

INTERNATIONAL MONETARY FUND

# Oman—A Financial Sector for the Economy of the Future

OMAN

Thomas Kroen

SIP/2024/019

*IMF Selected Issues Papers* are prepared by IMF staff as background documentation for periodic consultations with member countries. It is based on the information available at the time it was completed on December 14, 2023. This paper is also published separately as IMF Country Report No 24/032.

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SELECTED ISSUES PAPER

**IMF Selected Issues Paper**

Middle East and Central Asia Department

**Oman—A Financial Sector for the Economy of the Future  
Prepared by Thomas Kroen\***Authorized for distribution by Cesar Serra  
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**ABSTRACT:** Underpinned by Vision 2040, Oman aims to reduce its economic reliance on the hydrocarbon sector by diversifying its economy. Reforms are targeted to develop a well-diversified, private-led, sustainable, and inclusive economy where innovation and knowledge play a more prominent role. This requires the existence of a well-developed, inclusive, and stable financial sector that can navigate the country's transformation and fund the new economy. As the economic transformation gains traction and entrepreneurship and innovation take center stage, Oman's financial sector will face a more complex environment where it needs to develop innovative financial and risk management solutions to cater for the emerging and expanding financial needs of the different players in the economy. Against this background, this note provides an assessment of the development of Oman's financial sector, identifies areas for potential improvement, and proposes policy actions to foster further financial development and inclusion.

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SELECTED ISSUES PAPERS

# **Oman—A Financial Sector for the Economy of the Future**

Oman

## A. Context

**1. Underpinned by Vision 2040, Oman aims to reduce its economic reliance on the hydrocarbon sector by diversifying its economy.** Reforms are targeted to develop a well-diversified, private-led, sustainable, and inclusive economy where innovation and knowledge play a more prominent role. This requires the existence of a well-developed, inclusive, and stable financial sector that can navigate the country's transformation and fund the new economy. As the economic transformation gains traction and entrepreneurship and innovation take center stage, Oman's financial sector will face a more complex environment where it needs to develop innovative financial and risk management solutions to cater for the emerging and expanding financial needs of the different players in the economy. Against this background, this note provides an assessment of the development of Oman's financial sector, identifies areas for potential improvement, and proposes policy actions to foster further financial development and inclusion.

## B. Stylized Facts

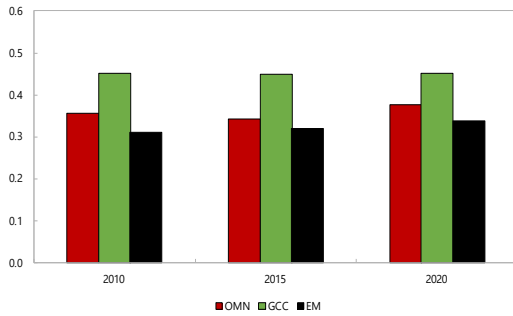
**2. The Omani financial system is dominated by banks amidst a still nascent NBFi sector.** Banks are the primary source of credit in the economy as debt capital markets are not widely accessible to the private sector. Credit to the private sector stood at 55.4 percent of GDP in 2022 and has persistently been among the lowest in the GCC in the past 5 years (Figure 1, Panel 2) while also lagging emerging markets (63 percent of GDP, on average). This partly reflects the still high footprint of state-owned enterprises across many sectors. The NBFi sector remains small, primarily represented by pension funds and some insurance companies. Recent consolidation of pension funds into one unified entity may contribute to scaling up NBFis and the size of their investments.

**3. Omani capital markets are comparatively small and illiquid.** The primary government bond market shows healthy activity but the secondary market is mostly inactive amidst persistent low market liquidity and no market-making system. Non-resident participation remains low due to the illiquidity and regulatory barriers such as the absence of OTC trading and lack of a link with Euroclear. Corporate bonds or sukuk have only been issued sporadically and the stock market significantly lags other markets in the region.

**Figure 1. Financial Development and Private Credit Provision**

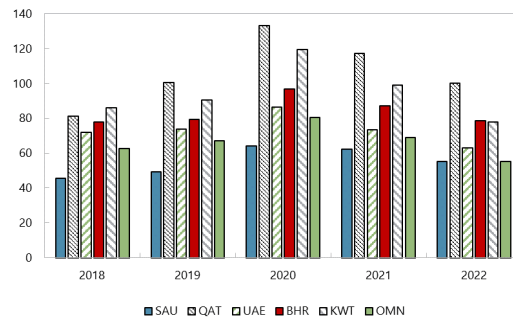
*Financial development has slightly progressed... ..but private credit provision is amid lowest in GCC*

**Financial Development Index**



**GCC: Credit to the Private Sector**

(In percent of GDP)



Sources: IMF Financial Development Indicators, Haver Analytics.

**4. Oman has shown some progress on financial development since 2010 but continues to lag GCC peers, notably on the development of financial markets beyond banking.** Oman's financial development index has marginally risen from 0.36 to 0.38 since the last FSAP in 2010 (Figure 1, Panel 1), driven by the strength of the local banking sector. However, it continues to lag other economies in the region. Structural challenges identified in the 2010 FSAP persist, including low capital market liquidity, the absence of a well-established yield curve, and barriers to SME funding.

## II. Challenges and Avenues for Development

**5. Development across all segments of the financial sector will be needed to sustain Vision 2040.** Structural regulations that limit banking sector development should be removed, including, once the credit registry is fully developed to ensure adequate risk scoring, the interest rate cap on personal loans. Developing capital markets, in particular for debt and equity funding of larger corporations, will enable banks to re-allocate funding towards SMEs that do not have direct capital markets access. In a second stage, over the medium term, other capital market instruments such as exchange traded funds, derivatives, and futures contracts could also be developed.

