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# The Saudi Arabian Economy

*Policies, Achievements and Challenges*

***Second Edition***



Springer

# CHAPTER 6

## THE SAUDI CAPITAL MARKET

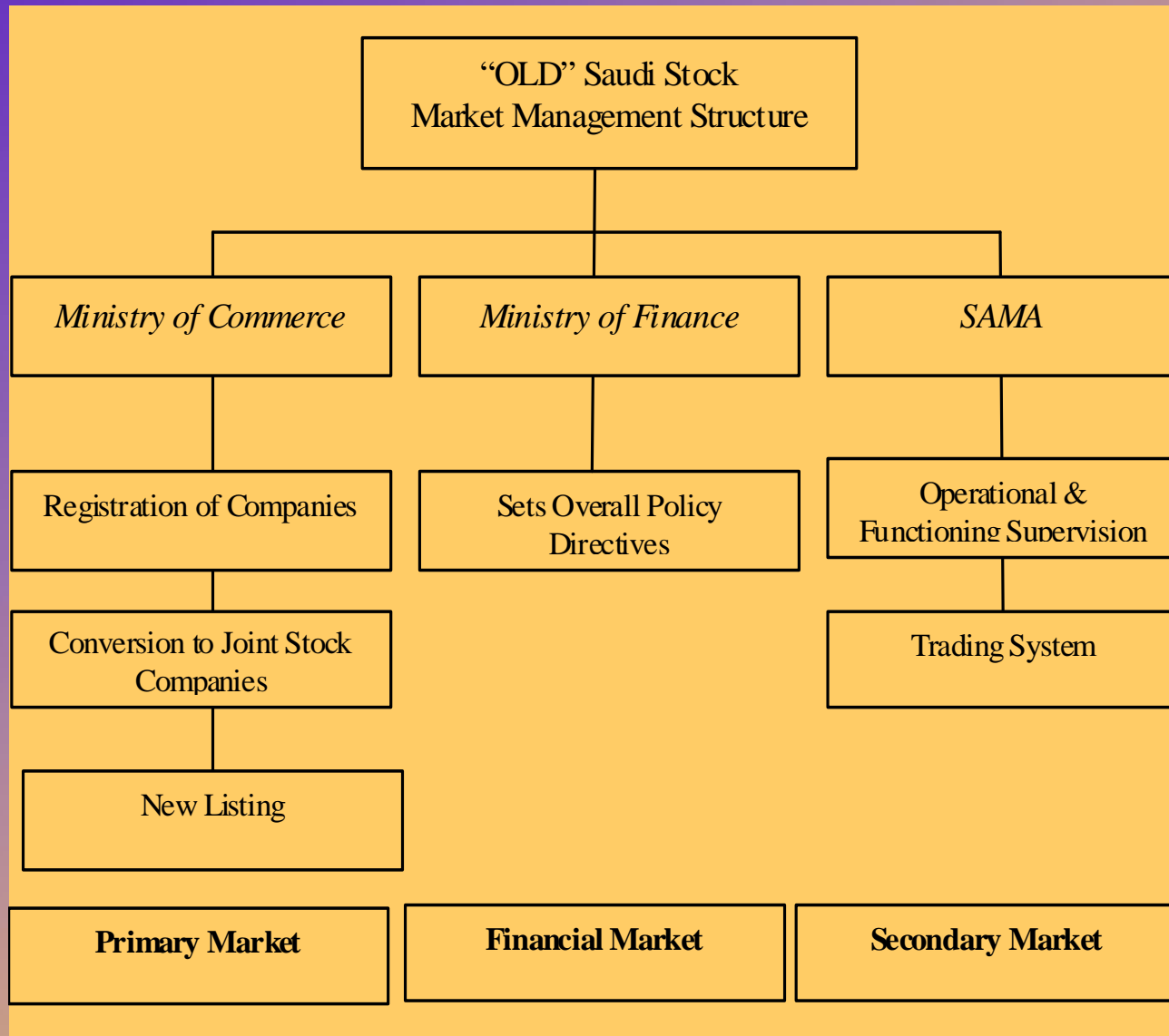
# The importance of the Saudi Capital Market:

- An important **tool** of financial intermediation and economic development.
- Assists to **recycle** capital surpluses from and to the private sector.
- Creation of new **risk-management instruments** (interest rate hedging, futures and options).
- A **well functioning** capital market can play an effective signaling effect to managers regarding investment opportunities, sourcing of financing and catalyst for corporate governance.

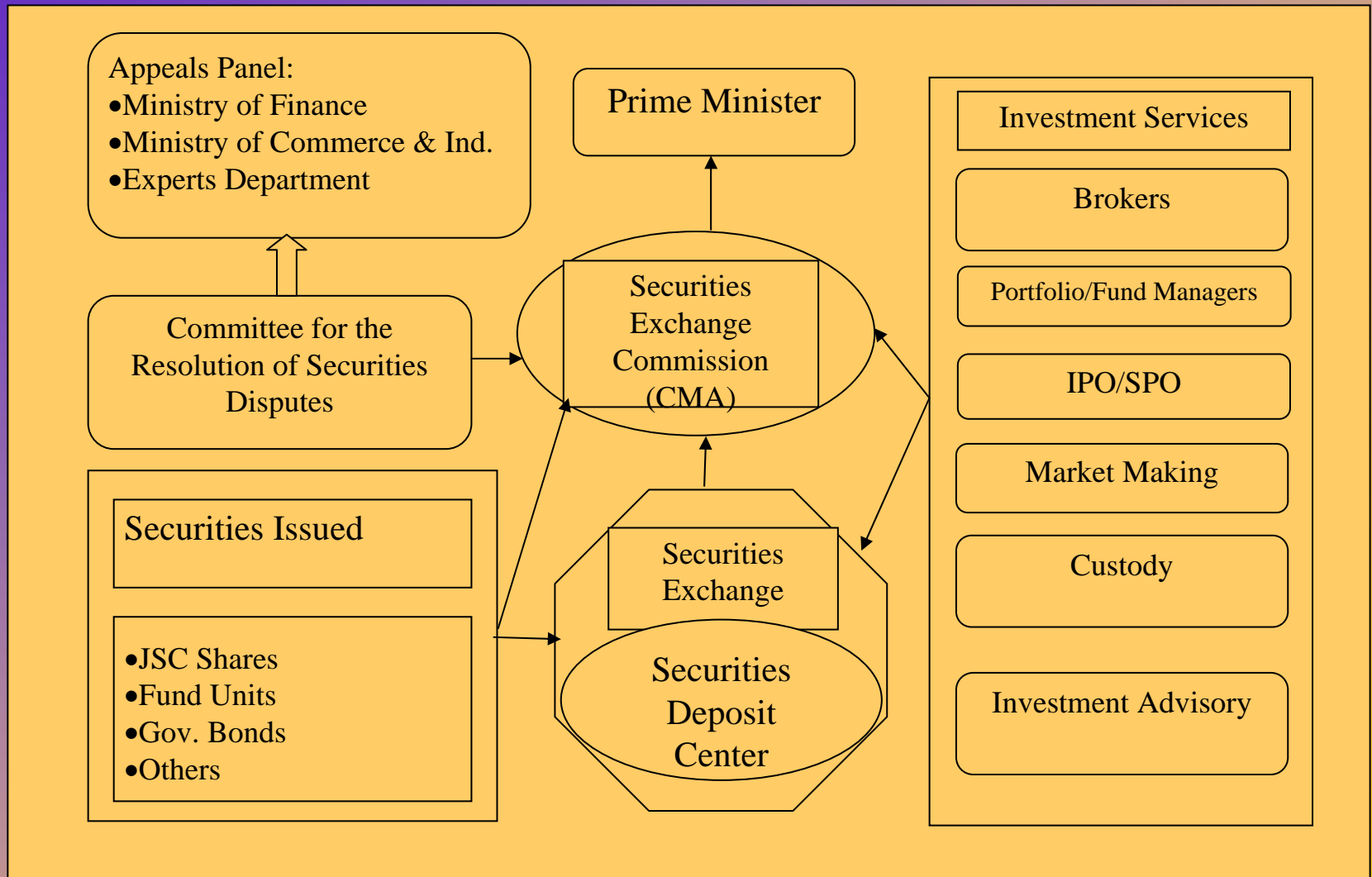
# Saudi Capital Market development:

- Plans to establish one started in early 1980's, but lacked organizational and legal framework.
- Three official government organizations supervised it – Ministry of Commerce, Ministry of Finance and SAMIA.
- Lack of organized brokerage services and few listed companies (38 listed in 1983).
- The **2003 Saudi Capital Market Law** was passed to regularize the stock market on a new basis and remove some of the operational obstacles.

