

Islamic Convertible Bonds

An Alternative to Bay^c al-‘Inah and Discounted Bay^c al-Dayn Islamic Bonds for the Global Islamic Capital Market

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ABSTRACT

This paper provides a critical overview of Islamic debt securities in Malaysia and ways to make them more attractive to global Islamic funds. Doing so involves an attempt to design an Islamic convertible bond (ICOB), which is a hybrid of *al-qard*, *al-wadiah*, *kafāla*, and *muḍāraba* contracts. *Sharī‘a* issues on equity kickers or warrants and call option of the convertible/exchangeable bond will be explained. Advantages of an ICOB include its smaller denominations and therefore salability to the Islamic unit trust sector and individual investors. It is also attractive to small- and medium-scale industry. Muslim venture capitalists will find ICOBs a suitable alternative to loan stocks and convertible loan stocks. Being equity substitutes, ICOBs will be more affected by company fundamentals than by macroeconomic factors such as interest-rate movements and inflation, and they will suffer from speculative tendencies less than straight bonds and common stocks. ICOBs should widen the application of Islamic bonds by the backbone of Malaysia’s manufacturing sector.

I. INTRODUCTION

This paper begins with the assumption that Malaysia has difficulty in attracting Islamic capital inflows due to the nature of Islamic bonds issued by Malaysian companies. Since 1992, the Rating Agency of Malaysia (RAM) and Malaysian Rating Agency Corporation (MRAC) have both rated 20 Islamic private debt securities (IPDS) issued in Malaysia. RAM undertook most of the rating exercises amounting to 8 issues while the newly formed MRAC rated the remaining two. In principle, most of these bonds are issued and traded on the basis of *bay^c al-‘inah* and discounted *bay^c al-dayn*.ⁱ Others, such as Khazanah zero-coupon and promissory notes have also incorporated *bay^c al-‘inah* and *bay^c al-dayn* as the basis of trading both for liquidity and closing position upon maturity.ⁱⁱ But both *bay^c al-‘inah* and *bay^c al-dayn* are not acceptable to the majority of Middle Eastern jurists. Only the Shafie school of thought leaves a loophole into allowing *bay^c al-‘inah* since the *niyya* or intention does not matter in determining the validity of a contract. But the same does not hold among the Hanafi, Hanbali, and Maliki jurists who still hold *niyya* as an essential element to a valid contract.

This paper will see attempt to design of a new Islamic financial instrument known as the Islamic convertible bond (ICOB) in which the elements of *bay^c al-‘inah* and discounted *bay^c al-dayn* are absent. It will apply the contracts of *Al-Wadiah*, *kafāla*, and *Al-Qirad* in three distinct and separate places to ensure that the attachment of sweeteners such as call option is observed within *sharī‘a* guidelines

II. THREE MAIN STEPS FOR ISLAMIC BOND ISSUANCE

To further understand the role of *bay^c al-‘inah* and *bay^c al-dayn* in an Islamic bond market, it is worthy to look at the three main steps involved in the bond issues, namely:ⁱⁱⁱ

1. Securitization – The creation of the *bay^c al-‘inah* assets
2. Bond issues – Issuance of debt certificate – *Shahdah al-dayn*
3. Trading of debt certificates – sale and purchase of debt certificates in the secondary market via the contract of *bay^c al-dayn*.

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A. Step 1: The Creation of a Bay^ʿ al-ʿInah Underlying Asset

Asset securitization is the essence of Islam bond issues as a bond must assume the role of *al-māl* or property to qualify as an object of sale (*mahallul ʿaqdī*). An object of sale in the Islamic law of contract must be a property of value. When a bond certificate is supported by an asset (as evidenced in the securitization process), it is transformed into an object of value and therefore as claimed, qualifies to become an object of trade whereby it can be purchased and sold in both the primary and secondary market. Investors then will have to the right to sell (*haqq māli*) these bonds. In the *bay^ʿ al-ʿinah* asset securitization, the financier purchases an asset from the issuer and sells it back to the same party at a credit price. This purchase-back agreement will ensure that the issuer will receive the money in cash while financier will be paid a prefixed or contracted amount in a future date. Debt payments will be made by installment through bond issues. The principle capital will be paid in bullet or lump sum at maturity date while the profits are paid once or twice a year. The difference between cash and credit price will represent the profit due to the financier.

The underlying asset is therefore crucial in determining the Islamic acceptability of these bonds as claimed. In the Malaysian experience these assets include factories, equipment, stock and inventory and even intangible asset such as a list including building and properties.^{iv} Some are given in Table 1.