### A. Banking

**6. The banking sector is dominated by domestic banks with an increasing share of Islamic banking.** Banking activity is concentrated in 6 domestic banks<sup>1</sup> and two Islamic banks. There are also 9 foreign banks, which however typically only operate one branch. The sector is moderately concentrated with the

<sup>1</sup> This accounts for the recent merger of Sohar International Bank and HSBC Oman.

largest bank, the only domestic systemically important bank (DSIB) as of now, accounting for about 40 percent of total banking assets.<sup>2</sup>

**7. Omani banks primarily lend with limited investments in securities.** Since 2015, the share of loans in total assets has risen from 66 percent to 75 percent while the share of securities remains low at about 13 percent due to a cap on government bond holdings.<sup>3</sup> As a result, Omani banks have the highest share of loans relative to total assets in the GCC (79 percent compared to a GCC average of 59 percent, Figure 2). Credit primarily flows towards corporate loans (46.7 percent), personal loans (32.1 percent), and SOEs (14.3 percent). While all segments have been growing in recent years, the strongest growth has been in SOE loans which have almost doubled since 2016, suggesting crowding-out of private sector credit. Across sectors, the correlation of credit growth with output growth over the past 5 years is weak, indicating that credit allocation to growing sectors can be strengthened (Figure 2 Panel 6). Utilities have seen a much larger credit growth than output growth over the past 5 years while credit provision to manufacturing, mining and quarrying, and agriculture has lagged output growth in those sectors.

**8. Funding is primarily through deposits, with a sizable footprint of the state.** Deposits account for two-thirds of total bank liabilities and 90 percent of non-equity funding. The domestic government, and to a lesser extent SOEs, continue to be critical funding sources accounting for 33 percent of deposits, virtually unchanged since 2015. With more than 90 percent of assets and 89 percent of liabilities owned by residents, non-resident participation remains low.

**9. Banking sector concentration is moderate but projected to increase under the impact of recent merger, while net interest margins are among the highest in the GCC.** The banking sector is somewhat concentrated with the third largest concentration in the GCC (Figure 3). The recent merger of Sohar International Bank and HSBC Oman and potential additional banking sector consolidation may increase concentration further against the backdrop of elevated net interest margins (Figure 4). Achieving economies of scale while preserving competition therefore remains a priority.

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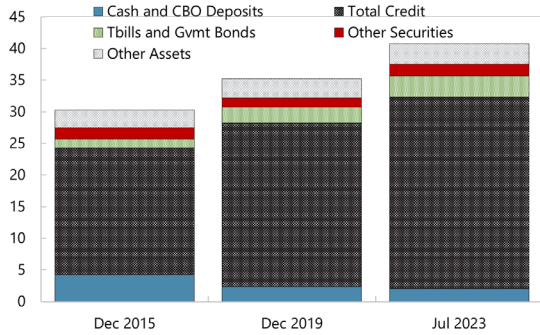
<sup>2</sup> After the merger of Sohar International Bank and HSBC Oman, the newly merged bank is a potential candidate for being classified as second DSIB in the country.

<sup>3</sup> Domestic government bond holdings cannot exceed 55 percent of net worth.

**Figure 2. Banking Sector Overview**

**Asset Composition**

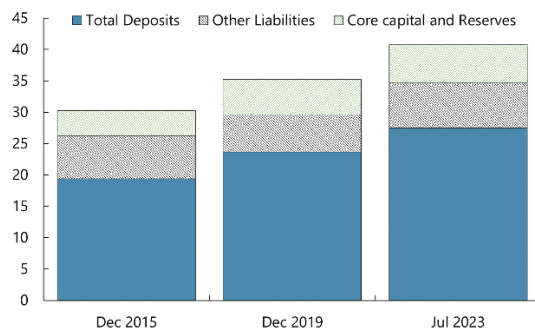
(OMR, billion)



Sources: CBO and IMF staff calculations

**Liabilities Composition**

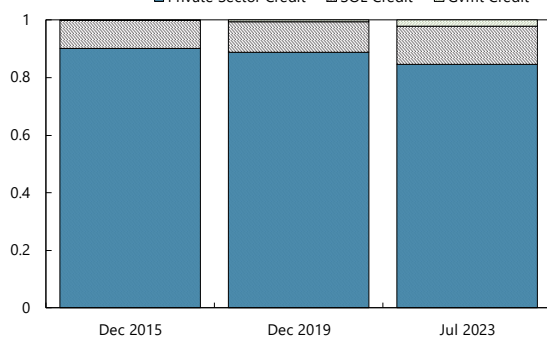
(OMR billion)



Sources: CBO and IMF staff calculations

**Credit Composition**

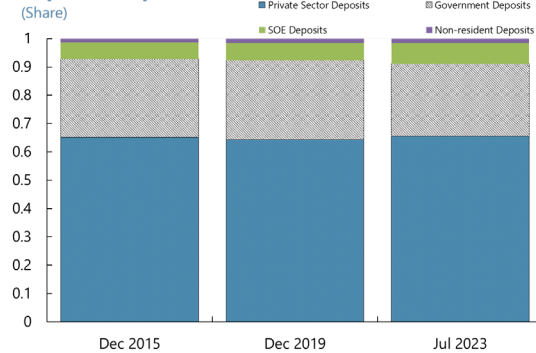
(Shares of Total)



Sources: CBO and IMF staff calculations

**Deposit Composition**

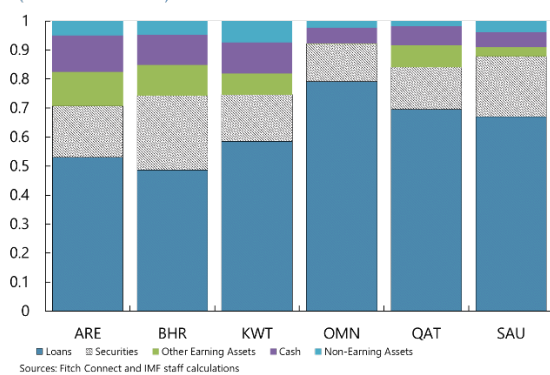
(Share)



Sources: CBO and IMF staff calculations

**Asset Composition of GCC Banks**

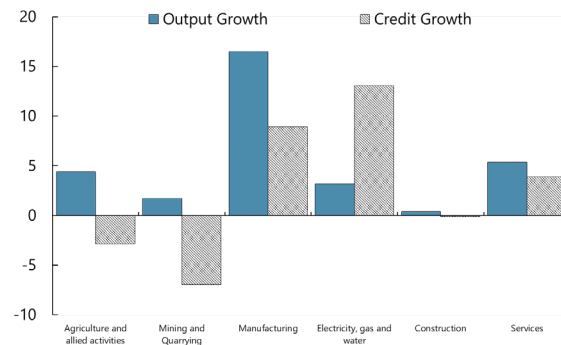
(Share of Total Assets)



