regulations have been enacted. This includes financial incentives for IFMIs to expand their business operations, as well as the development of specialized regulatory frameworks. Furthermore, the larger Islamic finance movement is inextricably linked with Ethiopia's trend of interest-free microfinance.⁸¹

The cultural and religious beliefs of Ethiopians are in line with Islamic financial norms, which forbid charging or accepting interest. Interest-free microfinance is becoming more widely recognized and used as a practical and moral financial solution as a result of this. All things considered, interest-free microfinance is predicted to keep expanding in Ethiopia due to the country's growing need for financial inclusion, encouraging legislative measures, and conformity to religious and cultural norms. This pattern might make a substantial contribution to the nation's inclusive growth, economic expansion, and decrease in poverty.⁸²

3.1 Opportunity and Potential of IFMI over IF Banking in Ethiopia

There should be a strong chance and possibility for learning from interest banking in Ethiopia, given the risk associated with any investment in interest-free microfinance. Several key prospects

⁸⁰ Ebisa D, Getachew N, and Fikadu M, 'Filling the Breach: Microfinance' (2013) 1 (1) Journal of Business and Economic Management, 010-017

⁸¹ Ahmed M.I, 'The Progress to Allow Fully Fledged Interest Free Banking Business in Ethiopia' (2019) 14 European Journal of Islamic Finance

⁸² Harun R. and others, 'Islamic Microfinance and Sustainable Development Goals in Bangladesh' (2018) 2 (1) International Journal of Islamic Business & Management, 67-80

for investment in interest-free microfinance in Ethiopia have been discovered following the examination of several data sets. These consist of a large consumer base, quick deposit mobilization and profitability, sufficient capital for formation, and significant public demand.⁸³

Ethiopia, like many other emerging countries, has a small percentage of high-income earners. With a sizable proportion of the population living below the poverty line, the majority of people are poor. Financial services play a limited role in the nation's infrastructure. As a result, access to financial services is limited. Microfinance companies may be more important in this situation than traditional banks. In countries such as Ethiopia, this provides financial justification for preferring interest-free microfinance institutions (IFMIs) to interest-free banks (IFBs). The following is a summary of the potential compensation that IFMI may receive over interest-free banking in Ethiopia:

- Improved outreach: IFMIs can potentially reach more Ethiopians, especially the underprivileged and marginalized financially. This advances financial inclusion and advances efforts to reduce poverty.
- IFMIs are capable of creating and providing financial solutions that are especially suited to the requirements and tastes of Ethiopia's target market. For the local populace, this personalization can improve the financial services' efficacy and relevance.

Local economic development: IFMIs may help Ethiopian communities thrive locally by giving entrepreneurs and small companies access to financing. This will also help create jobs in the region. Both the general expansion of the economy and the decrease of poverty may benefit from this.

- Impact on society: IFMIs frequently prioritize social welfare in addition to financial sustainability as part of their social purpose. Their activities may benefit Ethiopian communities' development, women's emancipation, and livelihood enhancement on a larger scale.

⁸³ Mekennon N, and Uvaneswaran S. M, 'Initiation of Sustainable Islamic Microfinance Institutions in Pastoralist Area' (2021)

3.1.1 Mobilize funds and Management Strengths

In Ethiopia, interest-free microfinance institutions (IFMIs) have proven to be very capable of raising capital and exhibiting excellent managerial qualities. These organizations, which follow Islamic financial principles, have had success raising capital from the general public and running their businesses efficiently.⁸⁴

To raise money, IFMIs in Ethiopia use a variety of funding sources. While non-profit IFMIs largely use Zakah and sadaqah donations from community members, profit-based IFMIs primarily rely on investor or member monies. Interest-free initiatives to reduce poverty are founded on the principle of zakat, which is a compulsory donation in Islam depending on certain requirements. To guarantee accountability and transparency, the distribution of Zakah is subject to stringent laws and regulations.⁸⁵

Recent events show that IFMIs in Ethiopia are increasingly turning to Zakah as a source of revenue. The practice of using Zakah monies for IFMIs has expanded under specific conditions and norms. This pattern shows how IFMIs are becoming more widely acknowledged as useful tools for reducing poverty and promoting sustainable economic growth. Furthermore, via encouraging the utilization of monies from Sadaqah and Zakah, IFMIs in Ethiopia support economic empowerment. In keeping with Islamic beliefs, which see debt as a last choice for meeting basic demands for consumption, they also push for community members to refrain from taking on needless debt. IFMIs in Ethiopia exhibit efficiency in terms of managerial strengths as they require fewer human resources, expertise, knowledge, and skills than traditional financial institutions. These organizations run their main offices and branches with fewer employees, which streamlines and lowers the cost of administration.⁸⁶

Furthermore, IFMIs in Ethiopia do not need to have the same level of sharia experience and understanding as regular banks. Their restricted array of services and product offerings, mostly customized to meet the need of the nearby community, enables them to concentrate on a more constrained range of sharia-based goods and services. It is crucial to remember that, in the event that any of the microfinance institutions had difficulties, their size and general makeup would likely prevent them from having a major effect on the sector. Unlike traditional banks, the

⁸⁴ Nasim S.S, 'Targeting and Socio-Economic Impact of Microfinance: A Case Study of Pakistan' (2012) 20 (2) Islamic Economics Studies, 1-28

⁸⁵ Nur Indah R, 'Islamic Microfinance as an Alternative for Poverty Alleviation: A survey' (2013) 2 (1 & 2) Afro Eurasian Studies, 254-271

⁸⁶ Ethiopian Microfinance Institution Associations, (Annual Report 2020)

potential failure of an IFMI in Ethiopia is unlikely to have a significant impact on other organizations, the financial system, or the overall economy.⁸⁷

To sum up, Ethiopian interest-free microfinance organizations have demonstrated their ability to raise capital from the general public and possess excellent managerial skills. The growing use of Zakah funds and the emphasis on economic empowerment are consistent with Islamic values and support national initiatives to reduce poverty.

3.1.1 Assists micro entrepreneurs in raising working capita

According to this logic, IFMIs gain from A major economic concern facing developing nations is the lack of job possibilities for youngsters. One of the competencies of IFMIs is to help micro businesses get working capital. Given that jobless individuals have several socioeconomic obstacles, unemployment is one of the major economic challenges. IFMIs could be quite important in this aspect. They help the impoverished in both profit-based and charity-based methods. To encourage the residents who are not working to engage in any kind of economic activity, they gather Zakah and charitable donations.⁸⁸

They also promote the growth of small and medium-sized businesses. For the beneficiaries, who typically do not have access to long-standing financial institutions, this opens up a job opportunity. This kind of work resembles self-employment, which boosts one's ability to compete in the formal sector by enhancing one's entrepreneurial spirit, skill set, and financial stability. Additionally, it generates job opportunities in a variety of direct and indirect ways for the recipients' family and communities.⁸⁹

As a result, it fosters political stability, social protection, and community-wide economic empowerment for all. Microfinance institutions play an important role in Ethiopia, where tens of millions of young people are in need of employment alternatives. The nation's ever-expanding youth population has a significant need for socially acceptable microfinance services, particularly in the areas that are primarily Muslim-IFM is.⁹⁰ Again, we can make a compelling case that the

⁸⁷ Shafii Z, and Rahman A. R. A, 'Issues on the application of IFRS9 and fair value measurement for Islamic financial instruments' (2016) 7(3) Journal of Islamic Accounting and Business Research, 202-214 <<https://doi.org/10.1108/JIABR-03-2016-0031>>

⁸⁸ Nobil MN, Billah MA, and Shohel A, 'Effectiveness of Islamic Microfinance in Alleviating Poverty: Empirical Evidence from Bangladesh' (2021) 5(4) International Journal of Science and Business, 1-10

⁸⁹ Shafii and Rahman (n 87)

⁹⁰ The Indonesian Financial Services Authority, (OJK Annual Report, 2019 <<https://www.ojk.go.id/en/kanal/iknb/Pages/Microfinance-Institutions.asp>>

limited scope, managerial focus, and insufficient capability of commercial banks as a whole prevent them from meeting this need. They require relatively little capital to launch and may provide services to hundreds, perhaps millions, of people. For instance, in Ethiopia, it takes less than 2% of total capital to establish an IFMI compared to founding a full-fledged bank.⁹¹

For this reason, IFMIs offer a financially advantageous solution to many low-income citizens' financial needs. Additionally, because they interact with the local population, IFMIs are very effective at raising and allocating funds. Furthermore, compared to banks, their credit risks are kept to a minimum due to the smaller loan amounts they grant their customers.⁹² But microfinance organizations have faced a number of difficulties and have grown inefficient in a number of nations. This is a result of the way they do business—that is, by giving credit to the most impoverished elements of society who encounter various socioeconomic challenges and are unable to repay the loan because of the higher interest rates.⁹³

If they have an interest-free framework and means of entrance in Ethiopia, the community's endorsement of moral principles and the balanced economic orientation of IFM institutions make them successful and efficient in this regard.

3.1.1 A Vehicle for Promoting Financial Inclusion

In summary, the amount of people using financial institutions at any level indicates how effective IFMIs are in increasing financial inclusivity. It has been demonstrated that by increasing income, consumption, and savings, this plays a significant part in improving people's financial circumstances. Following the success of microfinance programs that assist the underprivileged raise their standard of life, Ethiopia needs interest-free microfinance since a large number of low-income Muslims and middle-class Muslims would prefer interest-free financing options. Interest-free microfinance serves a similar goal to traditional microfinance, with the exception that it follows the decisions made to exclude interest.

