Chapter 6
The Saudi Capital Market

A fool and his money are soon parted.

George Buchanan

Learning Outcomes

By the end of this section, you would understand:

- *Role of capital markets in economic development*
- *The historical development of the Saudi capital market*
- *Functions of the Capital Market Authority*
- *Performance of the Saudi capital market, and its international comparisons*
- *Sectoral performance of the Saudi capital market and new listings*
- *Analysis of Saudi investor behaviour*
- *The Saudi mutual fund industry*
- *Deepening of the capital market*

Introduction

The role of capital markets in economic development has increasingly been emphasized as an important tool of financial intermediation. Saudi Arabia has been endowed with enormous wealth, gained in a short period of time. An efficient capital market structure could help in recycling capital surpluses, especially those held by the private sector. There is no doubt that Saudi Arabia possesses such capital surplus.

The development of a broader and deeper capital market will lead to other benefits, encouraging the creation of new risk management instruments (such as interest rate hedging, futures and options) while widening the scope of central banks to allow them to conduct monetary policy through open-market operations (Azzam, 2002). It is also recognized that a well-developed capital market, especially a stock market,

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performs at least three other functions. It is a signalling mechanism to managers regarding investment, a source of finance and a catalyst for corporate governance.

In principle, stock markets are a useful tool for economic development. Efficient stock markets pool private funds, and allocate them for corporate investment. This gives firms access to cheaper capital than traditional bank finance and also helps them to mitigate financial risk. Stock markets also encourage efficiency through the prospect of takeover: if management does not maximize shareholder value, then another economic agent could take control of the firm and introduce more efficient practices and personnel.

Academic research indicates that various measures of stock market activity are positively correlated with stronger economic growth and productivity improvement across countries and that the association is particularly strong in emerging markets.

Establishing a National Stock Market Carries with It Risks and Responsibilities

For example, very liquid stock markets might negatively influence corporate governance: with share prices rising, investors might be tempted to take a relaxed view of management practices, in the knowledge that they can sell their shares at any time and for a profit. This seemed to have occurred during the period 2005–2006 in Saudi Arabia when the stock market increased by virtually 100% a year or more before crashing in 2006. Markets also tend to favour big firms over smaller ones, often with little regard to efficiency. Thus, large inefficient firms are more likely to take over and/or absorb small efficient firms without any improvement in their own management practices. For a market to thrive, it also needs to have robust supporting architecture, such as good-quality institutions and a well-functioning supervisory structure.

A key question is whether stock market prices affect investment, independent of fundamentals of the economy and the financial health of companies, causing a misallocation of capital, which can lead to considerable damage at the sectoral level (Bolbol and Omran, 2004). As will be discussed later in this chapter, the Saudi capital market has seen sharp volatility due to several factors, necessitating the need for an efficient regulator.

Saudi Capital Market Developments: A Historical Perspective

Plans for establishing a formal Saudi stock market have been in the making since the early 1980s (Abdeen and Shook, 1984). It is interesting to note some of the major concerns raised then regarding elements that might be a hindrance to the smooth functioning of a Saudi stock market, and to assess whether the same "problems" continue to exist in the new millennium. According to earlier observers (Dukheil, 1995, Abdeen and Shook, 1984), the first problem related to the lack of an “organized legal framework for a stock exchange,” with three sources of official directives controlling the stock market. A second problem concerned the “non-specialist” offices that emerged to deal with shares. A third difficulty was the “ownership of a large percentage of shares by board members and founders.” A fourth challenge was that “most Saudi citizens have little understanding of stock market operations and transactions.” Such transactions were based on rumours, because of a lack of analysis of companies’ financial positions, profitability or other financial considerations. Another problem, according to the early market observers, was that citizens from “other Gulf countries invested in Saudi stocks via Saudi agents.”

Even in those early days, there were recommendations for overcoming such problems. These included the “assigning of one government body responsible for share companies; establishment of an effective set of regulations for the organization of stock operations and transactions”; and the imposing of limits on individual stock ownership. A final plea was made for increasing the number of publicly held companies in the Kingdom in order to “increase the potential number of issues and shares.” In 1983, Saudi Arabia could only boast 38 publicly listed companies, while Kuwait had 48 (Abdeen and Shook, 1984, Nashashibi, 1983).

Until the Saudi Capital Market Law (CML) was passed in 2003, the Kingdom was slow to restructure its stock market to encourage private domestic investment. The Saudi stock market remained more a “government-controlled banking consortium” than a real stock market (Cordesman, 2003).

From 2003 to date a determined effort has been made to structure the operational and regulatory capability of the Saudi Capital Market Authority (CMA), as the benefit from such a determined reform can contribute to the economic development of the Kingdom, fuelled by the provision of risk capital. Transparent, efficient and well-regulated markets can add to the general level of investor confidence, and can reverse capital flight as happened during the periods 2002–2004 and 2008–2009 owing to fear of investing in falling Western assets and global financial instability.

A new capital market law, although essential to market reform, dragged on for many years. The Capital Market Law, which was approved by the cabinet and passed into law in November 2003, was only implemented in July 2004. The pace of change had more to do with the conservative regulatory approach adopted by the Saudi Arabian Monetary Agency (SAMA), the financial market supervising authority. However, the intention for reform seems to address most of the issues and problems highlighted by observers of the early stock market.

Saudi Capital Market Operation

Before analysing the new Capital Market Law and the Capital Market Authority (CMA), it would be useful to examine the stock market structure that this new law replaced. By examining the deficiencies in the previous system, we can assess

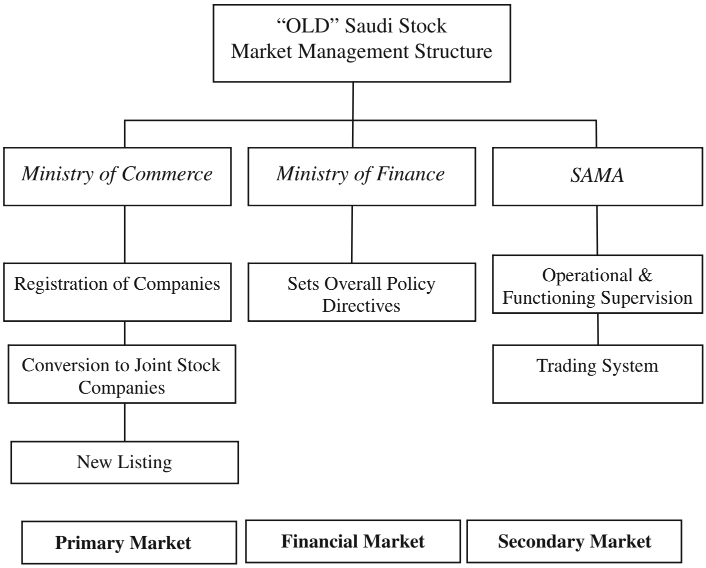

Fig. 6.1 "Old" Saudi stock market

whether the new law has rectified outstanding operating concerns. Figure 6.1 illustrates the workings of the "old" stock market structure.

As noted from Fig. 6.1, the "old" Saudi stock market structure operated under three masters. The Ministry of Commerce was directly responsible for the formation of new companies, the conversion of firms to joint stock companies and IPOs. In essence, it was the primary market function. The second regulator was the Ministry of Finance, which set the overall policy directives and objectives of the stock market. Finally, SAMA controlled the operational and functional management of the Saudi stock market. This was the secondary market function. Share trading activity was executed through Saudi commercial banks that were responsible for the settlement of transactions between buyers and sellers against a maximum 1% commission. Figure 6.1 highlights the absence of an exchange bourse and of independent market makers. Under the old regulations, forward trading of shares and acceptance of post-dated checks to settle transactions were prohibited, no doubt influenced by what happened during the Kuwaiti *Souk Al-Manakh* 1982 stock market crash.

In 1985, SAMA introduced certain operational improvements in the share-dealing process. First, it established the Saudi Shares Registration Company (SSRC) and limited its shareholding to banks. However, share ownership was based on a physical documentation exchange. In 1990, SAMA introduced an electronic trading system called Electronics Securities Information System (ESIS), through which all the buy and sell orders placed at individual banks are transferred from bank computers to a central system at SAMA for matching. This fostered market liquidity and increased trading volume. The overall price movement in the Saudi stock market was tracked by the *Bakheet* and CCFI stock market indexes, which were the most widely quoted Saudi indexes, similar to the Dow Jones index for the USA.

In 2001, an automated trading system called *TADAWUL* was launched which enabled trading to be carried out through the Internet. By virtue of its ease, transparency and speed in processing, *TADAWUL* gave yet another boost in trading volumes for the Saudi stock market. It is no exaggeration to state that as of 2004, the Saudi stock market trading system became one of the most technologically advanced system in the world, with *T + Zero* delivery – transaction plus zero days. The establishment of *TADAWUL* enabled a new stock market index to emerge called *TASI* or *TADAWUL All Share Index* and it is currently quoted as the official Saudi stock market index.

