Oman banking perspectives 2018

Transforming horizons
Foreword

Major developments in technology and regulation are likely to have a transformative effect on the current and future landscape of the banking sector in Oman.

With the exponential increase in technological innovation, such as Artificial Intelligence, blockchain and numerous FinTech initiatives, in Oman and globally, there is a growing risk of more aggressive cyber-attacks on individual companies, as well as countries as a whole. As a result, there is a greater need for vigilance and continued focus on enhancing existing regulations and introducing new ones in response. These efforts, together with existing international and local initiatives to improve the stability of the global financial system, require continued focus from both regulators and the banking sector, a situation that is more complicated for those with extensive operations across multiple jurisdictions.

In addition, continued policy uncertainty due to both global and regional political change in recent times, has presented banks with the need to explore new solutions and/or markets, to grow and diversify their businesses in an economic environment manifesting muted growth forecasts in the immediate and mid-term.

Against this backdrop, banks are assessing how they can use new and innovative technologies to differentiate themselves from their rivals. Competition is no longer limited to traditional banks, but also to new, disruptive entrants to the market. Banks also find themselves having to invest to comply with ever more stringent and complex regulations.

In Oman banking perspectives 2018, we undertake an analysis of the key financial indicators for the past year, and evaluate where we are in the roll-out of recently released legislation and regulations, as well as looking at the latest developments in innovation and regulation that we see emerging, globally and in Oman, that the local banking sector players should be preparing for.

This is the first Oman Banking Perspectives we have produced. It complements our GCC listed banks results report, which highlights some of the key financial trends, challenges and opportunities for the banking industry in the region.

As a team, we look forward to discuss these themes with you in the coming weeks, and continue to update you as we see these evolve.

Emilio Pera
Partner and Head of Financial Services

Emilio Pera
Partner | Head of Financial Services
T: +968 2 474 9611
M: +971 56 508 5073
E: emiliopera@kmpg.com

Emilio leads KPMG’s financial services practice in the Lower Gulf (the UAE and Oman). He has worked in the financial services industry – both as a consultant and as a banker – for almost 30 years and has been based in the UK, the Middle East and Africa. He has led a number of risk, finance and credit advisory engagements, including leading governance and cost-efficiency reviews. Emilio has been the lead partner on the external audits of a number of major, blue-chip financial institutions in Africa, the UAE. He was a member of the IAASB’s ISA540 task group with a focus on revising the standard in preparation for the audit of IFRS 9.
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Executive summary

The Oman banking sector is in a healthy position, despite a challenging economic environment. Innovation through technology will enable banks to improve operational efficiency, augment revenue and reduce risk, whilst enhancing customer experience. This may offset growing pressure as a result of the increasing costs of compliance with new regulation.

We have seen an increasingly disruptive banking sector emerge over the last year, particularly in technological advances, which has heightened the degree of both opportunity and threat. At the same time, new – often tighter – regulation has come into force, or is coming soon, much of which may have an impact on the banks’ bottom line. At the same time, banks are generally in better shape compared with a few years ago, which is being further enhanced by new corporate governance regulations that should provide for a more sustainable economy.

Perhaps more than any other development, blockchain has dominated financial news in recent years with a number of exciting initiatives already announced and it is likely that we will see more pilot projects and live projects emerging using permissioned blockchain across both public and private sectors. This may allow smaller entities to conduct business at a lower cost, while enjoying similar security, transparency and interoperability benefits.

The banking sector has often been in the forefront of adopting new technologies, and Artificial Intelligence (AI) is no different. CEOs are considering how to integrate basic automation with AI. We are seeing an increasing trend where AI is applied in customer engagement, to drive greater loyalty, provide pervasive security protection and reduce operational cost.

With a wave of new FinTech players emerging with solutions covering most of the complex aspects of the banking value chain, it is clear that although banks have the upper hand when it comes to scale and resources, they may have to collaborate with FinTechs to innovate, in order to stay relevant.

The way customers expect to interact with banks has changed significantly: they now demand omni-channel access. This is resulting in a rapid adoption of electronic channels in the banking sector and money increasingly moving in a digital manner. At the same time, we have seen a consequently marked increase in cyber security breaches and fraud. Cyber security has, over the last five years, been one of the top ten priorities in the board room. Leading banks have now formalized their cyber security strategy and governance to respond to this threat and also to pro-actively adapt to new regulations in order to succeed – and outpace – competitors.

Although VAT still has to be rolled out in Oman, there are some lessons to be considered from other GCC countries where it has already been implemented. It could have far-reaching implications for banks’ profit margins since banks can only recover a small fraction of the total VAT incurred, because most services provided are VAT exempt. It will be interesting to see how they manage their pricing policy in future.

International Financial Reporting Standard (IFRS) 9 came into effect on 1 January 2018. Although most banks technically have been able to meet the date of initial implementation, much more refinement of processes will have to be done before IFRS 9 will become business as usual. The inter-dependency between the IT, Finance and Risk functions also highlights the need for a revised governance framework. In addition, whilst the increase in provisions is not as severe as in Europe, they are substantial and will require banks to reflect on the profitability of some business lines in their current format.

Banks in Oman have many leasing arrangements that will now be in the ambit of the new IFRS 16 standard which becomes effective on 1 January 2019. Branches, ATMs, IT infrastructure and outsourcing arrangements to name a few will have to be assessed to evaluate the impact on their financial statements, operations and capital requirements, which can be significant. Banks cannot afford to delay and should conduct an impact assessment as soon as possible. This assessment
will be more complex for banks with a geographically dispersed network with more lease commitments, and may take longer to conduct.

**The Basel III amendments (also referred to as Basel IV)** to credit and operational risk are likely to be implemented in Oman. This is expected to result in a reduction in the capital adequacy ratios for most banks. The methodology to calculate the amended numbers will require adjustments to systems as well as collection of additional data requirements.
For the eight leading banks in Oman, total asset growth exceeded 5.6%, whilst net profits declined only marginally by 0.2%. This is partly a result of the increased cost of funds due to liquidity pressure (liquidity ratio declined by 2.8%), as a result of the persistent low oil price and despite net impairment charges falling 3.7%.

The Central Bank of Oman has stringent loan-loss impairment requirements which enabled banks in Oman to avoid the large rise in impairment charges as seen across a number of other GCC countries. Regulatory capital has risen due to several Omani banks issuing perpetual debt instruments and although the Capital Adequacy Ratio (CAR) has fallen from 18.1% to 16.9%, it remains well above the required CAR of 13.25%.

