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Client Alert

Providing Strategic Legal Guidance to the Global Financial Services Industry

FINANCIAL SERVICES

APRIL 20, 2021

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LIBOR Transition: Challenges for Islamic Finance Transactions

INTRODUCTION

On 5 March 2021, the UK's Financial Conduct Authority (the **FCA**) announced that all LIBOR settings will either cease to be provided by any administrator or will no longer be representative by 31 December 2021 or, for some LIBOR settings, by 30 June 2023. This client alert examines the implications of the cessation of LIBOR in the context of Islamic finance transactions and suggests potential solutions for the *Shari'ah*-compliant use of near risk-free reference rates (**RFRs**) in such transactions.

For the purposes of illustration, this client alert only focuses on *murabaha* transactions and the potential issues arising as a result of the use of RFRs. Other Islamic financing techniques (such as *ijaras*) and other financial markets (such as derivates) are outside the scope of this client alert.

BACKGROUND: CESSATION OF LIBOR

In July 2017, Andrew Bailey, then Chief Executive of the FCA, announced that market participants should not rely on LIBOR being available after 2021.

More recently in March 2021, the FCA announced the dates on which each LIBOR setting will either cease to be provided by any administrator or will no longer be representative. In summary, LIBOR settings will permanently cease or will no longer be representative:

- immediately after 31 December 2021 for all sterling, euro, Swiss franc and Japanese yen settings and for one-week and two-month US dollar settings; and
- immediately after 30 June 2023 for the remaining US dollar settings.

The announcement marks a formal confirmation of the cessation of the LIBOR benchmark.

Over the past years since the initial announcement by the FCA, work has been progressing on the transition to alternative RFR in each of the five LIBOR currencies.

LIBOR and RFRs are fundamentally different in a number of ways. For the purposes of this client alert we have focused on the following key distinctions:

- **LIBOR is a forward-looking term rate**: It is a term rate (with seven tenors) which is reset periodically in advance. This means that the rate is fixed and is known at the start of each calculation period. LIBOR takes into account term credit risk and interest rate changes over the relevant tenor and interest is paid in arrears.
- **RFRs are backward-looking rates**: RFRs are reset daily, they are backward-looking and they are overnight. This means that such rates are not known at the start of each calculation period. Instead, they are determined on the basis of historical data at the end of each calculation period. They have virtually no term credit risk priced in.

ISLAMIC FINANCE: THE PRINCIPLE OF CERTAINTY AND CHALLENGES WITH RFRS VS. LIBOR

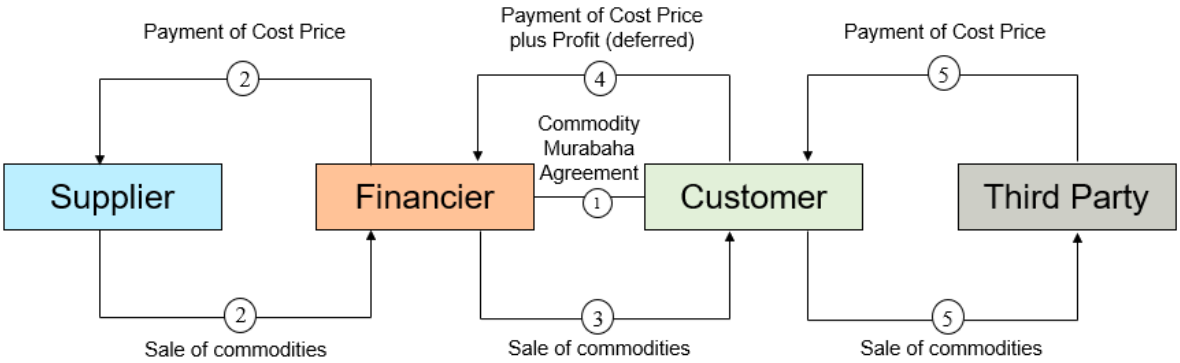
Islamic finance is based on Islamic principles and jurisprudence which enable Islamic investors to participate in the financial markets in conformity with their faith. Therefore, any Islamic finance transaction must comply with the principles of Islamic *Shari'ah*.

