Armenia

Neighbourhood SME financing

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This report is based on a survey of the intermediaries conducted by the Economics Department of the European Investment Bank. Information about the market context draws on a number of international and national sources.

About the Economics Department of the EIB

The mission of the EIB Economics Department is to provide economic analyses and studies to support the Bank in its operations and in its positioning, strategy and policy. The Department, a team of 25 economists and assistants, is headed by Debora Revoltella, Director of Economics.

Disclaimer

The views expressed in this document are those of the authors and do not necessarily reflect the position of the EIB.

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1 Summary

1.1 Economic background

- Armenia is a low-middle income country with a GDP per capita estimated at USD 8,468 in PPP terms in 2015 and total population of three million. In late 2014 regional and global conditions significantly deteriorated and weighed heavily on domestic economic activity. As a result, real GDP growth decelerated to 3% year on year in 2015 down from 3.5% in 2014.
- Armenia is a small open economy historically characterised by negative current account balances. The country's main exports are mineral products, base metals, precious and semi-precious stones, metal and food items. The current account deficit contracted for the sixth consecutive year to 2.6% of GDP in 2015 due to large adjustments in the trade balance. Remittance inflows are an important part of the economy, due also to the large Armenian diaspora living abroad.
- The slowdown in the Armenian economic activity was reflected into government's budget performance. The fiscal deficit widened to 4.8% of GDP in 2015 from a 2000-2014 average of 2.7%. This was mainly related to a weak revenue performance and tax policy changes. The government debt stood at 46.6% of GDP in 2015.
- Armenia has made a considerable progress in improving business environment during the past years and created more favourable conditions to start and sustain business activities. Armenia ranks 35 out of 189 economies in the World Bank Doing Business 2016 Report, progressing from 43rd position (out of 183 economies) in 2010.
- Small and medium sized enterprises (SMEs) are an important part of the economy. Most of the micro, small and medium enterprises are concentrated in the services sector, particularly wholesale and retail trade.
- The government of Armenia has been active in supporting the SME segment development. In 2000 the Law on State Support and the "Concept for SME Development Policy and Strategy" were adopted. As a consequence of that the SME Development National Centre of Armenia (SME DNC) was established in 2002.

1.2 The financial sector

- The banking sector dominates the Armenian financial system. It accounts for roughly 90% of total financial assets. The financial system is composed of 20 commercial banks, one development bank, 32 credit organisations, 8 insurance companies and 3 insurance brokers. There are also a number of pawnshops, exchange bureaus, and money transfer companies.
- The banking sector has a high share of foreign ownership with non-residents accounting for 68% of aggregate equity. Armenia's banking sector shows relatively low concentration. The top five banks hold 53% of total banking sector assets.
- Financial intermediation in Armenia has been expanding over the past decade, albeit remaining at low levels. Banking sector total assets, total deposits and aggregate credit made up 68%, 30% and 40% of GDP respectively in 2015. The recent slowdown in the economic activity led to weak credit performance and ultimately a reduction in loan portfolio during 2015 and early 2016.
- The banking sector in Armenia remains well-capitalized. The aggregate CAR stands at 17.2% (May 2016) and is well above the regulatory minimum of 12%. However, recent weak economic activity and domestic currency depreciation weighed heavily on the profitability of the sector. The share of non-performing loans increased to around 10% of total loan portfolio.
- Banking sector dollarization is high, leaving it exposed to currency induced credit risks. Roughly 69% of deposits and 68% of loans are denominated in foreign currency, while borrowers largely rely on local currency denominated income sources.
- Commercial banks are primarily funded by non-bank deposits, combined with the funding from foreign sources.

- Non-bank financial institutions account for a modest share in the financial system. Credit organizations account for 8% of Armenian financial sector assets, followed by the insurance sector with a 1.1% asset share.
- Funding constraints vary across banks. Banks generally have better access to foreign currency funding both from domestic and external sources. On the other hand some factors limit the supply of credit, *inter alia* high market interest rates; low profitability; lack of local currency funding as well as lack of long-term funding.

1.3 Gaps in SME finance

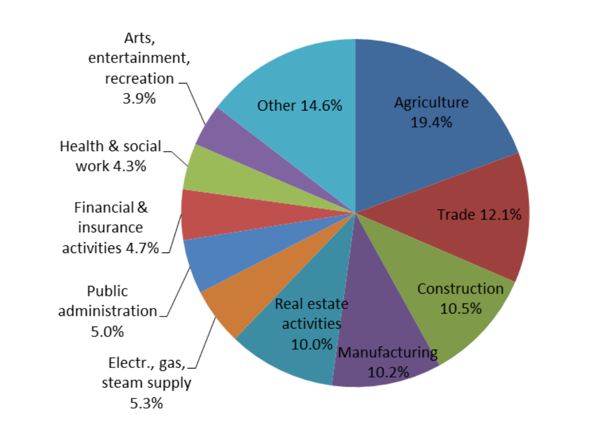
- The analysis of gaps in financial products availability is based on publicly available information and data, direct due diligence on the field as well as an EIB proprietary survey conducted to detect credit market conditions and bottlenecks, with a particular attention to SMEs financing.
- Banks are the main source of external funding to SMEs, mostly through loans. Non-bank finance and capital markets are under-developed.
- Access to finance represents a constraint for companies, particularly SMEs. The share of credit constrained SMEs is high. Many of them are discouraged even from applying due to high interest rates or complex procedures. Therefore, SMEs rely heavily on internal funds.
- Both demand and supply factors constrain the expansion of SME credit portfolio. The dominance of demand-related issues is largely linked to current turbulent macroeconomic conditions, while supply-related issues can be considered rather structural.
- The most prevalent bank-specific factors constraining SME credit growth are: high market interest rates; low profitability; lack of local currency funding. High interest rates are linked to the funding structure of banks and to the lack of local currency resources. For example, there is a generalised lack of long-term funding.
- Most banks indicate some degree of difficulty for SMEs to post the necessary collateral. Real estate is the main asset requested as collateral; while micro enterprises and SMEs primarily own movable property.
- As a result:
  - Local currency instruments to support SMEs are limited, especially for longer-term maturities.
  - Trade finance instruments are available; however the market remains undeveloped due to demand-side bottlenecks, including low awareness and low financial literacy among SMEs.
  - Private equity and venture capital markets are very shallow. Securing financing for start-ups or firms at early stages of business operations represents a severe problem. The leasing sector is underdeveloped.
  - Credit guarantee schemes are present on the market but are not widely employed. The unavailability of funding constraints local programmes. Moreover some regulatory issues limit the full utilisation of guarantee schemes, even when supported by international organisations.
  - Technical assistance and advisory services for SMEs could increase their bankability through enhanced financial literacy, improved business planning capacity and management practices.

