This White Paper is only covering precisely the impact of global IBOR transition to Risk Free Rate and it is not intended to cover the Islamic benchmark rate need and its possible development as that is totally different subject and to be tackled separately.

This White Paper is organized into seven (7) sections and Appendix as per the contribution of the participating institutions.

Compiled by IIFM
March 22, 2021
In the name of Allah, the Entirely Merciful, the Especially Merciful.
Acknowledgment by IIFM

Foremost, we wish to express our sincere thanks and appreciation to the IIFM Board of Directors for their ongoing support and assistance to IIFM in its market unification efforts specifically global standardization of Islamic Documentation and Product confirmations.

IIFM Board of Directors and Management are thankful to the following members of Core-working Group (CWG) for their invaluable expert input and active participation in the meetings which enabled IIFM to host a very well attended and successful IBOR Transition event held on 24th November 2020:

1. Islamic Development Bank
2. Standard Chartered Saadiq
3. Kuwait Finance House
4. The National Commercial Bank
5. Abu Dhabi Islamic Bank
6. Dubai Islamic Bank/Dar Al Sharia
7. Bank ABC Islamic
8. Credit Agricole Corporate & Investment Bank
9. EY Bahrain
10. Clifford Chance
11. Norton Rose Fulbright
12. Refinitiv

We are also thankful and gratitude to the below CWG member institutions for their contribution to this IBOR Transition white paper which has enabled us to develop a detailed understanding of the subject as well as some solutions to be developed by IIFM specifically.

1. Standard Chartered Saadiq
2. Refinitiv
3. Habib Motani - Consultant, Clifford Chance
4. Mr. Paul Richards of ICMA
5. EY Bahrain
6. Dubai Islamic Bank/Dar Al Sharia

IIFM is also thankful to the following Institutions who have presented at the IIFM event held on 24th November 2020:

1. Standard Chartered Saadiq
2. Dar Al Sharia
3. EY Bahrain
4. Clifford Chance LLP
5. Mr. Paul Richards of ICMA

Finally, sincere thanks to ICMA for arranging its senior representative to deliver a valuable briefing on IBOR Transition from capital market perspective.
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</tbody>
</table>
Since 2013, IOSCO and the FSB Official Sector Steering Group and public-private groups specifically in EU, UK, North America, Japan have been working to reform major benchmark rates, identify alternative rates and develop plans for adoption of those rates. The importance of this work was amplified in July 2017 when the UK Financial Conduct Authority announced that it would not compel panel banks to submit to London Inter-Bank Offered Rates (LIBOR) after 2021, which called into question the future of LIBOR after that date.

Globally, work on benchmark rates reforms and transition to Risk Free Rates (RFR) is either completed in some cases or nearing completion by the various working groups in Europe, North America, Switzerland and Japan for currencies such as USD, EUR, GBP, CHF and JPY. The regulators in these jurisdictions are pushing the conventional financial services industry to start implementing RFR as benchmark rate instead of Inter-Bank Offered Rates (IBOR) which has regulatory oversights issues and is subject to manipulation as well.

The global benchmark rates transition has implications which Islamic finance industry needs to be aware of and find a workable Shari’ah solution to overcome challenges particularly affecting Islamic product structures, transactions, documentation, accounting & profitability, credit and legal matters.

IIFM is following the Global IBOR benchmark rates reforms and related development for last two years and has created awareness in the Islamic finance market by organizing sessions at IIFM Awareness Seminars on this important global regulatory driven reform of transition from IBOR to RFR.

Since IBOR transition to RFR is a significant development which requires consultation with relevant stakeholders, therefore, in September 2020 IIFM formed a ‘Core Working Group’ (CWG) of Key institutions:


The main purpose of the CWG was to provide deeper insight to IBOR transition, its challenges to Islamic industry, strategy to be developed and to help in the development of a comprehensive ‘Consultative Paper’ which was used as a main source at the ‘IIFM Industry Consultative Meeting’.

IIFM achieved its objectives set for the IBOR transition event held on 24th November 2020 as follows:

1. Assess the impact of RFR on Islamic transactions (existing and new for all segments particularly, Financing, Hedging and Sukuk. (In other words, Commodity Murabaha, Sukuk, Syndication, and other Financing transactions such as Ijarah, Diminishing Musharakah etc.)

2. Identification of remedies and solutions to be tackled by IIFM after the consultative meeting (benchmark replacement/benchmark fallback and guidance on the language for existing and new contracts)

3. Development of Islamic structures and solutions by IIFM in coordination or jointly with other relevant Infrastructure organization

4. To develop global communication and assess the possible development of benchmark protocols by IIFM

5. Identification and consultation on issues such as accounting and governance which could be tackled by relevant Islamic standard-setting bodies in particular AAOIFI and IFSB

6. Creating awareness on IBOR Transition and its impact on Islamic Finance Industry

This white paper on the Global IBOR Transition & its impact on the Islamic industry is updated version for creating better awareness in the Islamic industry and will be used as basis in the development work to be undertaken by IIFM in particular to this major transformation which has consequences for new and already concluded transactions such as bilateral and syndicated financing, hedging and capital market fixed profile securities (Sukuk).
White Paper Contributions
By: Institutions
Section 1
Introduction to London Inter-Bank Offered Rate (LIBOR) and Transition to Risk Free Rates (RFRs):
By: Standard Chartered Saadiq
1. **Introduction to London Interbank offered Rates (LIBOR) to Risk Free Rates (RFRs)**

Over the last few years, regulators across the globe have encouraged firms to shift away from using the London Interbank Offered Rate (LIBOR) and switch to alternative overnight Risk-Free Rates (RFRs). This is a seismic shift for financial markets as LIBOR is one the most widely used benchmarks in global financial markets, underpinning an estimated USD400 trillion of financial contracts\(^1\), quoted across five currencies and seven maturities (overnight, one week, and one, two, three, six and 12 months). The rate provides an indication of the average rate at which each LIBOR contributing bank can borrow unsecured funds in the London interbank market for a given period, in a given currency.

The discontinuation of LIBOR and its identified replacements may raise certain issues and challenges for Islamic Banking transactions. This paper aims to discuss the impact of the transition from LIBOR and other Interbank Offered Rates (IBORs) to RFRs on Islamic Banking transactions in a number of areas such as documentation, new & legacy contracts, profitability, accounting, risk and regulation.

2. **The need to transition from LIBOR to RFRs**

LIBOR’s calculation is based on a trimmed average of submissions made by a selection of panel banks. These submissions are computed using available transaction data, however, in the absence of sufficient transaction data, panel banks can use their expert judgement in the calculation of their submissions.

Following the financial crisis in 2008, changes to bank capital requirements resulted in a significant decrease in transaction volumes in the unsecured interbank lending market, the market which LIBOR is based on.

With limited market activity and insufficient transaction data, LIBOR submissions increasingly relied on expert judgement from the panel banks. As a result, Regulators have also grown increasingly concerned about the long-term sustainability of the benchmark. Panel banks have also expressed discomfort about providing submissions “based on judgements with little actual borrowing activity against which to validate”.\(^2\)

In addition to the liquidity issues there have been a number of high-profile rate manipulation cases involving LIBOR. The first, and one of the most well-known being the case of ex UBS and Citi Japanese Yen trader Tom Hayes who was found guilty of LIBOR manipulation.

In July 2017, the UK’s Financial Conduct Authority (FCA) announced that they will no longer compel panel banks to submit LIBOR after 2021\(^3\). The FCA encouraged banks and financial markets to begin removing their dependencies on LIBOR and begin actively transitioning away from the rate by 31 December 2020 to avoid disruption when the publication of LIBOR ceases.

To facilitate this global transition, the five LIBOR jurisdictions established working groups to identify alternative RFRs to replace their respective LIBORs. This was part of a G20 initiative, delegated to the Financial Stability Board (FSB), to review and reform critical benchmark rates. The five identified RFRs are as follows:

---

Beyond LIBOR, other regulatory bodies across the globe have followed suit in reviewing the status of their respective IBORs, as some IBORs utilise USD LIBOR in their calculation such as Singapore’s Singapore Dollar Swap Offer Rate (SOR). In some jurisdictions, regulators have taken a multi-rate approach and retain reformed versions of existing IBORs to operate alongside the relevant RFR for that jurisdiction (e.g. Australia, Canada and Hong Kong) whilst others such as Singapore, has recommended the staggered cessation of the Singapore Interbank Offered Rate (SIBOR) in the next three to four years, while SOR will be transitioned to the Singapore Overnight Rate Average (SORA).

In December 2020, the ICE Benchmark Administration (IBA), with support from both the UK and US regulators, issued a consultation on the proposed end dates of LIBOR.

On 5 March 2021 the FCA announced the future cessation and loss of representativeness for LIBOR:

- EUR and CHF LIBOR – all fixings will cease after 31 Dec 2021.
- JPY LIBOR – Spot Next, 1W, 2M and 12M will cease after 31 Dec 2021. FCA will consult on requiring IBA to publish 3 JPY LIBOR settings (1M, 3M and 6M) on a changed methodology (synthetic LIBOR) for 1 more year. FCA expects publication of these three settings to cease permanently after 31 Dec 2022.
- GBP LIBOR – O/N, 1W, 2M, 12M will cease after 31 Dec 2021. FCA will consult on requiring IBA to publish 3 GBP LIBOR settings (1M, 3M and 6M) on a changed methodology (synthetic LIBOR).
- USD LIBOR – 1W and 2M will cease after 31 Dec 2021.
- USD LIBOR – O/N and 12M will cease after 30 June 2023. FCA will monitor the market and assess the need for the continued publication of 1M, 3M and 6M USD LIBOR on a synthetic basis for a further period after 30 June 2023.

As next steps, FCA will be consulting on the continued publication of synthetic LIBORs (for the 9 fixings), as well as permitted usage of synthetic LIBOR (which does not remedy the loss of representativeness of LIBOR rates).

Following the FCA statement, ISDA stated, that this constitutes an index cessation event under the IBOR Fallbacks Supplement and the ISDA 2020 IBOR Fallbacks Protocol for all 35 IBOR settings.

The discontinuation of LIBOR and subsequent introduction of RFRs could pose challenges for Islamic Banking transactions, given the characteristics of as explained in the next section.
3. **The difference between IBORs and RFRs**

There are a number of differences between IBORs and RFRs which are important to consider:

<table>
<thead>
<tr>
<th>Key differences</th>
<th>IBORs</th>
<th>RFRs</th>
<th>Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Calculation methodology</td>
<td>Based on submissions from panel banks which use transaction data were available, and then expert judgement where none exists</td>
<td>Based on actual transactions in liquid markets</td>
<td>RFRs are seen as more robust benchmarks, given the strong volumes and use of actual transactions</td>
</tr>
<tr>
<td>Term structure</td>
<td>Term structure with seven different forward-looking tenors, from overnight to 12 months</td>
<td>Backward-looking overnight rates</td>
<td>RFRs require averaging or compounding to determine a cost of borrowing for any period greater than one day</td>
</tr>
<tr>
<td>Credit premium</td>
<td>IBOR reflects the cost of borrowing by panel banks and therefore includes a credit premium component</td>
<td>RFRs are proxies to risk-free and therefore have no credit premium</td>
<td>Spreads or margins are being determined and will potentially be added to the RFRs</td>
</tr>
<tr>
<td>Consistency / Timing</td>
<td>IBORs are based on a consistent methodology across the five currencies and are published at the same time</td>
<td>RFRs have different methodologies and publication timelines for each currency</td>
<td>There may be a change to operational activity to ensure appropriate implementation</td>
</tr>
</tbody>
</table>

Regarding Credit Premium, also known as Credit Adjustment Spread (CAS), upon confirmation of the respective LIBOR cessation dates the ISDA Credit Adjustment Spread will be calculated, using a 5-year historical median, for use in fallbacks and as an alternative for active conversion. Alternatively, the UK’s WGRFR published a paper in December 2020, citing various methodologies for determining the CAS for active GBP loans conversions, the principal ones being:

- Forward Approach - calculating the CAS based on the forward-looking basis swap market using the linear interpolation between differing tenors of LIBOR vs RFR swaps
- Historical Median Approach as described for ISDA CAS above but using data published by Bloomberg Index Services Limited prior to the confirmed announcement of LIBOR’s cessation.

The current use of LIBOR is in line with Sharia law principles as it a forward-looking rate, which enables the profit mark to be calculated at the start of the contract.

However, with RFR’s, the key challenge for Islamic Banking transactions is their current backward-looking nature, given the rates are overnight. Their overnight nature means overnight rates must be compounded in arrears over the actual period, thus the borrower will not know for certain the profit payment amount until shortly before the end of the period. The lack of visibility in forward looking RFR means there is not complete certainty on the products terms and therefore they do not satisfy the Shari’ah principle of gharar (uncertainty).