TABLE 1. SELECTED ISLAMIC DEBT SECURITIES (IPDS) IN MALAYSIA: UNDERLYING ASSETS

Issuer	Instrument	Underlying Asset
Hicom Holdings Bhd	Guaranteed <i>Murābaḥa</i> Notes Issuance Facility	Mixture of <i>ḥalāl</i> shares (including unquoted shares)
Amanah International Finance Sdn Bhd	Guaranteed <i>Murābaḥa</i> Notes Issuance Facility	A list including buildings and properties
KFC Holdings	<i>Al-bay^ʿ-bithaman ajil</i> Islamic debt securities	Restaurants, breeder, farm, and hatchery
Petronas Dagangan Bhd	Redeemable Islamic debt securities	Gas processing line and pipeline

Source: Rating Agency Malaysia, 1998

The first stage is critical because it is where the yield or simple the rate of return is determined. The purchase-back arrangement using a deferred sale approach will show that the yield is a fixed one since there the contract specifies only one selling price.

B. Step 2: Issuance of Islamic Debt Certificates (*shahdah al-dayn*)

This usually takes place in the primary market where in settling its debt, the issuing company will sell debt certificates or bonds to investors. As mention above, debt certificates issues is valid only when an asset supports it. In other words, the bonds must be securitized. Here the underlying security is the BBA or *murābaḥa* asset. The underlying asset need not be BBA or *murābaḥa* alone. If the first stage involves a contract of *ijāra*, then the debt certificate is called *Sukuk al-ijāra*. If an *istiṣnāʿ* contract is used, we can called it *Sukuk al-istiṣnāʿ*.

Islamic bonds new issues can be categorized into two, namely bonds issued with coupons and those with none. The former is known as the Islamic coupon bond while the latter Islamic zero-coupon bond.

1. Islamic Coupon Bond

The term “coupon” here denotes the profit component of the Islamic bond issues in both forms of *murābaha* notes issuance facility (MuNif) and *al-bay^c-bithaman ajil* Islamic debt securities (ABBA).^v The difference between MuNif and ABBA is mainly on their respective maturities. Long-term issues normally apply *the al-bay^c-bithaman ajil* purchase-back contract while short-term and medium-term issues will use *murābaha*. Some selected bond issues are given below:

TABLE 2. SELECTED ISLAMIC DEBT SECURITIES IN MALAYSIA: TENURE AND MATURITIES

Issuer	Instrument	Tenure	Date of Issue	Maturity Date
Houlon Corporation	<i>Al-Bay^c-Bithaman Ajil</i> Islamic debt securities	7 years	Sep. 3, 1997	Sep. 2, 2004
Teledata Sdn Bhd	Guaranteed <i>Murābaha</i> Notes Issuance Facility	5 years	Apr. 4, 1996	Apr. 4, 2001
Moccis Trading Sdn Bhd	Guaranteed <i>Murābaha</i> Notes Issuance Facility	5 years	Mar. 29, 1996	Mar. 28, 2001

Source: Rating Agency Malaysia, 1998

In both MuNif and ABBA, two types of debt certificates were issued. Certificates that represent the capital component are called primary notes while the profit portion is known as secondary notes or coupon notes. Coupon need not mean interest alone. In the IDS, it also refers to the profit or markup portion of the deferred sale. So it is safe to say that the Islamic version of the conventional coupon bonds are the MuNif and ABBA.

2. *Murābaha* Notes Issuance Facility (MuNif)^{vi}

The selling of *dayn* or debt by the issuer to the financier therefore involves two types of bond issues. In other words, *Shahdah al-dayn* (debt certificates) consists of the primary and secondary notes. The process is shown the following illustration:

Cost of financing: RM100 million
 Annual profit rate: 8%
 Underlying asset: Land and building
 Issue Date: February 5, 1999
 Maturity: February 5, 2002
 Tenure: 3 years
 Total profit: $RM100,000,000 \times 8\% \times 3 = RM24$ million
 Selling price = cost of financing + profit margin = RM124 million

Number of Primary notes: 100,000 units
 Price per unit = $RM100,000,000/100,000 = RM1000$
 Number of Secondary notes = 50,000 units
 Price per unit = $RM24,000,000/50,000 = RM480$

FIGURE 1. MODE OF PAYMENTS IN MUʿNIF

1 st month	6	12	18	24	30	36
•	•	•	•	•	•	•
RM4m	RM4m	RM4m	RM4m	RM4m	RM4m	+RM100m

Based on the above calculations and illustration in Figure 1, all primary notes will mature on February 5, 2002, which implies that the capital component will be paid in a lump sum of RM100 million at maturity. Since investors desire to take out the profit out periodically, secondary notes maturing every six months were normally issued. In the above case, a 3-year maturity shall imply 6 semiannual profit redemptions at RM4 million each. The above example shows that MuNif or BaIDS are not zero coupon bonds. The absence of coupon interest payments does not mean that Islamic bonds are zero-coupon. MuNif and BaIDS are coupon bonds because profit payments are contractual or fixed. Although similar to conventional coupon payments, issuance of secondary notes issues are said to be valid in Islamic law since it is based on sale (*al-bayʿ*) while the former is based on debt (*al-duyun*)

3. Islamic Zero-coupon Bonds

Zero coupon bonds are bonds sold at a discount. Although no coupon or interest payments are made, the implicit interest is the difference between par value and discount value. The Islamic zero-coupon bond operates on the same principle but works on a sale contract (*al-bayʿ*) which makes it a valid transaction in Islamic law. The Khazanah benchmark bond will be used to illustrate some pertinent issues.