Sources: Fitch Connect and IMF staff calculations

**Sectoral Output and Credit Growth**

(Percent, 2018-2022 averages excl. 2020)

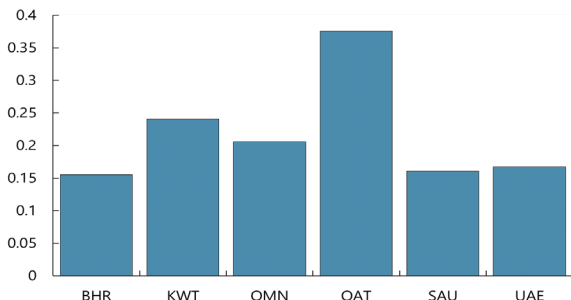


Sources: CBO, Haver Analytics, and IMF staff calculations

**Figure 3. Banking Sector Concentration in Oman (Herfindahl Index, 2022)**

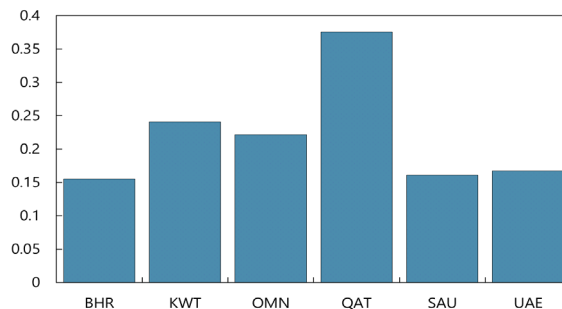
**Current HHI**

(Index, 2022 values)



**Counterfactual HHI including mergers**

(Index, based on 2022 data)



Sources: Fitch Connect and IMF staff calculations

Notes: Data is from 2022. HHI = Herfindahl-Hirschman Index. Counterfactual HHI includes impact of recent merger in Oman and another merger that has been discussed.

**10. Despite some of the highest net interest margins in the region, the profitability of Omani banks is weighed down by elevated costs.** Omani banks' net interest margins of close to 3 percent are leading the GCC (Figure 4, Panel A) alongside Saudi Arabia. Profitability, measured by return on assets, however, ranks below Qatar, Saudi Arabia, and the United Arab Emirates (Figure 4, Panel B). A main driver of this difference are Oman's comparatively elevated overhead costs and non-interest expenses (Figure 4, Panel C-D). Cost efficiencies could be achieved by exploiting economies of scale and accelerating the digitalization of the sector.

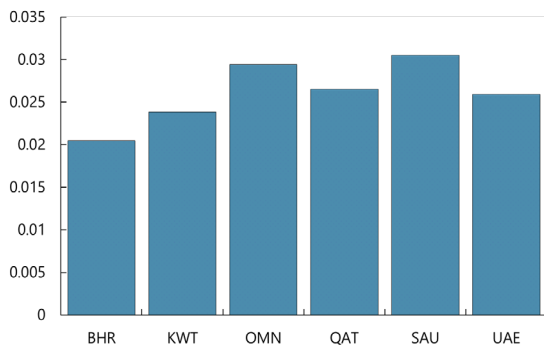
**Figure 4. Profitability and Efficiency of Omani Banking Sector**

*Despite one of the highest NIMs in the GCC ...*

*... Omani banks' RoA is weighed down by...*

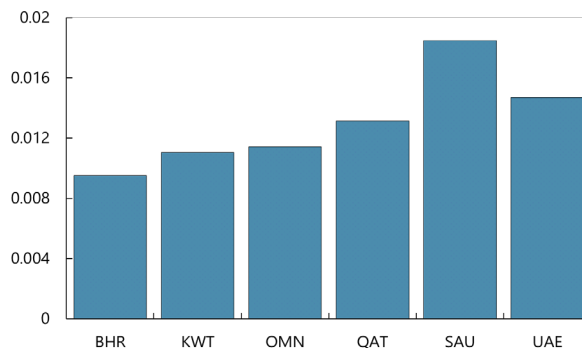
**Net Interest Margin**

(Reported as Fraction)



**Return on Assets**

(Net income / Total Assets)



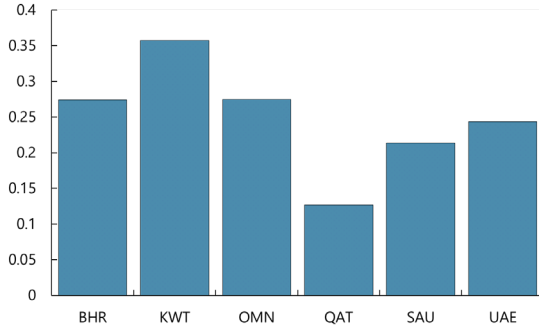


**Figure 4. Profitability and Efficiency of Omani Banking Sector (concluded)**

... elevated cost-to-operating income ratios.

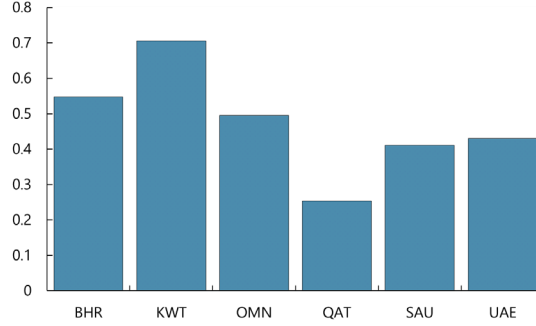
**Overhead Costs/ Operating Income**

(Ratio)



**Non-interest Expenses/ Operating Income**

(Ratio)



Sources: Fitch Connect and IMF staff calculations

Notes: Data is from 2022. Figures are reported as median across banks within each country.

