Strategic Directions to Develop Sukuk and Debt Capital Market

هيئة السوق المالية
Capital Market Authority

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Introduction

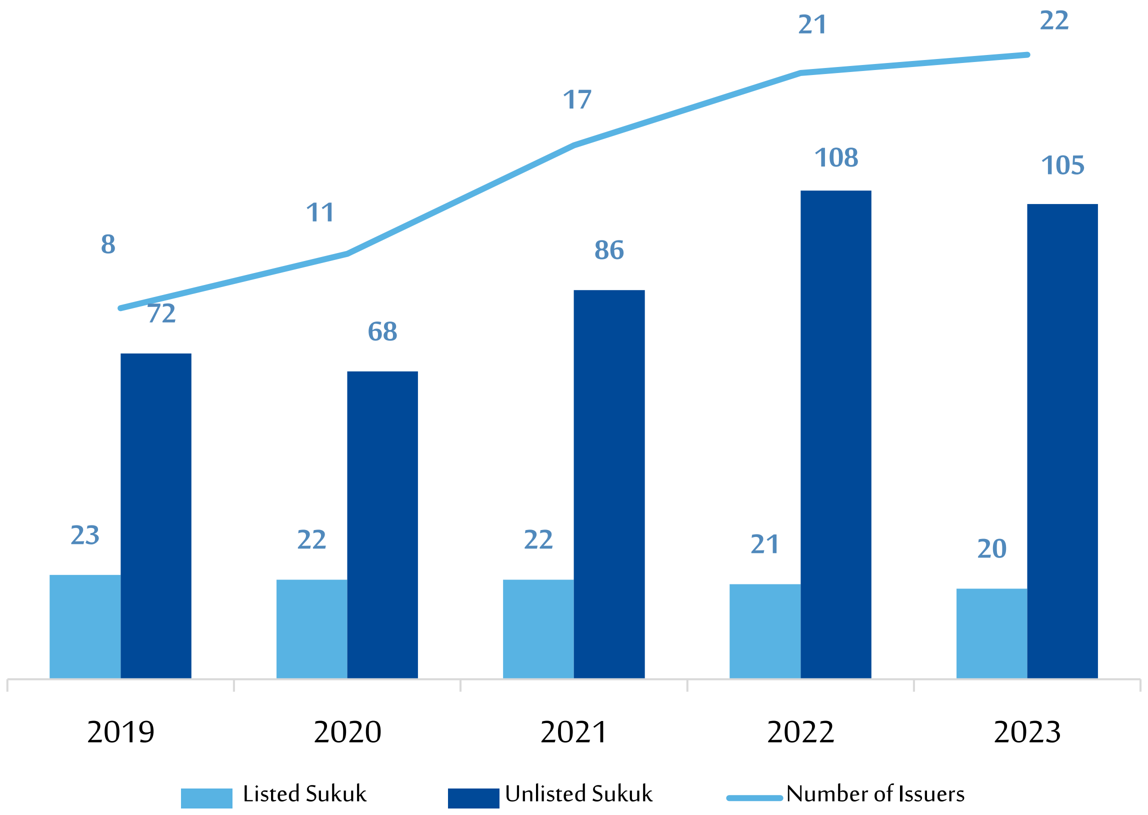
The Capital Market Authority (CMA) seeks to establish a thriving debt market that encourages both government and non-government issuances. In addition, it aims to develop the legal and regulatory environment by providing modern investment mechanisms and products that attract and enable the participation of local and foreign investors. A thriving debt market is essential for contributing to the growth of the economy and its activities. For this reason, and due to the importance of the debt market, the Sukuk and Debt Instruments Development Committee was formed to develop the Sukuk and Debt Instruments Market. The committee is chaired by His Excellency the Chairman of the CMA and operates as a subsidiary committee under the Financial Sector Development Program. Its purpose is to unify the efforts of key stakeholders, including the CMA, the Saudi Central Bank, the National Debt Management Center, the Financial Sector Development Program Office, and the Saudi Stock Exchange Group (Tadawul).

The committee has worked on defining the strategic Directions for developing the Sukuk and Debt Instruments Market to contribute to the achievement of the Financial Sector Development Program's objectives, which is to establish an advanced financial market, particularly in relation to debt instruments. The strategic directions have been determined based on various criteria, including the evaluation of regulatory and infrastructure gaps, benchmarking and best global practices, as well as gathering insights from market participants.

First: Status Quo of the Sukuk and Debt Capital Market

When examining the state of the domestic corporate DCM in recent years, the size of the unlisted corporate DCM has increased, while the market size of the listed DCM has remained stable.

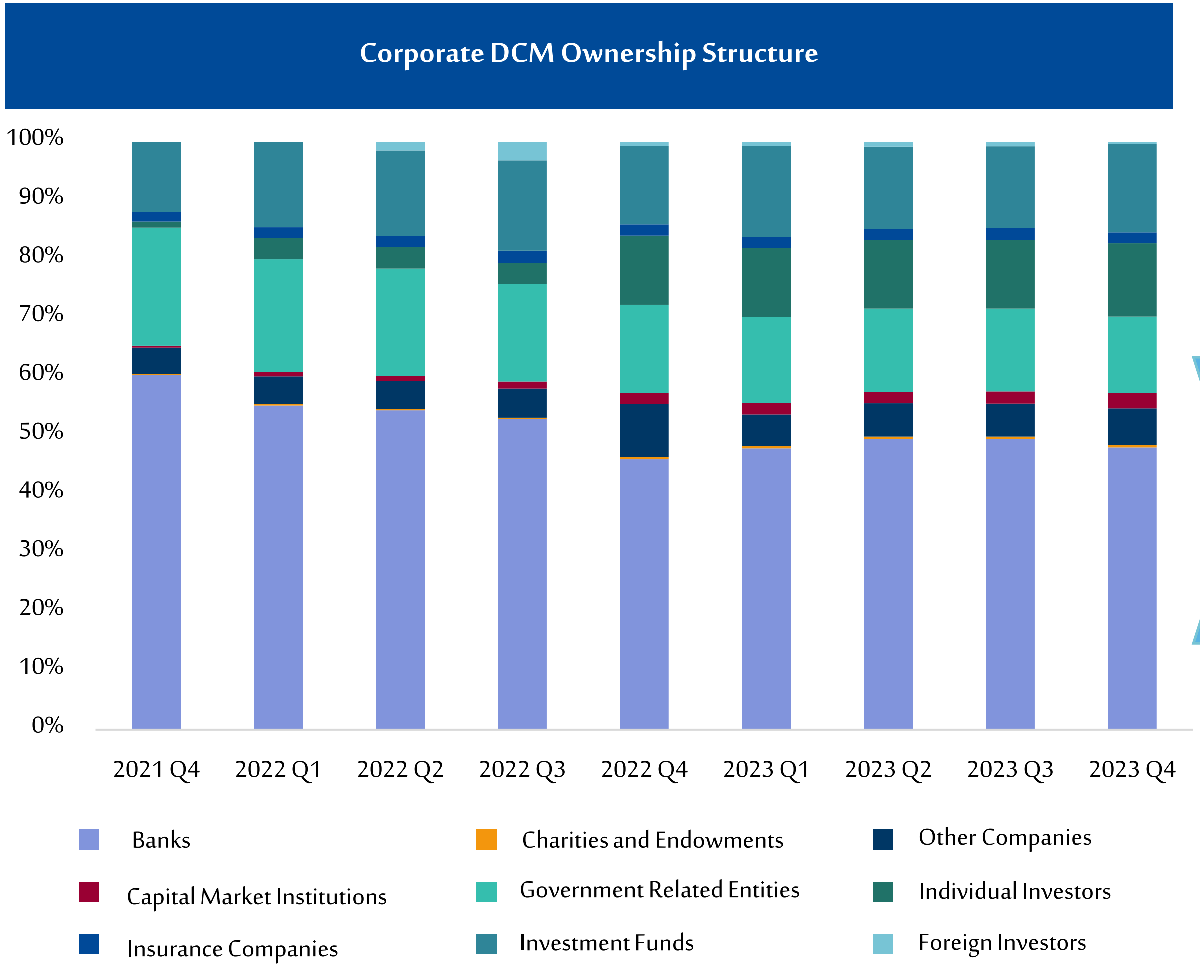
Outstanding Issuers and Issuances (Sar bn)



