

# ISLAMIC MICROFINANCE IN THE D-8 ORGANIZATION FOR ECONOMIC COOPERATION: ADDRESSING CHALLENGES AND STRATEGIC SOLUTIONS

## *MICROFINANÇAS ISLÂMICAS NA ORGANIZAÇÃO PARA A COOPERAÇÃO ECONÔMICA D-8: ENFRENTANDO DESAFIOS E SOLUÇÕES ESTRATÉGICAS*

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### Abstract

Islamic microfinance is a critical mechanism for enhancing financial inclusion and socio-economic development across the D-8 Organization for Economic Cooperation. Nonetheless, the sector's expansion is constrained by the absence of a harmonized regulatory architecture, limited public cognizance, insufficient innovation, intricate risk management exigencies, and heightened market

### Resumo

*A microfinança islâmica é um mecanismo fundamental para promover a inclusão financeira e o desenvolvimento socioeconômico nos países da Organização para a Cooperação Econômica D-8. No entanto, a expansão do setor é limitada pela ausência de uma estrutura regulatória harmonizada, pelo conhecimento público restrito, pela inovação insuficiente, pelas complexas exigências de gestão de risco e*



competition. This conceptual study outlines theory-based strategies to mitigate these challenges. Establishing harmonized regulatory bodies, leveraging social marketing and religious partnerships, and fostering digital engagement can strengthen institutional and public support. Dedicated research, pilot initiatives, and fintech collaborations can promote innovation, and monitoring systems, portfolio diversification, and client training are necessary for robust risk management. Market intelligence, loyalty programs, and tailored financial products can enhance competitiveness. Collectively, these interventions aim to overcome systemic barriers, enabling Islamic microfinance institutions to achieve sustainable growth and contribute meaningfully to financial empowerment within D-8 economies.

**Keywords:** Financial Inclusion. Islamic Microfinance. Product Innovation. Regulatory Framework. Risk Management.

*pela crescente concorrência no mercado. Este estudo conceitual delinea estratégias baseadas na teoria para mitigar esses desafios. O estabelecimento de órgãos regulatórios harmonizados, o aproveitamento do marketing social e de parcerias religiosas, e o fomento do engajamento digital podem fortalecer o apoio institucional e público. Pesquisas dedicadas, iniciativas-piloto e colaborações com fintech podem promover a inovação, e sistemas de monitoramento, diversificação de portfólio e treinamento de clientes são necessários para uma gestão de risco robusta. Inteligência de mercado, programas de fidelidade e produtos financeiros personalizados podem aumentar a competitividade. Coletivamente, essas intervenções visam superar barreiras sistêmicas, permitindo que as instituições de microfinanças islâmicas alcancem um crescimento sustentável e contribuam significativamente para o empoderamento financeiro nas economias do D-8.*

**Palavras-chave:** Inclusão Financeira. Microfinanças Islâmicas. Inovação De Produtos. Estrutura Regulatória. Gestão de Risco.

## 1 INTRODUCTION

Microfinance offers small loans and basic financial services to poor and low-income individuals often excluded from traditional banking. These microloans support self-employment projects that enhance income and economic stability. Microfinance institutions (MFIs) provide accessible loans without physical collateral, using group guarantees instead. Popular for its role in fostering economic development and reducing poverty, microfinance promotes entrepreneurship and improves living standards. It attracts international donors and NGOs by aligning with neo-liberal self-help principles and providing a sustainable alternative to grants, as loans are expected to be repaid (Robinson, 2001).

Islamic microfinance follows Islamic finance principles, avoiding interest (riba) and emphasizing risk-sharing, fairness, and social justice. It uses methods like Murabaha (cost-plus financing), Mudaraba (profit-sharing), and Qard Hasan (benevolent loans) to comply with Shariah law. This ethical financing serves Muslim populations who avoid

conventional finance due to religious reasons, aiding their economic empowerment and growth. Unlike traditional microfinance, Islamic microfinance promotes profit-sharing and ethical investments, offering Shariah-compliant financial services to poor and unbanked Muslims. Modes include Murabaha, Mudaraba, Musharaka (joint venture), and Qard Hasan, tailored for diverse micro-entrepreneur needs while adhering to Islamic law (Ali, 2012).

Islamic microfinance provides financial inclusion to Muslim communities excluded from traditional banking due to prohibitions against interest-based loans. It aligns with Islamic principles like avoiding *riba* (interest) and promoting risk-sharing, advancing social justice and economic equity. These programs aim to alleviate poverty, empower women, and develop communities, aligning with Islamic social justice goals. Islamic microfinance institutions (IMFIs) foster economic growth in underserved Muslim areas by adhering to Shariah principles and ensuring ethical, transparent financial practices. Careful structuring for Shariah compliance, project viability, and fund monitoring is essential, along with transparency and community involvement. Growing demand for Shariah-compliant services positions Islamic microfinance to significantly impact global poverty reduction with ethical financial solutions (Qadri & Ali, 2024).

### **1.1 Problem statement**

The D-8 Organization for Economic Cooperation, comprising Bangladesh, Egypt, Indonesia, Iran, Malaysia, Nigeria, Pakistan, and Turkey, faces significant hurdles in implementing effective Islamic microfinance systems (Obaidullah & Khan, 2008). Challenges include the lack of a unified regulatory framework tailored to Islamic finance, low awareness of Islamic microfinance products, the need for innovative product development, complex risk management, and intense market competition. Current financial regulations in many member countries are based on conventional systems, leading to operational and legal complexities for Islamic microfinance institutions (IMFIs) and deterring investors.

Additionally, awareness of Islamic microfinance among potential clients and financial institutions is low. Many Muslims, especially in rural areas, are unfamiliar with its benefits and mistrust these services, impeding adoption. Financial professionals often

lack the expertise to develop and manage Sharia-compliant products, further hindering effective implementation (Satar & Kassim, 2020).

Innovation in product development is a major challenge for Islamic microfinance. Creating compliant products that meet diverse client needs while adhering to Islamic principles requires significant expertise and resources. This lack of innovative products restricts IMFIs' ability to offer competitive services, essential for client attraction and retention. The risk-sharing model of Islamic finance, while ethically aligned with Islamic values, introduces unique risks. It exposes IMFIs to higher risks if projects fail, necessitating advanced risk management strategies that many institutions lack.

Without addressing these issues, the growth and effectiveness of Islamic microfinance in D-8 nations will be limited (Prastowo, 2014). This would continue the financial exclusion of low-income Muslims who avoid conventional banking due to religious reasons, restricting their economic opportunities. Small enterprises, crucial to developing economies, would struggle to access capital, hindering entrepreneurship, job creation, and economic growth. Furthermore, the inability to innovate and compete effectively could cause IMFIs to lose market share to conventional and other Islamic financial institutions, reducing their impact.

Those most impacted by these challenges are low-income individuals and micro-entrepreneurs in Muslim-majority countries who rely on accessible financial services for self-employment and income-generating activities. Without effective Islamic microfinance, they continue to face economic instability and poverty, remaining excluded from the formal financial system. This financial exclusion hinders the broader socio-economic development of D-8 nations, as it impedes support for small enterprises, economic progress, and poverty alleviation. In essence, failing to address these issues perpetuates economic inequities and undermines the potential of Islamic microfinance to promote inclusive growth and social justice in D-8 countries.

