CLIFFORD CHANCE

TRANSITIONING FROM LIBOR: IMPLICATIONS FOR ISLAMIC FINANCE

– THOUGHT LEADERSHIP

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TRANSITIONING FROM LIBOR: IMPLICATIONS FOR ISLAMIC FINANCE

The discontinuation of LIBOR as an interest rate benchmark raises a number of issues for Islamic finance transactions. This briefing looks at the challenges ahead and outlines some of the potential solutions.

Key issues

- LIBOR is likely to cease to exist by the end of 2021.
- There is an incompatibility between "backward-looking" RFRs and Shari'a principles in Islamic financing.
- The development of suitable and consistent solutions for the use of RFRs within the Islamic finance market is a priority.

In July 2017, Andrew Bailey, then Chief Executive of the UK's Financial Conduct Authority ("**FCA**"), announced the need for the market to transition away from LIBOR as an interest rate benchmark before the end of 2021. Working groups established for each of the five LIBOR currencies have since chosen replacement overnight risk-free rates ("**RFRs**"). These RFRs are currency specific and each currency working group is at a different stage of transition. For example, SONIA (the replacement rate for Sterling LIBOR) and SOFR (a replacement rate for USD LIBOR) have been published since April 2018, whereas €STR (the replacement rate for EONIA) was only published for the first time in October 2019.[1]

Regulators and policymakers remain focused on managing the transition away from LIBOR and discussions remain ongoing around the roles of competent authorities and legislative proposals, such as those tabled by the US Alternative Reference Rate Committee ("**ARRC**") in March 2020 and the Working Group on Sterling Risk-Free Reference Rates, suggesting that regulatory or legislative assistance could be considered in New York and the UK. These discussions provide an important forum for market participants to raise issues which arise for different products transitioning away from LIBOR.

Overview

The RFRs which have been selected differ from LIBOR in a number of material respects. LIBOR is a "forward-looking" term rate, meaning that the rate is fixed and publicly available at the start of each calculation period. In contrast, the RFRs are overnight rates and – at this stage – the market consensus is that a term rate can only be produced on a "backward-looking" basis, meaning that an RFR would be determined on the basis of historical data at the end of each calculation period.

When using an RFR for a "cash product" (for example, conventional facilities, certain types of swaps, floating rate notes, structured notes and securitisations), the floating rate must be calculated daily on the basis of the overnight rate and then averaged over the relevant calculation period in order to determine the applicable floating rate amount. This would mean that the floating rate amount cannot be calculated in advance.

This lack of visibility presents an issue in Islamic finance transactions. The Shari'a principle of *gharar* (uncertainty) requires absolute certainty on all fundamental terms in Islamic financing contracts. In order to achieve this certainty, the floating rate must be set at the start of a calculation period for the contracts to be considered as Shari'a-compliant. This is possible using a forward-looking rate published at the start of the calculation period, but is more challenging to achieve when using a backward-looking rate.[2]

1 For additional background information and discussion of the discontinuation of the publication of LIBOR, please see previous Clifford Chance Thought Leadership pieces on the topic here.

2 The Working Group set up a Term Rate Use Case Task Force to provide guidance on the need for and potential usage of forward-looking Term SONIA Reference Rates. Islamic finance was one such use case suggested in a paper published by the Working Group in January 2020 entitled "*Use Cases of Benchmark Rates: Compounded in Arrears, Term Rate and Further Alternatives*".

Compounded rates for RFRs

The International Swaps and Derivatives Association, Inc. ("**ISDA**"), in particular, has been pioneering the efforts amongst market participants to develop industry-accepted methodologies to determine RFRs, term rates using RFRs and credit spread adjustments. This has culminated in very advanced drafts of contractual terms using RFRs as fallbacks to LIBOR in the form of the much-anticipated ISDA 2020 Fallbacks Protocol and a Supplement to the ISDA 2006 Definitions for the derivatives industry.

Bloomberg has also published a Rulebook for IBOR Fallback Methodology (the "**Bloomberg Rulebook**")[3] using the methodologies that ISDA expects to implement for certain key IBORs (including USD-LIBOR and GBP-LIBOR), with accompanying test data for certain currencies available since May 2020.

The methodology in the Bloomberg Rulebook is an Adjusted RFR, meaning that it is based on daily compounding of the publicly available RFR which is published by central banks of the relevant currency (such as SOFR and SONIA), with rate-setting in arrears for the relevant tenor.

Although there have been indications that forward-looking RFRs in certain currencies could become available in the future once a sufficiently liquid and robust market develops based on trading in futures contracts using the relevant RFR, and forward-looking RFRs have featured in the waterfall of fallbacks to LIBOR in industry riders published by trade associations such as ISDA and the International Capital Markets Association ("**ICMA**") as well as working groups such as the ARRC, it is looking unlikely that market-accepted forward-looking RFRs will be available at the point at which LIBOR transition needs to take place.

The conventional bond market has already started to use compounded backward-looking rates in certain issuances. For instance, the approach taken in the SONIA floating rate market to date has been to use a five-day lag mechanism so that the coupon amount is known five days prior to the payment date. However, compounded rates with "lag mechanisms" do not give obligors visibility at the start of a profit period and so this solution may not translate for Sukuk instruments.