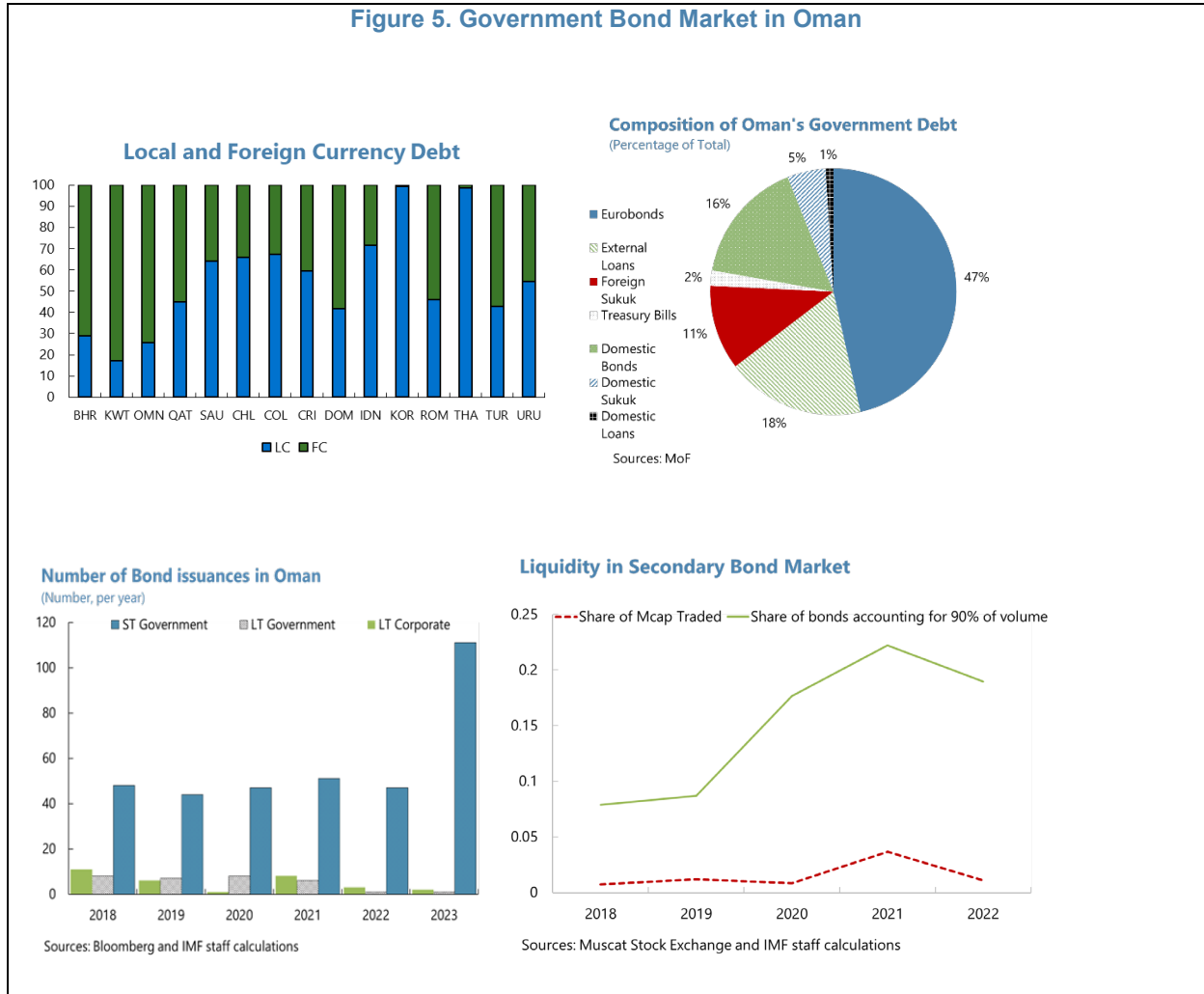
## B. Fixed Income Markets

**11. Well-functioning and liquid fixed income markets form the bedrock of a well-functioning financial system.** Government bond markets with issuances of various maturities and sufficient liquidity across the yield curve establish a risk-free benchmark rate for the pricing of riskier financial assets. The Omani authorities are currently developing their local currency bond market following recommendation from a recent MCM TA, with several preliminary steps requiring completion before a primary dealer system for the secondary market can be established. This can in turn pave the way to the development of asset-backed securities and corporate bond markets.

**12. Fixed income markets in Oman remain small and illiquid due to very limited secondary market trading.** Relative to other countries in the region and emerging markets, Oman has a very low share of local currency government debt at 26 percent, split between conventional bonds (government development bonds), sukuks, and some Treasury bills (Figure 5, Panel A). Irregular issuances especially at longer maturities (Figure 5, Panel D), lack of benchmarks, absence of secondary market trading, and impediments to non-resident participation further hold back domestic fixed income markets (IMF 2023). As a result, secondary market activity in corporate bond markets<sup>4</sup> and sukuks is also subdued. While the share of bonds traded in the secondary market has increased over the past five years, total secondary bond market trading accounted for 1.1 percent of market capitalization over the entire year of 2022 (Figure 5, Panel C). In July 2023, total secondary bond market trading on the Muscat Stock Exchange amounted to OMR 18 million relative to a market capitalization of OMR 4.4 billion. The average bond or sukuk traded 18 times in 2022, with trading concentrated, however, in a few issuances: 19 percent of bonds accounted for 90 percent of transaction volume in the secondary market while 22 out of 58 bonds did not trade at all.

<sup>4</sup> The vast majority of corporate bond issuances in Figure 5, Panel D are from financial sector firms.