2 The Macroeconomic Environment

Armenia is a lower-middle income country with an estimated GDP per capita of USD 8,468 (PPP) in 2015. It is a small landlocked economy with a total population of about three million. A constitutional referendum in December 2015 changed the country's governance structure from a semi-presidential system to a parliamentary republic. Armenia's economy is driven by a small-scale agriculture sector contributing 19.4% of total GDP in 2015, followed by the industry (18.3%), wholesale and retail trade (12.1%) and construction (10.5%) (Figure 1). Dependence on commodity exports - mainly minerals and metals - leave the country exposed to international price shocks. Moreover, geopolitical risks[1] weigh on development prospects.

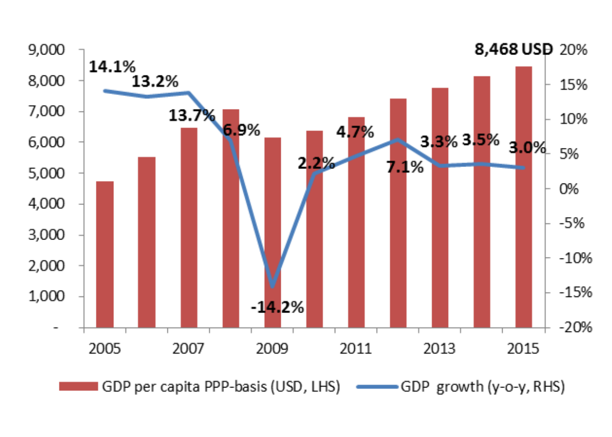
The global financial crisis caused GDP growth to drop to a low of -14.2% year-on-year in 2009 (Figure 2). Following this event, the country recovered posting positive growth outcomes (4.7% year-on-year in 2011, 7.1% in 2012, 3.3% in 2013 and 3.5% in 2014). In late 2014 the Armenian economy has been going through turbulent times. Regional and global conditions significantly deteriorated and weighed negatively on domestic economic activity. An economic slowdown of the main trading partners (predominantly Russia) and a decline in base metal prices had negative spill-overs on trade and financial flows. Furthermore, the depreciation of the Russian Rubble (not fully matched by a depreciation of the Armenian dram) deteriorated Armenian firms' competitiveness and negatively affected country's exports. As a result, real GDP growth decreased to 3% year on year in 2015, driven by industry and agricultural sectors. Projections for 2016 show a further slowdown slightly over 2%[2] year on year.

Figure 1. Gross Domestic Product by Sectors, 2015



Source: National Statistical Service of Armenia

Figure 2. Dynamics of Gross Domestic Product



Source: World Economic Outlook April 2016, IMF

Monetary policy and inflation: Maintaining price stability is the primary goal of Central Bank of Armenia (CBA) since 1996. The inflation target is defined at 4% with a confidence band of ±1.5 p.p. and a policy horizon of three years. CBA adopted an inflation targeting regime in 2006. CBA relies on a forward looking approach and utilizes a Forecasting and Policy Analysis System in monetary policy decision-making process. The Monetary Policy Program is adjusted and published each quarter, and followed by a decision on the policy rate. Altogether eight decisions on policy rates take place each year.

Monetary policy is considered to be quite effective due to a high level of independence of the Central Bank of Armenia. Various measures have been implemented to develop a strong institutional and technical framework, forecasting and policy analysis system, increasing transparency and gaining

[1] In April 2016 the military conflict in the Nagorno-Karabakh region intensified temporarily.
[2] IMF Third Review Under the Extended Arrangement. July 2016.

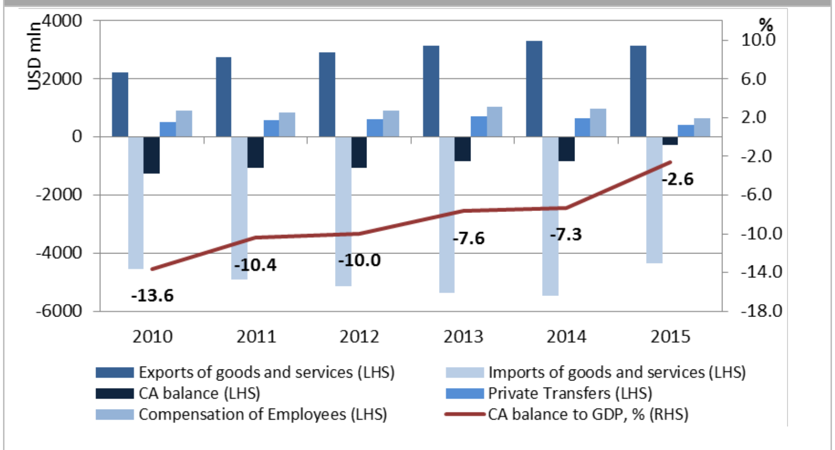
more credibility. However, some obstacles remain. Particularly, the high level of dollarization is obstructing the efficiency of monetary policy transmission. CBA deploys reserve requirement ratio, diversification of liabilities in national currency and foreign currency, capital adequacy ratio aiming to decrease the level of dollarization in the system.

Inflation has been volatile over the past years due to *inter alia* global commodity prices, agricultural harvesting and exchange rate developments. In 2007-2016 the annual inflation rate was on average around 5%, with a peak of 11.5% reached in March 2011 and deflation between December 2015 and May 2016 (-2.1% year on year). Low agricultural product prices and low inflation on imports continue to compress local inflation. In addition, a reduction in natural gas tariffs is expected to add to deflationary pressures. As a consequence CBA has decreased its policy rate starting in December 2015. In June 2016 the monetary policy rate stood at 7.5%.

External Sector: On average the current account balances of Armenia have been negative. Openness to trade is modest, hampered by a landlocked position and closed borders with the neighbouring Azerbaijan and Turkey. Mining exports, especially copper, account for half of Armenia's export goods. However, a decline in international prices of key exports is suppressing export proceeds and outweighing the impact of a fall in oil prices. Copper prices are at the lowest level since the 2008-2009 crisis. Remittance inflows are an important part of the economy. Export shares directed to Russia and EU decreased, whilst trade with Middle Eastern countries, Canada and China deepened.

Current account deficits have been very large between 2008 and 2011 (Figure 3). However the deficit position has been improving over the past years. It served as a mitigating factor to external shocks in recent periods (see Figure 3). The current account position continued to improve for the sixth consecutive year to 2.6%[3] of GDP in 2015 (7.3% of GDP in 2014), mainly due to large adjustments in the trade balance. One-off increases in agricultural production and copper exports, lower import prices and weak domestic demand boosted real exports, whilst nominal and real imports declined. In Q1 2016 the current account deficit was lower in nominal terms compared to Q1 2015 as exports grew and imports contracted. The trade balance improvement is further support by long-term productivity growth.

