Preparing for change in Saudi financial markets

Saudi Arabia's decision to open its stock exchange to foreign investors has been the biggest story in GCC finance this year – and one of the most significant developments in Middle Eastern capital markets for several years.

As *Arab Banker*'s Editor, Andrew Cunningham, explains, the opening of the exchange confirms the long-term commitment of the Saudi authorities to develop and expand their financial system.

Investors have been talking about the opening of the Saudi stock market for years.

In 2007, the market was opened to citizens of other GCC countries. Non-GCC citizens have been able to gain exposure to the market through swaps.

But the Saudi stock market (known as the Tadawul) is by far the biggest in the Middle East and non-GCC investors wanted direct access.

The opening was handled in a way that is the typical *modus operandi* of Saudi Arabia's financial authorities. Refusing to be rushed by outside pressure, the authorities waited until they were ready. But when they were ready, the matter was handled professionally and in a timely manner.

The Capital Market Authority (CMA) announced in July 2014 that they would prepare draft regulations for direct investment by Qualified Foreign Investors (QFIs) in the Tadawul, that there would be a three-month consultation period, and that final regulations would be issued in time for the market to open during the second quarter of 2015. And that is precisely what happened.

The first trading took place on 15 June.

The regulations that govern trading by QFIs have been framed to limit the type of institution that will, in practice, be able to take advantage of the new opportunities, and also to limit the impact of overseas investment on Saudi companies.

QFIs must already have at least $5 billion under management and be regulated in their home market. They may buy no more than 5% of a listed company's stock, and no more than 49% of the stock may be held by all QFIs.

The Authorities' insistence that trades be settled on the same day – T+0, as opposed to T+2 that is used in Europe – will in practice mean that only large and technically sophisticated institutions will be able to trade.

The Tadawul is listed as a 'Frontier Market' by MSCI, along with most other stock exchanges in the Middle East. Only Egypt, Qatar and Bahrain qualify as 'Emerging Markets' and none as 'Developed.'

The Tadawul's Chief Executive, Mohammed al-Jadaan, has publicly stated that he wants to see the exchange upgraded to 'Emerging Market' by 2017. Since such upgrades are dependent on factors such as tradability, liquidity and transparency, Mr Jadaan's ambition implies that further moves to expand the investor base and to increase trading volumes are in the pipeline.

The market capitalisation of the Tadawul was around $580 billion in the weeks that followed the opening to QFIs. This was more than three times the market capitalisation of the next biggest Arab stock market in Qatar, and more than four times the capitalisation of the exchanges in Abu Dhabi, Dubai or Kuwait.

The next big development in Saudi financial markets is expected to occur in the fixed income markets. Issuance of conventional bonds, though not unknown, has always been constrained by the sensitivity attached to interest payments, which are forbidden under strict interpretations of Islamic law. (The financial statements of Saudi banks do not refer to interest income or interest expense: the terms 'special commission income' and 'special commission expense' are used.)

Increasing global issuance of sukuk – which fulfil the economic objectives of conventional bonds but in a Shari'a-compliant manner – opens the way for Saudi Arabia to develop a sukuk market, but it will be some time before the Kingdom will be able to boast a thriving sukuk/fixed income market.

Global sukuk issuance may be increasing, but it remains limited. Global issuance was approximately $110 billion in 2014. Two thirds of global issuance is usually in Ringgit, aimed at the local market, with the Malaysian government or central bank being by far the biggest single issuer.

The Gulf Bond and Sukuk Association listed 55 sukuk from Middle Eastern issuers for the first half of 2015, but only one of those was by a Saudi company: Najran Cement. In 2014, Saudi issuance was more substantial, with large issues by Saudi Electricity Company, and issues by the Saudi Petrochemical Company and three local banks, but, as in previous years, issuance by Emirati companies and banks dwarfed that from the Kingdom.

Nonetheless, there are reasons to believe that the Saudi bond and sukuk market may be ready to expand.