## **1.2 Rationale for the study**

The necessity for developing a conceptual framework for Islamic microfinance in D-8 countries stems from the pressing need to address the unique challenges faced by Islamic microfinance institutions (IMFIs) in these nations. The D-8 countries—

Bangladesh, Egypt, Indonesia, Iran, Malaysia, Nigeria, Pakistan, and Turkey—collectively represent a significant portion of the global Muslim population, where conventional microfinance often fails to align with Islamic principles. A conceptual framework tailored to the distinctive requirements of Islamic finance can provide a structured approach to overcoming regulatory inconsistencies, increasing awareness, driving innovation, and managing risks effectively. This framework is critical for harmonizing operations across different regulatory environments, improving client engagement, and fostering sustainable growth in the Islamic microfinance sector. By creating a unified and systematic model, the framework will guide IMFIs in developing strategies that are both compliant with Sharia principles and responsive to the socio-economic needs of their communities.

### **1.3 Research gap in existing literature**

Existing literature has extensively explored various aspects of microfinance and its impact on poverty alleviation and economic development. For example, Hotman, Hilman and Ahmad (2024) discuss the general benefits of Islamic microfinance in improving living standards by adhering to Sharia principles, such as prohibiting interest and promoting profit-sharing schemes like Mudarabah and Musharakah. Haque and Yamao (2011) also highlight the potential of Islamic microfinance to cater to Muslim populations that are otherwise excluded from conventional financial services due to religious reasons. Moreover, Qadri and Ali (2024) emphasize the role of Islamic microfinance in reducing poverty and enhancing socio-economic stability, particularly during crises like the COVID-19 pandemic. However, while these studies provide insights into the benefits and potential of Islamic microfinance, they often lack a comprehensive framework that addresses the operational, regulatory, and strategic challenges unique to D-8 countries.

The past studies fail to adequately address the fragmented regulatory landscape, limited awareness among potential clients, and the need for continuous innovation and effective risk management within Islamic microfinance. These gaps highlight the absence of a holistic conceptual framework that can guide IMFIs in navigating the complexities of providing Sharia-compliant financial services. Developing such a framework is

essential to bridge these gaps, offering a structured methodology for addressing the specific challenges identified in the context of the D-8 countries. This framework will not only standardize best practices but also enhance the scalability and impact of Islamic microfinance across diverse regulatory and socio-economic environments.

#### 1.4 Research objectives and research question

Based on the identified research gap, the primary research question guiding this study is: How can a conceptual framework be developed to address the unique regulatory, operational, and strategic challenges faced by Islamic microfinance institutions in D-8 countries to enhance their effectiveness and sustainability?

To address this question, the study aims to achieve the following objectives:

1. **Identifying challenges:** Examine and identify the key regulatory, operational, and strategic challenges faced by Islamic microfinance institutions in D-8 countries. This includes understanding the gaps in the regulatory framework, awareness, and understanding of Islamic microfinance products, innovation in product development, risk management, and market competition.
2. **Proposing solutions:** Develop and propose a conceptual framework that addresses the identified challenges. This framework should include strategies for establishing a supportive regulatory environment, enhancing financial literacy and awareness, innovating Sharia-compliant financial products, implementing advanced risk management strategies, and improving market competitiveness for IMFIs in D-8 countries.

This study contributes to the field of Islamic microfinance by providing a conceptual framework that addresses the specific challenges faced by IMFIs in D-8 countries.

## 2 D-8 ORGANIZATION FOR ECONOMIC COOPERATION

The D-8 Organization for Economic Cooperation, also known as the Developing-8, is an intergovernmental organization established to promote economic and development cooperation among eight member states: Bangladesh, Egypt, Indonesia,

Iran, Malaysia, Nigeria, Pakistan, and Turkey (Ferguson, Khalid, & Asadullah, 2023). Formed in 1997, D-8 aims to enhance the economic position of its member countries on the global stage, diversify and create new opportunities in trade, and increase their participation in international decision-making processes. The organization's areas of focus include trade, industry, agriculture and food security, energy, transportation, and tourism.

With a combined population of about 1.2 billion, which accounts for approximately 60% of the global Muslim population and nearly 13% of the world's total population, the D-8 countries span an area of 7.6 million square kilometers, making up 5% of the world's land area. This significant demographic and geographic footprint shows the potential impact and importance of the D-8 in the global economic scenario (Aral, 2005).

The D-8 Organization for Economic Cooperation was officially established during the Heads of State/Government Summit held in Istanbul in 1997, with Turkey playing a pivotal role in its formation (Acar & Karaağaç, 2021). The organization's headquarters is located in Istanbul, and the current Secretary-General is Ambassador Isiaka Abdulqadir Imam from Nigeria. The D-8 operates with the primary objective of improving the status of developing countries within the global economy, fostering diversified commercial relations, and ensuring robust participation in international decision-making forums.

The significance of the D-8 is highlighted by the fact that its member countries collectively represent one-seventh of the world's population and account for 14% of global trade, amounting to approximately 700 billion dollars. The combined economic size of the D-8 countries exceeds 4 trillion dollars. The inclusion of major economies from different regions of the Islamic world adds to the strategic importance of the organization, making it a crucial player in the economic development of its member states.

All D-8 member states are also part of the Organization of Islamic Cooperation (OIC), and they stand out within the OIC due to their levels of technological and economic development, commercial potential, and population size. Membership in the D-8 is not restricted to a specific region; instead, it is open to all developing countries, reflecting its global orientation based on principles rather than geographic limitations.

The D-8's activities span several key sectors, including agriculture and food security, trade, transportation, industry, and energy (Hakim, AboElsoud, & Dahalan, 2015). Additionally, the organization engages in initiatives related to health and tourism. Regular ministerial and sectoral working group meetings facilitate ongoing collaboration and progress in these areas.

Cooperation within the D-8 framework is primarily sectoral. For instance, Turkey coordinates activities related to industry, health, and environment; Bangladesh focuses on rural development; Indonesia leads efforts in poverty alleviation and human resources; Iran is responsible for science and technology; Malaysia handles finance, banking, and privatization; Egypt oversees trade; Nigeria manages energy; and Pakistan is in charge of agriculture and fisheries. This sector-specific approach allows each member state to leverage its strengths and expertise, contributing to the collective goals of the organization.

The D-8's focus on agriculture and food security is crucial given the significant agricultural output and potential of its member states. By collaborating on agricultural research, development, and best practices, the D-8 aims to enhance food security and rural development, thereby improving the livelihoods of millions of people within its member countries.

The D-8 seeks to boost intra-member trade by reducing trade barriers, harmonizing standards, and promoting economic integration. Initiatives such as preferential trade agreements and trade facilitation measures are designed to create a more conducive environment for trade among member states, ultimately leading to increased economic growth and prosperity. The transportation sector is another key area of focus for the D-8. Improved transportation infrastructure and connectivity are essential for facilitating trade, tourism, and people-to-people exchanges. By investing in transportation projects and fostering cooperation in this sector, the D-8 aims to enhance regional connectivity and integration, which can drive economic development.

