

# LIBOR TRANSITION – IMPLICATIONS FOR ISLAMIC FINANCE

2 MARCH 2021 • ARTICLE



As we reported in our previous article [LIBOR Transition: What? Why? When? How?](#), the financial markets anticipate that LIBOR (at least for currencies other than USD) will no longer be published after the end of 2021 and market participants are working to transition to the use of alternative “risk free” rates (or RFRs) when pricing financial products.

**"The use of overnight or backward-looking rates, and the lack of certainty and visibility that they entail, presents a significant challenge for Islamic finance transactions."**

This article covers the issues arising from the discontinuation of LIBOR for Islamic finance transactions and considers some of the potential solutions that may benefit industry participants and, in particular, providers of Islamic finance.

## RFRS VS IBORS

At the outset, it is worth re-iterating that RFRs differ from existing interbank offered rates (such as LIBOR) in the way in which the rates are formulated, set and administered and it is *not* a case of simply substituting an IBOR for a currency with the chosen RFR for that currency. In particular:

- LIBOR is a forward-looking term rate – this means the rate is fixed and known at the start of an interest period; RFRs are backwards-looking because they are based on actual transactions reported to the administrator of the relevant RFR. In sterling, SONIA reflects the average of the overnight interest rates paid in the sterling money markets and the SONIA rate for a given London business day is published at 9am on the following London business day; and
- LIBOR (as a forward-looking term rate) contains both a credit and liquidity premium priced into it – these components are absent in a RFR (as a backward-looking overnight rate) or other alternative rates which could be used (such as a central bank rates); credit adjustment spreads are one way of dealing with any potential transfer of value between the parties.

## ISSUE FOR ISLAMIC FINANCING PRODUCTS

The use of overnight or backward-looking rates, and the lack of certainty and visibility that they entail (in not being able to calculate the amount payable in advance for a contract or calculation period), presents a significant challenge for Islamic finance transactions.

The *Sharia* principle of *gharar* (uncertainty) requires certainty on all fundamental contract terms. For Islamic financing products using LIBOR as a reference rate, certainty as to pricing can be provided at the start of any contract or calculation period (for example the profit mark-up under a commodity *Murabaha* or the variable element of the rental payment under an *Ijara* (or lease) financing) because of the availability of a forward-looking rate for that period. This will not be the case using a RFR so alternative solutions will need to be used when pricing Islamic financing products.

## ALTERNATIVES

Some potential alternative arrangements which may be able to support backward-looking RFRs in Islamic finance structures include the following:

**"There are still issues with the rebate approach, notably that, unless the fixed rate is "uncommercially" high, there could still be the risk that the fixed rate may not be high enough to cover the actual rate, leaving the bank exposed."**

### *Alternative rates*

Market participants may choose to use an alternative rate (such as a central bank rate) at the start of a contract or calculation period. Although central bank rates are daily rates, they are less susceptible to change over short periods. There however remains a risk of a rate change during the tenor of the contract or calculation period which is not priced in until the start of the next period. This may leave either the bank or the customer exposed.

### *Reconciliation payments*

An Islamic financing product could be entered into with a "best estimate" based on the RFR at the start of a contract or calculation period. At the end of that contract or calculation period the profit rate could be recalculated using the RFR for that contract or calculation period to determine what the rate for that period should have been. Any difference can then be considered when calculating the profit rate

for the next contract or calculation period (and added or deducted accordingly). However, there are issues with this approach: this may leave a balancing payment at the end of the contract and no contract or calculation period to add it to or deduct it from. Payment undertakings could be used to resolve this, but an element of uncertainty is introduced which is not ideal and may not be acceptable, in particular in jurisdictions with a more conservative interpretation of the underlying Islamic principles.

### *Rebate*

An Islamic financing product could be entered into with a fixed rate set at a rate higher than is expected to be payable in respect of a contract or calculation period, with a rebate allowed at the end of that period once the profit rate has been determined using the RFR for that period.

Rebates are, of course, a common feature of Islamic financing products and are often used to deal with, for example, early prepayment amounts (i.e. so that the customer only pays the profit rate to the point of prepayment rather than the entire contract or calculation period as they are contracted to do so).

However, there are still issues with this approach, notably that, unless the fixed rate is “uncommercially” high, there could still be the risk that the fixed rate may not be high enough to cover the actual rate, leaving the bank exposed. Likewise, whilst in some jurisdictions such as Malaysia the use of rebates is regulated, in others it is often permitted and applied on a basis of the bank’s discretion – this may leave the customer exposed.

## Term rates

Although the UK Financial Conduct Authority and the Working Group on Sterling Risk-Free Reference Rates (or WG) have both made clear that they expect the majority of loan market participants to use SONIA compounded in arrears as the variable interest rate in facilities agreements, the WG has stated that there are potential limited use cases for term RFR rates in syndicated lending, with Islamic financing being one of them<sup>1</sup>. The FICC Market Standards Board is also in the process of developing a proposed market standard for limiting the use of forward-looking SONIA term rates. This is expected to be published for market consultation and to build on existing market consensus, including that set out in the WG use case paper<sup>2</sup>.