⁹¹ UNDP, 'Beyond income, beyond averages, beyond today: Inequalities in human development in the 21st century' (Human Development Report, 2019) <http://hdr.undp.org/sites/all/themes/hdr_theme/country-notes/ETH.pdf>

⁹² Ernst and Young, *New Realities and New Opportunities* (World Islamic Banking Competitiveness Report 2016, East African Business Week July 2017)

⁹³ Usman and others, 'The role of entrepreneurial empowerment in the relationship between Islamic microfinance and well-being of clients: A view from a service provider' (2019) 26 (2) *Islamic Economic Studies*, 73-93

Even by Sub-Saharan African standards, Ethiopia has an extremely low rate of financial inclusivity, despite seeing rapid growth over the past ten years. After falling below 31% in 2022, the proportion of adults over 15 with accounts in financial institutions increased to over 44% in 2021. In 2022, the average rate for nations in Sub-Saharan Africa was around 43%, and the worldwide average was almost 69%. Financial institutions have a very low lending rate. The majority of individuals borrow money via friends, relatives, the sale of an asset, savings clubs (like Equb), and other unofficial sources. Based on data from 2022, the nation has about 41 microfinance organizations that provide services to millions of individuals, primarily in rural regions.⁹⁴ In a country with a small number of commercial banks and their coverage, the significance of these institutions is astounding. However, in many parts of the country, there are insufficient interest-free alternatives. Due to religious beliefs, a sizable portion of Ethiopia's population lacks a bank account. Promoting IFM services will thus provide significant benefits to the nation.⁹⁵

Because many economists believe that the common goal of interest-free microlending is to help people become self-sufficient, entrepreneurial, and self-respecting. Interest-free microfinance, which includes lending without collateral or other assets as a guarantee to the poor and Shariah-compliant financing methods, can be viewed as an effective means of reducing poverty, empowering the poor and increasing productivity, providing them with long-term social benefits, and supporting Ethiopia's economic development.⁹⁶

3.1.1 Prospective of IFMIs in Reducing Poverty

The ability of IFMIs to lower poverty is the first justification. Currently, billions of people worldwide are suffering from terrible living circumstances. A sizable fraction of people live below the poverty line in some Latin American, Asian, and African nations. The 2018 Human Development Index (HDI) for Ethiopia, which measures living standards, health, and education, was 0.470. Despite improvements, the rating remains lower than the average score of nations in sub-Saharan Africa and the poor human development category.⁹⁷ Aside from the Human Development Index (HDI), the Multidimensional Poverty Index (MPI) score was 0.489, indicating the percentage of the population experiencing multidimensional poverty.

⁹⁴ Thomson Reuters and ICD, (Global Transformation Report 2022, East African Business Week 2022)

⁹⁵ Somali Region Bureau of Finance and Economic Development, (Somali Regional State of Ethiopia, Report 2021)

⁹⁶ Malcolm Harper and Ajaze Ahmed Khan, Islamic Microfinance in Africa: Sharia Compliant and Sustainable? (Cranfield School of Management UK, July 2019)

⁹⁷ Ernst and Young (n 92)

Multidimensional poverty affects approximately 83.5 percent of the population, with an average deprivation score of 58.5 percent. This represents the breadth of deprivation, or severity. Full-fledged IFBs may not be as effective in eradicating poverty as Interest Free Microfinance Institutions (IFMI). Microcredit, micro equity, micro savings, micro transfer micro insurance, and microenterprises are among the key but micro services that the impoverished require, which is the prime reason for this. Furthermore, because life-cycle events, emergency requirements, and investment possibilities frequently arise, the impoverished require financial services. Life-cycle events encompass both recurring and once-in-a-lifetime events, such as festivals, education costs, and harvests, which affect every family. Examples of these events include birth, marriage, death, building a home, and old age. A breadwinner's death or unemployment, thievery, and personal problems like illness or accident are examples of emergencies. There are also occasionally opportunities to invest in houses, companies, or land. A variety of services are required to meet the requirements of the impoverished. Among these are interest-free microcredit and micro savings services, which are typically hard to come by via interest-free banks or traditional financial organizations.

Regarding this, IFMIs are important since they help the underprivileged by offering interest-free banking and financing options such salam (advance payment sale), ijara (lease), murabaha (profit sharing), and qerhasan (loan). Citizens who are not working can thus pursue a variety of profitable careers. They require micro-insurance once they start to engage in the economy. For them, the IFMIs can offer takaful (Islamic insurance) services. Moreover, there seems to be a need for micro-transfer. Several IFMI types can also address this. In the communities in which they operate, IFMIs support microbusinesses by offering micro insurance, micro saving, microcredit, and micro transfer services.⁹⁸ They thereby support the community's initiatives to combat poverty. Microfinance institutions, as a whole, play a significant role in a nation like Ethiopia where there is almost no access to banks in rural regions. Analogously, by empowering millions of Muslim consumers to utilize financial services assertively, IFMIs can increase the size of the recipients of microfinance services. By doing this, they may help promote rural development and the decrease of poverty. Due to these IFM services' limited availability in rural areas, lack of funding, and lack of orientation, covering them via windows and future full-fledged IFBs will be extremely difficult.⁹⁹

⁹⁸ Elsadig Musa Ahmed, and Anwar Ammar, 'Islamic Microfinance in Sudanese Perspective' (2015) 4(3) Business and Financial Affairs Journal, <<http://dx.doi.org/10.4172/2167-0234.1000149>>

⁹⁹ Ernst and Young (n 92)

3.2 Social Advantages Enhance Local and National Development

In addition to the economic reasons, there are also various social or socio-economic reasons, which make promoting IFMIs more gainful than full-fledged IFBs. This includes the capacity to increase social mobilization, creating community participation in development, enhancing community development.

3.2.1 Organize the community and Social Mobilization

As the impoverished residents' financial situation improves, they begin to participate in a variety of social activities. Their wellbeing rises, they acquire new skills, collaborate, share resources, give up some bad habits, and begin to engage in a variety of developmental activities. Through the use of their services, microfinance institutions encourage community members to work together, share resources, and develop the skills and knowledge necessary to take advantage of possibilities. In particular, IFMIs may organize the community for these benefits by utilizing their religious moral principles.¹⁰⁰ They thereby establish a society that is vibrant, growth-oriented, and has solid social ties. In Ethiopia, the same may actually be true.

In rural locations, IFMIs may help communities organize and integrate with other public and private development players. They greatly improve social interactions, ties between the community and public institutions, encourage settlements, foster peace and security, and greatly advance both local and national development. The provision of financial services to underserved communities is another notable advantage of microfinance firms.¹⁰¹

Finally, IFMIs have demonstrated their ability to raise the standard of living for the poor in several countries by increasing production, developing capacity, and generating revenue. Their participation improves well-being by altering society's overall human habits. By taking a participatory approach to meeting the microfinance needs of rural Ethiopian communities, IFMIs can help them develop.

3.2.2 Creating gender equality and Women Empowerment

IFMIs can increase community empowerment through entrepreneurship. This makes people and many groups—including women—more valuable and capable. In addition, their position boosts

¹⁰⁰Mohammed Warsame, 'The role of Islamic Finance in enhancing the economic prospects of Kenyan Muslims: An empirical study on Kenyan Islamic Banking Sector' (2015) 13 (9) I J A B E R, 6885- 6911

¹⁰¹ Michael Bennett, 'Islamic Finance as an engine for sustainable economic development (IFN Issuers and Investors forum, London 2013)

women's dignity, self-worth, self-strength, and self-confidence in the community. By teaching and training women, enhancing their potential as leaders, influencing social interactions, enhancing the accumulation of assets, and other means, IFMIs may have a significant impact in rural communities. Above all, microfinance institutions in general and IFMIs in particular play a vital role through the salam (advance payment sale) and ijara (lease) services in rural economies, where impoverished women are strongly involved.

3.3 IFMF-related lawful Advantages

The availability or character of the legal framework is a significant failure or success element for IFBs in many nations. The IFB industry is still facing a similar issue in Ethiopia. The main issues facing the industry are taxes, property rights, legal disputes, and other legal problems pertaining to IFBs. The provision of financial services, including small loans, to the underprivileged and microbusiness owners is an essential component of microfinance. Typically, microfinance aims to assist underprivileged individuals in expanding their businesses and starting new ventures for people who are not eligible for loans from commercial banks and other financial institutions.¹⁰²

Furthermore, compared to bank loans that are legally defended, the terms and circumstances of these loans are typically easier to comprehend and more flexible. For microfinance, the repayment schedule is based on weekly payments for short-term borrowing. The microfinance program will give the impoverished access to educational programs, cash-flow management classes, bookkeeping, and accounting, among other technical and professional skills. It will also educate the poor the fundamentals of investing to launch a new business. Nonetheless, as several nations have demonstrated, IFM institutions face fewer difficulties with this issue. Again, this mostly stems from their nature: restricted commercial participation, restricted services, and ownership structure.¹⁰³

3.1 Technology and Facilities Requirements

Banks often need significant expenditures in a range of infrastructures and technology. They require enormous funding to set up their system. This covers personnel services, transportation systems, customer service facilities, branch facilities, operational programs, and so forth. Because of the inadequate infrastructure and amenities in rural areas in developing countries, banks are

¹⁰² *ibid*, 56

¹⁰³ Malcolm and Ajaze (n 96)

unable to run efficiently. Nonetheless, some of these infrastructure services and amenities are required by Ethiopia's interest-free microfinance organizations. As a result, compared to banks, they may provide more controllable services.

3.2 Decaling sociopolitical pressures

The extent or degree of effect the IFB sector has on the economy and societal attitudes is primarily responsible for these sociopolitical pressures. Interest-free banks have a negative religious reputation in many nations, and the emergence of IFBs has given rise to these misconceptions.¹⁰⁴ For instance, certain organizations in Nigeria established ethno-religious attitudes and implications on the IFB industry due to the political climate of the country. This has an impact on the investors' little interest in the industry.¹⁰⁵

Similarly, in Ghana, non-Muslims are less likely to use IFB services due to a lack of awareness or misunderstanding of the sector in society.¹⁰⁶ This makes the proportion of the population using the services very low.

This, in return, generates different interest groups who can challenge or manipulate the policymakers and politicians to rigorously regulate the sector.¹⁰⁷ IFMIs may be able to serve the majority in this way without facing significant socio-political obstacles. They have a good possibility of receiving less attention due to their scope of effect and the socioeconomic status of the community they serve. Furthermore, they are too little to draw the attention of powerful economic interest groups.