**Figure 6.1 “Old” Saudi stock market**



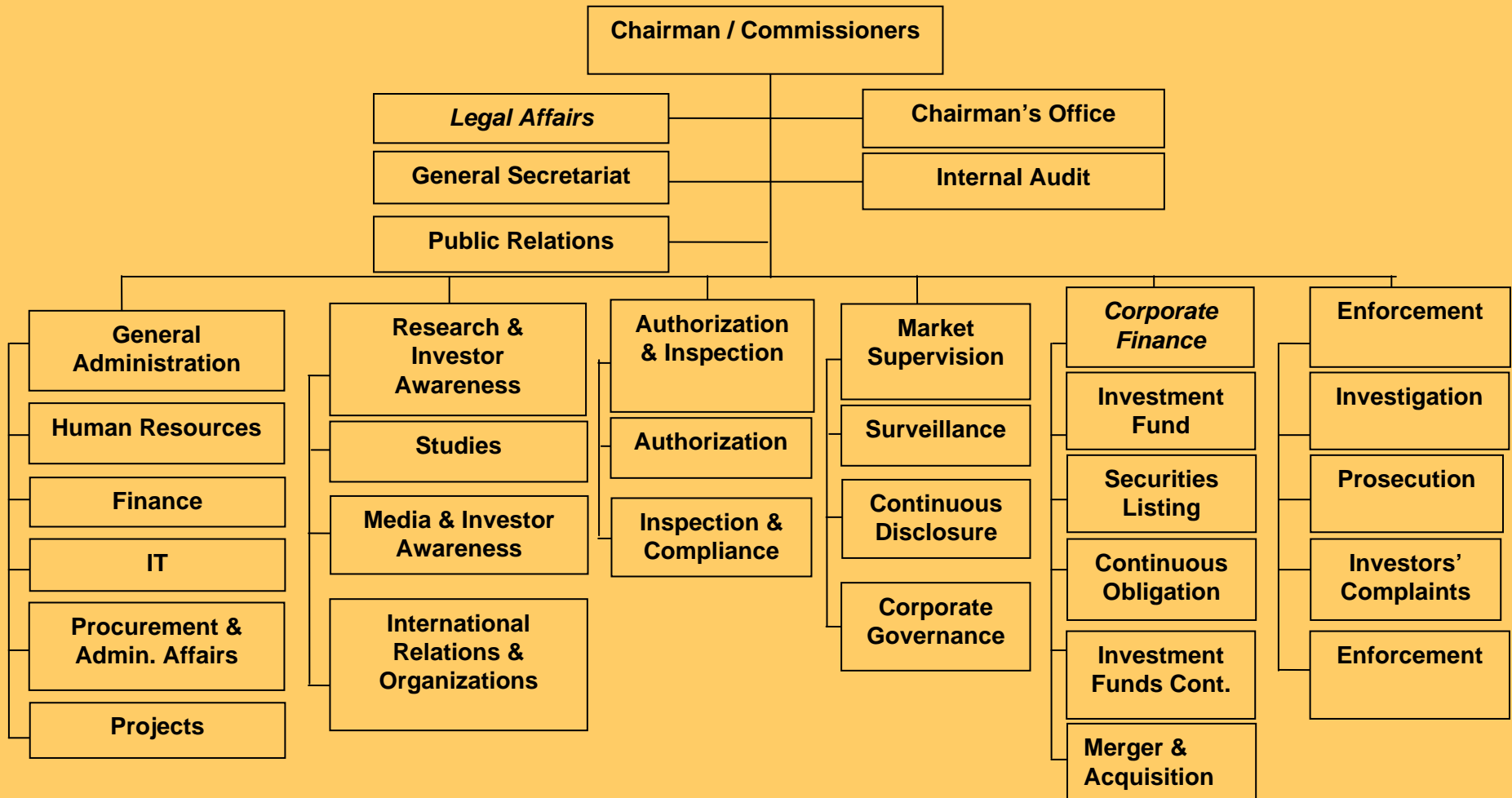
**Figure 6.2 The new Saudi capital market regulatory structure**



# The current Saudi Capital Market supervisory structure

- The establishment of the **Capital Market Authority (CMA)** has been a significant development in establishing a well regulated Saudi Capital Market.
- The CMA has a **wide range of powers**, including:
  - Ensuring fairness and transparency
  - Admitting new members for broking and clearing.
  - Listing new companies
  - Promoting high ethical standards amongst members, employees and market participants
  - Ensuring high standards of corporate governance
  - Ensuring timely and accurate market information
  - Establishing an efficient system of nationwide securities trading
  - Applying penalties on irregularities and insider trading

**Figure 6.3 Saudi CMA organizational structure**



Source: CMA



## Table 6.1 Parties subject to CMA control and supervision

<i>Party</i>	<i>Definition</i>
<b>1. Tadawul Saudi Stock Exchange</b>	<ul style="list-style-type: none"><li>• <i>Tadawul</i> is the sole entity authorized to carry out trading in Saudi Arabia in securities trading and responsible for all operation of the exchange.</li></ul>
<b>2. Authorized Persons</b>	<ul style="list-style-type: none"><li>• Legal entities authorized to carry on securities business and only persons holding a valid license issued by CMA are allowed to perform this function.</li></ul>
<b>3. Listed Companies</b>	<ul style="list-style-type: none"><li>• Companies whose securities are traded in the Saudi Capital Market <i>Tadawul</i>.</li></ul>
<b>4. Traders</b>	<ul style="list-style-type: none"><li>• Entities representing the public who trade in securities in the Saudi capital market.</li></ul>

Source: *CMA, 2009*

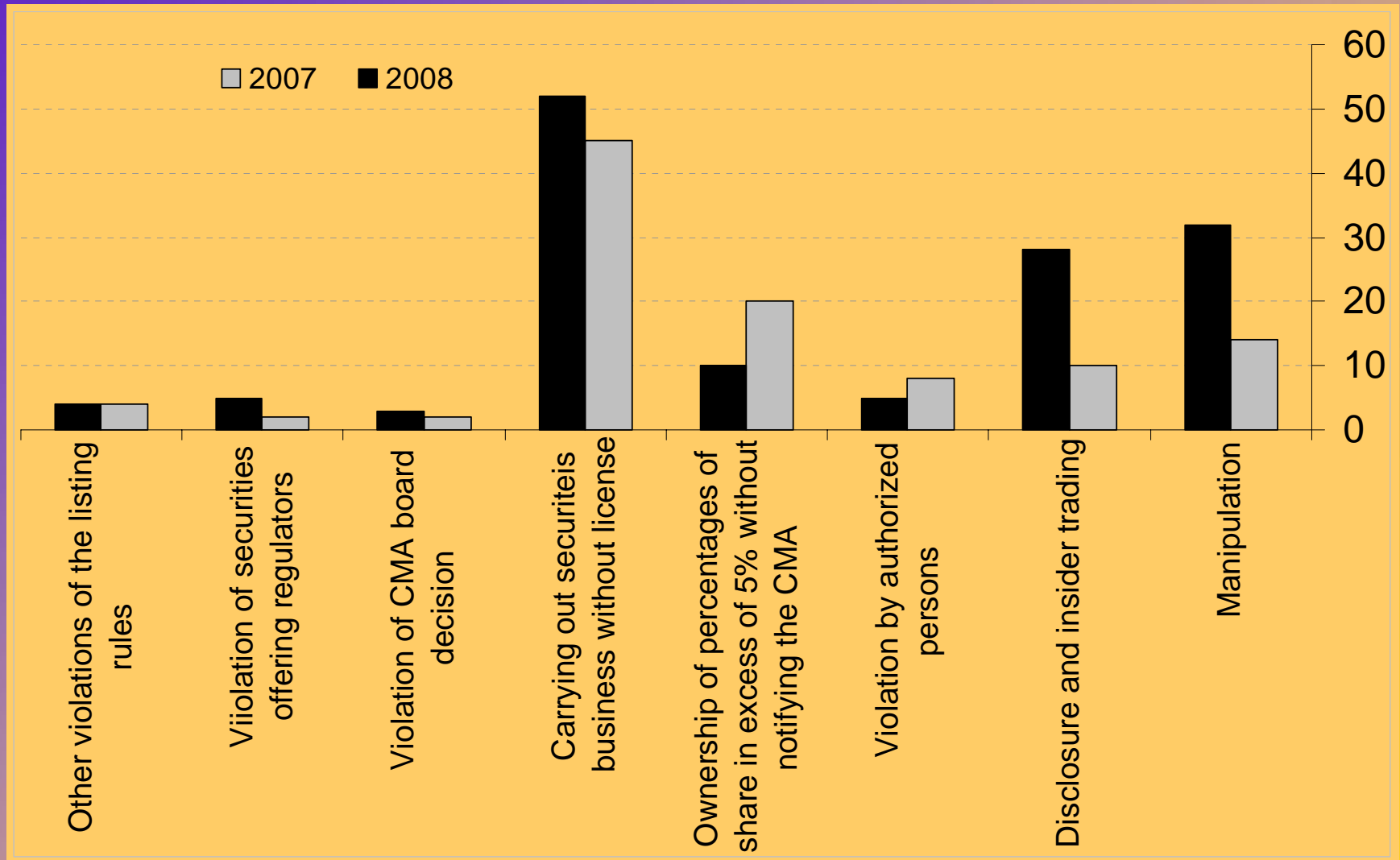
# The CMA has introduced a wide range of implementation regulations since 2004

- These included **implementation regulations** in the fields of:
  - Market conduct
  - Securities business regulations
  - Real estate investment funds
  - Investment funds
  - Listing rules
  - Mergers and acquisitions
  - Anti-money laundering and counter terrorist financing
  - Offering of securities.
- All the above comply to **international best standards** and the CMA has established close cooperation with other western regulators (FSA, SEC, etc.)

**Table 6.2 Major Saudi CMA implementation regulations and regulatory decisions (2004-2009)**

<i>Year</i>	<i>Regulation Type</i>	<i>Key aspects covered</i>
2004	• <b>Market Conduct Regulation</b>	• Sets out key guiding principles in terms of prohibition of market manipulation, insider trading, untrue statements and authorized persons conduct.
2005	• <b>Securities Business Regulation</b>	• Defines the securities business scope and carrying out security business, exclusions from authorizations and established procedures for securities advertisements.
2006	• <b>Real Estate Investment Funds Regulations</b>	• Establishes the operating framework for the real estate investment funds in Saudi Arabia, fund management disclosure, fund asset requirements, custody of assets and the functions of the fund managers, as well as valuation and custodian services for such funds.
	• <b>Investment Funds Regulations</b>	• Establishes the authorization process and offer of launching of such funds, the required level of disclosure to the public, the organization of investment funds and the role of fund managers, fund governance, and the methods of offers and redemption of funds.
	• <b>Listing Rules</b>	• Sets out the role of the Financial Advisor, conditions for admission and listing, admission to the official list and compliance with listing rules and the continuing obligations after listing.
2007	• <b>Merger and Acquisition Regulations</b>	• Set out the steps for announcements and takeover timetable for M+A's , independent advice, and restrictions on dealings, acceptance conditions and compliance of the offer with competition law, documentation on display and the method of profit and asset valuation precasts.
2008	• <b>Anti-money Laundering and Counter-Terrorist Financing Rules</b>	• Established the principles of AMT/CTF procedures, beneficial ownership, business relationships, clients and counterparties as well as dealing with non-profit organizations and politically exposed persons.
	• <b>Offers of Securities</b>	• Sets out the general provisions on offers of securities in Saudi Arabia, public offers and private placements, as well as the liability for incorrect documents.

