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PARALLEL GOVERNANCE: THE PATH TO UNLOCKING THE POTENTIAL OF ISLAMIC FINANCE IN A CONVENTIONAL FINANCE SYSTEM

❖ Note ❖

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I. INTRODUCTION

The global debt levels have reached new records despite the massive technological advances made in recent decades.[1] The current global debt has reached approximately 350% of the global GDP, or the equivalent of $37,500 per person in the world.[2] Although international economists have forecasted that the global economy will continue to grow in 2023, albeit at a decreased rate of 2.7% from the 6% of 2021, their predictions are based upon gross domestic product, ("GDP"),[3] a metric that is often criticized as misrepresenting the true state of economic health or the general well-being of societies.[4] Looking at the debt levels within the United States alone, circumstances do not appear to be any better as federal borrowing has practically reached the nearly $31 trillion national cap, with the Treasury Department using latch ditch accounting maneuvers to postpone a default on the debt, which many view as being inevitable.[5]

However, as the governments of the world's economic powers rush to stave off a debt crisis that could reach cataclysmic proportions,[6] the global Islamic finance industry has proven itself to be resilient under mounting pressures, like the recent pandemic. Its success has come from its, unique principled approach that complies with the Environmental, Social, and Governance ("ESG") framework,[7] a tool utilized by institutions in assessing the sustainability of an organization.[8] Driven

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[1] *See* Nicole Goodkind, *The World Has a Major Debt Problem. Is a Reset Coming?*, CNN BUS. (Jan. 17, 2023, 7:37 AM), https://www.cnn.com/2023/01/17/investing/premarket-stocks-trading/index.html.

[2] *See id.*

[3] *See* IMF, *Countering the Cost-of-Living Crisis*, World Economic Outlook (Oct. 2022).

[4] *See, e.g.*, Joseph E. Stiglitz, *GDP Is the Wrong Tool for Measuring What Matters*, SCI. AM. (Aug. 1, 2020), https://www.scientificamerican.com/article/gdp-is-the-wrong-tool-for-measuring-what-matters/.

[5] *See* Drew Desilver, *5 Facts about the U.S. National Debt*, PEW RSCH CTR(Jan. 14, 2023) https://www.pewresearch.org/fact-tank/2023/02/14/facts-about-the-us-national-debt/.

[6] *See* Goodkind, *supra* note 1.

[7] *See* Shereen Mohamed & Tayyab Ahmed, *Islamic Finance Development Report 2022: Embracing Change*, REFINITIV, https://icd-ps.org/uploads/files/ICD%20Refinitiv%20ifdi-report-20221669878247_1582.pdf.

[8] *See generally What Is Islamic Finance?*, CORPORATE FINANCE INSTITUTE: CAPITAL MARKETS (Mar. 15, 2023), https://corporatefinanceinstitute.com/resources/capital-markets/islamic-finance/.

significantly by the high demands of increasing Muslim populations and consumers averse to the heightened risks of conventional financing from increasing interest rates, assets held by Islamic financial institutions ("IFIs") are forecasted to maintain double digit growth rates like the record rate of 17% seen in 2021.[9]

The theory that widespread adoption of Islamic financial practices could provide relief from the mounting debt levels is one of rational basis, but the feasibility of implementing Islamic financial practices on a large scale and stimulating the sustainable growth of these institutions in the American market may be problematic. Despite their demonstrated resilience and high demand amongst consumers, the principles of IFIs, especially the requirement that all transactions be underpinned by a legitimate trade or real asset,[10] are inherently at odds with the conventional financial scheme upon which the American system of regulating was built around,[11] and significant regulatory changes would be necessary if IFIs are to successfully proliferate and provide the economy with the needed relief.