Figure 3. Components of the Balance of Payments of Armenia



Source: Central Bank of Armenia

Remittances are a relevant part of the economy. These are a direct function of the enormous diaspora - i.e. roughly about 70% of Armenians live abroad. Although, dependence on remittance income has declined over the past year, it still remains high. In 2015, the net inflow of remittances stood at about 10% of GDP as opposed to over 15% in previous years. The inflow of remittances amounted to USD 1.4 bn. in 2015[4] (dropping by about 30% from 2014). It compares to FDI (net incurrence of liabilities) of USD 179 mln in 2015. The drop in remittances was predominantly driven by Russia's slowdown. It is the main contributor accounting for 76% of total remittances in 2015. On the other hand, the share of remittances from US has almost doubled over the past 5-6 years, reaching 10% of total remittance inflows in 2015.

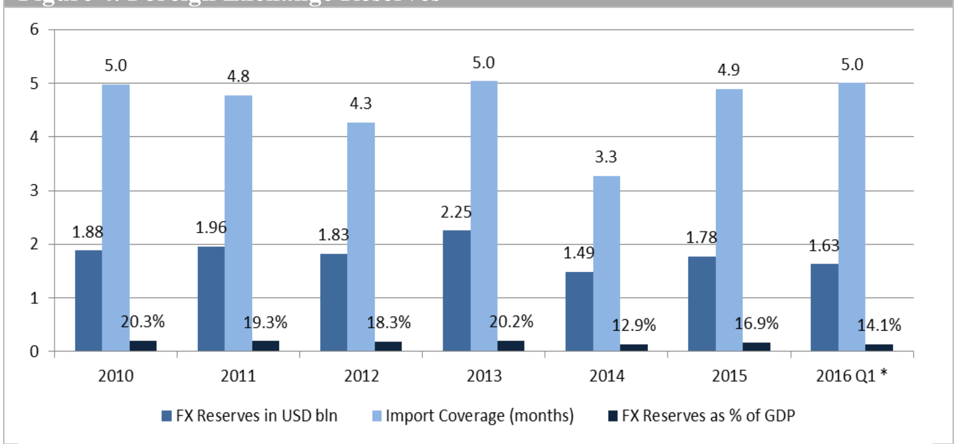
[3] The Central Bank of Armenia
[4] By the Balance of Payment. Central Bank of Armenia

January-April 2016 data for money transfers of individuals showed a 2.5% decline in total inflows compared to the same period of the previous year. However the drop in net inflows amounted to 19%.

Armenia experienced a significant slowdown in FDI flows recently. This was partially a result of the Eurozone financial crisis. The slowdown in Russia exacerbated the weakening of investment activities. Russia accounted for about half of the net stock of foreign direct investment in 2015, down from 58% share in 2009. Armenia's dependence on capital inflows from Russia decreased gradually in favour of Switzerland, Germany, Cyprus and Lebanon. FDI inflows (net incurrence of liabilities) amounted to USD 179mln in 2015, down from USD 404mln in 2014. This negative trend in FDI inflows from Russia to Armenia is mirrored into a deterioration of the trade account, share of exports to Russia in total exports decreased to 15% in 2015 from 23% in 2013. Moreover the inflow of remittances sharply decreased. Remittances from Russia contracted by 10% in 2014 and by another 36% in 2015[5].

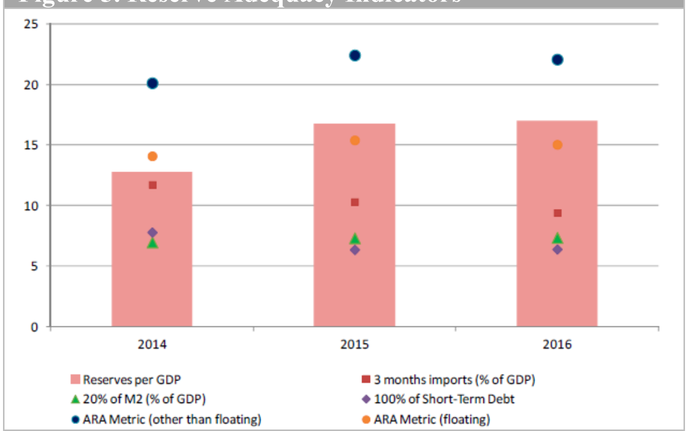
International reserves and exchange rate: The gross international reserves increased four times during 2003-2013, reaching USD 2.25bn at the end of 2013 (Figure 4). However, FX reserves recorded a sharp drop at the end-2014 to USD 1.49bn due to deteriorated foreign currency inflows and heavy FX interventions as the pressure on the exchange rate mounted. For example, the central bank (CBA) injected around USD 212mln in Q4:2014[6]. Moreover the FX interventions continued in 2015 at a slower pace. The CBA sold around USD 150mln in Q1:2015 and another USD 82mln in Q3:2015, while purchased USD 25mln in Q2:2015[7]. As a result the IMF performance criterion (PC) on net international reserves (along with PCs on net domestic assets and fiscal deficit) was missed at the end of June 2015 as identified under the Second Review of Armenia's Extended Arrangement[8]. Reserves partially recovered to USD 1.78 by the end-2015, supported by Eurobond proceeds and other foreign borrowings. According to the IMF Third Review under the Extended Arrangement, the PC on the NIR was met at end-2015. As of Q1:2016, CBA holds international reserves of roughly USD 1.6 billion, equivalent to 14.1% of GDP or 5.0 months of import cover (Figure 4). International reserves remain adequate according to the internationally adopted

Figure 4. Foreign Exchange Reserves



Source: Central Bank of Armenia

Figure 5. Reserve Adequacy Indicators



Source: IMF, "IMF Third Review Under The Extended Arrangement", July 2016

[5] Measured in USD, Moody's Investors Service.
[6] CBA Inflation Report. Q1 2015.
[7] CBA Inflation Reports of respective periods.
[8] The IMF Executive Board approved the authorities' request for waivers of non-observance of the missed PCs.

import and debt metrics, in line with the adequacy level suggested by the IMF's new metric (ARA) for floaters[9], but below the level suggested for non-floater economies (Figure 5).

Fiscal situation: Armenia has been running an average fiscal deficit of roughly 2.7% of GDP during 2000-2014. The government deficit was 1.0% of GDP in 2013, and 2.1% in 2014[10]. However, the deficit widened to 4.8% in 2015 due to weak revenue performance and tax policy changes such as deletion of the minimum profits tax, reduction of the turnover tax rate, extension of the payment date for VAT collections on imports from Eurasian Economic Union (EEU) countries, and shift to accrual reporting for VAT. The government committed to a tighter fiscal policy, largely through spending cuts; therefore the fiscal position is expected to start stabilizing in 2016, with a projected fiscal deficit of around 4.1% in 2016 (IMF, Third Review Under The Extended Arrangement). To meet the financing needs of the budget, the government issued 10-year Eurobonds in March 2015, with a nominal value of USD 500mln and 7.5% yield. Large part of proceeds - about USD 205 mln - was used to buy back the previous issue of Eurobonds (USD 700 mln placed in 201311). Another USD 85mln was deployed to cover the budget deficit. The overall debt stock increased to 46.6% of GDP in 2015 (expected roughly 50% in 2016)[12] compared to 14% in 2008. External debt as percentage of GDP increased from roughly 30% in 2008 to 80% in 2015. Over 85% of public and publicly-guaranteed debt is foreign currency denominated. Therefore it is highly sensitive to exchange rate shocks.

