



Role of Interest-Free Microfinance in Enhancing Financial Inclusion and Sustainable Development

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ABSTRACT

In India, the creation of interest-free microfinance (IFM) has emerged as an inclusion mode through which households who do not want to seek traditional interest-based borrowing in an ethical, religious, or other affordability reasons do so. Although Indian microfinance has grown in significant proportions, the fact that financial exclusion still persists and that socio-cultural barriers continue to be relevant prompts the notion that plural models of inclusive finance, which do not compromise consumer protection standards or institutional sustainability, are required. This hypothetical paper presents the synthesis of India-specific evidence of the documented cooperative case-studies, and policy-based evidence to illuminate the contractual tools applied in IFM, institutional pathways of IFM implementation in India, and regulatory tensions and policy alternatives that influence its scaling opportunities. The discussion will be based on peer reviewed case studies of Bait-un-Nasr Urban Cooperative Credit Society and Al-Khair Cooperative Credit Society and supported by evidence of collateral-based lending by Muslim funds and by a modern microfinance regulatory framework and financial inclusion

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policy used in India. The paper contends that the IFM in India can well be viewed as a series of contractual and governance adaptations executed mostly through cooperatives and community institutions as opposed to a separate Islamic banking system. The synthesis identifies three key findings. They are 1. IFM outreach can be enhanced through trust in communities and mobilization of member savings 2. sustainability can be achieved through a clear cost recovery and governance discipline and 3. regulatory congruence by establishing standardized disclosure and reporting categories of non-interest pricing that are protective of borrowers and yet remain legitimate to the IFM. The paper finishes with the policy suggestions, standardization of the disclosures, capacity building to cooperative governance and the inclusion of the IFM in the broader financial inclusion policy of India.

Keywords: Interest-free microfinance, Islamic microfinance, cooperative credit, financial inclusion, microfinance regulation, India, Shari'ah-compliant finance

1. INTRODUCTION

Financial inclusion has been broadly acknowledged to be a key economic opportunity, poverty alleviation, and resiliency driver, especially to households with unstable incomes and low collateral. This focus can be seen in the policy orientation of India, which includes a sustained inclusion program, a technology-enabled delivery channel, and a clear strategic focus that defines the concept of inclusion as either access to affordable, safe, and transparent financial services with the help of consumer protection and grievance redressal systems (Reserve Bank of India, 2021). However, the results of inclusion are still uneven and not uniform across the regions and social groups, and socio-cultural do not act as homogenous forces that will drive households to work with formal providers. In this context, interest-free microfinance (IFM) has emerged in India as an ethically positioned conceptualization of microfinance that aims to offer microfinance at small-ticket levels and non-charge (riba), usually based on Shari'ah-compliant contractual forms and community-based institutions (Reserve Bank of India, 2021). The Indian institutional context is that IFM is occasionally referred to as Islamic microfinance, though the Indian institutional fact is that it has been developed mostly by incorporating cooperative credit societies, trusts and community funds, in place of licensed Islamic banks (Chakrabarty, 2015). Therefore, IFM in India is not simply a case of replacing interest with some other name, but the formulation of instruments, governance, and reporting that can be used in the legal and regulatory framework of India and still maintain an interest free reputation.

First, traditional microfinance has been periodically challenged in the legitimacy of operations in India, with the alleged excessiveness of price and stress on the borrowers. Second, an ongoing population group is desiring the financial products that can be used with the religious or ethical beliefs. (Shaik Mohammed, & Waheed, 2019). IFM is hence a demand-sensitive inclusion channel and another reputationally differentiated model that purports to alleviate exploitative burdens. Nevertheless, the inclusion promise of IFM is only credibly assessable when it is considered as an institutional system: its tools, revenue structure, disclosures to consumers, and risk management procedures should comply with the norms of borrower protection and operational sustainability. (Tay,et al.,2022). The paper transforms the topic framework into a publication-style conceptual research article devoted solely to India. It combines the evidence on the data of the cases of the Indian cooperative IFM and the regulatory and policy document in India to examine the manner in which the instruments of IFM are operationalized, how institutions will cope with the lack of interest income, and how regulatory frameworks built based on interest-based lending may generate tensions of disclosure and legitimacy. (Anakpo, et al., 2023). The contribution of the paper is to connect the institutional evidence at the micro-level to the macro-level regulatory design and, thus, elucidate the policy implications at the actionable level when it comes to responsible scaling.

