دار المراجعة الشرعيّة

SHARIYAH
REVIEW BUREAU

BOND CUM WARRANTS

Can it shift up to the high gear of Sharia compliance?

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Introduction

Investors have two common types of investment options in the financial markets: equity and debt securities. Similarly, companies and governments who need to raise external capital to finance their operations can turn to investors by selling equity shares or borrow from investors through debt securities. When a large company or government borrows money, it usually does so through financial markets. The company or government issues securities that are generically called debt securities, or bonds. Debt securities come in different forms and can have different features. One type of debt security is warrant bonds. This research looks into the nature of warrant bonds and examines them in light of Shariah principles.

What are bonds

A bond is a type of investment that represents a loan between a borrower and a lender. Think of it as similar to getting a personal loan from a bank – except in this case you are the lender (known as the investor or creditor) and the borrower is generally a government or corporation (known as the issuer)[1]. With bonds, the issuer promises to make regular interest payments to the investor at a specified rate (the coupon rate) on the amount it has borrowed (the face amount) until a specified date (the maturity date). Once the bond matures, the interest payments stop, and the issuer is required to repay the face amount of the principal to the investor. Because the interest payments are made generally at set periods of time and are fairly predictable, bonds are often called fixed-income securities.

1 IIAC (2008), Bonds: An introduction to bond basic

Bond-cum warrants

A bond with option rights is called a warrant bond. For a limited time, it confers the right to buy equity securities, such as shares, of the bond issuer at a predetermined price (exercise price)[2].

When you buy a bond with an attached warrant, the warrant gives you the right to buy a certain number of fixed-price shares of stocks for a company that issues the bond. You are not obligated to purchase the stock, and the price specified on the warrant may be different from the price at which the stock is trading on the day you buy your bonds.

Unlike normal bonds, warrant-linked bonds are issued with warrants that entitle the bearer to buy shares in the issuing company at a predetermined price, usually following a given period. Once the exercise period has begun, the investor can separate the warrants from the bond and sell them on the stock exchange. The bonds are then listed with the addendum “ex”.

Issuers benefit because the interest rates on warrant-linked bonds are relatively low. Moreover, if the warrant is exercised, their shares will be sold to the investor at a relatively high price. Investors benefit from the fixed interest payments on warrant-linked bonds, and from a potential increase in the stock price [3].

Difference between warrant bonds and convertible bonds

Warrant bonds differ from convertible bonds firstly in that the bond still exists after the option right has been exercised. When the holder exercises the warrant, he retains ownership of the bond, whereas when he exercises convertible debt, the bonds are exchanged for stocks[4]. The second difference is that the warrant of a warrant bond can be traded separately. A cum warrant is more commonly called a “bond-cum-warrant” or “cum-warrant bond.” Unlike a convertible bond, a cum warrant can be detached from a bond and either instrument can be sold separately before the warrant is exercised. The bond then becomes an ex-warrant bond with a lower value than the original bond[5].

Investing in warrant bonds claims to offer different forms of benefits. On the one hand, there is the potential for price gains in the event of rising share prices, while on the other hand the price risk is limited since a warrant bond is a conventional bond with additional rights in the form of options. However, ownership of the option alone needs to be considered separately. Depending on the terms and conditions, unattached options have enormous potential both for gains and losses[6].

2 Swiss Exchange, Types of Bonds,.

3 Deutsche Borse Group, Warrant-linked bond

4 Investopedia, Cum Warrant, Available from: https://www.investopedia.com/terms/c/cumwarrant.asp

5 Investopedia, Cum Warrant, Available from: https://www.investopedia.com/terms/c/cumwarrant.asp

6 Swiss Exchange, Types of Bonds, Available from: https://www.six-swiss-exchange.com/knowhow/products/bonds/types/war-rant_en.html

Analysis of Warrants

Warrants are securities that give the holder the right, but not the obligation, to buy a certain number of securities (usually the issuer's common stock) at a certain price before a certain time. Warrants that confer the right to buy a security are known as call warrants; those that confer the right to sell are known as put warrants.