This note will argue that if the current regulatory regime is modified to create a parallel governing structure that accommodates the principles and practices of IFIs, the growth of these institutions and their services could remedy the looming threat of increasing debt and grant the economy a reprieve for recovery. Part II provides a breakdown of the history and fundamentals of Islamic financial practices as well as conventional Western financial practices, how they differ from one another, and describes the current regulatory regime. Part III will analyze the risks associated with Islamic financial practices, the risks of the conventional Western financial practices, and the sustainability of each of the categories in practice. Part IV will argue that a substantive change in the regulatory framework to accommodate IFIs and their growth should be adopted if regulators want to avoid the total economic collapse threatened by the national and global debt crises.

II. BACKGROUND

The twentieth century marked the beginning of a new era in rapid growth of the global economy, driven largely by developments in international monetary systems, a restructuring of the major industries from technological innovations, and an expansion in the role of the public sector into the commercial space.[12] Spurred by decreased administrative controls on international capital mobility and increased free trade, the efforts to address the financial instability that arose following the World Wars, Western financial institutions were able to bypass any remaining controls[13] and penetrate the Islamic world by establishing branches.[14] Although the basic principles guiding trade and business in the Islamic world were established in the seventh century,[15] the end of European colonization, which had destroyed the previous socio-political and economic structures in the

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[9] *See* Mohamed & Ahmed, *supra* note 7.

[10] *See* CORPORATE FINANCE INSTITUTE, *supra* note 8.

[11] *See* Mona E. Dajani, *Islamic Financing and Structures in the USA*, 5 ISLAMIC FIN. AND MKTS L. REV. 133, 134 (2020).

[12] *See* IMF, *The World Economy in the Twentieth Century: Striking Developments and Policy Lessons*, World Economic Outlook (May 2000).

[13] *See id.*

[14] *See* Nagaoka Shinsuke, *Critical Overview of the History of Islamic Economics: Formation, Transformation, and New Horizons*, Kyoto University Asian and African Area Studies. 114, 115 (2012).

[15] *See generally* ROBERT CROTTY & TERRENCE LOVAT, ISLAM: ITS BEGINNINGS AND HISTORY, ITS THEOLOGY AND ITS IMPORTANCE TODAY, 2 (2016) (providing a historical account on the development of Islamic ideologies and practices).

Middle East, brought forth a need for new systems as a means of asserting Muslim independence and self-determination.[16]

The presence of Western banks in the Islamic world combined with an absence of viable alternatives to the Western banking model that could meet the demands of a globalized economy was a serious issue that needed resolving if Muslims wanted stabilized communities and participation in global trade.[17] The banking institutions of the West, having been developed and made profitable on the charging of interest, were found incompatible with the religious doctrines of Islam, as it strictly prohibits the use of interest in transactions.[18] In Islamic law, also known as "*Shariah"*, interest is considered usury, or "*riba*" in Arabic, and is strictly prohibited as it is traditionally seen as being a means for devouring the wealth of others and inherently based on a system of the gain of one at the loss of another.[19] Also, the *Shariah* prohibitions on gambling or speculation, known as "*maysir,"* as well as excessive risk and uncertainty in investments, known as "*gharar*," has made dealing with Western financial institutions while maintaining adherence to Islamic values extremely challenging.[20]

In response to the impracticalities of Western banking in the Islamic world and increasing pressure on the governments of Muslim countries, the 1970s witnessed a push for Islamic financial services[21] which spilled into the United States in the 1980s.[22] Emerging IFIs sought to base their services in three basic principles compliant with the rule of Shariah: equity, risk sharing, and real ownership.[23] Regarded as an alternative to interest-based transactions, the application of the principle of equity and equality of risk sharing is adopted in the transactions and services of IFIs as a measure of ensuring that none of the parties in any given transaction are at a disadvantage to another.[24] Whereas in conventional debt-financing the bulk of the risk is bore by the borrower in a lending transaction in the use of interest rates, Islamic finance views this practice as being unilaterally exploitative of borrowers[25] and returns on capital borrowed are predetermined in the form of a markup fee at the origination of a lending transaction, profit-and-loss sharing partnerships, or deferred payment contracts.[26]

The sharpest contrast between conventional Western and Islamic financial practices is the general underpinning of each of their respective transactions. *Shariah* requires all banking products and finance transactions to be backed by assets which are traded, rented, or invested in on a risk sharing basis.[27] Thus, IFIs are generally known to be asset-based,[28] although some EFIs may also

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[16] *See* ACADEMY FOR INTERNATIONAL MODERN STUDIES, *History of Islamic Banking*, https://aims.education/study-online/history-of-islamic-banking/.