[9] Effective from November 2014, the IMF has reclassified Armenia's de facto exchange rate regime as "floating".
[10] IMF
[11] The big part of USD 700mln issue of 2013 was used to repay the USD 500mln Russian loan ahead of schedule.
[12] IMF Third Review Under the Extended Arrangement. July 2016..

3 Financial Sector Overview

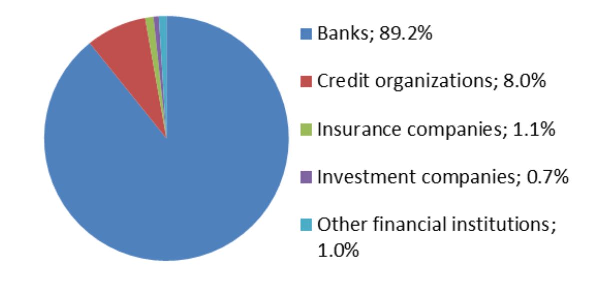
3.1 Banking Sector

3.1.1 Structure

The banking sector dominates the Armenian financial system. It accounts for roughly 90% of total financial assets (Figure 6). The financial system is composed of 20 commercial banks, one development bank, 32 credit organisations, 8 insurance companies and 3 insurance brokers. There are also a number of pawnshops, exchange bureaus, and money transfer companies. The development bank – PanArmenian Bank (PAB) was established in 2009 and is fully owned by the central bank. But due to conflict of interests, the CBA has been strongly encouraged to divest its shares. The non-bank market remains highly underdeveloped.

The total number of banks has been in the range of 21-22 during past seven years. The banking sector has a high share of foreign ownership with non-residents accounting for 68% of aggregate equity as of June 2016, down from 75% in 2011. Armenia's banking sector shows relatively low concentration with the top five banks holding 53% of total banking sector assets. Out of 22 banks, 18 has foreign equity participation and for 11 of them foreign equity share exceeds 95%. The public sector share accounts for approximately 2%. The banks are structured either as an open joint stock company (OJSC), a limited liability company (LLC), or a closed joint stock company (CJSC), the latter being the most commonly adopted form.

Figure 6. Asset Distribution in the Financial Sector, 2015.



Source: Central Bank of Armenia

Currently the banking sector is undergoing a process of consolidation, encouraged by the five-fold increase in minimum regulatory capital, effective from the end-2016. The latest acquisition deal was secured in December 2015, when the Inecobank overtook 100% of shares of the Procredit Bank Armenia. The Inecobank raised funds from the EBRD in the form of equity investment and from the IFC loan. Further mergers and acquisitions are expected in the banking system, unless all banks decide and manage to inject additional required capital.

The largest bank operating in Armenia accounts for about 14% of the sectoral assets, while top three banks make up 36%. The banking sector Herfindahl-Hirschman indices (HHI) based on assets, loans and deposits (around 0.08 in April 2016) indicate a low level of concentration, thus limiting the impact of the concentration risk on the financial sector stability. However, the concentration has been gradually increasing over the past five years and further acquisitions and future mergers cannot be ruled out given the increase in minimum regulatory capital requirement. Considering the small size of the Armenian economy, the presence of such number of banks leads to strong competition among the financial institutions and puts pressure on their profit margins. The high degree of competition is reflected in banks' marketing strategies. Some of them make use of intensive promotions and aggressive sales. All in all, a narrowing of interest rate spreads is observed.

3.1.2 Credit developments

Financial intermediation in Armenia has been expanding over the past decade and the loan portfolio has increased roughly ten-fold during 2006-2014. The banking sector assets peaked at 70.3% of GDP in 2014, while banking sector loan portfolio reached 42.7% of GDP. Deposit to GDP ratio reached a peak at 27.3% of GDP at end-2014 (Figure 7). However, financial intermediation declined in 2015: asset-to-GDP and credit-to-GDP ratios decreased to 68.5% and 39.8%, respectively[13]. This corresponds to AMD 3.5 trillion assets (approx. USD 7bn) and AMD 2.0 trillion loans (approx. USD 4bn). To the contrary, the deposits-to-GDP ratio grew to 29.8% of GDP at the end-2015. The slowdown in banking sector activity was due to a weak economic environment, increased uncertainties, and negative spillovers from regional developments. As a result, demand for loans declined and banks started to apply more conservative lending policies. Overall, loans to the economy decreased by about 3.0% in 2015: loans to enterprises and organizations declined by 3.7%, while loans to households decreased 2.8%.

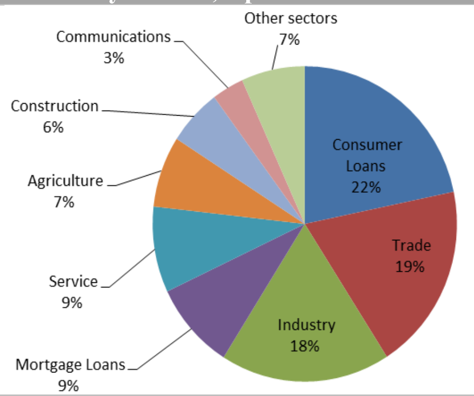
Figure 7. Banking Sector Indicators

	2011	2012	2013	2014	2015
Banking sector assets/GDP	54.7%	61.8%	69.0%	70.3%	68.5%
Total loans/GDP	33.6%	40.2%	42.1%	42.7%	39.8%
Deposits/GDP	20.2%	23.7%	25.2%	27.3%	29.8%

Source: Central Bank of Armenia

Credit activity remained weak at the beginning of 2016. During January-April 2016, loans to the economy grew by about 2.6%, compared to end-2015. Loans to enterprises and organizations registered higher growth (3.5%) compared to loans to households (1.1%). As for the sectoral credit activity, stronger credit growth was observed in the services (10.7%), trade (9.2%) and construction (6.5%) sectors, while loans to the industry (-5.7%) and communications (-5.5%) recorded declines. Commercial banks' loan portfolio is dominated by consumer loans with a 22% share, followed by trade sector with 19% share and industry with 18% share (Figure 8). The agriculture sector accounts for another 7% of total loans.

