# Chapter 24
# Harmonising Microfinance With Islamic Banking

**Shahab Aziz**
https://orcid.org/0000-0003-1275-3061
*Department of Business Studies, Bahria University, Pakistan*

**Maizaitulaidawati Md Husin**
https://orcid.org/0000-0002-2789-8274
*Azman Hashim International Business School, Universiti Teknologi Malaysia, Kuala Lumpur, Malaysia*

**Muhammad Ashfaq**
*IUBH University of Applied Sciences, Germany*

## ABSTRACT

*While microfinance institutions play a role in the provision of financial services to individuals and small businesses that lack access to banking and related services, the question is: Can this role be taken up solely by the banking institutions? This chapter discusses the performance and application of microfinance institutions and challenges in developing a sustainable microfinance environment. The chapter deliberates the importance of integrating Islamic microfinance with Islamic commercial banks. It is argued that the integration of Islamic microcredit into the banking and credit schemes of Islamic commercial banks and Islamic microfinance institutions is a key to promoting financial inclusion. In addition, the chapter discusses how the Islamic microfinance model can be applied towards improving and humanising society and suggests strategies to improve the sustainability of microfinance institutions.*

## INTRODUCTION

Access to finance is essential for market growth and penetration. Financing constraints often prevent businesses from expanding their capacity to meet new demands and extending market distribution, while for the households, financial services such as savings, cash transfers, and loans are part of a powerful formula for beating extreme poverty. According to the World Bank Group and Bank Negara Malaysia

DOI: 10.4018/978-1-6684-7552-2.ch024

(BNM) (2017), an estimated 2 billion adults still lack access to a transaction account and remain excluded from the formal financial system. This shows that microfinance has yet to reach the unbanked group. Country-specific, in India, Ernst & Young (2016) reported that a significant portion of the rural population does not have access to the banking system. In China, the World Bank Group (2017) reported that around 200 million rural adults remain outside the formal financial system; while in Afghanistan, less than 15% of the adults have a bank account (Mehta & Bhattacharya, 2018).

The poor and less educated individuals have been reported to form a large proportion of the unbanked group (World Bank Group, 2017). Further to that, it's reported that low bank penetration rate and high poverty rates are at worrying rates in Eastern Europe, especially in Lithuania, Spain, Bulgaria, Romania, Estonia, Greece, Ireland, Portugal, Spain, and Italy (Bruhn-Leon, Eriksson & Kraemer-Eis, 2012). While microfinance institutions are expected to provide financial access to the poor's, the institutions itself having difficulties to sustain in the economy. For example, in Mogadishu, the capital city of Somalia, microfinance institutions are having a lack of funds and receive a lack of support from the government. Further, microfinance institutions have collapsed in Nigeria due to poor loan quality, the default in loan repayment, high transaction costs, as well as widespread delinquency, and management deficiencies (Kanayo, Jumare, & Nancy, 2013). In addition to that, the microfinance institution in Nepal has been reported to have unhealthy competition, lack of resources, and dearth awareness from political (Karn, 2018).

Whilst the microfinance institutions play a big role in the economy, the challenges facing by these institutions can't be ignored. Therefore, there is a need to (i) reassess the performance and application of microfinance institutions, (ii) review the challenges in developing sustainable microfinance environment, (iii) examine the connection between Islamic banking and microfinance, and to (iv) suggest ways to improve the sustainability of microfinance institutions.

The outline of the chapter is as follows. In the next section, the performance and application of microfinance institutions will be reviewed. In addition to that, the challenges in developing a sustainable microfinance environment will be discussed. Second, the nexus between Islamic banking and microfinance institutions will be elaborated. Third, the Islamic microfinance model and its features will be explained. Next, ways to improve the sustainability of microfinance institutions will be discussed and finally, this chapter will be concluded with practical and theoretical implications.

## MICROFINANCE INSTITUTIONS: PERFORMANCE, APPLICATION AND CHALLENGES

The term "microfinance" generally refers to a broad set of financial services tailored to fit the needs of poor individuals (World Bank Group & Bank Negara Malaysia (BNM), 2017). According to Ernst & Young (2014), microfinance can be divided into three broad categories: microcredit, microsavings, and microinsurance. The purpose of microcredit is to provide small loans to micro-entrepreneurs to invest in their businesses, reinvest the returns, and allow them to grow out of poverty. Micro savings, on the other hand, aims to provide accessible and safe avenues for saving, either for future investments or as a precaution against economic shocks, while microinsurance is designed to mitigate different types of risks, such as agricultural or health risks.

Performance of microfinance institutions can be divided into two; financial and social. While financial performance is quantitatively measured using several indicators such as return on equity (ROE)

## Related Content

Macroeconomic Sensitivity, Risk-Return Trade-Off and Volatility Dynamics Evidence From Developed and Developing Markets
Faisal Khan, Hashim Khan, Saif Ur-Rehman Khan, Muhammad Jumaaand Sharif Ullah Jan (2019). *International Journal of Corporate Finance and Accounting (pp. 1-16).*
www.irma-international.org/article/macroeconomic-sensitivity-risk-return-trade-off-and-volatility-dynamics-evidence-from-developed-and-developing-markets/227417

The Auditor as a Determining Factor on Derivative Financial Instrument Disclosures
Kátia Lemos, Sara Serraand Amidel Barros (2019). *Organizational Auditing and Assurance in the Digital Age (pp. 70-93).*
www.irma-international.org/chapter/the-auditor-as-a-determining-factor-on-derivative-financial-instrument-disclosures/222619

Disclosures of the Environmental Management Accounting Practices in the Banking Sector of Bangladesh
Mohammad Mizenur Rahamanand Mst. Khadiza Aktar (2021). *International Journal of Corporate Finance and Accounting (pp. 27-46).*
www.irma-international.org/article/disclosures-of-the-environmental-management-accounting-practices-in-the-banking-sector-of-bangladesh/270936

Set-Up of the HPFF: Environments, Roles, and Profiles
(2022). *Building the High-Performance Finance Function (pp. 93-144).*
www.irma-international.org/chapter/set-up-of-the-hpff/298721

The PSK Method for Solving Fully Intuitionistic Fuzzy Assignment Problems With Some Software Tools
P. Senthil Kumar (2020). *Theoretical and Applied Mathematics in International Business (pp. 149-202).*
www.irma-international.org/chapter/the-psk-method-for-solving-fully-intuitionistic-fuzzy-assignment-problems-with-some-software-tools/231037