

The Discontinuation of IBORs and Its Impact on Islamic and UAE Transactions

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1. Introduction

When calculating interest rates for floating rate loans or other instruments, the interest rate has historically been made up of (i) a margin element, and (ii) an inter-bank offered rate (**IBOR**) such as the London Inter-Bank Offered Rate (**LIBOR**) as a proxy for the cost of funds for the lender. As a result of certain issues with IBORs, the loan market is shifting away from legacy IBORs and moving towards alternative benchmark rates that are risk free rates (**RFRs**) that are based on active, underlying transactions. Regulators and policymakers around the world remain focused on encouraging market participants to no longer rely on the IBORs after certain applicable dates (the **Cessation Date**) – 31 December 2021 is the Cessation Date for CHF LIBOR, GBP LIBOR, EUR LIBOR, JPY LIBOR and the 1 week and 2 month tenors of USD LIBOR, while 30 June 2023 is the Cessation Date for the remaining tenors of USD LIBOR (overnight, 1, 3, 6 and 12 month tenors). Other IBORs in other jurisdictions may have different cessation dates (e.g. SIBOR) while others may continue (e.g. EIBOR). Market participants should be aware of these forthcoming changes and make appropriate preparations now to avoid uncertainty in their financing agreements or other contracts.

2. What will replace IBORs?

Regulators have been urging market participants to replace IBORs with recommended RFRs which tend to be backward-looking overnight reference rates - in contrast to IBORs which are forward-looking with a fixed term element (for example, LIBOR is quoted as an annualised interest rate for fixed periods e.g. 1 month, 3 months, 6 months etc), however, in the US, the Alternative Reference Rates Committee (ARRC) will be recommending a Term SOFR rate as well which would be forward looking. Additionally, some market participants are seeking to use a credit sensitive rate (USD-BSBY). As a result, when RFRs are used, it may not be possible to calculate in advance the floating rate that would be applicable for a particular interest period depending on which RFR is used – creating some uncertainty as to the interest amount due at the end of that interest period. To combat this uncertainty (and help CFOs and accounting teams):

1. forward-looking term rates for RFRs are being developed (but it is unclear if they will be available prior to the Cessation Date);
2. the market has developed an approach which averages the RFRs on a compounded or simple average basis over an interest period to produce a term interest rate and introduce a mechanism to shift the observation period backwards by a short (typically 5 day) period so that the interest amount for the interest period is known five days prior to the payment date; and
3. for certain products, market participants may seek to utilise the averaged RFR from the prior period for the current period so that the RFR rate is known at the beginning of the period (known as compounding in advance).

Regulators recommend market participants to amend IBOR provisions in contracts with a

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suitable alternative rate and/or to use robust fall-back options which enable the contract to move to a suitable alternative rate. For new facilities, industry bodies (such as the LMA) have published suggested language to facilitate a change in the relevant IBOR and to make consequential amendments upon the occurrence of the relevant Cessation Date.

3. Tough Legacy Contracts

“Tough legacy contracts” are contracts with a term extending beyond the discontinuance of IBORs that contain problematic fall-back options (i.e. rates that are uneconomic or cannot be calculated) or do not contain any fall-back language at all; and are for one reason or another, difficult to amend (or there is no realistic ability for the contracts to be renegotiated or amended).

Tough legacy contracts are at risk of becoming unworkable if they cannot be transitioned to a suitable alternative reference rate prior to IBORs being discontinued. This issue is not limited to the world of finance as IBOR rates are also commonly used in other contracts such as sale and purchase agreements, shareholders agreements, inter-company agreements, joint-venture agreements and other commercial contracts to determine payment amounts due – each of these contracts should also be considered well in advance of the relevant Cessation Date to ascertain and, where necessary, implement appropriate amendments.

There has been some recognition by market participants that it may be advisable in certain circumstances to amend legacy documents so that consequential amendments may be made at a later date once an alternative has been broadly settled in the market – i.e. a two stage amendment process. However, certain regulators have favoured a more definitive approach (i.e. a hardwired approach) that sets forth the specific fall-back provisions for what the rate will be following the Cessation Date.

Certain governments are also introducing legislation to combat the issue of tough legacy contracts for the purpose of providing the regulators with the authority to change the calculation methodology and extend the publication for critical benchmarks for a limited time period (among other powers) to avoid economic risk and wider market disruption. It waits to be seen if similar legislation will be implemented in the UAE.

In the UK financing space, the market has settled on SONIA (compounded daily on a look back basis) as the replacement reference rate to GBP LIBOR (which is a look forward rate). However, as SONIA is a fluctuating overnight rate - there is no such thing as a SONIA term rate - it will not be a practical alternative to LIBOR for most commercial contracts. For most commercial contracts, it may be possible to use an alternative rate such as the Bank of England's base rate as an alternative to GBP LIBOR, this might constitute a much more practical solution because this rate is widely understood and moves relatively infrequently (and when it does move, any change will be well publicised). In addition, this rate is unlikely to fall foul of any “unfair terms” legislation. Alternatively, a reasonable and agreed numeric rate could be included if counterparties are worried about unforeseen spikes e.g. a Black Wednesday event.

Although most LIBOR rates will cease to be published from 31 December 2021, certain GBP LIBOR rates may continue on a non-representative basis after that date. Any such continuing rates are likely to be “synthetic” in nature. Whilst, it is possible that “replacement LIBOR” wording in an existing commercial contract could, as a purely contractual matter, pick up a non-representative GBP LIBOR rate - in most cases - contract counterparties will not be able to rely on any such drafting. In the United Kingdom, we are still awaiting full details of the primary and secondary legislation to deal with this but - to the extent introduced - the intention is that all such non-representative rates will only be available for the purposes of “tough legacy contracts” where it is impossible and/or impractical to amend such contracts to deal with LIBOR cessation. As such, in most cases, it will be necessary to amend existing commercial contracts that extend beyond the

end of 2021 and which reference GBP LIBOR. For documents that are not governed by English law but reference GBP LIBOR (e.g. a New York law governed bond), it will be a question of the governing law of the applicable non-English law contract as to whether the courts in that jurisdiction will enforce any limitations in such UK legislation on the use of “synthetic GBP LIBOR” as a fall back in contracts governed by that law.

