The Impact of Globalization on Saudi Capital Market

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Abstract

This paper studies the impact of globalization on Saudi capital market. It mentioned that the traditional role of Saudi exchanges has been changed to be able to compete in the era of globalization. The Exchange embarked on aggressive modernization plans, which will set it as one of the leading markets in the Middle East North Africa region and benefit globalization.

Introduction

The stock market is one of the most important channels of the Kingdom's capital market. In Mid 1980s, the government entrusted the supervision of all share trading operations to SAMA, and authorized commercial banks to act as brokers. With the introduction of the Electronic Share Information System (ESIS) in 1990, the share market witnessed a great development in all its operations. This was followed by steps to improve and update the dissemination of market information.

The Saudi capital market is the largest in the region in terms of market capitalization. By the end of December 2003, it was ranked first with$ 159 billion. In addition, Saudi Arabia is the largest free market economy in the Middle East and North Africa, holding 25% share of the total Arab GDP, the world's 25th exporter / importer and has also the biggest oil reserves in the world (25 percent). Despite several external shocks, ambitious reforms to liberalize the economy further, strengthen its institutional capacity, and prepare for accession to the World Trade Organization (WTO) are well under way and should contribute to further economic resilience.

The aim of this paper is to address the impact of globalization on Saudi capital market. The first section of the paper presents an overview of Saudi securities settlement systems. The second section focuses on the impact of globalization on Saudi capital market.

1. Saudi Securities settlement systems

1.1 Debt market

1.1.1 Government Development Bonds

Government Development Bonds (GDBs) were first offered to domestic banks and some special government agencies in June 1988. Ever since the government began to offer GDBs in the primary market, the authorities have been endeavoring to develop a secondary market for GDB trading. For this purpose, SAMA and primary dealers have jointly established procedures governing the market-makers' role.

Domestic banks play several important roles: as investors; as distribution agents; as secondary market-makers; and as sub custodians/paying agents. Banks have found it convenient to buy GDBs and hold them to maturity, particularly as the yield curve has continued to steepen. A small portion of GDB holdings has, however, been earmarked for trading. Secondary market trading is settled through SAMA.

1.1.2 Treasury bills

Treasury bills replaced Bankers' Security Deposit Accounts (BSDAs) in November 1991. BSDAs were SAMA obligations created in 1984 as a part of domestic money market reform. Treasury bills can be used by the banks for sale and repurchase arrangements with SAMA to raise liquidity in the amount of up to 75% of their gross Treasury bill holdings.

1.2. Money market

Instruments in the riyal money market are limited to deposits and Treasury bills. Treasury bills are used by the banks as short-term investment vehicles and are viewed as an additional cushion for raising liquidity from SAMA through sale and repurchase agreements. The inter-bank deposit market is up to one year, with the bulk of business taking place in shorter maturities. There is an active foreign exchange swap market, which complements banks' funding/placing operations. The market determines interest rates.

Historically, domestic banks have been net lenders of riyal deposits. Among derivative products, the banks have recently been focusing on riyal FRAs, interest rate caps/floors and currency options, mainly for customer-related operations.

1.2.1. Floating rate notes (FRNs)

Riyal FRNs were introduced in late December 1996 to broaden the range of available instruments and diversify the price risk. FRNs suit the banks' balance sheet structure, particularly in a rising interest rate environment. For the issuer, FRNs are a commonly used financing tool as they attract longer maturities at short-term funding cost. In order to raise financing requirements smoothly, the investment choice among floating and fixed rate instruments is quite helpful. 14 CPSS - Payment systems in Saudi Arabia, 2003.

1.2.2. Trading and settlement

SAMA uses a book entry system for GDB settlements because of the low cost and eases of administration. GDBs, carrying fixed coupons for two- to 10-year maturities (two, three, five, seven and 10), are offered to the domestic banks and some institutions every second Monday of the month. SAMA issues invitations to subscribe on Monday and the banks/institutions respond by Tuesday for settlement Wednesday. The subscription amount is deducted from the current accounts of the banks/institutions in SAMA's books against GDBs posted to their securities accounts. Resident and non-resident investors are eligible to buy GDBs through the domestic banks. One of the most important features linked to GDBs is SAMA's overnight repurchase facility, under which primary dealers are allowed to sell for repurchase up to 75% of their gross GDB holdings. The repurchase agreement is based on the nominal value of the issue. Banks receive discounted funds credited to their current accounts with SAMA. Treasury bills (discounted instruments) are offered by SAMA to the banks every Tuesday, for response on Wednesday and settlement on Thursday. The subscription amount is deducted from the subscribers' current account in SAMA's books and the Treasury bills are

added to their securities account. There are no restrictions on Treasury bill trading or ownership.
FRNs are currently issued every month in five- and seven-year maturities at three-month Sibor plus a spread. Spreads are advised to the banks on the last Saturday of the month and coupons are fixed the following Monday for settlement on Wednesday. The payment and delivery procedure is identical to that for GDBs. All debt market transactions are settled over SARIE on a gross basis.