[17] *See* Shinsuke, *supra* note 14, at 117-20.

[18] *See id.*

[19] *See* AZZAD ASSET MANAGEMENT, *Understanding Riba in Islamic Finance*, https://azzadasset.com/wp-content/uploads/2018/05/Riba-White-Paper.pdf.

[20] *See* CORPORATE FINANCE INSTITUTE, *Islamic Finance: Financing Activities that Must Comply with Sharia (Islamic Law)*, (Mar. 16, 2023), https://corporatefinanceinstitute.com/resources/capital-markets/islamic-finance/; *See also* Hamoudi, *infra* note 34 (arguing that true adherence to the Shariah is impossible under current regulations).

[21] *See* Ali Adnan Ibrahim, *Financial Innovations in the Muslim World: The Rise of Customary Businesses in International Financial Markets: An Introduction to Islamic Finance and Challenges of International Integration*, 23 AM. U. INT'L. REV. 661 (2008).

[22] *See* Dajani, *supra* note 11.

[23] *See* Mumtaz Hussain, Asghar Shahmoradi, & Rima Turk, IMF, *An Overview of Islamic Finance*, IMF Working Paper, WP/15/120, (Jun. 2015).

[24] *See id.*

[25] *See* Ibrahim*, supra* note 21.

[26] *See* Hussain, Shahmoradi, & Turk, *supra* note 23.

[27] *See* UBL, *Differences Between Conventional and Islamic Bank*, https://www.ubldigital.com/Banking/UBL-Ameen/Knowledge-Center/Differences-between-Conventional-Bank-and-Islamic-Bank.

[28] *See* Hussain, Shahmoradim & Turk, *supra* note 23.

offer equity-based products and services.[29] In contrast, Western financial conventions treat money as a commodity in itself and lend and borrow against it, operating on a system of credit with interest being its sole driver of profit.[30] The standard bank essentially acts as a liaison between the depositor and the borrowers the funds are lent to.[31] At any given moment, only a fraction of a customer's funds is readily available as banks rely on the notion that most will not need to access more than that fraction of their funds at any given moment.[32] Therefore, the entire system in practice operates as a debt-based system on credit.

Moreover, all banks in the United States must be licensed by either the Office of the Comptroller of the Currency ("OCC"), if they are national, or a state banking authority and all banks are subject to regulations imposed by the Federal Reserve System ("the Fed") and the Federal Deposit Insurance Corporations ("FDIC").[33] Although none of the laws in the current regulatory scheme of the United States expressly prohibit IFIs, many of the current regulations impose requirements that IFIs cannot comply with because they impose practices that conflict with *Shariah*.[34] This makes their proliferation within the U.S. banking market difficult, if not impossible, on a principled basis.[35]

For example, Islamic mortgage lenders must abide by the *Shariah* capital guarantee requirement that all transactions be underpinned by assets.[36] One way IFIs do so is by engaging in transactions called "*murabaha*."[37] In these transactions, the IFI will purchase real property, a home for example, and simultaneously enter into a lease-to-purchase agreement with a customer for the property from the IFI for the amount paid plus a flat premium markup.[38] In practice, this type of transaction resembles a lease-to-own deal.[39] However, the issue lies in that the National Bank Act[40] prohibits banks from holding real property with a provision that grants exceptions to four circumstances, none of which this type of transaction would fall under.[41] Although the statute was designed to protect consumers by preventing banks from holding masses of property[42] and by preventing speculation in real estate by banks[43] it was also largely implemented to forcefully reduce

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[29] *See generally*, Celine Meslier, Tastaftiyan Risfandy, & Amine Tarazi, *Islamic Banks' Equity Financing, Shariah Supervisory Board, and Banking Environments*, 62 PAC. BASIN FIN. J., (Sept. 2020) (inquiring into why IFIs rarely adopt equity-based practices despite their stronger compliance with the Shariah).