**Figure 6.4 CMA – Total number of investigations into suspected violations by type (2007, 2008)**

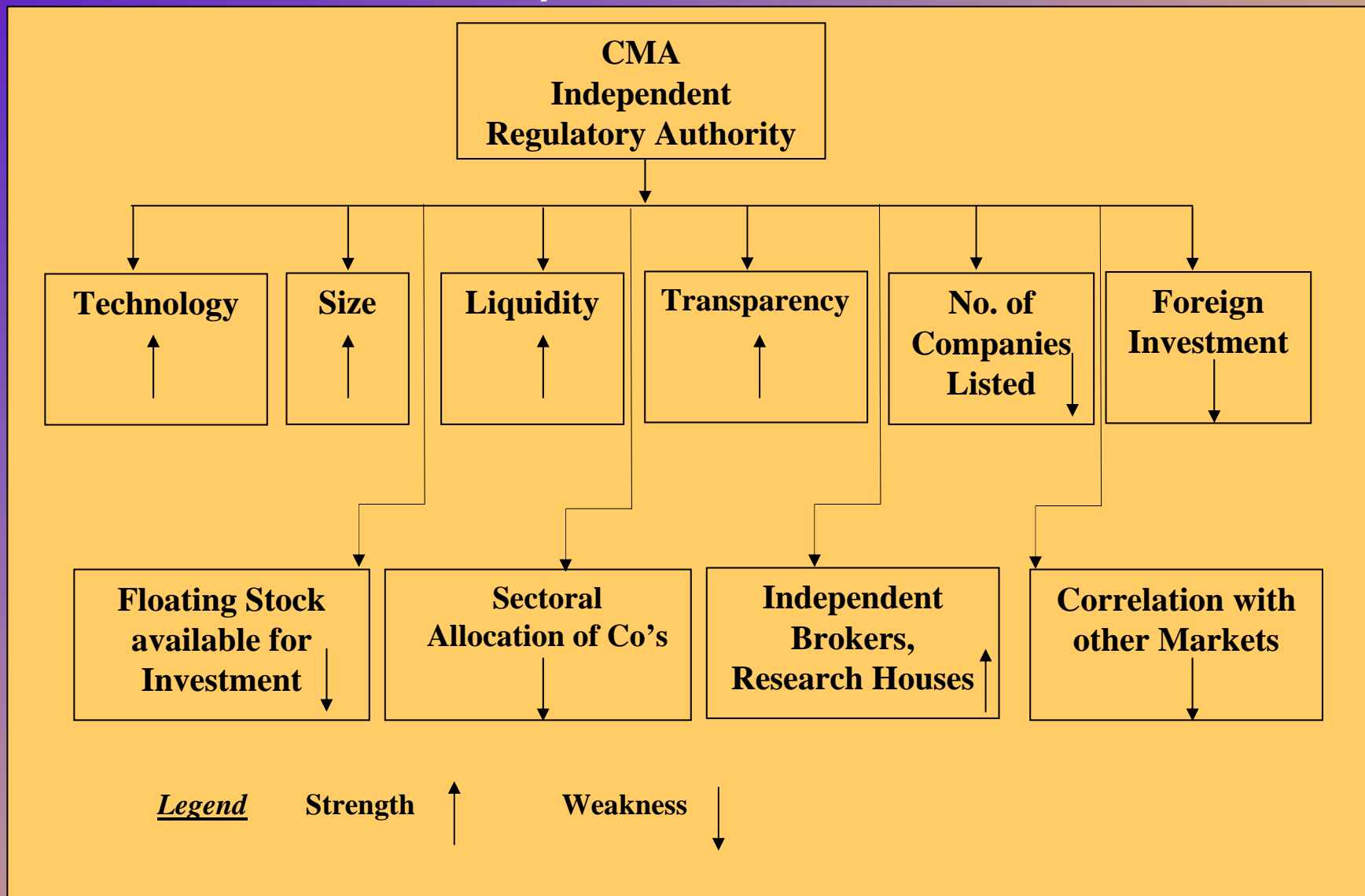


Source: CMA, 2009

# Strengths and weaknesses of the current Saudi Capital Market Law

- More **listed companies** are needed to add depth and breadth to the Saudi market.
- More **foreign investment** to be allowed despite some improvement made in March 2010 in allowing **ETF's** (Exchange Traded Funds) to add to existing **“Swap”** facilities.
- Weakness of limited floating stock availability for investment.
- Strengths includes high technology development, market size, liquidity, independent brokers and research houses.

**Figure 6.5 Assessment of current strengths and weaknesses of the Capital Market Law**



# **Number of Saudi listed companies are not commensurate with size of Saudi economy**

- **Number of listed companies has gone up from 70 in 1996 to 134 in 2009.**
- **Total number of shares issued is now around 41.2 million in 2009, compared with 3.9 million in 1996.**
- **Conversion requirements in Saudi Arabia have been eased by the Ministry of Commerce for Joint Stock Companies after 1999, but some companies still find the JSC Listing **new thresholds high.****

***Table 6.3 Saudi listed companies and number of shares issued.  
1990-2009***

<i>Year</i>	<i>Companies listed</i>	<i>Total shares issued (SR Million)</i>
1996	70	3,921
1997	70	3,983
2002	68	9,807
2006	86	19,328
2007	111	30,728
2008	127	39,728
2009	134	41,223

Source: CMA



**Table 6.4 Rules for company conversion into a Saudi joint stock company**

<i>Parameters</i>	<i>Pre-1999</i>	<i>Post-1999</i>
• Net assets	• SR 75 million	• SR 50 million
• Return on shareholders equity	• 10% for the last five years to be maintained for next five years	• 7% for the last three years to be maintained for next three years
• Public subscription	• 51%	• 40%
• Company age	• ten years	• five years

Source: *Ministry of Commerce*, Riyadh, 2002.

# However well intentioned a regulator, some potential regulatory *supervisory biases remain*

- These could arise from inherent:
  - **Supervision** biases
  - **Operational** biases
  - **Regulation** biases
- Such biases could lead the Saudi CMA to make judgmental regulatory decisions that are not conducive to market efficiency.

**Table 6.5 Potential CMA regulatory biases**

<i>Regulatory Bias</i>	<i>Cause and Effect</i>
<b><u>A. Supervision Bias</u></b>	
<b>1. Focusing Observation and Trustworthy Biases</b>	<u>Cause:</u> CMA could suffer from focusing too much on recent and immediately available information. As such too quick to see a pattern in a series of events that are random. CMA may suffer from observation bias, by placing too much weight on probability of past events that actually occurred, relative to those that did not. CMA might also have an “attribution” bias leading investigators to overestimate the influence of perceived outlook (eg. fraud) in explaining behaviour while overlooking the influence of the person’s particular circumstances in any given situation.
<b>2. Seeding effect</b>	• <u>Cause:</u> This may lead the CMA to act vigorously in cases to avoid possible investor losses or erosion in the CMA’s own authority. Many of the CMA’s regulatory initiatives were launched shortly after either a large investor losses or threat of diminished CMA authority.
<b><u>B. Operational Biases</u></b>	
<b>1. Over Confidence Bias</b>	• <u>Cause:</u> CMA may be overconfident in their policy prescriptions leading to errors and regulatory overreach. Example is CMA’s decision of reduction of repaying commissions from banks to investors before the April 2006 market crash. CMA officials were confident that decision taken would reduce speculation but investors took this as a signal that stock prices were overvalued and caused massive selling.

**Table 6.5 Potential CMA regulatory biases (Contd.....)**

<i>Regulatory Bias</i>	<i>Cause and Effect</i>
<b>2. Confirmation Bias</b>	<ul style="list-style-type: none"> <li>•<u>Cause:</u> Once regulations are on the books, regulators may feel the need to justify their worth instead of critically evaluating their effects. Evidence that does not discredit regulation unambiguously will be ignored. CMA regulators that focus on the success of the Saudi securities markets may become “locked in”, making future changes to regulations difficult.</li> </ul>
<b>3. Groupthink Bias</b>	<ul style="list-style-type: none"> <li>•<u>Cause:</u> Cognitive biases within the CMA could be magnified by organizational “group think” which occurs when individuals come to identify with the organization in uncritical manner, deferring to consensus. The CMA is known for its strong organizational culture and the mission of investor protection is taken to heart by CMA staff which could reduce the range of potential hypothesis that an organization considers when faced with a problem</li> </ul>
<b><u>C. Regulation Biases</u></b>	
<b>1. Bounded Rationality Bias</b>	<ul style="list-style-type: none"> <li>•<u>Cause:</u> The CMA receives vast amounts of information ranging from registration statements for IPO’s, periodic filings for public companies and filings for the secondary market transactions. Through its enforcement arm the CMA receives daily intelligence on market manipulation and potential fraud. Dealing with such a multitude of factors, regulators often develop a “tunnel vision” and stick to known regulatory schemes and are unable to assess all market risks and prioritize them due to the “bounded capabilities” of the regulatory staff.</li> </ul>

# Saudi Capital Market: Arab world's largest

- The Saudi Capital Market is the **largest** in terms of capitalization (around \$247 billion), followed by Qatar and Abu Dhabi in the GCC, with Egypt being the second largest in the Arab world at around \$86 billion in 2008.
- The **turnover ratio** (value of traded shares to market depth) is also high for Saudi Arabia but **market depth** (ratio of market capitalization to GDP) is not as high as other Arab markets.
- In terms of turnover ratio, the Saudi market is the most **liquid** of all Arab markets and also has a high ability to handle volatility.

**Table 6.6 Arab capital market indicators - 2008**

<i>Country</i>	<i>Market Capitalization (\$ Billion)</i>	<i>Value of shares traded (\$ Billion)</i>	<i>No. of Listed Companies</i>	<i>GDP at Current Prices (\$ Billion)</i>	<i>Market Depth % (1)</i>	<i>Turnover Ratio % (2)</i>
<b><u>GCC Region</u></b>						
<b><i>Saudi Arabia</i></b>	<b>246.5</b>	<b>523.4</b>	<b>127</b>	<b>465.6</b>	<b>53%</b>	<b>212.3%</b>
Kuwait	70.1	133.6	204	148.4	47.3%	190.4%
Bahrain	19.9	2.1	51	18.6	107.1%	10.5%
Oman	15.2	8.7	122	46.4	32.6%	57.4%
Abu Dhabi	68.8	63.1	65	240.4	28.6%	91.7%
Dubai	63.1	83.1	65	240.4	26.3%	131.7%
Qatar	76.6	48.2	43	95.8	80.0%	62.9%
<b><u>Other Arab</u></b>						
Egypt	85.9	87.9	373	159.2	54.0%	102.4%
Morocco	65.7	14.0	77	87.0	75.6%	21.4%
Jordan	35.8	28.6	262	20.1	178.4%	80.0%
Tunisia	6.3	1.7	50	38.9	16.2%	26.8%
Algeria	0.09	0.3	2	152.3	0.1%	0.3%
Palestine	2.1	1.2	37	6.2	34.2%	58.1%
Lebanon	9.6	1.7	13	28.3	33.9%	17.8%

Source: SAMA

Notes: (1) Market depth = Ratio of market capitalization to GDP

(2) Turnover ratio = Value of traded shares to market capitalization of shares at end of period.