Source: Edaa

- Since 2019, the size of Sukuk and Debt Market has grew at a 7.9% annual rate. Unlisted issuances have accounted for the majority of this expansion, growing at a 9.6% annual rate. As the market developed, so did the number of issuers also grew.
- The numerous regulatory requirements for the public offering of Sukuk and the debt instruments could be one of the factors contributing to the listed corporate debt market's limited growth. These requirements tend to raise the cost and duration of the offering process, which in turn makes it less feasible and appealing for issuers.
- It should be emphasized that companies have not issued Sukuk and debt instruments through exempted offering, and that the current market size illustrated in the chart includes private placements and public offerings.

When we look at the ownership structure in the market for listed and unlisted Sukuk and debt instruments, it appears banks hold ownership of around half of the outstanding debt issuances.



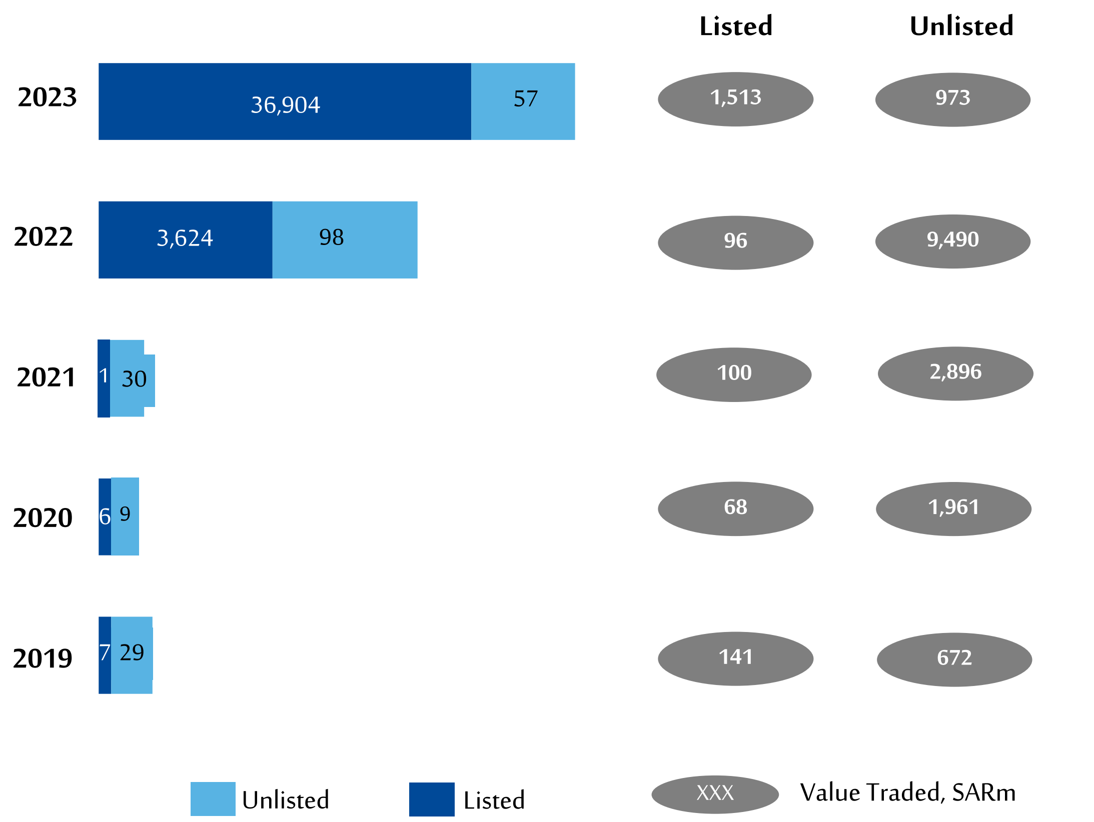
Source: Edaa

- A significant observation that has been made is the increase in the investor base, as seen by the decline in the concentration of banks from roughly 60% at the end of 2021 to 48% at the end of 2023. The share of government entities decreased from 20% at the end of 2021 to 13% at the end of 2023. While the proportion of investment funds increased from about 12% at the end of 2021 to 15% at the end of 2023.

- The proportion of individuals increased from about 1% at the end of 2021 to about 12.5% by the end of 2023, due to the successful completion of a public offering of sukuk in the fourth quarter of 2022, attracting over 125,000 individual investors, which in turn supports the diversification of the investor base in the local sukuk and debt instruments market.

Domestic corporate DCM liquidity was almost non-existent historically, however during 2022 liquidity has seen a noticeable increase.

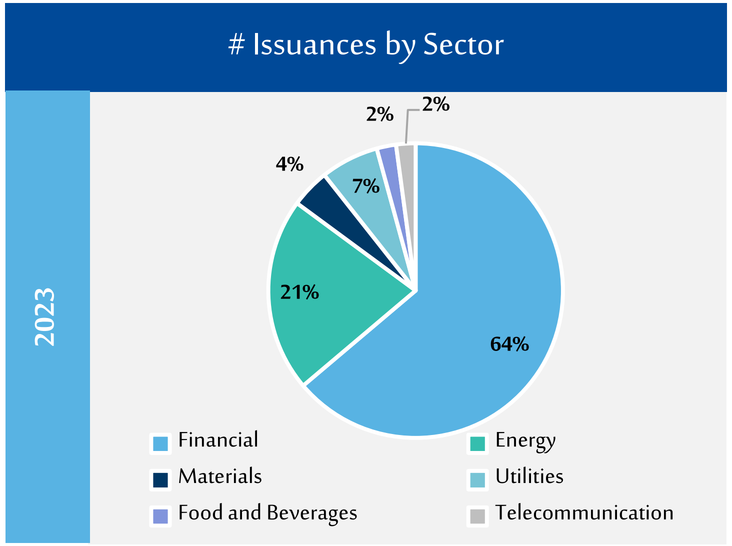
Number of Trades and Value Traded



- Virtually all domestic corporate DCM securities in KSA are held by institutional investors, including 48% by banks, which typically hold bonds/ sukuks to maturity.
- The liquidity of domestic corporate DCM has seen a notable increase during 2022 that can be attributed to a new listing of sukuk issuance which included high retail participation, as well as introducing a revamped and developed unlisted debt instruments and sukuk trading platform by Tadawul Group. However, a decline in value traded appears in 2023, which was affected by a sharp decline in trading of unlisted sukuk and debt instruments, which may be attributed to record high interest rates.

Source: Tadawul

And when taking a look at the sectors issuing sukuk and debt instruments by the end of 2023, it is clear that the financial sector is one of the most active sectors to utilize sukuk and debt capital market as a source of funding, followed by the energy sector.



