

The Shariah Advisory Council of Bank Negara Malaysia (SAC) Ruling on the Adoption of Risk Free Rate (RFR) as an Alternative Benchmark Rate to London Interbank Offered Rate (LIBOR) or as a Fallback Benchmark Replacement Rate following the Permanent Cessation of LIBOR

210th SAC Meeting dated 23 December 2020

Part I: SAC Ruling, Its Effective Date and Applicability

Pursuant to section 52 of the Central Bank of Malaysia Act 2009, the SAC ruled that the adoption of risk-free rate (RFR) as an alternative benchmark rate to LIBOR or as a fallback benchmark replacement rate after the permanent cessation of LIBOR is permissible based on the following justification:

- i. The compounding methodology is merely an arithmetic method in determining the term rate which does not affect compliance of the transactions with Shariah requirements; and
- ii. Uncertainty (*gharar*) from the adoption of average RFR or backward-looking term rate at the point of payment is mitigated via proper determination and disclosure of the ceiling price and formula to derive the periodic payment amount to the customer at the inception of the contract.

In transitioning to the alternative RFR, Shariah Committee of each IFI needs to determine the appropriateness of invoking the deemed consent mechanism to signify customers' consent on the incorporation of the fallback provision in the contract's terms and conditions.

This ruling comes into effect immediately upon publication of this ruling on Bank Negara Malaysia website dated 22 March 2021 and applies to the following Islamic Financial Institutions (IFIs):

- (a) licensed persons under the Islamic Financial Services Act 2013 (IFSA);
- (b) licensed banks and licensed investment banks approved under section 15(1) of the Financial Services Act 2013 (FSA) to carry on Islamic banking business; and
- (c) prescribed institutions approved under section 33B(1) of the Development Financial Institutions Act 2002 (DFIA) to carry on Islamic financial business.

In line with sections 28(1) and (2) IFSA or sections 33D(1) and (2) DFIA, as the case may be, IFIs are required to comply with this ruling as compliance with any ruling of the SAC in respect of any particular aim and operation, business, affair or activity of IFIs shall be deemed to be in compliance with Shariah.

Part II: Background

- In 2017, the United Kingdom Financial Conduct Authority (FCA) announced that the London Interbank Offered Rate (LIBOR) will cease to exist by the end of 2021. The scarcity of underlying transactions based on LIBOR has made the benchmark rate potentially inaccurate to reflect market conditions and unsustainable. Therefore, all existing contracts benchmarked to LIBOR have to be transitioned to an alternative benchmark rate before the end of 2021.
- Following this development, the global financial market has agreed for RFR to be the alternative benchmark rate for LIBOR as it is transaction-based and more reflective of market conditions.
- Comparison between RFR and LIBOR from various aspects is as follows:

Aspects	Alternative Risk-Free Rate (RFR)	London Interbank Offered Rate (LIBOR)
Administrator	Central banks of respective currencies, with the exception of Swiss Average Rate Overnight (SARON) which is administered by Swiss Exchange.	Intercontinental Exchange (ICE).
Methodology	Based on actual transactions in the money market.	Based on daily quote submission of the opinions of the panel banks.
Term Rate	Only overnight rate available. The term rate is derived based on methods such as compounded setting in-arrears where the exact term rate and payment amount are unknown at the onset of the payment period ¹ .	Overnight and term rates are available across various tenures based on forward-looking approach. This which allows the payment amount to be known upfront.
Risk Premium	Does not include credit risk premium of borrowing banks. This results in the rate to be typically lower than LIBOR.	Includes credit risk premium of borrowing banks.
Volatility	Less volatile than LIBOR as it moves in parallel with the policy rate of central banks.	Will be influenced by credit risk premium of borrowing banks. As such, the rate moves to reflect changes in the credit risk premium.

Reference:

1. Financial Stability Board (FSB) (2019), Overnight Risk-Free Rates – A User's Guide

Shariah issues

Based on the above, three potential Shariah issues have been identified as follows:

- Is the usage of the compounded setting in-arrears (CSIA) method to derive the term rate for profit component in sale-based and rental-based transactions complies with Shariah requirements?
- Does the usage of the backward-looking methodology in sale-based and rental-based contracts trigger uncertainty (*gharar*) issue given that the periodic payment amount can only be determined on or near the payment date?
- Is it appropriate to invoke deemed consent mechanism to signify customers' consent on the incorporation of fallback provision in the contract's terms and conditions in facilitating the transition to an alternative benchmark rate?

