Murabaha financings post-AAOIFI Standard 59 – a couple of alternative approaches while the dust settles

May 2, 2021

The adoption of Shari'a Standard Number 59 regarding the Sale of Debt (**Standard 59**) by the Accounting and Auditing Organisation for Islamic Financial Institutions (**AAOIFI**) and, in turn, in the United Arab Emirates (UAE) by the UAE Central Bank is causing some consternation for those involved in Islamic finance transactions structured as commodity murabahas (**Murabahas**) with variable profit rates (the equivalent of a variable interest rate in a conventional financing). Below, we summarise the issue and outline a couple of potential alternative approaches in the hope of facilitating progress towards a settled market position.

Traditional Murabaha structures

Structuring financings on an Islamic basis remains a key component of ensuring there is sufficient liquidity available to market participants in the UAE and the wider region, especially those seeking to obtain financing on a Shari'a-compliant basis. Murabahas (sometimes referred to as cost-plus financings) have been a popular Islamic financing structure deployed by Islamic financiers to help meet that need.

By way of very brief summary of a commonly deployed Murabaha structure prior to Standard 59, a Murabaha contract was entered into to effect the flow of funds to a customer and create a debt obligation owing to a financier by that customer by the sale of an asset by a financier to a customer on a deferred payment basis and the onward sale on a spot basis of those assets by that customer. At the end of the calculation period applicable to the Murabaha contract (the equivalent of an interest period in a conventional financing), being the deferred payment date, the customer had an obligation to pay the financier an amount agreed when that Murabaha contract was first entered into which had typically been calculated by reference to a benchmark rate for the applicable calculation period (such as LIBOR) plus margin (similar to a financier's economic return in a conventional financing).

Where the commercial agreement was to reflect a conventional term facility or to "roll over" a conventional revolving credit facility, more recently it was common for a subsequent Murabaha contract to be entered into between the parties to refinance the maturing Murabaha or (where the term facility was an amortising term facility) only that part of the amount payable by the customer on the deferred payment date under that maturing Murabaha contract that was to continue or be rolled over, with amounts ultimately being netted off and the customer being left with the obligation to just pay the difference (which reflected what in a conventional financing would represent the principal repayment instalment and the interest due on the final business day of an interest period). The same process would then be repeated in respect of that subsequent Murabaha contract and so on through to the final maturity date of the financing (**a Traditional Murabaha Structure**).

Standard 59 – what's the issue?

AAOIFI and, in turn, the UAE Central Bank recently adopted Standard 59. In summary, among other things, as a result of the guidance set out in Standard 59, a Murabaha cannot be directly refinanced by another Murabaha and, accordingly, the Traditional Murabaha Structure summarised above under which such direct refinancing was a central feature, is no longer held to be Shari'a-compliant by AAOIFI. The basic premise for this is that it looks and feels too much like a conventional loan. Historically, for this reason, a number of Islamic financiers have traditionally refused to offer Murabaha products or, if they did so, either had limits as to how much of their portfolio was Murabaha-based or strict rules as to when a Murabaha product could be used as a last resort, with preference for other structures that they deemed to be more Sharia-compliant.

Therefore, Standard 59 is causing some consternation among market participants who have commonly structured their financings using the Traditional Murabaha Structure. In the UAE, that unease is likely to be exacerbated for those financial institutions subject to Article 82 (Contravention of Islamic Shari'a Provisions) of UAE Federal Law No. 14 of 2018 **(the UAE Central Bank and Financial Institutions Law**) (i.e. Islamic financial institutions required to be licensed by the UAE Central Bank) pursuant to which Islamic financing transactions carried out by such financial institutions that are deemed not to be compliant with applicable Shari'a standards by the UAE Central Bank may be subject to review and such corrective measures as required by the UAE Central Bank. A desire to mitigate to the extent possible the uncertainty that such corrective measures under the UAE Central Bank and Financial Institutions Law might introduce into Islamic financing transactions should act as an additional incentive for such financial institutions to ensure, to the extent possible, that their Islamic financing transactions (including Murabahas) are structured in a manner that the UAE Central Bank is likely to regard as compliant with applicable Shari'a standards. Further, even if a financial institution is not an Islamic financial institution, or is but is not regulated by the UAE Central Bank, that financial institution will still want to consider the issues raised by this should, at some point in the future, it wish to transfer its participation to an Islamic financial institution regulated by the UAE Central Bank.