Sector	Issuances	Issuers	Issuers Average Market Cap (Billion SAR)
Financial	30	11	89,886,419,407[1]
Telecommunication	1	1	202,000,000,000
Utilities	3	2	133,299,793,759
Energy	10	5	9,116,111,646[1,2]
Materials	2	2	89,918,438,727
Food & Beverage	1	1	19,997,576,616

- Concentration of issuances from the financial sector could be attributed to Basel III requirements on financial institutions, as well as banks' willingness to harness opportunities to expand lending.
- Other sectors (other than the financial sector and energy) utilization of the Sukuk and financial instruments market is considered very limited for the telecommunication, utilities, materials, and food & beverage sectors. While the Sukuk and debt instruments market is not utilized completely by a number of other sectors such as capital and retail goods, commercial and professional services, transportation, consumer services, real estate management and development, and software and services.

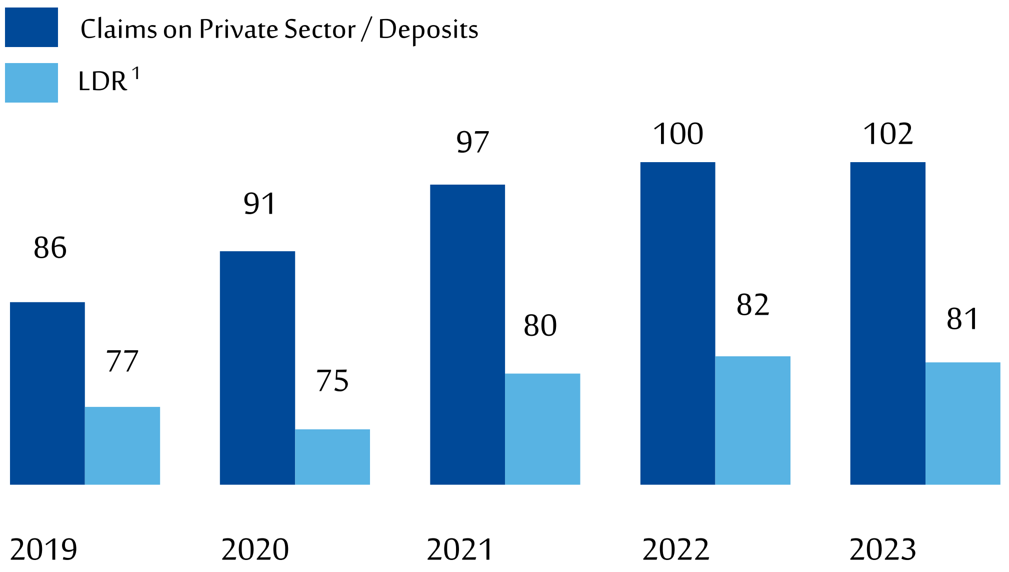
[1]Market cap for unlisted companies were calculated using sector P/E ratio.

[2] Aramco is excluded from issuers average market cap.

Second: Opportunities and Areas of Development

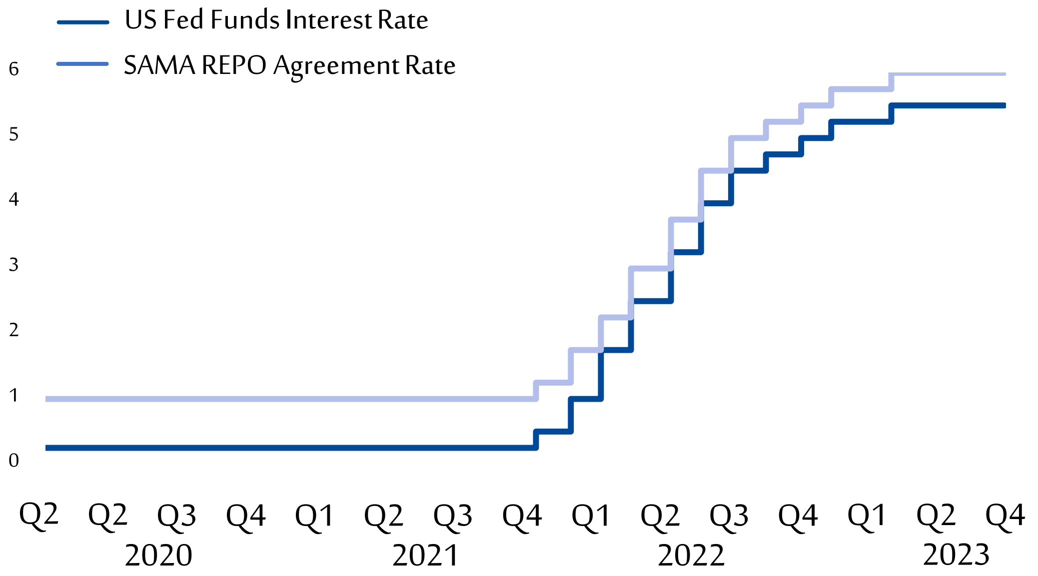
There are number of tailwinds that highlight the importance of the domestic corporate DCM going forward.

Narrowing opportunities for bank deposit funding



Banks deposit have almost reached full potential as funding source

End of quantitative easing globally with rising inflation[2]



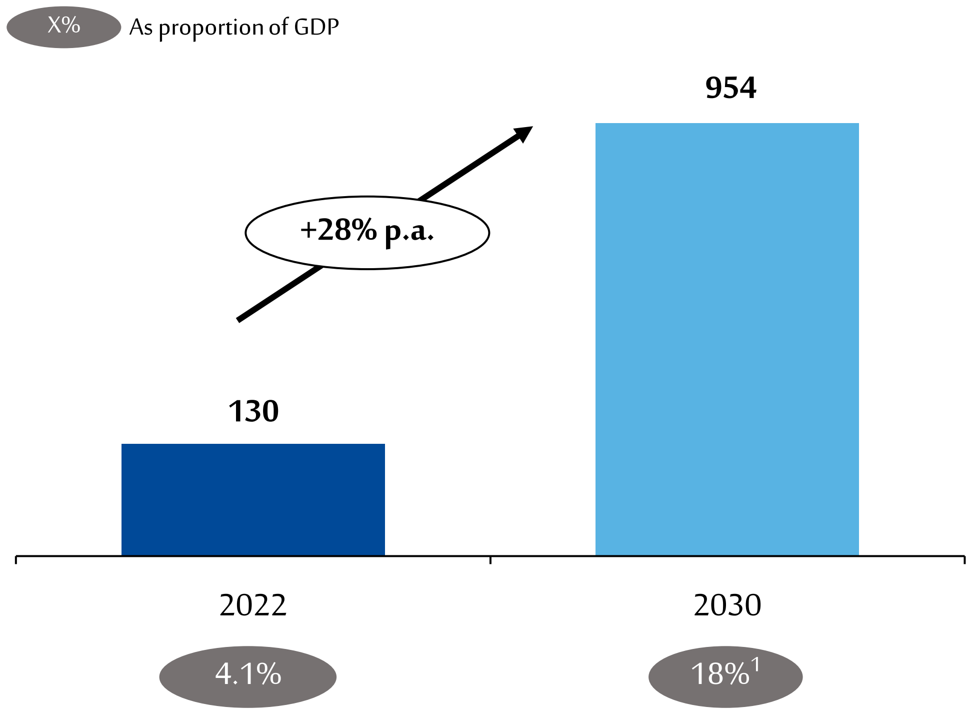
The prolonged period of ultra-low interest rates and abundant liquidity is reversing, both globally and in KSA

[1] Loan/Deposits ratio includes debt instruments in denominator and is capped at 90%, as of June 2023: The mechanism for calculating the loan-to-deposit ratio has been updated by applying weights to long-term debts in addition to deposits.
[2] SAMA, Federal Reserve.

