

Listed Warrants- Contributing to Economic development of Indian Economy

World Warrants (Structured product) Market

Structured warrants are financial instruments issued by a third-party financial institution, usually banks (referred to herein as “issuer”), and are traded in the securities market of the Exchange.

Structured warrant holders have the right but not the obligation to buy (for call warrants) or sell (for put warrants) an underlying asset at a predetermined price either on the expiry date (European-style warrants) or on or before the expiry date (American-style warrants). Underlying assets may be a particular security or a basket of securities or an index, and such securities may or may not be listed or quoted on the Exchange. The issuer of a structured warrant need not be the issuer of the underlying asset.

Structured warrants offer investors an alternative instrument to participate in the price performance of an underlying asset at a fraction of the underlying asset price. They can also be used as hedging tools to reduce or diversify investors’ portfolio risks. Holders or buyers of structured warrants are referred to as having a ‘long’ position, while the issuers of structured warrants are referred to as having a ‘short’ position as they have sold the structured warrant.

Structured warrants have a limited lifespan and if not exercised, become worthless at expiration. Structured warrants are different from company warrants which are issued by a listed company to raise funds for the company and give the holder the right to subscribe for or buy one share of that company

As per report published by HKSE, over 34 Exchanges (members of FIBV) permit warrants trading. Switzerland, Germany, Hong Kong offer both equity and derivative warrants and account for almost 80% of the turnover. Notwithstanding the developments of world warrant markets, the leading warrants Exchanges continue primarily to serve their domestic market.

Warrants in the leading markets, contribute significant numbers in form of Issuances and Turnover (Swiss statistics of year 2020: https://www.six-structured-products.com/en/search/detail-en#eq_typ=ALL&eq_quanto=ALL&eq_is_collateralized=ALL&eq_underlying_ag=ALL&eq_ich_level1_id=ALL&eq_ag=ALL&eq_currency_id=ALL&laufzeit_ende_alternative=ALL&emittent_id=ALL&eq_typ=ALL&eq_quanto=ALL&eq_is_collateralized=ALL&eq_class=6-110&search_id=scoach_ch_20_fa32206f233f9437f5cb87ed93b7c079&laufzeit_ende_alternative=all)

Features of Warrants

Warrants are securitised rights, issued by third parties in domestic Market and are different from ETFs or Options. They are for a predetermined period: 12-18 months. Warrants are more popular than ETFs.

The exercise price, or strike price, expiration date, exercise ratio as well as the underlying's market price constitute a warrant's key characteristics. Warrants can only be exercised if they are in the money, i.e. if the underlying price is higher than a call warrant's strike price or lower than a put warrant's strike price.

Enables Exchange, Depository, Clearinghouse, Brokerages, Investment banks, banks, Custodians to expand product base, market share, participate in capital formation develop revenue lines.

Issuers prefer Warrants over convertibles, Options and ETFs given the ease in trading and settlement, a fixed time frame of 12-18 months, ready acceptability by domestic investors, low cost of raising funds for fixed terms, expanding product range.

Switzerland:

<https://www.ceicdata.com/en/switzerland/six-swiss-exchange-listed-securities/listed-securities-six-swiss-exchange-leverage-warrants>

Hong Kong:

Hong Kong is the world's most actively-traded market for structured products. ADT of CBBCs, DWs and warrants was \$18.0 billion, accounting for 21 per cent of total market turnover. In particular, ADT of CBBCs reached a record high of \$8.1 billion in 2019, up 9 per cent from 2018. A new product type being the first in Asia, Inline Warrants, was launched in July 2019. Inline Warrants complement HKEX's Strategic Plan in developing Hong Kong into a trading hub for structured products in the Asia Pacific time zone and offer an alternative investment product to serve different trading strategies. As at 31 December 2019, 922 Inline Warrants were listed.

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Listed Warrants: Contributing to Capital markets development of India

Introduction

SEBI set the Roadmap for development of Capital Market. The NSE, NSCCL and NSDL have led the significant developments in India's capital formation and economic growth. The Global leadership position of NSE in derivatives has been scripted worldwide. The Indian intermediaries and Investors (mostly retail) have embraced complex products and lapped the variety now available. The said SROs ensured that in the T+2 scenario, Risk management systems were amongst the best in the world, in geographically daunting scenario while banking was evolving. The developments in banking augurs well for further developments of Capital Markets.

This note dwells on a considering introducing listed Warrants in India- especially as the Equity, derivatives, ETF markets are highly developed and thus provide the platform for introduction of listed warrants. Notwithstanding the developments of world warrant markets, the leading warrants Exchanges continue primarily to serve their domestic market and contribute to economic development. Warrants also enable the growth of the Equity and Derivatives segment and is more popular than ETFs.

My view is, given India's giant footprints in Trading and Settlement of derivatives, Currency, Equity market, the launch of warrants will add to the products lineage and strengthen the Global position/leadership of India and thereby of the NSE, NSCCL, NSDL It supports the development of Trust and Agency business, which in turn leads to development of other segments.

Its possible that within 3 years of Launch Indian SE may rank amongst the top 5(if not the top three) Exchanges, in the world warrants market.

The Indian investor has displayed excellent understanding and dealing in complex capital markets products and will finds warrants easy to grasp and accept. Warrants leverages existing setup wrt listing, trading, clearing and settlement with the one addition aspect (creation/exercise process), thus reducing complexity and time to market.

The note provides an overview of the world warrants market, key aspects, and opportunity space for SROs and intermediaries. It does not dwell on the operational aspects (dealt separately).