In early July, the Saudi government issued SR15 billion ($4 billion) in bonds to local quasi-sovereign companies and the Governor of the Saudi Arabian Monetary Agency (SAMA) then publicly said that the government would be issuing more bonds in the months ahead.

The government's appetite for bonds is driven in part by low oil prices. The Kingdom is reported to have drawn down about $65 billion of its reserves during the first half of 2015. Although reserves remain high – nearly $700 billion at mid-year – raising debt will provide the Saudi government with more financial flexibility as it contemplates the possibility of a prolonged period of low oil prices.

Greater and more diverse government issuance will enable the creation, for the first time, of a Saudi yield curve, which in turn will facilitate issuance by the private sector.

During 2015, the Capital Markets Authority has been preparing

Who's who in Saudi Finance?

The Saudi Arabian Monetary Agency (SAMA) acts the central bank and as the regulator and supervisor of the banking system. It also regulates and supervises insurance firms and their activities, and finance companies. Consumer protection also falls under SAMA's purview.

Under the Governor and Vice Governor, there are five deputy governors, responsible for Investment, Supervision, Banking Operations (including payment systems, bank branches and currency), Research and International Affairs (including monetary policy and financial stability, and financial sector development), and Administration.

There are four departments under the Deputy Governor for Supervision: Banking Control, Insurance Control, Finance Companies Control, and Consumer Protection. All of the current department heads were appointed in May 2013.

Governor of SAMA: H.E. Fahd bin Abdullah al-Mubarak.

Appointed December 2011 from outside SAMA. He had previously been Chairman and Managing Director of Morgan Stanley Saudi Arabia and Chairman of the Saudi Stock Exchange. Holds a doctorate in business administration from the University of Houston in Texas.

Vice Governor of SAMA: H.E. Abd al-Aziz Saleh al-Furaih.

Appointed August 2014 from outside SAMA. Before his appointment, Mr Furaih was deputy CEO of Riyad Bank, one of the largest and longest established commercial banks in Saudi Arabia. Mr Furaih has a masters degree in Accounting and has an American Certified Public Accountants Fellowship.

Deputy Governor for Supervision SAMA: Abd al-Aziz Al-Helaissi.

Appointed May 2013. Before his appointment, Mr Helaissi was JP Morgan's head of Corporate Banking for the Middle East and North Africa and its Senior Country Officer for Saudi Arabia. Prior to that, Mr Helaissi held senior positions in three Saudi banks: Saudi British Bank, Saudi Hollandi Bank and Arab National Bank.

Capital markets are regulated by the Capital Market Authority. The CMA regulates the Saudi Stock Exchange (which is commonly known by its Arabic name, 'Tadawul'); it regulates and monitors the issuance of securities; it is responsible for protecting investors and preventing market manipulation and insider trading; and it overseas the activities in Saudi Arabia of rating agencies.

The CMA effectively appoints the directors of the Tadawul, who then elect their own chairman and deputy chairman. (Legally, Tadawul's Board is appointed by the Saudi Council of Ministers on a recommendation by the CMA.)

Chairman of the Capital Market Authority: Mr Mohammed al-Jadaan

Appointed in January 2015. Before his appointment, Mr al-Jadaan was one of three partners of the Al-Jadaan law firm, which has a co-operation agreement with Clifford Chance. He also sat on the CMA's advisory Board. Before founding the Al-Jadaan law firm, Mr al-Jadaan worked at the Riyadh Miliary Hospital. In addition to his B.A. in Islamic law and economy, Mr al-Jadaan has a Masters in Law from the Institute of Public Administration. Mr al- Jadaan replaced Mohammed al-Sheikh who had been appointed in February 2013.

Chairman of the Stock Exchange: Mr Khalid al Rabiah

Elected by directors of the Exchange in February 2014, Mr Rabiah's experience lies primarily in petrochemicals (as CEO of Methanol Chemicals Company 'Chemanol') and Amiantit, the Saudi Arabian pipe manufacturer.

Minister of Finance: H.E. Dr Ibrahim al-Assaf

The Saudi Ministry of Finance conducts the activities that are generally expected of national ministries of finance. In addition, it oversees the activities of state-owned development banks and funds, such as the Agricultural Bank and the Public Investment Fund.