Energy is crucial for the D-8, with member states focusing on renewable energy, energy efficiency, and fossil fuel exploration. Collaboration helps address energy challenges and ensures sustainable energy security. The D-8 also aims to boost tourism by promoting joint marketing, improving infrastructure, and easing travel among members.

In health, the D-8 prioritizes public health challenges and healthcare system improvements through shared best practices, joint research, and disease control programs. Industrial development and technological advancement are key, with efforts to enhance industrial capabilities through cooperation and technology transfer, leading to more production, jobs, and economic growth.

The D-8 Organization for Economic Cooperation is a vital platform for collaboration among populous and economically dynamic developing countries. It promotes economic cooperation, sustainable development, and inclusive growth, benefiting member states and the broader international community.

Microfinance institutions (MFIs) across the D-8 Organization for Economic Cooperation have proliferated significantly over the past few decades. These institutions vary widely in number and structure, reflecting the diverse socio-economic and regulatory side of the member countries. For instance, Bangladesh alone has a dense network of over 700 MFIs (Mia, 2017), while Indonesia hosts more than 3,000 smaller Islamic financial cooperatives known as BMTs (Baitul Maal wat Tamwil) (Suseno, 2020). Similarly, Pakistan and Nigeria also boast numerous MFIs, though they face challenges related to operational scale and outreach. Despite their varying conditions, these institutions collectively contribute to alleviating poverty, improving living standards, and fostering economic development by providing essential financial services to the underserved populations who are often excluded from conventional banking systems. The primary contribution of MFIs in D-8 nations lies in their ability to offer small loans, savings, and other financial services to low-income individuals and micro-entrepreneurs, enabling them to invest in income-generating activities and entrepreneurial ventures. This financial support helps break the cycle of poverty by allowing recipients to start or expand small businesses, thereby generating employment and enhancing economic stability within their communities.

### **3 LITERATURE REVIEW**

The emergence of Islamic microfinance institutions (IMFIs) has brought substantial benefits to society and the economy by improving the living standards of impoverished communities. According to Hotman, Hilman and Ahmad (2024), Islamic

microfinance is a financial system grounded in Islamic principles, aimed at reducing poverty and fostering entrepreneurial growth. Unlike conventional microfinance, it forbids the charging of interest, deemed usury in Islam. Instead, it employs profit-sharing schemes like Mudarabah and Musharakah, where both lender and borrower share in the investment's profits and losses (Hotman, Hilman, & Ahmad, 2024). Haque and Yamao, (2011) defined Islamic microfinance as a specialized microfinance system that aligns with Islamic law (Shariah) principles and is practically applied through the development of Islamic economics.

Qadri and Ali (2024) argued that Islamic microfinance is significantly contributing to poverty reduction and enhancing living standards, per capita income, and employment levels. It also aims to achieve Maqasid al-Shariah, profitability, and sustainability. During the pandemic, the role of Islamic microfinance became even more critical. In developing countries like Pakistan and Bangladesh, Islamic microfinance institutions provided essential support to disadvantaged and affected communities during this challenging period.

However, these institutions face numerous challenges in providing micro-financial schemes and services to their clients. The challenges are pronounced in regions in developing countries. According to the Azmi and Thaker (2020), one of the issues faced by the Islamic microfinance institutions is limited outreach towards the unbanked people because of the structure of their branches, especially for those who live in rural areas. One of the factors is due to very poor promotion and advertisement about the Islamic microfinance instruments among the people. Plus, there are no proper ways and techniques of spreading awareness about the importance and benefits of the Islamic microfinance sector, especially to poor people.

One significant challenge faced by IMFIs is their limited outreach to unbanked populations, especially those residing in rural areas. The structural organization of IMFIs often impedes their ability to reach these populations effectively. A contributing factor is the inadequate promotion and advertisement of Islamic microfinance instruments among the general populace. There is a noticeable absence of effective strategies and techniques to raise awareness about the importance and benefits of Islamic microfinance, particularly among the poor. This lack of awareness prevents potential clients from understanding

how IMFIs can help improve their financial situation, thereby limiting the institutions' reach and impact (Alshebami & Khandare, 2015).

In Pakistan, IMFIs encounter the issue of limited market outreach despite a growing demand for microfinance services. The sustainability and outreach of the microfinance sector are significant challenges, preventing it from achieving its full potential in poverty alleviation. Many potential clients remain unaware of the available services, or they choose not to engage with IMFIs due to a lack of financial literacy and religious beliefs. This gap in market outreach highlights the difficulty IMFIs face in penetrating deeply into communities that would benefit most from their services (Aslam, 2014).

Regulation and supervision are other critical issues affecting the Islamic microfinance industry. In Indonesia, while the outreach of Islamic financial cooperatives (BMTs) has been commendable, the regulation and supervision of these entities require significant improvement. Without a robust regulatory framework, BMTs struggle to maintain sustainable operations and provide comprehensive support services to their members. The absence of clear regulations and effective supervision results in operational inefficiencies and hinders the potential for growth and stability within the sector.

In Yemen, the regulatory environment poses another layer of complexity for IMFIs. The lack of a specific legal framework for Islamic microfinance institutions creates operational challenges and legal ambiguities. This situation complicates the ability of these institutions to function effectively and efficiently, further exacerbating the difficulties they face in serving their clients (Alshebami & Khandare, 2015).

The MENA region also faces issues related to restrictive regulations for deposits. In many countries within the region, IMFIs are registered as NGOs and are therefore restricted from providing deposit services in addition to loans. This restriction affects the sustainability of these institutions, as savings play a crucial role in maintaining a financial safety net for the poor and managing cash flows. Consequently, IMFIs in these regions struggle to secure sufficient funding and are often dependent on donor funds and government subsidies, which limits their growth and impact (Azmi & Thaker, 2020).

Inadequate infrastructure is another significant challenge for IMFIs in the MENA region. Poor infrastructure, including unreliable electricity, unsafe environments, inadequate transportation facilities, and unstable foreign currency situations, hampers the

operations of IMFIs. These infrastructural deficiencies make it difficult for IMFIs to reach low-income populations in rural areas, further limiting their outreach and effectiveness (Alshebami & Khandare, 2015).

High operating costs are another burden for IMFIs, particularly in Yemen. The cost of providing loans becomes prohibitive, leading to over-indebtedness among clients. High operating costs also force many poor clients to cancel their contracts with IMFIs and rely instead on informal support networks, such as family and friends, which does not contribute to their long-term financial stability or improve their standard of living.

The financial and operational capacities of IMFIs in the MENA region are often insufficient to narrow the gap in market outreach. Limited funding sources restrict the ability of these institutions to expand their services to underserved populations. The products offered by IMFIs often do not meet the diverse needs of micro-entrepreneurs, who require more than just credit for enterprise investment. This lack of diversity in product offerings prevents IMFIs from fully addressing the financial needs of their clients (Alshebami & Khandare, 2015).