[30] *See* UBL, *supra* note 27.

[31] *See* Kyle Peterdy, CORPORATE FINANCE INSTITUTE, *ESG (Environmental, Social, and Governance): A management and Analysis Framework to Understand and Measure How Sustainably an Organization Is Operating*, (Feb. 22, 2023), https://corporatefinanceinstitute.com/resources/wealth-management/banking-fundamentals/.

[32] *See id.*

[33] *See* Dajani*, supra* note 11, at 135.

[34] *See* Haider Ala Hamoudi, Article, *The Impossible, Highly Desired Islamic Bank*, WM. & MARY BUS. L. REV. 105, 121-36 (2014) (discussing how American laws and regulations force violations of Shariah onto Islamic Banks).

[35] *See id.* at 121-24 (arguing that the current US regulations make Shariah compliant banking "absolutely impossible" and that its current permissibility has been conditioned on the maintenance of a fictional representation of its practices).

[36] *See* Dajani*, supra* note 11.

[37] *See* Keith S. Varian and Jennifer M. Rockwell, *Islamic Financing and Foreclosure*, 34 REAL EST. ISSUES 31, 33 (2009).

[38] *See id.*

[39] *See id.*

[40] *See* 12 U.S.C. § 38 (codified The National Bank Act).

[41] *See* 12 U.S.C. § 29.

[42] *See* National Bank and Federal Savings Association Premises, 86 Fed. Reg. 7979 (proposed Feb. 3, 2021) (codified in 12 C.F.R. 7).

[43] Colorado Nat'l Bank v. Bedford, 310 U.S. 41, 49 (1940); Exchange Bank of Commerce v. Meadors, 184 P.2d 458, 463 (Okla. 1947).

the risk banking institutions could take on.[44] The risk it was intended to prohibit, however, was exactly the type of risk created in the profit and loss sharing principles that IFIs base their practices upon.[45] In 1997 an accommodation was made for *murabaha* transactions when the OCC, under pressure from the Bank of Kuwait,[46] issued an interpretive letter reconciling the statutory violations posed by its principle in practice.[47]

Additionally, the Western banking system has long operated on a system of creditworthiness, requiring institutions to partake in the debt-based credit system in order to access the capital that is needed to hedge against liquidity risks and insure themselves.[48] IFIs in the United States are subject to the insurance requirements governing deposits, imposed by the FDIC, if they do not meet the high minimum capital requirements[49] to be sufficiently liquid and allow depositors to withdraw funds at any time without notice.[50] The FDIC, established during the catastrophic bank failures of the Great Depression, was intended to promote stability and consumer confidence in the nation's banking systems by guaranteeing that depositors would not lose their funds if a bank failed.[51] However, this standard practice of insuring is not *Shariah* compliant because it creates an imbalance in the apportionment of risk by reimbursing depositors using funds which they have not contributed to regularly.[52] As commentators have argued, by ensuring that bank depositors suffer no losses from risky lending practices, this insurance requirement effectively requires IFIs to violate their *Shariah* compliant profit and loss sharing model.[53] But, if IFIs are to offer relief to the issues caused by overleveraging, regulatory agencies need to make substantive changes to accommodate the alternative approach, rather than use superficial technicalities to reconcile them with the very practices and standards that caused the debt crisis in the first place.

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[44] *See* Office of the Dist. Counsel, Comptroller of the Currency, Interpretive Letter #867, (June 1, 1999) (stating that Murabaha transactions were compliant with the National Bank Act, in part, because they would not expose the IFI to greater risks than it would face in a traditional real estate financing transaction).