The BoE have also called out the potential challenges the discontinuation of LIBOR brings to Islamic Banking in its January 2020 use case paper, with the recommendation of a term or alternative rate as a preferred approach.

The development of such term rates within the five RFR markets are at varying stages of progress, though it should be noted that the Swiss NWG has indicated that it is unlikely to develop a forward-looking term fixing for SARON. The next section outlines the progress and approaches of each of the LIBOR jurisdictions.


3 (a) Methodologies for Tenor Rates

As of October 2020, none of the five LIBOR jurisdictions have published final forward-looking term RFRs. However, four of the five have commenced the process of producing RFR terms using variations of Overnight Index Swaps (OIS) quotes and futures.

<table>
<thead>
<tr>
<th>#</th>
<th>RFR</th>
<th>Term Status</th>
<th>Expected publication date</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>SONIA</td>
<td>In progress, currently testing beta term rate</td>
<td>End 2020</td>
</tr>
<tr>
<td>2</td>
<td>SOFR</td>
<td>In progress, RFP for vendor issued</td>
<td>End H1 2021</td>
</tr>
<tr>
<td>3</td>
<td>JPY</td>
<td>In progress, currently testing beta term rate</td>
<td>End H1 2021</td>
</tr>
<tr>
<td>4</td>
<td>€STR</td>
<td>In progress, vendor selection process ongoing</td>
<td>TBD, testing to begin early 2021</td>
</tr>
<tr>
<td>5</td>
<td>SARON</td>
<td>No term rate planned</td>
<td>N/A</td>
</tr>
</tbody>
</table>

1) UK (SONIA)
   - There are three vendors who are being considered for the administrator of the forward-looking SONIA term, ICE benchmark administration (IBA), Refinitiv and FTSE Russell.
   - All three approaches utilise a waterfall structure using SONIA OIS quotes, futures.
   - Beta SONIA term has already been developed by the above providers in Q3 2020, with a final administrator to be chosen by end 2020.

2) US (SOFR)
   - The proposal requests a rate for 1 and 3 months and if possible 6 month and 1 year rates and requires data to be publically accessible. The responses to the RFP will include a historic estimation of rates over the last year, a description of the data inputs and the features to prevent rate manipulation.
   - The targeted publication date for rates is end H1 2021.

3) Japan (JPY)
   - Following two market consultations, Japanese market participants have signaled their preference for a term reference rate based on JPY OIS, as oppose to an overnight RFR compounded rate (TONA).
   - QUICK Corp was chosen in February 2020 to commence developing a prototype JPY term rate to replace JPY LIBOR, based on JPY OIS, with the final production rate expected by end H1 2021.

4) Europe (€STR)
   - There are 4 possible providers are being considered for building a forward-looking fallback rate, these include; IHS Markit, the European Money Markets Institute IBA (EMMI-IBA), Refinitiv and FTSE Russell
   - EMMI IBA, Refinitiv and FTSE Russell are all using OIS data and futures committed quotes from multilateral trading facilities (MTFs) and exchanges. In comparison IHS Markit is using OIS and futures trade data
   - Testing of data is due to start at the end of 2020 (IHS Markit) / start of 2021 (EMMI). Refinitiv and FTSE Russell have not indicated when they will start testing

5) Switzerland (SARON)
   - There are no plans to produce a forward looking SARON term rate
   - The production of these forward looking RFR terms should facilitate the transition away from LIBOR for Islamic Banking transactions and satisfy the principle of Gharar by providing the required cash flow visibility and certainty.
References:

Section 2
Regulations & Administrators (EU, UK, North America, Japan) & Implementation Timelines
By: Refinitiv
1. Regulations & Administrators (EU, UK, North America, Japan)

Information is updated version submitted on 28th January 2021.

Unlike the LIBOR rates, where the rates for five currencies (USD, GBP, EUR, JPY and CHF) were regulated by the FCA and administered by ICE Benchmark Administration, alternative risk-free reference rates will be regulated by different regulators and potentially multiple administrators for each currency.

Currently, five different working groups have been set up by the respective regulators. Each working group is composed of a different mix of regulators and market participants, and is taking a different approach and timeline to the development of the alternative risk-free reference rates. But despite the differences, each working group supports the use of it’s own central bank administered overnight risk free reference rate as the primary alternative for LIBOR, where possible.

The table below provides details for the different currencies and working groups

<table>
<thead>
<tr>
<th>Existing IBOR</th>
<th>Regulator</th>
<th>Working Group</th>
<th>Alternative RFR</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD LIBOR</td>
<td>Federal Reserve Bank of New York</td>
<td>Alternative Reference Rates Committee</td>
<td>SOFR</td>
<td>Overnight US Treasury repo (new)</td>
</tr>
<tr>
<td>GBP LIBOR</td>
<td>Bank of England</td>
<td>Working Group on Sterling Risk-free Rates</td>
<td>SONIA</td>
<td>Overnight unsecured deposit (enhanced)</td>
</tr>
<tr>
<td>EUR LIBOR</td>
<td>European Central Bank</td>
<td>Working Group on Euro Risk-free Rates</td>
<td>€STR</td>
<td>Overnight unsecured deposit (new)</td>
</tr>
<tr>
<td>CHF LIBOR</td>
<td>SIX Swiss Exchange</td>
<td>The National Working Group on CHF Reference Rates</td>
<td>SARON</td>
<td>Overnight repo transactions (existing)</td>
</tr>
<tr>
<td>JPY LIBOR</td>
<td>Bank of Japan</td>
<td>Cross-Industry Committee on JPY Interest Rates</td>
<td>TONAR</td>
<td>Overnight unsecured call rate (existing)</td>
</tr>
</tbody>
</table>

For each currency there are overnight rates, compounded overnight rates and forward-looking term rates. The alternative risk-free rates and compounded risk-free rates are primarily central bank administered and are either overnight or backward looking (i.e. we only know the cost of borrowing at the end of the period). These rates are expected to be adopted in the derivative, bond, securitized products and loan markets.

The forward-looking term rates are to be administered by private commercial benchmark administrators, were the cost of borrowing is known at the beginning of the period, and are expected to be adopted in loan, trade finance and working capital markets, and possibly for legacy instruments.

The Working Group on Sterling Risk-free Reference Rates allows the publication of forward-looking term rates - Term SONIA (GBP). There are currently two benchmark administrators that are providing production-ready versions of the Term SONIA rates that can be used in financial contracts and a third
administrator that has a prototype version available in the market for testing. The Working Group permits multiple benchmark administrators to compete to provide the most attractive rate, and market participants will select which of the competing rates they prefer. Whilst the EU is somewhat behind that of the UK, the Working Group on Euro Risk-free Rates will follow a similar approach by allowing multiple private benchmark administrators to offer competing Term €STR rates.

By contrast, some working groups such as the Cross-Industry Committee on JPY Interest Rates, have appointed a single benchmark administrator for their forward-looking term rates. In the United States, the ARRC will be following this approach and is expected to select a single benchmark administrator for a Term SOFR rate during H1 2021, subject to sufficient liquidity in SOFR derivatives markets.

The table below provides the details of the three benchmark administrators that currently publishing Term SONIA rates for GBP.

<table>
<thead>
<tr>
<th></th>
<th>IBA</th>
<th>Refinitiv</th>
<th>FTSE Russell</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tenors</td>
<td>1M, 3M, 6M</td>
<td>1M, 3M, 6M, 12M</td>
<td>1M, 3M, 6M, 12M</td>
</tr>
<tr>
<td>Publication Time</td>
<td>11:50am UK</td>
<td>11:55am UK</td>
<td>11:50am UK</td>
</tr>
<tr>
<td>Level One Source</td>
<td>- Committed SONIA OIS quotes</td>
<td>- Committed SONIA OIS quotes</td>
<td>- Committed SONIA OIS quotes</td>
</tr>
<tr>
<td></td>
<td>- Tradition, TP ICAP, BGC Partners</td>
<td>- Tradition, TP ICAP</td>
<td>- Tradition, TP ICAP</td>
</tr>
<tr>
<td>Data Collection Window</td>
<td>120 minutes (9:00-11:00)</td>
<td>20 minutes (10:50-11:10)</td>
<td>10 minutes (10:55-11:05)</td>
</tr>
<tr>
<td>Snapshots</td>
<td>24 (five-minute intervals)</td>
<td>40 (30 second intervals)</td>
<td>30 (20-second intervals)</td>
</tr>
<tr>
<td>Data Eligibility</td>
<td>- Quotes only eligible with minimum volume £250M</td>
<td>- Quotes ineligible below standard market size (undisclosed for anti-gaming purposes)</td>
<td>- Quotes ineligible below standard market size. Tops and tails removed from orderbook snapshots</td>
</tr>
<tr>
<td></td>
<td>- Snapshots ineligible with crossed or zero spread bid/offers</td>
<td>- Median of snapshot midrates ignores outliers</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Snapshots removed if midprice above 75th / below 25th percentile</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Level Two Source</td>
<td>Tradeweb D2C platform</td>
<td>Tradeweb D2C platform</td>
<td>SONIA Futures quotes data</td>
</tr>
<tr>
<td>Level Three Source</td>
<td>SONIA Futures quotes data</td>
<td>T-1 compounded SONIA to previous day’s Term SONIA rate</td>
<td>n/a</td>
</tr>
</tbody>
</table>

2. Implementation Timelines

The information is updated version submitted on 28th January 2021.

In terms of timelines, each working group is working at a different pace, despite that fact that GBP, JPY, EUR, CHF and some USD LIBOR tenors are expected to cease production immediately following publication on 31st December 2021 and the main USD LIBOR tenors are expected to continue until immediately following publication on 30th June 2023. The Working Group on Sterling Risk-free Reference Rates is likely the most advanced, having defined detailed interim milestones in the LIBOR transition and target use cases for Term SONIA.
Each of the benchmark administrators for Term SONIA have been publishing rates since July 2020. Furthermore, the regulator will mandate that no new loans can be issued linked to GBP LIBOR from the end of Q1 2021.

The US Alternative Reference Rates Committee (ARRC) commenced the process of defining and creating the term reference rate in July 2020, and issued the RFP to the benchmark administrators in September 2020. It is expected that the USD Term SOFR will be published in H1 2021, subject to sufficient liquidity in the derivatives markets.

The Working Group on Euro Risk-free Rates is still defining its timelines and use cases, with the term rates not expected to be published before 2021.

The table below provide high level timelines for the transition

<table>
<thead>
<tr>
<th></th>
<th>Q3 2020</th>
<th>Q4 2020</th>
<th>H1 2021</th>
<th>H2 2021 Onwards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term SONIA (GBP)</td>
<td><strong>July 2020</strong></td>
<td></td>
<td><strong>January 2021</strong></td>
<td><strong>End December 2021</strong></td>
</tr>
<tr>
<td></td>
<td>Benchmark administrators launch prototypes</td>
<td></td>
<td>Benchmark administrators launch regulated production rates</td>
<td>GBP LIBOR production expected to cease</td>
</tr>
<tr>
<td></td>
<td><strong>September 2020</strong></td>
<td></td>
<td><strong>March 2021</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Lenders must offer non-GBP LIBOR linked loans to customers</td>
<td></td>
<td>New issuance of GBP LIBOR referencing loans cease</td>
<td></td>
</tr>
<tr>
<td>Term SOFR (USD)</td>
<td><strong>July 2020</strong></td>
<td><strong>September 2020</strong></td>
<td><strong>H1 2021</strong></td>
<td><strong>End December 2021</strong></td>
</tr>
<tr>
<td></td>
<td>Working Group commences process of defining and creating term reference rate</td>
<td>Working Group issues RFP for Term SOFR</td>
<td>Term SOFR to be published, subject to sufficient liquidity in derivatives market</td>
<td>Expect cessation of 1-week and 2-month USD LIBOR</td>
</tr>
<tr>
<td></td>
<td><strong>End June 2023</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Expect cessation of all other USD LIBOR tenors</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Term €STR (EUR)</td>
<td><strong>November 2020</strong></td>
<td><strong>Q1 2021</strong></td>
<td></td>
<td><strong>End December 2021</strong></td>
</tr>
<tr>
<td></td>
<td>Working Group consults on EURIBOR fallbacks</td>
<td>Working Group requests update on Term €STR from benchmark administrators</td>
<td></td>
<td>EUR LIBOR production expected to cease</td>
</tr>
</tbody>
</table>
Section 3
Use of a Protocol
By: Habib Motani
(Consultant, Clifford Chance)
Use of a Protocol

A number of market participants have raised the possibility of adopting a protocol mechanism as an efficient means of effecting the necessary contractual changes to their Islamic Finance transactional documentation to transition the relevant transactions from ones using one or more IBORs to ones using the appropriate new replacement rates or rate fallbacks.