2.LITERATURE REVIEW

The international literature on Islamic microfinance typically presents the sphere as a common ground of microfinance social mission and Islamic finance taboo of interest and focus on ethical restrictions. In the Indian setting, though, the most instructive literature has been case-based and institutional, which chronicles the manner in which interest-free finance has been instituted within the permitted organizational structures as opposed to being structured along a parallel banking model. (Van, et al., 2025). The literature of work indicates that Indian IFM is mixed with the offering of demand credits and trade-based financing and community-based Bait-un-Nasr Urban Cooperative Credit Society, which is largely based on collateral and service-charge models. It describes the operations of an interest-free cooperative microfinance organization and points to operating characteristics, limitation to sustainability, and the importance of regulatory classification of interest-free organizations operating within a system where reporting and pricing conventions are dominated by an interest-based approach (Mohammed & Waheed, 2019b). The case highlights that despite the absence of interest

charged by an institution, there exist administrative expenses and portfolio risk that the institution has to contend with thus putting strain on the need to implement service charges, or other mechanisms that may be misconstrued when disclosure and accounting conventions are not consistent with the conceptual model of the institution.

A second study that can be used as a foundation to India-specific research is the example of the Al-Khair Cooperative Credit Society a multistate cooperative with the Multistate Cooperative Societies Act under which it functions. Al-Khair study is a comprehensive report of the deposit products, loan products, structure of governance and trends in financial performance, in addition to outlining the operational constraints like lack of training, bad debt situation, and the necessity of an effective Shari'ah governance process (Mohammed & Waheed, 2018). Of specific interest to the analysis of instruments is the fact that the study describes how the demand loans are similar to the qard hasan in spirit and tend to add service charge, as well as the description of the use of murabahah-type financing to purchase assets with profit margins published (Mohammed & Waheed, 2018).

A third literature stream on India-related topics deals with the Muslim funds in North India that are given as interest-free loans on collateral (al-rahn). A survey by the representative funds by Khan and Nisar, records the centrality of operations of the gold and silver collateral and its use through the deposit collection agents and the mechanism of generating income through service charges or security storage fees (Khan and Nisar, 2004). The research has two essential reasons. First, it broadens the concept of IFM through formal cooperative structure into community financial structures operating outside mainstream bank regulation. Second, it also shows that the lack of interest does not obviate the issue of recovering the cost; rather, it moves the sustainability debate to the issue of service charge and whether it is Shari'ah compliant, transparent and legally allowed (Khan and Nisar, 2004).

The case study of Sanghamam Multistate Cooperative Credit Society is yet another India-related source, which has been captured here as an accessible publisher record rather than as text. According to the publisher record, the outreach and financial performance of Sanghamam were compared with the benchmarks in Indian microfinance industry and that the liquidity risk and the identification of service charges were emphasized (Mohammed & Waheed, 2019a). To support this paper, the case of Sanghamam is taken as an example that the IFM institutions in

India can also attain the competitive outreach and performance in spite of the instrument-design and governance problems that need standardization and control. Policy and regulatory sources offer the wider inclusion framework within which IFM has to be placed. The National Strategy of Financial Inclusion, developed in India, focuses on the access, usage, quality, financial literacy, and customer protection, explicitly acknowledging the presence of socio-cultural barriers and the necessity of the strong grievance redressal framework (Reserve Bank of India, 2021). Regulatory Framework of Microfinance Loans of the RBI provides the norms of the protection of borrowers such as the assessment at the household level, the restriction of the repayment payments as the portion of the income, the use of a standardized loan card, the requirements of disclosures, and the prohibition of rough methods of their collection (Reserve Bank of India, n.d.). These standards are targeted at controlled parties, nevertheless, they establish a policy minimum of responsible microfinance practice which must govern the approach to different models like IFM. Lastly, policy focus on interest-free finance has been publicly realized with the government messaging which references committee-based recommendations and the establishment of an inter-departmental group at RBI to investigate legal and technical matters connected to alternative or Islamic banking (Press Information Bureau, 2015). Although this does not directly imply a regulatory regime of IFM, it has been hinted at that policy discourse has intermittently addressed the prospect of interest-free finance as an option in the formal system, which supports the applicability of the regulatory alignment problems to IFM institutions that strive to establish legitimacy and scalable models. On the whole, it is argued that the India-related literature indicates that IFM has been practiced in a variety of different institutional forms, but that the largest gaps in the discourse of policy pertain to standardized disclosure of non-interest charges, consistent Shari'