In Pakistan, the reluctance of potential borrowers to engage with IMFIs is another challenge. This reluctance stems from a combination of factors, including lack of awareness, low financial literacy, and religious beliefs that discourage the use of conventional financial products. Additionally, financial analysis of organizations like Akhuwat has revealed that while they provide valuable interest-free loans to the poor, their financial stability is at risk due to declining growth in their loan portfolios and equity (Akhter, Akhtar, & Jaffri, 2009).

In Indonesia, the small size of many Islamic microfinance institutions limits their ability to attract clients and effectively combat poverty. Organizational challenges, such as the need for better governance and management practices, further impede their growth. The lack of a central entity to oversee and supervise these institutions exacerbates these issues, leading to operational inefficiencies and financial instability (Seibel, 2013).

The slow growth and development of the Islamic microfinance sector in the MENA region are often due to a lack of commitment from policymakers. There is insufficient innovation and creativity in developing new Islamic financial products and services. This lack of innovation stifles the potential for IMFIs to offer solutions that meet the evolving needs of their clients.

The shortage of trained and qualified staff is a significant challenge for IMFIs. In Yemen, for instance, there is a dearth of Shariah advisors who can ensure that the products and services offered by IMFIs comply with Islamic law. The absence of such expertise compromises the integrity and effectiveness of the financial products offered by these institutions, further limiting their appeal and reach (Alshebami & Khandare, 2015)

These challenges include limited outreach, inadequate promotion and awareness, regulatory and supervision issues, restrictive regulations for deposits, poor infrastructure, high operating costs, insufficient financial and operational capacity, reluctance of potential clients, organizational inefficiencies, slow growth and development, and a shortage of qualified staff. Addressing these challenges is essential for IMFIs to achieve their full potential in improving the living standards of impoverished communities and contributing to socio-economic development.

Obaidullah and Khan (2008) have identified significant challenges and proposed solutions for Islamic microfinance providers at both the micro and meso levels. At the micro level, the major challenges stem from the diverse organizational structures of microfinance providers, issues related to Shariah compliance, a lack of product diversification, and poor linkages with banks and capital markets. To address these challenges, the authors suggest several solutions. One proposed solution is for Islamic financial institutions to participate in the equity of specialized microfinance divisions. Another recommendation is to create Qard al-Hasan-specific funds to support various Qard al-Hasan-based microfinance institutions globally. Additionally, they advocate for the design of a Credit Guarantee Scheme tailored for Islamic microfinance providers.

At the meso level, the challenges are predominantly related to a lack of education and training among both clients and organizational personnel within the Islamic microfinance sector. Furthermore, ineffective networking poses another significant challenge. To mitigate these issues, Obaidullah and Khan (2008) propose developing a robust knowledge base through research focused on building inclusive Islamic financial systems. They also emphasize the importance of undertaking comprehensive training and education programs to enhance the skills and knowledge of all stakeholders involved in the sector. These multifaceted solutions aim to address the inherent challenges and foster a more resilient and effective Islamic microfinance ecosystem.

## 4 METHODOLOGY

### 4.1 Analytical framework

The analysis in this study leverages several key theoretical frameworks to address the challenges faced by Islamic microfinance institutions (IMFIs) within the D-8 countries. Each framework can assist to understand and propose solutions to these challenges.

Regulatory Capture Theory explores the influence that industry stakeholders can exert on regulatory agencies, potentially leading to regulations that favor the industry over public interest (Dal Bó, 2006; Novak, 2013). In the context of Islamic microfinance, this theory shows the importance of establishing specialized regulatory bodies with expertise in Islamic finance. These bodies would mitigate the risk of regulatory capture by ensuring that regulations are tailored to the unique needs of Islamic microfinance, rather than being unduly influenced by conventional finance interests.

The Theory of Planned Behavior suggests that individual behavior is driven by attitudes, subjective norms, and perceived behavioral control (Ajzen, 1991; Godin & Kok, 1996). This theory is relevant to Islamic microfinance, as it helps to understand how potential clients' attitudes toward Islamic financial products, the influence of community and religious norms, and their perceived control over engaging with these products affect their adoption. Addressing these three factors—attitudes, subjective norms, and perceived behavioral control—through well-designed marketing and education campaigns can significantly increase the acceptance and usage of Islamic microfinance services. By positively influencing clients' attitudes, aligning with influential norms, and enhancing their perceived ability to engage with Islamic financial products, institutions can foster greater trust and adoption among target populations.

Dynamic Capabilities Theory emphasizes an organization's ability to integrate, build, and reconfigure internal and external competencies to address rapidly changing environments (Bleady, Ali, & Ibrahim, 2018; Teece, 2014). For IMFIs, this theory highlights the necessity of continuous innovation and adaptation. By establishing R&D departments and fostering partnerships with fintech companies, IMFIs can develop new products and stay competitive in a changing market landscape.

Agency Theory focuses on the relationship between principals (financiers) and agents (clients), emphasizing the importance of aligning their interests to minimize conflicts and ensure mutual benefits. Effective risk management strategies are crucial in Islamic microfinance to align the interests of financiers and clients. This involves rigorous project assessment, continuous monitoring, and client training to ensure that both parties benefit from financial arrangements and adhere to Sharia principles.

Porter's Five Forces Analysis provides a framework for assessing the competitive forces that shape an industry's structure and profitability, including the threat of new entrants, the bargaining power of buyers and suppliers, the threat of substitute products, and competitive rivalry (Porter, 2008). Applying this analysis to Islamic microfinance helps in understanding the competitive dynamics and developing strategies for IMFIs to navigate market competition. This includes identifying competitive advantages, developing customer loyalty programs, and creating niche products for underserved segments.

#### **4.2 Methodological steps**

The methodology of this study is structured into clear, actionable steps to identify challenges and propose strategic solutions for Islamic microfinance institutions in D-8 countries.

The first step involves a review of existing literature to identify the primary challenges faced by Islamic microfinance institutions in D-8 countries. This review focuses on various aspects such as regulatory frameworks, awareness and understanding, product development, risk management, and market competition. By thoroughly understanding these challenges, the study can accurately pinpoint the areas that need strategic intervention. Based on the identified challenges, the study proposes theory-based strategic solutions.

### **5 CHALLENGES**

Islamic microfinance presents a unique set of challenges in Muslim developing countries, primarily due to its adherence to Sharia law, which prohibits interest (riba) and

speculative activities (gharar). While these principles create opportunities for ethical and inclusive financial services, they also introduce complexities that conventional microfinance institutions do not face. Understanding and addressing these challenges is crucial for the growth and success of Islamic microfinance.

### **5.1 Regulatory framework**

One of the primary challenges facing Islamic microfinance is the lack of a unified regulatory framework tailored to Islamic finance principles. In many Muslim-majority countries, the existing financial regulations are based on conventional banking systems that do not accommodate the unique requirements of Sharia-compliant financial products. This regulatory gap complicates the operations of Islamic microfinance institutions (MFIs) and limits their scalability. Without a supportive legal environment, MFIs struggle to gain the necessary recognition and trust from both clients and potential investors. This regulatory incongruity means that Islamic microfinance institutions often operate in a grey area, where the rules are unclear, and the enforcement is inconsistent. This uncertainty can deter both domestic and international investors who are wary of the legal risks involved.