[45] *See* Office of the Dist. Counsel, Comptroller of the Currency, Interpretive Letter #806, (Oct. 17, 1997) (arguing that when an agreement transfers all of the benefits and risks incident to the ownership of property to the lessee while the lessor retains title to the property it is not a form of an impermissible risk to banks); *see also* Hamoudi, *supra* note 34, at 115-36 (describing the profit and loss sharing scheme underlying IFIs and analyzing why it runs directly afoul and is the very antithesis of conventional Western banking practices).

[46] *See* Huda Ahmed, Note, *Not Interested in Interest? The Case for Equity-Based Financing in U.S. Banking Law*, OHIO ST. BUS. LAW. J. 479, 481 & n.9 (2007).

[47] *See generally* Office of the Dist. Counsel, Comptroller of the Currency, *supra* note 45; *see also* Office of the Dist. Counsel, Comptroller of the Currency, *supra* note 44; U.S. DEP'T OF TREASURY, *Speech: Regulation of Islamic Financial Services in the United States*, (Mar. 2, 2005) (discussing regulations on Islamic financial services and noting that although federal regulators have provided "little formal guidance with respect to Islamic financial products," the OCC has been able to deem certain products permissible through its interpretive letters).

[48] *See* Dajani*, supra* note 11, at 135-38; *see also* Hamoudi, *supra* note 34, at 130-31 (explaining how FDIC insurance prevents financial collapses caused by bank runs by depositors).

[49] 12 C.F.R. § 324.1 (establishing minimum capital requirements and overall capital adequacy standards for FDIC-supervised institutions).

[50] 12 U.S.C. § 1841(c)(1)(b) (defining banks under the purview of the Federal Deposit Insurance Act as including those that "accept demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others"); *see also* Hamoudi, *supra* note 34, at 129-31 (stating that due to the widespread practice of offering FDIC insurance, it would be hard for any banking institution of a significant size to operate without it and noting that there is only one IFI in the United States offering demand deposit services, which has had to become federally insured).

[51] *See generally* Bill Chappell, *The FDIC Was Created Exactly for this Kind of Crisis. Here's the History,* NPR, (Mar. 14, 2023, 8:05 AM), https://www.npr.org/2023/03/13/1163138002/the-fdic-insurance-limit-was-last-raised-in-2008-heres-how-it-works.

[52] *See* Dajani*, supra* note 11, at 136.

[53] *See also* Hamoudi, *supra* note 34, Part II (describing the areas of financial regulation that make Shariah compliant banking based on profit and loss sharing principles illegal).

III. ANALYSIS

In the years preceding the Great Recession of 2008, the residential housing market experienced a boom which mortgage lenders were eager to capitalize on.[54] Lenders proceeded to approve as many loans as they could, including to subprime borrowers not typically qualified for conventional loans due to their heightened risk of defaulting, and then, to profit off the low interest rates, bundled the loans together and sold them to secondary market investors.[55] Through the complex process of securitization, Western mortgage lenders were able to secure new fundings by selling off their consumer debt holdings to securities investors, effectively transferring the risks to the investors while generating new capital for lending.[56] Then during the recession, Congress authorized the Department of Treasury (the "Treasury") to establish federal programs to stabilize the financial system[57] or, as many viewed them, bail outs for the lending institutions whose risky lending practices caused the recession in the first place.[58] Rather than acknowledging the failure of the conventional financing system and its high-risk propensities, the government swept it under the rug.