3.1 Intimidating Ethical and Moral Issues

The IFM institutions in the sector are one of the things that detractors of the IFB literature point out. This indicates that a large portion of the impoverished people goes unnoticed. There are a few major causes for this. First off, many nations' current economic systems do not favor the poor. Second, a small group of wealthy families in the Gulf hold the largest banks in the region, which have branches in several western nations, controlling the IFB sector.

¹⁰⁴ Thomson Reuters and ICD (n 94)

¹⁰⁵ Ibid, 98

¹⁰⁶ ibid

¹⁰⁷ IMF, *Multi Country Report* (2014, 2015 and 2017)

Third, there is not enough development in the IFM industry to draw scholars.¹⁰⁸ Lastly, compared to banks, IFM services are significantly less lucrative. As a result, the IFM industry is seeing lower levels of innovation, investment, and general development. Thus, ethical concerns arise if the IFB industry as a whole continues to cater only to the wealthy.

In conclusion, interest-free microfinance organizations benefit Ethiopia's economy and society in a number of ways. This does not imply that they are easy to promote or that they do not encounter difficulties. They also face a variety of difficulties. Global experiences indicate that some of the problems that IFMIs must face include high supervision needs, a high customer drop-out rate, and misunderstandings about their products and services.

¹⁰⁸ Kabir Tahir Hamid, International Finance Corporation Report (Mobile Money Scoping Country Report, South Sudan 2012) See also International Institute of Islamic Banking Finance (IIIBF), Islamic Microfinance Products and Models: FCIFC, FIDRP, FCITM (Bayero University, Kano-Nigeri)

CHAPTER FOUR

DISCUSSION

4.1 Overview of Microfinance Institutions in Ethiopia

The government issued the Licensing and Supervision of Microfinance Institution Proclamation, which encouraged the growth of MFIs in both rural and urban areas by granting them the legal authority to accept public deposits, draw and accept drafts, and manage funds for the microfinance business, among other things. Ethiopia began offering formal microfinance in 1945.¹⁰⁹

Directive No. MFI/11/98, which states that "the interest rate to be charged on loans and advances granted by a micro financing institution should be established by the Board of Directors of each micro financing institution," lifted interest rate restrictions on MFI loans. For many, this has made it easier to set a lending interest rate high enough to cover operational costs. In contrast, there is a minimal amount of interest that can be given to depositors.¹¹⁰

Subsequent improvements to the regulatory framework remove the interest rate credit restriction, increase the maximum loan amount for individual borrowers, and prolong the loan repayment terms from one year to two years. This resolves many significant regulatory problems that the industry was facing since Ethiopia does not offer interest-free microfinance.¹¹¹

There is still no way for Ethiopian microfinance institutions to acquire novel concepts from interest-free microfinance abroad; also, there are insufficient Ethiopian-owned IF'MFs and ineffective management techniques for indirect foreign ownership.¹¹² Because of the rise in interest rates, the poor continue to have insufficient access to microfinance service providers. Despite the industry's tremendous growth over the last few decades, the poor and Muslim minority continue to have unmet needs because the services are interest-based.¹¹³

¹⁰⁹ Gobezie G, *Microfinance Development: Can Impact on Poverty and Food Insecurity be Improved Upon?* (Paper presented at the 'International Conference on Microfinance Development in Ethiopia' organized by AEMFI, Awassa, Ethiopia 2004)

¹¹⁰ IFAD, *Ethiopia: Rural Financial Intermediation Program* (Formulation Report, RUFIP Working Paper No.1., 2001)

¹¹¹ Amha W, Prudential Regulation of the Microfinance Industry: Lessons from Ethiopia (Paper presented at the ACSI's First General Assembly, 2014)

¹¹² Aman Ali, and Bushera, (2020) 12 (1) Microfinance Development Review

¹¹³ Ebisa, Getachew, and Fikadu (n 80)

As an alternative to traditional microfinance, Islamic finance management (IFM) emerged with the goal of providing financial and non-financial services to low-income and poor people in accordance with Islamic values. Based on the Association of Ethiopian Microfinance Institutions' report.¹¹⁴ As of right now, approximately 3.7 million Ethiopians are actively using the service; but, from a bank perspective, there are less than 8,000 IFM clients. As with interest-free banking, there is no official legal structure supporting Ethiopia's interest-free microfinance sector.¹¹⁵

In a country like Ethiopia, where access to banks is almost nonexistent in remote regions, microfinance groups, in general, play a crucial role. Parallel to this, IFMIs can expand the number of people who get microfinance services by enabling millions more Muslim customers to use financial services assertively.¹¹⁶ By doing this action, people may help reduce poverty and promote rural development. For Windows and soon-to-be fully-fledged IFBs, these IFM services are very challenging to cover because of their restricted availability in distant locations, lack of money, and lack of orientation.¹¹⁷

4.1 The legal and regulatory framework governing IFM in Ethiopia

The legal basis for these institutions is established by a variety of laws and norms that govern the establishment, administration, and supervision of interest-free microfinance companies in Ethiopia. These legislative initiatives seek to ensure the effective functioning of interest-free microfinance institutions and promote financial inclusion across the country.¹¹⁸

Microfinancing Institutions Decree No. 626/20}: This proclamation serves as the general legislative basis for all types of microfinance enterprises in Ethiopia. The licensing, operational, and regulatory monitoring requirements—including those unique to interest-free microfinance organizations—are described. This directive serves as the foundation for the establishment and supervision of interest-free microfinance institutions in Ethiopia.¹¹⁹

¹¹⁴ Association of Ethiopian Microfinance Institutions report, September 2017

¹¹⁵ Mahmood, Hafiz Zahid, and others, 'Islamic Microfinance and Poverty Alleviation: An Empirical Ascertainment from EGAD' (2019) 11 (2) Journal of Islamic Economics, Banking and Finance, 85-105

¹¹⁶ UNEDP, 'Microfinance and well-being of clients: A view from a service provider' (2020) 26 (7) Journal of Ethiopian Studies

¹¹⁷ *ibid*, 93-94

¹¹⁸ Aman and Bushera

¹¹⁹ Ebisa, Getachew, and Fikadu (n 80)

In other hand, Interest-Free Microfinance Directive No. SBB/60/2010: Issued by the National Bank of Ethiopia, ¹²⁰Specifically tailored for interest-free microfinance institutions, this regulation provides extensive guidelines. It covers a wide range of subjects, including as capital requirements, governance standards, risk management practices, and consumer protection legislation. To preserve their legal standing and operational compliance, interest-free microfinance organizations are required to follow this directive.¹²¹

Nonetheless, the Ethiopian Financial Supervisory Authority (EFSA), which is in charge of regulating financial institutions, releases guidelines and rules that govern the day-to-day activities of interest-free microfinance companies. These directives address a variety of subjects, including licensing, anti-money laundering protocols, financial reporting requirements, prudential norms, and corporate governance standards. Following these rules is crucial if interest-free microfinance organizations want to maintain their legal status and ensure operational compliance.¹²²

The Ethiopian Commercial Code (ECC) regulates banking and finance, and it plays a significant role in controlling the legal matters of interest-free microfinance institutions. It establishes a framework of law for matters like as agreements, transactions, security interests, and other business aspects that are vital to these organizations' operations.¹²³ For instance, Non-Profit Organizations Proclamation No. 1113/2019 sets down the legal requirements for their creation, registration, and management. It lays forth the particular requirements—such as the need to register with the relevant government agency—for non-profit organizations that participate in microfinance.¹²⁴

What is the revised statement that backs up the aforesaid claim? In order to guarantee the secure and effective operation of interest-free micro financing while simultaneously promoting it for wider financial inclusion, the National Bank of Ethiopia published "Directive No. MFI/32/2021, titled "Licensing and Authorization of Interest Free Micro financing Business."¹²⁵The National Bank of Ethiopia revised the legal and legislative framework

¹²⁰ Interest-Free Microfinance Directive No. SBB/60/2010: Issued by the National Bank of Ethiopia

¹²¹ Association of Ethiopian Microfinance Institutions report, September 2017

¹²² Mahmood, Hafiz Zahid, and others (n 115)

¹²³ UNEDP (116)

¹²⁴ Non-Profit Organizations Proclamation No. 1113/2019

¹²⁵ Licensing and Authorization of Interest Free Micro financing Business Directive No. MFI/32/2021

governing Interest Free Micro financing Business Directive No. MFI/32/2021 in order to promote interest-free microfinance for better financial results. The regulation establishes clear, measurable standards for Ethiopia's interest-free microfinance company licensing and authorization. The Interest-Free Microfinance Business Authorization Directive No. MFI/32/2021 contains numerous key provisions.¹²⁶

The directive also provides clear definitions for terms used within its context, so that everyone is aware of terms like "interest-free microfinance business," "interest-free microfinance institution," "interest-free microfinance window," "microfinance institution," "National Bank," and "Person." All interest-free micro lending organizations in Ethiopia that provide microfinance can use this lesson.¹²⁷

The National Bank requires applications for licenses from individuals or companies wishing to create interest-free microfinance institutions, in accordance with the guidelines provided in Directive No. MFI/23/2013. This pertains to the licensing and authorization of interest-free micro financing businesses.¹²⁸ Microfinance institutions must submit a thorough application along with all required documentation, such as financial statements, risk management plans, balance sheet structures, and reports on resource mobilization, in order to operate an interest-free microfinance window inside their current operations. Additionally, it said that before modifying the maximum amount of their interest-free micro financing window on their consolidated balance sheet, microfinance institutions must receive approval from the National Bank. The period for interest-free micro financing may end if you do not follow this requirement.¹²⁹

When providing interest-free microfinance, microfinance institutions need to ensure that the proper documentation is maintained in order to segregate money and maintain separate books of accounts for the life of the program. Focusing on account and financial statement upkeep is necessary for this. Furthermore, in accordance with Article 7/2021, they are required to submit to the Microfinance Institutions Supervision Directorate of the National Bank a weekly report detailing their interest-free micro lending operations.¹³⁰

¹²⁶ Interest-Free Microfinance Business Authorization Directive No. MFI/32/2021

¹²⁷ *ibid*

¹²⁸ *ibid*,art.4

¹²⁹ Directive No. MFI/23/2013

¹³⁰ Interest-Free Microfinance (n 126) Article 9

Apart from the interest rate limitations set by the National Bank, a microfinance institution engaged in interest-free micro financing operations must adhere to all legal and supervisory norms. The board of directors of such organizations is in charge of creating comprehensive procedures and guidelines for Shariah monitoring.¹³¹

As a result, starting the day the legislation goes into effect, interest-free microfinance organizations that are already in operation will have six months to comply with its standards. Although the current legal and regulatory framework has flaws, it also has the potential to promote financial inclusion, increase transparency, and meet the needs of individuals and businesses seeking Shariah-compliant financial services. Improving and changing the arrangement could potentially lead to opportunities for interest-free microloans in Ethiopia.¹³² In summary, Ethiopia's regulatory framework for interest-free microfinance institutions is contingent upon the implementation of Directive No. MFI/32/2021. In addition to ensuring the safe and effective operation of interest-free micro lending businesses, it promotes financial inclusion. Important terminology, detailed guidelines for license and authorization, and requirements for maintaining separate accounts and reporting activities are all included in this regulation.