3. RESEARCH OBJECTIVES AND HYPOTHESES

The research is theoretical and based on the synthesis of the written India-specific sources instead of the newly collected primary surveys or the econometric estimations. In this design, there are four objectives in the paper. The initial goal is to help identify the definition of interest-free microfinance and real-life application in India as an instrument, institution, and revenue model of interest-free lending maintenance. The second goal is to organize the main IFM tools which are reported in India practice and evaluate their comparative operational implication in the delivery of microfinance. The third goal is to discuss regulatory and governance restrictions which influence the legitimacy and scalability of IFM, especially in the situation when disclosure and accounting conventions are biased towards interest-based

products. The fourth goal is to make policy implications to empower responsible scaling of IFM in the way that aligns with the financial inclusion plan of India and the Microfinance borrower protection principles (Reserve Bank of India, 2021; Reserve Bank of India, n.d.).

Since the guidelines involve hypotheses, the paper presents analytically testable propositions as based on the reviewed Indian evidence. Hypothesis 1: Interest-free microfinance will increase effective inclusion among households not utilizing conventional microcredit, because of socio-cultural or ethical reasons, and will lead to enhancing the inclusion strategy focus on breaking barriers based on beliefs and trust (Reserve Bank of India, 2021). Hypothesis 2: IFM institutions that depend on a high portion of member deposits and cooperative governance have an increased liquidity risk and governance sensitivity than a diversified regulated MFI, and therefore the quality of governance will be a determinant of sustainability (Mohammed and Waheed, 2018; Mohammed and Waheed, 2019a). Hypothesis 3 is that lack of standardized disclosure and reporting categories of non-interest price increases compliance friction and reputational risk of the IFM institutions particularly where service charges or markups are seen as disguised interest (Mohammed and Waheed, 2019b; Reserve Bank of India, n.d.). These hypotheses are also designed to be empirically tested in the future but they do not contradict the conceptual synthesis that we have made here.

4. RESEARCH METHODOLOGY

The conceptual research methodology applied in this paper is the structured qualitative synthesis of India-specific peer-reviewed case literature and authoritative policy documents. This methodology is suitable since the goal is not to create new quantifiable estimations but to construct a reasonable analytical framework that presents how IFM has been working in the Indian institutional environment, the way its tools work, and how regulatory alignment could be enhanced without undermining the borrower protections (Mohammed & Waheed, 2018; Mohammed and Waheed, 2019b). Such cases are supplemented by evidence on collateral-based Muslim funds to indicate other institutional forms thus through which interest-free lending has been practiced in India (Khan and Nisar, 2004). Another institutional source is provided with the purpose of supporting the comparative comprehension of IFM outreach and performance themes and recurring operational problems such as liquidity and the structure of the service charges, the policy-level publishing on the situation of microfinance lending and the regulatory framework (Mohammed and Waheed, 2019a). These documents are utilized in

establishing minimum expectations on consumer protection, assessment of household repayment capacity, disclosure standards, and grievance redressal that is supposed to guide any inclusion model that aims to attain legitimacy and scale (Reserve Bank of India, 2021; Reserve Bank of India, n.d.).

The synthesis is also made with reference to governmental discourse on the policy discourse of interest free finance in order to define regulatory viability and historic policy interest in alternative banking discourse (Press Information Bureau, 2015). The synthesis is conducted in three steps. To start with, the IFM instruments are categorized and contrasted based on a contractual logic, cases of microfinance use, income mechanisms, and the allocation of risk. Second, the analysis of institutional pathways is carried out in respect to the governance, sources of funds, processes of operation and limitations that have been reported in the cases of India. Third, the findings are discussed in relation to the principles of microfinance regulation in India and the objectives of national inclusion, and policy implications are created that are realistic without the use of fabricated data.

Figure 1: This figure below will give the conceptual framework of this study, which will connect interest-free microfinance instruments, the pathways that are predominant in India to deliver such services, and the regulatory-policy interface with the inclusion outcomes that will be discussed in the next section.