4. Khazanah Islamic Benchmark Bonds

Unlike MuNif and BaIDS, the Khazanah bonds are government guaranteed. But for trading purposes, Khazanah bond issues must fulfill the securitization requirement, which involves assets of Khazanah Nasional Berhad (KNB). The securitization of Khazanah bonds is similar to other Islamic bonds in which the contract of *bayʿ al-inah* is applied. Securitization creates *hak māliy*, the right to sell or purchase a commodity one owns.^{vii} To exercise this right shall also imply an ability to derive usufruct or *manfaat* from it, which in essence qualify Khazanah bonds to take the role of *al-māl*.^{viii}

Although the Khazanah Islamic benchmark bonds are sold at a discount, the discount price is market determined through a bidding process (*bayʿ al-muzayadah*). The bidding process allows the bond to be priced according to the forces of demand and supply so as to produce a yield that can be used as a benchmark for the local bond market.^{ix} While the issuer sets the purchase-back price at par value, secondary trading will mean selling rights of debt to the third party. At this point, the contract of *bayʿ al-dayn* at a discount is intensively applied to create liquidity (*al-suyulah*) through secondary trading.

The basic feature of the Khazanah Islamic bond is quite straightforward. Say that through the bidding process, a RM1000 bond at par value is sold at RM800 per unit. For one million unit issues, the market value of securitized asset is therefore RM800 million, while the purchase back price is RM1 billion. The return to investors is RM200 million. The *bayʿ al-inah* element emerges in the securitization process, involving of some underlying assets, namely *Khazanah* assets consisting of physical and financial assets that the Malaysian government owns such as land, buildings, shares, bonds and reserves in hard currencies.

C. Step 3: Trading of Debt Certificates (Discounted *bayʿ al-dayn*)

For liquidity purposes, bond trading in the secondary market is crucial. However, almost all Islamic bonds today were bought for long-term investments. The lack of secondary market however should not imply that trading issues is no longer significant. One of the objectives in the Khazanah bond issues is to create a dynamic secondary market. This calls the need to explain the Islamic view of bond trading in the secondary market.

As mentioned earlier when a debt certificate is securitized, it now becomes property (*al-māl*) which is also an article of trade. As an article of trade, investors can sell the bonds to the issuer or the third party if a secondary market for Islamic bonds exists. The trading i.e. sale and purchase of the debt certificates is called *bayʿ al-dayn*. In Malaysia, the contract is *bayʿ al-dayn* at a discount is acceptable while Middle East Ulama' considered it invalid even though the debt is supported by underlying assets. Any profit created from the sale and purchase of a debt is *ribā*. For example, consider a person holding a bond worth RM1000. His urgent need for cash makes him sell the

bond for RM900. For whatever reasons, the buyer purchases the RM900 bond because he felt the price of bonds might go up. He will dispose the bond when price exceeds RM950 to make a RM50 that according to Islamic law is *ribā*.

In the case of a zero coupon Islamic bond, the company issues the bond at a discount, say RM900. The bond is redeemable at par value of RM1000 upon maturity. In other words, when the bond matures, the bondholder sells the bond to the issuer or another dealer for RM1000. Here trading of debt took place where the bondholder received RM100 as profit over a period of 1 year. In the Malaysian Islamic capital market, the \$100 profit is considered permissible (*halāl*) while it is not permissible (*halāl*) in the Middle East countries although the bond is asset backed. It is therefore not surprising to observe that none of the deals made in the Arab countries so far has embraced *bay' al-dayn* bonds. The mode of financing applied in these countries were mostly the syndicated *murābaḥa* and *ijāra* as shown in Table 3 below.

III. ISLAMIC SECURITIES IN THE MIDDLE EAST

Financial instruments for project finance in the Middle East have largely been dominated by *murābaḥa* and *Ijāra* financing, as shown in Table 3 below. The *murābaḥa* project financing however, did not utilize bond instruments, as doing so will mean applying *bay' al-'inah* for securitization purposes as well. The process simply involves the usual *murābaḥa* technique where financiers will purchase the raw material and equipment from the supplier. The goods will be sold to the customer at a markup price. This type of purchase and sell technique proves suitable in projects involving lumpy items since it retains most of the characteristics found in traditional debt such as the need for collateral, debentures and guarantees. Among others, the documentation normally include the asset sale and purchase agreement among the contracting parties while the installment payments made adopts the usual traditional amortization principle.^x

TABLE 3. SELECTED PROJECT FINANCE DEALS AND TRANSACTIONS IN THE MUSLIM WORLD

Country	Amount	Project	Mode Of Financing
Bahrain	US\$30m	Purchasing construction material for Pakistan's Lahore-Islamabad Highway	Syndicated <i>Murābaḥa</i>
Kuwait	US\$30m	Purchase of capital equipment for the production of medium-density fiberboard	<i>ijāra</i> (lease finance)
Malaysia	RM1 billion	Finance of Tenaga Nasional's current capital expenditure	<i>Bay' -bithaman ajil- bay' al-dayn</i> (debt trading)
Bahrain	US\$70m	Water and Power Development Authority	Syndicated <i>Murābaḥa</i>
Egypt	US\$11.2m	Alexandria National Iron and Steel Company	<i>ijāra</i> (lease finance)
Pakistan	US\$2.05m	Equity capital investment in Al-Meezan Investment Bank	<i>mushāraka</i>