**Table 6.7 Saudi Arabian share market indicators  
1993-2008**

<i>Year</i>	<i>Value of Shares Trading (SR Billion)</i>	<i>Market Capitalization (SR Billion)</i>	<i>Turnover Ratio (%)</i>	<i>Market Capitalization as % of GDP</i>
1998	51.5	159.6	32.2%	29.3%
1999	56.6	228.6	24.8%	37.9%
2000	65.3	255.0	25.6%	36.1%
2001	83.6	275.0	30.4%	39.4%
2002	133.8	280.7	47.6%	40.4%
2003	596.5	589.9	48.0%	48.9%
2004	1,773.9	1,148.0	154.3%	122%
2005	4,138.7	2,438.2	169.7%	206%
2006	5,261.9	1,225.9	429.19%	91.7%
2007	2,557.7	1,946.4	131.4%	135%
2008	1,962.9	924.0	212.4%	53%

Source: SAMA

**Table 6.8 Arab stock market volatility 2009**

<i>Country</i>	<i>Turnover ratio</i>	<i>Annual volatility (%)</i>	<i>Annual turnover/ volatility ratio (%)</i>
<b><u>GCC Countries</u></b>			
<i>Saudi Arabia</i>	<i>1.01</i>	<i>0.44</i>	<i>2.30</i>
Abu Dhabi	0.26	0.47	0.54
Dubai	0.79	0.50	1.58
Qatar	0.28	0.52	0.53
Kuwait	0.71	0.32	2.25
Oman	0.29	0.36	0.81
Bahrain	0.03	0.24	0.12
<b><u>Other Arab</u></b>			
Egypt	0.59	0.35	1.66
Morocco	0.14	0.25	0.56
Tunisia	0.13	0.17	0.75
Lebanon	0.05	0.36	0.14

Source: *Riyad Capital, 2010*



# Saudi “free float” shares is an issue

- The percentage of **free float shares** in the Saudi market has declined to around 38% in 2009, compared with around 54% in 2003, despite new company flotation, and an increase in total shares from 2.232 million to **41.2 million shares**.
- Significant **reductions** have occurred in the banking and financial sector, as well as in energy, utilities, and telecommunication over the two periods.

**Table 6.9 Saudi Arabia shares outstanding and those held by the public as free float (2003-2009)**

<i>Sector</i>	<i>2003<sup>(1)</sup></i>			<i>2009</i>		
	<i>Total outstanding shares (millions)</i>	<i>Shares held by public free float (millions)</i>	<i>Free float as % of total shares outstanding</i>	<i>Total outstanding shares (millions)</i>	<i>Shares held by public free float (Million)</i>	<i>Free float as % of total shares outstanding</i>
1. Banking & Financial Services	378.9	226.8	60%	8,903.9	4,711.5	52.9%
2. Petrochemical Industries Sector	455.7	186.8	41%	8,664.7	3,533.7	40.8%
3. Cement	118.9	80.8	68%	828.0	569.9	68.8%
4. Retail Services	177.5	127.8	72%	302.5	215.8	71.3%
5. Energy & Utilities	765.7	290.9	38%	4,241.6	766.9	18.0%
6. Agriculture and Food	36.0	30.6	85%	939.4	666.2	70.9%
7. Telecommunication	300.0	249.0	83%	4,200	1,400	33.3%
8. Insurance Sector	N/A	N/A	N/A	661.0	254.3	38.5%
9. Multi-investment Sector	N/A	N/A	N/A	6,616.6	552.4	8.27%
10. Building and Construction	N/A	N/A	N/A	666.2	447.6	67.2%
11. Real Estate Development	N/A	N/A	N/A	3,136.2	1,427.6	47.2%
12. Transport	N/A	N/A	N/A	476.3	339.5	71.3%
13. Media & Publishing	N/A	N/A	N/A	155.0	91.8	59.3%
14. Hotel and Tourism	N/A	N/A	N/A	79.3	46.5	58.8%
15. Industrial Investment Sector	N/A	N/A	N/A	1,352.4	586.5	43.4%
<b>TOTAL SECTORS</b>	<b>2,232.7</b>	<b>1,192.7</b>	<b>53.4%</b>	<b>41,223.1</b>	<b>15,660.2</b>	<b>37.9%</b>

Source: SAMA, CMA

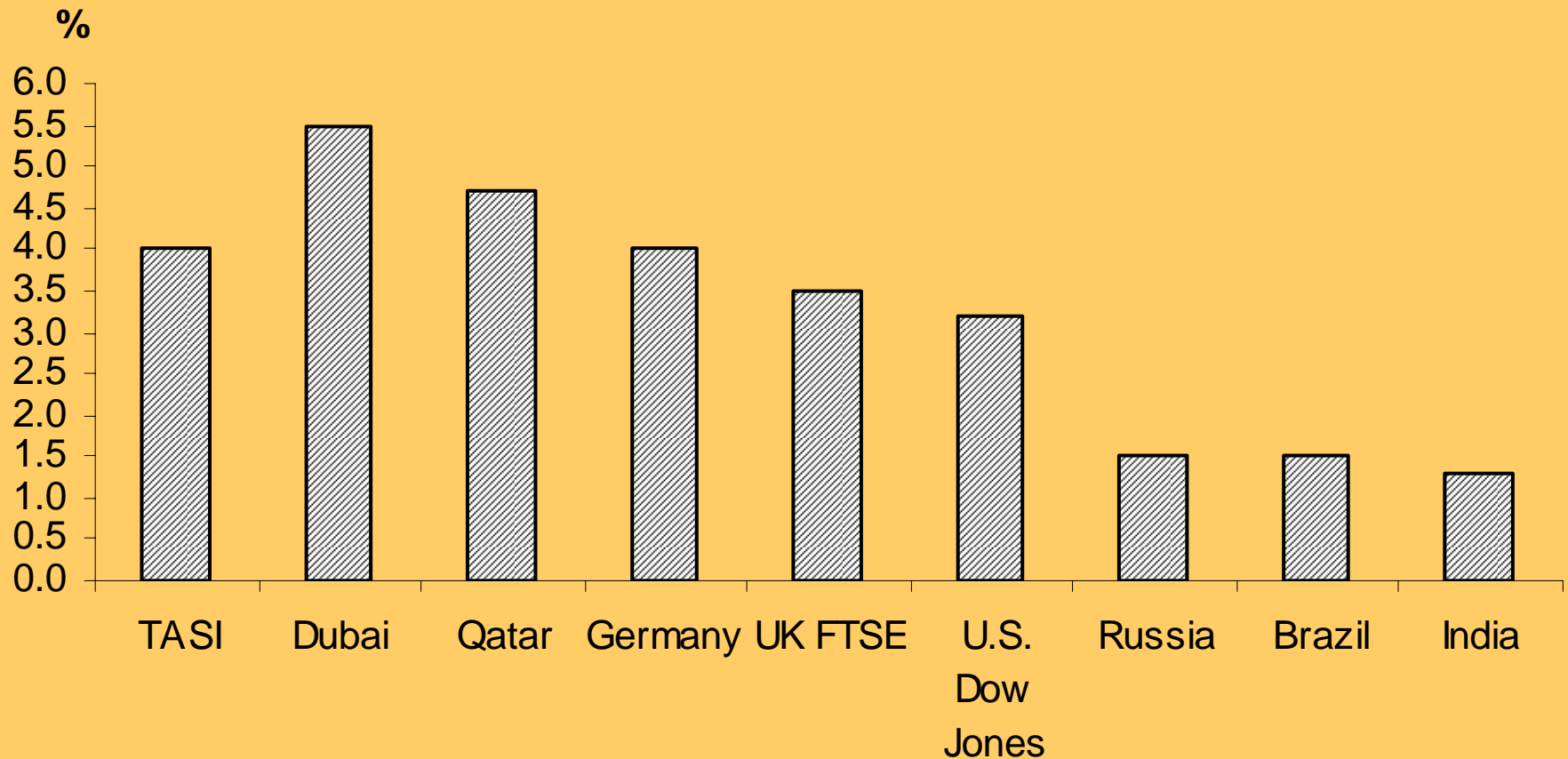
Note: <sup>(1)</sup> By 2007, the CMA had introduced 15 sub sectors compared with 7 .

N/A: Not available as not segregated.

# Saudi Capital Market performance

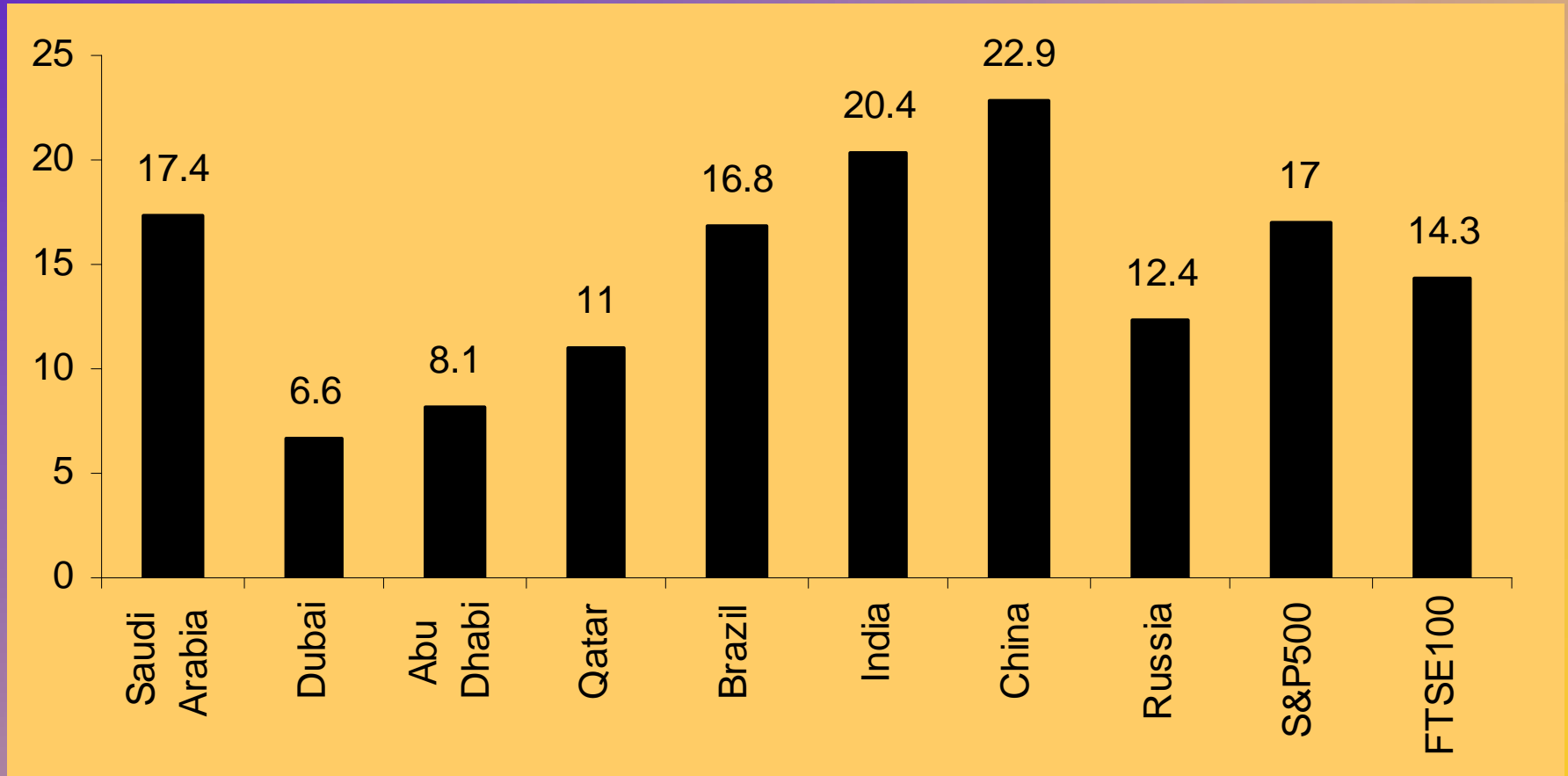
- Saudi Capital Market **(TASI)** dividend yield is slightly lower than some other Gulf markets such as Dubai and Qatar, but on par with other developed markets, and higher than emerging economies such as Russia, Brazil and India.
- The Saudi TASI **price-earnings ratio** however is less than emerging markets, but on par with developed markets and higher than Gulf markets.
- In line with other financial markets during the 2007-2008 global financial crisis, the Saudi TASI has also had a **volatile performance**.