Participation in the Saudi stock market was initially restricted to Saudi citizens, Saudi corporations and Gulf Cooperation Council (GCC) citizens. Foreign participation was initially allowed in the banks' mutual funds, with the first closed Saudi mutual fund (SAIF) introduced by the Saudi American Bank in 1997. In 1999, the stock market was opened for foreign investment through a wider range of Saudi bank mutual funds. In 2006, there were further significant developments, as the Kingdom announced that it would also allow foreigners resident in Saudi Arabia to invest directly in the stock market in order to strengthen the bourse, a move welcomed by many as it provided more investment choice rather than through mutual funds. In August 2008, the CMA approved new rules that allowed non-Arab foreigners to participate in share trading through "swap" arrangements with local CMA approved and licensed intermediaries in the hope of adding depth to market participants, especially foreign institutional investors. In March 2010, the CMA advised that it planned to start its first exchange-traded fund (ETF) and will allow non-resident foreign investors to trade in it.

The New Capital Market Law

After deliberation by the *Majlis Al-Shoura* or Consultative Council of Saudi Arabia in December 2002, a new Capital Market Law composed of 67 Articles was passed by the Council of Ministers in June 2003, with the law taking effect from November 2003 after publication in the Official Gazette.

At first glance, the new law seems to address some of the more glaring shortfalls of the "old" stock market structure, which had no independent brokerage firms, no investment advisory and custodial services and little or no market-making capabilities. Above all, the "old" law lacked an independent financial market regulator. The "new" law establishes an independent Saudi Arabian Securities and Exchange Commission (SEC), which later became the Capital Market Authority (CMA), the sole regulator of the stock market, with the objective of protecting investor interests, ensuring orderly and equitable dealing in securities and promoting and developing the capital markets. The CMA had the power to license non-bank financial intermediaries and to authorize the offering of securities to the public.

It also established the first ever national securities depository centre. In terms of management, the CMA was to be governed by five commissioners appointed by Royal Decree, one of whom will be nominated as Chairman and another as Vice Chairman. As Fig. 6.2 illustrates, the head of the CMA reports directly to the Prime Minister – the King of Saudi Arabia – to ensure that maximum freedom of power is given to the sensitive position of head of CMA.

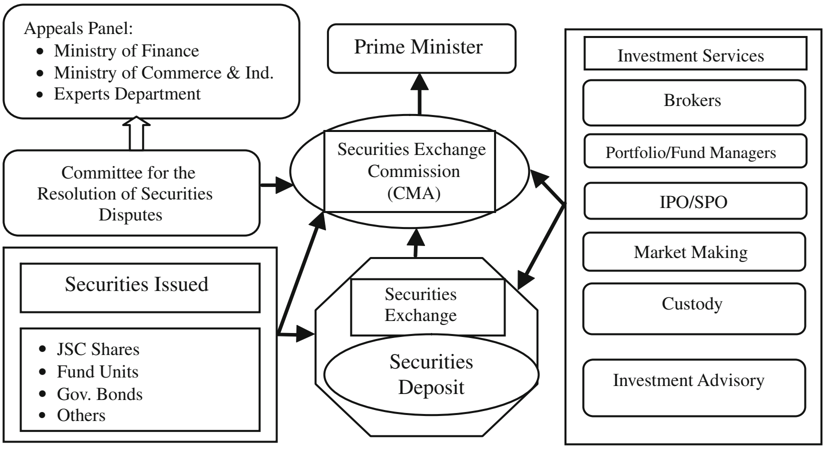

Fig. 6.2 The new Saudi capital market regulatory structure

In July 2004, a Royal Decree was issued naming Jammaz Al Suhaimi as Chairman with ministerial rank, Mohammed Al Rumaih as Vice Chairman as well as the other three members of the commission. The appointment of the Chairman was widely welcomed because of the continuity it brought. Mr. Suhaimi was the Deputy Governor of the Banking Control Department at SAMA and had been closely involved in the "old" Saudi stock market operations. In May 2006, Dr. Abdulrahman Al Tuwaijri was appointed as acting Chairman of the Capital Market Authority and was later confirmed as Chairman by Royal Decree in May 2009 along with a new Vice Chairman Abdulrahman Al Rashid, with Mazen Al Romaih and Abdulrahman Al Barrak as new commissioners. Mr. Mohamed Al Shumrani retained his position as Commissioner in the CMA reshuffle. Before that, in 2007, the Saudi government approved the establishment of the Saudi Capital Market Company with a capital of SR 1.2 billion, converting *TADAWUL* into a joint stock company fully owned by the Public Investment Fund, a decision that seemed to go in line with international stock market operations. Future plans call for part of the new company's share to be floated for public subscription.

While there is a large degree of autonomy for the CMA, there is also some measure of close cooperation with other government bodies.

Figure 6.2 highlighted the "Committee for the Resolution of Securities Disputes," which can use the services of an appeal panel composed of members from the Ministry of Finance, Ministry of Commerce and the Experts Department.

A novel feature of the Capital Market Law was the establishment of a Securities Exchange or "bourse" which incorporated the National Securities Depository. The exchange will be a private sector company, with a board of nine members, three from the government (Ministries of Finance and Commerce, as well as SAMA) and six from shareholders of the exchange. It will be the only stock exchange operating in the Kingdom, and its wide powers include the following:

- Ensuring fairness and transparency of the market
- Admitting members (brokering and clearing)
- Listing new companies
- Promoting high ethical standards amongst members, employees and market participants
- Promoting high standards of corporate governance
- Ensuring timely and accurate dissemination of market information
- Establishing and operating a nationwide system for securities trading, settlement clearing and depository service

The above seems laudable and could reduce deficiencies in corporate disclosure under the old law. The new Capital Market Law also sets out in some detail (Articles 35–64) the type of penalties and punishment for wrongdoing, which could be an important deterrent.

However, some could argue that the imposition of a maximum fine of SR 100,000 for each violation committed (Article 59(b)) was too lenient, given that no jail sentences are specified in the new law, especially for "insider information" trading, which has been a flaw in even developed and regulated capital markets.

The CMA has been aware of this, and over the past few years the level of fines and public disclosure of those committing them have been increasing, especially the latter, in a society which is sensitive to name disclosure of wrongdoers. The recent publicly reported actions taken by the CMA include the following decisions:

- *October 2005* – Suspension of an investor who sold large quantities of shares in two companies after publicly praising their prospects but quietly selling them after price manipulation.
- *October 2005* – Investigation and suspension of a trader for not declaring a stake of more than 5% built up in *Mubarrad Services Company.*
- *June 2009* – Imposing a fine of SR 100,000 on one of the Saudi market's top five retail investors after an appellate body affirmed that he had conducted insider trading in shares of Saudi Hotels Company based on his membership of the company's board, and was ordered to pay $3.37 million profit that the CMA said he had made in trading the shares.
- *October 2009* – Fining board members of the Saudi Chemical Company SR 50,000 each for allegedly approving an acquisition in which the Chairman had a vested interest, but failed to consult shareholders.

- *December 2009* – Imposing sanctions and fines on five people for insider trading and stock market manipulation, ranging from SR 450,000 to SR 250,000, and ordered to reimburse back around SR 3 million between them.
- *December 2009* – Fining the listed company National Industrialization Company (Tasnee) SR 50,000 for not disclosing the resignation of a senior finance and investment executive.

Over the period 2008–2009, according to the CMA, the supervisory body had revoked the licences of a dozen brokerage firms for violating market laws and regulations. Commendable in terms of boosting investor confidence and improving market transparency was that the above CMA actions were imposed on a wide range of individuals and corporations without fear or favour, to send out a strong signal about the CMA's vigilance and deterrence intentions.

Organization Structure and Operations of the CMA

According to the CMA, its vision is to raise the efficiency of the Saudi capital market and to enhance its competitive strengths by building on the best international standards and practices (CMA, 2009). Figure 6.3 sets out the CMA organizational chart which illustrates the depth of specialization that the CMA has at its disposal today compared to the pre-2004 Saudi stock market organization structure.