Essentially, within the parameters of this legal directive, microfinance institutions can adhere to requirements of regulation and supervision in addition to interest rate limits. The decree emphasizes the need of Shariah monitoring and requires institutions to have comprehensive policies and procedures in this area.

Directive No. MFI/32/2021 offers chances to enhance transparency, address flaws, and meet the financial needs of individuals and businesses seeking Shariah-compliant financial services, even if the existing legislative framework may need some improvement. By strengthening and broadening the framework, interest-free micro lending will be able to realize its full potential, supporting Ethiopia's financial sector as a whole and ensuring greater financial accessibility for anyone.

¹³¹ *ibid*, art. 8

¹³² *ibid*,art.9

4.2 Interest Free MFI in Malaysia

4.2.1 Overview

Micro enterprises account for 90% of Malaysia's small and medium-sized businesses (SMEs) and dominate the microfinance industry. Malaysia has four primary types of microfinance providers: microfinance institutions, cooperatives, development financial institutions, and commercial banks that offer microloans. Malaysia has three key microfinance institutions: Yayasan Usaha Maju (YUM), Amanah Ikhtiar Malaysia (AIM), and the Economic Fund for National Entrepreneurs Group (TEKUN).¹³³ AIM is a non-governmental organization, and both YUM and TEKUN are governed by laws issued by the Ministry of Agriculture and Agro-Based Malaysia.¹³⁴ While TEKUN imposes on the community's poor and moderately poor, AIM and YUM loan money to the community's impoverished and extremely poor female members.¹³⁵

To help micro businesses grow by giving them more access to the official financial system, the Malaysian government has mandated that development institutions such as Bank Rakyat, Bank Simpanan Nasional, and Agro bank provide microcredit services. Bank Simpanan Nasional provides microloans to non-agricultural businesses, Bank Rakyat offers an Islamic pawn broking tool, and Agro bank provides microfinance to micro enterprises in the agriculture and agrobased industries.¹³⁶ Furthermore, through their participation in the Pembiayaan Micro program, which was introduced in 2006, commercial banks in Malaysia are given the opportunity to offer microfinance by the government.¹³⁷ Free of interest the microfinance instruments available in Malaysia adhere to Shariah regulations. For example, AIM provided qard hassan, Bank Rakyat provided microfinance products based on rahn, and several cooperating financial institutions provided baiinah.¹³⁸ AIM and Bank Rakyat are Malaysia's two primary Islamic microfinance providers.

¹³³ *ibid*

¹³⁴ Paul B McGuire, John D Conroy, and Ganesh B Thapa, 'Getting the Framework Right: Policy and Regulation for Microfinance in Asia—Malaysia' (2022) <<http://www.bwtp.org/publications/pub/Appendix4.htm>>

¹³⁵ Che Zakiah Che Din, *Creating a Conducive Environment for Micro and Rural Finance—the Malaysian Experience* (Proceedings of the High-level Policy Meeting on Microfinance and Rural Finance in Asia, February 2004)

¹³⁶ *ibid*, 57

¹³⁷ Rajenthiran Arumugam, 'Malaysia: An Overview of the Legal Framework for Foreign Direct Investment' (2002 accessed on May 29, 2022, <<http://www.iseas.edu.sg/ef52002.pdf>>

¹³⁸ Bank Negara Malaysia, Small and medium enterprises annual report (2010)

One of Malaysia's non-governmental organizations, AIM was founded in 1987 with the goal of ending severe poverty in the country. It was stated that AIM was an Asian version of the original Grameen Bank.¹³⁹ Rahn, or pawning, is a further option for interest-free borrowing. Bank Rakyat is the biggest Islamic cooperative in Malaysia. It was the pioneer in the country to provide an Islamic pawnbroking plan known as Ar-Rahnu in 1993. The foundation of Bank Rakyat's Ar-Rahnu is the idea of a charitable loan (qard hassan).¹⁴⁰ Reliability (wadiyah yad-amanah), guarantee-filled safekeeping (wadiyah yad-dhamanah), and safeguarding charge (al-ujra). In addition to Ar-Rahnu, Bank Rakyat began providing its members with Islamic microfinance instruments based on the

4.3 4.2.2. Regulatory framework

Malaysia has put in place regulations that allow international companies to provide interest-free (Islamic) microfinance in the domestic market. Laws such as the Islamic Banking Act of 1983 (IBA), the Takaful Act of 1984, the Banking and Financial Institutions Act of 1989 (BAFIA), and the Securities Commission Act of 1993 have all contributed to the growth of Islamic financial institutions in Malaysia.¹⁴¹

The Islamic Financial Services Act of 2013 (IFSA), the Central Bank of Malaysia Act of 2009, and the Capital Market and Services Act of 2007.¹⁴² The Ministry of Finance and the central bank, Bank Negara Malaysia (BNM), which was established in 1959 under the Central Bank of Malaysia Act 1958, oversee interest-free¹⁴³ microfinance operations and regulate Islamic financing in Malaysia. The 2009 Central Bank of Malaysia Act replaced the 1958 Central Bank of Malaysia Act.

According to IBA 1983, the Central Bank of Malaysia may consult the National Sharia Advisory Council for advice on Sharia compliance in relation to MFIs. The Government Funding Act 1983 (GFA) authorizes the Malaysian government to issue Government Investment certificates, which are Sharia-compliant securities.¹⁴⁴ In order to satisfy liquidity needs and invest surplus money,

¹³⁹ Institutional Reform and the Informal Sector Center at the University of Maryland Cross-country Banking Regulation Data, November 2021

¹⁴⁰ Organization of Economic Corporation and Development, (Malaysia, 29 May 2020) <<http://www.oecd.org/dataoecd/23/20/1882063.gif>>

¹⁴¹ Bank Negara (n 138)

¹⁴² Islamic Financial Services Act 2013

¹⁴³ Central Bank of Malaysia Act 2009

¹⁴⁴ Islamic Banking Act 1983

Islamic MFIs are permitted to invest in Government Investment Certificates, which is another alternative for the government to raise cash through Sharia-based securities investments. The IFMFI Act and the BAFIA 1989 both have identical definitions for Islamic banking businesses. Institutions covered by the BAFIA report matters to the National Sharia Advisory Council for assessment to determine whether any Islamic Sharia principles have been broken.¹⁴⁵

However, the Financial Services Act of 2013 replaced the BAFIA 1989 (FSA). The banks began competing with the traditional system in 1993, when they introduced the interest-free MFI plan. The Islamic Financial Services Act (IFSA), enacted in 2013, established regulations for Islamic banking and insurance in Malaysia.¹⁴⁶ IFSA 2013 replaced 146 IBA 1983.¹⁴⁷ The Act was enacted in order to guarantee that the objectives, policies, and commercial dealings of the establishments that have licenses adhere to the principles of Sharia.

According to the Act, IFMF may receive Sharia compliance standards and guidelines from Bank Negara Malaysia (BNM). Bank Negara Malaysia (BNM) has released the Sharia Governance Framework for Islamic Financial Institutions, which provides guidelines for how Islamic financial institutions and takaful operators should establish their Sharia governance systems.¹⁴⁸

The IFSA, like the Financial Services Act (FSA), provides financial institutions with rules and recommendations to address financial stability and related concerns. With the assistance of IFSA, Islamic financial institutions in Malaysia can now compete with traditional financial institutions. Foreign institutions may provide Islamic banking services in Malaysia if they hold a valid IFSA license. An international insurance company may do business in Malaysia if it holds an IFSA license to offer takaful and retakaful services. Occasionally, the Securities Commission and Central Bank issue guidelines outlining specific disclosure or reporting requirements for Islamic funds, sukuk, and takaful. Organised as a corporate organization under the Labuan Financial Services Authority Act 1996, the Labuan Financial Services Authority (LFSA) is another regulator of Islamic Financial Institutions.¹⁴⁹

¹⁴⁵ Central Bank of Malaysia Act 2009

¹⁴⁶ Kasim N, Nuhtay S, and Salman S.A, 'Comparative analysis on AAOIFI, IFSB and BNM sharia governance guidelines' (2013) 4 (15) International Journal of Business and Social Science

¹⁴⁷ Islamic Banking Act 1983

¹⁴⁸ Financial Services Act 2013

¹⁴⁹ Sequerah F, and Hong J, *Islamic Finance and Market Malaysia* (2017) <gettingthedealthrough.com> accessed 28 October 2019

LSFA's goals include developing and managing the International Business and Financial Centre, as well as serving as the center's regulatory and supervisory body. The Capital Market and Services Act of 2007, which governs Malaysia's financial industry, defines Bursa Malaysia as an exchange holding company. Bursa Malaysia offers access to Islamic markets, including Bursa Suq Al-Sila, Sharia-compliant exchange-traded funds, Sukuk, Islamic Real Estate Investment Trusts, and Sharia-compliant securities.¹⁵⁰