1.3. Equity market

Saudi joint stock companies had their beginnings in the mid-1930s, when the first such company, the Arab Automobile Company, was established. By 1975 there were 14 public companies. The rapid economic expansion and Saudization of foreign banks in the 1970s led to the establishment of a number of large corporations and joint venture banks. Major share offerings were made to the public during this period.
The market remained informal until the early 1980s, when the government embarked on a rapid development program. A ministerial committee, comprising the Minister of Finance, the Minister of Commerce and the Governor of SAMA was formed in 1984. The Committee is responsible for the regulation and development of the securities market in Saudi Arabia.
The Securities Supervisory Committee, composed of senior representatives of the two ministries and SAMA, reports directly to the Ministerial Committee. The Securities Supervisory Committee supervises, and issues the regulations governing, the securities market. SAMA, through its securities.
Control Department is responsible for the day-to-day operation and regulation of the market. The Ministry of Commerce is directly responsible for primary market offerings and regulation and supervision of joint stock companies. The Regulations for Companies were issued in 1965 and have been amended several times. With the aim of improving the regulatory framework, share trading intermediation was restricted to commercial banks. In 1984 the Saudi Share Registration Company (SSRC) was established by the commercial banks. The SSRC provides central registration facilities for joint stock companies, and settles and clears all equity transactions. Automated clearing

and settlement was introduced in 1989. In 1990 the Electronic Securities Information System (ESIS) was launched. This was an electronic floorless share trading and settlement system operated and supervised by SAMA. ESIS almost entirely dematerialized share trading.

Between 1990 and 2000 the transactions traded, in terms of both volume and value, increased dramatically. Market capitalization has increased by 160% and the all share index has increased by 130%. ESIS has now been replaced by TADAWUL. TADAWUL (an Arabic word which means “exchange”) was launched during 2001, and is the new service for the trading, clearing and settlement of shares in Saudi Arabia.

TADAWUL provides for the opening of accounts at both the banks and the depository. Each investor must open an account either with a bank (this is referred to as a Member Account) or directly with the depository (this is referred to as a Global Account). Investors may open several Member Accounts with several banks, but an individual investor may only open one Global Account with the depository.

Investors receive from their banks on a regular basis a statement of all transactions and holdings. Investors may only trade through the banks where they have opened accounts.

TADAWUL supports all types of corporate actions. An increase in the number of shares resulting from a corporate action is immediately reflected in the account (or accounts) of the shareholder (investors do not have to collect or wait for the delivery of certificates). Rather than waiting for cheques, cash dividends can be paid directly into the bank account designated by the investor.

1.3.1 Trading and settlement

Step 1: Buying and selling investors submit orders via the bank where their accounts are maintained. This may be achieved directly by visiting the bank, or through delivery channels such as the internet. These orders represent the agreement between the bank and the investor to execute a specific business transaction. TADAWUL automatically validates availability of the shares and investor details.

Step 2: Orders are entered into the bank's order management system (OMS), providing banks with an effective way of managing and tracking investor orders. In accordance with market conditions and the requirements of the investor, the orders in the bank's OMS are forwarded to TADAWUL via a high-speed network.

Step 3: TADAWUL attempts to match orders according to price, and then time priority. A variety of order types and special terms are available to the investor. Unmatched orders are maintained in TADAWUL until they match, are taken out of the market or expire.

Step 4: From matched orders, trades are generated and reported electronically to the central securities depository.

Step 5: A trade results in the immediate transfer of shares from the account of the seller to the account of the buyer. All trading is conducted in dematerialized form. Cash transfer is performed via the national real-time gross settlement system, SARIE.