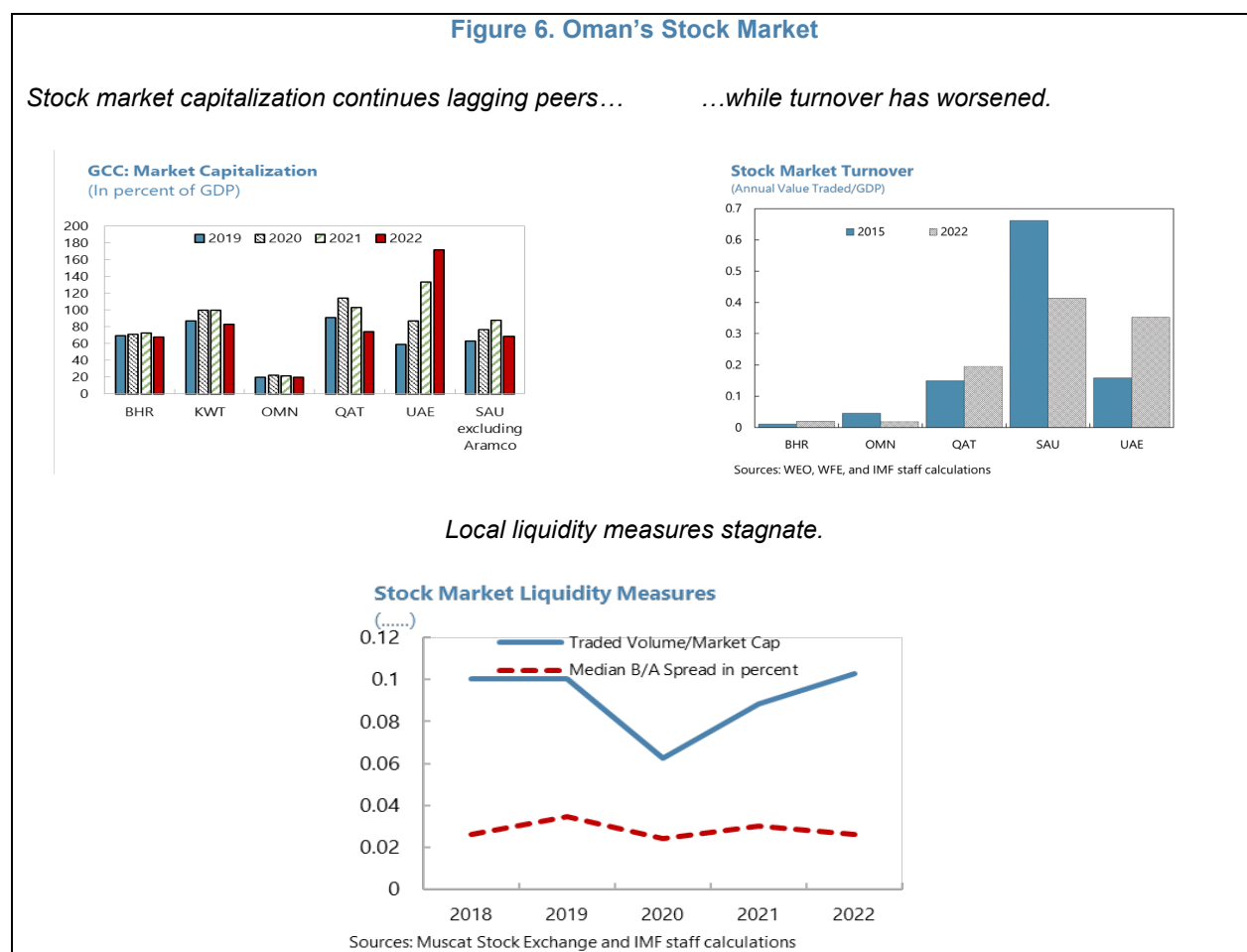
Figure 5. Government Bond Market in Oman



**13. The development of the local currency government bond market is a key pillar for financial market development.** Recommendations from the recent MCM TA include more regular and predictable issuances, developing money markets at the short end of the yield curve, and implementing a medium-term debt management strategy. To mitigate crowding-out of domestic bank credit, broadening the investor base in the government bond market will be critical, including insurance groups, the new consolidated pension fund, and other sources of demand. This could be achieved by incentivizing the development of life insurance products and further expand labor force participation. Eliminating barriers to non-resident participation such as the requirement that all secondary market transactions must go through a broker—rather than OTC—and facilitating the integration to Euroclear could further contribute to diversifying the investor base. In the longer run, efforts to gain eligibility to widely tracked emerging market bond indices could attract passive investors.

## C. Stock Market

**14. Stock market capitalization in Oman persists at low levels.** At the end of 2022, stock market capitalization stood at \$22 billion (19.4 percent of GDP), far behind other stock markets in the region (average of 93.1 percent of GDP)<sup>5</sup> and emerging markets. New listing activity over the past decade has remained subdued as most IPOs since 2010 ranged below OMR 60 million in volume. One factor limiting growth in the number of listed firms has been the large share of SOEs and of closely held companies.



**15. Persistent low liquidity, exemplified by low turnover and elevated bid-ask spreads, hampers secondary stock market trading and non-resident participation.** Oman's stock market traded value as a share of GDP reached 2 percent in 2022, the lowest in the GCC, and it has declined compared to 2015. Since 2018, stock market liquidity measures have not improved (Figure 6, Panel C). Yearly traded volume continues to account for about 10 percent of market capitalization. While the median bid-ask spread stood at 2.6 percent

<sup>5</sup> For Saudi Arabia, stock market capitalization was computed net of ARAMCO to mitigate the impact of a single company on the overall figures.

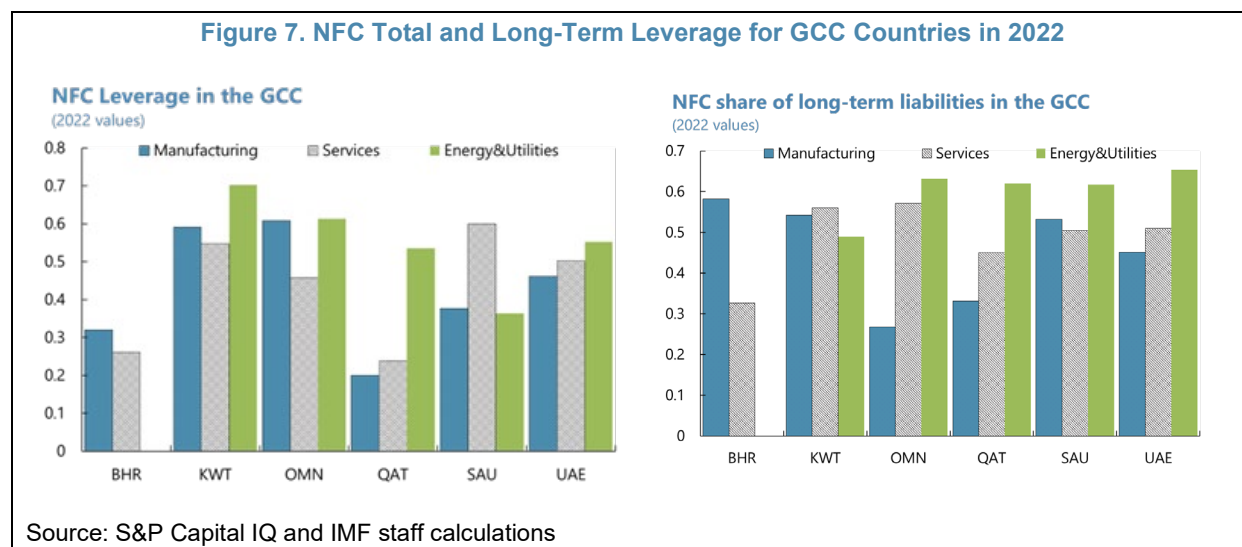
in 2022, somewhat down from 3.4 percent in 2018, it remains significantly higher than bid-ask spreads for other emerging markets.<sup>6</sup>