Where there is a group of several market participants, individual participants within that group have dealt with others within that group in one or more common forms of transaction and there is a consensus among them as to the changes they wish to make to the terms of those transactions to reflect, for example, the replacement of particular benchmark rates with new or other ones, a protocol mechanism can be an efficient mechanism through which the group can adopt the relevant changes as between each other.

By adhering to the protocol, in other words, by signing up to the protocol, an adhering party (A) is saying to the others who also adhere (B, C, D and E), that A’s agreements with each of B, C, D and E shall be amended as set out in the protocol. B, C, D and E are similarly agreeing with A and with each other. So instead of having to enter into individual documentation between A and B, A and C, B and C, B and D and so on, all of them can amend their contracts with each other through the one set of signatures involved in adhering to the protocol. This is efficient operationally and in terms of time and cost. However, in order for a protocol to be successfully usable, there are various considerations to take into account and preconditions to the practical viability of the use of a protocol.

Preconditions

User Group
The potential users of the protocol need to be identified—not necessarily individually, but as a group. In other words, there must be a target user group for the protocol, and it must be of sufficient size that taking the protocol approach is genuinely going to be efficient. If the potential group of users is very small, the question will be whether in reality it will be more efficient for them to deal with each other bilaterally.

The Need for Consensus
Even once the potential user group has been identified and there is comfort that it is sufficiently large to justify the protocol approach, there should be an adequate consensus among them as to what the protocol will provide and what transactions it will apply to. This is critical, not least in the context of IBOR transitioning. Before a protocol can sensibly be of value, the relevant market participants will need to have built up an adequate consensus on the replacement rates and fallbacks they wish to utilise. A protocol should not be the means by which market participants make up their minds as to what replacement rates and fallback rates they determine to transition to; it should be the means by which they record and contractually agree with counterparties the replacement rates and fallback rates they have already determined for their own purposes to be the replacement rates and fallbacks they wish to transition to. Therefore, identifying the potential replacement rates and fallbacks, and building a consensus as to which to transition to, is a crucial initial phase before a protocol mechanism can usefully serve its purpose.

Elements for which Consensus Required
In the context of an IBOR related protocol, issues in relation which consensus will be needed include: -the rates to which the protocol is to apply and which will therefore be subject to the transition arrangements established by the protocol; -the trigger events—that is what is the event that will trigger the transition in relation to each particular rate that is covered by the protocol, will the fact of its occurrence need to be determined by one of the parties or a third party and who; -what should the new rate should be and who will determine it; and -will that new rate apply irrespective of underlying product or transaction type or will there be different rates for different products?
**Products**

This last question, that is to which products will the new rate is a particularly important question, because in the financial markets different segments of the market are not necessarily taking the same approach. This raises challenges where products are linked: for example if parties have entered into a profit rate swap to hedge a sukuk issue, alignment between the sukuk and the profit rate swap may be a key consideration.

**Shariah aspects**

While a protocol can readily be used to amend an underlying contract by replacing one term with another, what is more challenging is amending the structure of a transaction. Islamic structures often contain transactions within them such as purchase and sale transactions. If the replacement of a rate will involve a change such as the timing of when the purchase transaction should occur, that level of restructuring may not be as easily accommodated through a protocol.

In the context of Islamic transactions, parties will need to ensure they have taken into account any shariah approvals that they may need in order to satisfy their own shariah requirements.

**Third parties**

If transactions to be subject to amendment through a protocol involve third parties, such as a guarantor, ensuring that any consents or approvals of the third party have been obtained for the amendments that are being made through the protocol will need to be addressed, as will any impacts on security arrangements. The protocol itself may well not be able to address these issues within its terms, and parties will thus need to establish how these aspects will be addressed outside the protocol.

**Protocol Infrastructure**

A key aspect of a protocol mechanism is who will administer it? Establishing and operating a protocol requires an infrastructure, such as the IT platform on which the protocol will be hosted. This involves cost. Creating the infrastructure and covering the cost of it is therefore something that will need to be resolved. Whoever the administrator is will have some responsibilities too, for example in determining that an adherence submitted by a party has been correctly completed and submitted, that the party submitting it is one of the market participants to whom adherence to the protocol is available and so on. Other market participants who adhere through the protocol mechanism will need to accept that the determinations of the chosen administrator are binding. The administrator will also wish to limit any liability it may incur and will likely seek adherents contractual acceptance of the limitation. The logistics of the establishment of a protocol also require to be determined, for example where will it be hosted, what will be the requirements to be met by a party which wishes to adhere to it, will there be any choices to be made by adhering parties and if so how will those be made and indicated and so on.

**Conclusion**

Although a protocol mechanism is potentially a useful and efficient way for multiple market participants to effect the contractual arrangements that they require to put in place between themselves in order to implement IBOR transition, the usability of a protocol and the choices, logistics and infrastructure required to support a protocol raise practical challenges which it will be important for market participants to address before an effective protocol mechanism can be put into place.
Section 4
THE TRANSITION FROM LIBOR TO RISK-FREE RATES IN THE BOND MARKET: RISKS AND REGULATION
(As of 24th November, 2020)
By: Mr. Paul Richards
Head of Market Practice and Regulatory Policy of International Capital Market Association Ltd (ICMA)
Introduction

1. I am going to talk briefly about the transition from LIBOR to risk-free rates globally in the bond market. I am going to focus on three issues: progress in the transition in the bond market; the regulation of the market; and the risks that need to be addressed by market participants by preparing for the end of LIBOR.

2. I should say at the outset that I am chairing the Risk-Free Rate Bond Market Sub-Group in London, working closely with the Bank of England and the FCA. The FCA, as you know, has an international role as the regulator of the administrator of LIBOR; and bond contracts referencing LIBOR under English law are denominated in a range of different currencies: particularly sterling and US dollars. As you know, LIBOR is due to cease on or after the end of 2021.

My first point is about the global transition in the bond market

3. The starting point for the transition is for market participants to use risk-free rates instead of LIBOR in new financial transactions. Substantial progress has already been made in using risk-free rates in wholesale markets internationally, including in the sterling and US dollar bond market. In the sterling bond market referencing SONIA, new issuance referencing LIBOR has all but ceased. New issues in the bond market are generally using risk-free rates compounded in arrears rather than forward-looking term rates. Both the Federal Reserve Bank of New York (since March) and the Bank of England (since August) have been publishing daily compounded indices, for SOFR and SONIA respectively.

4. The transition to risk-free rates for new transactions leaves a tail of legacy bond transactions still referencing LIBOR and maturing beyond the end of 2021. The FCA is encouraging the market to reduce the legacy tail through active conversion from LIBOR to risk-free rates before the end of 2021 or to introduce fallbacks from LIBOR to risk-free rates, where this is practicable. As risk-free rates are economically not the same as LIBOR, a credit adjustment spread needs to be added. In the case of fallbacks, the cash markets have adopted the same method of calculating the credit adjustment spread as the derivatives market: the historic median over a five-year look-back period.

5. Unlike the derivatives market, a multilateral protocol is not feasible in the bond market. Active conversion from LIBOR to risk-free rates in the bond market needs to be carried out bond by bond. Most legacy LIBOR bonds in sterling or US dollars will fall back to a fixed rate when LIBOR ceases, which was not the original intention. Some bond contracts are too difficult to convert, and there are also too many to convert by the end of 2021.

My second point is about regulation through legislation of tough legacy contracts

6. So there will be an irreducible core of “tough legacy” contracts outstanding at the end of 2021. The UK authorities are proposing to legislate for tough legacy. At pre-cessation (potentially at the end of 2021), when the FCA judges that LIBOR is no longer representative of its underlying market, LIBOR will no longer be permitted to be used in new transactions, but it will continue to be used in certain legacy transactions.

7. In response to its international role as the regulator of the administrator of LIBOR, legislation was introduced in the UK on 21 October to grant the FCA powers to direct the administrator of LIBOR to change the method of calculating LIBOR, when it is no longer representative, from a panel of banks to a different method. Last week, on 18 November, the ICE Benchmark Administration, the administrator of LIBOR, announced that it will consult on its intention that the euro, sterling, Swiss franc and yen LIBOR panels will cease at the end of 2021. Alongside this statement, the FCA published two consultations about its proposed policy in relation to the new powers that it will be granted by legislation.

8. The interaction between legislation in the UK, and legislation also proposed in the US and the EU, is still uncertain. It would make a big difference to the international bond market if the legacy rate for US dollar bonds issued under English law and the legacy rate for US dollar bonds issued under New York law would be the same.
My third point is about avoiding risks by preparing for the end of LIBOR

9. On 16 October, the Financial Stability Board Official Sector Steering Group, as the global standard setter for the transition from LIBOR to risk-free rates, published a global transition roadmap setting out ways in which private sector firms can minimise risks by preparing for the transition away from LIBOR, and noted that individual regulators may require firms to move faster in some instances. The steps include:

- Firms should already at a minimum have identified and assessed all their existing LIBOR exposures, by currency and maturity, beyond the end of 2021, and the fallback arrangements that those contracts currently have in place.

- Firms should have identified other dependencies on LIBOR outside of its use in financial contracts: for example, use in financial modelling, discounting and performance metrics, accounting practices, infrastructure, or non-financial contracts (e.g. in late payment clauses).

- Firms should have agreed a project plan and should have begun communicating with their clients about the transition.

- Firms should adhere to the ISDA Fallbacks Protocol, subject to individual firms’ usual governance procedures and negotiations with counterparties as necessary. Adherence to the protocol is strongly encouraged by regulators and, where the protocol is not used, other appropriate arrangements will need to be considered to mitigate risks.

- Providers of cleared and exchange-traded products linked to LIBOR should also ensure that these incorporate equivalent fallback provisions as appropriate.

10. By mid-2021:

- Firms should have determined which legacy contracts can be amended in advance of end-2021 and establish plans to do so in cases where counterparties agree.

- Where LIBOR linked exposure extends beyond end-2021, firms should make contact with the other parties to discuss how existing contracts may be affected and what steps firms may need to take to prepare for use of alternative rates.

- Firms should have implemented the necessary system and process changes to enable transition to robust alternative rates.

11. By the end of 2021:

- Firms should be prepared for LIBOR to cease.

- All new business should either be conducted in alternative rates or be capable of switching at limited notice.

- For any legacy contracts for which it has not been possible to make these amendments, the implications of cessation or lack of representativeness should have been considered and discussed between the parties, and steps taken to prepare for this outcome as needed. The scope and impact of any steps taken by authorities to support tough legacy contracts, if available, should have been clearly understood and taken into account.

- Finally, all business-critical systems and processes should either be conducted without reliance on LIBOR or be capable of being changed to run on this basis at limited notice.
Section 5
Impact on Profitability due to IBOR Transition & Accounting Issues

By: EY Bahrain

(The information was presented at IIFM event held on 24th November 2020).
IIFM has formulated a working group seeking comments from the participants to the Global Benchmark Rates Reform encompassing the transition from Inter-Bank Offer Rate (IBOR) to alternative Risk-Free Rate (RFR). This document highlights potential accounting and reporting issues arising in general on Shari’ah compliant contracts from RFR transition due to change in the basis for determining the profitability in the agreements and the resulting profit amount (pricing).

Following the decision taken by global regulators to replace certain IBORs with alternative RFRs, regulatory and accounting bodies, industry associations and central banks have issued various publications on the subject. Relevant public authorities, in the UK and internationally, have been clear that LIBOR will cease and relevant panel banks will not be compelled to submit LIBOR data post 2021. This will impact the variable LIBOR-linked contracts in particular, such as fixed-rate LIBOR-based master agreements entered before cessation of LIBOR and may require adjustments in other the contracts which will be indirectly impacted.

Various alternative RFRs have been recommended and are being considered for LIBOR; the most well-known which were in existence during the LIBOR era, are Secured Overnight Financing Rate (SOFR) for dollar-denominated contracts and Sterling Overnight Interest Average (SONIA) for sterling-denominated contracts. While both SOFR and SONIA are being widely embraced for use in conventional contracts, there are no broadly accepted Alternative Reference Rates (ARR) for Shari’ah compliant contracts which is both an opportunity and a challenge for the industry.

Reference has been drawn from International Financial Reporting Standards (IFRS), IBOR-related International Accounting Standards Board (IASB) Amendments – Phase 1 and Phase 2, existing Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Standards, EY material – Applying IFRS: IBOR Reform and research papers on IBOR impact for Islamic products such as Transitioning from LIBOR: Implications for Islamic Finance by Clifford Chance, Benchmark Reform - the Impact of IBOR Transition on the Islamic banking industry by Norton Rose Fulbright, etc. Furthermore, for EY commentary and opinion on the IASB Amendments: Phase 1 and Phase 2, please refer Applying IFRS: IBOR Reform.

Focus areas

1. Relevance of modification in financial assets and financial liabilities concept as defined in generally accepted accounting principles.