In early 2021, both ICE Benchmark Administration (IBA) and Refinitiv launched regulated term SONIA rates for use in place of sterling LIBOR. Each of these term SONIA rates is available in one-, three-, six- and 12-month tenors and uses a waterfall methodology. The key features of each benchmark reference rate are set out in the table below.

"The WG has stated that there are potential limited use cases for term RFR rates in syndicated lending, with Islamic financing being one of them."

Administrator		IBA	Refinitiv
<b>Tenors available</b>	1, 3, 6 & 12 months		1, 3, 6 & 12 months
<b>Launch date (as a regulated benchmark)</b>	11 January 2021		11 January 2021
<b>Where?</b>	Here		Here
<b>When?</b>	At or around 11.55am (London time)		11.50am (London time)
<b>How?</b>	ICE TSRR calculation methodology		Refinitiv Term SONIA calculation methodology
<b>Brief summary of calculation methodology<sup>3</sup></b>			
<b>Waterfall level 1</b>	Eligible, executable prices and volumes for eligible SONIA-linked overnight interest rate swaps provided by BGC Partners' BGC Trader platform, Tradition's Trad-X platform and TP ICAP's i-Swap platform		Bids and offers from TP ICAP's i-Swap and Tradition's Trad-X electronic platforms in a 20-minute window commencing at 10.50am and ending at 11.10am (London time)

Administrator	IBA	Refinitiv
<b>Waterfall level 2<sup>4</sup></b>	Eligible dealer to client prices and volumes displayed electronically by Tradeweb's Global Institutional Trading Platform	Streaming bids and offers from Tradeweb's institutional electronic swaps platform in a 20-minute window commencing at 10.50am and ending at 11.10am (London time)
<b>Waterfall level 3</b>	Previous trading day's SONIA-linked futures' settlement price published on ICE SONIA Futures, SONIA rates published by the Bank of England and scheduled MPC meeting dates	Overnight SONIA published daily by the Bank of England and historical values of the Refinitiv Term SONIA benchmark
<b>Not possible to calculate at waterfall level 3?</b>	Insufficient data policy applies	

**"It is critical that any potential solution is capable of adoption across all tranches in a relatively consistent manner in order to prevent differing treatment of lender groups."**

As we noted in our previous article, the Alternative Reference Rates Committee (ARRC) recommends the use of a term SOFR for US dollars as a fall back and it is anticipated that term SOFR will be developed and published over time.

Term RFRs may be a convenient alternative for market participants but it is still early days in their publication and the extent to which they are adopted by the market is yet to be seen. Nevertheless, it seems likely that the Islamic finance market will make use of these rates.

### *Issues with dual-tranche financings*

Many corporate finance transactions involving both *Sharia*-compliant facilities and those which are not *Sharia*-compliant are brought into effect through dual tranches,

meaning the same overall financing arrangement can cater for both Islamic and non-Islamic facilities. Whilst the suggested alternative arrangements referred to above can support the Islamic facility aspect of these dual tranche deals when addressing LIBOR transition, it is critical that any potential solution is capable of adoption across all tranches in a relatively consistent manner in order to prevent differing treatment of lender groups (including in relation to matters such as structuring and pricing of the respective facilities).

One more thing: as with LIBOR transition generally, and as we reported in our previous article, market participants will need to consider the tax, accounting and systems/operational (as well as *Sharia*) aspects of whichever approach is used.

## AND BEYOND

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Even with the relatively mature and standardised domestic and international loan markets, significant work remains to be done in order to reach market consensus and standardisation in the manner applicable to financings referencing IBORs. Islamic financial products tend to lack standardisation (significantly more so than their non-Islamic equivalents) and we await the emergence of market standards in relation to these types of product.

IBOR transition may well lead to the development of alternative benchmarks designed for use in the Islamic finance market and so reduce the reliance on other interest rate-based benchmarks. We await developments in this regard.

Market participants need to consider what changes need to be made to existing or legacy transactions which will continue after the end of December 2021 and on what basis to document new transactions going forward. Flexibility in order to accommodate future market consensus will be key.

This article was authored by London Partner Richard Hughes, Dubai Partners Andrew Baird and Michael Savva, and Professional Support Lawyer Sarah Tighe.

[1] Please see here.

[2] Please see here from paragraph 30 for further information.

[3] Taken from <https://www.theice.com/iba/risk-free-rates> and <https://www.refinitiv.com/en/financial-data/financial-benchmarks/term-sonia-reference-rates>

[4] IBA has declared an intention to include a further level in the calculation waterfall after existing level 2, which would use “executable SONIA-linked futures prices and volumes, displayed electronically by trading venues, to derive the ICE TSRR”.

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