Moreover, the lack of a standardized regulatory framework leads to inconsistencies in how Islamic financial principles are applied across different regions and institutions. This fragmentation can result in a lack of uniformity in the products and services offered, making it difficult for clients to understand and trust Islamic microfinance. It also poses challenges for regulatory bodies tasked with overseeing these institutions, as they must navigate a patchwork of guidelines and interpretations. Additionally, without clear regulations, there is a risk of non-compliance with Sharia principles, which can undermine the credibility of Islamic microfinance and erode client confidence. The development of a cohesive regulatory framework that integrates Islamic finance principles is therefore essential for creating a level playing field and fostering the growth of Islamic microfinance.

## 5.2 Limited awareness and understanding

Another significant challenge is the limited awareness and understanding of Islamic microfinance products, both among potential customers and within financial institutions. Many Muslims are unfamiliar with the concept of Islamic microfinance and the benefits it offers, leading to mistrust and reluctance to engage with these services. This lack of awareness is often rooted in a broader lack of financial literacy, particularly in rural and underserved communities. When potential clients do not understand the principles and operations of Islamic microfinance, they are less likely to use these services, even if they align with their religious beliefs. This reluctance can be compounded by negative perceptions or misconceptions about financial institutions in general.

Similarly, financial professionals may lack the expertise required to develop and manage Sharia-compliant financial products. Islamic finance principles necessitate a different approach to product design and risk management compared to conventional finance, requiring specialized knowledge and skills. This knowledge gap can hinder the adoption and effective implementation of Islamic microfinance, as institutions may struggle to develop competitive products and services that meet the needs of their clients while adhering to Sharia principles. The lack of trained personnel can also lead to operational inefficiencies and increase the risk of non-compliance with Sharia standards, further undermining the credibility of Islamic microfinance institutions.

## 5.3 Product development and innovation

Developing new and compliant products that meet the diverse needs of clients while adhering to Islamic principles requires significant expertise and innovation. Islamic finance principles necessitate the creation of products that do not involve interest and ensure risk-sharing between the lender and borrower. This can be resource-intensive and challenging for MFIs, especially those with limited access to skilled personnel and financial resources. The complexity of creating Sharia-compliant financial products often requires collaboration with Islamic scholars and legal experts, further increasing the cost

and time involved in product development. Despite these challenges, continuous innovation is essential for IMFIs to offer relevant and competitive financial services that meet the evolving needs of their clients.

The development of Sharia-compliant products also involves navigating a complex landscape of legal and religious interpretations. Different schools of thought within Islam may have varying opinions on what constitutes acceptable financial practices, adding another layer of complexity to product development. This can lead to delays and additional costs as institutions seek to ensure that their products are acceptable to a broad range of scholars and clients. Additionally, the need for continuous innovation means that Islamic microfinance institutions must invest in ongoing research and development, which can be a significant financial burden, particularly for smaller institutions.

#### **5.4 Risk management**

The risk-sharing model inherent in Islamic finance, while ethically aligned with Islamic values, presents unique risks that require sophisticated management strategies. Unlike conventional microfinance, which often relies on collateral to mitigate risk, Islamic microfinance employs contracts such as *Mudarabah* and *Musharakah* that involve profit and loss sharing. This dependency on the project's success can expose MFIs to higher risks, as the financial institution bears the risk of loss if the project fails. Effective risk management strategies are crucial to balance the ethical obligations of Sharia compliance with the need for financial sustainability. This includes rigorous project assessment, ongoing monitoring, and the development of contingency plans to manage potential losses.

Managing these risks requires a deep understanding of the projects being financed and the ability to accurately assess their viability. This can be particularly challenging in developing countries, where market conditions can be volatile and information is often scarce. The lack of reliable data can make it difficult for Islamic microfinance institutions to make informed lending decisions, increasing the risk of default. Additionally, the ethical obligation to share in the risk and avoid charging interest means that IMFIs have fewer tools at their disposal to manage and mitigate these risks compared to conventional

microfinance institutions. This can lead to higher default rates and financial instability, particularly in times of economic downturn.

### **5.5 Market competition**

Islamic microfinance institutions often face stiff competition from both conventional and other Islamic financial institutions. In many regions, conventional microfinance institutions are deeply entrenched, with well-established networks and customer bases. This makes it challenging for IMFIs to attract clients and secure a foothold in the market. Additionally, other Islamic financial institutions may offer similar products, increasing the competition within the niche market of Sharia-compliant financial services. To stand out, IMFIs must clearly differentiate their services based on their ethical and religious foundations, emphasizing the benefits of Sharia-compliant finance. Building strong relationships with clients and demonstrating the tangible benefits of Islamic microfinance can help IMFIs establish a competitive edge.

However, differentiating their services and building a strong client base can be difficult for Islamic microfinance institutions, particularly those with limited resources. Conventional microfinance institutions often have the advantage of larger networks, greater financial resources, and more established reputations, making it difficult for IMFIs to compete on equal footing. Additionally, clients may be hesitant to switch from conventional to Islamic microfinance institutions, particularly if they are unfamiliar with the principles of Islamic finance or if they perceive conventional institutions as more reliable. This competition can also drive down profit margins, making it more difficult for IMFIs to achieve financial sustainability.

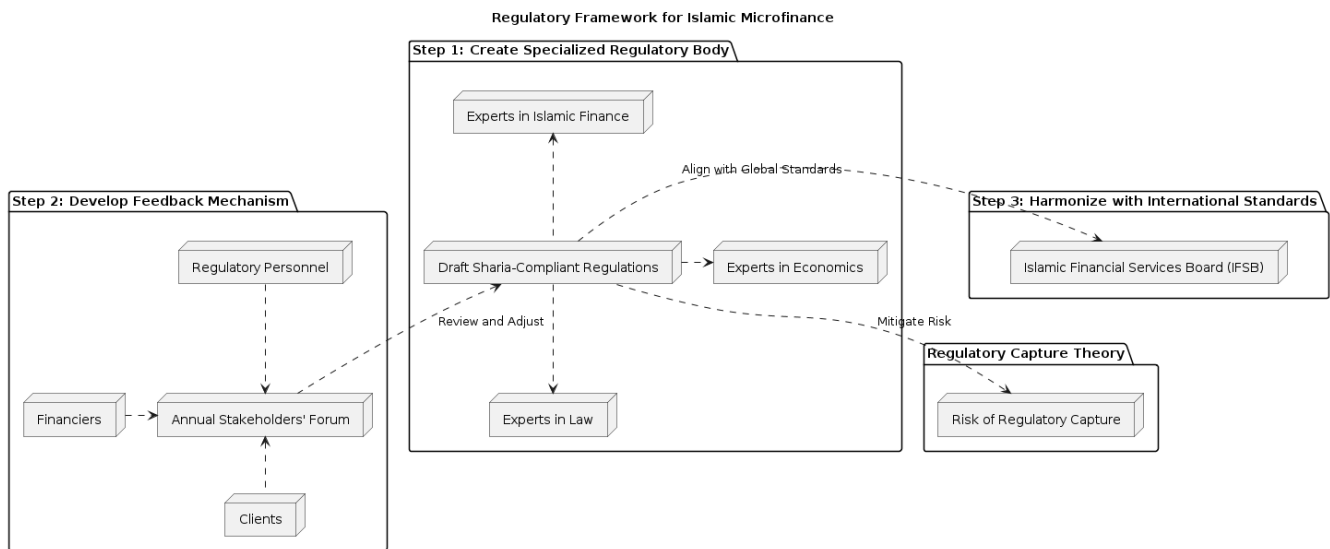
Islamic microfinance presents a promising avenue for enhancing financial inclusion and economic development in Muslim developing countries. However, realizing its full potential requires addressing several significant challenges. These include developing a supportive regulatory framework, increasing awareness and understanding of Islamic microfinance products, fostering innovation in product development, and implementing effective risk management strategies. Additionally, IMFIs must navigate market competition, operational complexities, and access to capital while building trust and credibility with their clients. By addressing these challenges