Warrants are not the same as call options or stock purchase rights[7], although there are some similarities, but a few key differences distinguish them. Warrants are generally issued by the company itself, not a third party, and they are traded over-the-counter more often than on an exchange. Investors cannot write warrants like they can options. Unlike options (with the exception of employee stock options), warrants are dilutive: when an investor exercises the warrant, they receive newly issued stock, rather than already-outstanding stock. Warrants (compared to options) tend to have much longer periods between issue and expiration. Warrants do not pay dividends or come with voting rights. Investors are attracted to warrants as a means of leveraging their positions in a security, hedging against downside (for example, by combining a put warrant with a long position in the underlying stock) or exploiting arbitrage opportunities.

Types of Warrants

Traditional warrants are issued in conjunction with bonds, which in turn are called warrant-linked bonds, as a kind of sweetener that allows the issuer to offer a lower coupon rate. These warrants are often detachable, meaning that they can be separated from the bond and sold on the secondary markets before expiration. A detachable warrant can also be issued in conjunction with preferred stock; often the warrant must be sold before the investor can collect dividends.

Wedded or wedding warrants are not detachable, and the investor must surrender the bond or preferred stock the warrant is «wedded» to in order to exercise it. Naked warrants are issued on their own, without accompanying bonds or preferred stock.

Covered warrants are issued by financial institutions rather than companies, so no new stock is issued when covered warrants are exercised. Rather, the warrants are «covered» in that the issuing institution already owns the underlying shares or can somehow acquire them. The underlying securities are not limited to equity, as with other types of warrants, but may be currencies, commodities or any number of other financial instruments[8].

7 Investing Answers, Warrant, Available from: https://www.investinganswers.com/financial-dictionary/optionsderivatives/warrant-861

8 Investopedia, Warrant

How does a bond-cum-warrant function?

Occasionally, companies offer warrants for direct sale or give them to employees as incentive, but the vast majority of warrants are «attached» to newly issued bonds or preferred stock. For example, if Company XYZ issues bonds with warrants attached, each bondholder might get a $1,000 face-value bond and the right to purchase 100 shares of Company XYZ stock at $20 per share over the next five years. Warrants usually permit the holder to purchase common stock of the issuer, but sometimes they allow the purchaser to buy the stock or bonds of another entity (such as a subsidiary or even a third party).

The price at which a warrant holder can purchase the underlying securities is called the exercise price or strike price. The exercise price is usually higher than the market price of the stock at the time of the warrants issuance. In our example, the exercise price is $20, which is 15% higher than what Company XYZ stock was trading at when the bonds were issued.
The warrants exercise price often rises according to a schedule as the bond matures. This schedule is set forth in the bond indenture.

One important characteristic of warrants is that they are often detachable. That is, if an investor holds a bond with attached warrants, he or she can sell the warrants and keep the bond. Warrants are traded on the major exchanges. In some cases, where warrants have been issued with preferred stock, stockholders may not receive a dividend as long as they hold the warrant as well. Thus, it is sometimes claimed to be advantageous to detach and sell a warrant as soon as possible so the investor can earn dividends.

If the price of the stock is above the exercise price of the warrant, the warrant must have what is known as a minimum value. For example, consider the warrants to purchase 100 shares of Company XYZ for $20 per share anytime in the next five years. If Company XYZ shares rose to $40 during that time, the warrant holder could purchase the shares for $20 each, and immediately sell them for $40 on the open market, pocketing a profit of ($40 - $20) x 100 shares = $2,000. Thus, the minimum value of each warrant is $20.

It is important to note, however, that if the warrants still had a long time before they expired, investors might speculate that the price of Company XYZ stock could go even higher than $100 per share. This speculation, accompanied by the extra time for the stock to rise further, is why a warrant with a minimum value of $20 could easily trade above $20. But as the warrant gets closer to expiring (and the chances of the stock price rising in time to further increase profits get smaller), that premium would shrink until it equalled the minimum value of the warrant (which could be $0 if the stock price falls to below $20)[9].