Over the past few years, the CMA's enforcement and market supervision functions have become more prominent, as incumbents in these positions gained experience and confidence in pursuing cases brought to their attention or through

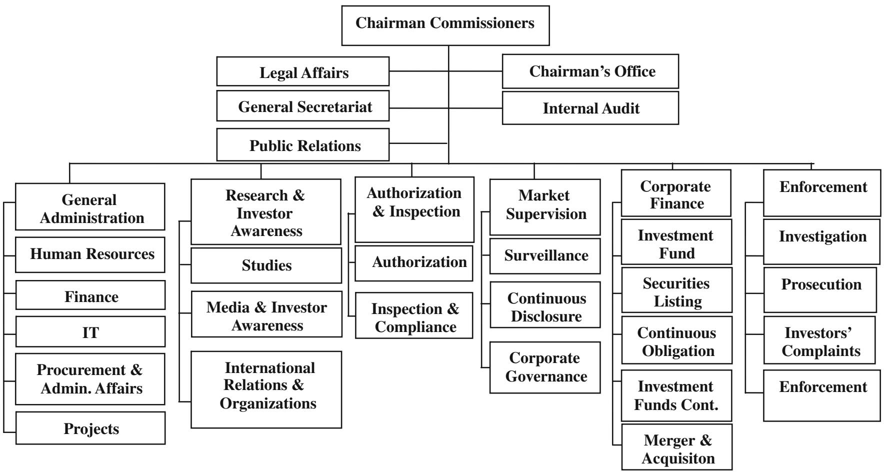

Fig. 6.3 Saudi CMA organizational structure (Source: CMA)

Table 6.1 Parties subject to CMA control and supervision

Party	Definition
1. *TADAWUL* Saudi stock exchange	• *TADAWUL* is the sole entity authorized to carry out trading in Saudi Arabia in securities trading and responsible for all operations of the exchange
2. Authorized persons	• Legal entities authorized to carry on securities business and only persons holding a valid licence issued by CMA are allowed to perform this function
3. Listed companies	• Companies whose securities are traded in the Saudi capital market *TADAWUL*
4. Traders	• Entities representing the public who trade in securities in the Saudi capital market

Source: CMA, 2009

inspection. At the same time, investor awareness programmes have become an important CMA tool to try and stabilize market speculation, as we will note later on in the chapter when analysing Saudi stock market behaviour.

The key players that are subject to CMA supervision and control are set out in Table 6.1.

Since its formation, the CMA has issued the basic guiding regulatory frameworks for those operating in the Saudi capital market, and an array of "implementation regulations" and regulatory decisions are available for authorized persons and others to refer to as guidance. Table 6.2 summarizes the main implementation regulations issued by the CMA since 2004.

The CMA regulations also comply to international best standards, as the CMA has established close cooperation with Western regulators such as the UK's Financial Services Authority (FSA) and the USA's Security and Exchange Commission (SEC).

On the operations side, the CMA has sought to enhance its capability, especially in systems that could detect stock trading manipulation. In 2006, the *TADAWUL* signed a contract with OMX, a leading supplier and operator for stock exchange trading that originated in Sweden which soon became the largest in the Nordic countries before being taken over by NASDAQ in the USA in 2007. The implementation of new systems now allows the CMA to obtain real-time reports and analyses of unusual trading activities and pinpoint violations, hence the pick-up in trading violations detection since 2008, illustrated in Fig. 6.4 by category of violations.

The CMA has also been active in issuing new directives at market participants and some of the key directives are summarized as follows:

- *2006* – prohibiting listed Saudi joint stock companies to buy and sell securities for themselves unless these financial activities are explicitly stated in the participating companies' codes and regulations.
- *2006* – drafting of regulations for the issuance of *sukuks* or Islamic bonds.
- *2007* – the introduction of "book-building" for new initial public offerings (IPOs) in Saudi Arabia to determine the price of shares for new listings. As such, market

demand and supply forces would determine the price of new IPOs and not financial advisors or the company. The change to book-building came on the heels of the spectacular crash of the Saudi stock market in 2006 which had left individual investors losing out after purchasing new share offerings during an equity boom in the previous 2 years, and paying prices set by the companies on flotation and not through market demand and supply forces.
- *2009* – establishing a market for debt securities including *sukuk* bonds helping to add depth to the Saudi capital market.

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

Year	Regulation type	Key aspects covered
2004	• Market conduct regulation	• Sets out key guiding principles in terms of prohibition of market manipulation, insider trading, untrue statements and authorized persons' conduct
2005	• Securities business regulation	• Defines the securities business scope and carrying out security business, exclusions from authorizations and established procedures for securities advertisements
2006	• Real estate investment funds regulations	• Establish 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
	• Investment funds regulations	• Establish 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
	• Listing rules	• Set 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	• Merger and acquisition regulations	• Set out the steps for announcements and takeover timetable for M&As, 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 precast
2008	• Anti-money laundering and counter-terrorist financing rules	• Establish 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
	• Offers of securities regulations	• Set out the general provisions on offers of securities in Saudi Arabia, public offers and private placements, as well as the liability for incorrect documents
2009	• Corporate governance regulations	• Establish the rights of shareholders and the role of the general assembly, the level of disclosure and transparency and the role and responsibilities of the board of directors

Source: CMA

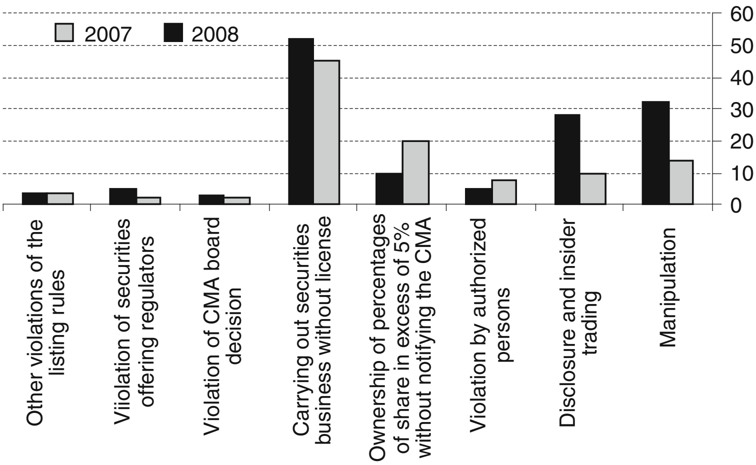

Fig. 6.4 CMA – Total number of investigations into suspected violations by type (2007 and 2008) (Source: CMA, 2009)

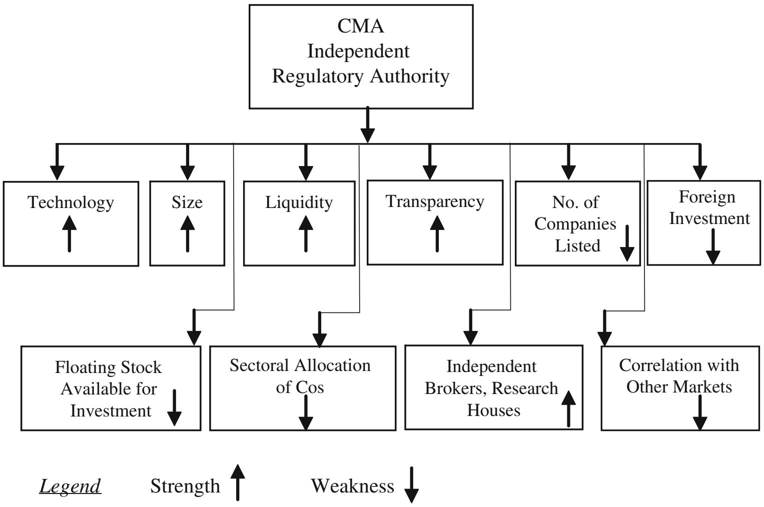

Fig. 6.5 Assessment of current strengths and weaknesses of the Capital Market Law

Given all the above developments in the "new" Saudi capital market structure, what are the remaining areas of weaknesses of the CMA going forward? Figure 6.5 identifies the perceived areas of current strengths and weaknesses of the CMA and the Capital Market Law.

Figure 6.5 points to strengths in independence, technology, transparency, size, independent brokers and researchers and liquidity. Weaknesses, however, remain in the areas of the number of companies currently listed, the limited participation of foreign investment despite some progress on this and the low level of floating stock available for investment due to the high level of shareholder concentration.

One of the major drawbacks of the Saudi stock market had been the small number of listed companies in relation to the size of the Saudi economy. In 2002, there were 68 listed companies with share capital of SR 38 billion compared to 121 registered joint stock companies, with SR 81.3 billion share capital (SAMA, 2003). There were another 6,000 limited-liability Saudi companies operating in the Kingdom and 1,400 joint venture companies (Saudi and non-Saudi), with a combined SR 85.5 billion of share capital.

By December 2009 the number of listed companies had risen to 134 with a share capital of SR 596 billion. At the same time, the number of registered joint stock companies were 400 with SR 470.2 billion share capital, with another 16,908 limited-liability and joint venture companies with a combined SR 155.6 billion in share capital (SAMA, 2009). The increase in listed companies on the Saudi capital market is illustrated in Table 6.3 for the period 1990–2009.

Table 6.3 Saudi listed companies and number of shares issued (1990–2009)

Year	Companies listed	Total shares issued (Million)
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

Despite the increase in the number of listed Saudi companies over the 7-year period, there was still a large potential for more IPOs and expansion of the stock market. According to some analysts, current Saudi listing requirements have been onerous and could explain the slow pace of new IPOs and listing (Najjar, 1998, Dukhayil, 2002, Azzam, 2002, Cordesman, 2003).

According to the Saudi Ministry of Commerce regulations, the procedure to convert into a joint stock company involves several necessary conditions. The major requirements are listed in Table 6.4, which sets out both the old listing requirements and those that were introduced in 1999 by the ministry.