Dr Assaf was appointed in 1996 and has remained in his post following King Salman's accession to the throne in January 2015 – he is one of the longest-serving Saudi ministers. Born in 1949, and with a PhD in Economics from the Colorado State University, Dr Assaf was Saudi Arabia's Executive Director at the IMF for six years before serving briefly as Vice Governor of SAMA and as a Minister of State before taking the finance portfolio. (Strictly speaking, Dr Assaf was Minister of Finance and National Economy from 1996 to 2003 and has been Minister of Finance since 2003. 'National Economy' is now contained with a Ministry of National Economy and Planning.)

Saudi Sovereign Wealth Fund

Saudi Arabia does not have a stand-alone sovereign wealth fund. The government's reserves are held and managed by SAMA. The Sovereign Wealth Fund Institute estimated SAMA's foreign holdings at $757.2 billion in December 2014.

regulations to license credit-rating activity in Saudi Arabia. Although this can be seen as part of a global trend in which domestic capital markets authorities are trying to exert control over global credit rating agencies, the move does indicate that the authorities recognise how important credit ratings will be in the development of their bond and sukuk markets.

The cornerstone of the Saudi financial system has always been – and will continue to be – the banking sector. Well-capitalised, profitable, and strictly and competently supervised, Saudi banks are among the best performers in the Middle East.

At the end of March 2015, the Saudi banking system as a whole showed a loans-to-deposit ratio of 76% – well within SAMA's 85% limit. In simple terms, Saudi banks have more than $40 billion of lending headroom, before they hit the SAMA limit.

No one is expecting any significant changes to the Saudi banking system.

Two new domestic banking licenses have been issued within the last 10 years (to Bank Al-Bilad, which began operations in 2005, and Al-Inma Bank, which began operations in 2008).

SAMA's official position is that it is willing to issue new licenses, both for domestic and foreign banks, but in private officials comment that those who have received licenses have not developed significant amounts of new business: so why issue new licenses?

The most significant development in Saudi banking over the last year was the Initial Public Offering by National Commercial Bank. The $6 billion issue reduced the shareholding of para-statal companies and was a huge success. Yet the issue was engulfed in controversy when some Muslim scholars questioned whether it was permissible for Muslims

	Financial figures, SRmn end-2014						
	Equity	Assets	Net loans	Customers' deposits	Net profit	Senior Executive	Shareholders > 5%
National Commercial Bank	46,920.9	434,878.1	220,722.4	333,095.5	8,793.2	Saeed al-Ghamdi	Public Investment Fund 44%, Public Pension Agency 10%, GOSI 10%
Al-Rajhi Bank	41,896.2	307,711.6	205,940.0	256,077.0	6,836.2	Steve Bertamini	Suleiman bin Abd al-Aziz al-Rajhi Endowment Company 15%, GOSI 10%
Samba Financial Group	38,912.0	217,398.8	124,079.4	163,794.8	5,010.5	Sajjad Razvi	Public Investment Fund 23%, Public Pensoin Fund 15%, GOSI 12%
Riyad Bank	35,537.1	214,589.3	133,490.3	164,079.4	4,352.4	Talal Al-Qudaibi	Public Investment Fund 22%, GOSI 17%, Al-Nahla Company for Trading and Contracting 9%, Public Pension Agency 9%, Masek Holding Company
Banque Saudi Fransi	26,471.3	188,776.9	116,540.7	145,275.2	3,516.3	François Couvegnes	Crédit Agricole 31%, GOSI 13%, Rashed Abd al-Rahman al-Rashed and Sons Company 10%
Saudi British Bank	26,071.2	187,609.3	115,220.8	145,870.5	4,266.1	David Dew	HSBC 40%, Olayan Saudi Investment Company 17%, GOSI 10%, Abd al-Qader al-Muhaidib and Sons Company 5%
Arab National Bank	20,639.8	164,668.4	103,724.0	129,631.2	2,877.2	Robert Eid	Arab Bank 40%, GOSI 11%, Rashed Abd al-Rahman al-Rashed and Sons Company 10%, al-Jaber Trading Company 6%
Alinma Bank	17,939.2	80,861.9	53,637.0	59,427.8	1,264.4	Abd al-Mohsen Al-Fares	Public Pension Agency 11%, Public Investment Fund 10%, GOSI 5%
Saudi Investment Bank	11,852.1	93,626.4	57,472.5	70,733.4	1,436.5	Musaed Al-Mineefi	Public Pension Agency 17%, GOSI 17%, Saudi Ogeh Company 9%, J P Morgan Finance International 7%, National Commercial Bank 7%
Saudi Hollandi Bank	10,741.9	96,619.2	65,147.8	76,813.9	1,820.9	Bernd van Linder	ABN AMRO 40%, Olayan Saudi Investment Company 22%, GOSI 10%
Bank Al Jazira	6,158.0	66,553.9	41,244.6	54,569.3	572.5	Nabil Al-Hoshan	Ittihad al-Ukhuwa Development Company 7%, National Bank of Pakistan 6%, Saleh Kamel 5%
Bank Albilad	5,891.4	45,229.9	28,355.3	36,723.7	864.0	Khalid Al-Jasser	Mohammed Ibrahim al-Siba'i and Sons Company 18%, Abd Allah Ibrahim al-Siba'I Investment Company 11%, Khalid Abd al-Rahman Saleh al-Rajhi 9%, Abd al-Rahman Saleh Abd al-Aziz al-Rajhi 8%, Abd al-Rahman Abd al-Aziz Saleh al-Rajhi 7%