**16. To play a more prominent role in the future, the stock market will require more depth and increased non-resident participation while exploiting synergies with the development of other markets.**

The planned listing of several state-owned enterprises over the coming years could contribute to growing the size of the market while Oman’s Capital Market Authority should seek to attract more non-resident participation. Satisfying the criteria for inclusion to widely used emerging market equity indices is one step to increase foreign inflows. Stock market development will also likely benefit from the development of debt capital markets as improved liquidity and depth of both markets will facilitate portfolio allocation for investors between safe and riskier securities. Jointly, these steps can pave the way towards introducing further investment vehicles, including exchange-traded funds or futures contracts, in the longer run.

**D. Corporate Financing**

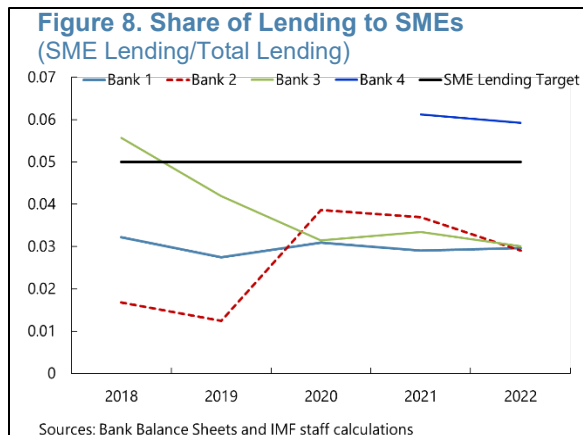
**17. Oman’s non-financial corporations (NFC) have among the highest leverage in the GCC, yet short-term funding dominates in some sectors.** Omani firms are among the most levered in the GCC with publicly listed firms in the manufacturing and energy sectors reaching a ratio of debt to assets of 0.6, above the average for the region (Figure 7, Panel A). In the manufacturing sector, however, most funding is short-term. The share of long-term debt in total debt only stands at about 20 percent, the lowest among the entire GCC (Figure 7, Panel B), suggesting that the provision of long-term debt instruments can be further expanded.



<sup>6</sup> Corwin and Schultz (2012) estimate bid-ask spreads in India between 1 and 2 percent for the pre-GFC period.

**18. While credit has continued to grow strongly in the past year, only a small share goes to SMEs.**

Credit growth stands at about 7 percent (y-o-y) in the first half of 2023, yet banks continue to miss the target of 5 percent of lending to SMEs. Amidst time-invariant effective lending rates (see Selected Issues Paper on Monetary Policy Transmission) and low risk appetite, credit access for SMEs remains a challenge. Close to two-thirds of credit flow to either personal loans, SOEs, or listed companies. At the same time, most banks continue to miss the target for SME lending (5% of total lending) and SME lending as a fraction of total lending has declined for several institutions over the past years (Figure 8).



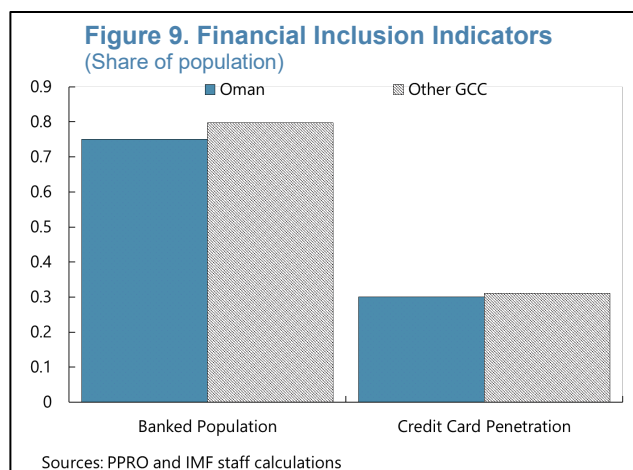
**19. Continued development of local debt capital markets could therefore be an important avenue to provide more long-term funding to non-financial corporations while freeing up bank credit for SMEs.**

Development of debt capital markets in the medium term, including the corporate bond market, can provide additional sources of debt funding for large private corporations with market access. Reduced bank reliance by large corporations would enable the banking sector to strengthen its exposure to corporations without market access, in particular SMEs.

**E. Other Aspects**

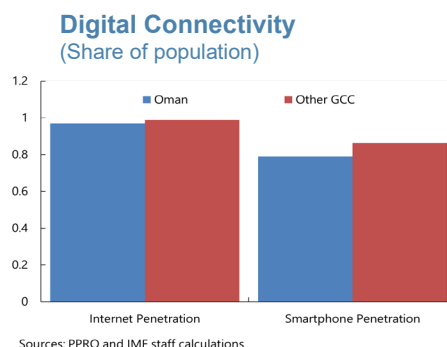
**20. With 75 percent of the population banked, Oman could further progress on financial inclusion.**

Oman's share of banked population and credit card penetration range in the middle of the GCC (Figure 9), which as a region, however, lags countries of similar levels of development in financial inclusion (IMF, 2022a). Further progress, including on promoting access to finance for women and the rural population, could increase savings and allow financial institutions to intermediate savings to investment opportunities. With close to full Internet penetration (at 97 percent) and new e-KYC guidelines, FinTech and digital payment solutions could play a stronger role in achieving financial inclusion targets.



### Box 1. Fintech in Oman

**Fintech has been growing rapidly around the world and with a young and digitally savvy population, Oman may be well positioned to develop its Fintech sector.** Over the past decade, increased connectivity amid rapid advances in Internet penetration and the rapidly declining cost of computing power have fueled the growth of fintech (World Bank, 2022). In the GCC, the number of fintech companies is growing rapidly after several countries launched regulatory sandboxes (IMF, 2022a). With its young population—24 percent of the population are between 15 and 29 years old—and high Internet and smartphone penetration (Figure B1), Oman satisfies important prerequisites for developing fintech.