**Paul Callaghan**

Partner | Audit  
**E:** PCallaghan@kpmg.com  
**T:** +968 2 474 9234

Paul has over 28 years of professional experience in the UK, UAE and Oman. He manages the provision of audit, tax and transaction services to a broad range of clients operating locally, regionally and globally. Paul is the Head of Financial Services for KPMG in Oman.
Cost-to-income ratio (%)
18.1% 16.9%
↓ 1.2%

Non-performing loan ratio (%)
2.8%

Liquidity ratio (%)
17.5% 14.6%
↓ 2.8%

Capital Adequacy Ratio (%)
18.1% 16.9%
↓ 1.2%

Return on equity (%) 2016 2017 Y-o-y improvement
6.7% 6.6% ↓ 0.1%

Key

Return on assets (%) 2016 2017 Y-o-y improvement
0.8% 0.9% ↑ 0.1%

Source: KPMG analysis of released figures for the top 10 listed banks. See also Key banking indicators on pages 28 to 31
Technology
Blockchain has dominated the news in the last couple of years, notably amongst public sector entities and banks. In Oman a number of initiatives have been embarked upon to create awareness of the potential benefits of blockchain in the digital economy.

Blockchain is an online, encrypted database. Transactions related to documents, shares, financial products, trade, contracts and digital currency, for example Bitcoin, can be implemented, processed and verified. Using a cloud-based network, blockchain technology is believed to be safe, i.e. inherently resistant to modification.

At a global level, blockchain is being considered by many as a panacea to the multiple challenges banks are facing in settlement and clearing, collateral management, KYC, trade finance or digital identities. With growing enthusiasm on future growth among the banking CEOs (77% of CEOs of banks worldwide), implementing disruptive technologies like blockchain is as high as third on the initiatives agendas, behind greater speed to market and fostering innovation.

**Action suggested now**
Our view remains similar to other technological trends disrupting the industry: waiting may not be an option now. Technology advancement today appears to expand exponentially, at least much faster than a decade ago, and early adopters may gain a larger market share. Still, the banks have multiple opportunities to reshape their business models and integrate or develop blockchain-based processes or products, to create further competitive advantage.

This may signal a strong start to the second phase of digital transformation, which provided robust growth in 2013-2014, under the umbrella of front-office transformation, which focused on customer experience and mobility.

This new phase focuses on improving the middle and back-office applications, by either eliminating unnecessary operations or by integrating FinTech solutions into legacy applications.

Under increasing regulatory pressure, customer demands and potential profitability erosion, the focus is to simplify and rejuvenate legacy processes or products, starting from simple application upgrades to completely overhauling IT architectures and internal processes around deployment methodologies, risk, security, application testing and procurement. With multiple market studies estimating that blockchain can significantly reduce a bank’s infrastructure cost, it is no wonder that over 70% of banks worldwide are experimenting with permissioned blockchain.

**New links**
We have analyzed the validity of exploring and implementing blockchain applications in light of three objectives: improving operational efficiency, optimizing revenue and reducing risk. Applications related to trade financing for domestic and international transactions can achieve all three objectives. User cases related to company records keeping, syndicated loans or over-the-counter (OTC) derivatives would likely bring significant advantages to operational efficiency and risk reduction.

Banks and other financial institutions that have explored using blockchain have started with cross-border payments for reconciliation and verification, with live implementation at leading international banks and other financial institutions. Digital Identifiers and KYC-related initiatives have also seen increased blockchain adoption.

During our discussions, proof of concept testing, and through projects implementation we identified four key factors that have the potential to accelerate the adoption of blockchain in the Oman banking sector:

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1. KPMG CEO Outlook report 2017
- Detailed development of industry-wide use cases: business and IT must work together to identify clear pain points that can be solved using blockchain, and outline, where needed, if sub-parts of the existing processes might be migrated to blockchain. Such cases would require agreed business and regulatory rules.
- Increased guidance from regulators on the governance model of such decentralized ledgers, and granting permission to experiment on certain, agreed topics.
- Willingness of one or more large banks to implement and lead various pilots. These would not only validate the technology but also the return on investment and additional value created.
- On-board multiple partners to create wider business potential and tackle data governance and interoperability.

With the initiatives embarked upon in Oman, it is likely that we will see more pilots and live projects using permissioned blockchain. We believe that the future is a healthy mix of public and private blockchain infrastructure, which may allow smaller entities to conduct business at a lower cost, while enjoying similar security, transparency and interoperability benefits.

"Our view remains similar to other technological trends disrupting the industry - waiting is not an option"

Farhan Syed
Partner | Management Consulting
T: +971 5 6520 5377
E: farhansyed1@kpmg.com

Farhan leads the Digital Transformation practice at KPMG in the Lower Gulf. He specializes in assisting clients understand the implications of digital forces, determine opportunities and threats, formulate strategy, transform businesses and bridge performance gaps. He brings a wealth of experience and has delivered numerous projects in the UAE, Saudi Arabia, India, Australasia, Europe and the US, working in financial services, telecommunications, retail, hospitality, aviation, mining and the public sector. Prior to joining KPMG, Farhan held leadership positions with IBM Global Business Services where he led their Digital Consulting Practice for various regions.
The banking sector has often been in the forefront of adopting new technologies and AI is no different. Investment banking, and trading in particular, has advocated as far back as 2011 for technology and advanced mathematical models to automate investment transaction execution.

We have recently seen automation and intelligence gaining traction in deal-making areas. JP Morgan launched Emerging Opportunities Engine, a predictive platform to help clients identify whether they should issue or sell equity; Goldman Sachs also published a plan in early 2017 to automate 146 steps of an Initial Public Offering process (IPO).

Automated portfolio management (or robo-advisors) – a combination of mathematical algorithms and machine learning aimed to calibrate the financial portfolio to the desired goals and acceptable risk thresholds – has come to the fore since 2013.

Earlier versions of AI and machine learning were employed to help detect fraud and security risk by using a complex set of rules. The newer algorithms involve active risk and security protection, adjusting in real time to potential and real threats by continuously analyzing streams of transaction data, internally and from outside sources. Lending and underwriting have also been areas with a predilection for machine-learning algorithms in an effort to improve the accuracy of defaults and reduce the insurance risk on particular products like health insurance.