Figure 8. Commercial Banks' Total Loans to Residents by Sectors, April 2016



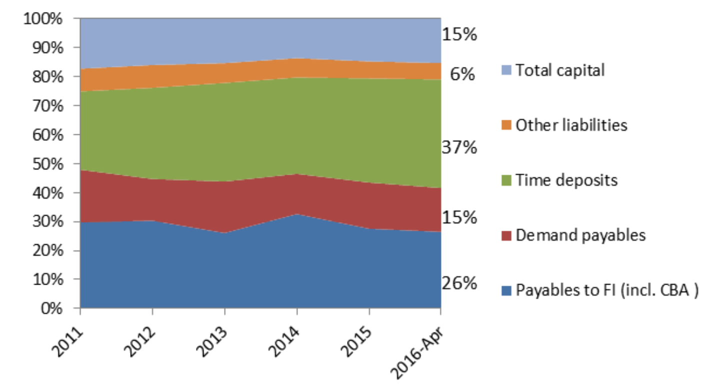
Source: Central Bank of Armenia

3.1.3 Funding

Commercial banks are primarily funded by non-bank deposits, which made up 53% of total banking sector liabilities (including equity) as of April 2016 (Figure 9). Deposits are the main source to finance local currency loans. However, only 38% of deposits are denominated in domestic currency and their maturity is rather short-term. More than one third of local currency deposits are demand deposits, while time deposits have also short maturities. The shortage of long-term domestic currency funding significantly holds back credit growth for enterprises, especially in the SME segment.

[13] Expressed in nominal terms, banking sector assets increased by 1.4% and total loans decreased by 3.0% at the end of 2015 as compared to the year before.

Figure 9. Liabilities and Capital of Commercial Banks



Source: Central Bank of Armenia

In addition to deposits, banks obtain some local currency funding through loans of international financial institutions channelled via the central bank. The CBA borrows in foreign currency and on-lends to banks in local currency. By doing so, the central bank aims to support the dedollarization process of the economy, whilst essentially taking the exchange rate risk. One of the existing mechanisms operates through the German Armenian Fund (GAF), established by the CBA in 1999 and originally funded by KfW. The GAF now channels several sources of funding for a variety of purposes, including the recent EIB Apex loan for SMEs.

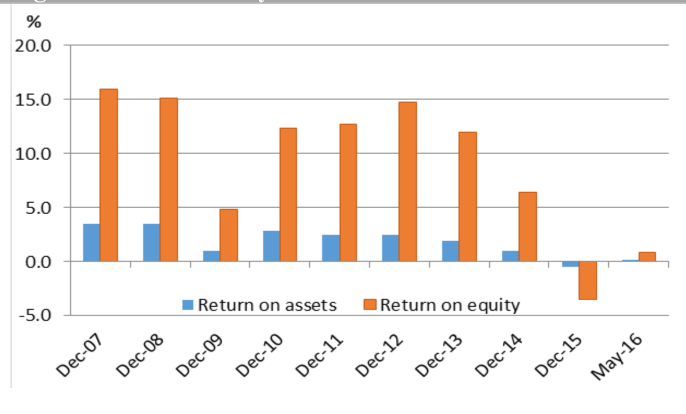
3.1.4 Performance

Capital Adequacy: The banking sector in Armenia is well-capitalized. The aggregate CAR was 17.2% in May 2016 up from 15.0% the year before and well above the regulatory minimum of 12.0%. The tier 1 capital ratio was also high at 14.5% in May 2016. Overall, banks injected roughly AMD 75bn in new capital in 2015. Given the sensitivity to exchange rate movements, the CBA applies a higher risk weighting on FX exposures (50% higher). Current capital adequacy framework in Armenia is largely based on Basel II and Basel III will gradually replace it by the end of 2019; and additional ratios are set to be introduced. Moreover, a draft law has been prepared in line with Basel III to impose counter-cyclical capital buffers for systematically important banks.

The increase in capital level over the course of 2015 was driven by the replenishment of statutory capital and long-term subordinated loans, mainly from external sources. The process of capital injections is attributed to the increase in minimum capital requirements. To consolidate and strengthen the banking sector, the CBA Board set the minimum capital requirement at AMD 30bn starting from 1 January 2017 as opposed to the current minimum of AMD 5bn. As a consequence new capital in the ballpark of USD 360mln[14] will be required by the end of the year for a full compliance of all banks.

Profitability: Profitability of the banking sector has been quite volatile over the past ten years and on a decreasing trend in recent periods (Figure 10). The banking sector have been making a net profit until 2015, when it registered a loss of AMD 21bn (approx. USD 44mln), calculated in accordance with the CBA supervisory reports[15] (15 banks reported net profits vs. 7 banks incurring losses). Recent weak economic activity and domestic currency depreciation weighed heavily on the profitability of the banking system. The banking system ended the year 2015 with Return on Assets (ROA) and Return on Equity (ROE) ratios of -

Figure 10. Profitability Indicators



Source: Central Bank of Armenia

[14] IMF Third Review Under the Extended Arrangement

[15] Net profit, according to IFRS standards, amounted to AMD 18bn (approx. USD 38mln) in 2015, with ROE at 3.5% and ROA at 0.5%

0.5% and -3.5% respectively. On the income side, the share of interest income decreased, while share of recoveries from asset loss provisions increased. On the other hand, the allocations for asset loss provisions increased while the non-interest expense decreased.

Liquidity conditions: The banking sector of Armenia is quite liquid, with liquid assets to total assets hovering between 24% and 31% during the past five years. In May 2016 liquid assets made up 28% of total assets, almost double the regulatory threshold of 15%. Likewise, liquid assets covered 155% of short term liabilities[16] (demand deposits), compared to 140% the year before. As for the breakdown of assets and liabilities by maturities, the ratios improved on the shorter end (30-days, 3-months) in 2015, while for the basket of up to 1-year there was some decline during the past two years. The latter was largely driven by increased loan maturities and deepening of financial intermediation.

The sector's loan to deposit ratio has remained consistently above 100% since 2008 (2015: 112.4%; 2014: 129.3%) reflecting a high level of funding from foreign banks, international organizations, the government and the CBA. Interbank lending is not a significant source of liquidity and the volume of operations is very small, mainly executed with minimal margins at CBA rates. The CBA can provide short-term liquidity support via its main instruments, provided collateral availability. The CBA imposes strict regulatory requirements on minimum liquidity levels (for details see Annex II). Some new regulations, as suggested by Basel III recommendations concerning the new liquidity standards, are currently examined against the existing standards to assess the feasibility of their introduction.