1.3.2. Use of securities infrastructure by the central bank

The Limits and Collateral Policy issued by SAMA sets out the rules governing intraday limits for the SARIE system. The policy states that the intraday overdraft limit must be fully collateralized by Saudi Arabian government-issued instruments which can be readily liquidated and over which SAMA has jurisdiction. The policy lists the instruments that are allowable as collateral. These are:

- Government Development Bonds - 100% of face value;
- Treasury bills - 100% of face value;
- Special bonds - 100% of face value;

١.4. Capital market

1.4.1. Main market indicators

Since the regulation of share trading through commercial banks in over the Chart 21985, the share market has witnessed significant growth period from 1985 to the end of September 2001, the number of shares traded has increased by more than 14,825 percent, increased by 151 percent at the end of 2002 compare with 2001, and by 221 at the end of 2003 compare with

2002. The value traded has gone up by 9,048 percent, increased by 60 percent at the end of 2002 compare with 2001, and by 346 percent at the end of 2003, compare with 2002. The market capitalization of issued shares has risen by 290 percent by the end of 2002, compare with 2001, and by 110.14 percent at the end of 2003 compare with 2002. The general share price index increased to 2,311.4, and increased by 3.62 by the end of 2002 compare with 2001, and by 76.23 percent at the end of 2003 compare with 2002. Over 1.6 million individuals have invested in the shares of Saudi joint-stock companies. Development and growth have encompassed all areas of the Saudi economy, including investment funds which have recorded a great expansion in their investments and the number of their subscribers which grew by an annual rate of 20 percent during the period 1992-end of 2003. The number of floated funds rose from 52 to 151 and their total investment assets increased from SR 12.4 billion to SR 52.23 billion during the same period.

Table (1)
SHARE MARKET INDICATORS

End of Period	Number of Shares Traded (Million)	Value of Shares Traded (Million Rls)	Market Value of Shares (Billion Rls)	Number of Transactions	General Index 1985 = 1000
1985	4	760	67	7,842	690.88
1986	5	831	63	10,833	646.03
1987	12	1,686	73	23,267	780.64
1988	15	2,037	86	41,960	892.00
1989	15	3,364	107	110,030	1,086.83
1990	17	4,403	97	85,298	979.80
1991	31	8,527	181	90,559	1,765.24
1992	35	13,699	206	272,075	1,888.65
1994	152	24,871	145	357,180	1,282.90

1995	117	23,227	153	291,742	1,367.60
1996	138	25,397	172	283,759	1,531.00
1997	312	62,060	223	460,056	1,957.80
1998	293	51,510	160	376,617	1,413.10
1999	528	56,578	229	438,226	2,028.53
2000	555	65,292	255	498,135	2,258.29
2001	691	83,602	275	605,035	2,430.11
2002	1,736	133,787	281	1,033,669	2,518.08
2003 Q1	481	44,107	367	358,246	2,779.10

Source: Saudi Arabian Monetary Agency. 39th annual report, 2003

Table (2)

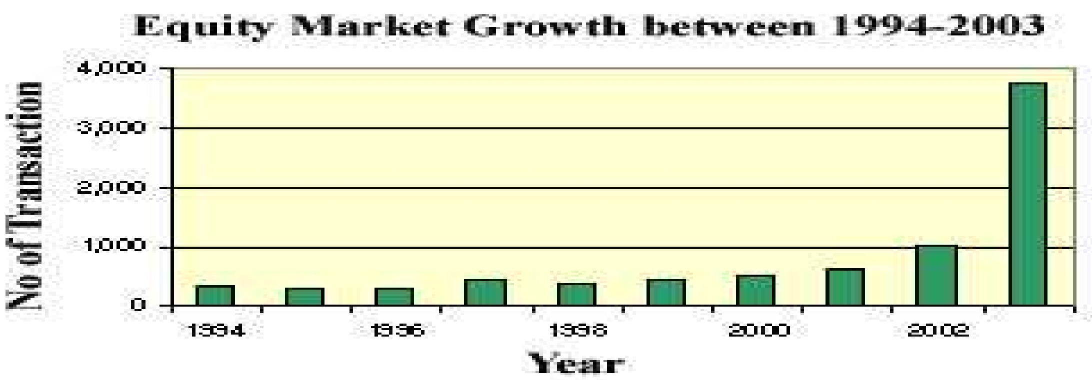
Year	Transactions (SAR k)	Shares Traded (SAR mn)	Market Cap (SAR bn)	Market Cap (USD bn)	All Share Index
1994	357	152	145	39	1,282
1995	292	117	153	41	1,368
1996	284	138	172	46	1,531
1997	460	314	223	59	1,958
1998	377	295	160	43	1,413
1999	438	528	229	61	2,029
2000	498	555	254	68	2,258
2001	605	692	275	73	2,430
2002	1,034	1,736	281	75	2,518
2003	3,763	5,566	590	157	4,438