Lately, AI is being employed to increase customer engagement, drive greater loyalty, provide pervasive security protection and reduce operational cost. Oman’s leading banks have continued to invest significantly in customer experience, using the power of digital to transform the sector. As well as using social media to engage with a younger generation of customers, banks across the Sultanate are developing applications such as mobile wallet and other enhanced digital products. Some of the offerings, such as an augmented reality application, have not been seen before in the GCC, suggesting that Oman’s banks may be setting the agenda in some areas of customer experience.

Intelligence quotient
At the same time, the fear that AI will displace jobs is, in our perspective, a fallacy. A more likely scenario is that AI will transform jobs, not eliminate them. Take the example of customer call centers: employing chat-bots to answer typical FAQs on new products reduces the need for staff. But at the same time it requires manpower to structure and classify the existing knowledge base, and also to ‘train’ the algorithms to provide adequate answers. Smart technology, after all, still needs smart people.

Specialist chat-bots companies have the chance to be life savers for many banks, by providing better service to their customers, without the need to invest in developing complex AI technology. We foresee this trend reaching the region this year, with many banks looking to further differentiate in customer engagement, while continuing with cost-optimization schemes.

The increased quality and efficiency obtained through the introduction of robotic process automation (RPA) is further enhanced by combining it with AI. For example, some banks are exploring automated decision-making based on sentiment analysis (using AI/machine learning), through extracting data from millions of emails and other data sources.

Security will continue to be a hot topic with the advancement of AI-powered counter-threat solutions. As the world moves more towards voice-interaction, we will most likely see greater integration of banks’ mobile apps and wearables with voice-powered robotic applications. The imperative to provide users with the platform they want to interact with must be matched at the same time with the privacy and security legal and ethical compliance.

To effectively use AI and machine learning as a competitive differentiator, banks will first need to identify the business use cases and understand what and where the relevant data are available; then cleanse, classify and augment it with outside, potentially unstructured data. Once the use cases are implemented, monitor the performance improvement and continue to train the models for greater accuracy.

We believe driving early AI adoption by focusing on clear, achievable outcomes and taking incremental steps can provide a good and safe platform for banks to drive innovation and achieve short and long term success.
Cristian Carstoiu
Director | Advisory, Head of Data and Analytics
T: +971 5 0619 8131
E: cristiancarstoiu@kpmg.com

Cristian specializes in mobility, omni-channel transformations, analytics, process consulting and the project management of large and complex implementations. He has worked extensively on strategy and digital transformation engagements, having worked across Europe and the Middle East with blue-chip clients. Cristian has also led multiple mobility and omni-channel strategy and delivery engagements for banking and government clients across the GCC and North Africa.

“A more likely scenario is that AI will transform jobs, not eliminate them”
Banks and FinTech: partners or competitors?

A new wave of financial technology companies, FinTechs, has emerged with solutions covering most of the complex aspects of the banking value chain. What does it mean for traditional banks and will they evolve accordingly, asks Umair Hameed.

Traditionally, banks would take end-to-end ownership of providing all aspects of their products and services to customers. They would go to great lengths to identify potential clients, market and sell their products and services to them, and thereby earn interest or a fee-based income.

Eventually, there was some decoupling of the value chain as the outsourcing trend emerged. Banks started to outsource various aspects of their value chain, such as call centers, sales teams, card issuance and so on, to third-party service providers, whilst benefiting from cost savings. At the same time, banks continued to retain the more complex aspects of their value chain in-house, such as know-your-customer (KYC), client on-boarding, risk and liquidity management, and reporting.

However, in the last couple of years, a cohort of FinTechs has emerged offering specific solutions across most of these aspects of the banking value chain. Unlike most banks, which are lumbered with corporate bureaucracy, legacy systems and processes, and costly infrastructure, FinTechs are often able to bring their products and services to market in a more effective and efficient manner.

**Triple check**

These FinTechs can broadly be categorized into three types, those that:

a) Sell to a bank: including those geared towards parts of the banking value chain that are generally invisible to the customer, such as transaction monitoring, customer analytics, regulatory reporting.

b) Sell through a bank: these help the bank to better serve its customers with, for example, authentication, chat bots, robo-advisors, and financial management.

c) Compete with a bank: these solutions focus on peer-to-peer transactions including payments, remittances, lending, borrowing, mobile wallets, where FinTechs are able to offer customers lower transaction costs, more conveniently, anytime, anywhere.

It would be natural to assume that the first two types of FinTech solutions could bring much needed innovation in the banking sector, as they would help banks derive operational efficiencies whilst improving customer experience. Based on our extensive discussions with banking clients in Oman, however, the extent to which they are embracing these solutions is still fairly low.

Banks either cite regulatory constraints or in other cases opt to establish in-house innovation centers to develop their own solutions, which, in many instances, tend to be costlier and more time-consuming, rather than seeking to embrace a FinTech solution.

As for the third category, FinTech solutions that compete directly with a bank on specific aspects of the value chain, banks do not appear to be worried, as they believe that when the time is right, they can always acquire them.

**No blank check**

At the same time, despite the agility and nimbleness of FinTechs, banks are likely to have the upper hand when it comes to scale and resources, something that most FinTechs need in order to grow their business from scratch. In such circumstances banks and FinTechs could look for ways to collaborate in a mutually beneficial manner.

Banks and FinTechs, however, both still have a long way to go when it comes to taking banking to the next level. Existing efforts, even from the FinTechs, have largely been iterative and incremental. Organizations are still trying to find ways to offer the typical banking products (current account savings account (CASA),
credit cards, loans and payment services) in a more convenient, cost-effective manner, rather than thinking about what today’s – and tomorrow’s – bank actually needs to look and feel like?

Friends or foes, banks need to collaborate with FinTechs to innovate in order to stay relevant.

When the world’s leading transportation company (private taxi hire), the leading accommodation company (online holiday rental), the leading retail companies (online books and other goods) and the leading media company (a video search engine) are all pure play technology companies with none of them having had a legacy conventional business to begin with, then how long will it be before the world’s leading financial services company becomes a technology one? Will it be a bank that embraces FinTech or a FinTech that fully embraces banking? Based on current form, it is more likely to be the latter, I would say.
The pace of technology-enabled innovation has increased exponentially over the last decade, resulting in new business opportunities in the banking industry, such as digital branding (via mobile and internet channels), augmented reality (AR) and virtual reality (VR)-based banking channels, blockchain-based transactions and the internet of things (IOT)-based payments. Transactions are being processed faster, free, and in a user-friendly manner.

These evolutions have fundamentally changed the way customers expect to interact with banks. They now demand an omni-channel presence, improved client experience, secure transactions, and better control over privacy of their data to protect against fraud.