Credit Risk: credit risk represents the essential component of the overall risks to the financial stability in Armenia. Correspondingly, the share of the credit risk in risk-weighted assets was high at around 90% at the end of 2015, followed by the interest rate risk (5.4%) and the operational risk (3.6%). Among other factors, indirect exchange rate exposures considerably increase credit risks to the financial sector in Armenia. Particularly, the banking sector is highly vulnerable to exchange rate fluctuations due to the high level of dollarization (Currency Induced Credit Risk). With around 68% of loans being denominated in foreign currency, sustained currency fluctuations can trigger financial instability through borrowers' unhedged exposures. There are no direct limitations of FX lending to businesses. However FX exposures are weighted 50% higher than dram exposures. Therefore, banks are free to lend as long as they are capable of complying with the capital adequacy threshold. As for consumer loans, according to the Law on Currency Regulation and Currency Control, they can be extended only in local currency. The issue of FX lending is originating from the funding structure of banks: deposits (the major component of bank liabilities) are predominantly FX denominated (roughly 70%). There are very few hedging mechanisms available. However, the cost of these mechanisms is very high and does not allow generating reasonable and appealing market pricing for the various banking products. The CBA absorbs some foreign currency risk by taking loans from international financial institutions in foreign currency and on-lending the funds to local financial institutions in drams.

Non-performing loan (NPL) ratios started to gradually increase at the end of 2014. High credit growth over the previous years, sharp exchange rate depreciation in late 2014 and weakening of the economic activity were the main contributors to the banks' asset quality deterioration. As a result, the share of NPLs peaked at over 9% of total loan portfolio during April-June 2015, from 7% at end-2014[17]. NPLs moderated in the second half of 2015, ending the year with a ratio of 7.8%. However NPLs increased again to 9.8% in May 2016. As for the sectoral distribution, non-performing loans grew considerably in agriculture; public catering and service; and industry. Against the weakened repayment capabilities, some banks went through the process of loan restructuring. According to CBA methodology, a loan is classified as non-performing after one day it became overdue. This is stricter than IMF definition. On the other hand, CBA definition of NPLs includes watch, substandard, and doubtful loans, whilst it excludes loss loans (i.e. more than 270 days past due). Due to these methodological differences, the IMF estimated an NPL ratio of 17.4% as opposed to CBA's 9.8% in May 2016.

[16] Regulatory minimum is 60%.
[17] Central Bank of Armenia

Market and Other Risks: The direct exposure of the banking sector to the foreign exchange rate risks remains limited. The CBA imposes a ratio of foreign currency position to total capital at 10% and the maximum ratio of each foreign currency to total capital is at 7%. As of April 2016, the net open position in FX is at -2.6% of capital (end-2015: -2.8%; end-2014: -11.1%). Overall banks are exposed to the risk of foreign currency appreciation in future. However the exposure levels are rather small. As described in the previous sections, indirect exposure to FX risks through unhedged borrowers is much more significant, leading to high credit risks.

Other market risks appear to be limited. Over the past five years spreads between lending and deposit rates have been decreasing, reaching a low 2.2% at end-2015. The trend was driven by increasing average interest rates on dram deposits. FX interest rates showed less variation over the same period. However spreads have widened again in April 2016. Average deposit rates in drams declined, while average lending rates in drams increased. As for the FX bank products, both deposit and lending rates declined, bringing the FX spreads down.

Regarding the risk pricing, conservative lending policies (with loan-to-value ratios on mortgages between 60-80%) should cushion a decline in real estate prices and are not likely to generate considerable losses on mortgages.

3.1.5 Regulation

The Central Bank of Armenia is the main body responsible for maintaining financial stability in the country. Starting from 2016, the function of financial stability was added as a goal to CBA on equal footing to the price stability goal. Legislation and Constitution were amended accordingly. The CBA is responsible for regulation and supervision of the financial sector in Armenia. The implementation of its tasks is independent from state authorities. The CBA has been in charge of the oversight of all financial system participants since 2005, when a single financial supervision and regulation framework was introduced. The regulatory environment is well developed and under continuous process of revision and upgrade to best banking practices[18]. The regulatory framework is based on international standards (Basel standards, IFRS). According to the FSAP assessment completed in 2012, the banking system in Armenia is largely compliant with Basel Core Principles. In 2014, the requirements for regulatory capital were amended and Basel III requirements were introduced. Full implementation of Basel III is expected by end-2019. The CBA applies standardised methods to measure credit and market risks. Limits are also defined for capital entry requirement, liquidity risk standards, counterparty credit concentration and FX position (for details see Annexes). As for the consolidated supervision, some features are in place; however, the regulatory framework is under a process of development.

Banking supervision includes both on-site and off-site screening. Off-site investigation is conducted on a weekly, monthly, quarterly and annual basis, based on the reports submitted to the CBA by banks and other sources of information. The CBA follows a risk-based supervisory approach. The intensity of supervision, including on-site visits, is determined by the significance, risk-profile and other bank-specific factors. Each bank is inspected at least once in three years, independently of its risk assessment profile[19].

In addition to regular liquidity providing monetary policy instruments, the central bank has a statute to act as a lender of last resort and provide liquidity and crisis support to distressed institutions through long-term repo agreements, foreign exchange purchases or swaps and marginal lending facilities. In addition, the current Law on the Central Bank of Armenia, in exceptional cases, allows the CBA to provide loans with special lending procedures and conditions, including unsecured loans with terms up to five years. As a matter of fact, the Armenian banking sector weathered the financial crisis

[18] Central Bank of Armenia
[19] Central Bank of Armenia

relatively well, aided by subordinated loans with long term maturity (at least 5 years) from the CBA to an amount matching the capital injection provided by bank shareholders. In addition, the government provided funds in guarantees for lending to SMEs[20].

The CBA made many attempts to limit dollarization, including high risk weights and provisioning charges on FX assets introduced in 2010. For example, the CBA imposes a risk weighting of 150% for foreign currency denominated loans vs. 100% for local currency. Twenty percent higher provisioning is applied to FX loans. Furthermore, there are higher reserve requirements on funds attracted in foreign currencies. Several changes to reserve requirements were applied at the end-2014, when reserve requirements on domestic currency resources were decreased to 2%, while for funds attracted in foreign currency was set at 20%. In addition, there are also some exceptions, where reserve requirements vary according to the remaining maturity. For instance, a zero reserve requirement was introduced for long-term funds in foreign currency from 1st March 2015. Moreover, all the reserve requirements with the CBA have to be met in local currency. According to the Law on the Central Bank of Armenia, mandatory provisioning are subject to interest rate remuneration (currently set at 0%).

3.2 Other financial institutions

3.2.1 Credit organizations

There are 32 credit organizations operating in Armenia[21]. The supervision of credit organizations falls under the mandate of the CBA. They accounted for 8% of total financial system assets or AMD 309bn in December 2015. Capital and liabilities increased by 20.6% and 10.6% respectively in 2015; whilst profitability of the sector slightly decreased: return on assets (ROA) and return on equity (ROE) were 3.6% and 10.3% (IFRS standards), respectively. The weak macroeconomic environment was mirrored into credit organizations asset quality. The share of non-performing loans to total loan portfolio increased 0.4 pp in 2015 to 6.6%.