through concerted efforts by policymakers, financial institutions, and communities, Islamic microfinance can play a pivotal role in promoting sustainable development and financial empowerment in Muslim developing countries. The integration of ethical and religious principles with modern financial practices offers a unique opportunity to create a more inclusive and equitable financial system.

## **6 Addressing the challenges**

### **6.1 Regulatory framework**

The regulatory framework for Islamic microfinance is crucial to its success, providing a stable environment for operations and ensuring compliance with Sharia principles. Regulatory Capture Theory suggests that regulatory agencies can be influenced by the industries they regulate, which is a risk for any financial regulation. However, creating specialized regulatory bodies for Islamic microfinance can mitigate this risk by ensuring regulations are drafted by experts in Islamic finance, economics, and law.

**Figure 1***Regulatory framework for Islamic microfinance in developing-8***6.2 Step 1: Create a specialized regulatory body**

Establishing a specialized regulatory body in each country dedicated to Islamic microfinance is the first step. This body should comprise experts in Islamic finance, economics, and law. These experts would be responsible for drafting appropriate regulations that align with Sharia principles and local economic needs. The presence of specialized knowledge within the regulatory framework ensures that the unique aspects of Islamic microfinance are understood and properly addressed, reducing the risk of regulatory capture by conventional financial interests. This body would also be tasked with ensuring that regulations are not only compliant with Islamic law but also conducive to the growth and stability of Islamic microfinance institutions (IMFIs).

**6.3 Step 2: Develop a feedback mechanism**

Developing a robust feedback mechanism is essential for the dynamic regulation of Islamic microfinance. Annual stakeholders' forums should be organized, involving clients, financiers, and regulatory personnel. These forums would serve as a platform to review the impacts of existing regulations and discuss necessary adjustments based on real-world experiences. By incorporating feedback from all stakeholders, the regulatory

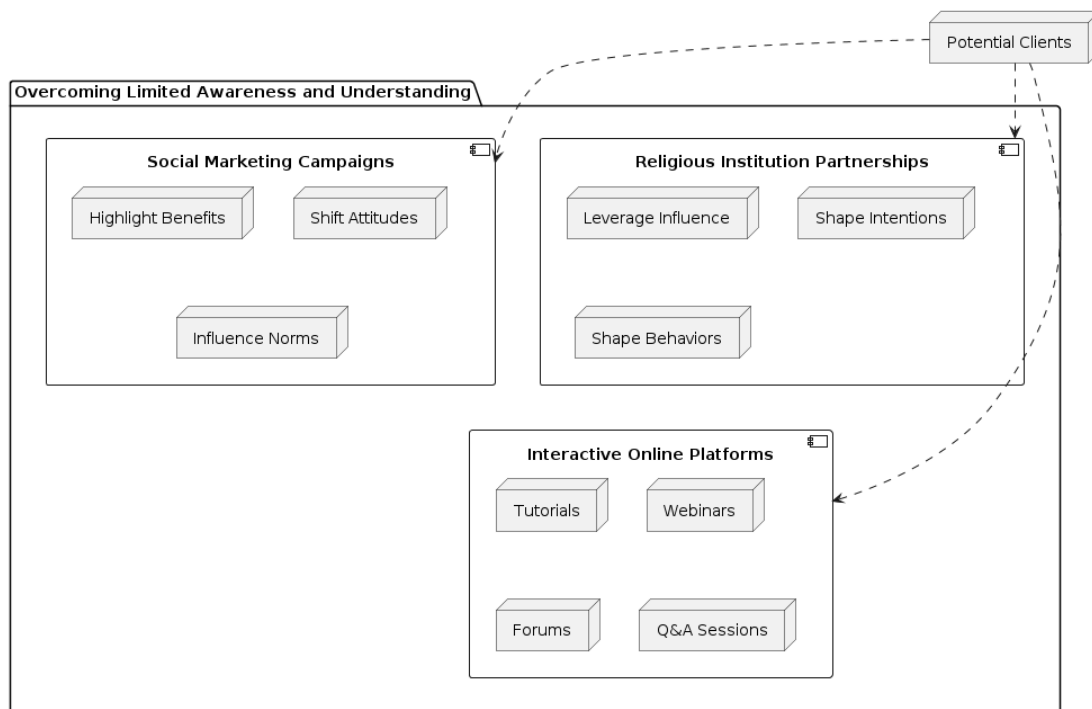
body can ensure that regulations remain relevant and effective. This iterative process helps in adapting to new challenges and opportunities, fostering a regulatory environment that supports sustainable growth.

#### **6.4 Step 3: Harmonize regulations with international standards**

To ensure global competitiveness and attract foreign investment, it is crucial to harmonize local regulations with international Islamic finance standards. Collaboration with bodies like the Islamic Financial Services Board (IFSB) can facilitate this process. By aligning with global standards, IMFIs can gain credibility and attract investments from a broader base of international investors. This alignment also helps in standardizing practices across different regions, making it easier for investors and clients to engage with IMFIs on a global scale.

#### **6.5 Limited awareness and understanding**

Limited awareness and understanding of Islamic microfinance pose significant barriers to its adoption. The Theory of Planned Behavior suggests that attitudes, subjective norms, and perceived behavioral control influence an individual's intentions and behaviors. Therefore, targeted efforts to shift these elements can enhance the acceptance of Islamic microfinance.

**Figure 2***Overcoming limited awareness and understanding in developing-8***6.6 Step 1: Launch targeted social marketing campaigns**

Launching targeted social marketing campaigns is essential to highlight the social and religious compliance benefits of Islamic microfinance. These campaigns should aim to shift attitudes and norms around financial services by emphasizing the alignment of Islamic microfinance with ethical and religious values. By showcasing success stories and benefits, these campaigns can influence potential clients' perceptions and encourage them to consider Islamic microfinance as a viable option.

**6.7 Step 2: Partner with religious institutions and community Leaders**

Partnering with religious institutions and community leaders can significantly enhance the outreach and credibility of Islamic microfinance. Integrating discussions of Islamic microfinance into sermons and community meetings leverages the influence of religious leaders to shape intentions and behaviors. These trusted figures can provide

endorsements and explanations that resonate deeply with the community, fostering greater acceptance and understanding.