2. Treatment of rental or profit amount in executory contracts (where performance remains outstanding) and their related accounting if:
   a. Referenced benchmark rates transition to RFRs; and/or
   b. Rental or profit amounts have been changed (such as Master agreements or future Ijarah periods);

3. Treatment of profit amount in equity or quasi-equity type contracts; and

4. Potential accounting issues if reference to benchmark rates and/or rental or profit amounts in executed contracts, where all parties have fulfilled their promises and transaction is closed, are changed;

5. Treatment of agency fee where it is based on variable benchmark rate such as LIBOR.

Assumptions:

a. This draft consultation paper is prepared as part of initiative of IIFM and anything in this paper should not be construed as an official opinion or position of EY;

b. We are not the Shari’ah scholars and anything in this paper should not be construed as Shari’ah interpretation of the matters;
c. There is no accounting standard or guidance from AAOIFI issued at the moment on IBOR transition. Introduction of new AAOIFI Financial Accounting Standard (FAS) may have impact on the potential accounting of Islamic contracts.

**Technical Arguments:**

1. **IASB Amendments:**

IBOR reform raises a number of accounting issues and in response, the IASB added a project, in 2018, to its agenda to consider the financial reporting implications of the reform. It identified two groups of accounting issues that could have financial reporting implications. These were:

- **Phase 1:** pre-replacement issues - issues affecting financial reporting in the period before the replacement of an existing interest rate benchmark with an alternative RFR; and
- **Phase 2:** replacement issues - issues that might affect financial reporting when an existing interest rate benchmark is replaced with an alternative RFR.

**Phase 1: Pre-Replacement Issues - Issues Affecting Financial Reporting in the Period before the Replacement of an Existing Interest Rate Benchmark with an Alternative RFR:**

In September 2019, IASB issued Interest Rate Benchmark Reform, Amendments to IFRS 9, IAS 39 and IFRS 7 (the Phase 1 Amendments). The Phase 1 mainly covers the temporary reliefs introduced to the requirements of hedge accounting under IFRS 9 and IAS 39. The reliefs will enable hedge accounting to continue during the interim period of uncertainty before the replacement of IBOR with RFR.

The amendments provide a number of reliefs in applying IFRS 9 that will apply to all hedging relationships that are directly affected by uncertainties, due to IBOR Reform, regarding the timing or amount of benchmark-based cash flows of the hedged item or hedging instrument. The amendments are broadly related to the assessment of probability of forecast transaction, reclassification of cash flow hedge reserve to profit or loss, assessment of the economic relationship between the hedged item and the hedging instrument and relief from ‘separately identifiable’ risk component of financial instrument and are covered in IFRS 9.6.8.4-9.6.8.7.

For entities that are applying IAS 39, amendments consistent with IFRS 9 are introduced with some differences. Since the change is significant and will require additional information to be disclosed to the users of financial statements, IASB also added IFRS 7.24H to specify some additional disclosure requirements.

The Phase 1 Amendments were effective for accounting periods beginning on or after 1 January 2020 and early application was permitted.

**Phase 2: Replacement Issues - Issues that might Affect Financial Reporting When an Existing Interest Rate Benchmark is Replaced with an Alternative RFR:**

In August 2020, the IASB issued Interest Rate Benchmark Reform Phase 2, Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16 (the Phase 2 Amendments). The Phase 2 Amendments provide the following with respect to changes in financial instruments that are directly required by the IBOR Reform:

- A practical expedient when accounting for changes in the basis for determining the contractual cash flows of financial assets and liabilities, to allow the effective interest rate to be adjusted
- Reliefs from discontinuing hedge relationships
- Temporary relief from having to meet the separately identifiable requirement when an RFR instrument is designated as a hedge of a risk component

- Additional IFRS 7 disclosures

The Phase 2 Amendments also affected IFRS 16 Leases and IFRS 4 Insurance Liabilities.

The Phase 2 Amendments are effective for annual periods beginning on or after 1 January 2021 and early application is permitted.

2. Modification of contractual cash flows – in the context of IASB Amendments:
   
i. In its Phase 2 Amendments the IASB has identified four ways that changes in the basis for determining the contractual cash flows of a financial instrument might be made in order to achieve IBOR Reform:
      
      - By amending the contractual terms (for instance to replace a reference to an IBOR with a reference to an RFR);
      - Through activation of an existing fallback clause in the contract;
      - Without amending the contractual terms, to change the way that an interest rate benchmark is calculated;
      - A hedging instrument may alternatively be changed as required by the IBOR Reform, not by amending the basis on which its contractual cash flows are calculated but, for instance, by closing out an existing IBOR-related derivative and replacing it with a new derivative with the same counterparty, on similar terms except referencing an RFR.

   ii. The first three of these types of changes to the basis for determining contractual cash flows may have an effect on how interest/profit is recognised on financial instruments recorded at amortised cost or at fair value through other comprehensive income / fair value through equity, and the consequences and reliefs are summarized below.

Changes in the rate of interest/profit:

iii. If an IBOR is amended to refer to an RFR, without the benefit of the amendments:
      
      - First, the entity would have to assess whether the changes made to a financial instrument to achieve the IBOR reform would lead to its derecognition;
      - Second, if the instrument is not derecognised and is recorded at amortised cost or at fair value through other comprehensive income, the entity would apply the requirements in paragraph 5.4.3 of IFRS 9 and recalculate the carrying amount of the financial instrument using the original effective interest rate (EIR), i.e., based on the IBOR before transition to the RFR.

   iv. The second of these would mean that interest/profit revenue or expense would continue to be recognised using an IBOR-based EIR over the remaining life of the instrument. The Board considered that, in the context of IBOR reform, this outcome would not necessarily provide useful information to users of the financial statements, as the interest/profit recognised would not reflect the economic effects of changes made to a financial instrument as a result of the IBOR reform.

   v. Therefore, practical expedient has been provided for changes to cash flows that relate directly to the IBOR Reform to be treated as changes to a floating interest rate, i.e., the EIR is updated to reflect the change in profit benchmark from IBOR to RFR without adjusting the carrying amount.
vi. The use of the practical expedient is subject to two conditions:

- First, the change in the basis for determining contractual cash flows must be a direct consequence of the IBOR Reform; and
- Second, the new basis for determining the contractual cash flows must be ‘economically equivalent’ to the previous basis immediately preceding the change.

vii. Examples of where changes would be ‘economically equivalent’ include:

- The addition of a fixed spread to compensate for the basis difference between an existing IBOR and the alternative RFR;
- Changes to the reset period, reset dates or the number of days between coupon payment dates that are necessary to effect the IBOR Reform;
- The addition of a fallback provision that specifies the hierarchy of rates to be used in the event that the existing rate ceases to exist.

However, the IASB regards ‘economic equivalence’ to be principles-based and the above list is not intended to be exhaustive.

**Derecognition**

viii. IFRS 9.3.3.2 states that for financial liabilities, a modification that results in a ‘substantial change’ in the expected cash flows will lead to the derecognition of the original liability and the recognition of a new one.

ix. Due to IBOR Reform, IASB has provided a practical expedient. Any changes that are directly as a result of IBOR reform would not qualify for derecognition, as discussed in “Changes in the rate of interest/profit” above. However, as per IFRS 9.5.4.9, after an entity applies the practical expedient, it must then separately assess any further changes that are not required by the IBOR reform (e.g. a change in credit spread or a maturity date) to determine if they constitute such a substantial modification that they result in derecognition of the financial instrument.

### 3. Modification of contractual cash flows – application on Islamic products:

i. In the context of Islamic finance products, Islamic Financial Institutions (IFIs) may follow IASB framework or AAOIFI framework depending on the local jurisdiction regulations. IASB has introduced various concessions and practical expedients to cater the IBOR-related accounting and reporting impact and concluded the IBOR Reforms in this regard. Accordingly, the requirements of IASB Amendments, Phase 1 and Phase 2 discussed in Sections 1 and 2 above may be applied by IFIs in line with the local regulations and with the approval of their Shari’ah Board having regard to the Shari’ah rules and principles.

ii. Under AAOIFI framework, AAOIFI has issued the Exposure Draft of “AAOIFI Conceptual Framework for Financial Reporting by Islamic Financial Institutions (Revised 2020)” which is approved in-principle by AAOIFI Accounting Board on 5th September 2020 and is in the process of final issuance. The Exposure Draft of Revised Framework discusses the concepts of discounting and time value of money. The Revised Framework will be applicable prospectively from the date of issuance.

iii. Furthermore, AAOIFI Shari’ah Standard No. 27: Indices discusses the Shari’ah requirements for the methods of calculation of indices, its uses and application which provides the yardstick to measure the permissibility of benchmarks or indices. AAOIFI
Shari’ah Standard No. 47: Rules for Calculating Profit in Financial Transactions should be considered for Shari’ah implications on profit calculation.

iv. However, as of the date, AAOIFI did not issue any guidance on the accounting and reporting issues arising on replacing IBOR with the alternative reference rates. Therefore, significant judgement and consultations will be required on the application of AAOIFI FAS in the event of transition from LIBOR and thereafter.

v. In the light of this, the following table provides a high-level comparative analysis on Islamic finance contracts commonly used in GCC, which could get impacted due to IBOR transition:

<table>
<thead>
<tr>
<th>Contract &amp; nature</th>
<th>Example of product</th>
<th>Treatment Under IFRS</th>
<th>Treatment Under AAOIFI</th>
<th>Impact</th>
<th>Key Shari’ah Implication</th>
</tr>
</thead>
<tbody>
<tr>
<td>Master Murabaha (Executory contract)</td>
<td>Corporate finance</td>
<td>There would not be any accounting implication before entering into individual Murabaha contract (i.e. draw down thru deal ticket). Murabaha contracts are generally treated as financing and carried at amortized cost under IFRS 9.</td>
<td>The reference rate stated in Master Murabaha remain floating and subject to adjustment until the contract is signed.</td>
<td>Revised profit rate cannot be accurately known on day-one due to backward looking ARR and therefore the previous LIBOR-based benchmark rate may not be ‘economically equivalent’ to the new benchmark rate.</td>
<td>AAOIFI Shari’ah Standard No. 8. If the profit rate and sale amount remain undecided due to backward looking ARR, this will most likely result in Gharar if overnight rate is applied. Furthermore, any adjustments after execution may result in breach of Shari’ah rules and principles.</td>
</tr>
<tr>
<td>Murabaha (Executed contract)</td>
<td>Corporate/Consumer finance</td>
<td>Murabaha transaction is generally treated as financing and carried at amortized cost under IFRS 9.</td>
<td>Murabaha contract, once executed, becomes a fixed rate, cost-plus sale contract and cannot be revised after execution. Murabaha transaction is disclosed as a trading transaction as per FAS 28.</td>
<td>Profit rate of Murabaha is fixed at inception due to Shari’ah requirement, therefore, this will not likely have any IBOR implication.</td>
<td>AAOIFI Shari’ah Standard No. 8. Shari’ah principle relating to fixing of profit and sale amounts in case of Murabaha needs to be observed.</td>
</tr>
<tr>
<td>Ijarah &amp; Ijarah Muntahia Bittamleek</td>
<td>Corporate/Consumer finance</td>
<td>This is treated as finance/operating lease as per applicable criteria under IFRS 16 which usually results in recognition of Net Investment in Lease in the books of lessor.</td>
<td>As per FAS 8/ FAS 32, Ijarah contracts are treated as operating leases with or without transfer of ownership in the books of lessor. Accordingly, (physical) Ijarah asset is not derecognized from the books of lessor until transfer of ownership and control.</td>
<td>Net investment in lease computed using the original EIR in the beginning would need to be revisited after implementation of ARR and to determine that cash flows must be ‘economically equivalent’. Under AAOIFI, value of physical asset will not change, however, future rentals to be</td>
<td></td>
</tr>
<tr>
<td>Ijarah contract with subsequent sale after the end of Ijarah contract</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>AAOIFI Shari’ah Standard No. 9. Ijarah rental amount must be fixed before the beginning of period subject to Shari’ah approval. Profit rate for rentals that become due and receivable cannot be increased.</td>
</tr>
<tr>
<td>Contract &amp; nature</td>
<td>Example of product</td>
<td>Treatment Under IFRS</td>
<td>Treatment Under AAOIFI</td>
<td>Impact</td>
<td>Key Shari‘ah Implication</td>
</tr>
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</tr>
<tr>
<td>Mudaraba</td>
<td>Corporate finance (Project financing)</td>
<td>The classification, recognition and measurement of Mudaraba/ Musharaka contracts are based on the business model adopted, management’s intention and cash flow characteristics, and are determined on contract-by-contract basis. Please refer the relevant IFRS applicable on financial instruments.</td>
<td>Initially, Mudaraba/ Musharaka investments are recorded at value of cash paid or fair value of assets (for capital provided in-kind) in accordance with FAS 3/ FAS 4 respectively with the recognition of profits to the extent these profits are being distributed. Whereas incurred losses are also deducted from Mudaraba/ Musharaka capital. (In constant Musharaka, capital is measured at historical cost subsequently)</td>
<td>Under IFRS, at the time of transition to ARR, implication for change in EIR on fair value needs to be worked out where ‘hold to collect and sell’ model followed. Since reserves and undistributable profits are not recognized under AAOIFI, there might not be any impact due to IBOR transition.</td>
<td>Implications in line with AAOIFI Shari‘ah Standards No. 13 &amp; 12. If the revised profit is not computed until the time of final distribution or loss cannot be assessed, this may result in Shari‘ah non-compliance.</td>
</tr>
<tr>
<td>Investment Participatory mode on profit-sharing/ loss-bearing basis</td>
<td>Musharaka Investment Participatory mode on profit and loss sharing basis</td>
<td>Shares, Sukuk and similar instruments</td>
<td>Corporate finance</td>
<td>The classification, recognition and measurement of these instruments are based on the business model adopted, management’s intention and cash flow characteristics, and are determined on contract-by-contract basis. Please refer the relevant IFRS applicable on financial instruments.</td>
<td>There might not be a difference in the requirements of business model test and cash flow characteristics test, however, differences may still arise due to Shari‘ah implications e.g. monetary debts are not allowed to be carried at fair value under FAS 33. Furthermore, as per existing Framework, difference will arise in equity instruments due to retention of ‘significant and prolonged’ approach under AAOIFI. In case of fair value through equity classification, treatment of fair value needs to be worked out where ‘hold to collect and sell’ model followed.</td>
</tr>
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</table>
In the above context, consideration would need to be given whether calculating present value of financial instrument based on the concepts of "time value of money and discounting" and "substance over form" is appropriate.