Relevance to Islamic finance practitioners and financiers

The issues raised by Standard 59 in the context of Murabahas will be of particular relevance to Islamic finance practitioners when either restructuring (in particular, a re-profiling of payment obligations) an existing financing which utilises the Traditional Murabaha Structure, or seeking to provide new financing structured on a Murabaha basis. In both instances, regard will need to be given to Standard 59 to ensure that the end product is not deemed to be Shari'a non-compliant by the Shari'a scholars guiding parties on such matters on the relevant transaction.

Two possible ways forward

In light of such developments, it is incumbent upon market participants active in Islamic financings, working alongside learned Shari'a scholars, to help restore some degree of standardisation and certainty to the wider financing community on how Murabahas might be structured in future in compliance with Standard 59 to mitigate uncertainty and facilitate the continued easy access of a wide range of viable Islamic based financing structures to support general market liquidity alongside the liquidity provided by conventional financiers. We are participating with the International IslamicFinancial Market's (**IIFM**) effort in this regard as part of its IBOR consultation process.

With that in mind, we summarise below (in no particular order, although arguably the second structure is more conservative from a Shari'a perspective) two possible alternative Murabaha structures which we are seeing deployed increasingly by market participants as alternatives to the now defunct Traditional Murabaha Structure, along with some brief reflections on each, for market participants to consider:

- **Alternative structure 1 – the "Long-Short Structure"**

  The first alternative Murabaha structure which seems to be gaining traction with some market participants involves entering into a "long Murabaha" contract and a series of separate "short Murabaha" contracts. Typically in this structure:

  - A "long Murabaha" contract is entered into for the entire tenor of the financing with a deferred sale price equal to the principal amount of the financing, plus the margin (calculated on the basis of the proposed amortisation of the principal amount). In some cases, a further "interest period" of the margin is added to the deferred sale price to cater for the risk that the short Murabaha contract (see below) is not entered into. The deferred payment price is then paid in instalments on the deferred payment dates under that single Murabaha contract reflecting the agreed amortisation payment profile and margin component of the "interest" for the financing through to the final maturity date.

  - That long Murabaha contract is supplemented by a series of "short Murabaha" contracts which cover just the benchmark element (typically LIBOR or EIBOR in the UAE, although please refer to the final section below on that) of the profit payments to be made by the customer on each deferred payment date.

  - This structure utilises a purchase undertaking (effectively a put option) to compel the customer to enter into each short benchmark Murabaha contract on the first day of each calculation period to reflect the forward-looking benchmark rate, with the deferred payment price of that short Murabaha ending on the next deferred payment date through to the final maturity date. The beauty of this is that the deferred payment price of the short Murabaha is all paid current (as would interest under a conventional facility) and so there should never be a concern that a new Murabaha would be refinancing a maturing Murabaha. The use of purchase undertakings in such contexts is common across various Islamic finance products and is generally not believed to be problematic. If the customer does not enter into the short Murabaha, then the deferred payment price under the long Murabaha can be accelerated. This structure circumvents the possible double exposure risk and extra day's profit under the One-Day-Gap Structure summarised below, but it remains to be seen whether perhaps the short Murabaha contract component of this alternative structure will be deemed to be Shari'a-compliant by more conservative Shari'a scholars.

  One particular concern that customers may have with this structure is that, once the long Murabaha is entered into, the payment obligation becomes unconditional. Whilst this is not a particular concern in relation to the principal component (as the principal should always be required to be paid), it does mean that the "margin" component is unconditional regardless as to whether the customer exercises any rights of early payment or if the deferred payments are accelerated and so (in the UAE at least where the Shari'a position is typically that a rebate must be discretionary) the customer is likely to need to rely on a discretion of the financier to offer a rebate of the excess margin at the particular time of early payment or acceleration. Customers may also wish to consider any accounting treatment arising as a result of the margin for the entire tenor of the facility becoming unconditional on the first utilisation date. One way to mitigate this risk could be to move the margin component from the long Murabaha into the short Murabaha, although this puts additional pressure on the purchase undertaking from the financier's perspective.