¹ In converting the overnight rate into term rate, compounded setting in-arrears (CSIA) method is one the method used which has been reflected in global benchmark rate reform e.g. ISDA IBOR Fallback Protocol. The CSIA is based on compounding the daily RFR throughout the observation period on backward-looking basis to derive a term rate to be applied to the underlying transactions. This backward-looking approach results in the exact term rate and payment amount being unknown at the beginning of the payment period which may trigger Shariah issue.

Part III: Key Discussion

Usage of the compounded setting in-arrears (CSIA) method to derive the term rate is permissible

- Compounding in this context is merely a computational method to derive the term rate from overnight RFR which will be used in the profit component of Shariah-compliant transactions.
- The compounding method for RFR does not cause additional charges being imposed on the accrued profit, as commonly practiced in the market for late payment incidences in conventional financial transactions.
- This view also takes into consideration the absence of reliable and widely-used term RFR.

Usage of backward-looking methodology in the RFR does not cause uncertainty (gharar) of the periodic payment

- For sale-based financial instruments with variable rate, IFIs will conclude the selling price with customers based on the ceiling profit rate (CPR)². Under this mechanism, the ceiling profit rate and the formula to calculate the effective profit rate (EPR) are made known to the contracting parties and agreed upfront.
- Therefore, the issue of uncertainty does not arise as it is mitigated by the existence and disclosure of the CPR and formula to determine the EPR.
- As for rental-based (*ijarah*) financial instruments with variable rate, the formula to calculate the periodic rental payment is made known to the contracting parties and agreed upfront. Therefore, the issue of uncertainty does not arise as it is mitigated by the existence and disclosure of the formula to calculate the periodic rental payment.³

The appropriateness of invoking deemed consent mechanism to signify customers' consent on the fallback provision to transition to an alternative benchmark rate shall be determined by Shariah Committee (SC) of each IFI

- IFIs are required to renegotiate contracts with their customers and to obtain their agreement to embed the fallback provision in existing LIBOR contracts. The inclusion of fallback provision is intended to facilitate a smoother transition to the RFR where customers provide upfront consent to IFIs to replace LIBOR with the RFR.
- The absence or lack of coverage of the fallback provision in existing contracts between IFIs and customers may expose IFIs to legal and Shariah non-compliance risks due to the absence of mutual consent of the parties to the contract. Some IFIs plan to invoke the deemed consent mechanism to deal with operational challenges such as non-responsive customers.
- Given the nature of the issue which is unique across IFIs in terms of profile of counterparties, size and complexity of exposures and the institution's risk appetite, the SAC has agreed to empower the SC of each IFI to determine the appropriateness of the use of deemed consent mechanism to incorporate the fallback provision in the agreement. The SC must also ensure that customers are provided with ample time to express consent or provide feedback on the transition to the alternative benchmark rate.
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² The usage of this method has been endorsed by the SAC at its 32nd meeting dated 27 February 2003.

³ The SAC, at its 33rd meeting dated 27 March 2003, 35th meeting dated 22 May 2003 and 38th meeting dated 28 August 2003, has resolved that the rate of rental in *ijarah* contract may vary based on an upfront agreement to base it against a mutually agreed variable for a specified period.

Part IV: Basis of Ruling

Usage of compounded setting in-arrears (CSIA) method to derive the term rate is permissible

- Shariah has not determined a specific pricing methodology for Shariah-compliant transactions. Therefore, any pricing methodology is deemed permissible unless there is a violation of Shariah requirements based on the following *fiqh* maxim:

الأصل في العقود والشروط الجواز والصحة

*"The basic principle with regard to contracts and conditions is permissibility and validity."*⁴

- The move towards the adoption of alternative RFR among market players is due to its features that are reflective of market conditions and not easily manipulated. This is in line with the Shariah principle of *siyasa shar'iyyah*⁵ in Islamic finance to ensure fairness in pricing as promoted by the following hadith:

عن أنس بن مالك رضي الله عنه: قال الناس: يا رسول الله، غلا السعر فسعر لنا. فقال رسول الله صلى الله عليه وسلم: إن الله هو المسعر القابض الباسط الرازق وإني لأرجو أن ألقى ربي وليس أحد يطالبني بمظلمة في دم ولا مال

*"It was narrated from Anas Bin Malik RA that: the people said to the Prophet PBUH: O Messenger of Allah, prices have risen, so fix the prices for us. The Prophet said: Indeed Allah is the One who fixes the prices, who withholds, who gives lavishly and who provides. And I hope that when I meet Allah none of you will have any claim on me for an injustice regarding blood or property."*⁶

- The above hadith implicitly indicates that the price movement in the market at that time was driven by market forces. Therefore, any indicator that is reflective of the prevailing market conditions is appropriate to be the benchmark rate for transactions within the given market.