We previously discussed the developments in the United Kingdom in our Client Alert dated [9 March 2021](#) and the newly adopted New York State LIBOR legislation in our earlier Client Alert dated [8 April 2021](#)^[1].

4. Islamic Transactions and IBOR complexities

From a Shari'a perspective, the replacement of IBORs with an RFR may cause further issues as (in accordance with the Shari'a principle of gharar) Shari'a transactions require that the calculation of the profit element must be certain. Historically the floating rate is set at the start of a profit period creating the necessary certainty - this was possible when using legacy IBORs but may become more challenging with backward-looking RFRs. Additional work will be required to align the IBOR transition approach to the needs of both the Islamic and the conventional finance markets but some possible solutions are:

1. On or prior to the Cessation Date, conventional and Shari'a compliant corporate facilities should contain appropriate fall-back provisions. To the extent there are conventional and Shari'a compliant facilities as part of one transaction, the fall-back provisions should be considered alongside one another and structured and priced accordingly.
2. Utilising the averaged RFR from the prior period for the current period so that the RFR is known at the beginning of the period – though in situations where there are conventional and Shari'a compliant facilities the compounding in advance method would have to be used for both facilities to avoid any pricing mis-match. Market participants will also need to consider whether using the compounding in advance method would put Shari'a financing at a competitive disadvantage (or advantage).
3. Forward-looking term RFRs could be adopted in respect of Islamic transactions (e.g. Term Sterling Overnight Index Average or term sterling overnight index average reference rates (TSSR)) – this would require the fewest changes to the documentation and structure, however TSSRs are only intended to be used in certain circumstances (Islamic finance qualifies for this according to a paper published by the SONIA Working Group in January 2020) but this may lead to pricing gaps / other issues between conventional and Islamic facilities if forward-looking term RFRs (once developed) are to be widely used in Islamic finance while the conventional finance market use RFRs compounded in arrears.
4. Effectively converting what was a floating rate transaction into a fixed rate transaction – though market participants will have to consider how to price these transactions to ensure that they remain competitive whilst still providing protection to the lenders. Participants should also consider that if fixed rate loans become the norm this would have a knock on impact to the derivatives market.
5. The IBOR transition could be a motivating factor for market participants to develop alternative Islamic benchmarks which could avoid reliance on interest-based conventional benchmarks such as RFRs.

5. UAE Guidance

The following regulatory authorities in the UAE have provided guidance on the transition away from IBOR benchmarks to other alternative solutions.

UAE Central Bank

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Emirates Interbank Offered Rate (EIBOR) is the benchmark interest rate, stated in UAE Dirhams, for lending between banks within the UAE market. While the relevant IBOR for the UAE is EIBOR, a number of contracts in the UAE use GBP and USD LIBOR as the reference rate (among others), therefore, GBP and USD LIBOR changes will also be relevant in the UAE. At present, we are not aware of any plans for the discontinuation of EIBOR. As the UAE Dirham is not a LIBOR currency, we do not anticipate EIBOR to be directly impacted by the discontinuation of certain IBORs. However, the UAE Central Bank may in the future adopt reforms to EIBOR. We understand that UAE banks have been asked to provide consultation on the migration to a new open currency rate. It waits to be seen if the UAE Central Bank will mandate a similar transition away from EIBOR, we will be following developments closely in this regard.

Dubai Financial Services Authority (DFSA)

Given the DFSA authorised firms frequently use other IBORs as the reference rate in their contracts, the transition away from certain IBORs is likely to impact the Dubai International Financial Centre (DIFC) market. As a result, the DFSA is engaging with those authorised firms on an individual basis on the progress of the transition arrangements. There is an expectation on DFSA authorised firms to consider how the challenges affect their DIFC operations by identifying and deciding, if necessary, subject to timelines, how they plan to:

1. deal with existing IBOR-referencing securities or products with maturities or rolling over arrangements beyond the end of the relevant LIBOR phase-out deadline;
2. negotiate with counterparties and include conversion clauses in legacy contracts referencing IBORs;
3. measure exposures, and adapt to new valuation methods;
4. adapt internal and third-party managed systems, processes and documentation to factor in the transition; and
5. conduct appropriate awareness and outreach with the firm's clients on the impact of the transition.

Further consultations between the DFSA and the authorised firms in the coming months will draw out the concerns and highlight the key areas where there is a need for more transition preparation.

6. Conclusion

Given the Cessation Date is fast approaching and industry bodies are taking an increasingly hard-line approach to the discontinuance of IBORs, market participants should focus on the agreements which will be impacted by these changes as a matter of urgency.

Existing contracts that reference IBORs should be reviewed (and amended) to ensure that appropriate provisions that accommodate the discontinuance of IBORs are included where appropriate and new transactions entered into prior to the discontinuance of IBORs should contain appropriate provisions to adopt an alternative benchmark rate, including RFRs, if appropriate.

[1] See, [The End Is Near: LIBOR Cessation Dates Formally Announced](#) (March 9, 2021) and [New York Adopts LIBOR Legislation](#) (April 8, 2021).

Gibson Dunn's lawyers are available to help with any of these issues and with the review of any contracts that may be impacted by these changes. Please contact any member of the Gibson Dunn team, the Gibson Dunn lawyer with whom you usually work in the firm's

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