As originally intended, the securitization of debt assets allows institutions to reduce their borrowing costs through the transfer of risk and thus lower their minimum capital requirements as enforced by regulators.[59] This practice has historically proven to have a net positive outcome in slow-moving developing economies in need of capital to stimulate their growth.[60] However, as demonstrated, practices like securitization, that leverage and transfer debts, are inherently high risk because their profits and the value of their assets are dependent on interest rates.[61] Once interest rates rose to remedy inflation fears, loans that originated at lower interest rates and were securitized became practically worthless.[62] The overall value of assets held by institutions engaged in this practice dropped and they became faced with a liquidity crisis.[63] As the banks failed, the FDIC stepped in and made sure that no one lost a penny of insured deposits.[64] Ultimately, it was consumers who bore the cost of the risky banking practices through higher interest rates on their debts, foreclosures on their homes, high unemployment rates, and through the government bail outs, using taxpayer dollars, of the very institutions who were at fault in the first place.[65]

Despite the global impact of the crisis, institutions that did not engage in high-risk securitization practices and those who took caution in retaining non-interest rate dependent assets

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[54] *See* Anne Field & Jasmine Suarez, *What Caused the Great Recession? Understanding the Key Factors that Led to One of the Worst Economic Downturns in US History*, BUS. INSIDER (Aug. 8, 2022, 2:56 PM), https://www.businessinsider.com/personal-finance/what-caused-the-great-recession.

[55] *See id.*

[56] *See* IMF, MONETARY AND CAP. MKTS. DEP'T. *Back to Basics: What Is Securitization*, (Sept. 2008) Andrea Jobst (Economist).

[57] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008) (authorized the Department of Treasury to create the Trouble Assisted Relief Program or "TARP").

[58] *See e.g.,* Field & Suarez, *supra* note 54.

[59] IMF, *supra* note 56.

[60] *Id.*

[61] Field & Suarez, *supra* note 54.

[62] *Id.*

[63] *Id.*

[64] *See generally* Brit McCandless Farmer, *What the FDIC Does When a Bank Fails*, CBS NEWS, (Mar. 19, 2023), https://www.cbsnews.com/news/what-the-fdic-does-when-a-bank-fails-60-minutes-2023-03-19/ (explaining how the FDIC responds to bank failures and what it does for consumers).

[65] *See generally* John Cassidy, *The Real Costs of the 2008 Financial Crisis*, NEW YORKER, (Sept. 17, 2018), https://www.newyorker.com/magazine/2018/09/17/the-real-cost-of-the-2008-financial-crisis (describing the aftermath of the 2008 crisis and its long-term consequences).

weathered the storm better.[66] Amongst them were IFIs, whose principles prohibited them from engaging in the high-risk interest-rate dependent practices that precipitated the crisis.[67] It is likely that if the institutions at fault adhered to the *Shariah* prohibitions on the use of interest for profit and speculation, the crisis never would have occurred. Hence, IFIs have become attractive for investors with recession concerns and those seeking to mitigate risks through diversification.[68]

Also, the inherent alignment of IFIs with the ESG approach has led some across the world to review it as a being well suited for economic recovery. Due to their macro-level aim of reducing inequity while fostering prosperity through contract moderated risk sharing,[69] IFIs would never engage in the excessively high-risk practices that caused the crisis. Even lenders responsible for the 2008 crisis, like Fannie Mae and Freddie Mac, have purchased *Shariah* compliant Islamic mortgages as hedges against their own subprime lending.[70] However, the profit and loss sharing basis of IFIs has its own risks but, unlike conventional financing, its risks incentivize stronger management and due diligence.[71] Being outcome dependent, IFIs have a greater incentive to exercise caution in their investment practices and thus, theoretically, a higher utility can be achieved using their methods of financing as opposed to debt financing.[72] In contrast, western debt-based financing practices are not only inherently higher risk, but their practice is also enabled by the assurances granted by FDIC regulations and requirements.[73] Although FDIC insurance was intended to maintain stability in the banking industry, it also creates a problem of a "moral hazard," where banks can take excessive risks with deposits knowing that if they fail the government will rescue their depositors rather than hold them accountable.[74]

In recent news, US banking saw the second largest bank failure in history which has caused great alarm in the markets.[75] Silicon Valley Bank ("SVB") experienced a reckoning when its decision to invest 94.4% of its deposits in low interest rate bonds and mortgage securities proved to be fatal once inflation increased and interest rates rose to tame it.[76] Not only was SVB dependent on interest for profit, but it also failed to back its transactions with enough liquid assets while gambling that interest rates would not rise and drop the value of its holdings.[77] Keeping in line with the 2008 failures, the federal government has announced that all depositors will be fully protected,[78] making an exception for funds that surpassed the $250,000 maximum that has been in place since 2008.[79] Given the current debt crisis, this exception complicates the issue because the funds used to repay

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[66] Hussain, Shahmoradim & Turk, *supra* note 23.