Besides the requirements listed in Table 6.4, there was another, rather unspecified condition relating to the management of a joint stock company. That provision set that the company was to have "able administrative and efficient internal controls." Until the level of corporate transparency rises and the quality of regular reports is raised to higher standards, in the immediate term, the Kingdom's regulators well err on the side of caution to protect investors from "rushed" IPOs and public listing, as it is felt that the threshold levels for company conversions to a Saudi joint stock company had already been significantly reduced in the 1999 Ministry of Commerce requirements.

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

Parameters	Pre-1999	Post-1999
• Net assets	• SR 75 million	• SR 50 million
• Return on shareholders' equity	• 10% for the last 5 years to be maintained for next 5 years	• 7% for the last 3 years to be maintained for next 3 years
• Public subscription	• 51%	• 40%
• Company age	• 10 years	• 5 years

Source: Ministry of Commerce, Riyadh, 2002

Regulatory Supervision and Inherent Biases

However well-intentioned a regulator, sometimes there are flaws arising due to ingrained systematic biases that can lead to systematic errors as opposed to random errors which tend to cancel each other out. Such potential CMA biases can be summarized as falling under the categories shown in Table 6.5.

Table 6.5 Potential CMA regulatory biases

Regulatory bias	Cause and effect
A. Supervision bias	
1. Focusing observation and trustworthy biases	*Cause*: CMA could suffer from focusing too much on recent and immediately available information. As such, the CMA is 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 (e.g. fraud) in explaining behaviour while overlooking the influence of the person's particular circumstances in any given situation
2. Seeding effect	• *Cause*: This may lead the CMA to act vigorously in cases to avoid possible investor losses or erosion in CMA's own authority. Many of the CMA's regulatory initiatives were launched shortly after either large investor losses or threat of diminished CMA authority
B. Operational bias	
1. Overconfidence bias	• *Cause*: 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 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 (continued)

Regulatory bias	Cause and effect
2. Confirmation bias	• *Cause*: 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
3. Group think bias	• *Cause*: Cognitive biases within the CMA could be magnified by organizational "group think," which occurs when individuals come to identify with the organization in an 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
C. Regulation bias	
1. Bounded rationality bias	• *Cause*: The CMA receives vast amounts of information ranging from registration statements for IPOs, 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

To its credit the CMA has become aware of many of the possible regulatory biases that can affect its operations and CMA staff are provided with extensive refresher on- and off-site training courses to ensure that they recognize and deal with emerging complex financial oversight and control. This will become even more important as the Saudi capital market deepens in terms of the range of securities offerings and the number and type of market players expand internationally, and when one day Saudi companies will be able to have dual listing of their shares in other major international bourses, thus adding to the complexity of CMA supervision.

The Saudi Capital Market: Arab World's Largest

Over the past decade, the Saudi capital market has overtaken all the other Arab capital markets to becoming the largest as illustrated in Table 6.6.

From the table, Saudi Arabia not only dominates the rest of the Arab world's bourses in terms of market capitalization and the value of shares traded, but also in

Table 6.6 Arab capital market indicators (2008)

Country	Market capitalization ($ Billion)	Value of shares traded ($ Billion)	Number of listed companies	GDP at current prices ($ Billion)	Market depth %[a]	Turnover ratio %[b]
GCC Region						
Saudi Arabia	*246.5*	*523.4*	*127*	*465.6*	*53*	*212.3*
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
Other Arab						
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

[a]Market depth = Ratio of market capitalization to GDP
[b]Turnover ratio = Value of traded shares to market capitalization of shares at end of period
Source: SAMA

terms of market depth and trading turnover. The second largest GCC capital market is Qatar's followed by Kuwait's, but the turnover ratio for Kuwait is three times that of Qatar. From the non-GCC countries, Egypt, with almost triple the population size of Saudi Arabia, has the second largest Arab market capitalization. Algeria's market activities are negligible for the country's GDP size, with only around 4% of Algeria's GDP, and is surpassed even by Palestine's stock market.

In most developed economies, the turnover ratio generally exceeds the total market capitalization. This has been rising for Saudi Arabia but it picked up sharply after 2004, before subsiding following the market crash of 2006 as illustrated in Table 6.7.

Besides the above measures, sometimes it is also valuable to examine the degree of liquidity and riskiness measures of stock market volumes. While market liquidity is measured by the annual turnover ratio and Table 6.7 indicates that the Saudi market has generally been very liquid, the level of market risk can also be measured by *annual volatility*. The annual turnover-to-volatility measure relates price swings to value-traded swings, and Table 6.8 examines this for the major GCC and Arab markets.

Analysis of Table 6.8 reveals that in terms of turnover ratio, the Saudi market is the most liquid of all the Arab markets. All the Arab markets, however, exhibited stable and non-volatile conditions in 2009 as they were all below 1.0, above which

Table 6.7 Saudi Arabian share market indicators (1993–2008)

Year	Value of shares traded (SR billion)	Market capitalization (SR billion)	Turnover ratio (%)	Market capitalization as % of GDP
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)

Country	Turnover ratio	Annual volatility (%)	Annual turnover/volatility ratio (%)
GCC countries			
Saudi Arabia	*1.01*	*0.44*	*2.30*
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
Other Arab			
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

markets are classified as being volatile (unstable if above 1.8 levels). Analysis of the annual turnover-to-volatility ratio is an important factor in assessing the measure of market liquidity. The higher the turnover-to-volatility ratio is, the more liquid is the market and such markets should be able to handle swings in volumes of trading without large price swings. From Table 6.8, both Saudi Arabia and Kuwait seemed to have the most ability to absorb large swings in trading volumes without large swings in price and volatility. In the non-GCC Arab countries, Egypt had the most ability to absorb large swings in trading volumes.

Free Share Float Is an Issue

Being liquid is one matter. Having enough "free float" shares available for trading is just as important to enable markets to operate efficiently without distorting prices based on trades in a few shares. Earlier studies on the Saudi stock market (Azzam, 1997a) had estimated the level of free float to be around 47.7% for 1995. By the end of 2009, according to *TADAWUL*, the level of free float had fallen to just under 38% for the whole market as illustrated in Table 6.9, but with significant sectoral differences.

From Table 6.9 one observes that the lowest free float was in the multi-investment sector at just 8.4% while the highest level of free float was in the retail services and

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

	2003[a]			2009		
Sector	Total outstanding shares (millions)	Shares held by public free float (millions)	Free float as % of total shares outstanding	Total outstanding shares (millions)	Shares held by public free float (Million)	Free float as % of total shares outstanding
1. Banking and 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 and 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 and 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
Total sectors	2,232.7	1,192.7	53.4	41,223.1	15,660.2	37.9

[a]By 2007, the CMA had introduced 15 sub-sectors compared with 7
N/A: Not available as not segregated
Source: SAMA, CMA

transport sectors at around 71%. The prime reason for the low float in the multi-investment sector was the fact that only 5% or 315 million shares were available for trading out of 6,300 million issued by Kingdom Holding Company owned by Prince Al Waleed bin Tallal bin Abdulaziz. This skewed the sector average considerably, but the energy/utilities, telecommunications and insurance sectors had low free float shares. As noted earlier in the chapter, there is a need to list more Saudi companies on the exchange to enable a larger float of shares and so avoid undue market price movements due to trades in a few shares of closely held sectors affecting the overall market.

Saudi Capital Market Performance

The Saudi stock market is relatively higher than global and other emerging markets in terms of dividend yield, reflecting the preference for high dividends not only in Saudi Arabia but also amongst the other GCC countries. This is illustrated in Fig. 6.6 as well as in Fig. 6.7, which sets out the price/earnings ratios for Saudi Arabia *TADAWUL* TASI index and other markets.