### 6.8 Step 3: develop interactive online platforms

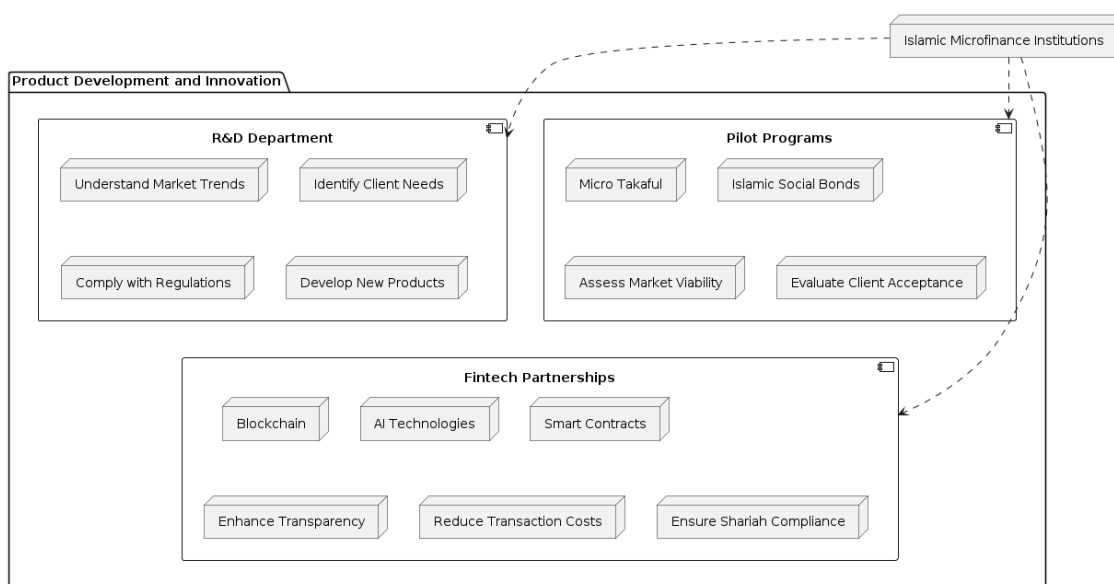
Developing interactive online platforms that offer tutorials, webinars, and forums can provide accessible and engaging ways for potential clients to learn about Islamic microfinance services. These platforms can facilitate direct engagement with providers, allowing clients to ask questions and gain clarity. Interactive elements, such as live Q&A sessions and case studies, can demystify Islamic microfinance and make it more approachable.

### 6.9 Product development and innovation

Product development and innovation are critical for meeting the evolving needs of clients and maintaining competitiveness. The Dynamic Capabilities Theory emphasizes the importance of an organization's ability to integrate, build, and reconfigure internal and external competencies to address rapidly changing environments.

**Figure 3**

*Product development and innovation strategies for Islamic microfinance in developing-8*



### **6.10 Step 1: establish a dedicated R&D department**

Establishing a dedicated Research and Development (R&D) department within Islamic microfinance institutions can focus on developing and testing new financial products. This department would be responsible for understanding market trends, client needs, and regulatory requirements to create innovative products that adhere to Islamic principles. By investing in R&D, IMFIs can stay ahead of market changes and continuously offer relevant products.

### **6.11 Step 2: introduce pilot programs for innovative products**

Introducing pilot programs for innovative products, such as micro takaful (Islamic insurance) and Islamic social bonds, allows IMFIs to assess market viability and client acceptance. These pilot programs can provide valuable insights into the practicality and demand for new products. By starting on a smaller scale, IMFIs can refine their offerings before a broader rollout, minimizing risks and optimizing product performance.

### **6.12 Step 3: encourage partnerships with fintech companies**

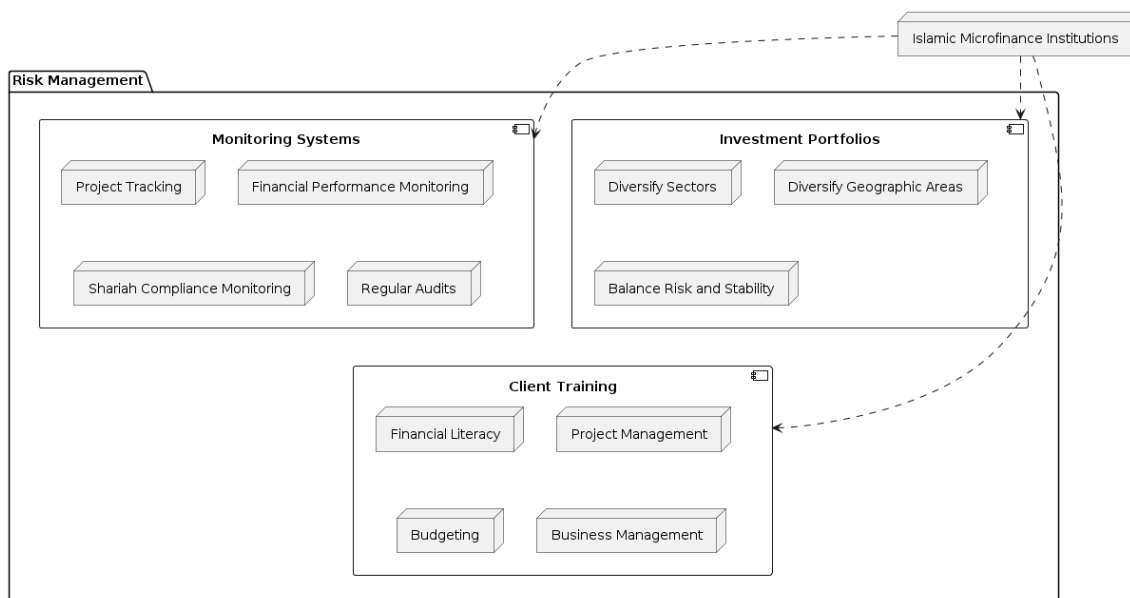
Encouraging partnerships between Islamic microfinance institutions and fintech companies can leverage advanced technologies for product innovation. Utilizing blockchain and AI technologies, for instance, can facilitate the development of smart contracts for Sharia-compliant loans. These technologies can enhance transparency, reduce transaction costs, and ensure compliance with Islamic principles, making financial products more efficient and accessible.

### **6.13 Risk management**

Effective risk management is essential for the sustainability of Islamic microfinance institutions. Agency Theory highlights the importance of aligning the interests of principals (financiers) and agents (clients) to minimize conflicts and ensure mutual benefits.

**Figure 4**

*Risk management for the sustainability of Islamic microfinance institutions in developing-*  
8



#### **6.14 Step 1: Implement enhanced monitoring systems**

Implementing enhanced monitoring systems provides continuous oversight of financed projects, ensuring adherence to agreed terms and risk-sharing principles. Advanced monitoring tools can track project progress, financial performance, and compliance with Sharia guidelines. Regular audits and performance reviews can identify potential issues early, allowing for timely interventions to mitigate risks.

#### **6.15 Step 2: Develop diversified investment portfolios**

Developing diversified investment portfolios can spread risk across different sectors and geographic areas, reducing the impact of any single project's failure. By investing in a mix of industries and regions, IMFIs can balance high-risk ventures with more stable investments. Diversification helps in achieving a more resilient financial performance, safeguarding the institution's sustainability.