Note 1: The above instruments are discussed from assets’ viewpoint to trigger the thought process for IBOR impact, however, effect on liability, equity or quasi-equity would need to be considered as well. Consideration would also need to be given where due to change in benchmark rates, the contract becomes onerous.

Note 2: In case of master / executory contracts, a situation may arise where one or both parties have entered into a promise that has to be honored. Accounting and reporting impact of these contracts would be different based on contractual terms and conditions. The assessment of modifications to contractual cash-flows as a consequence of IBOR Reform in Section 2 above, using EIR, involves the application of concepts of “discounting” and “time value of money”.

These concepts are not applicable in Islamic finance contracts on as-is-basis unless generally accepted accounting principles are used for financial reporting.

Concept of “time value of money and discounting” – AAOIFI Conceptual Framework for Financial Reporting by Islamic Financial Institutions (Revised 2020), Chapter 7, (AAOIFI Accounting Board has provided in principle approval to the Framework 2020):

i. Accruing additional return on receivables and monetary balances for the passage of time, or alternatively discounting receivables and monetary balances against early settlement, generally tantamount to Riba. In other words, time value of money is not acceptable while time value of economic resources is allowable (Framework 2020, Table A).

ii. Primary accounting computations shall not be based on time value of money. Time value of economic resources including sales profits, Ijarah rentals, service Ijarah payments etc. shall be the primary basis of accounting (Framework 2020, Table A).

iii. Time value of money (as a reflection of time value of economic resources, and a uniform measurement tool) may be used for estimations of fair values, provisions, reserves etc. but not as a primary accounting model (Framework 2020, Table A).

iv. In Shari’ah contracts, unlike generally acceptable accounting principles, equal importance is given to substance, form and economic reality and therefore, the existence of legal contract has its own importance which derives the recognition and derecognition of assets and liabilities along with transfer of control and risks and rewards (Framework 2020, Para 117).

v. If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with its substance and economic reality as well as the legal form (Existing Conceptual Framework Para 8/3/3).
vi. Financial reporting involves consideration of the substance of an economic phenomenon as well as its legal form (Existing Conceptual Framework Para 8/3/3).

Consideration would need to be given whether the application of modification of contractual cash flows concept, and hence replacing old financial instrument with a new one, is appropriate in Islamic finance contracts.

4. Executory contracts:

i. A master agreement is a consensus document between two parties, sometimes represents as a framework agreement, in which the parties agree to the standard terms and conditions that will govern future transactions or future agreements.

ii. A master agreement is a bilateral promise that does not bind any of the parties to enter into those transactions containing terms and conditions for the successive contracts unless offer and acceptance are exchanged between contracting parties to enter into individual and distinct transactions. Parties may agree to amend the standard terms and conditions with mutual consent at any time before entering into an individual transaction.

iii. These terms and conditions are expressly reconfirmed and incorporated in every contract.

iv. Accordingly, the parties may agree that in the event of cessation of LIBOR, owing to LIBOR reform, the reference rate in the Master agreement will be changed to affect the alternative RFR. Calculation of profits and/or rentals thereafter will be based on the revised benchmark rates for future contracts.

v. Since we are discussing the accounting for future contracts in this section, likely effect on the accounting treatment for recognition and deferment of profits and/or rentals needs to be re-evaluated based on the new reference rate regime.

Two important factors to consider are commercial viability of the alternative overnight backward-looking RFR when the contract period will end, and Shari’ah implications.

vi. Furthermore, backward looking RFR may not be workable in every Islamic contract. In Islamic debt and rental contracts such as Murabaha/Musawama, Ijarah, etc., the profit amount and/or rental needs to be fixed and agreed in absolute terms at the inception of the contract i.e. at the time of exchange of offer and acceptance and / or before the beginning of contract period, otherwise non-fixation of profit and/or rental would lead to Gharar (uncertainty). Gharar is defined as something which is uncertain or leads to unknown consequences.

vii. Work-around might be required e.g. forecasting future rates based on past trends or where the expected profit is more than the actual profit at the end of the contract, the bank may offer incentive to the customer at its own discretion where it is allowed. Similarly, if the expected profit is less than the actual profit, the parties may mutually agree to incorporate the differential amount into successive contract so that neither party will suffer. However, this may carry additional Shari’ah implications, such as Gharar due to changing sale price for a Murabaha transaction (intention to vary exists at inception).
5. Equity or quasi-equity type contracts:

i. “It is not permitted that the final allocation of profit take place based on expected profit, i.e. it is necessary that the allocation of profit take place on the basis of actual profit earned through actual or constructive valuation of the sold assets.” (AAOIFI Shari’ah Standard (12): Para 3/1/5/10)

ii. In equity and quasi-equity type contracts, profit distribution is subject to profit sharing ratio agreed between the parties.

iii. The parties may use the IBOR/RFR benchmark to reach an expected profit amount. However, final profit distribution cannot be based as a percentage of capital in a way that profit amount is fixed. Therefore, any profit derived using the benchmark rate of IBOR will be subject to final calculation based on profit sharing ratio agreed at the beginning of the contract.

In the light of above, consideration would need to be given that in the event IBOR is replaced with an alternative RFR, the governing documents should refer to the alternative reference rates and the provisional profit calculation may be updated accordingly.

iv. Due to the nature of equity and quasi-equity contracts, any profit calculated based on RFR during the interim period will be provisional only, therefore it will not require any adjustment to the provisional profits previously recognised in the books of accounts.

v. When final profit distribution is made, the accounting entry will reflect the final calculation based on profit sharing ratios and a part of provisional profit.

Accordingly, consideration would need to be given to understand what additional disclosures would be required to present the complete and transparent information to stakeholders.

6. Executed contracts:

i. Executed contracts where the respective obligations from all parties have been fulfilled and the transaction is closed except the payment is required from debtor (customer) to the creditor (the bank), the outstanding amount represents a receivable (dain). Examples may include Murabaha receivable or Ijarah rental receivable where the Murabaha commodity is sold or benefit from Ijarah asset has been obtained by the lessee.

ii. The receivable amount cannot be increased and it represents a kind of fixed contract even if it is originally calculated using some reference rate such as IBOR as allowed under Shari’ah guidelines.

Consideration would need to be given whether updating the reference to RFR in such contracts is required and whether it will have any accounting repercussions which is highly unlikely.

iii. On the other hand, any deferred profit to be amortised to income on contractual credit period on a time proportionate basis may continue to be recognised using implicit profit rate.
Consideration would need to be given whether the replacement of benchmark rate is required and/or would it require any adjustment in calculation of implicit profit rate given the concept of “time value of money and discounting” as discussed above.

iv. Any decrease in the amount receivable by the bank may be allowed by way of providing incentive to the customer following the applicable Shari’ah principles.

v. Last but not the least, Istisna requires a predetermined rate to be used at the time of signing of the contract. By virtue of that principle, Istisna schedule is usually agreed at the time of signing of contract and is not subject to any variations (except where Istisna incentive is provided) unless product is not delivered as per agreed specifications.

Consideration would need to be given whether on the date of replacement of IBOR, the benchmark for executed Istisna contracts will be subject to replacement which is highly unlikely.

7. Agency contracts:

i. In the investment agency contract, agency fees might be either fixed amount or linked to certain benchmark known to both parties before every investment as per AAOIFI Shari’ah Standard (46): Para 5/1.

If the agency is remunerated, the agent’s fee should either be a fixed amount or a percentage of the amount invested. It is also permissible to link the fee to an established index/benchmark that is known to both parties and is referred to before every investment period after the fee of the first period has been determined. It should, however, be capped and floored (by assigning it maximum and minimum limits).

ii. As per FAS 31.41, “agency fee is required to be recognised on accrual basis when the relevant services are provided”.

iii. If the agency contract is changed to reflect the replaced benchmark rate, agency fee will be required to adjust and accrue as per alternative RFR.

Accordingly, consideration would need to be given what additional disclosures are required to present the complete and transparent information to the stakeholders.
References:

Following material is referred while preparing this draft Paper:

- IFRS Developments, Issue 152 / September 2019, EY
- Applying IFRS, IBOR Reform, October 2020, EY
- Conceptual Framework for Financial Reporting by Islamic Financial Institutions, AAOIFI
- [Exposure Draft (F3/2019) v8.0 of the], AAOIFI Conceptual Framework for Financial Reporting by Islamic Financial Institutions (Revised 2020), AAOIFI
- Shari’ah Standard (8): Murabahah, AAOIFI
- Shari’ah Standard (12): Sharikah (Musharakah) and Modern Corporations, AAOIFI
- Shari’ah Standard (13): Mudarabah, AAOIFI
- Shari’ah Standard (46): Al-Wakalah Bi Al-Istithmar (Investment Agency), AAOIFI
- Shari’ah Standard (47): Rules for Calculating Profit in Financial Transactions, AAOIFI
- Financial Accounting Standard No. 25/33, Investment in Sukuk, Shares and Similar Instruments, AAOIFI
- Financial Accounting Standard No. 30, Impairment and Credit Losses and Onerous Commitments, AAOIFI
- Financial Accounting Standard No. 31, Investment Agency (Al Wakala Bi Al-Istithmar), AAOIFI
- IFRS 9: Financial Instruments, IASB
- Transitioning from LIBOR: Implications for Islamic Finance, Clifford Chance
- Benchmark Reform - the Impact of IBOR Transition on the Islamic banking industry, Norton Rose Fulbright
Section 6
Implications & Structuring Challenges on Islamic Finance
Developing Unified Remedies and Possible Solutions
By: Standard Chartered Saadiq

(The proposed solutions and possible remedies were presented at the IIFM event held on 24\textsuperscript{th} November 2020).
**Structuring Challenge**

The international banking community working with regulators and key industry bodies is at advanced stages of finalizing the new reference rates. Different markets are developing their own local reference rates (e.g. SONIA in UK and SOFR in US). However, there seems to be a consensus on developing the characteristics of the new reference rate. These are:

- The new reference rate would be a Risk-Free Rate (RFR) as opposed to LIBOR which incorporated an element of credit risk.
- The new RFRs would be overnight as opposed to term rates for LIBOR.
- As a result of the above, the new RFRs would apply on a look back basis i.e. for a given repricing period the accrued financial charges will only be determined at the end of the repricing period (rather than at the start of the period).

This poses great deal of challenge in terms of shariah structuring. In this new RFR based calculation the profit is accrued on a daily basis linked to a market benchmark of the overnight rates i.e. SONIA or SOFR and the payable amount is crystalized and communicated typically 2-5 days before the payment date. The proposals below are based on overnight backward looking RFRs, which appears to be the most probable industry benchmark at the moment.

**Alternate Structures for Commodity Murabaha**

**Variant 1: Dual Tranche Structure (Spot Profit Murabaha)**

This is structure involves executing the transaction in two tranches such that there is (i) A long dated Murabaha which matures at the maturity of the finance tenor and carries a profit amount that’s equal to profit margin plus an additional buffer (as explained below) and (ii) a second tranche which is a series of Murabahas executed on a spot payment basis at the end of each profit payment period where the profit amount is equivalent to RFR.