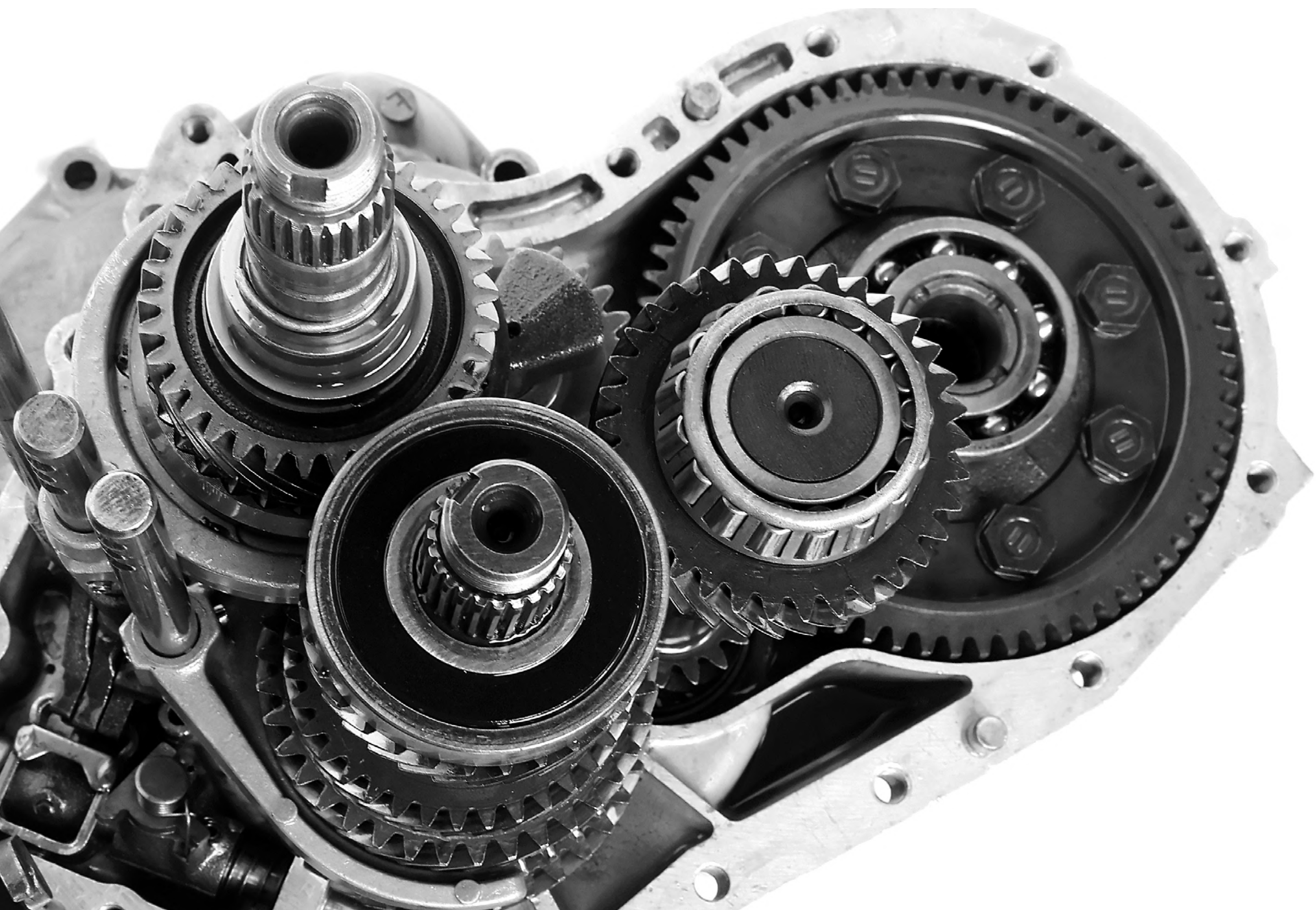
9 Investing Answers, Warrant, Available from: https://www. investinganswers.com/financial-dictionary/optionsderivatives/warrant-861

Shariah Analysis of Bonds

A conventional bond is fundamentally a loan contract. It is a contractual debt obligation on the issuer. The issuer is obliged to pay back the principal as well as the interest in the form of coupon payments. The payment for the bond is effectively a loan (*Qard*) from a Shariah perspective.

In Islam, a loan (*Qard*) is considered a gratuitous contract, and is considered commendable for a lender to provide a loan to a borrower who is in need of money. Both the Qur'an and Sunnah promise reward to a lender who provides a loan to a person in need. The fact that the Shariah prohibits the lender to derive any conditional benefit from the loan further emphasises its gratuitous nature. It also implies that the loan contract should not be used for profiteering purposes. Thus, any profit or additional return in lieu of the loan is impermissible and non-Shariah compliant. Both the Qur'an and the Sunnah have prohibited the lender from charging the borrower any additional amount. The Qur'an emphasises that the lender is only entitled to receive the principal amount. It states:

> *"O you who believe! Fear Allah,*
> *and give up what remains of your demand for usury,*
> *if you are indeed believers. If you do it not, take notice of war from Allah and His Messenger. But if you turn back, you shall have your capital sums:*
> *Deal not unjustly, and you shall not be dealt with unjustly"*
>
> (al-Qur'an, 2:278-279)



A famous juristic maxim states: "Any loan which draws increment is *Riba*" (Ibn Abi Shaybah).