### 6.16 Step 3: Train clients in financial literacy and project management

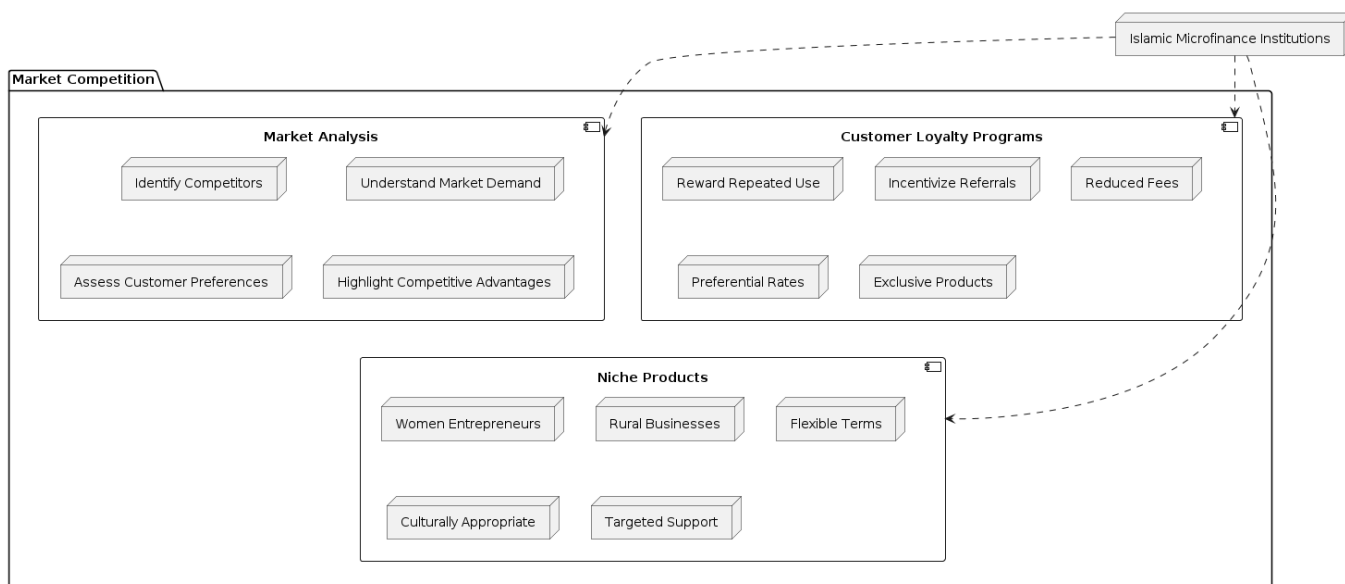
Training clients in financial literacy and project management can minimize the risk of default and improve the success rates of financed ventures. Education programs that cover budgeting, financial planning, and effective business management equip clients with the skills needed to manage their finances responsibly. This not only enhances their ability to repay loans but also contributes to the overall economic development of the community.

### 6.17 Market competition

Islamic microfinance institutions operate in a competitive market, facing pressures from both conventional and other Islamic financial institutions. Porter's Five Forces Analysis provides a framework for understanding these competitive dynamics and developing strategies to navigate them.

**Figure 5**

*Strategies for Islamic microfinance institutions to navigate in competitive financial market*



### **6.18 Step 1: conduct market analysis**

Conducting market analysis to identify specific competitive forces in different regions helps IMFIs develop tailored strategies. Understanding the strengths and weaknesses of competitors, market demand, and customer preferences can inform strategic decisions. This analysis enables IMFIs to position themselves effectively in the market, highlighting their unique value propositions and competitive advantages.

### **6.19 Step 2: innovate customer loyalty programs**

Innovating customer loyalty programs that reward clients for repeated use and referrals can foster a loyal customer base. Leveraging the communal aspects of Islamic societies, these programs can encourage clients to engage more deeply with the institution. Loyalty rewards, such as reduced fees, preferential rates, or access to exclusive products, can incentivize clients to remain with the IMFI and promote it within their networks.

### **6.20 Step 3: develop niche products for undeserved segments**

Developing niche products that specifically target undeserved segments, such as women entrepreneurs and rural businesses, provides tailored financial solutions that are not readily available from other financiers. By addressing the unique needs of these segments, IMFIs can capture new markets and differentiate themselves from competitors. Niche products that offer flexible terms, culturally appropriate services, and targeted support can create strong market positions in these undeserved areas.

## **7 CONCLUSION**

The D-8 Organization for Economic Cooperation can boost financial inclusion and socio-economic development through strategic Islamic microfinance improvements. To address challenges faced by Islamic microfinance institutions (IMFIs), clear actions

are needed in regulation, awareness, innovation, risk management, and market competition.

Creating a supportive regulatory framework is crucial. Each member country should have specialized regulatory bodies with experts in Islamic finance, economics, and law to draft Sharia-compliant regulations. Aligning these with international standards will enhance credibility and attract global investments, ensuring stability and scalability.

Raising awareness is essential. Social marketing, partnerships with religious institutions, and online platforms can educate potential clients and financial professionals on Islamic microfinance. Engaging community and religious leaders can build trust and encourage adoption, promoting broader financial inclusion.

Innovation in product development is necessary to meet client needs and remain competitive. Establishing dedicated research and development departments within IMFIs can drive the creation of new Sharia-compliant financial products. Pilot programs for these products can test market viability and client acceptance. Collaborations with fintech companies can introduce advanced technologies like blockchain and AI, enhancing product transparency, reducing costs, and ensuring Sharia compliance.

Effective risk management is crucial for the sustainability of Islamic microfinance institutions (IMFIs). Implementing enhanced monitoring systems, diversifying investment portfolios, and providing client training in financial literacy and project management can mitigate risks and improve project success, aligning with Islamic finance's risk-sharing principles.

Conducting market analysis and developing tailored strategies help IMFIs position themselves effectively. Offering customer loyalty programs and niche products for underserved groups, like women entrepreneurs and rural businesses, can differentiate IMFIs and build a loyal client base.

The proposed strategic solutions provide a framework to address the challenges faced by IMFIs in D-8 countries. Implementing these solutions can foster sustainable growth, offer financial services aligned with Islamic values, and meet diverse population needs. The D-8 Organization for Economic Cooperation can enhance financial inclusion, promote socio-economic development, and contribute to Islamic social justice and economic equity, driving economic growth and improving quality of life in Muslim developing countries.

A significant limitation of the study is its reliance on theoretical frameworks which may not fully capture the on-ground realities and nuances of Islamic microfinance operations in D-8 countries. While the conceptual framework proposed provides a structured approach to addressing challenges in Islamic microfinance, the lack of primary empirical data, such as case studies or field surveys, limits the study's ability to validate the practical applicability of the proposed solutions. This limitation suggests a need for future research to incorporate comprehensive field data to test and refine the framework in real-world settings, ensuring it addresses the practical challenges and opportunities faced by microfinance institutions effectively.

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### **Authors' Contribution**

All authors contributed equally to the development of this article.

### **Data availability**

All datasets relevant to this study's findings are fully available within the article.

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