

## WILL SAUDI ARABIA'S CAPITAL MARKETS BE AS OPEN AS THEIR GULF COUNTERPARTS IN THE NEAR FUTURE?<sup>1</sup>

# NO

**Restrictions derived from Islamic law (Sharia) will continue to prevent the emergence in Saudi Arabia of a fully-fledged capital market in the conventional sense, says Jochen Hundt.**

The recent decision to start trading bonds and Sukuk on the Riyadh market has attracted the attention of the regional media and some have predicted that this has marked the first step towards a swift emergence in Saudi Arabia of a sophisticated capital market with many more financial products being admitted for trading, establishment of a secondary market, etc. However, not only is the value of these new listings rather small but more importantly, when dealing with Saudi Arabia one has to always keep in mind that by virtue of its constitution, the Kingdom adheres to Islamic law (Sharia) as its primary and direct source of legislation and jurisprudence. The Islamic Sharia applies to all persons and properties within Saudi Arabia and governs any legal proceedings. As a matter of example, the Saudi Arbitration Act requires expressly that decisions must be made in line with the mandatory substantive rules of the Sharia and that foreign substantive rule will only be applicable if it is not contrary to the Sharia. Similar principles govern the enforcement of foreign arbitration awards in the Kingdom. Due to these fundamentals a number of restrictions always apply, which can not be evicted easily by increased 'creativity' of Islamic finance experts.

As far as the capital market is concerned, many restrictions stem from the prohibition of interest (*riba*) and speculation (*gharar*) but there are also other limitations such as the rule not to combine two or more transactions in one contract. Obviously, this has a major impact on the entire sphere of derivatives, which are commonly considered to be the key element of functionality of the secondary market as they permit the hedging of risks. As the Sharia provides for a number of tools that can address the needs of structured finance, the said restrictions do not put an absolute obstacle to developing the capital market in Saudi Arabia. However, due to the direct applicability of Sharia in Saudi Arabia, any solutions cannot simply be 'prescribed' by the sovereign drawing from international standards and practices but they must at the same time withstand the counter-check of Sharia compliance drawn directly from the religious sources. And these processes need time. This is why I tend to argue that in the near future we should not expect the Saudi

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market to follow the example of its Gulf counterparts in terms of openness and implementation of international standards and practices.

Another reason why stunning developments should not be expected is the fact that there is still an enormous deficit of regulation in the Saudi market. As a matter of example, the Saudi Capital Market Law regulates only a primary market. More importantly, the entire sector of Islamic finance is until today not subject to any specific law enacted by the sovereign, including the issuing of Sukuk. One fundamental reason for this in my opinion is that the Saudi government is extremely hesitant to grant the label 'Islamic' to any institution or product because this would imply labeling others as 'non Islamic' which, from a religious point of view, is a very delicate judgment. At the same time, however, this leaves the investor exposed to the often varying interpretations of Sharia sources in a country that in its ambition to establish a 'genuine' Islamic state has always resisted any calls and attempts to codify Islamic principles and law. While the ambition not to enshrine human interpretation of religious sources in codes of law is certainly praiseworthy, it makes the establishment of a sophisticated capital market, for the least to say, a rather time consuming exercise.

WHILE THE AMBITION NOT TO ENSHRINE HUMAN INTERPRETATION OF RELIGIOUS SOURCES IN CODES OF LAW IS CERTAINLY PRAISEWORTHY, IT MAKES THE ESTABLISHMENT OF A SOPHISTICATED CAPITAL MARKET, FOR THE LEAST TO SAY, A RATHER TIME CONSUMING EXERCISE.

The cautious approach of the Kingdom is further substantiated by the fact that international efforts to create harmonization in accounting rules for Islamic financial products proposed by the AAOIFI have not been adopted by Saudi Arabia although it is an active member of all international Islamic standards setting bodies. Similarly, the rules published by the Islamic Financial Services Board for regulation and supervision of Islamic financial institutions have also not been adopted in Saudi Arabia but are referred to as guidelines only. Other efforts like the International Islamic Financial Markets or development of the Islamic Financial Institutions Rating Agency have also not been supported whole-heartedly by Saudi Arabia.

Again: Comprehensive regulation of Islamic finance instruments and secondary markets in Saudi Arabia is not unthinkable but it will require manifold genuine solutions that do not restrict themselves to simply drawing from international standards and rules, and it will therefore require hard work and – time. In my opinion, the current financial crisis is a strong indication that taking the time necessary to elaborate well founded and thoroughly reflected solutions is not always a bad idea. Was it not a combination of greed and exaggerated 'creativity' in financial matters that made our planet lose nearly half of its wealth in just a few months?