**Figure 6.6 Dividend yield: Saudi TASI index and other selected markets (January 2010)**



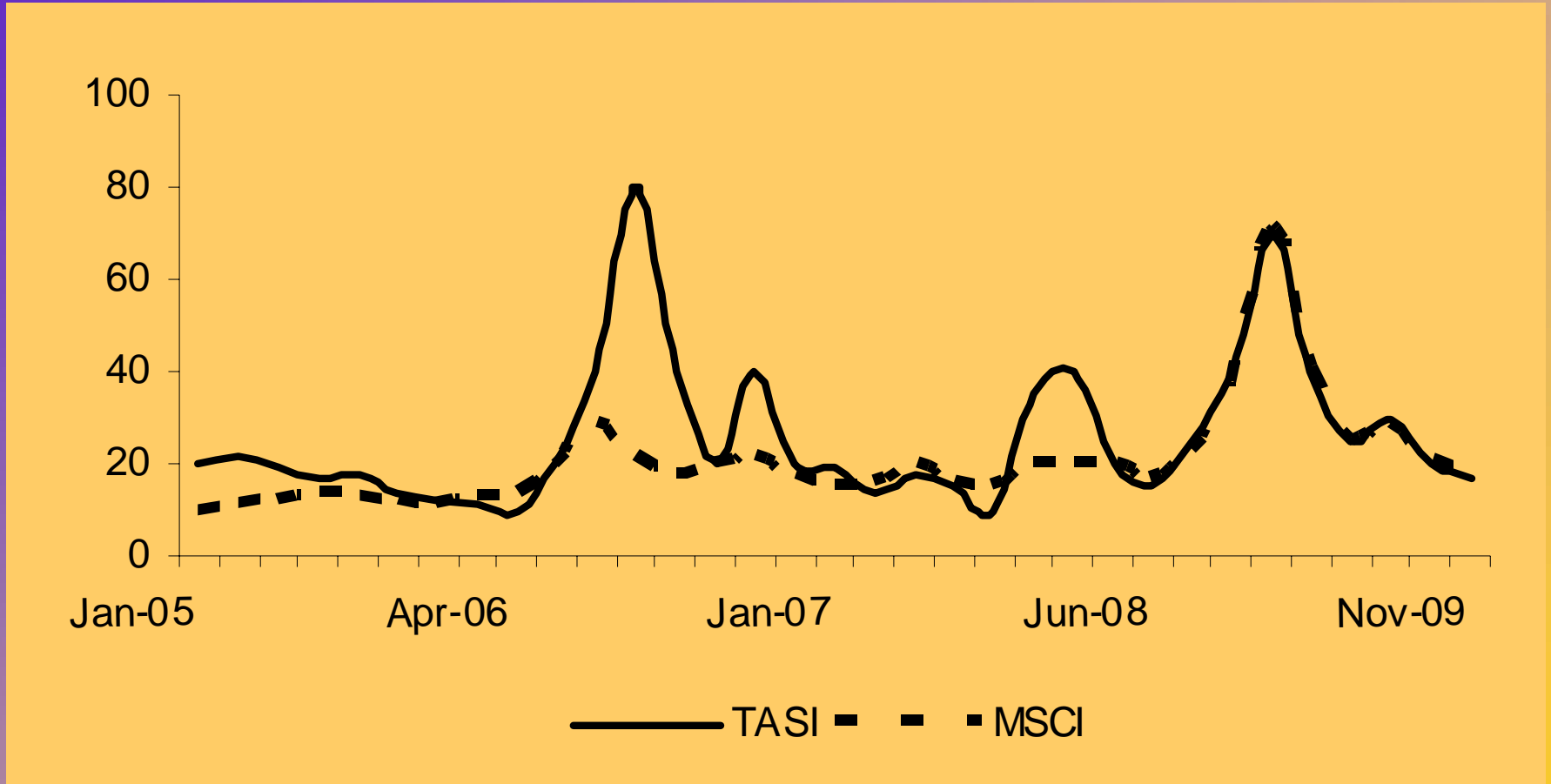
**Source: CMA, Bloomberg**

**Figure 6.7 Price earnings ratios: Saudi TASI and other selected markets (January, 2010)**



**Source: Bloomberg**

**Figure 6.8 Saudi TASI index and MSCI-EM Index:  
volatility comparison 2005-2009**

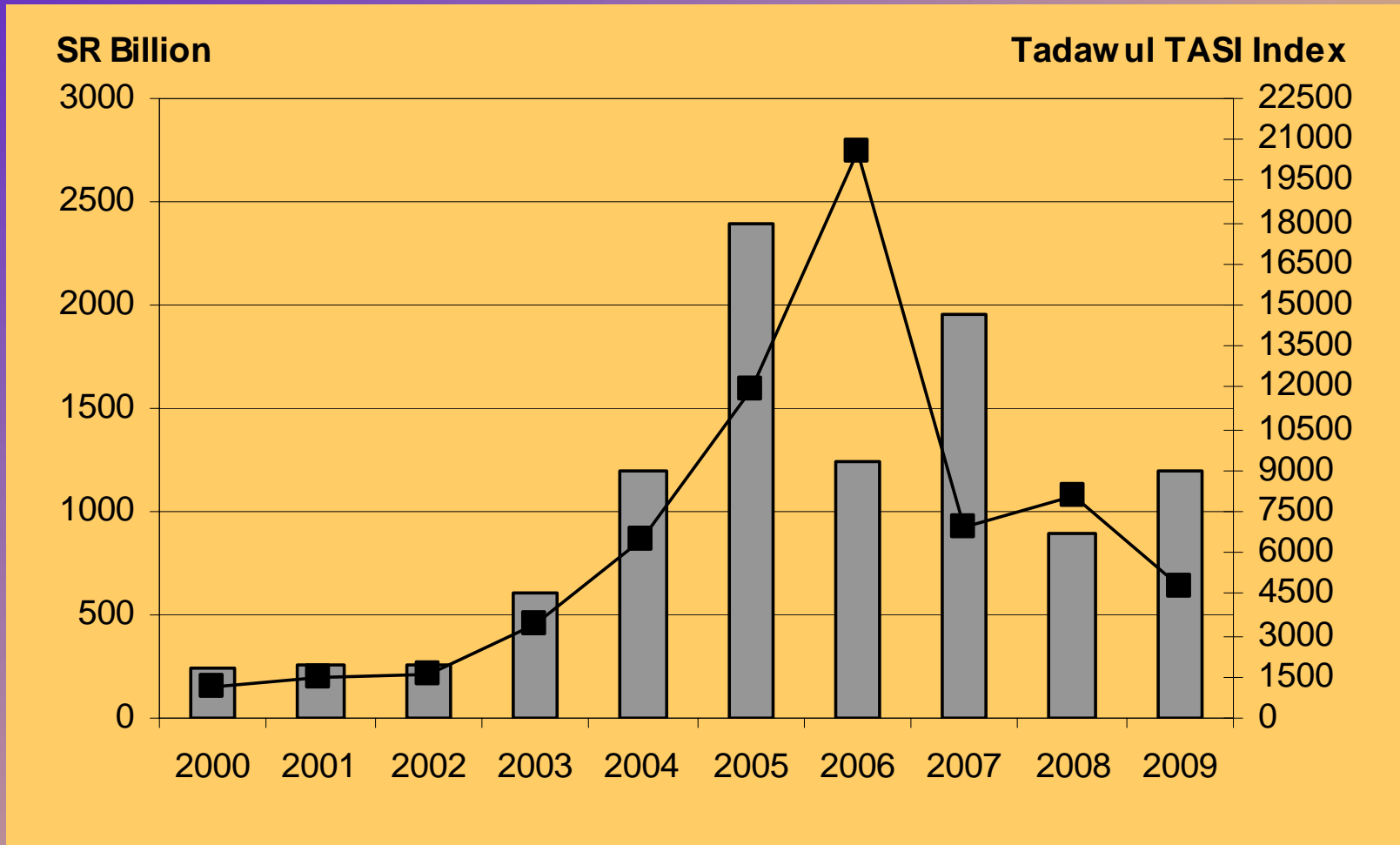


Source: Bloomberg

# Saudi TASI Index has not recovered from the crash of 2005/2006

- After reaching a peak of around 21,000 in February 2006, the Saudi TASI Index has languished at the **same levels of 2004**, at around 6,800 in April 2010.
- There are many reasons for the **bubble burst**:
  - Unsophisticated **individual** investors
  - **Uncorrelated** stock market sectoral base with the wide economic base, giving rise to an undue bias/trading effect of a few shares on the rest of the stock market.
  - Largest trading sector was in petrochemicals, followed by insurance and banking sector