In this context, domestic corporate DCM has a potential to reach 18% of GDP by 2030.

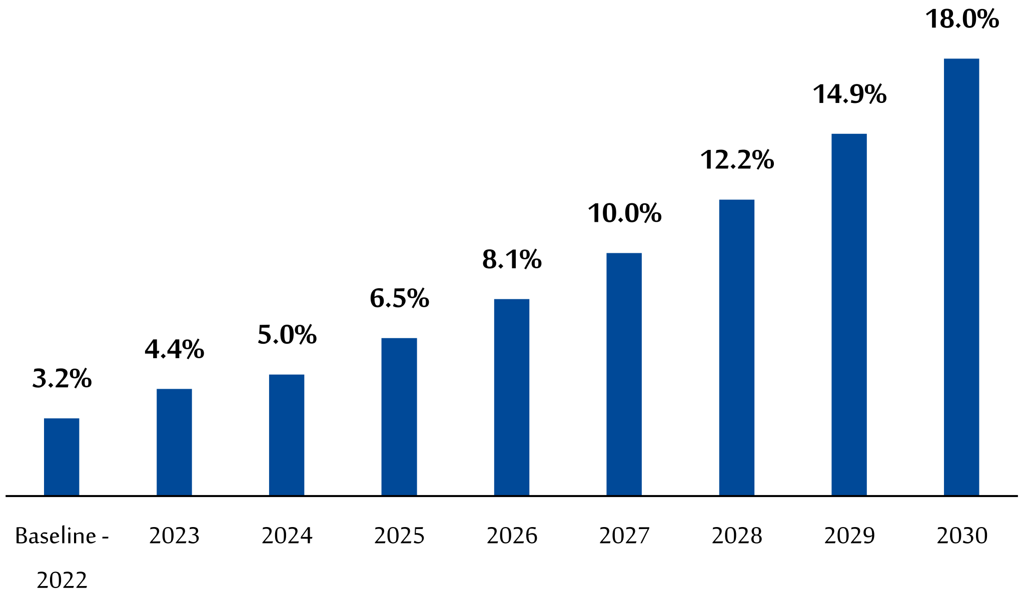
The aspiration is to grow the domestic corporate DCM size to 18% of GDP by 2030

Domestic corporate DCM size, SAR bn



Aspirational targets for size growth , requiring focused efforts to achieve

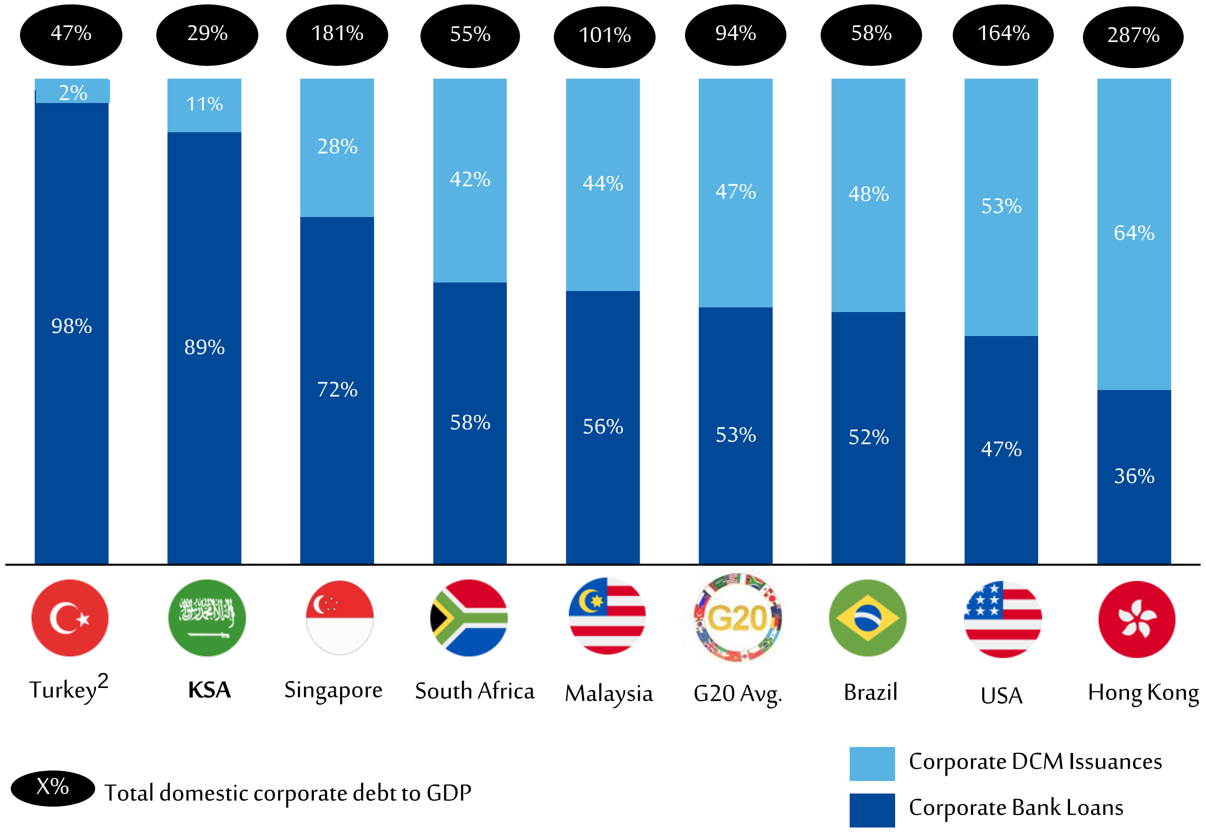
Domestic corporate DCM/GDP



[1] Assuming loan growth in line with nominal GDP, domestic corporate DCM will account to 33% of total domestic corporate debt by 2030.

Historically, borrowers in the Kingdom have mostly relied on traditional bank financing, largely disregarding the domestic DCM.

Proportions of domestic corporate DCM versus bank corporate loans [1]