Source: Islamic Banker, various issues

Ijāra financing on the other hand involves the issuance of profit certificates called *Sukuk- al-ijāra* bearing the name *ijāra* on which leasing transaction is based. The securitization process is valid since the underlying asset is

not fictitious but real *ijāra* assets from which cash flows are created from the lease payments. Here a special purpose vehicle (SPV) is first created to purchase the asset from the supplier. The asset is then leased to a company that will use it in real production. The lessee makes periodic rental payments to the SPV who in turn will use these proceeds to pay the financiers. Prior to the purchase of assets, the SPV issues the *ijāra* certificates to the investors with a predetermined profit. This is valid because in *ijāra* finance the lessor can always stipulate the rentals in advance so making it possible to guarantee profits to the investors. Apart the examples given in Table 3, some other examples of project financing using *Sukuk al-ijāra* include the Kentucky Fried Chicken and Citibank *ijāra* facility with Guthrie worth US\$30 million and the ANZ Investment bank with the Beximco group in Bangladesh worth at US\$4 million.^{xi}

As mentioned in the above, the absence bonds instruments in most *murābaḥa* project finance in the Middle East countries may be explained by the controversy on the validity of using *bayʿ al-ʿinah* in the securitization process and the application of *bayʿ al-dayn* at a discount in bonds in secondary trading. The question now is what is the underlying issues behind this controversy about the legitimacy of *bayʿ al-ʿinah* and *bayʿ al-dayn* in Islamic law?

In a nutshell, the Shafiʿe school of thought allows *bayʿ al-ʿinah* in view since the *niyya* or intention factor is not relevant in determining the validity of contracts. However, jurists from the Hanafi, Maliki and Hanbali schools have rejected this contract since the *niyya* element does play an important role in contractual agreement. In addition, *bayʿ al-ʿinah* is a special and isolated case during the lifetime of Imam Shafiʿe. Only if Imam Shafiʿe himself witnessed the rampant use of this contract in Malaysia, he must have condoned it as well

IV. ISLAMIC CONVERTIBLE BONDS (ICOB)

The need to provide new instruments that can avoid the application of *bayʿ al-ʿinah* and *bayʿ al-dayn* is therefore crucial into making Malaysia an attractive place for Islamic global investments. Although Islamic funds have made their way into various Islamic units trust and mutual funds in the Muslim countries and capitalist financial center such as New York and London, these took the form of equity instruments. Being risky and subjected to price volatility, these investments are relatively unsafe and may turn off potential Islamic investors who like to see more safety valves in their portfolio. A hybrid of debt and equity elements can thus provide a supplement to the existing *shariʿa*-approved instruments. This will help diversify Islamic investment portfolios so that potential losses arising from unsystematic risks can be reduced.

A. Main Features of the Islamic Convertible Bond (ICOB)

Traditional or conventional convertible securities or convertible loan stocks as it is called in Malaysia is used to raise capital. They are sometimes called deferred equity since they can be converted into shares later on a pre-specified date and on pre-specified terms. An owner of convertibles therefore owns a bond and a call option. He is not only entitled to interest payments and the principal but also the right to convert loan stocks into equity.

The Islamic convertible bond model in essence incorporates conventional convertible bonds or loan stocks features. Here the interest or *ribā* element as contained in the debt component will be eliminated and replaced by *Al-Wadiah* contract while the equity component will see the application of *al-muqarada* or *al-qirad*. Thus ICOB will retain the following tradition features of convertible securities:

1. Conversion Ratio = Number of shares per bond
2. Conversion Price = Par Value/Conversion ratio
3. Conversion Value = Conversion ratio x Current stock price

Conversion ratio is the number of shares the Islamic bondholder receives per \$1,000 par value when converting the bond into equity. The conversion price is found when the price of bond at par value is divided by the conversion ratio. Lastly, one can obtain the conversion value by multiplying the conversion ratio with the current stock price of the company.

The above features however assume that crucial *shariʿa* properties of the ICOB are already in place, which is not an easy thing to do here. There are several *shariʿa* issues one must attend to. These are given below:

1. **Contractual returns:** The debt component must be free from any contractual and predetermined compensating element due to positive time preference. This is the *ribā* issue. At this stage, one can use any contracts in *fiqh muamalat* as long as it does not violate *shariʿa* principles.
2. **Call options:** The conversion of bonds into common stocks normally involves a call option, which is the right to sell. Normally this call option has a price. The question now is what does the *shariʿa* say about

the attachment of warrants or call options to the Islamic bonds. Are these equity kickers or sweeteners similar to *ribā* since they are part of the incentives that issuers gave away in order to attract investors.