[67] *Id.*

[68] SHAYERAH ILIAS, CONG. RSCH. SERV., ISLAMIC FINANCE: OVERVIEW AND POLICY CONCERNS, 7-5700 (2010).

[69] *See* Susannah Hammond, *The ESG potential of Islamic Finance*, THOMSON REUTERS, (Jun. 14, 2022), https://www.thomsonreuters.com/en-us/posts/news-and-media/islamic-finance-esg/.

[70] ILIAS, *supra* note 68.

[71] *See generally* Hamoudi, *supra* note 34 (describing the profit and loss sharing scheme).

[72] *See generally* Abdulali Hadizada and Peter Nippel, Article, *Islamic Profit and Loss Sharing Contracting versus Regular Equity in Entrepreneurial Finance: Risk Sharing and Managerial Incentives*, 24 PEPP. UNIV. J. ENTREPRENEURIAL FIN. 209, 238-39 (2022) (providing a theoretical mathematical analysis of Islamic finance practices).

[73] *See* Sheila Bair, *Bank Bailouts Propped up the Financial System. But We Should Never Repeat Them,* WASH. POST, (May 23, 2019, 9:50 PM), https://www.washingtonpost.com/outlook/bank-bailouts-propped-up-the-financial-system-but-we-should-never-repeat-them (Sheila Bair is the former chair of FDIC and she argues that banks should be allowed to fail as check on risky behavior rather than bailed out).

[74] *See* John Turner, *Why Did Silicon Valley Bank Fail,* ECONOMICS OBSERVATORY, (Mar. 17, 2023), https://www.economicsobservatory.com/why-did-silicon-valley-bank-fail.

[75] *Id.*

[76] *Id.*

[77] *Id.*

[78] *See* U.S. DEP'T OF TREASURY, FED. RSV., AND FDIC, *Joint Press Release* (Mar. 12, 2023, 6:15 PM).

[79] *See* Chappell, *supra* note 51.

depositors will need to be borrowed from the Treasury if the Deposit Insurance Fund ("DIF") runs out.[80] Market commentators are concerned that if additional bank failures like SVB continue to occur before Congress can raise the debt ceiling, the risk of default on the national debt will increase.[81]

While recent times have shown that the government will bail out financial institutions when they make a mess, IFIs do not have those same assurances due to the limitations of the Establishment Clause of the Constitution[82] and the markets lack the infrastructure that can assist them in hedging liquidity risks.[83] Even though IFIs are structured around compliance with a particular moral framework, they are also open to consumers seeking their offered services from all backgrounds. However, their religious affiliation subjects any governmental support to judicial strict scrutiny when challenged[84] against the Establishment Clause.[85] Additionally, since they are privately held, like all financial institutions in the United States, IFIs face another issue in the operational differences across the industry.[86] The religious underpinnings of their principled approaches are varied across the different Islamic schools of thought, with each IFI having its own *Shariah* Board advising it on compliance with respect to the schools of thought adhered to by the Board members,[87] and devising a regulatory framework that can meet all their needs in a uniform manner could be difficult.[88]

IV. Recommendation

With the looming threat of economic collapse on the horizon, financial regulators should be looking at all potential remedies rather than transferring debts through accounting measures. Granted, individual consumers may be reluctant to allow changes in regulatory regime to accommodate institutions grounded in religiously derived viewpoints, specifically those associated with Islam, because of the negative stigmas associated with the faith practice.[89] However, as researchers for some of the preeminent capital market indexes have said, averting the crisis will require unpopular actions and a great reset of policymaker mindset.[90] While members of Congress are calling for the quick fix of raising the debt cap, it will not provide a long-term solution if financial institutions continue to trade debt as a commodity rather than backing their trades by liquid assets.[91]

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[80] *See* Sonali Basak, *The Big Bailout Bet: Markets are Rattled and Waiting for More Shoes to Drop,* BLOOMBERG, (Mar. 13, 2023, 11:17 AM), https://www.bloomberg.com/news/newsletters/2023-03-13/what-comes-after-svb-signature-bank-collapse-bailout.