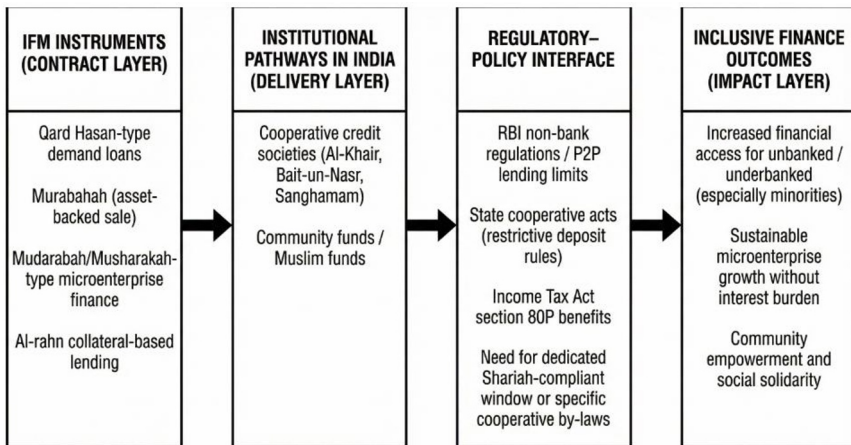


Figure 1 Conceptual Framework for interest free microfinance in India.

The key argument of this conceptual study is operationalized in Figure 1, which argues that interest-free microfinance (IFM) in India should not be understood as a single product of interest-free loans, but rather as a system, in which the contractual instruments, delivery institutions and the regulatory-policy environment are co-determining both the inclusion outcomes and the conditions under which the outcomes themselves are sustainable. The figure starts with the layer of contract as it is important to note that IFM in India is not implemented on the basis of a standard template but a set of instruments. The framework emphasizes the fact that interest-free is a price control rather than a form of contract by finding qard hasan-type demand lending, asset-guaranteed sale, partnership-based microenterprise financing (mudharabah/musharakah), and al-rahn collateral-based lending in the same conceptual box. This difference is of central importance to the research since it is the reason why Indian IFM institutions frequently engage in an administratively straightforward instrument (say, demand loans and murabahah) with a more complex partnership logic, which could be normatively optimal but operationally costly at micro scales; the figure thus predicts the argument in the paper that instrument choice is influenced as much by the problem of enforceability, the cost of monitoring, and the feasibility of disclosure as by the problem of normativity. The delivery layer, which comes next, transfers the analysis of contracts to institutions, highlighting the fact that the implementation of India IFM is done more by cooperative credit societies and community funds than using a special system of Islamic banking. In theory, the framework claims that the ethical purpose of IFM does not relieve it of consumer-protection principles; it must be converted into open-disclosure principles and discipline in repayment capacity in such a manner that non-interest pricing is not turned into opaque pricing. That is why regulation is portrayed as an active force of shaping things and not just a background condition in the figure. The last results block summarizes the dependent variables in the paper such as expanded access and usage, trust and legitimacy, affordability and ethical acceptability and sustainability contingent on governance and liquidity discipline hence elucidating that inclusion is multidimensional and that the success of IFM cannot be determined by mere lack of interest alone. Notably, the feedback arrows render the framework dynamic: the rules turn into the determinants of delivery as they can influence which institutional forms can scale, as well as deliver constraints as the requirements compel the institutions to enter into contracts which are administratively viable and legally defensible and can be comprehensively supervised in reality. Figure 1, when combined, offers the analytical gap between the literature synthesis in the study and its policy implications and the appearance of the outcomes of inclusion as the results of interactions between the layers and not by any one instrument or institution.

5. RESULTS AND DISCUSSION

Conceptual synthesis produces the following four outcomes. Such findings are interrelated, as in IFM the contract form cannot be singled out of the way institutions mobilize funds, risk management, and costs disclosure to borrowers. The former is that IFM in India is not a single product, but a collection of instruments and operational methods aimed at avoiding interest as a pricing instrument. The Indian cooperative cases demonstrate demand loans which are spiritually similar to qard hasan, with service charges to recover costs, and murabahah-based financing to acquire assets with announced margins (Mohammed & Waheed, 2018). Al-Khair case gives clear accounts of demand loans, murabahah loans, and business loans that are explained as partnership-oriented but adopted using negotiated profit-shares and scheduled repayments and reflects the fact that in practice much of operational constraint forces a compromise between the ideal contractual forms and practices that can be implemented (Mohammed & Waheed, 2018). The Sanghamam publisher record also sheds light on the Shariah concerns in determining service charges and in the design of the deposit and profit-sharing schemes, which validates the centrality of the instrument design problem (Mohammed & Waheed, 2019a).