4.4.1.1 Lending scheme

In Malaysia, interest-free microfinance is limited to microcredit loans and does not include other microfinance services such as micro savings or micro insurance. The Malaysia Banking and Financial Act of 1989, which states that "No person shall carry on banking services, including receiving deposits on current account, deposit account, savings account, or any other similar account, without a license as a bank or financial institution," is the reason for these restrictions and the limited financial services they provide.¹⁵¹ Additionally, interest on loans cannot be levied in Malaysia due to the constraints on interest-free microfinance imposed by Sharia Law; therefore, administration fees have been used in its place. For every type of company activity, regardless of their income cycle, AIM and YUM need weekly loan installments. For borrowers who operate agricultural companies, they impose grace periods of one to two weeks.¹⁵²

In contrast, TEKUN has loan instalment systems that require weekly payments for small firms and monthly or seasonal payments for some small businesses and agricultural enterprises including farming, fishing, and animal husbandry.¹⁵³ With TEKUN, agricultural company borrowers may customize the length of their grace periods according to the timing of their harvest or output.¹⁵⁴ In order to lessen the financial burden on borrowers in times of emergency or natural catastrophe, only AIM, out of the three microfinance organizations, has made the effort to offer welfare assistance to its borrowers and families. In a recent move in Malaysia's microfinance sector, Bank Negara Malaysia mandated in 2007 that various banking institutions provide microcredit loans.¹⁵⁵

¹⁵⁰ Malaysia Capital Market and Services Act 2007

¹⁵¹ Malaysia Banking and Financial Act 77/1989

¹⁵² *ibid*, 78-79

¹⁵³ Yussof SA, 'Malaysia's model framework for sharia compliance and stability' (2013) 3(4) *Islam and Civilizational Renewal Journal*,

¹⁵⁴ Sequerah and Hong (149)

¹⁵⁵ Islamic Financial Service Board, (IFSB, 2019) <investopedia.com> accessed 27 October 2023. See also Islamic International Rating Agency, (Islamic Finance Wiki, 2018)

This resulted from the discovery that 80% of the nation's 500,000 small and medium-sized businesses were microenterprises.¹⁵⁶ The amount of the microcredit loan, which is issued without collateral, ranges from RM1,000 to RM50,000. Based on the Bank Lending Rate (BLR) + 0.50%, the interest rate charged is calculated.¹⁵⁷ Since the BLR is 6.30% as of 2010, microcredit loans have an interest rate of 6.80%. This percentage is lower than that of YUM (10–18%) and AIM (10–12%), but significantly greater than that of TEKUN (4%).¹⁵⁸ The Credit Guarantee Cooperation (CGC) guarantees the interest-free microloans provided by commercial banks. A government agency called the CGC guarantees loans made by other financial institutions to small and medium-sized businesses who lack the collateral or credit history necessary to get credit facilities from the financial institution.¹⁵⁹ This move has increased the country's microfinance borrowers' ability to get a loan facility.¹⁶⁰

4.4 Interest Free MFI in Sudan

4.4.1 Overview

Sudan is Africa's first country to offer interest-free micro lending. According to the World Bank's Consultative Group to Assist the Poor (CGAP), Sudan's interest-free microfinance experiment serves as "a laboratory for Islamic microfinance delivery, where advancements may provide information on effective Islamic microfinance practices." Sudan was described as "a remarkable narrative of interest-free microfinance development," according to the aforementioned report.¹⁶¹ Sudan came in second place to Bangladesh among the nineteen nations that provide Islamic microfinance in terms of client outreach through the practice.¹⁶²

Sudan was also placed fourth in terms of an exceptional microfinance portfolio, behind Bangladesh, Indonesia, and Lebanon. According to the report, a proactive Central Bank that gave micro loaning by banks via a special unit priority is mostly to blame for the market's explosive growth in Sudan.¹⁶³

<wiki.islamic.finance.de> accessed 27 October 2023

¹⁵⁶ Hussain A, and Williams N, Islamic Finance in Indonesia (15 June 2016) <clydeco.com> accessed 28 October 2023

¹⁵⁷ Ginena K, and Hamid A, Foundations of Sharia Governance of Islamic Banks (John Wiley & Sons UK, 2015)

¹⁵⁸ *ibid*, 93-94

¹⁵⁹ *ibid*, 95

¹⁶⁰ *ibid*, 95-98

¹⁶¹ IMF, *Article IV Consultation Staff Report* (IMF Article of Consultation, Country Report 13/317, 2013) <<http://www.imf.org/external/pubs/ft/scr/2013/cr13317.pdf>>

¹⁶² *ibid*, 12-14

¹⁶³ *ibid*, 23-45

Furthermore, the expansion of Sudan's interest-free microfinance industry is indicative of the government's efforts to reach the underprivileged with financial services. IMF Article of Consultation, 2013 (Sudan), a recent report from the International Monetary Fund (IMF),¹⁶⁴ has comparable opinions regarding the Sudanese industry. As to the IMF study,¹⁶⁵ Because of the government's aggressive marketing, the microfinance industry is little but expanding quickly. So far, this drive has produced some outstanding outcomes. By 2012, there were 494,000 microfinance (MF) borrowers, up from 49,000 at the end of 2007.¹⁶⁶ The world leaders in Islamic microfinance in terms of active consumers are undoubtedly Bangladesh and Sudan, with Sudan expected to overtake Bangladesh given current growth rates.¹⁶⁷

Sudan's microfinance industry is divided into three categories: semi-formal (NGOs, civic groups, social funds, and rural development projects), formal (microfinance institutions, MF specialist banks, and commercial banks), and informal. Mohammad Abdul Munaim's most recent paper presents an overview of several informal financing sources in Sudan.¹⁶⁸ These include: shail, which is the sale of a portion of anticipated crops to village traders; istigrar, which is the grocer credit for household consumption guaranteed by salary; dalalia, which is the provision of utensils for a short-term installment and premium installment; and sandouk, which is the informal system of saving and borrowing in which each member of the group receives a predetermined amount of money on a regular basis to be used for marriage, childbirth, Furthermore, villages may organize efforts to address a person's or family's social needs through the nafeer system, a type of social takaful that can be used in kind or cash.¹⁶⁹ But the true beginning occurred in 2007, when the CBoS established the Microfinance Unit to oversee and advance microfinance in Sudan. Sudan now has 29 MFIs: seven federal MFIs (Al-Amal, Al-Shabab, Al-Ebdaa', Al-Mashien, Al-Watania, Al-Osra, and Iradaa') and twenty state MFIs (six in Khartoum states, two in the Red Sea state, two in South Kurdufan state, and one in other states, with the exception of Western Kurdufan and Central Darfur).¹⁷⁰

¹⁶⁴IMF, *Article IV Consultation Staff Report* (IMF Article of Consultation, Country Report 22/1002, Sudan 2022) <<http://www.imf.org/external/pubs/ft/scr/2013/cr13317.pdf>>

¹⁶⁵ibid

¹⁶⁶ibid

¹⁶⁷ Microfinance Unit, *Sundries Reports* (MFU, 2020)<<http://www.mfu.gov.sd/en/content/articlesstudies-and-statistics>>

¹⁶⁸ Mohammad and Abdul Munaim, (Paper presented on the 9th conference of Islamic Economics in Qatar,2013)

¹⁶⁹See <<http://www.sudantribune.com/spip.php?article51883>>

¹⁷⁰ See Central Bank of Sudan reports, 2017 <<http://www.cbos.gov.sd/node/25>>

The MFIs are classified into three types: NGOs that converted MFIs, such as the Port Sudan Association for Small Enterprise Development (PASED); MFIs with clients as shareholders, such as the Al Mithal, Baraa', and Al-Garra in Sudan; and private sector for-profit MFIs. Public entities are organized as the state arm to combat poverty and rely on funding from the respective regional governments.¹⁷¹

i. Regulatory Framework IF' MF in Sudan

Consistent with the MF policies implemented in Sudan, whereby the primary objective has been to establish and foster a conducive atmosphere that facilitates the growth of microfinance institutions and their effective contribution to poverty alleviation, the CBOS has periodically released various laws to bolster the industry.¹⁷²

Sudanese banking and Microfinance Act 232/2006 stipulates a minimum capital requirement for MFIs and banks. A law pertaining to MFI and bank licensing was implemented in 2006– 07, encouraging investors to create MF specialized banks and MFIs in state capitals.¹⁷³ In 2011, Sudan implemented a revised regulatory framework to create MFIs that accept deposits and those that do not, or that just offer loans.¹⁷⁴ Additional restrictions have also been imposed on MFIs generally. These include being prohibited from dealing in foreign exchange, accepting deposits from the public or government (without prior approval from the CBOS), trading or owning real estate, and investing reserve money in the financial market without the CBOS's approval.¹⁷⁵

According to the CBoS, a microfinance client in Sudan is someone aged 18 to 70 who earns less than twice the minimum wage per month, owns productive assets worth less than SDG 20,000, and, most importantly, has not received any official lending. This group is referred to as the economically active poor. As a result, the term encompasses a wide range of intended consumers in various microfinance categories, including but not limited to: prosperous families, artisans, graduates of technical and vocational programs, professionals, rural women, retirees, and so on.¹⁷⁶

¹⁷¹See < <http://www.tradingeconomics.com/sudan/inflation-cpi>>

¹⁷²Cull R, Demirgüç, and Morduch, Does Regulatory Supervision Curtail Microfinance Profitability and Outreach? (World Bank's Policy Research Working Paper 4748, 2009)

¹⁷³Sudanese banking and Microfinance Act 232/2006

¹⁷⁴Central Bank of Sudan, <<http://www.cbos.gov.sd/en>>

¹⁷⁵ Bank of Khartoum, <<http://bankofkhartoum.com/>>

¹⁷⁶ See Central banks of Sudan reports, <<http://www.cbos.gov.sd/node/2029>>

As previously stated, the CBoS has designated the international financial sector (MF) as a priority sector for banking financing, with a fund maximum of 20,000 SDG (Sudanese pounds, or approximately US\$ 4,000) and a minimum commitment of 12% of the banking portfolio.¹⁷⁷ Numerous Islamic financing forms of microfinance have been identified. In light of certain items such as murabaha, a reference margin of around 15% has been established.¹⁷⁸ The MFIs are free to choose a rate that best suits their consumers within this defined margin. The rate is between fifteen and eighteen percent. Partnership-based modes such as musharaka and mudaraba do not conflict with the sharing ratios.¹⁷⁹