[81] *Id.*

[82] U.S. CONST. amend. I ("Congress shall make no law respecting an establishment of religion or prohibiting the free exercise thereof.").

[83] Dajani*, supra* note 11.

[84] *See Agostini v. Felton*, 521 U.S. 203, 222-23 (1993) (modified the criterion of the *Lemon* test for excessive entanglement inquiries between government and religion in federal statutes).

[85] *See generally* Hania Masud, Paper, *Takaful: An Innovative Approach to Insurance and Islamic Finance*, 32 UNIV. PA. J. INT'L LAW, 1133-1164 (2011) (examining the viability of the practice of insurance under the principles of Islamic finance in light of potential Establishment and Entanglement Clause issues).

[86] Hussain, Shahmoradim & Turk, *supra* note 23.

[87] *See generally* Shinsuke, *supra* note 14 (describing the various views held by Islamic scholars on finance practices).

[88] *See e.g.*, Hussain, Shahmoradim & Turk, *supra* note 23.

[89] ILIAS, *supra* note 68 (stating that some U.S. financial institutions express concerns about the possible ties of IFIs to terrorist finance networks but that others assert that the risks of IFIs funding terrorism are not greater or different from conventional financing institutions).

[90] *See e.g.,* Goodkind, *supra* note 1.

[91] *See* Goodkind, *supra* note 1.

For the long-term sustainability and health of global markets and the US economy, it is imperative for financial institutions and governing bodies to transition away from high-risk speculative practices associated with debt-based financing and towards asset-based or equity-based financing. Regulators should hold banks accountable instead of enabling them to invest in interest dependent assets under the FDIC safety net. Allowing the reliability of institutions to dictate customer deposits would be a much more prudent approach. As such, the FDIC insurance requirements should be lifted, providing banks and consumers the option to choose their level of participation.

Additionally, to enhance oversight of IFIs, financial regulators should establish a separate agency with a specialized Shariah Board, well-versed in various schools of thought, that runs parallel to current agency regulators.[92] This agency can enforce consistent requirements across all IFIs, ensuring consistency and uniformity in their financial practices while limiting potential confusion for customers arising from a lack of familiarity with the products and services they offer. Moreover, the creation of a parallel regulatory structure for IFIs will facilitate their development and offer a safety net to IFIs that hedges against the risks of debt-based financing, serving as a remedy to the current debt crisis. By adopting these measures, financial institutions can contribute to the stability and long-term prosperity of both global and US markets.

V. CONCLUSION

When repeatedly faced with economic crises resulting from reckless speculative financial practices, the reasonable conclusion becomes that the practices must cease and be replaced with healthier alternatives. The current debt-based financing practices have proven to be unreasonably reckless, exploitative of consumers, and only beneficial to a minority profiting off them. Consumers entrusting their wealth to financial institutions should have confidence that their funds will not be used in reckless lending schemes. This fundamental fiduciary trust lies at the core of Islamic finance and banking practices. Implementing such principles into the economy, if done properly and embraced, can effectively address issues stemming from overleveraging debts.

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[92] *See* U.S. DEP'T OF TREASURY, *Speech: Regulation of Islamic Financial Services in the United States*, (Mar. 2, 2005) (expressing that US regulators understand the importance of IFIs and have a desire to learn about the principles so that they can accommodate them. Also explained the case-by-case approach adopted in issues raised by IFIs in granting them special permissions for the financial products and transactions).