3. **Single Product-Multiple Contracts:** The ICOB shall contain at least three distinct Islamic contracts, namely *Al-Wadiah*, *kafāla*, and *Al-Qirad*. Could such product with multiple contracts violate the pillars of Islamic contracts? Would it create *al-gharar* and other *bathil* elements in the investment? These are questions one must not overlook in any attempt to design an Islamic financial instrument.

We now look in greater detail how the above issues can be tackled from an Islamic perspective. Apart from these issues, one main problem now lies in the decision to convert or not to convert bonds into common stocks. Normally in traditional convertible securities, conversion will take place when the conversion value exceeded the bond market price. However in ICOB, bond market trading even for liquidity purposes (*al-suyulah*) will involve some form of discounting or selling bonds at a premium which may go against the ruling on *bay' al-dayn*. The majority of Islamic jurists today have no grudge against *bay' al-dayn* at par value and also *dhawa ta'ajjal* (bond discounting between the debtor and creditor). In the former, the bond is sold or redeemed upon maturity at face value. In the latter however, the bond is sold by the creditor (second party-financier) to the debtor (first partner-issuer) at a discount. However, trading of Islamic bonds on the basis of capital gains or loss is not allowed between the financier and a third party as this may amount to *ribā* on either side. For the same reason, selling the bond at a premium to the issuer (i.e. first party) is also not permissible in Islam. Would this mean the ICOB is solely meant for investment and therefore cannot serve as a speculative tool?

B. The Contract of *Al-Wadiah*

The application of *Al-Qard* (loan) to replace debt component of convertible securities is plagued with problems since Islamic issuers are not in the position to make any contractual commitment in the form of interest payment since this amounts to *ribā*. In the contract of *al-Qard*, legal claims by lenders can only be made on the principal sum. Any surplus given away must only be voluntary and will not be mentioned in the contract of lending. Certainly Islam enjoins debtors to pay more. Narrated Jabir bin Abdullah: I went to the Prophet (peace be upon him) while he was in the mosque. After the Prophet told me to pray two *Raka'at* he repaid me the debt he owned me and gave me an extra amount. In another occasion, the Prophet (peace be upon him) says, "The best amongst you is he who repays his debts in the most handsome manner (al-Bukhari)." Certainly this is not a policy but observed to acknowledge the fact that money today is worth more than money tomorrow by virtue of opportunity cost, which in Islam is non-contractual in nature. The extra payment was not be made contractually but released according to the paying capacity of the debtors.

On this basis, *Al-Qard* is not a viable financial instrument for commercial application. In the contract of *Al-Qard*, the lender has also no right to know the purpose of borrowing and this will make it even difficult to assess the risk of default although borrowers are required to place collaterals or seek guarantors. Most crucial is its inability to provide certainty in future cash flows as it cannot make promises on the payment of interests.

The contract of *Al-Wadiah* can help overcome this problem since it is not a contract of loan. (*Al-Qard*) even though at some point it does. *Al-Wadiah* is a contract of deposits or safe-custody with guarantee where the caretaker (*al-mustawda'*) is not liable to damages inflicted by market risks except his own for example due to negligence or transgression (*ta'addi*).^{xii} In classical form, *Al-Wadiah* is not applied commercially as it only serves as a voluntary mechanism of mutual aid (*ta'awun*). However, it can serve as a commercial tool when the owner or depositor (*al-mudi'*) allows the custodian to use his assets as long as the latter is returned safely and in good original condition. This is one way to reward the custodian for the service rendered.

In other words, if the assets are given away on the basis of *Al-Wadiah*, the owner possesses the legal right to be informed the manner in which the assets is utilized. For example, when it is used for business purposes, where a possibility of capital appreciation and depreciation is imminent, distributive issues will now take center stage. For example, when the assets are invested from which profits are created the question now is the following: who hold a legal claim on these profits? Three juristic views are in order, namely that:^{xiii}

1. The profits belong to the custodian. This approach is presently observed by Islamic banks in Malaysia. However, not guarantees are given on any form of surplus gained from the investment of *wadiah* deposits.
2. The profits belong to the owner of assets (*al-mudi'*). This is an opinion of 'Abd Allah ibn 'Umar. He said that if the depository-custodian used the deposited money, without any agreement of *al-Qirad* or *mudāraba*, any profit created from the transaction must be returned to the depositor.^{xiv}
3. The profits belong to charity (*sadaqah*)

To accommodate a guarantee on a contractual surplus but without involving *al-Qard*, the following must prevail:

1. Asset owners can only make legal claim on the principal asset, namely capital. This contract is known as *Al-Wadiah Dhamanah* (safe keeping with guarantee).
2. If profits are realized according to projections, it must be distributed accordingly to the agreed upon profit-sharing ratio. For example, if profit is 15%, the profit-sharing ratio is 40% (Custodian): 60% (Owner). Higher rate of returns say, 20% may increase custodian's share to say 45%. This graduated distributive scheme can be worked out as an alternative to the coupon rate. This is not *ribā* since no contractual nominal sum is defined in the *Al-Wadiah* contract. Only when the targeted rate of return is reached that profits must be distributed based on the distributive scheme that both party have mutually agreed on.
3. If the investment resulted in capital depreciation, the custodian must only return the full amount of capital. This is a better alternative to debt capital since the custodian is not burden with the interest payments or any contractual surplus if losses were incurred.

