Chapter 38
Blockchain for Islamic Financial Services Institutions: The Case of Sukuk Financing

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ABSTRACT

By enabling better traceability of funds against specific assets, technologies should appeal to a significant segment of the lending market – one that is religiously conscientious. Such Islamic FinTechs should therefore be disruptive for the existing regime of Islamic financial services institutions who have problems managing credit risk and compliance. Islamic financial instruments are no stranger to controversy. It emerged from the scandals that gaining investor confidence for Islamic financial instruments such as the Sukuk, which is the Islamic alternative to bonds and securities, investors demand more transparency in Sukuk to make sure they are Shariah-compliant, thus making traceability to assets a special hindrance to current schemes of Sukuk. In this chapter, the authors will discuss how technology could be disruptive in Islamic banking and finance sector keeping Sukuk as a case. The authors will further elaborate on it by discussing the proposed model of blockchain that could solve the issue of traceability which could also boost investor confidence in Sukuk.

INTRODUCTION

Blockchain technology represents a generational opportunity to mutualize database infrastructure across entities within financial services. What that translates into is an enormous cost-saving, risk-reducing, and capital-enhancing opportunity. (Blythe Masters)

DOI: 10.4018/978-1-7998-5351-0.ch038

The societal disharmony that results from a large income gap between the rich and poor is essentially what Islamic models of financing aim to alleviate. By eyeing a fairer distribution of risk and return between lender and borrower, such models focus on aiding the buying of assets on credit rather than directly taking out loans. Islamic financing, in spirit, is not about earning from loans but about helping people buy assets on credit or earn a profit from businesses.

The authors believe that blockchain technologies can greatly facilitate the type of large-scale asset-funding required by modern businesses and developers of infrastructure. By enabling better traceability of funds against specific assets, these technologies should appeal to a significant segment of the lending market – one that is religiously conscientious. Such Islamic fintechs (what is fintech?) should therefore disrupt the existing regime of Islamic Financial Services Institutions (IFSIs) as they have problems managing credit risk and compliance.

Islamic financial instruments are no stranger to controversy, with scandals such as those involving Dubai Islamic Bank, Invest Dar and Goldman Sachs to name a few. This suggests that Islamic Banks could also have spurious projects similar to their conventional counterparts. The authors believe that these controversies primarily arise from a lack of investor confidence in the compliance of an Islamic financial instrument to Shariah guidelines. In 2012, Goldman Sachs' $2 billion Islamic bond programme faced a setback when it emerged that the Sukuk were not endorsed by Shariah scholars, hence making it a spurious programme that adversely affected investor confidence. The programme was also accused of being used to finance other non-Shariah programmes that involved the interest-bearing side of conventional finance - an accusation that was rejected by the bank, yet further damaged already waning investor confidence. With such scandals, it emerged that gaining investor confidence for Islamic financial instruments, such as Sukuk (pronounced su-kook' – plural of sak) - the Islamic alternative to bonds and securities, is more challenging than for conventional bonds. Investors demand more transparency in Sukuk to make sure they are Shariah-compliant, thus making traceability to assets a notable hindrance to current schemes of Sukuk. This may also lead to questions such as whether technologies like blockchain could effectively rectify trust issues and also improve investor confidence in Islamic financial instruments. It is also worthwhile to mention that the current scheme of Sukuk financing requires the contract to be an operating lease rather than a finance one.

As the authors build up their argument on the crucial role technology may play in upscaling the growth of Islamic financial institutions, it is important to first briefly discuss what Islamic banks do and how they are different from their conventional counterparts.

In this chapter, the authors will discuss how technology could be disruptive in Islamic banking and finance sector using Sukuk as a case. The authors will further elaborate by discussing our proposed model of blockchain that could solve the issue of traceability and lead to a boost in investor confidence in Sukuk.

ISLAMIC BANKING AND FINANCE

Islamic banking and finance refers to financial activity that complies with Islamic Shariah law. The transactions undertaken by Islamic Financial Services Institutions (IFSIs) are required to follow Islamic Shariah-based principles. This sector is currently valued at over US$2 trillion globally and is growing rapidly. There has been significant work done in countries such as Malaysia, Saudi Arabia, Pakistan, Dubai and also the United Kingdom, in promoting and expanding this sector. It is already considered a mature market providing an Islamic alternate to conventional banking products and solutions.