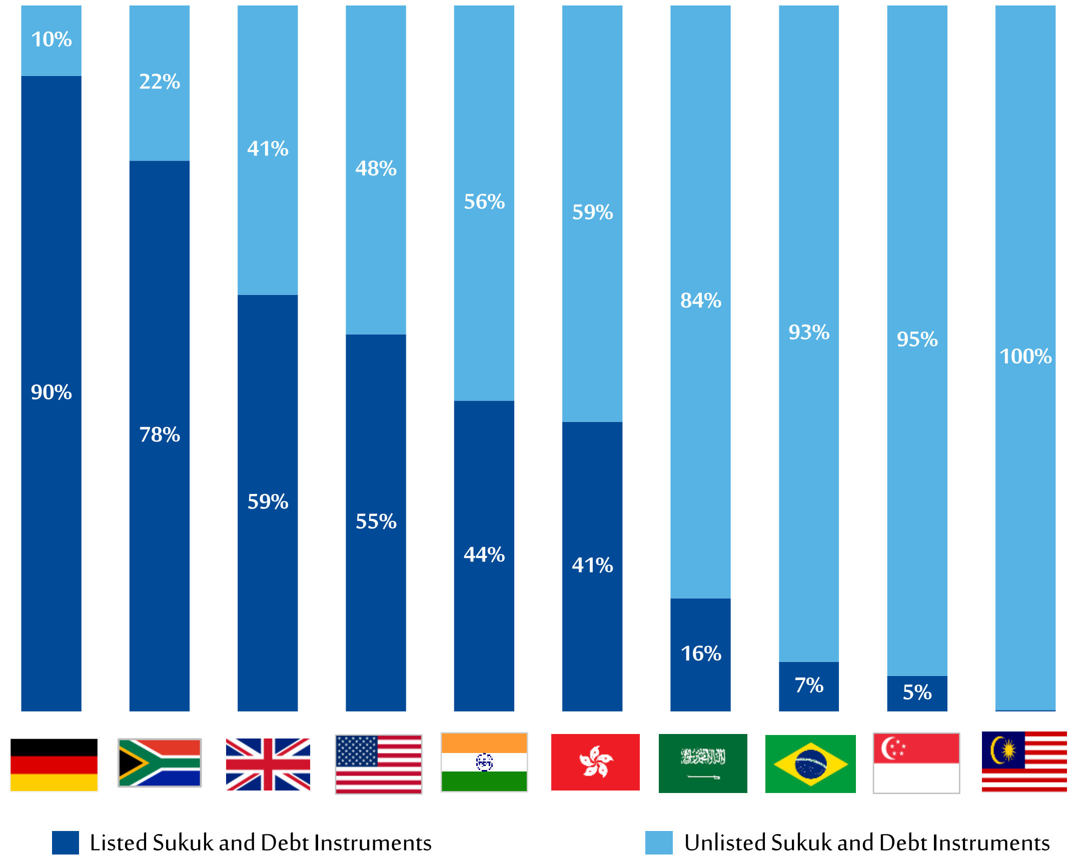


- There is potential to increase the size of the total financial leverage of companies in the Kingdom o through more active use of the domestic DCM as a financing channel, and this is evident by comparing the ratio of total corporate debt to the Kingdom's GDP with the ratio of total corporate debt to the G20's average GDP.
- When comparing the corporate financing mix in the Kingdom, which accounts for only 11% of the debt market, compared to 47% for the G20 average, It is also clear that there is potential to utilize the domestic DCM to finance corporate activities.

1- Based on latest available data, 2021 & 2022.
2- Concentration on bank financing due to lack of diversified investor base and general preference of corporates to be financed via banks, which were exacerbated by unstable domestic currency and tight monetary policy.
Source: National banking regulators.

The majority of corporate debt issuances in developed markets are listed, whereas the majority of corporate debt issuances in most emerging markets are unlisted, within the global practices sample.

The volume of issued debt instruments of listed and unlisted companies as a percentage of the overall volume of issued corporate debt instruments [1]

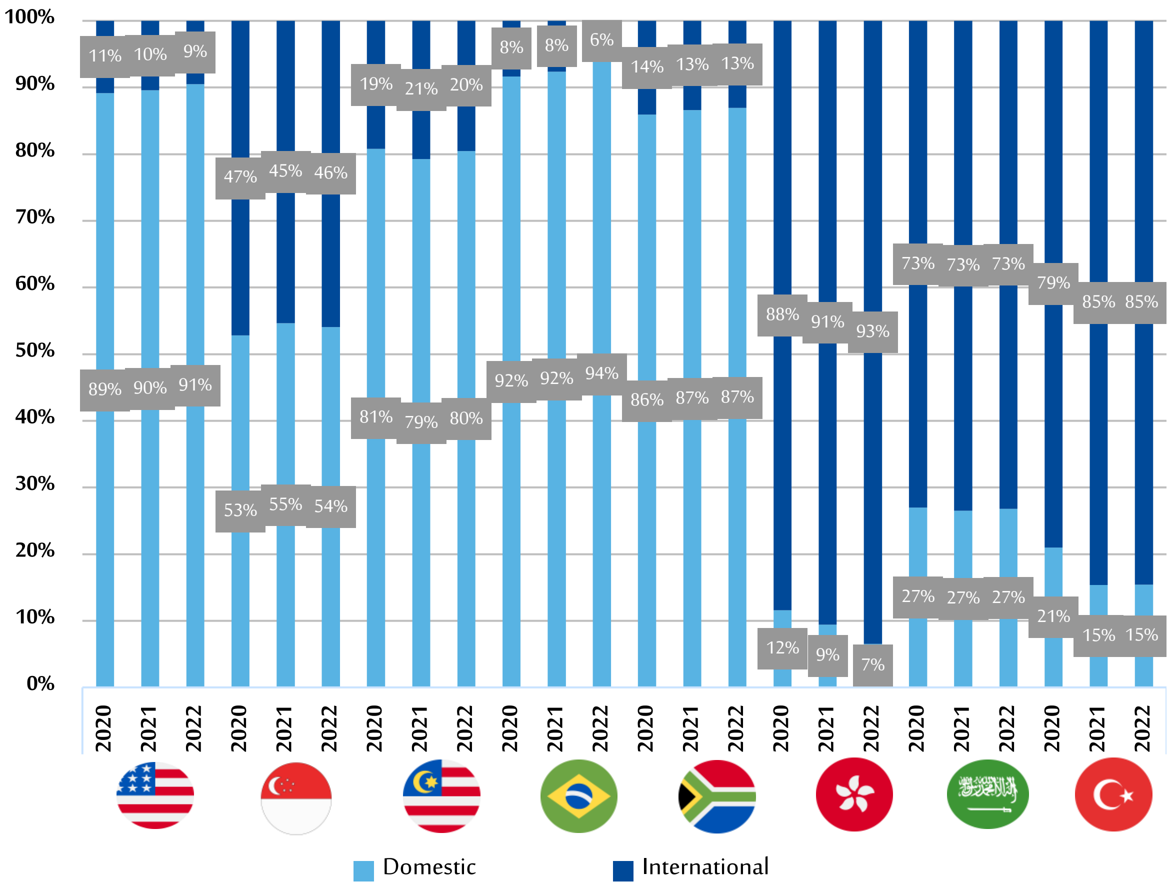


- The graph illustrates that the volume of unlisted debt instruments exceeds the volume of listed debt instruments on six financial markets, whilst the volume of listed debt instruments exceeds the volume of unlisted debt instruments in four financial markets.
- The volume of listed debt issuances in the Kingdom accounts for (16%) of the total size of the corporate debt market, indicating potential for local increase in debt instrument listing when compared to the average of the global practices sample (42%).

[1] At the end of 2023.
Source: Bloomberg

The proportion of local debt instruments issued in relation to the total local and international debt instruments issued by companies in the Kingdom indicates that this mix could be adjusted to be more in line with comparable nations.

Proportions of domestic debt instruments vs international debt instruments



1- Aramco constitutes around 60% of international debt issuance issued by domestic corporates.