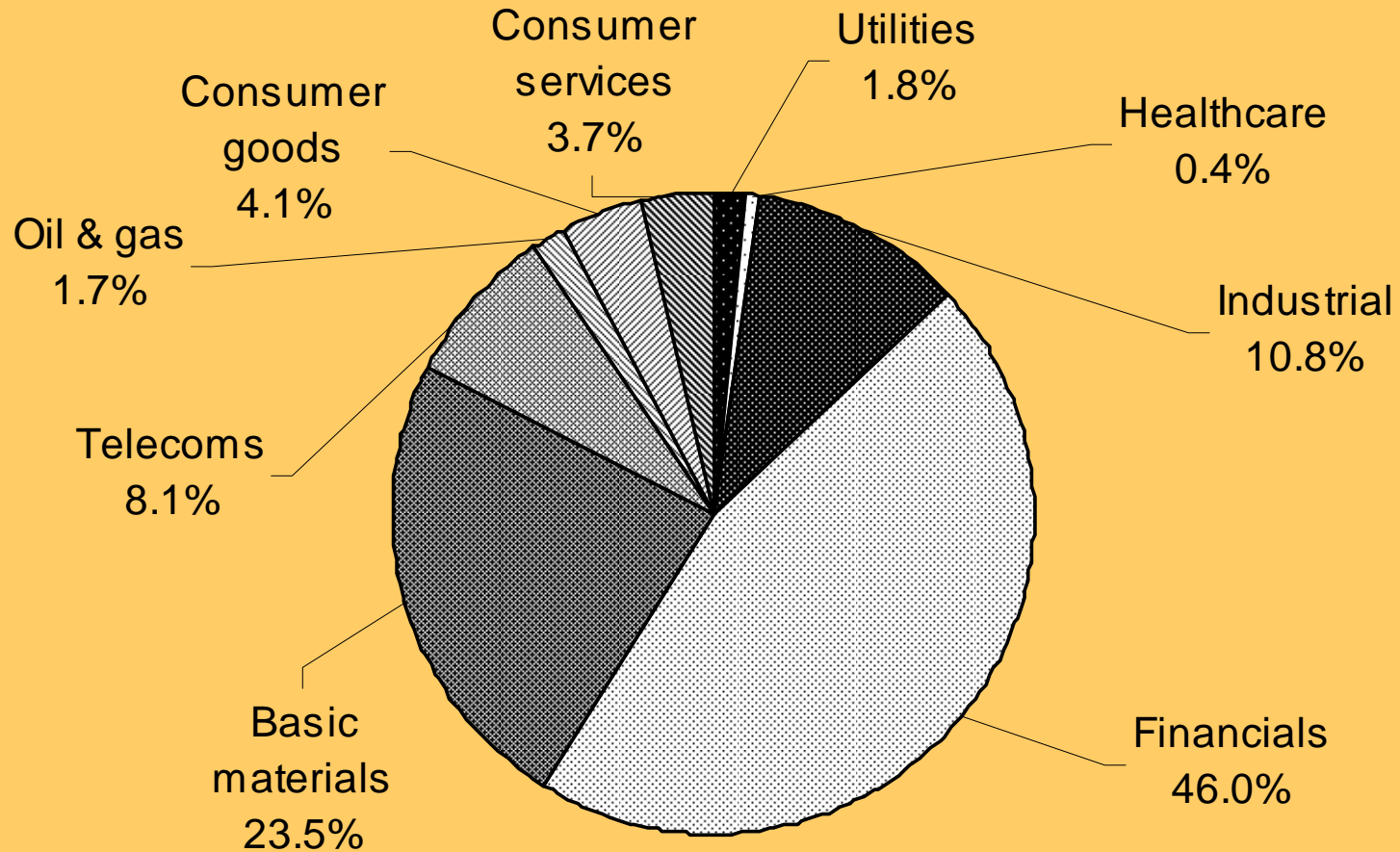
**Figure 6.9 Saudi market index year ends 2000-2009 and Tadawul TASI index highest levels reached 2000-2009.**



Source: SAMA, CMA, Tadawul

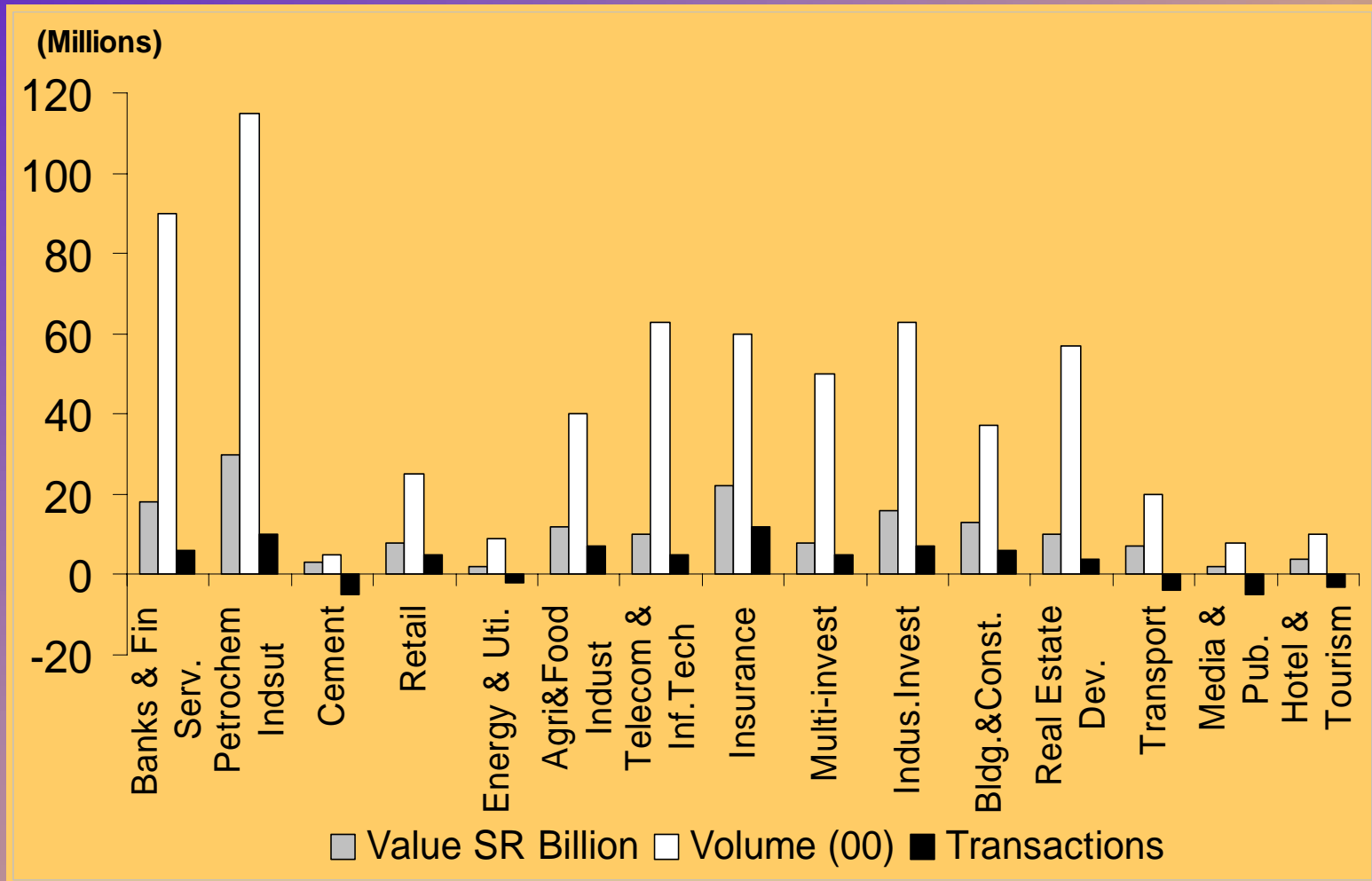


**Figure 6.10 Tadawul: Market share by sector  
(percent of market capitalization, December 2009)**



**Source: Tadawul**

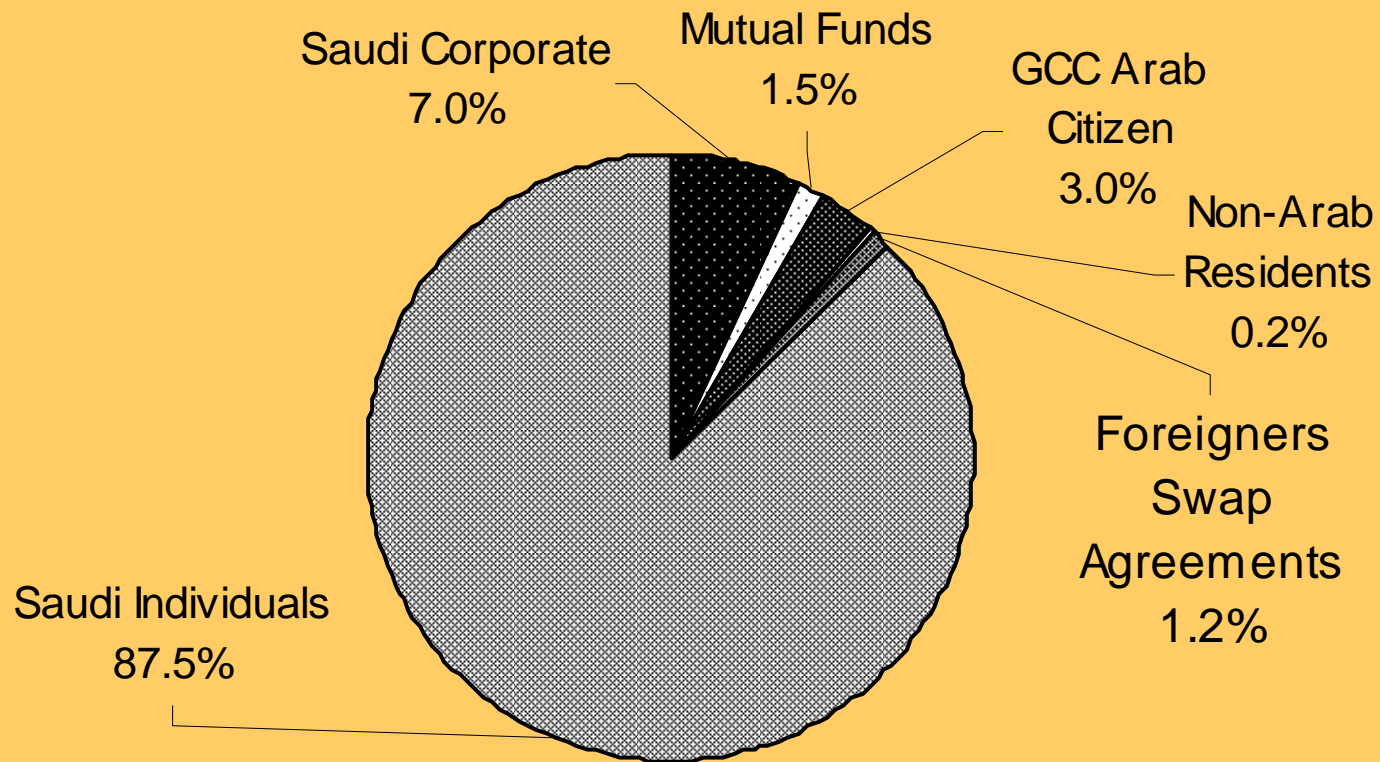
**Figure 6.11 Sectoral activities Saudi stock market 2009  
by value, volume and number of transaction**



