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Islamic Financing Faces A Post-Libor Test

By **Jawad Ali, Michael Rainey and Asal Saghari** (May 28, 2021, 1:05 PM EDT)

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Structuring Islamic financings is an intricate task.

On the one hand, there is navigating the tax, regulatory and legal framework of the relevant jurisdiction.

Running parallel to this is Islamic Sharia, the framework that governs Islamic jurisprudence.

Any contractual agreement must be legally valid, binding and enforceable before the applicable court while simultaneously ensuring it is permissible under Islamic Sharia.

There have been many challenges — and creative solutions — over the years in facilitating the fusion of Islamic Sharia, and the latest test looming on the horizon is the impending cessation of Libor.

The Demise of Libor

Dec. 31, 2021, will officially see the beginning of the end for Libor — a benchmark interest rate utilized since the 1970s for the pricing of various financial products based on submissions of rates from major financial institutions.

Libor's demise was largely down to the scandal from almost a decade ago when it emerged that numerous bankers and financial institutions had submitted interest rates to manipulate the Libor rates, either up or down.

The scandal led to regulatory, civil and criminal fallout, costing the banks billions.

The U.K.'s Financial Conduct Authority, or FCA, most recently announced that all Libor settings will either cease to be provided by any administrator or will no longer be representative by Dec. 31, 2021, for all British pound sterling, euro, Swiss franc and Japanese yen settings and for one-week and two-month U.S. dollar settings; and immediately after June 30, 2023, for the remaining U.S. dollar settings.

Libor will be replaced by near risk-free reference rates, or RFRs.

A crucial difference between RFRs and Libor is that Libor is a forward-looking term rate whereas the RFR system is anchored in the most recent interest rates.

Libor is a term rate — with seven tenors — that is reset periodically in advance, so the rate is fixed and established at the beginning of any given term. It also factors in term credit risk and interest rate changes over the relevant tenor and interest is paid in arrears.

In contrast, RFRs are retrospective. They can be reset daily so any rates are not known at the start of any given term but formed on the basis of historical data, resulting in an almost risk-free measure of borrowing costs. RFRs have virtually no term credit risk priced in.

Consequently, RFRs throw up certain unique issues for Islamic finance as Libor was one of the most common benchmark rates for Islamic financing transactions.

Added Nuances For Compliance

The shift to RFRs has been closely watched by those in the Islamic finance sector. The FCA and the Prudential Regulation Authority are the two regulatory bodies that oversee Islamic finance in the U.K.

Both conventional and Sharia-compliant lenders operating in the U.K. are held to the same regulatory standards, albeit that the U.K. regulators are not involved in the specifics of Islamic Sharia structurings.

As such, the transition from Libor to RFRs can be separated between the rather straightforward change in a traditional regulatory sense and the added nuances for Sharia compliance.

For instance, a critical factor when it comes to Islamic Sharia is the prohibition on uncertainty, or gharar, which requires complete certainty as to all fundamental terms of an Islamic finance contract. If a contract has any uncertainty as to one of the fundamental terms, such as subject matter or price, that contract will be null and void under Islamic Sharia.

Murabaha financing, for example, is a technique utilized in Islamic finance transactions to provide various forms of financing — ranging from working capital to acquisition financing. In essence, an entity wishing to obtain finance — being the customer — enters into a murabaha agreement with a financier.

In such a transaction the customer, as purchaser, agrees to purchase, and the financier agrees to sell, certain Sharia-compliant commodities — e.g., metals on the London Metal Exchange.

The amount payable under the murabaha agreement is the aggregate of (a) the cost price payable by customer to the financier of the commodities (the cost price) and (b) a pre-agreed markup (the profit, which is the cost price together with the profit, being 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 the financier for the transaction.

In the example of murabaha, however, moving to an RFR system effectively makes the model prohibited. RFRs are backward-looking, meaning that any rates, unlike under Libor which could be established at the commencement of a term, can only be applied at the end of a term, falling foul of gharar provisions.

There are a number of options to try to solve this challenge.

Term RFRs

The FCA and the Working Group on Sterling RFRs 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.

Islamic finance participants have often aspired to create a level playing field for Islamic investors, and using a rate different from that used in the majority of syndicated loan transactions would 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.

Reconciliation and Equalization

RFRs are backward-looking and only available at the end of the calculation period to which they relate.

Under this option and taking the murabaha example, the profit is set by the financier — i.e., the seller under a murabaha — 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 — i.e., 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 — being the purchaser under a murabaha — 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 a 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 and Rebate

A modified version of the reconciliations and equalizations model would see that the financier fix 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. The financier grants the customer a rebate — i.e., the difference between the two profit amounts.

While this ensures that the financier is not out of pocket if the facility is accelerated prior to a reconciliation date, from a practical perspective, the customer may not have sufficient funds to pay a higher rate of return.

Looking Ahead

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.

As with many Islamic finance structuring issues, the demise of Libor throws up a unique set of challenges.

In this instance, the new RFR system may be backward-looking but it is forward-looking creativity that will help structure Sharia-compliant models that can function within both the RFRs and the Islamic finance requirements.

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