One of the key principles of Islamic *Shari'ah* is the prohibition on uncertainty (*gharar*). This principle requires absolute certainty as to all fundamental terms of an Islamic finance contract. Therefore, any contract which contains uncertainty as to one of the fundamental terms (such as subject matter or price) is void.

The significance of this principle is illustrated in the context of commodity *murabaha* financings. Commodity *murabaha* financings are one of the most commonly used Islamic financing techniques which currently form the lion's share of lending transactions (including corporate financings) in this area.

A commodity *murabaha* agreement is executed between a financier (as the seller) and a customer (as the purchaser). The financier sells specified commodities to the customer on a spot delivery and deferred payment basis. The deferred price comprises the cost price (being the cost price at which the financier has purchased the commodities) and profit (being a pre-agreed profit). The deferred price is paid on deferred payment terms as per the agreement of the parties – for instance, at the end of the term of a *murabaha* contract or on agreed payment dates.

Murabaha Transaction



STEPS:

1. Financier (as seller) enters into a commodity *murabaha* agreement with Customer (as purchaser) pursuant to which Financier agrees to sell, and the Customer agrees to purchase, certain *Shari'ah*-compliant commodities (e.g., metals on the London Metal Exchange) (the **Commodities**). The consideration for the Commodities is the aggregate of (a) the cost price payable by Customer to Financier for the Commodities (the **Cost Price**) and (b) a pre-agreed mark-up (the **Profit**) (the Cost Price together with the Profit, being the **Deferred Price**). The Deferred Price is fixed at the start of each calculation period, and paid on a deferred basis. The Profit may comprise a conventional financing benchmark (e.g., LIBOR) plus a margin (representing the profit to Financier for the transaction).
2. Supplier (as seller) makes spot delivery of the Commodities to Financier (as purchaser). The consideration paid by Financier (as purchaser) to Supplier (as seller) is the Cost Price (being the market price for the Commodities).
3. Financier immediately upon the purchase of the Commodities from Supplier sells those Commodities to Customer, and Customer acquires title to the Commodities.
4. Customer agrees to pay to Financier the Deferred Price in accordance with the terms of the commodity *murabaha* agreement.
5. Immediately upon purchasing the Commodities from Financier, Customer (as seller) sells those Commodities to Third Party (as purchaser) on a spot basis for an amount equal to the Cost Price (being the market price for the Commodities). Third Party acquires title to the Commodities.

Following the completion of the above steps, Customer obtains a cash sum, with an obligation to pay the Deferred Price. After a *murabaha* calculation period expires (e.g., after 3 months if the Profit is linked to a 3-month LIBOR), a new *murabaha* contract is entered into, pursuant to which new commodities are purchased and sold as outlined above. As a result of netting, Customer will only pay Financier the Profit (comprising LIBOR and margin after the 3-month period). The Cost Price is then paid at the maturity date of the *murabaha* (or as otherwise agreed).

In the context of a conventional facility, Financier (the lender under a conventional facility) enters into a loan agreement with the Customer (the borrower in a conventional facility) to advance a loan (being an amount equal to the Cost Price component of the Deferred Price). Under such conventional arrangement, the Customer agrees to repay the loan (being the Cost Price), together with the agreed interest (being the Profit) in accordance with an agreed payment schedule over the term of the loan (being the deferred payment period under the *murabaha* financing). Based on the foregoing, parties to a *murabaha* transaction should be able to participate in the financing markets on the same broad economic terms as their conventional counterparts.

A key feature of the above structure which ensures that it meets the *Shari'ah* certainty requirements is that the Deferred Price must be at an agreed rate, for an agreed period and set at the start of each calculation period.

In *murabaha* financings using LIBOR, certainty as to pricing is achieved by fixing the profit rate at the start of each calculation period. In contrast, this will not be possible using RFRs where the rate for each day in the period would only be known at the end of the period.

POTENTIAL SOLUTIONS

We have set out below a number of potential solutions to the above highlighted issue:

- **Use of term risk free rates**

The FCA and the Working Group on Sterling Risk-Free Reference Rates have made it clear that RFRs "should become the norm in most … bilateral and syndicated loan markets given the benefits of the consistent use of benchmarks across markets and the robust nature of" such rates. Equally, they have acknowledged the continued use of term RFRs in limited circumstances, including Islamic finance.