![Diagram of Murabaha Transaction](image)

This structure contemplates two tranches for the settlement of the principal and the profit. First tranche includes a long term Murabaha contract to cover the Purchase Price and a fixed profit. Second tranche will cover the series of Spot Murabaha on each settlement date. Profit in this spot transaction will be calculated based on the Risk Free Rate (RFR). In the second tranche an undertaking to enter into spot Murabaha will be provided by the Client. Details of these two tranches are given below.

**Tranche 1- Murabaha A**

1. On the drawdown date, the bank will purchase commodities for a cost price (equal to the drawdown amount) from Broker 1.
2. Once the commodities have been purchased by the Bank, it will sell the commodities to the client for a deferred price (being the cost price plus a Fixed Profit) for Murabahah A due upon due upon the maturity of transaction.
3. Fixed Profit component in this longer dated Murabaha transaction can be structured in many ways e.g. all of the profit margin (above RFR) plus a fixed amount estimated to capture the RFR for a single or multiple profit periods. This will give buffer to the bank in case the customer refuses to enter into any of the series B Murabahas as discussed below. This additional buffer will need to be monitored and in case RFR increases substantially to a level where this additional buffer is not sufficient to provide coverage to the Bank, the Bank may ask the Customer to enter into additional multiple Murabahah under Murabahah B as discussed below to increase our additional buffer.

4. Upon purchase of the commodities, the client will on-sale the acquired Commodities to Broker 2 for an amount equal to the cost price, thereby receiving the liquidity required for the business needs.

5. The customer would then be required to pay the deferred price at the maturity of the financing which will essentially mean the repayment of the finance amount. The Murabaha agreement would carry customary acceleration provisions in case of a default or cross default by the client under any financing agreement with the Bank or any other creditor.

Tranche 2- Murabaha B

1. The Customer provides an Undertaking to enter into a series of Murabahas which could be settled on a spot payment basis or on a deferred payment basis. On each settlement date bank will purchase commodities for a cost price (being an amount agreed at the outset for structuring purposes) from Broker 1.

2. Once the commodities have been purchased by the Bank, it will sell the commodities to the customer for a spot price (cost price plus the profit calculated on RFR or any agreed profit).

3. Upon purchase of the commodities, client will on-sale of the acquired commodities to Broker 2 for an amount equal to the cost price. The proceeds of the sale will be utilized to settle the cost price element of the spot price on the relevant transaction date.

4. A new Profit Murabaha will be entered at the end of each profit period on the same terms to pay the profit amount due for that period which will continue till maturity.

5. In case the RFR rates substantially go up such that the additional profit buffer built under the Murabaha A seems to be at risk of depletion, the Customer may be asked to execute additional Murabaha B where the profit may be payable at maturity. This is essentially to build additional cushion in the buffer profit to mitigate the risk of client refusal to enter into future Murabahas.

6. In case the customer defaults on its Undertaking to enter into the spot Murabaha transaction it will constitute an Event of Default.

Analysis:
The above structure meets not only the RFR requirements but also address some of the challenges raised by the recently issued AAOIFI Standard 59. If the transaction continues till maturity Bank will waive off any additional profit left under executed Murabahas in favour of the client. One residual risk that remains in this structure is that if the client defaults on its obligation to enter into a spot Murabaha the Bank will be forced to rely on the additional buffer built in the executed Murabaha(s). To mitigate this risk one possibility is to explore addition of a Musawamah undertaking akin to the Hedging products as widely practiced in the market.

Variant 2 – Single Murabaha with Two Undertakings (Ceiling Rate Structure)
Under this variant, the bank will execute one Murabaha transaction for the entire tenor for the principal and the profit. The profit rate used will be higher rate than the commercial pricing agreed with the customer (called the Ceiling Rate). Separately, the bank will also agree a Commercial Rate through which the client will be required to make periodic payments. The total Murabaha Price calculated at the higher rate will be payable at maturity or as otherwise agreed with the bank. However, the bank will at its discretion provide a rebate if the profit amount calculated at the Commercial Rate is less than the Contract Rate profit amount.
Bank Undertaking:
As there are Shariah concerns on making the rebate obligatory therefore, the Bank will provide an undertaking to enter into a spot Murabaha to pay the differential between Ceiling Rate and Contract Rate to pass on the benefit to the Customer. This undertaking is exercisable at the maturity to provide protection to the Customer in case Commercial Rate is lower than Contract.

Customer Undertaking:
The Customer will also be providing an undertaking that in the event the Commercial Rate exceeds the Contract Rate under the first Murabaha, it would execute a spot or deferred Murabaha for the differential amount to be paid by the client.

The step by step process is as follows:

1. On the drawdown date, the bank will purchase commodities for a cost price (equal to the drawdown amount) from Broker 1.
2. Once the Commodities have been purchased by the Bank, it will sell them to the client for a deferred price (being the cost price plus profit amount) for the full tenor of the facility.
3. Upon purchase of the commodities, client will appoint the Bank as its Agent or Messenger for the on-sale Agent of the acquired commodities to Broker 2 for an amount equal to the cost price. The proceeds of the sale will be disbursed to the customer i.e. the drawdown amount.
4. Over the tenor of financing the profit settlement will take place based on the Commercial Rate and the customer will make profit payments as and when they become due in line with the commercial rate.
5. On any profit payment date, if the Commercial Rate profit amount exceeds the Contract Rate profit amount from the original Murabaha, then in that case the bank will ask the customer to execute a spot Murabaha to pay the differential amount.
6. If the Contract Rate profit amount is less than the Commercial Rate profit amount then in that case the bank at its discretion provide a rebate to the customer.
7. On the deferred payment date, client pays the outstanding amount to the bank.

Analysis:
The above structure also meets not only the RFR requirements but also address some of the challenges raised by the recently issued AAOIFI Standard 59. Similar, residual risk remains in this structure that if the client defaults on its obligation to enter into additional Murabaha (under Customer Undertaking) the Bank will be forced to rely on the additional buffer built in the executed Murabaha(s). To mitigate this risk one possibility is to explore addition of a Musawamah undertaking akin to the Hedging products as widely practiced in the market.

Alternate Structures for Ijarah/Diminishing Musharakah (DM)
The key Shariah requirement for Ijarah and DM structure is that the rent payments should be known at the beginning of rental periods. However, with the move to the Overnight RFR as a benchmark has created execution challenge. To address the issue following options are being proposed:

Variant 1: Daily Rental over the Calculation Period
Steps involved in this structure are as follows:

1. Bank and the customer will enter into an Ijarah agreement along with the Purchase Undertaking.
2. The calculation/rental period will be converted into daily rental refixing period (as opposed to the usual monthly/quarterly periods in practice today).
3. The daily rent will be linked to a known over-night RFR i.e. SONIA/SOFR
4. The client will be provided with the daily rate and the payment will be made as a summation of the daily rental for a calculation period at the end of agreed period. (monthly/quarterly etc.).
5. To address the issue of aljab-qobool (for the new rate), the clients will have access to the daily rates (e.g. through a website) and will be asked to convey their disagreement otherwise the rental period will be renewed every day on a deemed acceptance period.
6. In case the client disagrees with the new rate, the undertaking to purchase mechanism will kick in to accelerate and early terminate the transaction.
Analysis:
The above solution applies the daily rent rate to a daily rental period. One question that needs to be deliberated by the scholars is the use of a compounded RFR rate which is essentially a calculation where the daily rates for a given transaction are compounded over a defined profit period. Further discussions need to happen at IIFM working groups.

Variant 2: Breaking the Calculation Period into two Sub-rental Periods
1. In this proposal it is suggested to split a calculation period into two sub-rental periods.
2. The first rental period will start from the date of pricing/re-pricing until the time the calculation is certain this will be typically 2-5 days before the payment date.
3. The first sub rental period calculation will be based on an estimated rate through a look back exercise.
4. The second sub rental period will start once the calculation is final (2-5 days before payment date) and differential amount will be recovered as rental for the second sub-rental period which will span over 2-5 days.
5. It is important to note that it is quite likely that the rental amount for the second period could be substantially higher if the actual overnight RFRs are higher than the estimated RFRs.

For example if the Rental Period is from 1st Jan to 31st March. We break it into two parts as follows:
(i) From 1st Jan to 25 March: First Period
   The rental rate for this period can be any rate agreed upfront e.g. 3%p.a.
(ii) From 25th March to 31st March: Second Period
    The rental rate for this period will be a blended rate based on the quarterly RFR rate determined for the quarter on 25th March which will be applicable for 6 days (e.g. 3.5% p.a.)
    + An Adjustment Factor which will be equivalent to:
    \[
    \text{Adjustment Factor} = \frac{\left(\text{New Rate} (3.5\%) - \text{Frist Period Rate} (3\%)\right) \times \text{First Period Tenor} (84 \text{ days})}{\text{Second Period Tenor} (6)}
    \]

The same mechanism will be repeated for each rental period till the maturity of the transaction.

Analysis:
This structure is aligned to the “Lag Period” calculation as envisioned under the RFR calculation methodology whereby the rate calculation at period end will start a few days before the start of the profit accrual period and end a few days before.
Section 7
Recommendations & Conclusion
(As per the IBOR transition 24th November 2020 event presentations, deliberations and input by the participants as well as the advice of IIFM CWG members).
The following are recommendations for IIFM to further assess and may undertake to address the Global IBOR transformation:

A. Key takeaways from IIFM Industry Consultative Meeting held on 24th November 2020

1) Development of Islamic benchmark rates, practical issues to be highlighted in the Consultative Paper and to be tackled separately by the industry

2) Compliance with Risk Free Rates (RFR’s) and meeting the deadline is a priority

B. The Consultative Meeting Recommendations to be Undertaken by IIFM

i. Finalization of IBOR Transition White Paper

ii. Development of benchmark fallback clauses / definitions covering selected Islamic contracts or all types of contracts

iii. Assess the need for developing protocol for hedging segment and considering complexities involving operations & IT IIFM may look into publishing guidance note

iv. Development of Protocol for Sukuk and Securities may not be feasible as pointed out in the meeting hence possible development of guidance note

v. Development of RFR and AAOIFI Standard 59 related Shari’ah solutions involving:
   a. Murabahah
   b. Ijarah
   c. Musharkah
   d. Service Agency
   e. Others

vi. RFR transition related amendments in new and legacy contracts
IIFM awareness and the industry consultation campaign on Global IBOR Transition to Risk Free Rate RFR was well received by the industry participants including a number of major regulators from GCC and Far East in particular. The IIFM Core Working Group (CWG) consisting of major Islamic & International Banks, Islamic Development Bank, Law & Accounting firms and few other market participants had provided valuable input and guidance on the major issues and challenges to be addressed in the implementation of RFR through a number of CWG virtual meetings. Moreover, certain members of CWG (as mentioned in the acknowledgement) provide valuable update, information and proposed Shariah solutions which has resulted in the publication of this excellent IBOR Transition white paper by IIFM, given that IIFM is the only standard setting organization in the Islamic financial industry which has taken it upon itself to fulfill this much-needed task for the Islamic financial industry.

IBOR reform is a challenging project considering the predetermined phase out by the global regulatory timeline coupled with finding a Shariah solution to the RFR & certain Shariah solutions, amendments or inclusion of certain fallback clauses in the documentation and related guidelines particularly to Islamic Hedging, Financing and Sukuk segments of the industry.

In order to timely address the IBOR transition related issues and challenges IIFM with the support of the working group members, based in major Islamic hub jurisdictions, will now be working on the actual required development work as per IIFM mandate of documentation and products, confirmation standardization.

With the defined cut off time laid down by the global regulators IIFM with the help of working group members aim to address both legacy transactions as well as new transactions which crosses the regulatory cut of date and the pre-emptive use RFR involving transactions requiring spot or term benchmark rates.
Presentation on IBOR Transition from an Islamic Documentation Perspective
By: Dubai Islamic Bank/Dar Al Sharia
As of 24th November 2020
1. Introduction to IBOR Transition

Inter Bank Offered Rates (IBOR) are expected to transition to Alternate Reference Rates (ARRs) after 2021.

Financial market stakeholders are focused at finding suitable ARRs and adoption strategies in order to effectively transition from LIBOR.

In the absence of any specific guidance or recommendation it is pertinent that IFI aligns and embarks on an effective IBOR transition strategy in advance of the transition date.

The IBOR transition strategy for IFI should be cognizant of the Sharia parameters pertaining to the various Sharia nominate contracts and commercial requirements.

The impact for IFI is predominant for all floating rate financing (i.e. reference to the benchmark in order to determine the pricing under the subject transaction documentation)
2. Impact Areas of IBOR Transition

**Impacted Products and Transactions***

- Consumer
- Corporate
- Investment
- Treasury

**Impacted Departments**

- Sharia
- Business
- Risk Management
- Legal
- Finance
- Operations & IT

*Floating rate transactions and master documentation.