Lastly, there has not been much of a breakthrough for mobile banking or remittance services. The CBoS also recognized fifteen categories of collateral or guarantees that fit the needs of microlending. In Sudan, Islamic micro insurance predominates. The nation now has 13 micro insurance companies. With the release of the Micro Comprehensive Insurance Document by the CBoS, the idea is gaining even more traction. The current complete takaful, which includes credit, assets, physical handicap, and death, is a step forward for Sudan, which has a relatively lengthy history of micro-takaful.¹⁸⁰

1. Effectiveness

The Sudanese government has created an environment that may allow the CBoS to issue sharia-based regulations to establish Islamic microfinance providers by completely transforming the economy into an Islamic one. The policy of allocating at least 7% of the interest-free financing portfolio to microfinance clients in 2000, and gradually increasing this allocation each year until it reached 12% by 2014, demonstrate the strategy's intent to boost the Islamic microfinance sector and the overall economy.¹⁸¹

Subsequently, the Central Bank of Sudan and other banking institutions established Islamic microfinance units, which was suggested as a positive step toward the creation of an efficient regulatory organization to control Islamic microfinance across the nation's financial sector.¹⁸²

¹⁷⁷ Khartoum Stock Exchange, <<http://www.kse.com.sd/>>

¹⁷⁸ Central Bank of Sudan, <<http://www.cbos.gov.sd/en>>

¹⁷⁹ Central Bank of Sudan. (Annual Report, Sudan 2014) <<http://www.cbos.gov.sd/en/node/8938>>

¹⁸⁰ Central Bank of Sudan, (Policies for the year 2014) <<http://www.cbos.gov.sd/node/5721>>

¹⁸¹ Central banks of Sudan, (Annual Reports 2000-2012, 2017) <<http://www.cbos.gov.sd/en/node/906>>

¹⁸² See <<http://data.worldbank.org/country/sudan>>

Furthermore, in accordance with the guidelines and directives established expressly for that purpose, the CBOS also allowed Islamic banks operating in Sudan to create their own microfinance companies. Although the Sudanese government and the CBOS have increased their efforts to support Islamic microfinance, the microfinance beneficiaries in Sudan have not been reached. The Sudanese microfinance industry has both anticipated and unanticipated difficulties.¹⁸³

Multiple factors contribute to Sudan's extreme poverty and the extraordinary number of internal refugees that surround its major cities. The most prominent causes are the protracted civil wars, the division of the wealthy South, the protracted economic sanctions imposed by the United States, the unstable political environment in the Arab world, and the corruption of public officials. These variables may bring about unfavorable economic conditions for the first time since the National Salvation Government was established in 1989.¹⁸⁴ Poverty has increased nationwide, with no difference between urban and rural areas, as a result of the harsh economic climate that followed the nation's loss of oil money after its 2010 secession. It is projected that the number of microfinance clients would reach 9 million by the year 2000.¹⁸⁵

According to the CBOS report, throughout this time only 260,000 microfinance consumers have been reached (Note 10). According to these documents, by March 2011, just 2.9% of the anticipated recipients of Islamic microfinance had been reached.¹⁸⁶ Despite the substantial Islamic microfinance portfolio and donations and technical assistance provided by multilateral institutions such as the Islamic Development Bank and the IMF, the budget disbursed was significantly less than that appropriated for the 11 years following the actual initiative to establish the Islamic microfinance sector within the nation's financial system framework.¹⁸⁷ The inability of Sudan's interest-free microloans providers to reach the anticipated recipients was a major red flag for the CBOS's microloans policy and regulatory structure. The data shows the correlation between the actual amount allotted for microfinance from 2000 to 2010 and the budgeted amount for interest-free microloans out of the financing portfolio based on CBOS rules. This association is inversely linked, which is not what was expected.¹⁸⁸

¹⁸³Central Banks of Sudan, Microfinance Unit, Sundries reports 2019

¹⁸⁴Central Banks of Sudan (n 179)

¹⁸⁵IMF Country Report (162)

¹⁸⁶Central banks of Sudan, (reports, 2020) <<http://www.cbos.gov.sd/node/256>>

¹⁸⁷Central Banks reports, 2022 <<http://www.cbos.gov.sd/node/256>>

¹⁸⁸Mohammad A, Evaluating Islamic Microfinance in Sudan during the period '2000-2010': Case Study (Banking

The microfinance portfolio's real use budget is declining annually as the CBOS lifts the maximum on the provision, which now stands at 12% in 2014 compared to 7% in 2000.¹⁸⁹ Understanding the rationale for the CBOS's annual increases in the projected microfinance budget is challenging, given that, in recent years, the actual use of the interest-free microfinance provisions has been less than 2%. This was the case between 2000 and 2010.¹⁹⁰ The CBOS has designated several Islamic and specialty banks to carry out Interest-Free Microfinance initiatives.¹⁹¹

Finance policy instructions were released in 2008 to support interest-free microfinance institutions in their efforts to open specialized branches under circumstances that align with the 2006 framework for licensing these institutions, which was revised in 2007.¹⁹² Apart from the aforementioned banks, a limited number of non-bank microfinance providers hold dual licenses under the Interest-Free Microfinance Institutions regulations. The Sudanese central bank's regulatory policies have demonstrated positive evolution in recent times.¹⁹³

a. Interest-Free MFI in Egypt

i. Overview

In the 1980s, with USAID assistance, the Association of Businesses of Alexandria (ABA) and the National Bank of Development (NBD) established small loan programs throughout Egypt, ushering in the country's microfinance industry.¹⁹⁴ The industry gradually expanded as a result of the funding and assistance provided by other foreign organizations such as UNDP and UNICEF, which later partnered with the Egyptian Banking Institute and the Social Fund for Development.¹⁹⁵

sectors and Social Institutions paper presented on the 9th conference of Islamic Economics in Qatar, 2011) <<http://conference.qfis.edu.qa/app/media/336>>

¹⁸⁹ibid, 32

¹⁹⁰Central Banks of Sudan, Sundries Reports (n 179)

¹⁹¹WorldBank, Building Businesses for Sudan's Poorest (2013) <<http://www.worldbank.org/en/news/video/2013/04/04/building-businesses-for-sudan-s-poorest>>

¹⁹²Central Bank of Sudan (n 180) See also El-Zoghbi M, and Ve Tarazi M, Trends in Sharia-Compliant Financial Inclusion (Washington, World Bank 2013)

¹⁹³Ibrahim B. A, Islamic Microfinance - A Superior Model Often on a Wrong Track (Al-Markazi Magazine, Central Bank of Sudan 2013)

¹⁹⁴See Final Report of Mid-Term Evaluation of USAID/Egypt Small and Emerging Business Program, 2004

¹⁹⁵ibid, 31-35

The National Strategy plan saw the passage of new legislation in 2005 with the goal of giving the microfinance industry a clear legal framework, a network organization called The Egyptian Microfinance Network (EMFN), oversight from the Egyptian Financial Supervisory Authority (EFSA), and operational and reporting guidelines to the Egyptian authorities.¹⁹⁶ After more than doubling in size between 2005 and 2010, this move helped the market expand even faster, with 1.4 million customers and a market value of over \$375 million.

400 organizations are listed by the Egyptian Financial Supervisory Authority as offering microcredits to their consumers under various schemes, despite the fact that only 14 IMFs formally report to EMFN.¹⁹⁷ Planet Finance's 2008 national survey on the effects of microfinance in Egypt states that the IMF can be reorganized as public and private banks, Community Development NGOs, Umbrella NGOs (which are frequently closely associated with the government), Community Development Associations (CDAs), and small, local, voluntary organizations.¹⁹⁸

i. Regulatory Framework

Under the National Strategy plan, new legislation was passed in 2005 with the goal of providing the microfinance industry with a clear legal framework, a network organization known as The Egyptian Microfinance Network (EMFN), oversight from the Egyptian Financial Supervisory Authority (EFSA), and operational and reporting guidelines to Egyptian authorities. This move accelerated the market's expansion, which saw it more than quadruple in size between 2005 and 2010, reaching 1.4 million customers and over \$375 million in sales.¹⁹⁹ Nonetheless, until 2021, no definitive laws are in place.

There is no official dual banking system or specific regulation pertaining to Islamic microfinance in Egypt. Despite the existence of Islamic banking for more than thirty years, Islamic finance and microfinance are not covered by the current Banking Law (law number 88 of 2003), nor is there any explicit guidance about the financial handling of Islamic contracts.²⁰⁰ In actuality, the Central Bank of Egypt has granted 14 banks licenses to conduct business in Islamic banking, using a flexible regulatory framework. After scaling back, a few now provide Islamic microcredits.²⁰¹

¹⁹⁶Planet Finance, National survey of the impact of microfinance in Egypt (2008)

¹⁹⁷ibid, 89-92

¹⁹⁸ ibid, 93-95

¹⁹⁹See <www.efsa.gov.eg/content/efsa_en/micro_pages_en/main_micro_page_en.htm>

²⁰⁰The present Banking Law (law number 88 of 2003)

²⁰¹See <www.mixmarket.org/es/mfi/bdb>

After leading the way in Egypt's provision of non-Islamic microcredit, Abu Dhabi Islamic Bank (previously NBD) has converted all of its microfinance activities to comply with Islamic law since 2007. In 2012, Al Baraka Banking Group collaborated with the World Bank and the Social Fund for Development to launch an Islamic microfinance program worth half a billion Egyptian pounds (\$82.9 million). There is a need for regulation because small institutions operate in limbo, providing microfinance that complies with Sharia, sometimes without disclosing the terms of their contracts. There are formal, semi-formal, and informal Islamic finance institutions, including gam'iya (local association).²⁰²

Shekra and Yomken, two internet-based platforms, are the first Islamic finance and microfinance crowdfunding platforms in the region. They were only recently granted corporate status. An NGO called Alashanek Ya Balady Association for Sustainable Development (AYB-SD) provides low-income women in Cairo's suburbs with sharia-compliant microcredits. Another excellent example of how Islamic microfinance can empower women is AYB-SD.²⁰³

The gam'iya plans are the most conventional method of carrying out sharia-compliant finance operations in Egypt, particularly in the rural regions. These are classic Islamic finance systems known as ROSCAs (Rotating Savings and Credit Associations). The field is incredibly understudied, but Mohammed El Komi, a professor at the American University of Cairo,²⁰⁴ has committed to the topic in an effort to transform these programs which involve the inclusion of a bank or other financial institution to ensure accountability into fully fledged credit unions among the villagers. These credit unions would continue to operate in accordance with Sharia Law and might develop into the first iteration of an official Islamic microfinance system in rural Egypt.²⁰⁵

1. Regulatory framework of IF'MF on lending scheme

The perception of Islamic microfinance among Egyptians in comparison to standard interest- rate-based microfinance is not well-defined.