These issues have made cybersecurity one of the top ten priorities in the board room, as any breach could undermine the trust that customers have in their bank, and therefore affect the future profitability and sustainability of the organization. The Sultanate of Oman has always given great attention to cyber security: an exclusive electronic crimes section was incorporated at the General Directorate of Investigations and Criminal Investigations of the Royal Oman Police in 2004. The Oman National Computer Emergency Readiness Team (CERT), established in 2010, was one of Oman’s digital initiatives that reflected the vision and a strong desire to create a digital community in Oman. CERT aims to create a safe and secure environment for conducting electronic transactions in the Sultanate.

It is observed that The Sultanate has pro-actively sought to fully understand the threats posed by cyber criminals and has taken swift action in the fight against cybercrime. The financial services sector, being one of the most frequently targeted sectors globally, has taken a particular interest in this subject. In the financial sector in Oman we have noted that banks have invested significantly in cyber security.

Based on our global expertise of delivering cyber-security solutions and our experience of creating digital solutions for banks, we believe there are seven key capabilities that are strategic to secure digital solutions for clients and build greater trust in the organization:

- **Cyber Security Strategy & Governance**
- **Cyber Security Defense & Response**
- **Consumer identity and access management**
- **Advanced authentication**
- **Secure by design**
- **Device security**
- **Secure transactions**
- **Privacy**
- **Privacy Regulatory compliance**

**Cyber specifics**

- **Cyber security strategy & governance**
- **Cyber security defense & response** are the traditional blocks of security. These translate into a number of specific areas, as follows:

**Consumer Identity and Access Management** provides a single identity across multiple channels
for users to access their accounts, manage their preferences, and manage their credentials in a secure manner. It also provides a mechanism to gather data to understand customer needs and preferences. Changing technologies and increased security concerns have almost rendered passwords obsolete. In order to meet both security and customer requirements, multiple, advanced authentication options, such as biometrics and push notifications, will likely need to be offered. Higher assurance credentials can be leveraged to increase the security assurance of a user for higher risk transactions, such as balance transfers and trades.

New technologies, such as cloud and mobile, are driving customers to want to access their accounts from any channel, at any time, from anywhere. This is resulting in significant changes in architecture. In order to adapt to these changes, security ought to be designed into the architecture and development lifecycle, across different channels and technologies.

The proliferation of different devices poses new security risks. Understanding and adapting to the security of different devices and digital interfaces that the consumer connects with is essential to minimizing account takeover and malware introduction.

As digital financial transactions are becoming more common place, securing the mechanisms that enable each transaction is critical to successfully compete in the omni-channel and completely mobile environment.

**Up close and personal**

Banks handle a significant amount of personal information. Although regulations for handling this data vary from region to region, any personal information collected should be managed in accordance with the local regulations and only used with the consent of the owner of the information.

Understanding how regulations, such as the EU General Data Protection Regulation (GDPR) and others, play a part in the organization’s digital strategy is essential in order to succeed and outpace competitors. Increasing regulatory pressure from the US, the UK, Europe and elsewhere require adjustments in technology configurations, and security requirements are increasingly being enforced. New global regulatory pressures are likely to play a significant role in how financial services institutions interact and collect data on their consumers. This needs to be aligned and understood with the overall organizational digital strategy.

In our 2017 Global CEO Outlook survey it was clear that chief executives would be paying more attention to – and investing more in – cyber security in coming years. In the GCC, 87% of CEOs indicated that they saw cyber security as priority area for investment. Yet this will require finding staff with appropriate skills; many CEOs report that human capital is currently one of the biggest challenges they face when it comes to tackling this issue. These CEOs, however, believe that such risks, if tackled adequately, can further prompt innovation in products and services.

We don’t think there are many board meetings or executive meetings in Oman where the cyber threat isn’t discussed. If companies aren’t concerned, they probably should be.

**Sheikh Shadab Nawaz**

Associate Director | Head of Cyber Security, IT Advisory

T: +971 4 424 8973
E: snawaz1@kpmg.com

Shadab has thirteen years’ experience in cyber security; information technology (IT) governance, risk and compliance (GRC); data, software and cloud security; and IT Disaster Recovery. He has worked on over 100 complex technology projects across a number of industry verticals, including banking and financial institutions; telecommunications; retail; oil & gas; aviation and government. He has been based in the Middle East, India and South East Asia.

Shadab holds a bachelor’s degree in electrical engineering, a master’s in IT and a post-graduate diploma in systems management. His current research interests focus on security analytics, breach investigation and cyber insurance.

“If companies aren’t concerned, they probably should be”
Regulation
Saudi Arabia (KSA) and the UAE were the first GCC member states to go live with a VAT system from 1 January 2018, and the remaining Gulf States are expected to follow suit from early 2019. At the time of writing, Oman has not yet released its VAT legislation but is expected to during the course of 2018. This does provide an opportunity for the Oman banking sector to engage with the Oman government to foster a smooth transition to VAT, in particular to have clarity on a suitable apportionment approach and what types of financial services will be exempt and which taxable. The Oman banks can leverage off the legislation already in place in the UAE and KSA to prepare for the upcoming implementation of Oman VAT while also recognizing that there could be some differences in how the GCC Framework Agreement is mapped into the local VAT law. Oman banks should currently be reviewing their pricing strategy to take account of the future embedded VAT costs and communicating early to customers in preparation.

Many financial services may be VAT-exempt. As a general rule, margin-based products, such as those generating interest income (loans, mortgages, provision of credit, and operation of bank accounts) may be exempt from VAT. This will have no direct impact on the end consumer as they will not be charged VAT. However, there could potentially be a substantial impact on the profitability of the banks since banks will not be able to claim credit for any VAT incurred on expenses related to the making of these exempt supplies.

The VAT law introduced in the UAE also specified services on which customers will be charged five percent VAT, and it is expected that the same will be applicable to Oman. These are any financial services where an explicit fee, commission, discount or rebate is levied. Fees for account applications, money transfers, check books, account statements and ATM charges are now subject to VAT. Favorably for the banks, VAT incurred on costs directly related to making these taxable supplies will be recoverable.

Cost of VAT?
Our global experience indicates that banks tend to recover only a small fraction of the total VAT incurred on expenditure as a result of their exempt income, as it can be very difficult for banks to directly attribute their costs to specific revenue streams. The vast majority of costs therefore fall into the overhead category, which includes general expenses such as lease of premises, utilities, professional fees and marketing, to name a few.