Sources: Financial Figures taken from Darien Analytics GCC Banking Survey, *based on published financial statements. Senior Executive and Shareholders > 5% taken from the website of the Saudi Stock Exchange (Tadawul) accessed on 22 May 2015.*

to buy shares in a bank that paid and received interest as part of its routine business. Although most of NCB's activities were Shari'a-compliant, the bank quickly committed to make all its activities Shari'a-compliant within the next few years, and so side-stepped the scholars' objections.

Of course by far the most significant event in the Kingdom in recent times has been the accession to the throne of King Salman, following the death of King Abdullah in January 2015.

In April, King Salman appointed Mohammed Bin Nayef as Crown Prince and his own son, Mohammed, as Deputy Crown Prince. The two appointments make clear that King Salman will be the last of the sons of Ibn Saud, the founder of Saudi Arabia, to rule the Kingdom, and they clarify how power will be passed to the next generation.

The implications for the Saudi banking and financial sector of this hugely significant development cannot yet be discerned. King Salman has created two key governmental committees to address political issues (led by the Crown Prince) and economic issues (led by the Deputy Crown Prince).

Initial reports indicate that the Economic Committee has been actively questioning Ministers whose portfolios touch on economic matters, and it has been taking particular interest in issues that affect the Kingdom's economic development.

At some point, the Economic Committee will have to turn its attention to the King Abdulla Financial District (KAFD) – a huge area on the outskirts of Riyadh that is supposed to act as a magnet for Saudi financial services, rather as Canary Wharf has done in London. The District's detractors point to vast unoccupied office space and the unwillingness of major institutions to move there, but to its supporters, the District is a clear indication that the Saudi government will put the regulations and the infrastructure in place to enable domestic financial activity to expand and foreign players to enter.

The Economic Committee will also have to consider the management of Saudi Arabia's financial reserves. At the moment, these continue to be managed by SAMA rather than through a sovereign wealth fund. In December 2014, Finance Minister Ibrahim Assaf rejected suggestions that the Kingdom should create a sovereign wealth fund, but the fact that he made such a public statement was indicative of pressure building to change the way in which the reserves are managed.

Power in Saudi Arabia is passing to a younger, more technocratic generation. No one should expect quick changes or dramatic initiatives – that is not the Saudi way – but over the medium term, this new generation will have a profound impact on the way financial activity is conducted in the Kingdom. ■