3. Dealing with IBOR Transition

**Understand Exposure and Risks**
- Assess current exposure and risks associated with IBOR transition
- Consider risks mitigants in a range of scenarios across product and transaction documents.
- Assess the customer impact and regulatory requirements

**Formulating the Transition Approach**
- Formalize the Fall-Back Provisions
- Seek requisite internal and regulatory (HSA) approvals
- Formalize the Transition Action Plan and the customer communication strategy

**Implementing the Proposed Way-Forward**
- Implement the Transition Action Plan and Customer communication
- Amend the product and transaction documentation with the Fall-Back provision and commence execution and implementation

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Denotes that this aspect has been substantially either completed or in process to the extent of Fall-Back Provisions

Denotes that this aspect is yet to commence
4. Overview of the proposed Fall-Back Provisions

**Replacement of IBOR**
Provides how the existing IBOR shall be replaced for predominately all floating rate based financing (i.e. reference to the benchmark in order to determine the applicable rate under the subject transaction documentation)

**Definition of IBOR Replacement Event**
Provides what would trigger IBOR replacement

**Definition of Relevant Nominating Body**
Defines the Relevant Nominating Body

**Definition of Replacement Benchmark Reference Bank**
Identifies the reference banks that would relied upon if there is no applicable benchmark provided by the Relevant Nominating Body

**Replacement Benchmark Adjustment Margin**
Defines the adjustment margin that would considered whilst determining the Replacement Benchmark

**Replacement Benchmark**
Provides what constitutes the Replacement Benchmark, being the Aggregate of:
(i) Formally designated, nominated or recommended replacement for IBOR (with adjustment for variance of IBOR)
(ii) Replacement Benchmark Adjustment Margin

5. Implementation of the Fall-Back Provisions under the Documentation

**Existing Impacted Transaction Documents**
- IFI shall amend the existing transaction documents to provide for the Fall-Back provision.
- In relation to the Additional Customization, the relevant mechanism shall also be duly documented through agreement with the Customer.

**New Transactions**
- Facility Letter (FOL/FAL)
  - A suitable provision shall be introduced into the Facility Letter which shall provide the mechanism for the applicability of the Fall-Back provision under the documentation.
- Transaction documents
  - The transaction documents will have the relevant Fall-Back provision provided under the core financing document.
  - In relation to the Additional Customization, the relevant mechanism (as articulated in the previous slide) shall also be duly documented.

**Key Consideration Points**
1. Since a “Hard-wired” methodology has been used, upon the occurrence of the Screen Rate / IBOR Replacement Event the Fall-Back provision would be made applicable at the instance of IFI without any involvement of the Customer to execute any additional documentation.
2. Upon the occurrence of the Screen Rate / EIBOR Replacement Event for all floating rate financing (i.e. reference to the benchmark in order to determine the pricing under the subject transaction documentation) the existing Screen Rate / EIBOR applicable will be replaced by the Replacement Benchmark.
3. The Replacement Benchmark shall only apply with respect to the determination of the screen/applicable rate under the future periods (i.e. Lease Periods, Income Periods or subsequent Murabaha Transactions, etc.) and will not apply for the previous or current pricing periods.
6. Adoption of the Replacement Benchmark

1. To the extent Forward-looking Screen Rate for the relevant period is available then such Screen Rate shall apply as an industry practice in all transactions that involve floating rate financing (i.e. reference to the benchmark in order to determine the pricing under the subject transaction documentation).

2. To the extent Forward-looking Screen Rate for the relevant period is not available then the Screen Rate shall be determined on a backward-looking, setting in arrears, basis using the Screen Rate for the previous similar period subject to the adjustment on the quotation date for the next period. Resultantly the formulation of the Screen Rate shall be the aggregate of the following:

- Limb 1 (L1): Applicable Screen Rate for the applicable previous period.
- Limb 2 (L2): Difference between the Screen Rate that was applied with respect to the previous period and the actual Screen Rate that prevailed for such previous period.
- Limb 3 (L3): Replacement Benchmark Adjustment Margin.

3. Further to 2 above, if there is a positive difference under limb 2 with respect to the current period (the Positive Difference) then such Positive Difference can be collected from the Customer on the commencement date of the next period (which will coincide with the payment date for the current period) and the balance of the amount payable under the next period will be collected in arrears on the designated date set out in the relevant Notice. Depending on the Sharia structure (except Murabaha) used the Positive Difference can also be collected by the Bank by introducing an additional limb to the relevant undertaking used to close the existing facility (in case of Ijara or Service agency only) or may be collected by adjusting the incentive mechanism available (only in investment based structures).

7. Implementation of the Replacement Benchmark Across Core Sharia Structures

- **Ijara (Financial Lease)**
  - Lease Rental is determined using applicable Replacement Benchmark rate (Backward Looking) available on Quotation Date and usually collected in arrears.
  - Positive Difference can be collected as part of Exercise Price under the Purchase / Sale Undertaking exercisable at the end of the Facility.
  - Alternatively, Positive Difference may also be collected by reducing the incentive mechanism payable to Service Agent.

- **Service Agency (Asset Based)**
  - Income is determined using applicable Replacement Benchmark rate (Backward Looking) available on Quotation Date and usually collected in arrears.
  - Positive Difference can be collected as part of Exercise Price under the Purchase / Sale Undertaking exercisable at the end of the Facility.
  - Alternatively, Positive Difference may also be collected by reducing the incentive mechanism payable to Service Agent.

- **Murabaha**
  - Murabaha Profit is determined using applicable Replacement Benchmark rate (Backward Looking) available on Quotation Date and collected in arrears.
  - Positive Difference can be collected by dividing the last Subsequent Murabaha into two Subsequent Murabahas (one for long period and the other for short period) and the Positive Difference being used to determine the profit for the short period Subsequent Murabaha.
  - Please see next slide for illustration on the mechanism provided above.

- **Musharaka / Mudaraba / Investment Wakala**
  - Profit Distribution is determined using applicable Replacement Benchmark rate (Backward Looking) available on Quotation Date and usually collected in arrears.
  - Positive Difference can be collected by reducing the incentive mechanism payable to Service Agent.

If the Replacement Benchmark is based on a forward looking approach then it can be easily implemented across the Impacted Documentation. If the Replacement Benchmark is based on a backward looking approach then the following mechanism across the Impacted Documentation can be duly adopted to protect the commercial interest of the Bank.
8. Illustrative Replacement Benchmark Determination for Murabaha

A. The above mechanism has been prepared using indicative rates that may apply for the pricing determination upon the Screen Rate Replacement Event having occurred in relation to Murabaha facility.

B. The above only provides for the determination of the Replacement Benchmark (including the Screen Rate, adjustment of variance and the Replacement Benchmark Adjustment Margin) under the Murabaha Facility. However, it does not include the Customer Margin that is applicable.

C. In order to mitigate the commercial position of the Bank, it is envisaged that the otherwise last Murabaha prior to the scheduled maturity date will be subdivided into two Murabahas (one a long period of 83 days (M3) and the other a short period of 7 days (M4)).

9. Stages in relation to the Fall-Back Provisions and Additional Customization

**Developing Sharia Solutions**
- Provide the Sharia rationale and proposed implementation basis

**Legal and Business Feedback**
- Seek and incorporate legal and business feedback

**Sharia Approval**
- Seek Sharia approval from ISSC of IFI and the regulators (as applicable)

**Draft Language**
- Draft Fall-back and Additional Customization
- Amend the Impacted Documentation

**Additional Checks and Balances**
- Address ancillary considerations from commercial perspective

**Implementation of Fall-Back provision**
- Provide implementation support

Denotes that this stage has been substantially completed

Denotes that this stage is yet to commence
APPENDIX 1: Implementation of the Fall-Back Provisions under the FOL

Overview

• The Facility Letter can contain the following provision in order to provide for the implementation of the Fall-Back provision under the transaction documents:

Notwithstanding the Applicable Rate set out above, upon the occurrence of a [Screen Rate / EIBOR] Replacement Event the Bank shall be entitled to replace the [Screen Rate / EIBOR] with the Replacement Benchmark in accordance with the Fall-Back provision as set out in the relevant Transaction Document (Fall-Back Applicable Rate). The Fall-Back Applicable Rate shall apply in relation to the subject facility with respect to the determination of the applicable rate for all future relevant periods (Lease Periods / Income Periods / Profit Distribution Period / Subsequent Murabaha Transaction) as envisaged under the relevant Transaction Documents*.

*To be adjusted according to nature of the Sharia nominate contract for each transaction.
APPENDIX 2: Proposed Fall-Back Provisions – LIBOR Based (Sale Based Structure)

Overview

- The following proposed fall-back provision (using the “hard-wired” approach) is being advanced for the purpose of implementation across all Impacted Documentation based on a sale based structure (including Murabaha / Deferred Sale Agreement / Ijara) calculated using LIBOR.

1. Replacement of Screen Rate: If a Screen Rate Replacement Event has occurred in relation to the Screen Rate, the Replacement Benchmark shall apply from the date set out in the notice served by IFI to the customer notifying the customer of the Screen Rate Replacement Event. For avoidance of doubt, failure by IFI to serve the notice as envisaged above will not affect the ability of IFI to apply the Replacement Benchmark.

2. Applicable Definitions: In this Section:

   Relevant Nominating Body means any applicable central bank, regulator or other supervisory authority or a group of them, or any working group or committee sponsored or chaired by, or constituted at the request of, any of them.

   Replacement Benchmark means a benchmark rate which shall be an aggregate of the following:

   (a) formally designated, nominated or recommended as the replacement for the Screen Rate by:

      (i) the administrator of the Screen Rate (provided that the market or economic reality that such benchmark rate measures is the same as that measured by the Screen Rate); or

      (ii) any Relevant Nominating Body, and if replacements have, at the relevant time, been formally designated, nominated or recommended under both paragraphs, the “Replacement Benchmark” will be the replacement under paragraph (ii) above; or

   (iii) in case no such replacement for Screen Rate has been determined in accordance with sub-clauses (i) and (ii) above then the replacement for Screen Rate shall be the arithmetic mean of the rate (rounded upward to four decimal places) as supplied by the Replacement Benchmark Reference Bank to IFI on its request.

   For the avoidance of doubt the replacement benchmark will apply with effect from the next relevant period subject to adjustment of the variance in Screen Rate in respect of the period to which the Screen Rate is applicable.

   (b) a Replacement Benchmark Adjustment Margin.

   Replacement Benchmark Adjustment Margin (RBAM) means an additional margin [reflected as basis points per annum as a result of Screen Rate Replacement Event] as determined by IFI using commercially acceptable methods.

   Replacement Benchmark Reference Bank mean any of the following banks: [provide name of the banks].

   Screen Rate means the London interbank offered rate administered by ICE Benchmark Administration Limited (or any other person which takes over the administration of that rate) for dollars for the relevant period (immediately prior to the current similar period) displayed [before any correction, recalculation or reproduction by the administrator] on LIBOR1 or LIBOR2 of the Bloomberg/Thomson Reuters screen (or any replacement Bloomberg/Thomson Reuters page which displays that rate) or on the appropriate page of such other information service which publishes that rate from time to time in place of [Bloomberg/Thomson Reuters]. If such page or service ceases to be available, IFI may specify another page or service displaying the relevant rate.

   *RBAM can be determined as the historic median difference between the relevant IBOR and the risk free rate over a five year look-back period (this approach is suggested by ISDA).

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APPENDIX 2: Proposed Fall-Back Provisions – LIBOR Based (Sale Based Structure)

Screen Rate Replacement Event means:

(a) the methodology, formula or other means of determining the Screen Rate has, in the opinion of IFI, materially changed; or

(b) The occurrence of the following:

   (i) Insolvency of the Administrator:

      (A) the administrator of the Screen Rate or its supervisor publicly announces that such administrator is insolvent; or

      (B) information is published in any order, decree, notice, petition or filing, however described, of or filed with a court, tribunal, exchange, regulatory authority or similar administrative, regulatory or judicial body which reasonably confirms that the administrator of the Screen Rate is insolvent, provided that, in each case, at that time, there is no successor administrator to continue to provide the Screen Rate;

   (ii) the administrator of the Screen Rate publicly announces that it has ceased or will cease to provide the Screen Rate permanently or indefinitely and, at that time, there is no successor administrator to continue to provide the Screen Rate;

   (iii) the supervisor of the administrator of the Screen Rate publicly announces that the Screen Rate has been or will be permanently or indefinitely discontinued; or

   (iv) the administrator of the Screen Rate or its supervisor announces that the Screen Rate may no longer be used; or

(c) The administrator of that Screen Rate determines that that Screen Rate should be calculated in accordance with its reduced submissions or other contingency or fall-back policies or arrangements and either:

   (i) the circumstance(s) or event(s) leading to such determination are not (in the opinion of IFI) temporary; or

   (ii) that Screen Rate is calculated in accordance with any such policy or arrangement for a period of no less than one week; or

(d) In the opinion of IFI, the Screen Rate is otherwise no longer appropriate for the purposes of calculating return under the Transaction Documents.