An added complexity is that, as we have seen in the UAE, the Oman VAT legislation's standard method for apportioning VAT incurred on overhead costs to determine the recoverable VAT may be based on the use of the VAT paid on expenses (see diagram for an illustration of how this works).
in practice). The legislation may not allow a change in apportionment method to achieve a ‘fair and reasonable’ VAT recovery for some time after the law is introduced.

Future acquisitions of Capital Assets (from a VAT perspective, where the VAT-exclusive value paid exceeds AED 5m) will result in an increased administrative burden as the use of these assets will need to be monitored over their VAT economic life (ten years for buildings, five years for any other capital asset). Any change in use could result in either a payment or repayment of VAT to or from the Federal Tax Authority (FTA).

Pricing issues
As banks grapple with the new VAT regime and the high compliance costs associated with mandatory VAT registration, it will be interesting to see how they manage their pricing policy from now on. International trends would indicate that the banks may increase their fees to compensate for the additional, hidden costs.

Where banks suffer significant, irrecoverable VAT costs, and/or treat existing taxable fees as VAT inclusive, there may be incentives to cut costs in other areas. As there is no VAT charge on employee salaries or using own resources, banks that currently outsource services, such as back-office activities or call centers, may elect to bring these services in-house to mitigate potential, irrecoverable VAT costs. We believe it quite probable that banks will eventually be forced to increase prices to their customers to maintain their current profitability.

Ashok Hariharan
Partner | Head of Tax
T: +968 247 49231
E: ahariharan@kpmg.com

Ashok is the Head of Tax for KPMG’s Lower Gulf (UAE and Oman) Tax Practice. He is an experienced tax and professional services partner bringing in over 30 years of international tax experience to KPMG’s people and clients in the region. He has previously served as KPMG’s Regional Head of Tax and Regional Quality and Liaison Partner for the Middle East and South Asia (MESA) region. He helped KPMG set up an international tax practice in Dubai in 2003 which assists local and regional companies structure and manage their outbound investments. He has been rated as a leading Tax Advisor and Tax Controversy Leader by Expert Guides, a Euromoney publication.
Most banks across the world have completed the implementation projects over the last few months, if not years, under the much-awaited International Financial Reporting Standards (IFRS) 9. The conceptual transition from incurred loss to expected credit losses has been completed. IFRS 9 has impacted banks across the world and changed the way they approach and view the impairment process. The standard has brought about far-reaching changes in many areas such as financial reporting, risk management, capital management, regulatory reporting, data sourcing and collection, governance framework and IT systems. The standard has, in many ways, integrated the Risk, Finance and IT functions of banks.

The Central Bank of Oman (CBO) issued circular BM 1149 on 13 April 2017 laying down the guidelines on the “Implementation of International Financial Reporting Standard 9 on Financial Instruments”. In order to promote consistency and comparability, CBO prescribed certain requirements to be followed in the development of IFRS 9 expected credit loss models, including the definition of default, forward looking information, mapping of internal and external ratings definitions, significant increase in credit risk, low credit risk exemption and upgrading of accounts. Also included in the circular was a specific requirement to prepare and submit pro forma financial statements in compliance with IFRS 9 based on the financial performance and results of the banks for the year ended 31 December 2017. This was to determine the readiness of the banks for implementation of IFRS 9 from 1 January 2018.

Technically, most banks have been able to meet the date of initial implementation, but we believe it will take a while before IFRS 9 becomes business as usual. Current IT systems need to change significantly to calculate and record changes requested by IFRS 9 in a cost-effective and scalable way, and data sources and models need to be further enhanced.

Adequate infrastructure and systems should be made available for data, for example, recording collateral information, costs and recoveries used in loss given default (LGD) calculation. Models that have been implemented need to be validated and monitored continuously to aim for smooth transition now, and effectiveness in future. All these changes include substantial investment in terms of resources and time from the bank’s perspective.

Given the scale and scope of the impact of IFRS 9, implementation efforts are likely to continue as banks fine tune and work on the supporting areas – or infrastructure – to ensure all facets of the standard run smoothly. Bhaskar Sahay takes us through the important aspects.

Reinforcing sound governance
The inter-dependency between the IT, Finance and Risk functions puts forward the need for a revised governance policy. This includes a structure comprising a board of directors, steering committee, working group committee and technical working group committee. The Central Bank of Oman, Basel Committee for Banking Supervision (BCBS) and Global Public Policy Committee (GPPC) and other such bodies have all recommended minimum standards of governance to ensure that the implementation of IFRS 9 is appropriately supported. The implementation of these governance measures will need careful consideration and time.

It is also likely to bring changes to the way banks conduct business. IFRS 9 is expected to result in some of the business lines and the products becoming less viable than others. Provisions under IFRS 9 are point-in-time, thereby being closely related to the economic cycle. Banks are expected to reconsider the lending to those sectors that are sensitive to the economic cycle. Likewise, loans with longer duration and bullet payments are likely to come under increased pressure due to the effect of higher expected credit loss (ECL). Portfolio strategy ought to be adjusted in order to prevent this increase in volatility.
Profitability is affected currently and may be impacted in various ways in the future as well. Increased current provisions lead to decreased profitability. The implementation of Basel III, together with IFRS 9, will lead to increased cost of capital for banks since the capital adequacy ratio will increase to 16% by 2019 with an additional capital conservation buffer.

Additionally, Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) requirements make liquidity more expensive, affecting profitability and hence capital. This has implications for the pricing of products, deal origination, maturity and amortization of products offered.

**Credit management**

Credit management practices are also likely to be impacted in the future as banks may have to estimate forward-looking expected loss over the life of the financial facility and monitor for ongoing credit-quality deterioration. The credit benchmarks have become higher and more relevant; costs and recoveries will have to be captured and monitored frequently.

Banks may have to revise performance indicators, incentives and compensation schemes to reflect IFRS 9 adjusted profitability. Collections team would have to start their work sooner, considering the 30 days past due (DPD) threshold for significant increase in credit risk (SICR). Shocks on the economy would require vigorous monitoring and transferring of borrowers from stage 1 to stage 2. Such monitoring will lead to an increase in collection and recovery costs.

The relationship manager has a pivotal role in an IFRS 9 scenario. She or he has a role in structuring and pricing the product for the obligor, collecting the installments and being the first point of contact to obtain credit information from the customer.

The role of the business teams is likely to be more onerous with the incentive structures tied to an appropriate risk-adjusted profitability metric, such as return on risk-weighted assets, return on risk-adjusted capital or economic value added.