Interest (Riba) is more than just simple interest and compound interest; It is an unjustified excess in a bilateral contract which is stipulated for one of the two transacting parties and is without consideration. To elaborate, there are two types of *Riba*:

Riba al-Nasi'ah: this is the advantage and excess gained without consideration by deferring delivery of any homogenous counter exchanges. This excess manifests upon default or delay in payment where time is factored as a consideration.

Riba al-Fadhl: this is a contractually agreed excess in units without any consideration in an exchange of homogeneous goods.

Shariah has not considered money to be a commodity but a medium of exchange. When money of the same genus is exchanged, it must be in the same trading session and in equal quantity. Exchanging different amounts at different times brings into effect both forms of *Riba* : *Riba al-Nasi`ah* and *Riba al-Fadhl*.

Only a person who has a need borrows money. The need can be economic, business related or personal. Thus, lending is an act of charity helping those in need. Shariah has deemed lending as charity and not a form of business. Hence, profiting from lending by means of getting more in return of lending is totally prohibited as need is being commodified and thus, the borrower is exploited and disadvantaged. The commodification of need is oppression and wickedness fuelled by greed. Where capitalism thrives on commodification, Shariah on the other hand, prohibits unrivalled and unrestricted commodification. Such behaviour at a macro level creates wealth inequality and disparity. Furthermore, the mass availability of credit with cost promotes debt and debt creation which is unhealthy at a micro and macro level.

The distribution of wealth in a society becomes inequitable due to interest. Interest is an overhead charge which does not form part of any factor of production. Interest is received by the capitalist who continues the use his wealth to earn more wealth. This causes an unjust distribution of wealth in the society. In this way due mainly to interest, the rich in the society get richer and the poor, poorer.

Shariah Analysis of Warrants

Warrants are simply rights to buy. The holder has the right, but not the obligation, to buy a certain number of securities (usually the issuer's common stock) at a certain price before a certain time.

Contemporary jurists like Mufti Taqi Uthmani considers options – a right to buy/sell - as a mere promise[10]. He argues that such promises cannot have any consideration in lieu of it as they are not property (*Mal*) nor valid rights (*Huquq)*. The 'right to buy' is a commitment, pledge or a promise to transact. Let alone being lawful commodities, promises from a Shariah perspective are not even assets.

Promises are merely an expression of imposing a task on one's personal liability. Mufti Taqi Uthmani further states that a premium is paid without any transfer of property, benefits or rights. Hence, when there is no counter-exchange being transferred, a premium is unwarranted. As a consequence, the premiums paid for warrants fall under *Rishwa* (bribe) and are prohibited. *Rishwa* refers to taking consideration for something which does not warrant a premium or consideration[11]. It is also claimed that warrants have incentive-like elements.

Despite the incentive element in a warrant, the incentive does not make the warrant a valid tradeable asset. Imam al-Zayla'i discussed the prohibition of paying premiums for incentives which are not valid counter-exchange (*mabi'*) in Islamic law[12]. Imam al-Zayla'i suggests that such premiums are *Rishwah* (bribe). Therefore, the premium is unlawful and not Shariah compliant.

In addition, Warrants are different to rights (*Huquq*) recognised in Shariah; *Huquq* generally confer the power to benefit from an asset/service, whilst warrants necessitate the other party to transact once exercised. Warrants are connected to contracts, and thus, argued to be derivatives. The warrant is the right to contract which is being traded. A contract to contract is not Shariah compliant.

It is also incorrect to analogise warrants with Sharia options such as the option of condition (*Khiyar al-shart*), option of defect (*Khiyar al-ayb*), option of inspection (*Khiyar al-ru'yah*). These are not detached from the contract; rather, they are embedded in the contract and are exercised for the same contract. In fact, they are regarded as terms of the contract[13]. On the other hand, warrants are independent and are exercised to initiate another contract. They are not terms of a contract. Even if they were terms of a contract, such terms cannot be traded as commodities in Islamic principles.