The second finding is that the choice of institutional pathways plays a significant role in dictating feasibility in India. Without the mainstream Islamic banking channel, cooperative societies and community institutions have been important in the delivery of IFM. Membership based savings mobilization, localized trust, and participation in governance can also make outreach and social legitimacy strong and possible through the use of cooperative structures. Al-Khair case demonstrates how the deposits mobilization of an interest-free cooperative can be enhanced, along with the loans and the membership development in several states within a multistate cooperative system (Mohammed & Waheed, 2018). The institutional description of the Sanghamam activity focuses on a participatory microfinance model that mobilizes savings and diverted capital in form of interest-free micro-credits, which demonstrates an institutional story in line with cooperative inclusion pathways (Indian Centre of Islamic Finance, n.d.). Such institutional channels are important in that they put IFM in those legal forms accepted in India, but also suggest reliance on local funding and governance quality that can make it susceptible to liquidity stress or lopsided professionalization.

The third outcome is the sustainability and governance. This lack of interest does not abate the necessity of revenue; it alters its manifestation with which institutions recuperate the expenses and regulate feasibility. According to the evidence of the cases, it is possible to state that the IFM institutions can earn income with the help of admission fees, account maintenance fees, service charges, and trade margins (Mohammed & Waheed, 2018). Muslim funds are also based on service charges and security storage fees although most of the funds, the study notes, invest deposits in interest based banks and this indicates that tension is yet to be resolved between operation reality and the Shari'ah ideals (Khan & Nisar, 2004). These are sustainability systems that establish governance and legitimacy demands. The institutions are expected to prove that the charges made are related to costs or allowed profit margins and that customers are notified in a transparent manner. As indicated in the Al-Khair case, Shari'ah consultation can take place without an independent Shari'ah board or regular Shari'ah audit, which implies that one of the principal spheres of institutional fortification is governance formalization (Mohammed and Waheed, 2018).

Regulatory alignment is a constraint, and an opportunity, which is the fourth outcome. The microfinance model of RBI focuses on the household level assessment, repayment limits, standard disclosure using loan cards and pricing factsheets, and restraints on aggressive recovery practices (Reserve Bank of India, n.d.). Such principles can be reconciled with the ethical goals commonly linked to IFM, however, where disclosure templates and reporting conventions presuppose interest as the leading price variable, friction occurs. Whenever the IFM institutions set service rates or even profit margin the policy dilemma is to make sure that the total cost is well made known without compelling the institution to package its pricing in a manner that may jeopardize its interest free identity. This friction is significant in that IFM regularly relies on trust and legitimacy, when the disclosures are not aligned or even when the charges are seen as a masked interest, the inclusion mission of the institution would be undermined. Simultaneously, the customer protection, trust, and socio-cultural barriers as the central aspects of the national strategy imply that clarity of policy regarding ethical and trust-based financial models may make the inclusion stronger as long as it does not undermine consumer protection (Reserve Bank of India, 2021).

Table 1.

Comparison of key interest-free microfinance instruments in India

The table below summarizes the definitions of instruments and practical considerations that are found in the India focused literature on cooperative and community (Khan and Nisar, 2004; Mohammed and Waheed, 2018; Mohammed and Waheed, 2019a; Mohammed and Waheed, 2019b).

Instrument	Contractual logic	Typical microfinance use	Institution income basis	Key risk allocation
Qard ḥasan-type demand loan	Benevolent loan in spirit; principal repayment; often administered as a demand/term loan	Emergency needs, consumption smoothing, small working capital	Service charges or administrative fees may be used for cost recovery	Credit risk borne by lender; repayment risk depends on borrower capacity
Murābahah	Institution purchases asset and sells to client at disclosed markup payable in installments	Tools, inventory, productive assets, durable goods	Profit margin on sale price	Asset/price risk during purchase/holding; credit risk on receivables
Muḍārabah-type microenterprise finance	Profit-sharing partnership between capital provider and entrepreneur-manager	Microenterprise finance where profits can be measured	Share of realized profits	Capital loss borne by financier unless misconduct; effort risk with entrepreneur
Mushārahah-type partnership	Joint venture with shared capital and profit/loss sharing	Enterprise expansion and joint ventures	Profit share as agreed	Loss shared by contribution ratio
Al-rahn collateral-based lending (community funds)	Loan provided against pledged valuables (commonly gold/silver)	Emergency needs, illness, marriages, debt repayment	Service charges ("cost of loan form") or security storage fees	Low credit risk due to collateral; operational risk of storage and safety