²⁰²Pakdel Nahal, and Rodriguez Monroy, Microfinancial in Mena Region: A Partial Success (4th International Conference on Industrial Engineering and Industrial Management, San Sebastián 2010)

²⁰³Islamic Finance Information Service, Egypt Islamists Draft Code to Boost Islamic Banks (IFIS, Cairo 2012) <www.securities.com/IFIS.>

²⁰⁴Khaled Mohammed, Building a Successful Business Model for Islamic Microfinance (The Consultative Group to Assist the Poor – CGAP, New York 2011)

²⁰⁵EL-Gamal Mahmoud, EL-Komi Mohamed, and others, Bank Insured RoSCA for Microfinance: Experimental Evidence in Poor Egyptian Villages (Rice University, Houston 2011)

In contrast to a traditional Grameen-style group, the gam'iya demonstrated greater take-up and payback rates in a recent randomized field experiment.²⁰⁶ Our conclusion is that, given the authors' discussion of intuition, religion may have contributed to the public's greater adherence to traditional Islamic microcredit, particularly in the rural areas where the experiment was carried out. However, this cannot be confirmed.

Customers of traditional microfinance were questioned about their opinions of Islamic microfinance as part of a countrywide survey conducted in 2008 by the non-governmental organization Planet Finance to examine the effects of microfinance in Egypt. This group is likely not reflective of society as a whole because they had previously used traditional microfinance, but Planet Finance has noted an increase in concerns around the noncompliance of the microcredits they have received with Sharia law. It appears that the MENA region is gradually becoming more sensitive to Islamic finance principles.

This is exemplified by Jordan, where in 1999 the majority of people were unaware of Islamic finance principles, but in 2006, 32% of respondents to an IFC survey stated that they refused to obtain a conventional loan due to religious beliefs. Data from the Global Financial Inclusion survey—a global poll conducted by Gallup on behalf of the World Bank—will be used in 2020 UN research. Egypt is one of the MENA nations that were the subject of special attention in this study.²⁰⁷

The summary statistics for loan comparison do not, however, contain data from Egypt because of flaws in survey implementation.²⁰⁸ Due to the generally low penetration of interest-free microfinance in Egypt, the offer is insufficient to satisfy the demands of these customers, who would rather obtain loan from an Islamic bank even at a higher cost. The majority of MFI consumers are often unaware of the features of interest-free microlending product.²⁰⁹ Clients of Islamic MFIs in Egypt mostly requested MURABAHA, as they were generally unaware of the features of Islamic microfinance programs.²¹⁰

²⁰⁶EL-Komi Mohamed, Faculty Research on Turning Gami'ya into Credit Unions (The American University in Cairo, 2013)

²⁰⁷Grais Wafik, (2012): Islamic Finance - A Development Opportunity for Egypt, (The Prince Alwaleed Bin Talal Bin Abdulaziz Al Saoud Center for American Studies & Research, American University, Beirut 2012)

²⁰⁸Seibel Hans Dieter, Islamic Microfinance in Indonesia: The Challenge of Institutional Diversity, Regulation and Supervision (S. Nazim Ali edn, Sharia-Compliant Microfinance, London 2011)

²⁰⁹Siyasah Shar`iyah and Nur Jamaludin, The Role of Government of Indonesia in Improving Islamic Microfinance (Microfinance Consultant of Mutual Consulting, Bali 2021)

²¹⁰Mahmood, Hafiz Zahid, and others (n 114) University, 32(2), 139-160

a. The Legal and Regulatory Framework of IMF in Ethiopia: Comparative Analysis

Malaysia has a well-established legal and regulatory framework for interest-free microfinance, which is supported by comprehensive regulations such as the Shariah-based Financial Institutions Act 1983 and the Islamic Financial Services Act 2013. Sudan and Egypt both have sophisticated systems that are subject to specific regulations imposed by their respective financial regulators. However, Ethiopia's legal and regulatory framework for interest-free microfinance is still in its early stages and may continue to evolve.

Regarding to Specificity and Clarity, Malaysia, Egypt, and Sudan have more specific and detailed regulations that provide clear guidelines and requirements for interest-free microfinance institutions. These frameworks often address various aspects such as licensing, capital adequacy, reporting, disclosure, and consumer protection.²¹¹ In Ethiopia, while Directive No. MFI/32/2021 provides guidance; there may be a need for further elaboration and more specific regulations to address various operational aspects.

Moreover, to Market Size and Scope, Malaysia has a well-developed Islamic finance industry, including interest-free microfinance, with a wide range of institutions and products available. Egypt and Sudan also have relatively established interest-free microfinance sectors.²¹² In comparison, Ethiopia's interest-free microfinance sector may be relatively smaller and less developed, with fewer institutions and limited product offerings.

As regards Regulatory Capacity, Malaysia, Egypt, and Sudan have regulatory authorities with well-established expertise and capacities to oversee and supervise interest-free microfinance institutions. These authorities have experience in the sector and the resources to effectively regulate and monitor compliance.²¹³ Ethiopia, being a newer entrant in interest-free microfinance, may need to further strengthen its regulatory capacity to effectively supervise the sector.

²¹¹Hassan S, Rahman R. A, and others, 'Designing Islamic microfinance products for Islamic banks in Malaysia' (2013) 17(3) Middle-East Journal of Scientific Research, 359-366 <<https://doi.org/10.5829/idosi.mejsr.2013.17.03.12160>>

²¹²Al-Mamun A, Wahab S. A, and Malarvizhi C. A, 'Impact of Amanah Ikhtiar Malaysia's microcredit schemes on microenterprise assets in Malaysia' (2010) 60 International Research Journal of Finance and Economics, 144-154 <<https://doi.org/10.2139/ssrn.1946089>>

²¹³ibid

Rearguing to Legal framing regarding to International Standards and Best Practices, Malaysia has been at the forefront of developing and implementing international standards and best practices in Islamic finance, including interest-free microfinance. It has actively participated in global initiatives and has gained recognition as a leader in the field. Ethiopia, while making progress may benefit from further aligning its legal and regulatory framework with international standards and practices (see table 1) summary below:

Table 1; compare the legal and regulatory framework for interest-free microfinance in Ethiopia with that of Malaysia, Egypt, and Sudan, taking into account similarities and differences

Similarities:

1. Shariah Compliance: All four countries, Ethiopia, Malaysia, Egypt, and Sudan, emphasize the importance of Shariah compliance in the operations of interest-free microfinance institutions. They aim to provide financial services that are in line with Islamic principles.

2. Regulatory Oversight: Each country has established regulatory authorities responsible for overseeing and supervising interest-free microfinance institutions. These authorities ensure compliance with regulatory requirements and maintain the stability and integrity of the sector.

3. Financial Inclusion: All countries recognize the importance of promoting financial inclusion through interest-free microfinance. They aim to provide access to financial services for individuals and businesses who prefer Shariah-compliant products and services.

Differences:

1. Legal Framework: The specific laws and regulations governing interest-free microfinance differ in each country. For example, Ethiopia has Directive No. MFI/32/2021, while Malaysia has the Shariah-based Financial Institutions Act 1983 and Islamic Financial Services Act 2013. Egypt has its own regulations issued by the Egyptian Financial Supervisory Authority, and Sudan has its own regulatory framework.

2. Licensing and Authorization: The requirements and procedures for obtaining a license and authorization for interest-free microfinance institutions vary across countries. The specific criteria and processes differ based on the legal framework of each country.

3. Definitions and Scope: The definitions of terms related to interest-free microfinance and the scope of the regulatory framework may differ. Each country may have its own specific definitions and coverage of institutions and activities within the interest-free microfinance sector.

4. Reporting and Disclosure Requirements: The reporting and disclosure requirements for interest-free microfinance institutions may differ across countries. The frequency and content of reporting, as well as the extent of disclosure obligations, may vary.

5. Supervisory Approach: The supervisory approach taken by regulatory authorities may differ. The level of supervision, enforcement mechanisms, and supervisory practices may vary based on the specific legal framework and regulatory practices of each country.

While there are similarities in terms of Shariah compliance, regulatory oversight, and financial inclusion objectives, the legal and regulatory frameworks for interest-free microfinance in Ethiopia, Malaysia, Egypt, and Sudan have distinct differences in their specific laws, licensing requirements, definitions, reporting obligations, and supervisory approaches.