# Saudi Capital Market investor behavior

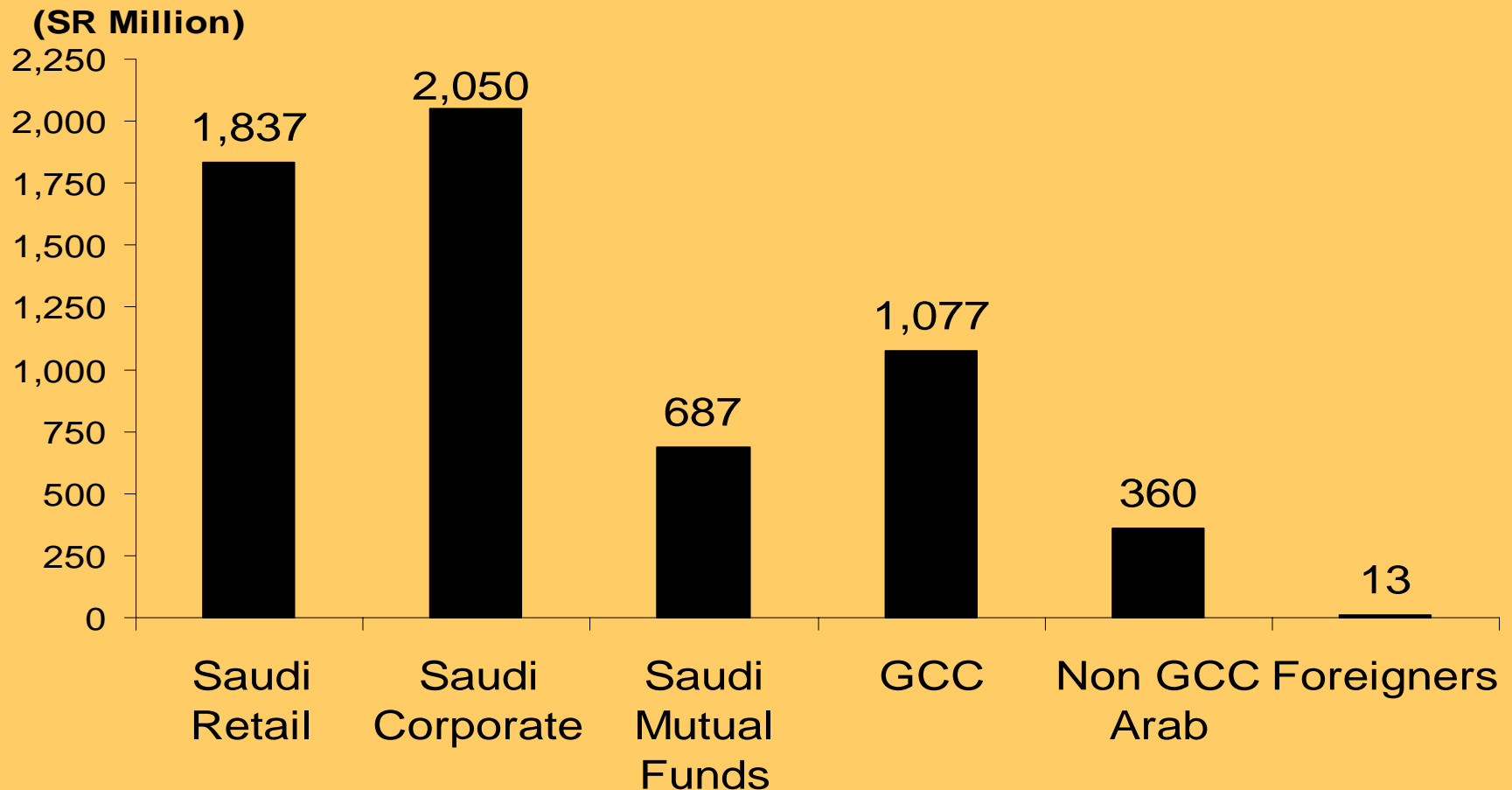
- **Individual investor driven** and seems to be guided by bouts of **irrational exuberance during market rises** and a **herd mentality during market downfalls**.
- The Individual investor represents around 88% of the market participants, while Saudi corporates are around 7%, and foreigners around 1.5%.
- Saudi market is open to GCC citizens who represent around 3% of participants.
- **“Efficient” market hypothesis** seems to suggest that a “strong firm” efficiency (where all information is fully reflected in securities pricing) is **not prevalent in Saudi Arabia**, and that rumors and panic selling and buying predominates.

**Figure 6.12 Average monthly contribution to Saudi stock market trades by category of investor and % of value traded. (2009)**