Moreover, Warrants are different to *Arbun* (earnest money). *Arbun* (in the *Hanbli* fiqh) is paid by the buyer to the seller at the time of contract on the basis that the buyer has the option to revoke the contract during an agreed period of time. If he confirms the contract, the earnest money is credited towards the price. If he does not confirm the contract or fails to pay the remaining price during the stipulated time, the seller is entitled to forfeit *Arbun* (Earnest Money)[14]. Thus, the partial payment is not a fee or premium, as in an option or warrant contract, but more of a deposit.

10 Uthmani, M.T. (2014), Fiqh al-Buyu, Karachi: Maktaba Ma'arif al-Qur'an

11 Uthmani, M.T. (2014), Fiqh al-Buyu, Karachi: Maktaba Ma'arif al-Qur'an

12 ولو قال بع عبدك من زيد بألف على أي ضامن لك مائة سوى الألف فباع صح بألف وبطل الضمان، وإن زاد من الثمن، فالألف على زيد، والمائة على الضامن: قوله وبطل الضمان أي؛ لأنه رشوة على البيع لعدم المقابلة بالمبي

13 Al-Laknawi, Umdat al-Ri'ayah, Beirut: Dar al-Kutub

14 AAOIFI (2017), Shariah Standard No. 53: Arboun (earnest money, Bahrain: AAOIFI

Alternatives

The tradability of warrants as a 'right to buy' in a secondary market is non-compliant with Shariah principles. However, if the incentive element of a warrant is considered, an alternative Shariah compliant incentive can be offered as a substitute to a warrant meaning a unilateral *Wa'd* (promise/ undertaking) agreement can be structured to offer incentive features of a warrant. The seller of the warrant can instead make an undertaking to transact equity with the buyer for a limited time at a pre-determined price or market rate. This is supported by the AAOIFI standard No. 49 which states:

"It is permissible for a party to promise to enter into a commutative contract in the future."

The legal nature of such a promise is described in the standard in the following words:

"It is permissible to promise to perform an action or a financial transaction and it is then a religious obligation to fulfill it, meaning that breaking a promise without an excuse is a sin. However, a promise is not legally binding except when there is a real need for it to be enforced, such as when the promisor causes the promisee to incur a liability as a result of the promise. For example, if a person instructs a merchant to purchase a specific item and then resolutely promises the merchant that he will buy this item from him. If the merchant purchases the item solely in reliance on the promise, the promisor is legally bound to purchase the item from him, failing which the promisor is required to indemnify the promisee (merchant/seller) for any actual loss suffered such that if the merchant is unable to sell the item for a price that covers the cost of the item, the promisor is required to make up the difference between the cost of the item and the price obtained by the merchant for it. Actual loss does not include opportunity cost."

In reference to exercising the promise, the standard states:

"When a promise is made to enter into a contract in the future, such contract is not effected automatically. The contract must be entered into at the relevant time by the exchange of offer and acceptance. Where the promise is legally binding, if the offer is made by the promisee, the promisor is bound religiously and legally to accept it. And if the offer is made by the promisor, the promisee has the option to accept or reject it."

However, unlike warrants, such a Wa'd cannot be traded as the trading of a Wa'd is not Shariah compliant.

Warrant bonds are different to normal conventional bonds. A bond with option rights is called a warrant bond. For a limited time, it confers the right to buy equity securities, such as shares, of the bond issuer at a predetermined price (exercise price). Just like conventional bonds, warrant bonds are non-Shariah compliant. Bonds are interest bearing transactions which are prohibited due to the element of Riba. Similarly, the warrants attached to bonds are also non-Shariah compliant. Warrants are 'right to buy/sell' a security. The right to buy is not a valid asset in Shariah, therefore, charging a premium for such a commitment is invalid and unlawful. If the purpose of a warrant is merely an incentive to the buyer to enter into a contract, an alternative is to offer a promise to contract for a limited amount of time. However, such a promise is not a substitute for warrants. The promise can neither be traded on a secondary market. Therefore, warrants are not Shariah compliant securities.

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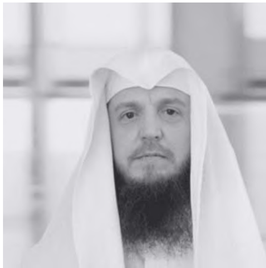

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Disclaimer

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