Despite the volatility and underperformance of the Saudi TASI in 2009, the price/earning ratio is relatively at the same level with other emerging economies such as Brazil, Russia as well as the S&P 500 index. The Saudi P/E ratios, however, are higher than GCC peers which range from 7 to 11, compared with a Saudi P/E ratio of nearly 18, causing some concern that another asset price bubble might be developing in Saudi Arabia, but traditionally Saudi P/E ratios are at these high ranges. The Saudi capital market though has had a roller-coaster experience, especially during the period 2005–2009 as illustrated in Fig. 6.8 for volatility in the Saudi

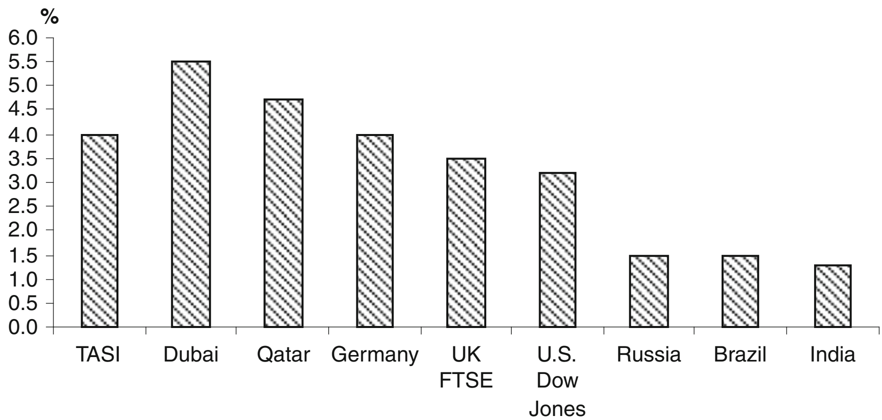

Fig. 6.6 Dividend yield: Saudi TASI and other selected markets' indexes (January 2010) (Source: CMA, Bloomberg)

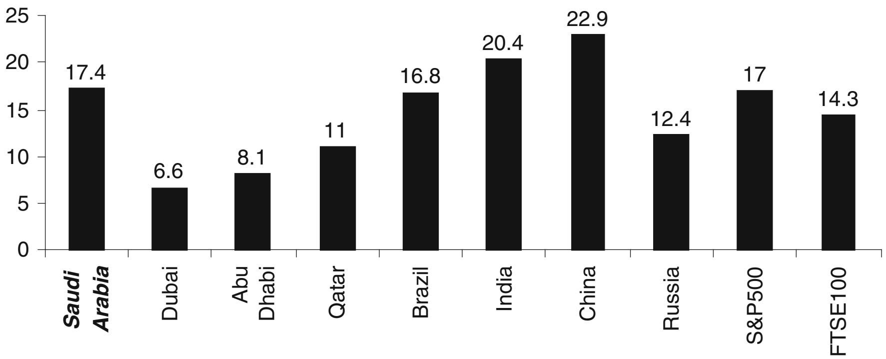

Fig. 6.7 Price earnings ratios: Saudi TASI and other selected markets' indexes (January, 2010) (Source: Bloomberg)

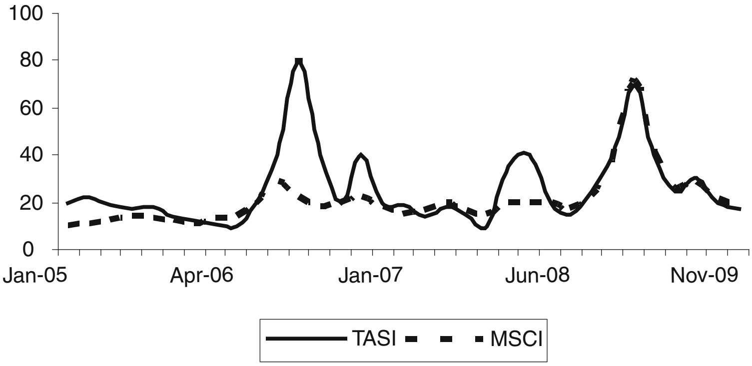

Fig. 6.8 Saudi TASI and MSCI-EM: volatility comparison 2005–2009 (Source: Bloomberg)

TASI in comparison with the Morgan Stanley Capital Index (MSCI) for emerging markets.

The greatest period of volatility compared to the MSCI was during the period 2006–2007 when Saudi P/E ratios reached a high of 67 in February 2006, and in some cases exceeded 100 for a few companies. Expected corporate profit growth began to be ahead of actual results, compounded by some annual company reporting showing that many companies had invested heavily in the stock market and booked unrealized stock exchange earnings. It was this asset bubble build-up and companies entering into non-core financial transactions activities that forced the CMA in 2006 to introduce directives prohibiting listed companies from buying and selling securities of listed companies for themselves, unless these are explicitly stated in their company codes and regulations. By 2006 there was sign that the Saudi market was overheating when the *TADAWUL* index touched the 21,000 level in February 2006 and then started its sharp fall to close at the 7,000 levels. The Saudi year-end

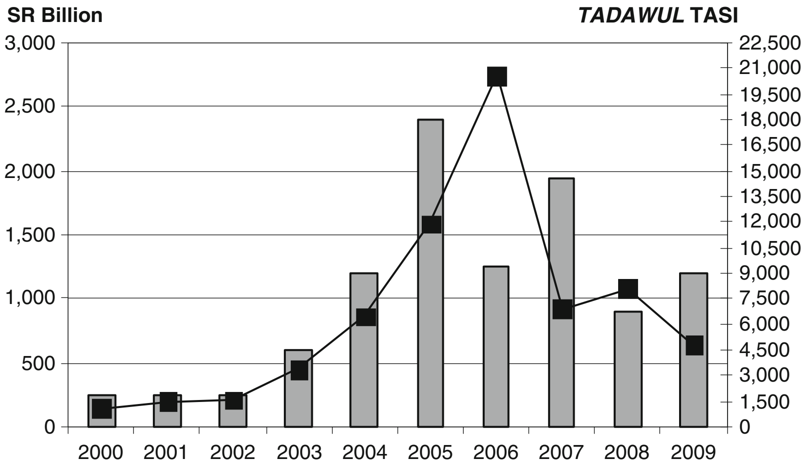

Fig. 6.9 Saudi market index year ends and *TADAWUL* TASI highest levels reached, 2000–2009 (Source: SAMA, CMA, *TADAWUL*)

market capitalization and the highest levels reached by the *TADAWUL* TASI index are set out in Fig. 6.9. By 2009 the Saudi index and market capitalization were once again at the levels of 2004, and in May 2010 the TASI touched 5,750.

Sectoral Performance of the Saudi Market

Like any other stock market in the world, the Saudi TASI composite stock market index masks sectoral differences. The Saudi stock market has 15 sectors and, in order of size, finance and basic materials are the dominant sectors, together accounting for just under 70% of market capitalization, with the two biggest companies Saudi Arabian Basic Industries (SABIC) and Al Rajhi Bank accounting for around 11% of the market. Figure 6.10 illustrates the Saudi market capitalization for year-end 2009 by the different sectors.

What is of some concern for the Saudi capital market is that while some of the smaller sectors have a larger number of companies, they only account for a smaller percent of the market capitalization. As such, a small movement in the highly capitalized sectors will unduly influence the whole market index.

This is demonstrated in Fig. 6.11, which sets out the sectoral activities for 2009 in terms of value of shares traded, the volume for the year and the number of transactions. Volume indicates how many trades took place for a security on a given day, with high trading volume an indicator of high investor interest.

What is noticeable is that the largest value of share trading was in petrochemicals followed by insurance and then banking and financial services. The number of transactions was lower for banking compared to insurance and around the same for industrial investment and building construction, but the value for banking was far higher indicating the sensitivity of price movement in this sector.

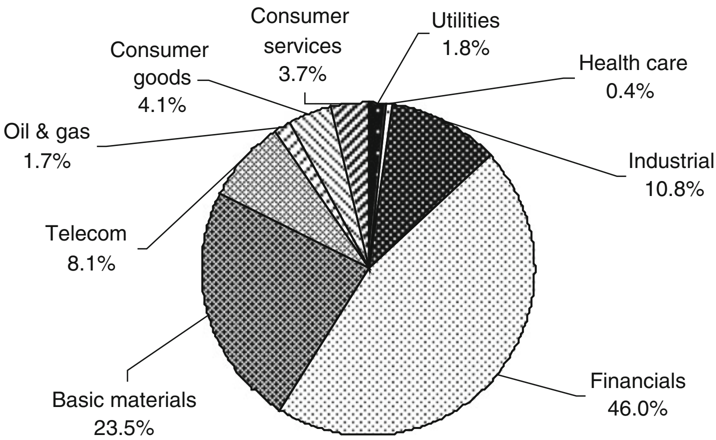

Fig. 6.10 *TADAWUL*: Market share by sector (percent of market capitalization, December 2009) (Source: *TADAWUL*)

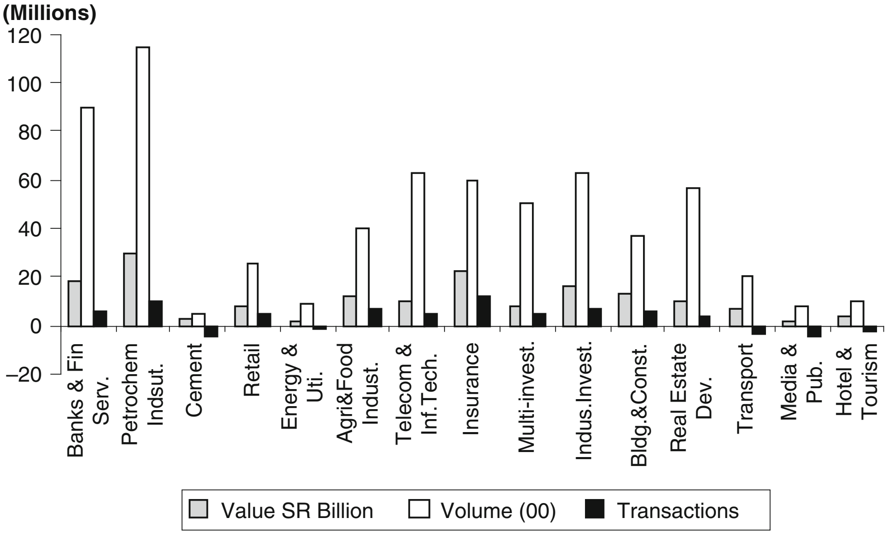

Fig. 6.11 Sectoral activities Saudi stock market 2009 by value, volume and number of transactions

Investor Behaviour: Irrational Exuberance and Herd Mentality

While extensive analysis has been carried out on the actual results and price movements of the Saudi stock market, far less research has been carried out on investor behaviour of current players in the Saudi market compared to other markets which have tried to understand what drives investors, particularly individual investors. The effect of "herd mentality" – with investors driven to act in the same direction irrespective of underlying market fundamentals – has been observed in many markets including the GCC markets (Chang et al., 2000, Dahel and Labbas, 1999, Devenow and Welch, 1996, Hammoudeh and Choi, 2006). A principal aim of such research is to test whether "efficient market" hypothesis exists and under what circumstances the hypothesis does not operate.