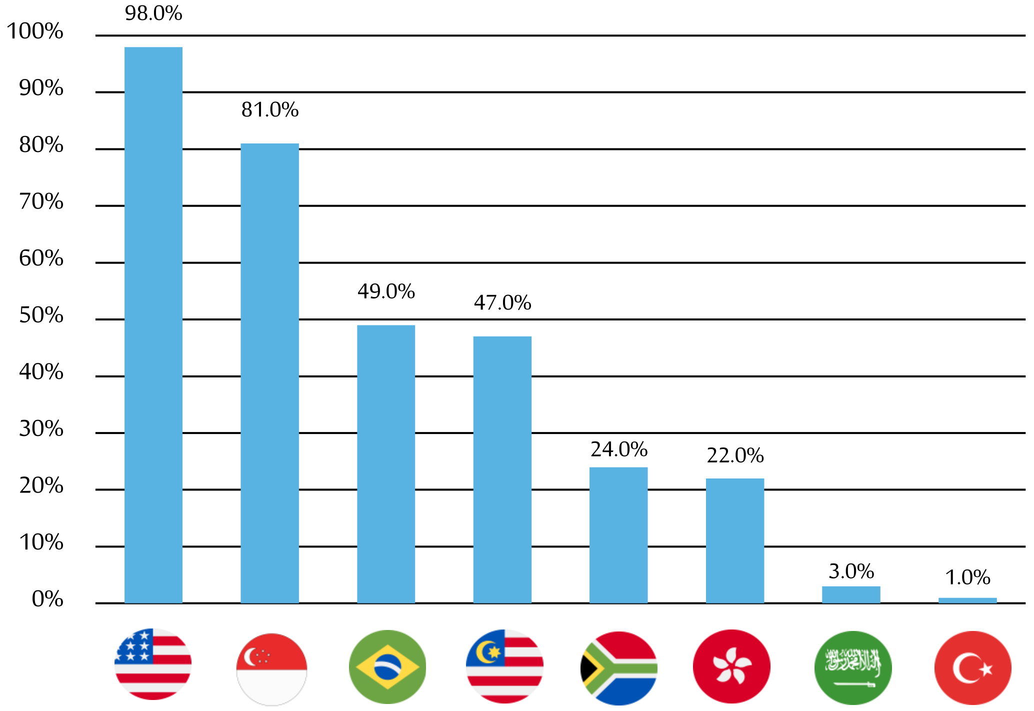
2- Domestic debt instruments refers to debt securities issued by domestic corporates in their respective markets; while international debt instruments refers to debt securities issued by domestic corporates in other markets

Source: Bank for International Settlements, Edaa

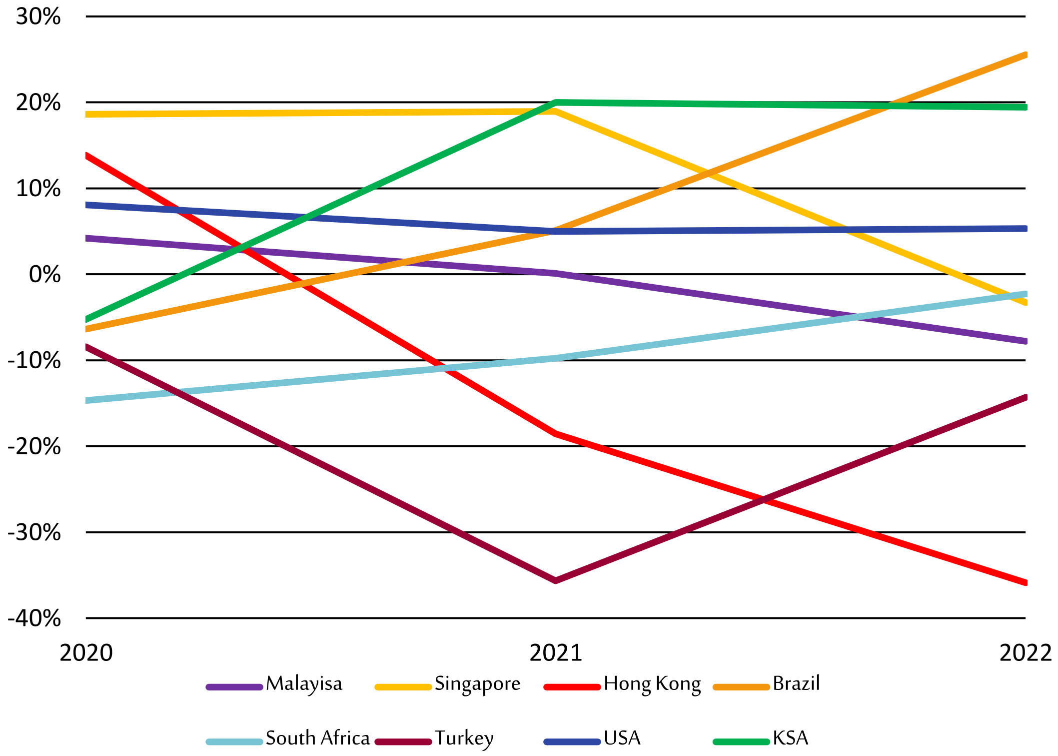
- Although KSA's share of international debt is relatively high, domestic debt has been around 27% of total KSA corporates debt issuances for the past three years.
- Generally, USD pegged currency markets such as Hong Kong and KSA have a common high concentration of international borrowings. With that being said, the development of KSA's domestic DCM can provide opportunities for local debt issuances size to reach 45% out of total debt issuances.
- In Hong Kong, international borrowings are driven by the companies from Mainland China registering HK subsidiaries for international debt issuance. In Turkey, domestic debt market is crowded out by government borrowings.

Despite recent momentum in corporate DCM issuances, KSA domestic market size relative to GDP remains below the benchmarks due to high liquidity in banking sector historically which is expected to fade in the future; while growth trends in the domestic DCMs varied between markets in the recent year.

Domestic Corporate DCM (% of GDP) [1]



Domestic Corporate DCM (YoY Growth)

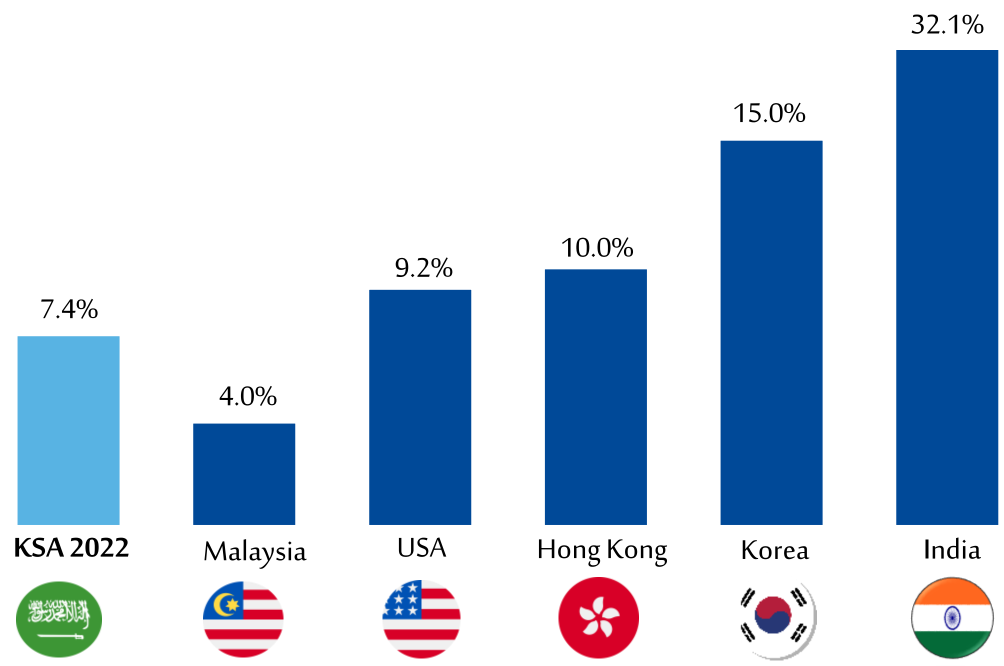


[1] Domestic Corporate DCM refers to Debt Securities issued by domestic corporations in their respective markets. Data as of 2022, and includes asset-backed securities.