Since *Al-Wadiah* is not a loan (*al-Qard*), it is likely that some contractual return can be guaranteed based on mutual consent (*ta'awun*) if and only if the investment is profitable. This arrangement does not seem to violate the *sharī'a* since it readily observe the principle of *fath al-dzari'ah* (commanded to do). It serves to make way toward doing something good. *Dzari'ah* means "a way or means toward something." The opposite of *fath al-dzari'ah* is *sadd dzari'ah*, which means "to block the means toward destruction." Hence the principle of *fath al-dzari'ah* allows man to pursue an action if it helps achieve goodness. Likewise, the distributive scheme of *Al-Wadiah* can help provide an incentive to asset-owners cum investors to take minimal risk but assured of some returns when some profits are indeed realized. Leaving the prerogative of profit distribution to the fancies of custodians may lead to agency problem.

Once the rights of asset owners and custodians are defined in clear terms such as the above, the expected coupon rate can be computed based on simulations. This rate however is ex-post and turned contractual if the targeted profit rate is attained. This Islamic coupon rate should be higher than coupon rate of traditional bonds but lower than returns on equity. The premium over traditional coupon rate is explained by the variable rate of return that *Al-Wadiah* convertible bonds can offer. Next is the issue of call options that is, the rights given to *Al-Wadiah* bondholders to purchase common stocks when they opted for conversion.

C. Call Options/Warrants

It is interesting to note that the issue of options need not imply one to make hasty juristic or *sharī'a* decisions on derivatives in the market for futures and options contracts. Even without one, issues on convertible securities or loan stocks requires one to study the Islamic view of awarding the right the purchase stocks at a certain strike price. Convertible securities are not only used today by corporations but also by venture capitalists. It is thus, crucial to understand the Islamic view of call options or the right to purchase shares.

Call warrant is a contract that gives the warrant holder a legal right to purchase the underlying shares. The right to purchase or not to purchase the shares comes with a price. For example, a person purchases a call warrant from TA Securities for \$4.00 each for one Telekom Malaysia share at an exercise price of \$25.00. Thus if the individual bought 10000 call warrants he pays a sum of \$4000. To the hedger, if the market price of Telekom Malaysia increases to \$30.00 per share at the expire date he will exercise his right to purchase the shares and therefore makes a capital gain of \$5.00 per share or \$50,000. Thus his net gain will be \$45,000. But if the share price falls to \$20.00, he can avoid losses by opting not to purchase the shares.

But to the speculator, his main intention is not to exercise the right of conversion. Instead he will trade the call warrant, when there is capital gain in sight. Normally, price of call warrant increases as the market price of underlying shares rises. For example, when the market price of Telekom shares increases from \$25.00 to \$28.00, the price of the call warrant increases from \$4 to \$4.50. A speculative trader in this case will not think of conversion but to sell the call warrant at a capital gain of 50 sen each. However, if the share price falls which reduces the price of the warrant, the individual is expected to sell the warrant for fear of losing more if the price falls further down. For example, if Telekom shares fall to \$20 each and cause the price of the warrant to fall from \$4 to 3.50, selling the warrant will cause him to lose 50 sen per share. Thus, if he purchases 100,000 warrants, his total loss is \$50,000.

The question now is what is the Islamic position on the trading of warrant? Since warrant is the right to purchase the underlying shares, trading of warrants implies trading of rights or *Al-Haq*. Usually, a contract (*al-'aqd*) in Islam is built on four basic fundamental rules, namely:

1. Rights or (*hak*) and commitment (*iltizam*) to pursue the objective of the business transaction (*maudlu'ul 'aqdi*)
2. Agents of contract (*Tharafayil 'aqdi*)
3. The object of trade in the contract (*mahallul 'aqdi*) and
4. The pronouncement of willingness to enter into a contract (*shighatul 'aqdi*).

Of the four above rules, only the rule pertaining to the object of trade or *mahallul 'aqdi* is most intriguing as it requires an answer whether the “right to purchase common stocks” i.e. the warrants is *al-māl* or property? But this is not our main concern since ICOB does not involve the trading of warrants. ICOB investors cannot sell the right to purchase stocks to any foreign party. This is also true for traditional convertibles.

Recall that a call warrant is the right to purchase an underlying share of a corporation. The focus of ICOB however is not about the trading of warrants but the conversion of *Al-Wadiah* bonds to common stocks. The right to convert is not free in common trading but now it is given away free as sweeteners. Which then imply that *Al-Wadiah* bond issuers have given investors a contractual gift, which unlike the variable rate coupon is measurable in nominal terms.

For example, a \$1000 *Al-Wadiah* convertible bond is sold by XYZ to investors and is convertible to say, 25 shares per bond on a certain date. The conversion price is = Par Value/Conversion ratio = \$1000/25 = \$40 per share. This means that bondholder has the right to buy 25 shares of XYZ at \$40 apiece for each \$1000 par value held, regardless of the current stock price.