In summary, the legal and regulatory framework gap for interest-free microfinance in Ethiopia compared to Malaysia, Egypt, and Sudan can be attributed to differences in the development stage, specificity and clarity of regulations, market size and scope, regulatory capacity, and adherence to international standards and best practices. While Ethiopia's framework is evolving and shows potential, further development and alignment with established frameworks can help bridge the gap and promote the growth and effectiveness of interest-free microfinance in the country.

ii. The legal and regulatory framework gap in Ethiopia

According to study analysis a comparison of the legal and regulatory framework weaknesses and gaps for interest-free microfinance in Ethiopia compared to Malaysia, Egypt, and Sudan:

- i. **Limited Clarity and Specificity:** One weakness in Ethiopia's legal and regulatory framework is the relatively limited clarity and specificity of regulations. Directive No MFI/32/2021 provides guidance, but there may be a need for more detailed regulations to address specific operational aspects and provide clear guidelines for interest-free microfinance institutions. In contrast, Malaysia, Egypt, and Sudan have more specific and detailed regulations that provide clearer guidance to institutions operating in the interest-free microfinance sector.
- ii. **Capacity and Expertise:** Ethiopia may face challenges in terms of regulatory capacity and expertise in overseeing and supervising interest-free microfinance institutions.
- iii. **Regulatory Resources:** The regulatory authorities may need further resources and expertise to effectively monitor compliance, conduct inspections, and ensure the stability and integrity of the sector. In comparison, Malaysia, Egypt, and Sudan have regulatory authorities with established expertise and capacities in regulating the interest-free microfinance sector.
- iv. **Market Development:** Ethiopia's interest-free microfinance sector is relatively new and may still be in the early stages of development. This can be seen as a weakness in terms of the overall market size and availability of diverse interest-free microfinance products and services. Malaysia, Egypt, and Sudan, on the other hand, have more developed interest-free microfinance markets with a wider range of institutions and products available.

- v. Alignment with International Standards: While Ethiopia has made efforts to align its legal and regulatory framework with international standards; there may still be a gap in fully adhering to global best practices. Malaysia, being a leader in Islamic finance, has actively participated in global initiatives and implemented international standards and best practices. This gives Malaysia an advantage in terms of aligning its framework with global benchmarks.
- vi. Consumer Protection: Ensuring adequate consumer protection measures are vital in the interest-free microfinance sector. Ethiopia may need to strengthen its consumer protection regulations and mechanisms to ensure the fair treatment of customers, transparent disclosure of terms and conditions, and effective resolution of disputes. Malaysia, Egypt, and Sudan have established consumer protection frameworks to safeguard the interests of clients in the interest-free microfinance sector.
- vii. In summary, the legal and regulatory framework weaknesses and gaps for interest-free microfinance in Ethiopia, compared to Malaysia, Egypt, and Sudan, include limited clarity and specificity, regulatory capacity and expertise challenges, the early stage of market development, the need for further alignment with international standards, and strengthening consumer protection measures. Addressing these weaknesses and gaps can contribute to the growth and effectiveness of interest-free microfinance in Ethiopia.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.1 Conclusion

The study's overall goal is to examine the legal framework of interest-free microfinance institutions in Ethiopia and compare it to Sudan, Egypt, and Malaysia. The entire field of interest-free microfinance appears to be underrepresented in the literature. Current researchers have discovered no specific books on the subject, only a few papers of research for Sudan, Egypt, and Malaysia to enact required laws and policies and regulate Islamic financial institutions, with little research in the field. Even searching for documentation in Sudan, Egypt, and Malaysia did not improve the quality or quantity of useful documents for our study.

The legal framework for interest-free microfinance institutions in Ethiopia is established through a range of laws and regulations that govern their establishment, operations, and supervision. The Microfinance Institutions Proclamation No. 626/2009 serves as the overarching legal framework, outlining licensing requirements and operational guidelines. The Interest-Free Microfinance Ethiopia has Directive No. MFI/32/2021, provides detailed guidelines specifically tailored to interest-free microfinance institutions.

The Ethiopian Financial Supervisory Authority (EFSA) issues directives and guidelines that govern the operations of interest-free microfinance institutions, covering areas such as licensing, prudential regulations, anti-money laundering measures, corporate governance standards, and financial reporting requirements. The Commercial Code of Ethiopia establishes a legal framework for matters such as contracts, transactions, security interests, and other commercial aspects relevant to interest-free microfinance institutions. In comparison, Egypt's legal framework for interest-free microfinance institutions is primarily governed by the Egyptian Microfinance Law No. 141/2014, with the Financial Regulatory Authority responsible for supervision and regulation.

Sudan's legal framework is established through the Microfinance Act of 2011, with the Microfinance Unit under the Central Bank of Sudan responsible for regulation and supervision. Malaysia's legal framework is based on Islamic finance principles, with the Islamic Financial Services Act 2013 and the Islamic Banking Act 1983 serving as regulatory frameworks overseen by the Central Bank of Malaysia. While these countries share similarities in promoting financial inclusion and regulating interest-free microfinance institutions, the specific laws, regulations, and regulatory authorities vary, reflecting the distinct characteristics and requirements of each country's financial system and regulatory environment.

In conclusion, the legal framework for interest-free microfinance institutions in Ethiopia exhibits some distinct gaps and differences when compared to Egypt, Sudan, and Malaysia. Ethiopia has established specific regulations through the Microfinance Institutions Proclamation and Interest-Free Microfinance Directive, providing detailed guidelines for these institutions. However, Egypt and Sudan have more general microfinance laws that encompass both interest-based and interest-free institutions, while Malaysia has a dedicated legal framework focusing on Islamic finance principles. The regulatory oversight in Ethiopia involves the National Bank of Ethiopia and the Ethiopian Financial Supervisory Authority, while Egypt, Sudan, and Malaysia have different regulatory bodies responsible for overseeing microfinance institutions. Licensing requirements also vary among these countries, with Ethiopia having specific criteria outlined in its regulations, while Egypt and Sudan have more general requirements and Malaysia having a separate licensing framework for Islamic financial institutions.

Furthermore, the legal basis for interest-free microfinance institutions in Ethiopia is primarily derived from the Microfinance Institutions Proclamation, whereas Egypt, Sudan, and Malaysia have broader legal frameworks that encompass both interest-based and interest-free microfinance institutions. These gaps and differences highlight the unique characteristics, requirements, and regulatory environments of each country's financial system. Addressing these gaps and considering the recommended policy measures can help Ethiopia strengthen its legal framework for interest-free microfinance institutions, fostering financial inclusion and sustainable growth in the sector.

5.2 Recommendations

The assessment found that various policy level reforms and feasible regulatory frameworks for IF'MFI exist in Malaysia, Sudan, and Egypt, as well as regulatory frameworks for IF'MFI that Ethiopia could learn from Malaysia, Sudan, and Egypt. Based on the findings of this study, the following recommendations were made to relevant bodies.

Policy Guidelines and legal frame work Support to interest free Microfinance in Ethiopia

Develop diverse and more feasible models:

Despite more than three years of operation, Ethiopia's interest-free bank providers reach less than 3% of their target clients. These could be attributed to a variety of factors, including weak regulations and the concentration of microfinance providers in urban areas rather than poor rural areas. Furthermore, the criteria developed by Islamic banks and microfinance providers failed to account for the diversity of microfinance clients in Ethiopia. Developing more feasible models in which risk is shared by the MFI and the client is important because it provides people with more opportunities. Such models can reduce supply, and the absence of interest means that there is no consistent cash flow with which to earn income that can be used to extend loans to additional clients, posing a challenge to IFMF's sustainability and growth. Strive to create a more diverse market in which more providers offer a wider range of products based on customer needs and behaviors.

Advocacy towards formulation of a National Policy conducive:

- The Interest-Free Microfinance Scheme is committed to collaborating and advocating for the development of national policies that promote interest-free microfinance in Ethiopia. In particular, it should concentrate on:
- Advocating for practical steps to overcome registration hurdles for interest-free microfinance and cooperative societies across the country.
- Development of suitable co-operative structures based on Interest free Microfinance.
- Insights on the feasibility of interest-free business models in diverse and democratic societies, such as Malaysia and Sudan.
- Promoting financial inclusion, socioeconomic up liftmen, self-employment, and poverty reduction through interest-free co-operative societies.

- Need to develop marketable, ethical, and socially responsible interest-free microfinance products with a higher chance of sustainability in the Indian context, as well as mechanisms to improve service quality.

It has been observed that the development of sciences and models has an inherent bias toward urban concentrations. Because the majority of microfinance activities will take place in rural areas, these theories must be restated in a rural context.

Legal and regulatory frameworks:

For example, interest-free microfinance providers required beneficiaries to show a residential certificate, despite the fact that the majority of the targeted poor are homeless and live in camps or as tenants in cities. For effective outreach, the NBE must completely revise the methods and means used to regulate and supervise interest-free microfinance. These may necessitate drastic proposals and decrees in the strategic ways that were and are intended to be used to alleviate poverty in Ethiopia.

Essentially, every effort should be made to ensure that finance reaches the poor and that the service provider operates efficiently and humanely. While interest rate restrictions alone can have significant negative consequences, when used wisely in conjunction with a number of the measures described here, they can also help to achieve the goal of providing low-income families with access to finance in a fair and equitable environment. Overall, the microfinance industry has shifted significantly in recent years. Microfinance institutions in Asia and other developing regions prioritize efficiency, transparency, and sustainability as core values.

The development of social ratings IFMF frameworks, as well as financial rating by specialized microfinance rating agencies, the work of the Smart Campaign to ensure client fairness, and the work of Sharia's law with interest-free MF to emphasize relevance to the needs of the poor, is important steps in this direction that have gained acceptance to varying degrees. The fact that politicians and bureaucrats with little knowledge or understanding of microfinance design subsidies and interest rate restrictions remains a source of confusion. Such measures are motivated by political and populist considerations rather than a thorough understanding of their practical implications.

A better and more widely shared understanding of the drivers of interest rates in various financial markets, including microfinance, is required to inform policy discussions and improve the design of development projects aimed at increasing MFI internal efficiency and promoting competition that reduces interest rate spreads.

Furthermore, there is a need for a better understanding of the effects of government policy on market interest rates: when governments run large public deficits, high average interest rates in the domestic financial market raise the cost of funds for financial intermediaries. Similarly, if the domestic currency depreciates or is devalued, microfinance operators who have borrowed abroad may be forced to raise interest rates to cover the increased cost of foreign debt. The goal must be to bring these sets of measures together so that governments and regulators can make informed decisions and collaborate with agencies that understand microfinance.

Finally, governments are suspicious of their motives, even when dealing with seemingly impartial and well-respected microfinance research agencies, so multilateral interest-free MFI legal frameworks must play a much more active role in bridging the understanding gap. The distance to the goal of universal financial inclusion must be significantly reduced from the long road it appears to be in the current policy environment.

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