Source: *Tadawul*

**Figure 6.13 Average monthly net investment in absolute terms per category of Saudi investors (2009)**

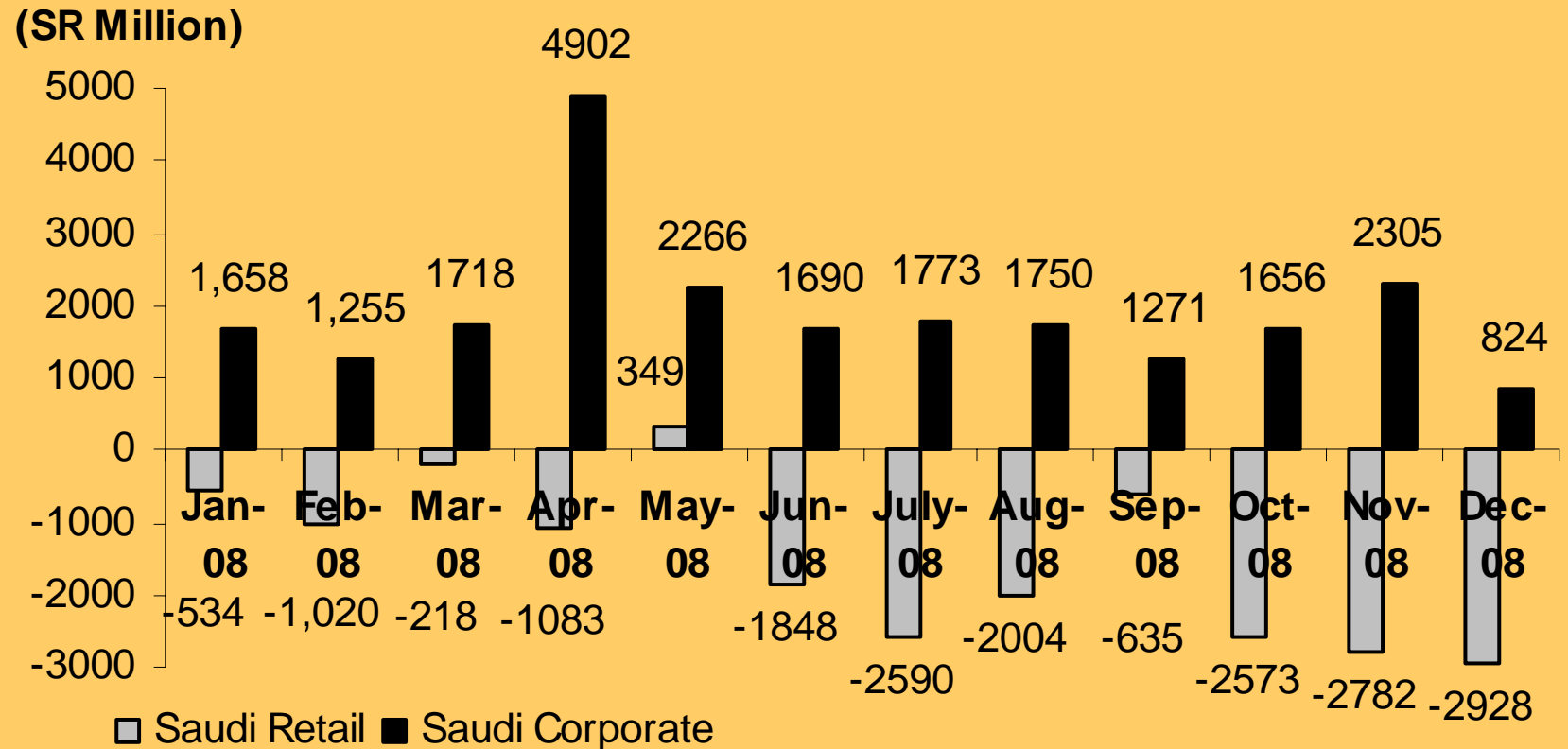


**Source: Tadawul.**

# Saudi retail/individual investors and corporate investor evidence counter trading and investment patterns

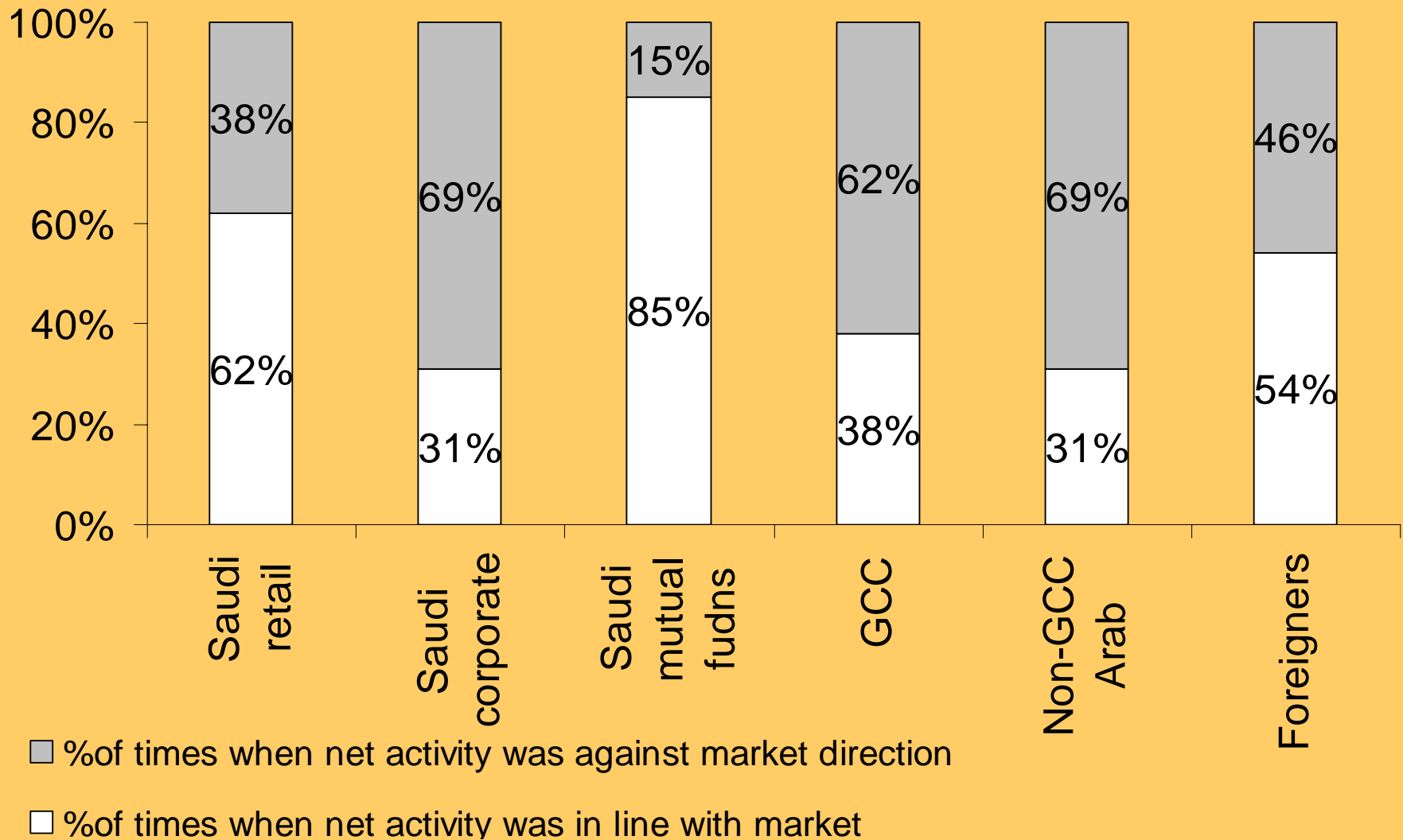
- Data-suggests that the **two groups seem to invest in opposite directions to each other**, as evidenced from monthly net investment patterns for the whole of 2008.
- When analyzing gains made, the Saudi retail/individual investors seem to **outperform** the Saudi corporate sector, as did Saudi mutual funds and foreigners.
- This could be explained by the fact that **individual decisions to sell/buy are made immediately, while corporate decisions are more lengthy**, and that mutual funds and foreigners' decisions seem to be based on professional stock analysis.

**Figure 6.14 Average monthly net investments (2008)**



Source: *Tadawul, SHUAA Capital, 2009*

**Figure 6.15 Saudi market trends and participants correlation % of times (2008)**



**Source: Tadawul, SHUAA Capital 2009**

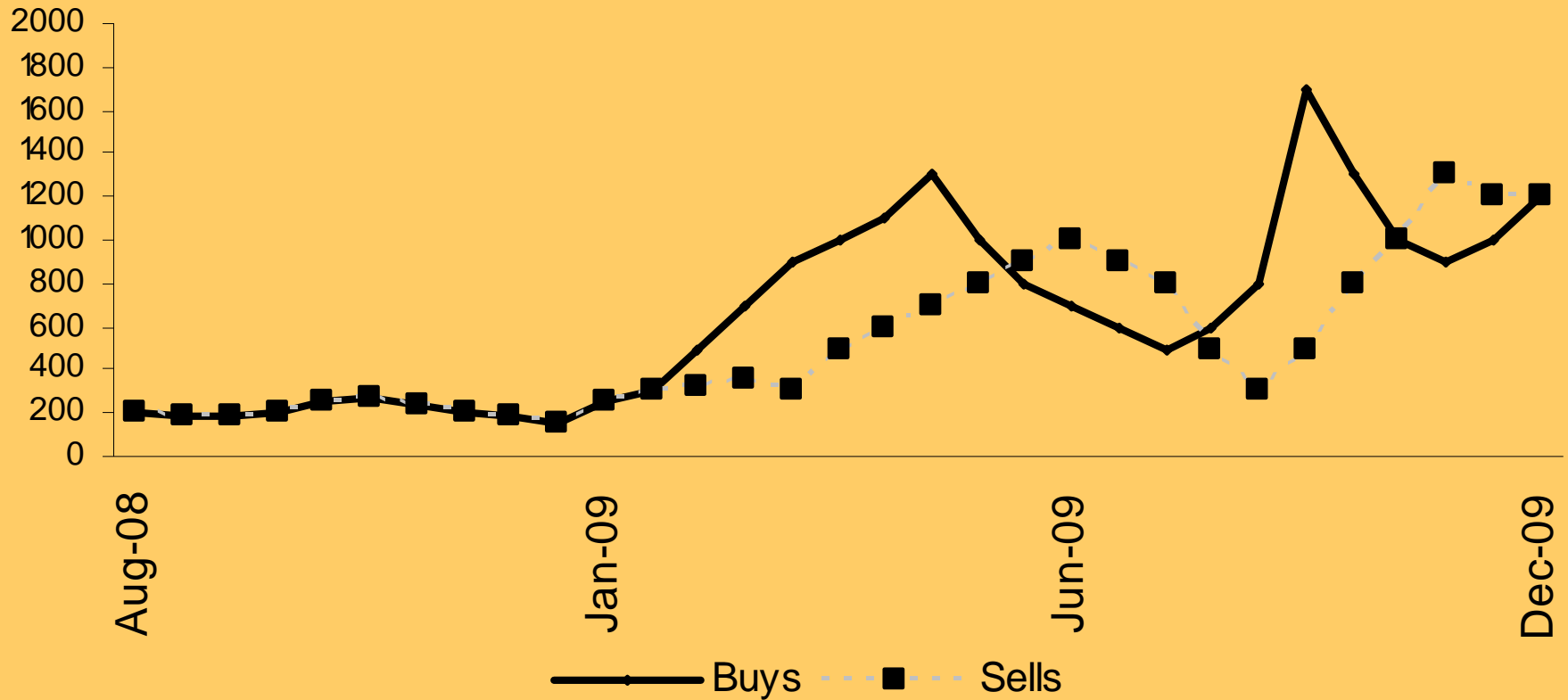


# Foreign participation becoming more important

- Since 2005 the CMA has awarded investment banking licenses to **foreign banks and investment houses** to provide **brokerage and advisory services**.
- This has encouraged the CMA to open up the local market to foreign investors.
- First step was in 2008 to allow foreigners to own Saudi shares through **Swap agreements** with Saudi banks (Total Return Swap or TRS), where the local Saudi intermediary retains the legal ownership of the stock. TRS volumes have risen.
- In 2010, the CMA allowed foreign participation through **ETF's (Exchange Traded Funds)** which can be bought and sold like normal shares and provides exposure to a wide range of stocks.

**Figure 6.16 Tadawul foreign swap volume August 2008-December 2009**

**(SR Million)**



**Source: Tadawul**

# The Saudi Mutual Fund sector

- The sector has **grown rapidly** from around 70 authorized funds with SR 13 billion in assets in 1995, to 250 funds and SR 77 billion assets by 2009.
- There has been a significant **shift towards domestic asset allocation over time**.
- The number of Saudi and resident foreign subscribers was around 370,000 in 2009, down from a peak of 569,000 in 2005, due to investors preferring to trade by themselves over time rather than through funds.
- **Islamic funds** are the most popular in terms of assets under management, followed by local equity investments.

**Table 6.10 Growth in Saudi managed mutual funds 1995-2009**

<i>Characteristics</i>	<i>1995</i>	<i>2005</i>	<i>2006</i>	<i>2007</i>	<i>2008</i>	<i>2009<sup>(1)</sup></i>
Number of funds	71	199	214	252	262	253
Number of subscribers	33,051	568,282	499,968	426,085	374,975	375,097
Assets under management (SR Billion)						
Domestic	5.5	115.6	61.3	79.8	61.3	64.5
Foreign	7.2	21.3	27.7	25.2	13.6	12.7
<b>TOTAL SR BILLION</b>	<b>13.0</b>	<b>136.9</b>	<b>84.0</b>	<b>105.0</b>	<b>74.9</b>	<b>77.2</b>

<sup>(1)</sup> First Quarter, 2009

Source: SAMA, CMA

**Table 6.11 Saudi mutual fund sector by assets under management and type of funds (2007-2008)**

<i>Type of fund</i>	<i>2007</i>		<i>2008</i>	
	<i>Number</i>	<i>Assets (SR Bn)</i>	<i>Number</i>	<i>Assets (SR Bn)</i>
Local equity	35	43.7	45	16.5
GCC equity	13	3.8	16	1.6
International equity	74	14.8	74	6.7
Debt instruments	11	0.8	7	0.1
Murabaha	49	33.9	57	43.0
Real estate	4	1.6	4	2.3
Fund of funds	33	2.3	34	1.8
Other	14	4.2	25	2.8
<b><i>TOTAL</i></b>	<b><i>233</i></b>	<b><i>105.1</i></b>	<b><i>262</i></b>	<b><i>74.8</i></b>

Source: CMA

# Future challenges

- The trend for the Saudi capital market is still **decentralized and private sector based economy**.
- A deeper and more dynamic Saudi capital market is essential for this to succeed.
- There is **room for further development** for new players to participate such as **pension funds, insurance companies and mutual funds** to add depth and long term liquidity flows to investors.
- A well regulated capital market will enhance risk management practices, and respond to infrastructure demand needs.

**Table 6.12 The changing face of the Saudi capital market**

<i>1970s</i>	<i>1980s</i>	<i>1990s</i>	<i>2010 onwards</i>
<ul style="list-style-type: none"> <li>• No disclosure</li> <li>• External funding on selective basis</li> <li>• Poor regulatory and legal structure</li> <li>• Commercial bank funding on secured basis</li> <li>• Dominance of family companies</li> </ul>	<ul style="list-style-type: none"> <li>• Regulatory regimes improving</li> <li>• External funding</li> <li>• Government soft loans</li> <li>• Syndicated loans</li> <li>• Some disclosure available</li> </ul>	<ul style="list-style-type: none"> <li>• Technology utilization</li> <li>• Specialized funds</li> <li>• Government debt increasing</li> <li>• Islamic financing</li> <li>• Foreign ownership on joint venture basis</li> <li>• Non-recourse finance</li> </ul>	<ul style="list-style-type: none"> <li>• Commercial paper and bonds</li> <li>• Family businesses going public</li> <li>• Mergers and acquisitions</li> <li>• More disclosure and transparency</li> <li>• Foreign Inward Investment</li> <li>• Privatization</li> <li>• Foreign participation</li> <li>• IPOs</li> <li>• Securitization</li> <li>• Islamic financing</li> </ul>