3.2.2 Insurance companies

Insurance companies represent 1.1% of the total assets of the financial sector in Armenia[22]. Eight insurance companies had an active licence in December 2015; however only seven of them were carrying out insurance activities. In 2015 the balance sheet of insurance companies contracted. Liabilities decreased by 12% and assets by 5.3%. However aggregate capital registered annual growth of 6.5%. More than a third of insurance companies' assets are held as deposits in banks. Receivables on direct insurance (19%) and securities sold under repo agreements (10%) are two large items on balance sheets.

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[20] IMF (January 11, 2013). Financial System Stability Assessment Report. ***HTTP://WWW.IMF.ORG/EXTERNAL/PUBS/FT/SCR/2013/CR1310.PDF***

[21] The Central Bank of Armenia. Financial Stability Report 2015.

[22] The Central Bank of Armenia. Financial Stability Report 2015.

4 The SME Segment

Armenia has a well-structured definition for small and medium enterprises (SMEs). It was incorporated in the Law of the Republic of Armenia on State Support of Small and Medium Entrepreneurship in 2011. SMEs are categorized following three criteria, namely: (i) employed staff; (ii) carrying value of the assets; (iii) turnover. The breakdown based on the number of employees is in line with EU standards (Figure 11); whilst balance sheet and turnover amounts are benchmarked to the Armenian market. To define SMEs, financial intermediaries apply employment thresholds combined with other business specific indicators, such as annual sales, asset size and exposure to the client.

Figure 11. SME Definition

Category	Average staff headcount	The carrying value of the assets for the enterprises engaged in production or industrial sectors	Turnover of enterprises engaged in sectors of non- financial services
Micro	<10	≤AMD 100mln (EUR 188 000)	≤AMD 100mln (EUR 188 000)
Small	<50	≤AMD 500mln (EUR 938 000)	≤AMD 500mln (EUR 938 000)
Medium	<250	≤AMD 1000mln (EUR 1 875 000)	≤AMD 1500mln (Eur 2 813 000)

Note: Exchange rates as of 1 June 2016

The Economics Department of the European Investment Bank has recently conducted a Bank Lending Survey among the main financial institutions in Armenia. The survey collected information on lending conditions, availability of different financial products and credit extensions to corporates, particularly to SMEs. The survey included questions related to recent credit developments, demand and supply factors that affect credit growth, availability of various financial instruments, breakdown of loan portfolio by sectors/maturity/purpose and perception of credit conditions. The survey covered about 65% of banking sector assets. Some of the key results of the survey are reported in this section and in the following sections of the report.

4.1 SME performance

The private sector in Armenia is dominated by the micro, small and medium enterprises, making up about 98% of total registered enterprises. However the SMEs segment accounts for a rather small share of production, employment and exports. For instance, in 2014 the SME segment accounted for about 24.4% of country's GDP (down from 25.8% share in 2013) and 32.7% of total employment (up from 32.2% in 2013). As of end-2014, there were 68,117 micro, 5,108 small, and 1,141 medium enterprises registered in Armenia (Figure 12)[23]. The number of SMEs and their turnover (in dram terms) has remained rather stable during recent years. According to the Small and Medium Entrepreneurship Development National Center the number of registered SMEs increased only 0.6% and total nominal turnover 0.7% between 2012 and 2014. Factors hindering the expansion of the micro and the SMEs segment are discussed in the following sections of the report.

Figure 12. Number of Enterprises

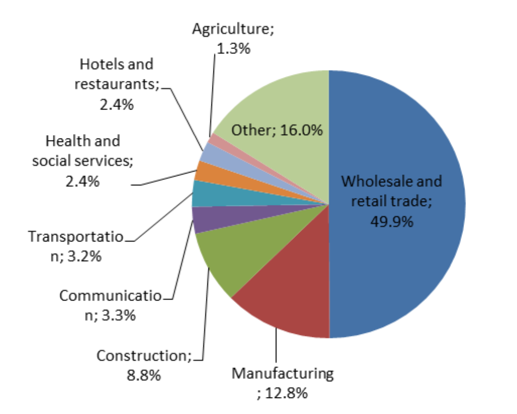
	2012	2013	2014
Micro	69,096	69,510	68,117
Small	3,928	5,159	5,108
Medium	901	1,177	1,141
Total SME	73,925	75,846	74,366

Source: SME DNC

[23] SME DNC

Most of the micro, small and medium enterprises are operating in the services sector. About 59% of registered SMEs engaged in wholesale and retail trade, while another 9% operated in the manufacturing sector in 2014. Similarly, trade accounts for half (49.9%) of total SME turnover, followed by manufacturing (12.8%) and construction (8.8%) sectors(Figure 13). SME production is primarily directed to local markets with a limited number of exporting SMEs. Some governmental programs aimed at assisting this segment with internationalisation processes and at enhancing SMEs competitiveness. For instance, SME Development National Centre provides, among other measures, advisory support to small and medium-sized enterprises to expand operations in foreign markets.

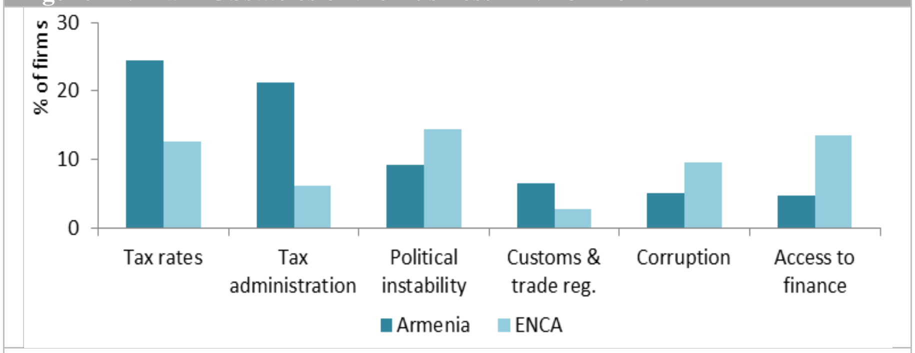
Figure 13. SME Turnover by Sectors, 2014



Source: SME DNC

Results from BEEPS[24] help gauge the main obstacles in doing business as perceived by SMEs (Figure 14). The most prominent obstacles were tax rates, tax administration, political instability, customs and trade regulations, corruption and access to finance. The survey was conducted in 2012 and the timing of the survey may have led to an overrating of certain results. Given that numerous institutional and regulatory changes have been implemented throughout the past years, administrative burden has become less of a concern for enterprises. The Doing Business 2016 confirmed this result. Access to finance is detected as a key obstacle in line also with the Global Competitiveness Report 2015-2016.