If the current stock price of XYZ is \$50, the conversion value of ICOB is = conversion ratio x current stock price = 25 x \$50 = \$2500. Given that ICOB remains at par value till maturity, it is always profitable to exercise the option to convert. Thus the lower the conversion price, the higher gain one can enjoy when XYZ stock prices go up. This readily imply that giving the warrant or call option free as gifts or equity kickers is extremely costly to XYX if stock prices is always rising.

The question now lingers around the issue of call options as a contractual gift to investors. This contractual surplus is the legal right to convert bonds into stocks without paying a price. It is given out as a sweetener so that people are attracted to invest in convertible bonds. Since it will be problematic to infer Islamic legality of conversion without paying any price, it is important to consider separating this feature from the *Al-Wadiah* contract.

D. One Product with Multiple Contracts

The above problem can be overcome by allowing contracts to operate separately, so the sweeteners can be detached from the *Al-Wadiah* bonds. Our experience in designing Islamic auto-financing based on the *Al-ijāra Thumma Al-Bayʿ* contract (Leasing ending with sale) explains well how two different contracts are applied to produce one banking product.^{xv} Here, the first stage saw the application of leasing (*ijāra*) contract. If the lessee wish to exit or finishes his rental payments, the bank will offer him to purchase the car (*al-bayʿ*) at a nominal price. The same technique can be applied to ICOB.

1. First Stage: *Al-Wadiah* Contract

1. XYX offers ICOB at \$1000 per bond.
2. XYZ guarantees the *Wadiah* asset.
3. A guarantee on profit is made if targeted rate of return(s) is attained.
4. Bond is redeemable only at par value upon maturity date.

2. Second Stage: *Kafāla* Contract

1. A third party guarantee on the conversion of *Al-Wadiah* bonds into common stocks.
2. Conversion price will be based on a discount sale of stocks (*bayʿ al-Wadhiah*).^{xvi} That is, the *kafāla* company will guarantee to sell the stocks below market price (i.e. at the conversion price).
3. Based on this conversion price, which is below current market price a conversion ratio can be determined.
4. The *kafāla* is applied here so that investors can obtain guarantees of conversion without involving the issuer. The issuer (first party) pays some fees to the guarantor (third party) for the service rendered.

3. Third Stage: *Al-Qirad* Contract

1. Upon redemption at par value the investor will use the cash proceeds to purchase common stocks at the conversion price.
2. If current stock price is higher than the conversion price, the investor enjoys a paper gain.
3. Profit distribution in the *Al-Qirad* contract will be based on performance and therefore not guaranteed.

The above three stages in which ICOB operates can be further understood in the following illustrations.

Iecons Corporation issues \$1 million ICOB (no fixed rate coupons) in denomination of \$1000 each with maturity date 2005. At the same time, the *kafāla* contract guarantees investors of conversion from *Al-Wadiah* into *Al-Qirad* in two pre-specified dates.

The term of conversion is handled by the *kafāla* contract while the *Al-Wadiah* contract takes care the investment of deposits. The terms of conversion pre-specified in the *kafāla* agreement are:

1. Each ICOB share with face value \$1000 can be converted into 20 shares with a term of trade of 20:1. The conversion value is therefore equal to \$1000 divided by 20 = \$50.
2. If the stock is currently selling for \$30, then the conversion premium is \$20. The conversion premium is the spread between the conversion price and current market price.

V. CONVERSION DECISIONS

A. Conversion when Current Stock Price Is Higher than Conversion Price

1. *Al-Wadiah* Contract

When the stock is selling above \$50 (say \$55), an investor may want to convert his *Wadiah* bonds into *Qirad*. This takes place within the *Al-Wadiah* contract in which he will ask for full redemption at par value.

2. *Kafāla* Contract

As he now holds \$1 million in cash, he will turn to the *kafāla* contract for conversion, which is to purchase 20 million shares at \$50 each. The *kafāla* company will sell Iecons shares at \$50 each.

3. *Al-Qirad*

The investor as the *rabb al-māl* can either hold the stocks if he expects the price to further increase or sell them to realize the profit equivalent to \$100,000 (i.e. \$1.1 million to \$1 million).

B. Conversion when Current Stock Price Is Lower than Conversion Price

The investor will not convert when current stock price is lower than conversion price. Failure to convert can also mean losses when Iecons declares large dividends and bonus issues. Thus it is important for investors to study and monitor the business performance of ICOB issuers, which means that ICOB investments tend to be less speculative.