3. Application of Screen Rate Replacement Event: If the Screen Rate Replacement Event occurs with respect to a current [Murabaha Agreement / Deferred Sale Agreement / Ijara Period] under the relevant Transaction Document then the Replacement Benchmark shall not apply for the current [Murabaha Agreement / Deferred Sale Agreement / Ijara Period] but shall only apply with respect to all future [Murabaha Agreement / Deferred Sale Agreement / Ijara Period] under the applicable Transaction Document subject to adjustment of the variance in the Screen Rate for the relevant period and immediately preceding period.
APPENDIX 3: Proposed Fall-Back Provisions – LIBOR (Investment Based Structure)

Overview

1. Replacement of Screen Rate: If a Screen Rate Replacement Event has occurred in relation, the Replacement Benchmark shall apply from the date set out in the notice served by FI to the customer notifying the customer of the Screen Rate Replacement Event. For avoidance of doubt, failure by FI to serve the notice as envisaged above will not affect the ability of FI to apply the Replacement Benchmark.

2. Applicable Definitions: In this Section:

   - Relevant Nominating Body: any applicable central bank, regulator or other supervisory authority or a group of them, or any working group or committee sponsored or chaired by, or constituted at the request of, any of them.
   - Replacement Benchmark: means a benchmark rate which shall be an aggregate of the following:
     (a) formally designated, nominated or recommended as the replacement for the Screen Rate by:
        (i) the administrator of the Screen Rate (provided that the market or economic reality that such benchmark rate measures is the same as that measured by the Screen Rate); or
        (ii) any Relevant Nominating Body, and if replacements have, at the relevant time, been formally designated, nominated or recommended under both paragraphs, the “Replacement Benchmark” will be the replacement under paragraph (ii) above, or
        (iii) in case no such replacement for Screen Rate has been determined in accordance with sub-clauses (i) and (ii) above then the replacement for Screen Rate shall be the automatic mean of the rate (rounded upward to four decimal places) as supplied by the Replacement Reference Bank to IFI on its request.
     
   - For the avoidance of doubt the replacement benchmark will apply with effect from the next relevant period subject to adjustment of the variance in Screen Rate in respect of the period to which the Screen Rate is applicable.

   (b) a Replacement Benchmark Adjustment Margin.

   - Replacement Benchmark Adjustment Margin (RBAM): means an additional margin (reflected as basis points per annum as a result of Screen Rate Replacement Event) as determined by IFI using commercially acceptable methods.*

   - Replacement Reference Bank: means any of the following banks: [provide name of the banks].

   - Screen Rate: means the London interbank offered rate administered by ICE Benchmark Administration Limited (or any other person which takes over the administration of that rate) for dollars for the relevant period (immediately before the current similar period) displayed (before any correction, recalculation or republication by the administrator) on RBAM or LIBOR of the Bloomberg/Thomson Reuters screen (or any replacement Bloomberg/Thomson Reuters page which displays that rate) or on the appropriate page of such other information service which publishes that rate from time to time in place of Bloomberg/Thomson Reuters. If such page or service ceases to be available, IFI may specify another page or service displaying the relevant rate.

   *RBAM can be determined as the historic median difference between the relevant IBOR and the risk free rate over a five year look-back period (this approach is suggested by ISDA).

APPENDIX 3: Proposed Fall-Back Provisions – LIBOR (Investment Based Structure)

Screen Rate Replacement Event means:

(a) the methodology, formula or other means of determining the Screen Rate has, in the opinion of IFI, materially changed; or

(b) The occurrence of the following:

(i) Insolvency of the Administrator:
   (A) the administrator of the Screen Rate or its supervisor publicly announces that such administrator is insolvent; or
   (B) information is published in any order, decree, notice, petition or filing, however described, of or filed with a court, tribunal, exchange, regulatory authority or similar administrative, regulatory or judicial body which reasonably confirms that the administrator of the Screen Rate is insolvent, provided that, in each case, at that time, there is no successor administrator to continue to provide the Screen Rate;

(ii) the administrator of the Screen Rate publicly announces that it has ceased or will cease to provide the Screen Rate permanently or indefinitely and, at that time, there is no successor administrator to continue to provide the Screen Rate;

(iii) the supervisor of the administrator of the Screen Rate publicly announces that the Screen Rate has been or will be permanently or indefinitely discontinued; or

(iv) the administrator of the Screen Rate or its supervisor announces that the Screen Rate may no longer be used; or

(c) The administrator of that Screen Rate determines that that Screen Rate should be calculated in accordance with its reduced submissions or other contingency or fall-back policies or arrangements and either:

(i) the circumstance(s) or event(s) leading to such determination are not (in the opinion of IFI) temporary; or

(ii) that Screen Rate is calculated in accordance with any such policy or arrangement for a period of no less than one week; or

(d) in the opinion of IFI, the Screen Rate is otherwise no longer appropriate for the purposes of calculating return under the Transaction Documents.

3. Application of Screen Rate Replacement Event: If the Screen Rate Replacement Event occurs with respect to a current [Income Period / Rental / Profit Distribution Period] under the relevant Transaction Document then the Replacement Benchmark shall not apply for the current [Income Period / Rental / Profit Distribution Period] but shall only apply with respect to all future [Income Period / Profit Distribution Period] under the applicable Transaction Document subject to adjustment of the variance in the Screen Rate for the relevant period and immediately preceding period.
APPENDIX 4: Proposed Fall-Back Provision – EIBOR Based (Sale Based Structures - Master Documents)

Overview

- The following proposed fall-back provision (using the “hard-wired” approach) is being advanced for the purpose of implementation across all Impacted Documentation based on a sale based structure (including Murabaha / Deferred Sale Agreement / Ijara) calculated using EIBOR.

1. Replacement of EIBOR: If a EIBOR Replacement Event has occurred in relation to the EIBOR, the Replacement Benchmark shall apply with effect from the date set out in the notice served by IFI to the customer notifying the customer of EIBOR Replacement Event. For avoidance of doubt, failure of IFI to serve the notice as envisaged above will not affect the ability of IFI to apply the Replacement Benchmark.

2. Applicable Definitions: In this Section:

   EIBOR Replacement Event means:
   
   (a) the administrator of the EIBOR publicly announces that it has ceased or will cease to provide the EIBOR permanently or indefinitely and, at that time, there is no successor administrator to continue to provide the EIBOR; or
   
   (b) the methodology, formula or other means of determining the EIBOR has, in the opinion of IFI, materially changed; or
   
   (c) in the opinion of IFI, the EIBOR is otherwise no longer appropriate for the purposes of calculating return under the Transaction Documents.

   Relevant Nominating Body means the Central Bank of the UAE or other supervisory authority or a group of them, or any working group or committee sponsored or chaired by, or constituted at the request of, any of them.

   Replacement Benchmark means a benchmark rate which shall be an aggregate of the following:

   (a) Formally designated, nominated or recommended as the replacement for the EIBOR by:

   (i) the administrator of the EIBOR (provided that the market or economic reality that such benchmark rate measures is the same as that measured by the EIBOR); or

   (ii) any Relevant Nominating Body, and if replacements have, at the relevant time, been formally designated, nominated or recommended under both paragraphs, the "Replacement Benchmark" will be the replacement under paragraph (i) above; or

   (iii) in case no such replacement for EIBOR has been determined in accordance with sub-clauses (i) and (ii) above then the replacement for the EIBOR shall be the automatic mean of the rate (rounded upward to four decimal places) as supplied by the Replacement Benchmark Reference Bank to IFI on its request.

   For the avoidance of doubt the replacement benchmark will apply with effect from the next relevant period subject to adjustment of the variance in Screen Rate in respect of the period to which the Screen Rate is applicable.

   (b) Replacement Benchmark Adjustment Margin.

APPENDIX 4: Proposed Fall-Back Provision – EIBOR Based (Sale Based Structures - Master Documents)

Overview

- The following proposed fall-back provision (using the “hard-wired” approach) is being advanced for the purpose of implementation across all Impacted Documentation based on a sale based structure (including Murabaha / Deferred Sale Agreement / Ijara) calculated using EIBOR.

Replacement Benchmark Adjustment Margin (RBAM) means an additional margin (reflected as basis points per annum as a result of Screen Rate Replacement Event) as determined by IFI using commercially acceptable methods.*

Replacement Benchmark Reference Bank mean any of the following banks: [provide name of the banks].

3. Application of EIBOR Replacement Event: If the EIBOR Replacement Event occurs with respect to a current [Murabaha Agreement / Deferred Sale Agreement / Ijara Period] under the relevant Transaction Document then the Replacement Benchmark shall not apply for the current [Murabaha Agreement / Deferred Sale Agreement / Ijara Period] but shall only apply with respect to all future [Murabaha Agreement / Deferred Sale Agreement / Ijara Period] under the applicable Transaction Document subject to adjustment of the variance in the Screen Rate for the relevant period and immediately preceding period.

*RBAM can be determined as the historic median difference between the relevant IBOR and the risk free rate over a five year look-back period (this approach is suggested by ISDA).
APPENDIX 5: Proposed Fall-Back Provision – EIBOR Based (Investment Based Structure)

Overview

- The following proposed fall-back provision (using the "hard-wired" approach) is being advanced for the purpose of implementation across all Impacted Documentation based on a investment based structure (including Musharaka / Investment Wakala & Service Agency / Mudaraba) calculated using EIBOR.

1. Replacement of EIBOR: If a EIBOR Replacement Event has occurred, the Replacement Benchmark shall apply with effect from the date set out in the notice served by IFI to the customer notifying the customer of EIBOR Replacement Event. For avoidance of doubt, failure of IFI to serve the notice as envisaged above will not affect the ability of IFI to apply the Replacement Benchmark.

2. Applicable Definitions: In this Section:

EIBOR Replacement Event means:

(a) the administrator of the EIBOR publicly announces that it has ceased or will cease to provide the EIBOR permanently or indefinitely and, at that time, there is no successor administrator to continue to provide the EIBOR; or
(b) the methodology, formula or other means of determining the EIBOR has, in the opinion of IFI, materially changed; or
(c) in the opinion of IFI, the EIBOR is otherwise no longer appropriate for the purposes of calculating return under the Transaction Documents.

Relevant Nominating Body means the Central Bank of the UAE or other supervisory authority or a group of them, or any working group or committee sponsored or chaired by, or constituted at the request of, any of them.

Replacement Benchmark means a benchmark rate which shall be an aggregate of the following:

(a) Formally designated, nominated or recommended as the replacement for the EIBOR by:
   (i) the administrator of the EIBOR (provided that the market or economic reality that such benchmark rate measures is the same as that measured by the EIBOR); or
   (ii) any Relevant Nominating Body, and if replacements have, at the relevant time, been formally designated, nominated or recommended under both paragraphs, the "Replacement Benchmark" will be the replacement under paragraph (ii) above; or
   (iii) in case no such replacement for EIBOR has been formally determined in accordance with sub-clauses (i) and (ii) above then the replacement for the EIBOR shall be the automatic mean of the rate (rounded upward to four decimal places) as supplied by the Replacement Benchmark Reference Bank to IFI on its request.

For the avoidance of doubt the replacement benchmark will apply with effect from the next relevant period subject to adjustment of the variance in Screen Rate in respect of the period to which the Screen Rate is applicable.

(b) Replacement Benchmark Adjustment Margin.

APPENDIX 5: Proposed Fall-Back Provision – EIBOR Based (Investment Based Structure)

Overview

- The following proposed fall-back provision (using the "hard-wired" approach) is being advanced for the purpose of implementation across all Impacted Documentation based on a investment based structure (including Musharaka / Investment Wakala & Service Agency / Mudaraba) calculated using EIBOR.

Replacement Benchmark Adjustment Margin (RBAM) means an additional margin [reflected as basis points per annum as a result of Screen Rate Replacement Event] as determined by IFI using commercially acceptable methods.*

Replacement Benchmark Reference Bank mean any of the following banks: [provide name of the banks].

3. Application of EIBOR Replacement Event: If EIBOR Replacement Event occurs with respect to a current (Income Period / Rental / Profit Distribution Period) under the relevant Transaction Document then the Replacement Benchmark shall apply with respect to the current and all future (Income Period / Rental / Profit Distribution Period) (as applicable) under the applicable Transaction Document subject to adjustment of the variance in the Screen Rate for the relevant period and immediately preceding period.

*RBAM can be determined as the historic median difference between the relevant IBOR and the risk free rate over a five year look-back period (as suggested by ISDA for derivative transactions).