In the conventional financing market, notwithstanding the availability of exposure drafts of facility agreements for SONIA and SOFR-based conventional facilities, market agreement on the conventions applicable to these rates remains in flux.

Credit spread adjustment and value transfer

As RFRs are determined on the basis of overnight rates, they have historically been lower than LIBORs. As such, a so-called "credit spread adjustment" or "spread adjustment" will need to be added to an RFR in order to minimise, to the extent reasonably practicable, any transfer of economic value from one party to another as a result of the replacement of a LIBOR with an RFR.

The ISDA market-wide consultations on methodologies for calculating credit spread adjustments to derivatives contracts have now been finalised and the spread adjustment set out in the Bloomberg Rulebook uses the median of the historical differences between the IBOR for each tenor and the compounded RFR for that tenor over a five-year period prior to an announcement triggering a fallback.

3 Bloomberg page on Preparing for LIBOR Transition.

However, a credit spread adjustment may not fully eliminate the possibility of a value transfer occurring on a transaction-specific basis and recent consultations in the United States and the United Kingdom on the determination of credit spread adjustments for cash products show that there is still ongoing industry-level work to find credit spread solutions for different products.

Islamic finance solutions

Market participants who are transitioning away from LIBOR have highlighted the potential risks of currency and product fragmentation. The ubiquity of LIBOR across different cash products and the close interrelationship between some of those products means that changes to one transaction or product cannot be looked at in isolation. The key issue for any proposed solution will be the interplay between the Islamic finance product and its equivalent conventional product. For example, in the context of corporate facilities, companies continue to access both Islamic and conventional facilities through dual tranches, and any differences between solutions in Islamic transactions and conventional transactions will give rise to further issues, including around the structuring of the transaction and pricing for each of the respective facilities.

For Shari'a-compliant transactions, the extent of the changes required also need to be assessed in light of transitioning to an Islamic structure that would support the use of a "backward-looking" RFR where the relevant periodic payment amount may not be known until the end of a calculation period.

We can use the example of a murabaha transaction to consider the potential solutions in Islamic finance structures which can support a "backward-looking" RFR. As a reminder, murabaha transactions are a common structure adopted in a range of cash products to facilitate periodic payments by one party to another through the purchase of Shari'a-compliant commodities by the payer party on a "spot-delivery, deferred payment" basis where the deferred purchase price would include a profit amount equal to the amount of the economic payment.

Examples of its use are prevalent in corporate financings, collateralised murabaha facilities, structured investments and deposits, hedging arrangements and also as part of a supporting structure underlying Sukuk instruments.

A floating rate amount typically comprises two components: (i) the benchmark rate (such as LIBOR) and (ii) the spread rate (or margin).

Potential solutions in Islamic finance structures which can support a "backward-looking" RFR may involve the following:

1. Multiple murabaha transactions

To transpose a murabaha-based product to accommodate a backward-looking RFR, the parties may enter into a combination of two different types of murabaha transactions under the same product/transaction:

- **Spread Rate Murabaha** – a single murabaha contract can be entered into at the outset of the transaction with a final deferred payment date corresponding to the maturity date of the transaction (the "**Credit Spread Murabaha**"). The Credit Spread Murabaha will have a profit rate equal to the spread rate, and a portion of the deferred payment price for the Credit Spread Murabaha will be paid on each periodic payment date. For products or transactions where there are step-ups to the spread rate, further Credit Spread Murabaha contracts can be entered into in respect of the step-up rate; and

- **Benchmark Rate Murabaha** – separate murabaha contracts (each a "**Benchmark Rate Murabaha**") would be entered into at the end of each calculation period which is based on the actual benchmark rate for that period. Failure to enter into a Benchmark Rate Murabaha would constitute an early termination event. Instruments such as purchase undertakings could provide the basis on which the parties would periodically enter into these Benchmark Rate Murabaha contracts.

We are aware that the above combinations of murabaha contracts are already in use amongst certain market participants for Shari'a-compliant structured investments, structured certificate issuances and have also been used in corporate financing facilities.

The use of a purchase undertaking (*wa'ad*) in conjunction with a series of transactions for the sale and purchase commodities (so-called "*wa'ad plus murabaha*") has already received general acceptance through industry-level product templates in the Islamic hedging space such as the ISDA/IIFM templates for *Mubadalatul Arbaah* (profit rate swaps) and *Himaayah Min Taqallub As'aar Assarf* (cross currency swaps).

If there is an early termination event, then the Credit Spread Murabaha becomes immediately due and payable and that could be used to pay the notionally accrued and unpaid profit in the period in which the early termination event has occurred, given that there would be no Benchmark Rate Murabaha in the period in which the early termination event occurs.

The following solutions may also be used in Islamic corporate financing facilities but it should be noted that they may not be universally suitable and they are less likely to be to be applicable in respect of structured investments or derivates and structured certificate issuances.