Source: Bank for International Settlements, Tadawul

When comparing the turnover rate of the domestic DCM with international markets, it appears that there is potential to develop domestic DCM liquidity to levels in line with other international markets.

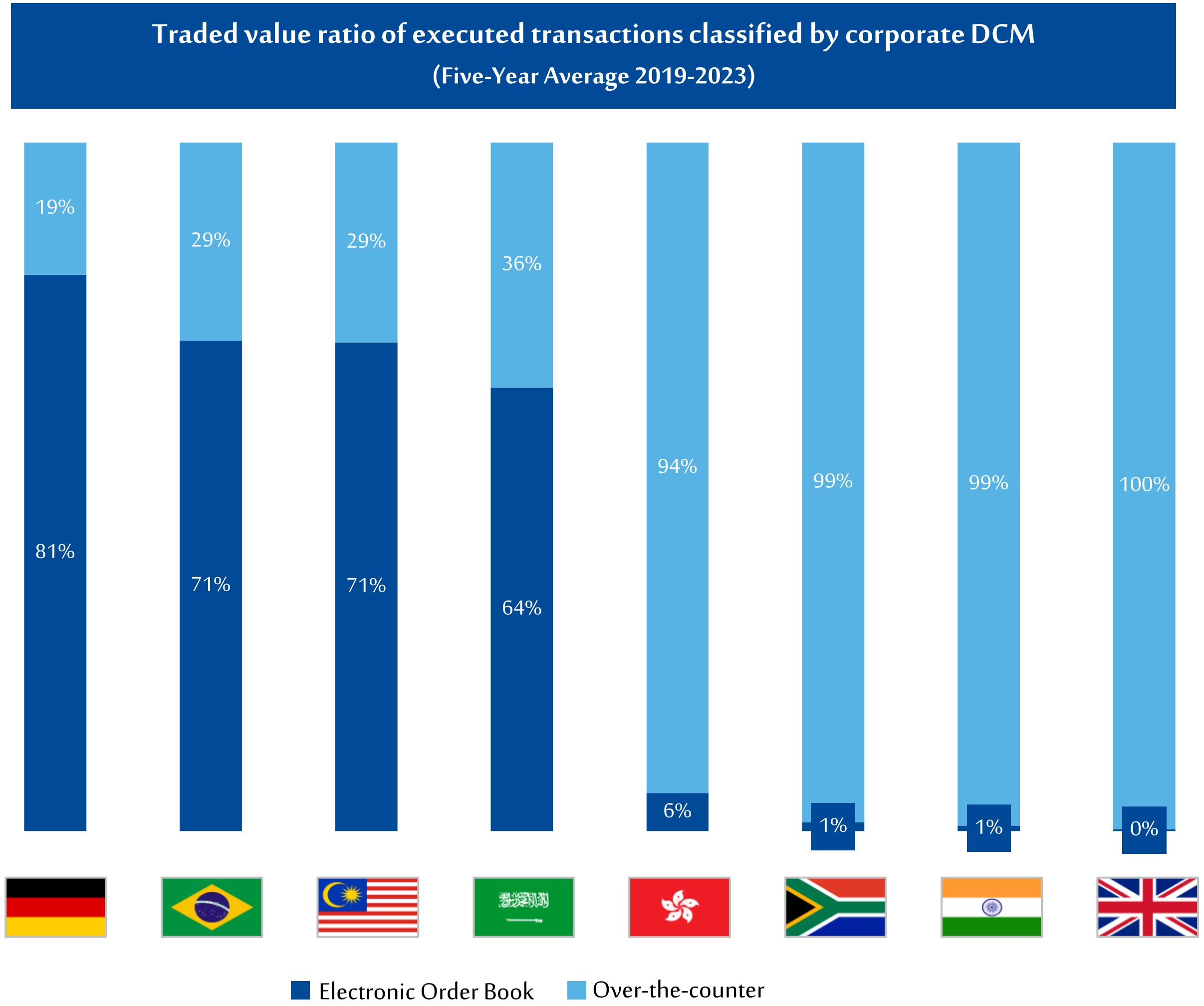
Corporate DCM Turnover[1]



- Given that the domestic corporate DCM turnover rate is still far from the average turnover rate in other markets (14%), it is evident that there is potential to improve liquidity levels to align with international markets with active DCM.

1- Data at end- 2022. It is also worth noting the sample of benchmark is limited due to lack of published data in regard domestic corporate DCM trading.

Also, when looking at Corporate DCM transactions executed globally, it is clear that there is a discrepancy in the types of prevalent executed transactions between over-the-counter transactions in four markets and electronic order book transactions in three markets.



Source: Tadawul, World Federation of Exchanges

- The dependence on the type of transactions varies between international practices, with four markets relying on over-the-counter transactions (UK, South Africa, India, and Hong Kong) and three markets relying on order book transactions (Malaysia, Germany, and Brazil) in line with the Kingdom.
- Over-the-counter transactions dominate corporate debt instruments in the most active markets, such as the United Kingdom, the United States, India, and South Africa, where they are traded in large quantities and comprise a wide range of issuances that require flexibility in settlement and negotiation.
- Some other markets rely heavily on order book transactions to enhance transparency, liquidity, and efficiency due to the simplicity of trading various investor segments and the relatively low costs associated with it. While over-the-counter transactions are still used to trade certain types of sukuk and bonds that may require greater flexibility in trading and settlement.

The financial sector accounts for the majority of local and international issuances of sukuk and debt instruments globally, yet many other sectors issue to fund their businesses, including utilities, luxury retail, and industrial. Despite the nature of other sectors that usually benefit from Sukuk and debt offerings globally, this has not been reflected in the Kingdom due to several factors, including historically high liquidity in the banking system and the level of awareness about the DCM as a funding channel.

	USA	UK	South Africa	Singapore	KSA	Malaysia	India	Hong Kong	Germany	Brazil
Utilities	3.0%	0.8%	-	2.2%	8.8%	4.0%	4.7%	1.2%	0.1%	4.5%
Technology	1.5%	0.3%	-	0.5%	-	0.7%	1.3%	-	0.1%	0.6%
Materials	1.9%	0.2%	1.3%	-	5.8%	2.1%	1.9%	-	0.1%	0.9%
Industrial	1.5%	0.2%	2.7%	5.5%	-	11.6%	8.2%	0.1%	0.2%	2.5%
Health	1.7%	0.2%	0.3%	-	-	0.3%	0.7%	-	0.1%	1.1%
Financial	83.5%	95.8%	89.5%	84.6%	70.7%	68.7%	73.4%	94.8%	98.9%	84.4%
Energy	1.0%	0.4%	-	0.5%	12.2%	4.1%	2.3%	-	0.04%	1.4%
Consumer retail	1.3%	0.9%	-	2.2%	1.5%	3.3%	2.3%	0.5%	0.03%	0.9%
Luxury retail	3.5%	0.7%	5.5%	3.3%	-	3.8%	4.2%	3.3%	0.4%	2.9%
Telecommunication	1.1%	0.4%	0.7%	1.1%	1.0%	1.4%	0.9%	0.1%	0.01%	0.8%
Not available	0.1%	-	-	-	-	-	-	-	-	-
Total	**%100**	**%100**	**%100**	**%100**	**%100**	**%100**	**%100**	**%100**	**%100**	**%100**

Source: Bloomberg

This study aims to identify areas of development and enhancement for the regulatory frameworks for the offering of sukuk and debt instruments thus contributing to deepen the market. To that end, a systematic mechanism was followed to analyze the corporate domestic DCM taking into consideration the following factors:

Regulatory and infrastructure gaps

Assessment of regulatory and the infrastructure gaps of the local corporate DCM in comparison to other international markets

Benchmarks

A benchmark study of the local DCM with international markets, summarizing the main areas of development

Market Participants

Gather feedback from market participants such as financial advisors, legal advisors, current issuers and potential issuers

Literature and analytical resources

Analyze previous literature, analytical resource, laws and international practices

To fully unlock the potential of domestic corporate DCM in KSA, a number of challenges have to be resolved which relate to three main pillars, Issuers, Investors and Infrastructure.