The efficient market hypothesis (EMH) asserts that financial markets are "informational efficient" or those prices on traded assets, e.g., stocks, bonds, or property, already reflect all known information and therefore are unbiased in the sense that they reflect the collective beliefs of all investors about future prospects.

The efficient market hypothesis states that it is not possible to consistently outperform the market by using any information that the market already knows, except through luck. Information or news in the EMH is defined as anything that may affect stock prices that is unknown at present and thus appears randomly in the future. This random information will be the cause of future stock price changes. The efficient market hypothesis requires that agents have rational expectations; that on average the population is correct (even if no one person is) and whenever new relevant information appears, the agents update their expectations appropriately.

There are three common forms in which the efficient market hypothesis is commonly stated:

Weak form efficiency: It asserts that all past market prices and data are fully reflected in securities prices. In other words, technical analysis is of no use.

Semi-strong form efficiency: It asserts that all publicly available information is fully reflected in securities prices. In other words, fundamental analysis is of no use.

Strong form efficiency: It asserts that all information is fully reflected in securities prices. In other words, even insider information is of no use.

From evidence presented earlier in the chapter, it is certainly correct to assume that "strong form efficiency" does not completely exist in Saudi Arabia today given the number and range of CMA violations listed. Anecdotal evidence suggests that the Saudi stock market is currently driven by irrational exuberance and herd-like mentality characterized by rumours and bouts of buying followed by panic selling as the *TADAWUL* TASI index had earlier highlighted. Over time, with investor experience and CMA investor awareness programmes, such type of investment behaviour could change towards a long-term investment outlook and asset holding. It is important to highlight that there are differences in Saudi individual investors behaviour based on education, gender and age. Field research results carried out (Koshhal, 2004) showed some interesting differences amongst Saudi Individual Stock Traders (SISTs), indicating the following:

- The level of financial and technical knowledge among the SISTs were below average; 80% had no formal training in stock trading.

- The majority of SISTs were risk-takers who believed that they would continue to make high profits on the Saudi stock market, despite falls.
- In picking stocks, some 40% of SISTs depended on technical analysis, some 32% depended on financial analysis while 25% depended on other people's opinions and Internet forums. Only 3% went with their personal "feelings."
- The 25–35 age groups seemed to make the most profit on the Saudi stock market, which the research survey correlated to higher levels of education and formal course training.
- The lowest level of profits were found amongst those who depended on others' opinions, while the highest was achieved by those who depended on technical analysis.
- Respondents with the highest education levels (masters and doctorates) depended on financial analysis and made medium to high profits. Those with lower levels of education depended on others' opinions and made the lowest profits.
- Respondents with lower risk aversion depended solely on financial information in their decision-making and realized medium profits.

Research conducted for other developed markets seemed to corroborate the above Saudi field research findings (Ackert et al., 2003), but such findings have important implications for the future development of the Saudi stock and capital market, concerning how to widen the number of players (foreign and domestic) and type (institutional or individual). Figure 6.12 illustrates that the individual retail investor still dominates the market with an average of over 87% of the monthly traded value.

In larger European bourses such as London's, institutional investors tend to account for around 90% of the transactions value. While the Saudi data indicate the sizeable contribution of individuals to total value added, analysis of net investment flows for each investor category indicates that they are not the sole drivers of the market, but that the Saudi corporate sector is the main driver as illustrated in Fig. 6.13.

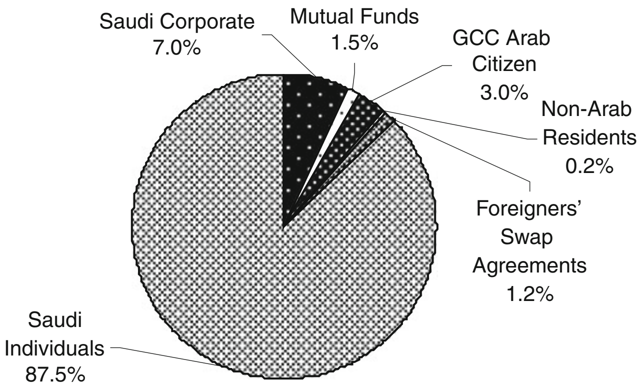

Fig. 6.12 Average monthly contribution to Saudi stock market trades by category of investor and % of value traded (2009) (Source: *TADAWUL*)

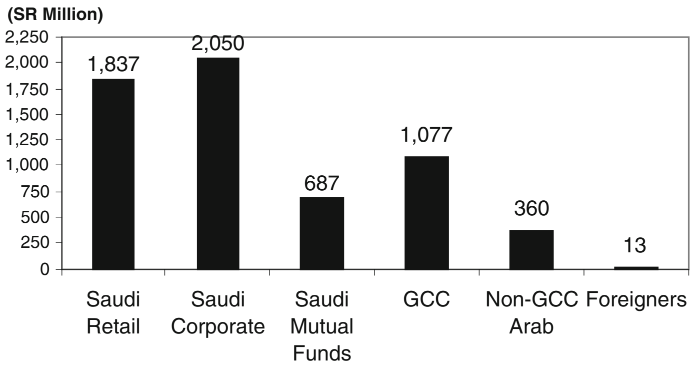

Fig. 6.13 Average monthly net investment in absolute terms per category of Saudi investors (2009) (Source: *TADAWUL*)

From Fig. 6.13 it is interesting to note the increasing importance of non-Saudi investors such as those from the GCC, non-GCC Arabs resident in Saudi Arabia and foreigners in terms of net investment flows. However, the fact that Saudi retail investors dominate in terms of value, while Saudi corporates dominate in terms of net flows, indicates that they could balance each other out to some respect in terms of market price movement. This is illustrated in Fig. 6.14, which indicates that, except for one month (May 2008), retail and corporate investors seemed to work in a *contrarian* manner.

However, it is important to analyse deeper to assess whether the various participants also move in the same direction when the market direction changes and shed some light on the earlier findings on Saudi individual investor behaviour. Figure 6.15 highlights some interesting but surprising findings, especially concerning the Saudi corporate investor sector.

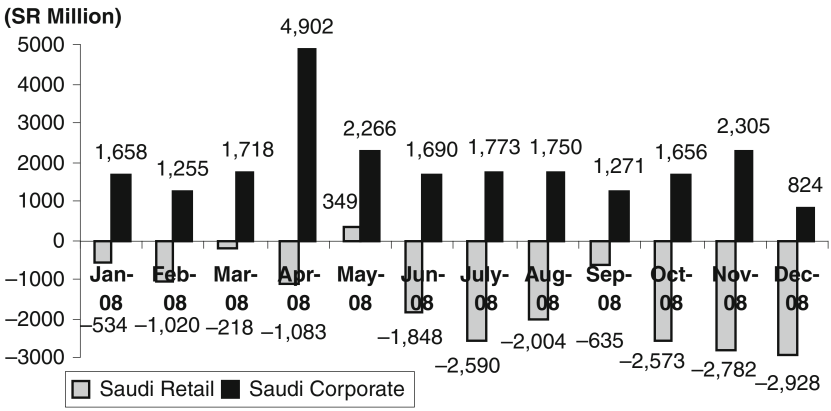

Fig. 6.14 Average monthly net investments (2008) (Source: *TADAWUL*, SHUAA Capital, 2009)

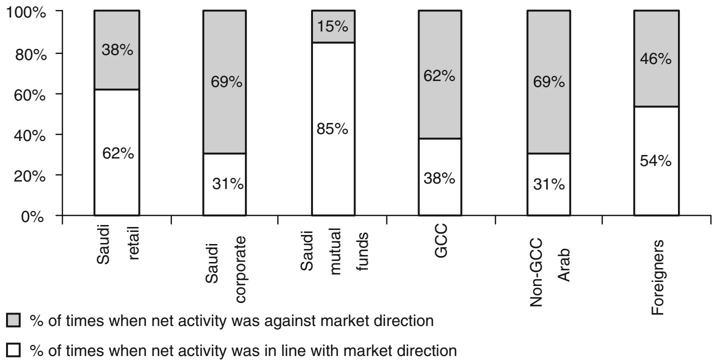

Fig. 6.15 Saudi market trends and participants correlation % of times (2008) (Source: *TADAWUL*, SHUAA Capital 2009)

While the Saudi corporate sector dominated the net monthly inflows, they seemed to do poorly when it came to forecasting market direction compared to individual investors, mutual funds and foreigners. Saudi corporates were on average 31% of the times in the same direction as the market, while individual investors were 62% , mutual funds 85% and foreigners 54%.