Source: Saudi Arabian Monetary Agency

Figure (1)

Source: Saudi Arabian Monetary Agency

Figure (2)



Source: Saudi Arabian Monetary Agency

Figure (3)

Source: Saudi Arabian Monetary Agency

1.4.2. Market participants

Currently, 11 commercial banks are operating as brokerage firms in exchange. In addition, 151 local open-end funds, 1 pension fund, and The Public Investment Fund are currently operating. The 70 companies listed on the stock exchange by the end of 2003, include diversified range of industries including telecoms, financials, cement, food, building, agriculture, chemicals, pharmaceuticals, etc.

The Public Investment Fund (PIF) has a sizable portfolio of holdings in about 24 domestic listed companies. A process of divestment started In December 2002 with the sale of a 30% stake in the Saudi Telecom Company, which raised about $4 billion. Central government debt currently stands at about 95% of GDP, but more than 80% of it is medium- and long-term and held by the pension funds, the PIF, and other government institutions. Consequently, on a consolidated basis, general government debt is relatively low, at about 20% of GDP at year-end 2002. Taking into account a conservative estimate of the governments listed and unlisted equity investments domestically and abroad, Standard & Poor's estimates that the government is currently a net creditor at a level equivalent to about 54% of GDP, and expects this position to remain broadly unchanged up to 2005.

2. The impact of globalization on Saudi capital market

In reaction to the global technological advancements in business, the Saudi capital market is being forced to update, consolidate, and expand its activities. Globalization has affected Saudi capital market in the following:

2.1. Market Deregulation

There are no restrictions on foreign investment, no restrictions on foreign exchange and repatriation of capital and profits, and no taxes on capital gains, dividends or repatriation of earnings.

In 1997, foreigners with or without local participation, were allowed to participate in the Saudi equity market through the Saudi Arabian Investment Fund (SAIF), instituted in London. Since November 1999, foreigners have also been allowed to participate in the Saudi equity market through open-end mutual funds offered by Saudi banks. GCC citizens are permitted to directly invest in the Saudi equity market. Foreigners enjoy full market access and suffer no restrictions on capital mobility or convertibility. Saudi Arabia has no foreign exchange curbs, allow companies to carry forward losses indefinitely, effectively relieving businesses of the tax burden until they become profitable. The Kingdom is signing agreements with an increasing number of with countries, to provide relief from double-taxation.

The Kingdom is drastically revising its business-related laws to increase transparency and strengthen the country's global competitiveness. The laws currently under revision include the Capital Markets Law, the Companies Law, the Agency Law, the Insurance Law, the Mining Law and the Labor Law. Several laws are currently under revision with the aim of pushing forward the process of economic liberalization. In May 2001 the government also issued guidelines for transparency of economic and fiscal data. In addition, a new Supreme Economic Council (SEC) was created in 2001 to speed up economic reforms aimed at opening Saudi markets and ensure stability for investors.

2.2. Market surveillance and investor protection and fairness

The Exchange undertook serious steps in order to enhance investor's protection in the market. Effective security relies on the development and implementation of adequate security policies and security measures for processes within the bank, and for communication between the bank and external parties. Security policies can limit the risk of internal and external attacks on Internet banking systems, as well as the reputation risk arising from security breaches.

A security policy states management's intentions to support information security and provides an explanation of the bank's security organisation. It also establishes guidelines that define the bank's security risk tolerance. These include administrative guidelines, user guidelines and contingency procedures. The policy may define responsibilities for designing, implementing, and enforcing information security measures, and it may establish procedures to evaluate policy compliance, enforce disciplinary issues, and report security violations.

In addition, the Kingdom is a signatory to various regional agencies guaranteeing a level playing field to foreign investors. The Kingdom is a member of the Multilateral Investment Guarantee Agency (MIGA). The Kingdom, hence, ensures the same treatment, protection and incentives accorded to a national capital.

2.3. The market is becoming more dominated by financial institutions

such as mutual funds, pension funds etc. Globalization is accompanied by institutionalization. By the end of 2003 first quarter, 151 local open-end mutual funds with total assets of SR 50.23 billion (34.05 billion as global investments, and 16.18 billion as local investments), were operating by Saudi Banks, confront with 52, with total assets of 12.4 billion Saudi Rials in 1992. The Public Investment Fund (PIF) has a sizable portfolio of holdings in about 24 domestic listed companies. Central government debt currently stands at about 95% of GDP, but more than 80% of it is medium and long-term bonds are held by the pension funds, the PIF, and other government institutions.