VI. CONCLUSION

In summary, the Islamic convertible bond shall consist of three separate contracts. This is done to prevent *gharar* arising from inability to fulfill bond redemption or conversion by the issuer. Since the ICOB can only be redeemed at par value, it is less volatile compared to traditional convertible securities. Here, speculation can only take place on the basis of equity price movements rather than bond price or interest rate movement, which can still affect the performance of ICOB in dualistic banking setup such as the one in Malaysia. However, investors can redeem the bond at discounted value. This is allowed in Islam under the contract of *Dha'wa Ta'ajjal* but only to take place between the issuer (first party) and investors (second party). This will help serve to provide liquidity (*al-suyulah*) arising non-speculative investments. We have shown that ICOB is able to do away with *bay' al-inah* and discounted *bay' al-dayn* such that it is relatively easier and more attractive for Middle Eastern investors to take up this bond in Malaysia. On the supply side, it should also be cheaper than the *bay' al-inah* bonds such as MuNif and ABBA since the ICOB provides investors an option to convert bonds into stocks through the *kafāla* company at no cost. It is also expected to be less volatile than traditional convertibles since *Wadiah* bonds can only be redeemed at par value. In this sense, ICOB holders observe the development and performance of Iecons corporation (i.e. the issuer) so that they can the right of conversion without inflicting harm on themselves and others as well.

ⁱ For a more detailed exposition on *bay' al-inah and al-dayn*, see Rosly, Saiful Azhar and Mahmood Sanusi. "Islamic Bond Issues: Malaysian and Middle Eastern Islamic Bonds in Comparative Perspective." Paper presented at Asia Business Forum Seminar on Restructuring Islamic Project Financing. Kuala Lumpur, Malaysia, April 16-17, 1999.

ⁱⁱ The absence of an active secondary market for Malaysian Islamic bonds, however, limits the application of *bay' al-dayn* for liquidity purposes.

ⁱⁱⁱ Rosly, Saiful Azhar. "Sukuk-Islamic Securities." The Sun. April 25, 1997.

^{iv} Note that these underlying assets do not act as collaterals or securities to the facility. In the event of default, the bond indenture makes no mention about securities involving these underlying assets, which usually are taken up by debentures and performance bonds.

^v In the *bay' al-'inah* mechanism, the sale of underlying assets using the name of *murābahā* and *al-bay'-bithman ajil* does not mean putting *bay' al-'inah* in a legitimate setting. These underlying assets are not part of the plant and equipment needed in the project operation. If these assets are collaterals to the issuers' existing interest-based debt, it is again difficult to gauge the legitimacy of this so-called Islamic securitization. As a precautionary note, Islamic securitization has nothing to do with asset-backed securitization (ABS) when the latter deals with financial claims on the cash flows of securitized assets such as mortgages, credit card account receivables, and vehicle loans.

^{vi} See Kamil, Wan Abdul Rahim. "Jati's Pioneering Commercial Paper Chase." Islamic Banker (May/June 1996). pp. 8-10.

^{vii} Ahmad, Hassan. "*Fiqh* Methodology for Islamic Benchmark Bonds." Paper presented at Seminar on Islamic Bonds. Malacca, 1998.

^{viii} Further discussions on Khazanah bonds can be found in Hussain, Abdul Rashid. "Malaysia's Khazanah Benchmark Bonds." Islamic Banker (April 1998). pp. 9-11.; and Ahmad, Hassan. "*Fiqh* Methodology for the Creation of the Benchmark Bond in Islam." Paper presented at Seminar on *Sharī'a* Experts. Melaka, Malaysia, October 30, 1998.

^{ix} At present, the yield on the Malaysian government bond (MGS) cannot be used as a benchmark yield since its demand is captive, while its supply is irregular. Banks will subscribe to the MGS only to fulfill liquidity requirements, while the supply of MGS to finance economic development is irregular due to the privatization of public works.

^x A good source of deals and transactions made in the Arab countries using Islamic modes of financing can be found in Islamic Banker magazine, published in London, England.

^{xi} At present, only one *ijāra* bond is issued in Malaysia. Known as *Sukuk al-ijāra*, it was issued by Segary Energy Venture Sdn. Bhd worth RM337.5 million with a four-year maturity. For more detail, see "Segary Uses Islamic Facilities to Refinance Loan." Islamic Banker (March 1997). pp. 8-9.

^{xii} On this point, 'Ali ibn Abi Talib and 'Abd Allah ibn Mas'ud regarded the custodian or depository (*al-mustawda'*) as a trustee (*amin*). Therefore, the custodian is not liable to make compensation except when breaching the contract by deception (*khiyanah*). Ibrahim al-Naka' asserted that there is no liability to the depository/custodian, except when infringement or misdemeanor has occurred. See Hasan, Abdullah Alwi Haji. Sales and Contract in Early Islamic Commercial Law. Islamabad: 1997. pp. 127-131.

^{xiii} The authors would like to thank Mahmood Sanusi of the Kulliyah of Laws, International Islamic University Malaysia, for this input. Further textual exposition will be given as this research proceeds into *fiqh* matters.

^{xiv} Hasan, Abdullah Alwi. Sales and Contract in Early Islamic Commercial Law. p. 129.

^{xv} *Ijāra Thumma Al-Bay'* auto financing was designed for EON Finance Pte. Malaysia.

^{xvi} *Bay' al-Wadhiah* is a discount sale, while *Al-Wadhiah* is a deposit. These are two distinct contracts.