As such, the corporate investors in Saudi Arabia seem to play a significant net monthly investment role, but more a balancing role when it comes to market movements. What Fig. 6.14 indicated is that other participants in the Saudi market are playing an increased role in balancing market movements, and these are mutual funds and non-resident foreigners.

Boosting Foreign Participation

The Saudi regulatory authorities have recognized the potential contribution of widening institutional participation, particularly from foreign entities, but at a controlled pace to avoid the sudden injection and outflow of so-called "hot-money" investments as seen in other open emerging markets, especially during the 1998 Asian currency crisis. The argument for more foreign participation lies on assumptions such as having foreign participation reduces the potential volatility in the market by buying stocks when they are undervalued and withdrawing when valuations become overstretched. Foreign investment firms' focus on technical research also might discourage price bubbles from developing by promoting more vigorous fundamental analysis of the emerging market and helps to promote corporate governance.

Since 2005, the CMA has awarded investment banking licences to a number of foreign banks, which have also been allowed to provide brokerage services. Consequently, the quantity and quality of corporate research has improved markedly, and many investors are now better informed than previously. Regular analysis of individual shares of major companies is now available, providing valuations based on internationally recognized models such as discounted equity cash flow, dividend discount and peer-based valuations, as well as buy, hold or sell recommendations.

This has encouraged the Saudi authorities to open up the local market to foreign investment and in 2008 the CMA opened the *TADAWUL* exchange for non-resident foreign investors, whether individual or institutional, as long as the Saudi stocks are acquired by an authorized Saudi intermediary. These were the so-called "total returns swap" (TRS) agreements, which operated under the conditions that the authorized local intermediary will have the legal ownership of the stock and the foreign non-resident investor will have exposure to the stock's economic gains or losses.

In further developments, the CMA also imposed some restrictions on the TRS, such as a maximum term of 4 years for the agreement. The authorized entity, however, has voting rights on the stock under swap agreement. Finally, the CMA required the authorized persons to avoid any credit risk by receiving 100% of the funds from the foreign investor.

The move, although not fully opening the Saudi market to all forms of investors, was a major step towards the integration of the *TADAWUL* with the global market. For whatever the limitations might be, the CMA, by doing away with the restriction on foreign ownership limits, has rendered the Saudi market, on this specific issue, more open than other GCC markets (with the exception of Dubai), which are still bound by such restrictions.

The result of the gradual opening up of the Saudi capital market has been a steady volume in swap activity, as illustrated in Fig. 6.16.

It will still be some time before the current swap facilities are replaced by outright ownership of Saudi stocks by non-resident foreigners but the experience gained by both sides has been beneficial to the Saudi capital market, making the CMA consider other changes. In 2009, the CMA indicated it was considering the possibility of allowing exchange-traded funds (ETFs) and agreed to this in March 2010. Such ETFs can be bought and sold like shares, have lower costs than mutual funds and

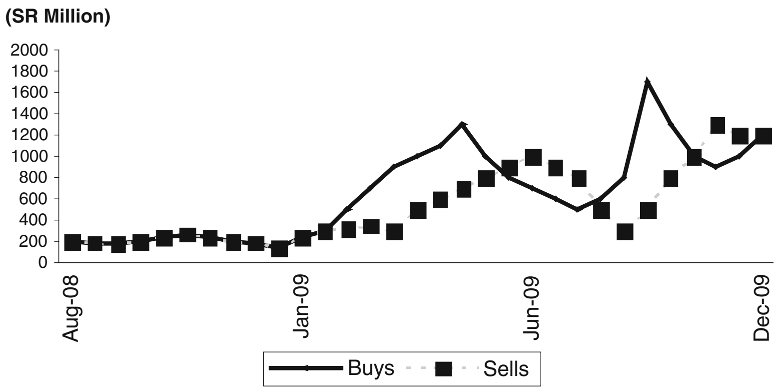

Fig. 6.16 *TADAWUL* foreign swap volume August 2008–December 2009 (Source*: TADAWUL*)

can give investors exposure to a wider selection of stocks then individual shares. Such an introduction would also create an international market for "shadow" Saudi stock market indexes, unlike the current swaps. In July 2009, the Dow Jones Indexes of the USA became the first international index provider to offer indexes on the Saudi *TADAWUL*, and Dow Jones currently provides four Saudi indexes based on real time data and prices from Saudi Arabia. This has encouraged other international companies such as Standard & Poor's and Bloomberg to consider Saudi indexes.

Once again the CMA has demonstrated that "learning by doing" approach benefits Saudi Arabia, and during 2009 the CMA granted licences to launch indices tracking the performance of *Shariah*-compliant companies listed on the Saudi exchange, catering to the strong demand for Islamic financial products, especially following the global financial crisis of 2008/2009 which hit traditional investment banking hard.

Saudi Mutual Fund Market Growth

As illustrated earlier in Fig. 6.15, the Saudi mutual funds sector seemed one of the few that correctly moved in line with market direction, adding to some stability to market prices in times of volatility despite its smaller net monthly investments. This could be due to the fact that mutual funds are managed by professional and authorized fund managers and are closely regulated to ensure compliance with the terms of the fund structure and investment guidelines.

The mutual fund market has exploded in size and diversity of products all over the world and now constitutes a large and important segment of the financial and capital markets. The US market, the largest in the world, saw the market share for mutual funds reach $5.8 trillion in 2005 from $371 billion in 1984, according to the number one US fund manager, Fidelity, which handled around $550 billion in its institutional retirement group alone (Fidelity, 2006).

The history of the Saudi mutual funds market has been equally impressive and today Saudi Arabia has the largest mutual funds industry in the Arab world. Mutual funds were first introduced in the Saudi market by the National Commercial Bank (NCB) through its "open-ended" *Al Ahli* Short-Term Dollar Fund in 1979. It was aimed at the smaller investor, particularly the expatriate worker, and it quickly became a success with this market segment due to the fund's low service charges, ease of entry and redemption.

Over the years, public interest and demand for this financial product has risen to a peak of SR 137 billion in 2005 before falling back in later years, as the figures in Table 6.10 show, with assets under management in all mutual funds standing at SR 77.2 billion by the end of first quarter of 2009.

Table 6.10 indicates Saudi investors moved out of the mutual funds sector to try direct investing in the stock market during the boom year of 2005/2006 and reverting back to mutual funds in 2007 following the crash of 2006, as explained earlier in this chapter. The table also shows the switch towards domestic assets from 1995 onwards.

Table 6.10 Growth in Saudi managed mutual funds (1995–2009)

Characteristics	1995	2005	2006	2007	2008	2009[a]
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
Total SR billion	13.0	136.9	84.0	105.0	74.9	77.2

[a]First Quarter, 2009
Source: SAMA, CMA

The causes of the switch towards domestic assets are many, including the sharp rise in Saudi share prices compared to international equity markets, the growth of Islamic mutual funds and the growing expertise over time amongst Saudi banks in managing such funds by themselves.

The reasons for investing in Saudi mutual funds are also varied. Only a decade ago, most Saudis looked to their employers – whether in the government or private sector – to provide them with a pension, but an increasing number of Saudis (and expatriates living in the Kingdom) have now invested in these funds as a form of retirement hedging. The attraction of holding mutual funds is apparent: pooling the resources of small investors and sharing risk in many diversified stock/bond portfolios while minimizing transaction costs and information costs. Mutual funds also provide greater liquidity, meeting investors' need for cash.

As mentioned earlier, the growth of mutual funds in Saudi Arabia has been impressive over such a short period of time. Initially, the focus was on select high net worth or "private bank" clients, but all Saudi banks have now expanded their target market to include the professional middle-income and top-tier expatriates. Competition has been fierce amongst banks and some have developed in-house expertise to manage their funds, whereas others have established strategic alliances with international fund managers to design funds exclusively for their Saudi clients. Those Saudi banks with foreign affiliation and part ownership such as Saudi British Bank, Saudi Fransi and others had a head start over the "pure" Saudi banks such as NCB and Riyad Bank. However, the local banks have gained mutual fund management experience, especially in the domestic equity market, and have created a niche market in Islamic mutual funds, which now account over 50% of the total assets under management and nearly one fifth of the number of funds as illustrated in Table 6.11.

What is noticeable from Table 6.11 was the decline in investment in international equities following the 2008 global financial crisis, mirrored by a fall in domestic equities, but a sharp rise in *murabaha* Islamic mutual funds.