Usage of backward-looking methodology in the RFR does not cause uncertainty (gharar) of the periodic payment

- Avoidance of dispute and resentment among contracting parties are among the *'illah* (effective cause) for the prohibition of *gharar*. The *fiqh* maxim says:

الجهالة التي لا تفضي إلى المنازعة لا تمنع صحة العقد

*"Ignorance that does not lead to dispute does not prevent the validity of the contract."*⁷

الجهالة في المعقود عليه إذا كانت تفضي إلى المنازعة تمنع صحة العقد

*"Ignorance in contract that leads to dispute prevents the validity of the contract."*⁸

⁴ Muhammad Mustafa Al-Zuhayli (2006), *Al-Qawa'id al-Fiqhiyyah wa Tatbiqatuha fi al-Mazahib al-'Arba'ah*. Damsyik: Dar al-Fikr, v. 2, p. 815

⁵ Basis and approach taken by the ruler for the interest of the nation and the people which is in line with Shariah principles

⁶ Abu Daud (2009), *Sunan Abi Daud*, Beirut: Dar Al-Risalah Al-'Alamiyyah, v. 5, p. 322, hadith no. 3451

⁷ Al-Sarakhsi (1989), *Al-Mabsut*, Beirut: Dar Al-Ma'rifah, v. 13, p. 7 & v. 15, p. 166; Abu Al-Harith Al-Ghazzi (2000), *Mausu'ah Al-Qawa'id Al-Fiqhiyyah*, Beirut: Dar Ibn Hazm, v. 3, p. 39-40

⁸ Ibid

- RFR is a common indicator used by majority market players that serves as a reliable measure of market movement and is publicly available for reference. Therefore, disclosure of the formula to calculate the periodic payment is sufficient and will not lead to dispute as the RFR itself and the backward-looking approach are widely accepted as a common benchmark rate and method to calculate term rate for commercial contracts.
- Furthermore, determination of the formula is done through a bilateral agreement with customers. Therefore, once the terms and conditions have been agreed between them, all contracting parties must abide by the agreement as per following hadith:

المسلمون على شروطهم إلا شرطا أحل حراما أو حرم حلالا

“Dealing of Muslims is based on conditions (as agreed) amongst them, except conditions that permit a forbidden matter or forbid a permissible matter.”⁹

- In addition, the determination of the effective profit rate for each periodic payment in sale-based financial instruments with variable-rate is considered as an ancillary (*tabi'*) and does not form part of the essential element (*asl*) of a contract. Therefore, the uncertainty or ignorance in the ancillary can be forgiven based on the following *fiqh* maxim:

يغتفر في التوابع ما لا يغتفر في غيرها

“Certain things are forgiven in its ancillary and not forgiven in others.”¹⁰

Part V: Implication of the SAC Ruling

- Enables the orderly transition to alternative RFR (including backward-looking term RFR) by IFIs before reliable and widely used forward-looking RFR term rates become available.

⁹ Abu Daud (2009), *Sunan Abi Daud*, Beirut: Dar Al-Risalah Al-'Alamiyyah, v. 5, p. 445, hadith no. 3594

¹⁰ Al-Suyuti (1983), *Al-Ashbah wa Al-Nazair*, Beirut: Dal Al-Kutub Al-'Ilmiyyah, p. 120; Ibn Nujaim (1999), *Al-Ashbah wa Al-Nazair*, Beirut: Dar Al-Kutub Al-'Ilmiyyah, p. 103; Muhammad Mustafa Al-Zuhayli (2006), *Al-Qawa'id al-Fiqhiyyah wa Tatbiqatuha fi al-Mazahib al-'Arba'ah*. Damsyik: Dar al-Fikr, v. 1, p. 447