2. Reconciliation payments

A murabaha contract can be entered into in the usual way and ahead of each calculation period the profit rate is set in advance on the basis of the available "backward-looking" RFR. At the end of each calculation period the profit rate is recalculated using the "backward-looking" RFR for that calculation period, which will allow the bank to determine what the actual rate for that calculation period should have been. Any difference between the amount that was paid and the amount that should have been paid for that calculation period can then be added (or deducted) when calculating the profit rate for the subsequent calculation period.

In respect of the final calculation period, there would be an undertaking from both the bank and the obligor to make any final reconciliation payment. We note that there has been some discussion in the ARRC's User's Guide to SOFR of solutions to use an "in-advance" calculation methodology similar to the above.

3. High profit rate margin with purchase undertaking or rebate

A single murabaha contract can be entered into at the outset of the transaction with a final deferred payment date corresponding to the maturity date of the transaction (the "**Murabaha Contract**"). The Murabaha Contract will have a fixed profit equal to say 12% or 15% (i.e. a rate greater than the anticipated profit rate at any time during the life of the facility).

During the life of the facility, on each deferred payment date the obligor has the discretion to pay a lower amount calculated on the basis of the aggregate of the actual benchmark rate and the spread rate.

On the final maturity date, to the extent the amount paid under the immediately preceding paragraph is less than the amount agreed to be paid under the Murabaha Contract (the "**Shortfall Amount**") the obligor will have to pay the Shortfall Amount to the bank. To address this, there will be two purchase undertakings granted at the outset, one in favour of the obligor and one in favour of the bank. These purchase undertakings will document the entry into of spot commodity murabaha transaction to ensure any excess amounts are paid to the obligor, and in the unlikely event there is a shortfall in the actual profit rate there will be a top-up payment to the bank made by the obligor.

A variation on the use of the purchase undertakings may be that the bank can offer a rebate in an amount equal to the Shortfall Amount. This may work better in certain jurisdictions where rebates are mandatory (e.g. in Malaysia) but may not operate effectively in other regions where the granting of rebates is typically discretionary (e.g. in the UAE and GCC region).

The key consideration for banks utilising this method will be the accounting treatment of the profit being generated where the contractual profit amount will be greater than the actual profit amount it is commercially intended to generate.

Amendments to Shari'a compliant documentation

Whereas it is generally accepted in the conventional markets that legacy transactions outstanding past LIBOR cessation would need to be amended on a transaction-by-transaction basis, ISDA has published protocols to facilitate documentation amendments whereby parties can adhere to a relevant protocol to incorporate the relevant changes to designated "protocol covered agreements". To date, there is an ISDA 2018 Benchmarks Supplement Protocol to facilitate incorporation of a RFR fallback regime in connection with IBOR transition.

We expect the majority of market participants in the Islamic hedging industry will need to follow the approach taken in conventional OTC markets in order to replicate the economic effects of LIBOR replacement. However, parties are also likely to be required to make corresponding amendments to existing master agreement documentation on a "master agreement-by-master agreement" basis as these documents have traditionally been outside the scope of the ISDA protocols.

There is also the need to amend legacy corporate facilities which will remain outstanding past LIBOR cessation. Unlike the hedging industry there is no guidance or protocols on how such finance documents should be amended. The market will therefore need to quickly adopt, preferably, a single solution on how it wishes to structure Islamic corporate financing facilities and then work quickly to implement the new structures in both new and legacy documentation.

Other regional developments

Whilst not the subject of this client briefing, it should also be noted that there are other regional developments in Islamic finance transactions. The adoption by the Accounting and Auditing Organisation for Islamic Financial Institutions ("**AAOIFI**") of its Shari'a Standard Number 59 regarding the Sale of Debt ("**Standard 59**") and its adoption in the UAE also means that commodity murabaha transactions can no longer operate in the same manner as they did before 31 December 2019. The market is still adapting to the implementation of Standard 59 and also given there is no single standardised approach in how a new commodity murabaha transaction should be implemented, it would make sense for the market to try to adopt a solution which caters both to the discontinuation of the publication of LIBOR and other market developments such as the implementation of Standard 59.

Conclusion

In late March 2020, the FCA confirmed that market participants should not rely on LIBOR being published after the end of 2021 regardless of any difficulties caused by the COVID-19 pandemic.

It is a matter of priority that robust solutions are developed within the Islamic finance industry and given recognition amongst market participants in order to alleviate the inevitable challenges of transitioning Shari'a-compliant transactions and products when the publication of LIBOR ceases. Whilst the end of 2021 may seem some time away, in terms of shifting how the whole industry operates and the implementation of new transaction structures in both new and legacy transactions, there is no time to lose and Islamic banks must be proactive in assessing and identifying their LIBOR-based exposures and assets to enable them to plan for an orderly transition.

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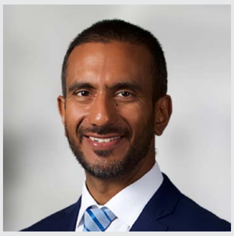

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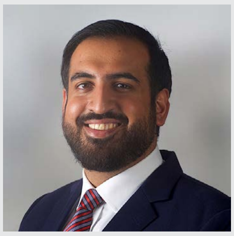

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