Given the hard work invested by banks in the earlier stages of IFRS 9 implementation, banks should start afresh setting up a project plan for the next phase to make it become business as usual. The plan should also include provisions to ready the bank for regulatory scrutiny. The date of implementation is a job well begun but only partially done.

**Bhaskar Sahay**

Director | Accounting Advisory Services
T: +971 1 4424 8914
E: bsahay@kpmg.com

Bhaskar’s responsibilities include: leading clients through emerging accounting challenges, specifically IFRS 9, IFRS 15 and IFRS 16; advising on difficult accounting transactions, especially during mergers and acquisitions; and guiding senior stakeholders on accounting matters. His focus is on the integration of the risk and financial data to achieve business outcomes while meeting compliance requirements.

He has extensive experience in revenue recognition, financial instruments, business combinations and lease accounting, and has worked in India, Australia and the UAE.

“Banks should start setting up a project plan for the next phase to make it become business as usual”
IFRS 16: the next big challenge

IFRS 16, the new leases standard which replaces IAS 17, will have significant implications for lessee banks’ balance sheets and consequently on their operations and regulatory capital requirements. Yusuf Hassan assesses what banks should be doing now.

International Financial Reporting Standards (IFRS) 16 Leases, applicable for periods beginning after 1 January 2019 (early adoption permitted), brings significant enhancements in accounting requirements for leases. Lessees, that is the entity that takes assets on lease, are most affected by these changes. Instead of recognizing a periodic lease expense over the lease term for operating leases, as under International Accounting Standard (IAS) 17, lessees are required to recognize most of the leases on the balance sheet. Interestingly, IFRS 16 does not change the way lessors classify and account for their leases.

Banks in Oman have many leasing arrangements that will now be in the ambit of the new IFRS 16 standard: branches, automated telling machines (ATMs), IT infrastructure, outsourcing arrangements and many more. As such, IFRS 16 will have significant implications for the lessee-banks’ balance sheets and consequently on their operations and even regulatory capital requirements. Importantly, it will also change how they assess their obligors’ balance sheets.

How will accounting for lessees change?

Presently, IAS 17 requires lessees to recognize a periodic lease expense on a straight-line basis over the term for operating leases. IFRS 16, on the other hand, will require lessees to recognize most operating leases on their balance sheets as a right-of-use (ROU) asset and a corresponding lease liability. There is no significant change in the accounting for leases currently defined as finance leases.

Lessees will subsequently recognize amortization expense on the ROU asset and interest expense on the lease liability. As the interest expense depends on the declining balance of the lease liability, total expenses arising from the lease contract will

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**Impact on balance sheet**

Companies with operating leases will appear to be more asset-rich, but also more heavily indebted

**Impact on profit and loss**

Total lease expense will be front loaded even when cash rentals are constant
be higher during the initial years of the lease contract, similar to finance lease accounting under IAS 17.

It is also important to note that IFRS 16 allows lessees to opt for a method similar to IAS 17 in accounting for their operating leases when the leases under consideration have a term of 12 months or less, and they do not contain a purchase option. In addition, for low-value assets, lessees may choose to retain accounting for leases similar to IAS 17. However, IFRS 16 does not provide a quantitative threshold for assets to qualify as ‘low-value’. Banks in Oman will have to exercise significant judgment in applying guidance under the new standard.

The impact on a bank’s capital and operations

Banks commonly enter into long-term operating leases for many assets. Under current principles, leased assets are not recognized on a bank’s balance sheets. However, under IFRS 16, such off-balance sheet leases are expected to become on-balance sheet, and result in an increase in the total assets and total liabilities of the bank.

Grossing up of the balance sheet will impact the capital adequacy ratio (CAR) computation for banks. Since operating leases are not currently recognized on the balance sheet, the regulatory requirement to hold capital against such lease liabilities does not arise. On the date of implementation of IFRS 16, the recognition of the ROU asset and the lease liability may result in banks being required to set aside further capital.

The Central Bank Oman has not yet issued guidance in relation to IFRS 16 or its impact on prudential reporting and CAR reporting of banks in Oman. It is essential, nevertheless, for banks to evaluate the potential impact of the new standard on their capital requirements.

In addition, some banks enter into sale-and-leaseback transactions to manage their capital or liquidity requirements. Since all long-term leases will now have to be recognized on the balance sheet, such sale-and-leaseback transactions may no longer provide the lessee banks with a source of off-balance sheet financing.

The client impact Banks also need to anticipate how IFRS 16 will affect the way they do business with their customers. Since the impact of IFRS 16 will extend to the banks’ borrowers, who may have substantial operating lease commitments, significant training would be required for the business to review the change in presentation in the financial statements. The additional liabilities on the balance sheet translate to reduced ability to be able to meet their debt covenants.

As a result, borrowers may seem to be stressed even though nothing in essence has changed. This could also have an impact on the expected credit loss calculations, and could increase the pressure on capital. Banks would either need to allow more headroom on the debt covenants to their clients, or to retain the use of the current lease accounting for the debt covenants.

In conclusion, IFRS 16 is likely to have significant implications for banks’ financial statements, operations and capital requirements. Banks should therefore consider conducting an impact assessment as soon as possible. This assessment will be more complex for geographically dispersed bank networks with more lease commitments, and may require more time to conduct. With IFRS 9 implementation projects safely out of the way, we recommend that banks should aim to set up the processes, systems and controls necessary to comply with IFRS 16.

“Banks should consider conducting an impact assessment as soon as possible”

Yusuf Hassan
Partner | Head of Accounting Advisory Services
T: 971 5 0167 5443
E: yusufhassan@kpmg.com

Yusuf leads our Accounting Advisory Services function for KPMG Lower Gulf and is the Head of Department of Professional Practice (DPP) in the Middle East and South Asia region. He is responsible for assisting our clients with technical IFRS related issues, in particular advising on: the interpretation and application of IFRS to specific transactions and scenarios; the implementation of the latest IFRS developments; standard setting processes; and regional IFRS issues. Yusuf has provided IFRS assistance to a wide range of blue chip clients in various industries across the Middle East. He has conducted IFRS training in South Africa and across the Middle East and has presented at a number of regional IFRS seminars.
The Basel III framework is a central element of the response of the Basel Committee on Banking Supervision to the global financial crisis. Released in June 2011, the original Basel III reforms were primarily aimed at strengthening the capital base of banks and introduced two new liquidity metrics: the Liquidity Coverage Ratio and the Net Stable Funding Ratio.