World Warrants Market

Switzerland, Hong Kong (HK), Germany the three top exchanges, offers both equity and derivative warrants. The three Exchanges recorded an annual growth of 20% in turnover in this segment. Six Top Stock exchanges represent 90% of the aggregate warrant turnover.

In HK and Germany derivative warrants contribute the majority of warrant turnover. The rising popularity of warrants in Switzerland is increasingly reflected from the fact that approx 15200 listed warrants exist. In recent years derivative warrants is more popular than equity in Hong Kong (contributing almost 80% of total warrant turnover) as is in the case of Germany. Eleven of the 34 Exchanges are in Asia- Pacific, HK (introduced in 1977) the largest being 4 times larger than the second best, Thailand.

Warrants traded on the Key Exchanges:

- Swiss: Equity, basket, index, bond
- Germany: Equity, Covered, basket, index, bond, options and futures, currency, commodity
- Hong Kong: Equity, derivatives-index, currency, others

Features of Warrants

1. Structured Listed Warrants are securitised rights, issued by third parties (thus not same as options), usually Finance houses/Investment or Universal Banks. Warrants a derivative, has been in existence for many years, it tested and growing. Warrants are like Local Notes issued in domestic Market.
2. Enables Exchange, Depository, Clearinghouse, Brokerages, Investment banks, banks, Custodians to expand product base, market share, develop other products, add to revenue lines.
3. Warrants are more popular than ETFs.
4. Warrants find favor with Retail investors and represent a large proportion of total trading (see attached statistics). Also targeted at Institutional Investor.

5. Normally issued with a 12-18 months expiry date and mostly American Style (exercised anytime during lifecycle of the warrant), they are popular products, aimed for the domestic markets.
6. A warrant is a right – but not an obligation – to buy (call) or sell (put) an underlying instrument (stock, index, structured product) within a given time span and at a fixed price.
7. It differs from options as the issuer is not an Exchange and follows a listing process. The product is also of longer shelf life and sits between Options (3 months period) and equity (open period).
8. If an investor believes that the underlying instrument's price will rise in future, he could actually consider buying the underlying directly. Still, small investors often decide to rather buy a call warrant, as in relative terms, warrant prices generally rise more steeply than those of their underlying instruments.
9. The exercise price, or strike price, expiration date, exercise ratio as well as the underlying's market price constitute a warrant's key characteristics. To a large extent, these factors determine the warrant's value. Another factor is the market's expectation of the underlying instrument's future price development. This factor is reflected in the warrant's premium.
10. Warrants can only be exercised if they are in the money, i.e. if the underlying price is higher than a call warrant's strike price or lower than a put warrant's strike price. When exercising in-the-money index warrants, the investor receives the price difference between the index's value on expiry and the strike price, in proportion of the exercise ratio. A call warrant's price rises with the underlying price; a put warrant's price rises when the underlying price falls.
11. Warrants are out of the money if the underlying price is lower than a call warrants strike price or higher than a put warrant's strike price. It is pointless to exercise warrant positions that are out-of-the-money, as it is cheaper to buy/sell the underlying instrument directly in the market.
12. If a warrant position remains in a client deposit beyond their expiration date, the Issuer will remove them from the books as worthless. In most cases, this is not in the client's interest (unless the warrant's market value has actually fallen to zero, which can also happen!!).

Other Features:

Issuers

1. Warrant issuers use this product to provide more variety to the clients, especially in portfolio management (a fast-growing segment in India). It creates a new asset class (which is not options, nor futures).
2. Issuers in advanced markets use this product over convertibles, Options and ETFs given the ease in trading and settlement, a fixed time frame of 12-18 months, ready acceptability by domestic investors.
3. Being third parties, usually Finance houses/Investment or Universal Banks. The Issuers perform the activities similar to a company listing its shares.
4. Enables Issuer to issue a short-term product and raise funds for a time bound period. Helps beat inflationary borrowing. This product also serves short-term aspirations like CPs in case of Corporates.
5. Warrants are sold back to the issuer to crystallize the profit when “in money”
6. Warrants issued are exercisable against Cash or Securities (can be domestic/ International- paving a market for trading in international securities).

7. On expiration, the holder must exercise, though driven by Issuer. The payment of cash proceeds to holder in the event of payment of Exercise price/ in respect of cash settlement is- the money is taken from the agent and distributed to the holders.
8. Issuer issues term sheet for public (similar to prospectus).
9. The Issuer notifies corporate actions (In the Swiss market, it's the Depository that notifies).

Exchange/ Clearing House/ Depository:

1. Enables Exchange, Depository, Clearinghouse, Brokerages, Investment banks, banks, Custodians to expand product base, market share, participate in capital formation develop revenue lines.
2. Warrants are listed and bear an ISIN. It's a new product class (not being options, nor futures). The issuer issues/maintain the warrants in DEMAT form.
3. Listing & clearing makes warrants more it secure and creates confidence with investors.
4. Settlement of warrants is similar to conventional equity- on exchange/ off exchange. The only difference being the creation/ exercise process.
5. The Depository's requirement at the end of the tenure- the Issuer ensures settlement of all warrants exercised and is redeemed.

Intermediaries

1. Custodians provide services as- Issuance related; Exercising Agent (both mid term and at Maturity/ expiry; Clearing Agent (Settlement Agent). Agency and Trust business perform the function of exercising and cancellations.

Sources:

SWX (Swiss Stock Exchange); Viraj Kulkarni introduced Warrants Clearing at Citibank Switzerland and worked closely with the Exchange (SWX), Depository (SIS) intermediaries (legal firms, CPA's and broker dealers.

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