The level of progress in developing term RFRs has been limited globally which in practice does not render the use of such rates as a viable alternative rate to RFRs in the context of Islamic finance transactions. Furthermore, it is not clear if term RFRs will be available in all currencies. For instance, it is unlikely that a term RFR will be produced for Swiss francs.

We believe that Islamic finance participants have always looked to create a level playing for the Islamic investors, and using a rate different to that used in the majority of syndicated loan transactions does not sit at ease with such an outlook. It will also make it difficult to compare the pricing of Islamic financial products with their conventional counterparts - which is far from ideal.

In the meanwhile, we will be closely monitoring the development and uptake of the term RFRs in Islamic finance transactions.

- **Reconciliation / equalisations**

RFRs are backward-looking and only available at the end of the calculation period to which they relate. The Profit is set at the start of each calculation period by reference to the available RFR (i.e., instead of using the forward-looking LIBOR, the Financier uses the backward-looking RFR as the basis for calculating the Profit (being the RFR for the prior calculation period and, in the case of the first calculation period, before the commencement of the facility). At the end of each calculation period the Profit is calculated again for that calculation period using the RFR. Comparing the two Profit amounts enables the Financier to calculate the actual Profit for that calculation period. Such difference can then be taken into account when calculating the Profit for the subsequent calculation period. This process is then repeated until the maturity date.

A variation of the above option would be that, for the first calculation period, there is no Profit (as there is no rate available for that calculation period at the start of such period). At the end of the first calculation period the Profit is calculated by applying the RFR (available at the end of such calculation period). Such amount is stated to be the Profit for the second calculation period, payable on the first day of the second calculation period. This process is then repeated until the maturity date.

With respect to both of the above options, there is an issue with respect to the Profit for the final calculation period as there is no subsequent period. Therefore, there needs to be a mutual undertaking from the Customer and the Financier to make any reconciliation payments.

Another issue would arise if the facility is accelerated on a day other than a reconciliation date. In such scenario, the Financier would not be entitled to the reconciliation amount (as such amount has not yet been determined and therefore has not become due and payable).

- **Reconciliation / rebate**

A tweak to option one above (under the heading Reconciliation / equalisations) would be that Financier fixes the Profit at the start of each calculation period by reference to the then-available RFR (i.e., for the prior calculation period) plus a margin. At the end of each calculation period the Profit is calculated again for that calculation period using the RFR. Financier grants Customer a rebate (i.e., the difference between the two Profit amounts). Whilst this ensures that

Financier is not out of pocket if the facility is accelerated prior to a reconciliation date, from a practical perspective, Customer may not have sufficient funds to pay a higher rate of return.

- **Islamic benchmark rate**

The Islamic finance industry has over the years discussed the need for a separate benchmark rate for Islamic finance transactions. However, the discussion around any such rate very much remains at its embryonic stages.

CONCLUSION

The transition from LIBOR certainly exposes the Islamic finance industry to new challenges. Such challenges are further exacerbated by certain local / market specific factors, including the following:

- Although the financial institutions in the Gulf Cooperation Council (the **GCC**) have been focused on updating their internal regulatory and operational systems, limited overall progress has been witnessed in the GCC in terms of financing documentation (including conventional facilities) reflecting the cessation of LIBOR (for instance, by reference to a hard-wired switch to the fallback reference rate), compared to the US and the UK.
- It is also worth noting that financing transactions denominated in local currencies in the GCC refer to local IBORs – for instance EIBOR (for UAE Dirham), SAIBOR (for KSA Riyals) and OMIBOR (for Omani Riyals). Although each of those currencies are pegged to US Dollars, there is currently no intention to discontinue or replace such rates. The implication of the divergence between such IBORs and the introduction of RFRs is likely to add a further layer of practical complexity in this area. This risk may somewhat be mitigated by the fact that a large number of loan transactions in the region are in US dollars.

The Islamic finance industry recognises the above challenges as illustrated by the issuance of its first White Paper by the International Islamic Financial Market in March 2021.

We remain committed to facing the challenges together with our clients and trusted partners alike. Please do not hesitate to contact us if you would like to further discuss any of the issues raised in this client alert.

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