- **Alternative structure 2 – the "One-Day-Gap Structure"**

  The second alternative Murabaha structure that also seems to be gaining traction with some market participants aligns closely with the literal reading of that part of Standard 59 which says that a customer may use the proceeds received from a subsequent Murabaha contract "at his own discretion, to repay the initial debt after one business day from the receipt or deposit of the sale proceeds in his account" (unofficial translation).

  This structure involves a day one Murabaha contract being entered into as would have been the case under a

Traditional Murabaha Structure but then, in contrast to a Traditional Murabaha Structure where a subsequent Murabaha contract is entered into at the end of the calculation period on the maturity date of the relevant Murabaha contract, the subsequent Murabaha contract is instead entered into one business day before the maturity date of the maturing Murabaha contract. The commitment reduction schedule (which, in practice, is akin to an amortisation schedule in a conventional context) is aligned accordingly, with payments on that earlier business day too instead of the final business day of the calculation period.

Two key points to consider in respect of this structure are firstly that there is effectively a double exposure for a financier during the one business day period between the date on which new funds are advanced under the subsequent Murabaha contract and the date on which those funds are deployed by the customer to partly settle the maturing Murabaha contract. In practice, however, financiers will probably seek to mitigate this risk by ensuring they retain de facto control of the proceeds to be made available to the customer under the subsequent Murabaha contract so that this risk is somewhat theoretical only (at no point will the two amounts under the initial and subsequent Murabaha contract be "out the door") but the point remains nonetheless, although we would query whether any financier taking such mitigating action would be deemed to be Shari'a-compliant on a strict reading of Standard 59. Secondly, it is noteworthy that, as a result of this structure, an extra day's profit (i.e. interest in a conventional context) would accrue, but again the option to structure around this would remain available to parties so that, in practice, this was not charged to the customer if that was agreed commercially.

A possible third way?

As one would expect, there are nuances on the two alternative Murabaha structures summarised above and also other approaches that are being considered and deployed by market participants to varying degrees to accommodate Standard 59. For instance, there is a potential third alternative structure that easily comes to mind (although we have not seen this come to the market yet) involving a single fixed-rate Murabaha (effectively akin to the long Murabaha referred to above, but with a slightly higher margin) which is supplemented by financier hedging which could help to mitigate issues arising as a result of IBOR reform (see below) although the issues set out above in relation to early payment or acceleration would still exist.

In each case, whatever structure is being considered, the guidance of the relevant Islamic scholars should always be sought during the structuring phase of an Islamic financing to ensure that their blessing is available on the proposed structure prior to the documentation phase to avoid inefficiencies later in the transaction. We remain hopeful that official guidance might be issued at some point in the near future, which market participants can follow. In the meantime, our reflections on the possible alternative approaches above should, we hope, help some to frame their initial discussions on this topic.

A final word, on IBOR transition

Finally, although it is beyond the remit of this article, it would be remiss not to mention the current transition from the use of forward-looking interbank offer rates (IBORs), as the benchmark rate for calculating return in Islamic finance structures, to backward-looking virtually risk-free rates (RFRs) or other rates such a central banks rates. The publication of IBORs is largely expected to be discontinued in certain key currencies (including sterling by the end of 2021 and US dollars by mid-2023), although we are not aware of any current plans in relation to GCC currencies. In summary, the main issues with RFRs in the context of Islamic financing transactions generally is that, given they are backward-looking, they do not easily lend themselves to Islamic financing transactions given the principle of Gharar and the need for certainty at the start of a calculation period of the amounts that will be payable in respect of that calculation period. Accordingly, it would be prudent for those involved in helping to restructure approaches to Murabahas in light of Standard 59 to also consider at the same time the possibility of restructuring the basis of calculating the deferred sale price under such Murabaha structures on an alternative non-IBOR basis. As set out above, the IIFM has kicked off a consultation process in relation to such issues. Please refer to our LIBOR Transition: FAQs if you would like to read more about that topic in the context of both Islamic and conventional financings.

Your Key Contacts

Nathaniel Armstrong
Partner, Abu Dhabi
D +971 2 613 1518
M +971 56 683 0816
nathaniel.armstrong@dentons.com

Stephen Knight
Partner, Abu Dhabi
D +971 2 6131521
M +971 52 604 8541
stephen.knight@dentons.com

Qasim Aslam
Partner, Dubai
D +971 4 4020 901
qasim.aslam@dentons.com