Since then, the Basel Committee has been busy drafting numerous new standards, including redefining requirements for credit, market and operational risks. These are expected to provide greater risk sensitivity when it comes to how banks are required to manage risk, especially credit risk. The aim is to allow the banking system to support the ‘real economy’ through the economic cycle.

Some industry leaders, including KPMG, have termed these fresh requirements as ‘Basel IV’. The Committee, however, views these as the final touches to the 2011 edition of Basel III, and not the implementation of a new ‘Basel IV’ framework.

The new standards are expected to impact the risk-weighted assets (RWAs), and off-balance-sheet exposures weighted according to risk, for all banks. RWAs are an estimate of risk that determines the minimum level of regulatory capital a bank must maintain to deal with unexpected losses. A prudent and credible calculation of RWAs is integral element of the risk-based capital framework.

In December 2017, the Basel Committee published a number of significant amendments in Basel III: Finalizing post-crisis reforms. These reforms complement the initial phase of the Basel III measures announced in 2010. The 2017 reforms seek to restore credibility in the calculation of RWAs and improve the comparability of banks’ capital ratios. They address weaknesses that were revealed by the global financial crisis and provide a foundation for a resilient banking system that will help avoid the build-up of systemic vulnerabilities. The main changes that may affect banks in Oman are around changes to calculation of regulatory capital for all Pillar 1 risks, namely credit, market, and operational risk.

### Residential real estate
Repayment not dependent on property cash flows

- **70%** LTV > 100%
- **50%** 90% < LTV < 100%
- **40%** 80% < LTV < 90%
- **30%** 60% < LTV < 80%
- **25%** 50% < LTV < 60%
- **20%** LTV < 50%

**Risk weight**

### How will the reforms to Basel III affect banks in Oman?
Steve Punch looks at the implications for risk capital calculation.

**Raising the standard**
Most banks around the world and indeed all banks in Oman use the standardized approach (SA) to determine credit risk capital. Under this approach, supervisors set the risk weights that banks apply to their exposures to determine RWAs. This means that banks do not use their internal models to calculate risk-weighted assets.

Under the recently released Basel changes, it is expected that RWAs for retail customers and financial institutions exposures will rise, thereby requiring banks to hold more regulatory capital against those exposures. The main changes to
the SA for credit risk will:
- Enhance risk sensitivity while keeping the SA for credit risk sufficiently simple
- Provide for a more detailed risk-weighting approach instead of a flat risk weight, particularly for residential and commercial real estate
- Reduce reliance on external credit ratings
- Require banks to conduct sufficient due diligence when using external ratings
- Have a sufficiently detailed non-ratings-based approach for jurisdictions that cannot or do not wish to rely on external credit ratings

For example, under current rules residential mortgages carry a risk weight of 35%, irrespective of loan-to-value (LTV). Under the new rules, LTV will be the determining factor that will drive the risk weight.

Streamlining treatment The financial crisis also highlighted weaknesses in calculating capital requirements for operational risk, or the risk of loss due to inadequate or failed internal processes, people and systems, or from external events. The capital requirements were not deemed enough to cover the losses incurred by some banks. And the sources of such losses – including those related to fines for misconduct or poor systems and controls – are also hard to predict using internal models.

The 2017 reforms were therefore designed to:
- Simplify the framework by replacing the four current approaches with a single standardized approach
- Make the framework more risk-sensitive by combining a refined measure of gross income with a bank’s own internal loss history over ten years
- Make it easier to compare RWAs from bank to bank by removing the options to use multiple approaches or to use internal models

The 2017 Basel III amendments to credit and operational risk are likely to be implemented locally in Oman on 1 January 2022. They will probably have some impact on processes and regulatory capital values, due to the overall increase on RWAs. Overall, it is estimated that for banks in Europe, this will lower the capital adequacy ratio (CAR) by approximately 50-70 basis points, with a similar effect on banks in Oman. The methodology for calculating these values may also require adjustments to systems as well as the collection of additional data requirements.

Steve Punch
Director | Head of Financial Risk Management
T: +971 4 356 9870
E: spunch1@kpmg.com

Steve has 25 years’ experience in Australia, UK, Japan, New Zealand and Hong Kong. He has worked for several blue-chip, international investment banks and has also been an independent consultant to a number of other, large global banks across Finance, Risk and Compliance. Before joining KPMG in 2011, Steve was a Director at UBS Investment Bank in Hong Kong leading a regional ASPAC initiative covering 16 countries from Japan to India to Australia. He has a particular interest in evolving banking regulation as a means to building stronger banking systems.

“The main changes that will affect banks in Oman are around calculation of regulatory capital, namely credit, market, and operational risks.”
Key banking indicators

LDR

<table>
<thead>
<tr>
<th>Bank</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ahli Bank</td>
<td>119.8%</td>
<td>112.7%</td>
</tr>
<tr>
<td>Alizz</td>
<td>107.5%</td>
<td>970%</td>
</tr>
<tr>
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<td>103.6%</td>
<td>105.9%</td>
</tr>
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<td>106.7%</td>
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<td>112.7%</td>
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<td>Bank Sohar</td>
<td>124.9%</td>
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<td>76.0%</td>
<td>72.2%</td>
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<tr>
<td>NBO</td>
<td>111.3%</td>
<td>1078%</td>
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CAR

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<tr>
<th>Bank</th>
<th>2016</th>
<th>2017</th>
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<td>Ahli Bank</td>
<td>15.0%</td>
<td>16.7%</td>
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<tr>
<td>Alizz</td>
<td>14.4%</td>
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<tr>
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<td>16.9%</td>
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<td>16.2%</td>
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<tr>
<td>Bank Nizwa</td>
<td>14.0%</td>
<td>16.9%</td>
</tr>
<tr>
<td>Bank Sohar</td>
<td>14.0%</td>
<td>17.3%</td>
</tr>
<tr>
<td>HSBC Oman</td>
<td>14.0%</td>
<td>17.4%</td>
</tr>
<tr>
<td>NBO</td>
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<td>17.4%</td>
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ROE/ROA

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<tr>
<td>HSBC Oman</td>
<td>0.8%</td>
<td>0.8%</td>
</tr>
<tr>
<td>NBO</td>
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Minimum average regulatory CAR as of 31/12/2017: 12.0%
Source: KPMG analysis of released figures for the top 8 listed banks
Regulatory capital (US$ billion)