ISSUERS

A — **CFO's perception of competitive disadvantage of domestic DCM** vs bank loans (longer process and higher costs).

B — **Limited domestic DCM promotion by the government, limited regulatory and financial incentives** for corporate issuers.

C — **Rigorous offering and disclosure requirements, relatively high minimum listing size, and high Edaa charges.**

INVESTORS

D — **Limited investor base,** as banks own about half of the total value of the corporate DCM, while there is limited participation by other categories of investors such as investment funds, insurance companies, and individual and foreign investors.

E — **Limited visibility on credit quality** of borrowers, as only 10 listed companies are rated by credit rating agencies and more than 90% of listed companies are not issuers of debt instruments.

F — **Withholding tax costs (5%)** are unattractive and discouraging for foreign institutional investors.

INFRASTRUCTURE

G — **Insufficient liquidity** of domestic DCM instruments (lack of market-making activity and channels of trading, absence of REPO ability for the domestic corporate DCM).

H — **Excessive market frictions** (e.g., limited connection to global infrastructure, lack of technical trading in FX-denominated bonds).

Third: Strategic Directions to Develop Sukuk and Debt Capital Market

To take full advantage of the opportunities of the corporate domestic DCM to finance local companies, various challenges will be addressed and overcome relating to issuers, investors and infrastructure through launching the following initiatives:

ISSUERS

A
- 1 Create **awareness program** for corporate CFOs

B
- 2 **Incorporate debt Issuances** in PIF & PIF's portfolio companies financial strategy
- 3 Create **bond guarantee mechanisms**
- 4 Introduce **sustainable bonds regulatory framework and incentives**

C
- 5 Easing **offering, listing, and registration frameworks**

INVESTORS

D
- 6 Run **investor awareness sessions** to engage broad investor base
- 7 Expanding **availability of debt instrument funds**
- 8 Publish **DCM guidebook**

E
- 9 Facilitate **credit rating services** for domestic corporate DCM

F
- 10 Consider removing **withholding tax requirements**

INFRASTRUCTURE

G
- 11 Study expansion feasibility of **REPO framework to include Corporate DCM**
- 12 Enhance **market liquidity** by institutionalizing market-makers
- 13 Encouraging brokers **to provide electronic trading services**

H
- 14 Inclusion of **domestic corporate DCM to global indices**
- 15 Linking of **domestic corporate DCM to global depository centers**
- 16 Organizing **trading, settlement, and clearing in foreign currencies**

Strategic Directions to Develop Sukuk and Debt Capital Market

The Capital Market Authority and the Sukuk and Debt Instruments Market Development Committee members will continue to implement strategic initiatives that contribute to raising the attractiveness and efficiency of the Sukuk and debt instruments market, and enhancing its competitiveness regionally and internationally. To this end, the legal framework, incentives, and infrastructure will be developed to encourage issuers to issue sukuk and bonds locally, as well as encourage investors to invest and trade in such securities; which aligns with its strategic objective to develop an advanced DCM that attracts both issuers and investors. To measure the performance of the strategic initiatives, the CMA will monitor a number of strategic indicators, including the percentage of the volume of funds collected from the offering of sukuks and debt instruments as a % of total public financing, size of DCM as a % of GDP, DCM turnover, and % of foreign ownership in DCM.

Sukuk and Debt Instruments Market Development Committee will work on the following initiatives:

#	Initiative	Initiative Objectives
1	**Create awareness program for corporate CFOs**	Strengthening communication with corporate's financial managers regarding the role of the Sukuk and debt instruments market as a channel for financing by publishing awareness materials, holding workshops and bilateral meetings.
2	**Incorporate debt Issuances in PIF & PIF's portfolio companies financial strategy**	PIF in addition to selected and suitable PIF's portfolio companies to incorporate debt issuances as part of their financial policy to finance their activities and projects, which will create benchmarks, support market liquidity and build momentum for other corporate issuances.
3	**Create bond guarantee mechanisms**	Establishing a regulatory framework to provide financial guarantees to issuers of debt instruments operating in priority economic sectors, in order to stimulate debt instrument issuances as a financing channel.
4	**Introduce sustainable bonds regulatory framework and incentives**	stablishing a regulatory framework for green, social and sustainable debt instruments to align with global practices, thus stimulating the diversification of issues and issuers in the sukuk and debt instruments market.
5	**Easing offering, listing, and registration frameworks**	Easing the requirements of offering, disclosure, listing, and registration of debt instruments in line with global practices, to contribute to encouraging local issuances and deepening the domestic DCM.
6	**Run investor awareness sessions to engage broad investor base**	Communicating with the diverse and priority investor segments in the Sukuk and debt instruments market through workshops to increase their participation in a way that contributes to enhancing liquidity in the Sukuks and debt instruments market.
7	**Expanding availability of debt instrument funds**	Enabling capital market institutions to establish various investment funds that invest in the sukuk and debt instrument market, accompanied by an awareness program for investing in debt instrument funds.
8	**Publish a market guidebook**	Promoting awareness of the regulations and operations related to the local Sukuk and debt instruments market by publishing a comprehensive operational guide for market participants.

Strategic Directions to Develop Sukuk and Debt Capital Market

#	Initiative	Initiative Objectives
9	**Facilitate credit rating services for corporate DCM**	Launching a campaign aimed at enhancing access to credit rating services through awareness-raising activities and an incentive framework for companies, to increase the positive impact of credit rating on the transparency of the Sukuk and debt instruments market.
10	**Consider removing withholding tax requirements**	Study easing tax requirements for foreign investors by removing the withholding tax on interest payments on debt instruments.
11	**Study expansion feasibility of REPO framework to include Corporate DCM**	Study the feasibility of expanding the framework of repurchase operations to include debt instruments of unlisted companies, thus increasing their attractiveness and enhancing the liquidity management tools available in the Sukuk and debt instruments market.
12	**Enhance market liquidity by institutionalizing market-makers**	Enhancing liquidity in the Sukuk and debt instruments market by regulating market-making activity and and introducing an incentives framework.
13	**Encouraging brokers to provide electronic trading services**	Encouraging market members to provide the feature of electronic trading in debt instruments to all investors to facilitate access to the market and enhance liquidity.
14	**Inclusion of domestic corporate DCM to global indices**	Study the possibility of the local sukuk and debt instruments market joining the main global indices of corporate debt instruments.
15	**Linking of domestic corporate DCM to global depository center**	Linking Edaa to the global depository centers (ClearStream and Euroclear) to facilitate foreign investors access to the domestic corporate DCM, in addition to monitoring the linkage effectiveness.
16	**Organizing trading, settlement, and clearing in foreign currencies**	Study enabling the market infrastructure to facilitate trading, settlement and clearing of debt instruments of local companies denominated in foreign currencies.

Thank you

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