**The CBO's Fintech Regulatory Sandbox launched in December 2020 follows in the footsteps of several GCC peers.**

Three cohorts have started with a focus on digital wallets, blockchain technology for trade finance, and alternative financing methods. The next cohort in 2024 will work on open banking solutions. In the future, dedicating one cohort to SME financing solutions could foster innovation in a market segment that has been traditionally underserved by the domestic banking sector.

**Facilitating access to capital, setting regulatory frameworks, and fostering human capital will create the conditions for Fintech growth and facilitate industry-led approaches.** Recent education initiatives, such as the creation of a dedicated Fintech certificate in higher education, will need to continue to develop sector-specific human capital at the intersection of finance and computer science. Financial sector development can further promote industry-led approaches in fintech. More liquid equity markets with more IPOs will be important to provide exit options to fintech founders and their investors. In combination with private initiatives and increased OIA funding for venture capital, this can contribute to growing Oman's small venture capital sector.<sup>17F</sup> Throughout, authorities will need to ensure that adequate regulatory and supervisory frameworks are in place to foster financial innovation while ensuring customer financial protection and safeguarding financial stability in the wake of potentially disruptive financial innovation.

<sup>1</sup>Industry figures report a total of 11 venture capital deals for a total volume of \$3.5 million for Oman in 2022 relative to \$907 million in Saudi Arabia, \$36 million in Qatar, and \$26 million in Jordan.

## III. Addressing Policy and Regulatory Gaps

### A. International Practices

**21. Successful financial market development hinges on the right sequencing of reforms, while exploiting synergies.** Many emerging economies aim to transition from an initially bank-dominated financial system towards a multi-pronged one. Chami et al. (2010) emphasize the foundational role of the government bond market in providing a risk-free asset and hence, a risk-free rate. Developing the yield curve of government bonds can serve as a steppingstone to develop a repo market and markets for asset-backed securities and covered bonds before developing commercial paper and corporate bond markets. Financial market development will need to exploit synergies and interdependencies to maximize success. For example, the development of the repo market increases demand for government bonds and can foster secondary market

trading (BIS 2020). Hence, the development of the latter can be accelerated by the former. Likewise, fostering venture capital and equity market trading can reinforce each other. Venture capital funding is unlikely to occur in the absence of a well-developed IPO market, which in turn relies on liquid secondary equity markets. Hence, simultaneously developing different markets is critical.

**22. Financial market development requires an evolution of banks' business models.** As capital markets grow and large corporations gain direct capital market access, banks' traditional lending business would shrink. To offset lost income, banks will need to expand the scope of their operations to include securities underwriting, liquidity provision through market making, or wealth management. Financial market development will only succeed if banks face the right incentives to alter their business model. Otherwise, the initial bank-based financial system is likely to prevail. A mix of direct incentives for domestic banks, potentially complemented with increased competition by foreign institutions, can achieve the evolution of the banking sector.

**23. In practice, development of local bond markets coupled with increased non-resident participation has been pivotal for financial market development.** Domestic bond markets are the cornerstone of the financial development agendas in many EMs (e.g., Malaysia, Mexico, Thailand–BIS 2020).<sup>7</sup> More predictable and transparent issuances at benchmark maturities have proven successful in Mexico and Thailand (BIS, 2020). In several countries, such measures have been combined with repo market development (e.g., Hungary, Malaysia, Mexico, Thailand) to initiate more secondary market trading in government securities. Specific policies include adopting the standards of the General Master Repurchase Agreement and fostering repo market activity in private markets, rather than repos intermediated by the central bank. Taking steps towards inclusion in widely used emerging market indices can further increase non-resident participation as seen in Colombia or Mexico.<sup>8</sup>

**24. The development of deeper and more diversified capital markets needs to be complemented with adequate supervision and regulation.** As capital markets grow, large corporations increasingly substitute from bank borrowing towards direct issuances, while banks reallocate those funds towards SMEs. More liquid, deeper, and less concentrated capital markets with a broader investor base have multiple potential benefits ranging from lower sovereign yields (e.g., Colombia), greater total credit provision (e.g., Poland), and diversification of bank lending towards SMEs (e.g., Malaysia). Monetary policy passthrough has also strengthened in several countries that have undergone active financial market development, including Colombia, Indonesia, Korea, Mexico, and Thailand (BIS, 2020) as interest rates in more liquid financial markets become more sensitive to the policy rate. Regulators and supervisors need to update their frameworks adequately as financial markets develop to mitigate financial stability risks, including from increased non-resident participation which can increase vulnerabilities from capital outflows.

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<sup>7</sup> For example, growing and diversifying domestic bond markets was a core pillar of Malaysia's Financial Sector Master Plan from 2001-2010 (IMF 2014).

<sup>8</sup> Similarly, non-resident participation in equity markets can benefit from the inclusion in such indices, e.g., MSCI Emerging Markets Index, as in the case of Saudi Arabia's Tadawul exchange (BIS, 2020).

## Box 2. International Best Practices for SME Financing

**Several countries around the world have resorted to targeted measure to improve SME access to finance beyond capital market development.** While developing financial markets and providing financing alternatives for large corporates will free resources for SME lending in the long-run, additional policies are needed to improve access to finance in the short and medium term. This ensures SMEs have access to adequate funding that enables them to grow and boost economic growth.

**Credit reporting can provide critical information to evaluate SME creditworthiness.** A significant impediment for SMEs' access to finance is the lack of established hard information about their financials and business prospects. Hence, they require closer relationships with potential lenders, which in turn can impose additional costs on the lender. Easily accessible credit registries can facilitate access to credit information on SME for lenders for the purpose of credit scoring. In a cross-country study, Martinez Peria and Singh (2014) show that the introduction of a credit registry raises the likelihood that a firm has access to finance by 7 percentage points, leads to a 5-percentage-point drop in interest rates, and 7 months longer maturities. Customized products for SMEs have been introduced in some countries. For example, a Chilean credit bureau developed an SME credit score based on encrypted mobile data that supplements information from the traditional credit database (World Bank, 2018).