<table>
<thead>
<tr>
<th>Bank</th>
<th>Tier 1 capital 2016</th>
<th>Tier 2 capital 2016</th>
<th>Tier 1 capital 2017</th>
<th>Tier 2 capital 2017</th>
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<tbody>
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<td>0.6</td>
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<td>Alizz</td>
<td>0.2</td>
<td>0.2</td>
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<tr>
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<td>3.6</td>
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<td>0.3</td>
<td>0.0</td>
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<tr>
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<td>0.7</td>
<td>0.7</td>
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<td>0.2</td>
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<td>0.8</td>
<td>0.8</td>
<td>0.8</td>
<td>0.0</td>
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<tr>
<td>NBO</td>
<td>1.3</td>
<td>1.3</td>
<td>1.3</td>
<td>1.1</td>
</tr>
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FY16: Tier 1 capital = 8.8 billion, Tier 2 capital = 10.1 billion
FY17: Tier 1 capital = 1.1 billion, Tier 2 capital = 1.2 billion
Net impairment charge on loans and advances
(US$ million)

<table>
<thead>
<tr>
<th>Bank</th>
<th>2016</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Ahli Bank</td>
<td>0.4</td>
<td>9.3</td>
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<tr>
<td>Alizz Islamic Bank</td>
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<td>57.1</td>
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<td>Bank Nizwa</td>
<td>3.7</td>
<td>14.6</td>
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<tr>
<td>Bank Sohar</td>
<td>14.8</td>
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<tr>
<td>HSBC Oman</td>
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<tr>
<td>NBO</td>
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<td>62.8</td>
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Credit rating

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<th>Moody’s</th>
<th>Fitch</th>
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<tr>
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<td>NA</td>
<td>BB+</td>
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<td>Negative</td>
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<tr>
<td>HSBC Oman</td>
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<td>NBO</td>
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<tr>
<td>Overall country rating</td>
<td>BB</td>
<td>Stable</td>
<td>Baa2</td>
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Source: KPMG analysis of released figures for the top 8 listed banks
The information in this report is based on our authors’ in-depth knowledge of financial services industry in Oman, allied with detailed analysis of banks’ financial performance. The GCC listed banks results – Shifting horizons analyses and compares the performance of approximately 60 of the GCC’s leading listed banks. A snapshot of those findings is included on pages 28-31.
KPMG Lower Gulf Limited is a provider of audit, tax and advisory services to a broad range of domestic and international clients across all sectors of business and the economy. We work closely with our clients, helping them to mitigate risks and grasp opportunities. Established in 1973, KPMG Lower Gulf now consists of approximately 1,200 staff members, including more than 70 partners and directors, across six offices: Muscat, Dubai (three), Abu Dhabi and Sharjah. The KPMG member firm in the United Arab Emirates, along with the member firm in Oman, form KPMG Lower Gulf.

In addition to its presence in Oman and the UAE, KPMG is widely represented in the Middle East and has offices in Saudi Arabia, Bahrain, Qatar, Egypt, Kuwait and the Lebanon.

Full details of all the services we offer can be found on our website: www.home.kpmg.com/ae/en/home

KPMG Lower Gulf is part of KPMG International Cooperative’s global network of professional member firms. The KPMG network includes approximately 200,000 professionals in over 150 countries around the world. KPMG in Oman is well connected with its global member network and combines its local knowledge with international expertise, providing the outstanding sector and specialist skills required by our clients. KPMG was the first major firm of its kind to organize itself along industry lines – a structure which enabled us to develop in-depth knowledge of our clients’ businesses and provide them with an informed perspective.

Over the years, KPMG has developed specialist industry and discipline groups to meet client needs for professional advisors who understand and are experienced in a wide variety of business fields. We have significant experience across key geographic areas, and are engaged with leading industry players on a range of issues critical to the future of their industries. In addition to having many of the Middle East’s leading organizations and government-related entities as its clients, KPMG in the Lower Gulf has been party to numerous milestone engagements in the region.

**KPMG Financial Services**

We help clients navigate the increasingly complicated financial landscape towards a prosperous future. KPMG’s dedicated financial services practice in Oman offers access to various key financial marketplaces. It delivers leading practice advice and recommendations through an up-to-the-minute understanding of the vital issues facing the local and international financial services industries.
High quality, independent financial statement audits are essential to maintaining investor confidence. Our audit professionals are committed to the public interest. They seek to challenge assumptions and unlock valuable insights based on a thorough understanding of an organization’s business and industry, and innovative audit methodologies and approaches.

Understanding the financial performance of any business must be placed in the context of strategic priorities, risk appetites and competitive positioning. Our technology-enabled audit approach applies extensive data analytics to provide the necessary evidence confirming that critical controls and disclosures uphold the highest level of integrity.

Our high capability teams offer deep industry and technical knowledge, and market-leading tools to deliver solutions across every business and industrial sector.

Our consultants assist clients to make better decisions that may reduce costs, enhance organizational effectiveness and develop appropriate technology strategies.

Our risk consulting practice combines the knowledge and expertise of over 100 partners, directors and professionals. We help organizations transform risk and compliance efforts into competitive advantage by applying a risk lens to corporate strategy. This improves risk intelligence and decision making, protects financial and reputational assets, and enhances business value.

Our experienced investment professionals skilfully assess how opportunities to buy, sell, partner, fund or fix a company can add and preserve value. Our teams combine a global mind-set and local experience with deep sector knowledge and superior analytic tools to support clients. From assisting to plan and implement strategic change to measurably increasing portfolio value, we deliver tangible results.

A business’s approach to tax is increasingly subject to public scrutiny and is now a major reputation driver. From company set-up to cross-border and transfer pricing solutions, we work with a wide range of national and multinational organizations to deliver effective tax solutions. Our tax professionals combine international experience with local knowledge to provide leading edge commercial tax strategies tailored to specific client needs.

Tax issues are constantly evolving. Changes in law, practice, or approach—in Oman and the UAE and globally—can have major ramifications on local and international organizations.

— Audits of financial statements
— Audit-related services
— Audit data & analytics
— People & Change
— Customer & Analytics
— Financial Management
— Operations
— Strategy & Economic Advisory
— IT Advisory
— Forensic
— Business Process Management
— Accounting Advisory Services
— Internal Audit & Risk Compliance
— Climate Change & Sustainability
— Capital Markets
— Valuations
— Debt Advisory
— Transaction Solutions
— Mergers & Acquisitions
— Restructuring
— Inbound & indirect taxes
— Mergers, acquisitions and restructuring
— International tax services
— Transfer pricing
— Tax management consulting
— Global mobility services
— Automatic exchange of information
— VAT