According to NCB, there is a growing desire among Saudi investors to participate in Islamic-based mutual funds that are *Shariah*-compliant and are consistent with the principle of equity participation and risk-sharing. For the Saudi economy, this

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

	2007		2008	
Type of fund	Number	Assets (SR Billion)	Number	Assets (SR Billion)
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
Total	233	105.1	262	74.8

Source: CMA

type of funds not only improves market liquidity but also provides risk diversification opportunities in medium- to long-term maturity structures, although most of the Islamic mutual funds started through low-risk and modest-return instruments such as *murabaha* (short-term secured commodity trade finance) and *ijarah* (structured medium-term leasing).

According to a survey carried out by the same bank, most participants in mutual funds are Saudi males, the majority of whom have college degrees. Nearly half of the female investors were in the 18–25 age group. According to the survey, the most important objective for investing in the mutual funds was to secure a comfortable retirement. About 38% of those surveyed said they would not tolerate any risk, while 40% were prepared to take some risk, suggesting that a very small proportion of Saudi mutual fund investors are ready for higher risk (NCB, 2000).

The risk profile seems to be different from those investing directly in the equity markets, which we examined earlier, but given that a large number are investing in the mutual funds for long-term retirement pension objectives, this risk aversion is not surprising.

Based on the data in Table 6.10, the average investment per person is around SR 400,000, reinforcing the fact that mutual funds are mostly investment instruments for the upper-income groups, while lower- to middle-income groups depend mainly on bank deposits or individual share purchases to grow their savings.

In conclusion, the outlook for the Saudi mutual market looks bright, with growth anticipated in total assets, especially for *Shariah*-compliant funds.

Conclusion

While significant strides have been made in the development of the Saudi capital market over recent years, some further changes are needed to make the Saudi market even more attractive to both domestic and international investors. Countries are competing for investment capital; either they constantly try to improve or they will

Table 6.12 The changing face of the Saudi capital market

1970s	1980s	1990s	2010 onwards
• No disclosure	• Regulatory regimes improving	• Technology utilization	• Commercial paper and bonds
• External funding on selective basis	• External funding	• Specialized funds	• Family businesses going public
• Poor regulatory and legal structure	• Government soft loans	• Government debt increasing	• Mergers and acquisitions
• Commercial bank funding on secured basis	• Syndicated loans	• Islamic financing	• More disclosure and transparency
• Dominance of family companies	• Some disclosure available	• Foreign ownership on joint venture basis	• Foreign inward investment
		• Non-recourse finance	• Privatization
			• Foreign participation
			• IPOs
			• Securitization
			• Islamic financing

be left behind. Saudi Arabia, while blessed with a national private sector capital surplus, needs as well to attract international investments in order to establish a better investment, financial and regulatory environment that will maximize their potential to attract investment. Table 6.12 summarizes the changing pace and face of the Saudi capital market.

The Saudi capital market took off during the 1990s, with the beginning of domestic economic reforms in the field of privatization and liberalization, especially when the country opened up to the outside world for inward investments. The post-2010 era requires an even bolder capital market reform programme to address several key issues highlighted in this chapter.

First, the government should vigorously encourage and support listings of new companies on the Saudi stock market. The Ministry of Commerce can re-examine some of its stringent guidelines, procedures for listing and the laborious documentation that accompanies conversion to joint stock companies. The current number of listed companies and their narrow sectoral basis cannot be sustained.

The passing of the Saudi Capital Market Law has gone a long way in convincing the Saudi private sector and the international community at large that policy-makers in the Kingdom are serious about implementing reform strategies aimed at economic liberalization, competition and market efficiency. Time and again, commentators have said that while the intentions of the Saudi government and policy-makers were sound and well-meaning, the problem has been the speed of implementation.

The Saudi authorities have sent robust signals that the way forward for the economy lies in decentralized, private market-based activities, and the new capital market would play a vital role in the following areas. As a priority, Saudi Arabia can attract back Saudi capital resources held abroad. A deeper and more dynamic Saudi capital market has the potential to draw back Saudi resources invested abroad, which could contribute towards the financing of the non-oil sector.

In the past, the liquidity, safety and dependable market infrastructure of overseas markets have attracted private Saudi wealth. There are varying estimates as to the size of this overseas investment, ranging from a conservative $480 billion to a generous $900 billion according to various bank sources (NCB, 2000, SAMBA, 2003), although this figure could have decreased following the turmoil in the global financial markets in 2008/2009. Whatever the actual figures, these are substantial sums, and the response to the latest IPOs shows that the public is ready to invest locally. However, for this capital repatriation to be sustained, a new Saudi capital market must build solid investor confidence.

Second, development of the domestic Saudi capital market will contribute directly to the growth of the non-oil sector by promoting the financial services industry. A market-based expansion of contractual savings to service pensions, insurance and diversification needs will create a demand for institutional investors, such as pension funds, insurance companies and mutual funds. They will be in a better position to satisfy the economy's demand for long-term resources and to assume the role now played by specialized government credit agencies. Since the early "boom" days of the mid-1970s and early 1980s, government financing has been made available for manufacturing enterprises at zero interest rates. This encouraged reliance on the state, institutionalized operating inefficiencies and promoted a business culture of relying on commercial bank debt financing and soft loans from the government, rather than equity financing.

Third, a well-developed capital market will improve risk management practices. In previous chapters, we showed that the volatility of oil prices leads to volatility and unpredictability in Saudi government revenues, resulting in a magnified effect on other sectors of the economy. Financial market developments can contribute to better risk management in the economy; for example, the introduction of derivative instruments (hedging) can help domestic market participants manage the effects of oil price volatility on their activities. This can lead to greater macroeconomic stability, thus improving the investment climate and growth in the non-oil sectors.

Fourth, a well-developed local capital market can respond to the demand of infrastructure services. With the Saudi government signalling its disengagement from public investment and announcing its ambitious privatization programme, infrastructure finance will be at risk if international capital markets lose their appetites for taking risks on emerging countries. Furthermore, international capital is more likely to flow when there is evidence of private domestic capital in the projects they are called to finance. As such, limited recourse finance needs a diversified menu of financing instruments that can expand without relying on government guarantees. Only a capital market that is liquid, transparent and diversified could help in this process.

Above all – and this must be emphasized continuously – the Saudi Capital Market Authority must carry out its regulatory responsibilities vigorously. Capital markets that function well offer their investors the twin virtues of transparency and protection. Through transparency, investors will be able to see exactly what is going on inside the listed companies; they will feel protected if they see that their money is safeguarded from intermediaries. Such changes in attitude and regulatory frameworks take decades to achieve. The omens are good as evidenced by the vigorous actions of the CMA over the past few years. The road that Saudi Arabia has taken could be a long one, but the Kingdom has achieved much in the development work already. If this is now put into practice, the Capital Market Regulatory Authority in Saudi Arabia will become one of the leading regulators in the world, and the Saudi capital markets will become one of the most productive developments that Saudi Arabia has witnessed.

Summary of Key Points

- *Efficient capital markets can play an effective role in recycling capital surpluses and promoting economic growth. The Saudi private sector has demonstrated that it has the liquidity to participate in any deepening of the current capital market.*
- *The Saudi capital market has evolved from the formal establishment of a stock market in the 1980s to the passing of the Capital Market Law in 2004, which created an independent Securities Exchange Commission (SEC) and later the Capital Market Authority (CMA) to oversee the stock market.*
- *The establishment of the CMA has helped to overcome some of the previous obstacles in expanding the capital market, namely an increase in the number of listed companies, increase in the number of shareholders, expansion of brokerage and investment advisory services and licensing of non-bank financial institutions.*
- *The benefits of the Capital Market Law could be felt in several areas: potential to draw back Saudi resources invested abroad, growth of non-oil financial services sector, improvement in risk management practices and response to the infrastructure services demand.*
- *In terms of performance, the Saudi capital market dominates the rest of the Arab world in size and has registered impressive performances, especially during 2003–2004, when it outperformed most international market indexes but saw sharp retreats after 2006. The Saudi market has improved in terms of turnover ratio and market capitalization as % of GDP.*
- *The total "free float" shares for trading is around 50% of all listed shares. This could benefit from additional planned government privatization sales and private sector IPOs.*
- *The capital market is still characterized by a high degree of sectoral concentration and the dominance of banking, electricity and telecommunications, with six companies accounting for nearly 70% of the total market capitalization.*
- *The Saudi capital market has made some progress in opening up to foreign investors through swap facilities and there are some developments in expanding the use of exchange-traded funds (ETFs) and index funds.*

- *Investor behaviour in the capital market is characterized by a mixture of sophisticated technical analysis and those with no formal training in stock trading who depend on opinion and make the lowest profits.*
- *The Saudi mutual fund market is now relatively mature with a broad range of investment vehicles catering to middle-income Saudi investors. A discernible growth in demand for Islamic investments has been noted.*