2.4. Technology

Saudi Arabia has automated its traditional stock exchanges, using technological advancements in telecommunications in connecting dealers locally, and all over the world, so, that orders can be promptly executed; money has become enormously mobile with the touch of a computer, irrespective of national borders. It transmits real life information on prices, which allows investors to monitor global markets and assess the impact the information will have on the risk/return profile of their investments. The Saudi stock exchanges have benefited from the automation to improve the operation efficiency, accuracy of trading, settlement processing, information dissemination in addition to enhancing surveillance and better tracking of trades. In the late 1980s SAMA introduced two key initiatives, important for further rapid development of the payment systems in the Kingdom.

First: it required all Saudi banks to use the SWIFT network for international payments, and

Second: in 1990 it launched the Electronic Securities Information System (ESIS). The latter is an electronic floorless share trading and settlement system that is operated and supervised by SAMA. This system, which has almost entirely dematerialized share trading, achieves T + 1 settlement as standard, and will soon be moving to delivery vs. payment (DVP).
Since installing the settlement system in 1989, ESIS has experienced considerable architectural changes to meet the dynamic business requirements. These changes have been very positive to the functionality of ESIS. In developing its Electronic Securities Information System, SAMA opted for a floorless stock exchange for numerous benefits it provides. It concentrates all local securities trading into one single market. The system that supports this market provides the means by which investor orders and data are captured, trades are executed and settled before transfer of ownership instructions are sent to company registrars.
The system makes available to authorized users up to minute price information on all securities in the market. It also facilitates the capture and dissemination of listed companies, information and market statistics that are needed to support investment decision.

Despite these advances, inter-bank settlements until early 1997, continued to be affected by cheques clearing or account transfer at SAMA's head office and branches. This suffered from all the inefficiencies and risks associated with a paper based system. Consequently there was a clear need for an Electronic Funds Transfer (EFT) system that would permit automated inter-bank payments and settlements and become the backbone of the Saudi payments system. SAMA recognized that such a system would need to combine the functionality of both a high value and a high volume payment system that would be the cornerstone for its future payment system strategy.

2.5. Capital raising

More companies (15 companies, including National Commercial Bank, National Company for Cooperative Insurance, which will all add about 14% to the market capitalization) will tap the market, motivated by the need to raise capital, as well as the desire to obtain higher valuations, increase their shareholder base and raise their company's profile via listing on local exchange. In addition, more banks raised their capital (National commercial Bank, Riyadh Bank and Al-Rajhi Bank), and some banks (Saudi Cairo Bank and Saudi United Commercial Bank jointed together in the Saudi United Bank, which was merged with Saudi American Bank), and many companies (Saudi Electricity Companies which jointly established the Saudi United Company for Electricity), were jointed together as a cartel.

2.6. Investor education and creating an investment culture

As banks open up their systems and launch Internet banking, and brokerage, they invariably increase their risk and vulnerability. Consequently, banks are seeing the heightened imperative of building confidence into their digital business systems and relationships.

The very open, connected nature of e-business calls for an increased amount of trust among customers, and Internet banking and brokerage service providers. Trust that an investor's confidential data will remain confidential. Trust that the information supplied to others in a network is correct and of the highest integrity. And trust that systems will be up and running-available 24/7, as needed in Internet time. A way to build this trust is by educating the investors. Banking institutions educate investors in the following areas:

- How to use new products and services. Banks provide sufficient information for their products and services and instructions for their use, e.g. with a demonstration.
- How to avoid security breaches in their transactions.
- Technical matters and the value of technical features.
- How to react in problematic situations, e.g. in the case of a fraud.

To increase the awareness of the general public of the significant role that a stock market plays and the different products on the market, the Exchange has undertaken few programs and has planned several more to be implemented in the future.

Conclusion

The paper presented the Saudi securities markets and focused on recent changes in the Saudi capital markets under globalization. It was shown that Saudi's economic reform as well as more privatization programs had a positive impact on the growth of its capital market. It mentioned the important role of Saudi Banks in capital markets. Furthermore, it was shown that the Saudi Exchange embarked on aggressive modernization plans, which set Saudi Arabia to be one of the leading markets in the Middle East North Africa region and prepares the Exchange to benefit the globalization era.

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