6. Policy implications

The policy implications of this synthesis are related to the way to facilitate the pathways to plural inclusion without damaging the protection of borrowers. According to the financial inclusion strategy in India, inclusion is seen as a safe and open access with customer protection, grievance redressal, and financial literacy as sustainability pillars (Reserve Bank of India, 2021). The first implication is that the ultimate objectives of this vision need to be attained by regulatory and institutional practices that make customers aware of the cost and responsibility

of funding and safeguard them against over indebtedness and coercive recovery. The microfinance system of RBI focuses on simplified pricing factsheet and clear loan cards (Reserve Bank of India, n.d.). In the case of IFM, the equivalent need is to reveal service charges, fees, and profit margins, as well as to make any compulsory payments in a manner that enables a borrower to know all the cost of finance and compare options without any misunderstandings. The aspect of standardization is critical since the IFM legitimacy is largely dependent on trust; any ambiguous labels may cause reputational risk and compromise the socio cultural inclusion argument upon which the IFM demand is being driven. The consumer protection would increase but not decrease with increased scale of IFM as a disclosure standard that separates service charges, trade margins and penalties and provides an effective summary of costs.

The second implication is that it is necessary to enhance cooperative governance and risk management. Member deposits and local networks are typically important to IFM cooperatives. Some of the operational limitations pointed out by the case evidence include a lack of training, bad debt, and formal Shari'ah audit structure (Mohammed & Waheed, 2018). All these limitations indicate that the policy support should focus on institutional capacity building namely internal controls, the monitoring of the portfolio, liquidity planning, audit quality and development of believable Shari'ah governance mechanisms such as independent boards or periodical audit. The fact that the Sanghamam case record has identified the possible liquidity risk makes it possible to support the idea that governance and the liquidity discipline are not marginal to sustainability but their core (Mohammed and Waheed, 2019a).

The third implication is that IFM should be considered as a part of the wider inclusion architecture instead of a rather niche or symbolic innovation. The national strategy recognizes the presence of socio-cultural barriers as the source of exclusion and proposes regulatory mechanisms that would keep customers safe and permit them to be flexible in innovations (Reserve Bank of India, 2021). IFM could be thought of as an inclusion innovation with definite guardrails: consumer protection cannot be compromised, but the rules on instruments and disclosure need to be made more explicit to allow noninterest models in which it creates inclusion value without undermining transparency. The fact that governmental communication puts into consideration the issues at committee level is a sign that the policy system has already acknowledged the relevance of the issue and is open to the idea of structured, pilot based initiatives that would involve testing the viability of interest free windows in the current legal forms (Press Information Bureau, 2015). The fourth implication is that of regulatory arbitrage

prevention and borrower welfare. The IFM should not be a way to avoid the norms of borrower protection, but they must be subjected to the same or greater programs of disclosure, fair practice and ability to repay. The structure of RBI focuses on measuring indebtedness, which is at the household level, and having a limit on the amount of debt that has to be repaid in relation to income (Reserve Bank of India, n.d.). Such principles may be applied to the IFM settings even where the pricing is not based on the interest, since the ethical principle of IFM is the same with the prevention of over indebtedness. The crucial thing is then to put the borrower protection regulations into disclosure and underwriting practices that are consistent with the IFM instruments at a cost that does not impose misleading classification.

7. Conclusion

Interest free microfinance in India is an institutional solution to longstanding inclusion deviations and socio-cultural barriers that impact on involvement in interest-based finance. The evidence summarized in this paper indicates that IFM in India has evolved on a path of cooperative and community development and uses a set of instruments such as qard hasan type lending and murabahah financing or collateral based community lending and hybrid profit sharing systems (Khan and Nisar, 2004; Mohammed and Waheed, 2018). These pathways have the potential to develop trust and mobilize member savings; however, these are also the pathways that increase the significance of the quality of governance, transparency, and disciplined risk management to sustainability.

Convergence of regulations is thus at the center. The microfinance borrower protection system and the national inclusion policy of India offer an excellent normative foundation of responsible finance, which focuses on transparency, repayment capacity, and customer protection (Reserve Bank of India, 2021; Reserve Bank of India, n.d.). The paper concludes that responsible scaling of IFM in India should be based on three priorities as long as disclosure standards and reporting categories are made clear such that nothing is hidden and that the noninterest pricing is reported in a transparent and credible manner. The former is standards of disclosure of noninterest pricing which protect consumers and minimize confusion. The second is enhanced cooperation governance and Shari'ah assurance mechanism that enhances the credibility of the institution and minimises the weakness in the operation. Thirdly is policy integration which considers IFM as one of the many valid inclusion avenues that can be used to resolve the socio-cultural barriers and ensure that borrower protections and fair practices are never compromised.

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