**Secured lending and alternative financing mechanisms such as leasing and factoring can further support SME lending.** Given the higher opaqueness of SMEs, secured lending can alleviate information frictions between lenders and SME borrowers. Collateral registries with notice-based registration and online access provide a unified source of information for lenders. Financing and maintaining a consistent cash flow are among the largest challenges for SMEs (World Bank, 2018). Factoring—the selling of accounts receivable to receive an immediate cash flow—can alleviate those liquidity challenges. In Mexico, for example, Nacional Financiera—a development bank institution—provides factoring and reverse factoring services. SMEs can thus use accounts receivable from large clients to secure loans. Interest rates for factoring services are capped at 7 percentage points above the bank rate, a rate significantly below the average commercial bank interest rate (World Bank, 2018).

**Promoting FinTech solutions for SME funding can enhance financial inclusion for firms without access to the conventional banking system.** The development of Fintech as an alternative financing solution can complement steps to increase financial inclusion of SMEs into the formal banking system. Examples include equity-based crowdfunding (e.g., Eureeca in the UAE), peer-to-peer business lending, and invoice lending (IMF, 2019). While the government can provide guardrails for fostering the fintech environment, for example by setting regulatory and legal frameworks, successful FinTech development will ultimately hinge on private sector initiatives.

**These steps need to be accompanied by structural policies to aid SME access to finance.** Oman satisfies several of the macroeconomic criteria that are associated with facilitating SME access to finance in IMF (2019) including macroeconomic stability, financial sector soundness, and financial regulatory and supervisory capacity. Maintaining a competitive banking sector and reducing the public sector footprint in the economy (to limit crowding out of SMEs) will further support efforts to enhance credit access for SMEs (s. IMF, 2019).



## B. Policy Recommendations to Foster Financial Development

**25. Oman's Vision 2040 requires substantial financial market development to support the funding needs of a diversified economy.** The current financial system is centered around domestic banks, features a substantial government footprint, is characterized by low liquidity, and provides very limited SME funding. Authorities' diversification plans to unlock sustained growth from non-hydrocarbon activities require a deeper, more liquid, and larger financial sector. Successfully developing financial markets will depend on structural financial sector reforms and successful coordination with other policy areas, particularly government debt management.

**26. Developing local capital markets requires a proper sequencing of reforms.** To that end, reform recommendations regarding fixed income markets should be phased appropriately. There should be at least two phases of reform.

**27. In Phase 1, the key priorities should be continued development of local currency bond markets to improve market liquidity.** The first step consists of developing local currency government bond markets, in particular secondary market trading, to establish a benchmark yield curve. Priorities include deepening the market by developing the NBFIs sector<sup>9</sup> and facilitating non-resident participation, removing regulatory hurdles, such as the cap on government bond holdings, and introducing a market maker system. The repo market should be developed alongside the government bond market as it can create additional demand for government bonds and invigorate secondary market trading. The authorities may consider adopting the Global Master Repurchase Agreement (GMRA) to standardize transactions and encourage private market repo activity that is not intermediated by the central bank. Throughout, reform efforts need to be consistent with government debt management. A medium-term debt management strategy and predictable issuances at benchmark maturities facilitate participation, especially for new market participants.

**28. In Phase 2, after establishing a benchmark yield curve, markets for riskier securities can be developed, including corporate bond and equity markets.** Unlocking these alternative funding sources for corporations allows to reduce bank dependence of large corporations, which in turn frees up resources for SME lending in the banking sector. The development of markets for riskier debt securities can proceed with covered bonds or asset-backed securities. As riskier fixed income securities are getting priced, this will facilitate the emergence of the still nascent corporate bond market in Oman, providing more large corporates with direct debt market access and thus freeing banking sector resources for SME lending. Broadening the investor base to include domestic NBFIs and non-residents is essential to ensure that capital market development does not result in crowding out of corporate credit.

**29. Under the impetus of the planned listing of several SOEs, the equity market would likewise benefit from increased secondary market activity to attract a broader investor base.** Satisfying the criteria for inclusion to widely used emerging market equity indices will attract greater non-resident participation.<sup>10</sup> While broadening the investor base is desirable to achieve investor diversification and mitigate crowding out of

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<sup>9</sup> The insurance sector remains underdeveloped but could provide an important source of demand for longer-dated bonds as those naturally match the liabilities profile of life insurance companies.

<sup>10</sup> The MSCI Emerging Market Index already features 4 of the 6 GCC economies. Saudi Arabia reports a substantial pickup in inflows after inclusion to the index (BIS, 2020).

bank credit, regulators need to remain mindful of financial stability implications by adapting their regulatory frameworks and increased monitoring of NBFIs and foreign investors. One example is the recently issued framework for cybersecurity and resilience.

**30. The banking sector will benefit from relaxing regulatory constraints and achieving cost efficiencies while maintaining healthy competition.** The development of debt capital markets will enable banks to re-allocate lending towards SMEs. Authorities should consider relaxing or removing the current cap on government bond holdings. Since it only applies to the gross stock of government bonds, the cap is unlikely to be effective at mitigating crowding-out of private credit. Instead, the cap should either target net exposures (e.g., government bond holdings and loans to the government net of government deposits) or flows rather than stocks. Relaxing the interest rate cap on personal loans would allow to adequately price risks, maintain margins, and improve access to credit for private sector employees. To be successful, a relaxation of the interest rate cap will hinge on increased usage of the credit registry (Mala'a), which is currently being developed into a full-fledged credit bureau. Against the backdrop of ongoing banking sector consolidation, efficiency and cost gains from larger bank scale need to be balanced against rising market power and systemic risks.

**31. Improving SME's access to finance and promoting fintech can further contribute to deepening the financial sector and diversifying the economy.** Facilitating factoring and secured lending for SMEs can bridge information asymmetries, alleviate cash flow shortfalls, and facilitate credit provision by the formal banking sector. New fintech businesses can complement the development of debt capital markets and resulting reallocation of bank funding to support growth of SMEs and the non-hydrocarbon sector. Investors can benefit from a well-designed SME credit guarantee scheme with the objective to provide third-party credit risk mitigation to lenders to stimulate debt financing to SMEs (IMF, 2022). Throughout, authorities should consider exploiting synergies between different financial market development measures.

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