Figure 14. Main Obstacles of the Business Environment



Source: BEEPS Survey

The level of innovation of Armenian SMEs compares favourably to regional peers. According to BEEPS around 14% of SMEs undertook innovative decisions (new product or process of production) over the past three years in Armenia. A number of policy measures are in place to encourage innovative practices in SMEs through both policy incentives and financial support. Nevertheless, further support for innovative approaches and new technologies is essential to boost productivity and growth, especially for SMEs.

4.2 The institutional and legal environment

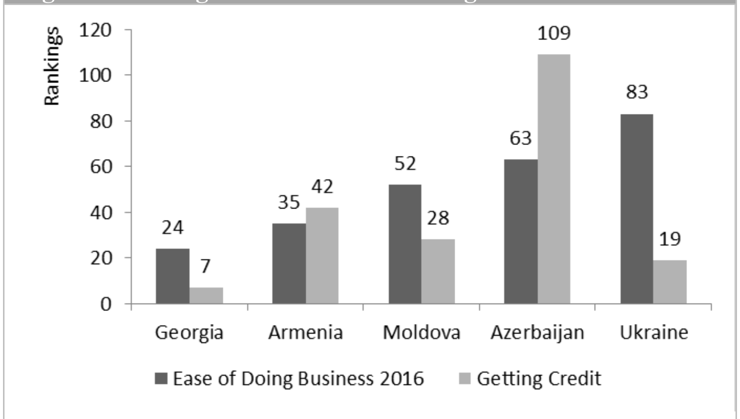
Armenia has made considerable progress in improving its business environment over the past years. It created more favourable conditions for starting and sustaining business activities. The country ranks 35 out of 189 economies in the World Bank Doing Business 2016 Report, progressing from a ranking of 43 (out of 183 economies) in 2010. Armenia scores favourably compared to regional peers, just lagging behind Georgia (Figure 15). Improvements in ranking were supported mainly by improved performance in terms of starting a business (ranking 5); dealing with permits (ranking 62); trading across borders (ranking 29). More specifically, dealing with construction permits was made easier by exempting lower risk projects from requirements for approval of the architectural drawings by an

[24] These results are derived from an in-house analysis of the World Bank/EBRD The Business Environment and Enterprise Performance Survey (BEEPS) database, whereby SMEs are defined as companies with less than 100 employees.

independent expert and for technical supervision of the construction. Second, trading across bordered improved as the Eurasian Economic Union led to reductions in the time and cost for document preparation, customs clearance and inspections in trade (export and import) with Russia. Third, enforcing contracts was made easier by introducing a computerized system that randomly assigns cases to judges in the Yerevan Court of First Instance. Furthermore, in recent years the government has significantly reduced the administrative burden on businesses by eliminating outdated business-related legislation and procedures and introducing e-government services. However, Armenia's performance remains weak in terms of getting electricity (ranking 99) and resolving insolvency (ranking 71).

Armenia performs rather low in terms of getting credit. It ranks 42 out of 189 countries. This rating reflects weaknesses related to legal rights of borrowers and lenders. Collateral and bankruptcy laws should be better shaped to accommodate interests of both lenders and borrowers. This highlights the need of implementing further regulatory and legislative measures to ensure an enhanced access to credit. To the contrary, the credit information system is well developed. Public and private credit bureaus are present in the country with 94% coverage. The Credit Registry under the Central Bank of Armenia keeps records of loans over AMD 1.5mln and all overdue loans. Furthermore, the Law on Secure Rights Records of Mobile Assets – adopted in 2014 and effective since late 2015, set grounds for the creation of an online database for movable assets.

Figure 15. Doing Business 2015 Rankings



Source: World Bank Doing Business 2015

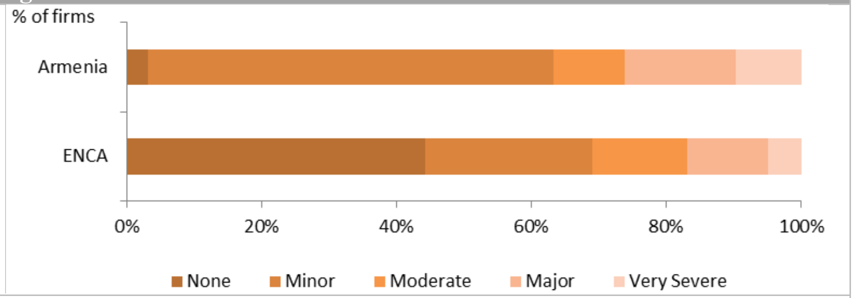
In 2000, the Law on State Support and the "Concept for SME Development Policy and Strategy" were adopted followed by the establishment of the SME Development National Center of Armenia in 2002. The center is the main public institution implementing SME support programs and policies using budgetary resources as well as funds from international and donor organisations. The SME support activities of the center include: (i) business consulting and trainings; (ii) innovation and export support programs; (iii) financial support. The latter component provides loan guarantees to solvent entrepreneurs who have insufficient pledged amounts (guaranteeing up to 70% of the principal of the loan and the interest rates for up to 5 years). The maximum amount guaranteed cannot exceed 15 million drams (approx. EUR 28 thsd). In addition, interest rates for the loans provided by the partner banks through Loan Guarantees Provision program are lower than the market rates.

5 SMEs Access to Finance and SME Financing

5.1 SME access to finance

SMEs in Armenia face constraints when asking for credit (Figure 16). For example, roughly 90% of small and medium firms make use banking services in the form of checking or saving accounts. Nevertheless, only 31% of small firms and 55% of medium firms take up bank loans or credit lines[25]. Approximately 36% of SMEs find access to financing as a moderate to very severe obstacle for business operations. In addition, access to foreign equity or borrowing is difficult. Last but not least, the availability of funding, particularly in local currency, is essential for the development of the SME segment. Also the Global Competitiveness Report 2015-2016 ranks access to finance as the key barrier for businesses in Armenia, followed by inefficient government bureaucracy and foreign currency regulations.

Figure 16. SME Access to Finance Seen as an Obstacle



Source: BEEPS Survey

In Armenia, over 55% of small and medium enterprises are in need of a credit; however approximately half of them are constrained because they are primarily discouraged from applying. Among the reasons for being credit constrained, complex procedures account for a half, followed by unfavourable rates (37%)[26]. SMEs have to rely heavily on internal sources of funding and retained earnings. For example, over 70% of investments in fixed assets and working capital are financed with internal resources. Bank products are the second largest source to finance fixed assets and working capital in Armenia. Compared to regional peer countries, Armenian SMEs make better use of bank financing for working capital; however they employ bank funding less than peer countries to finance fixed assets. It is worth noting that equity financing is used more extensively in Armenia than in ENCA region on average (Figure 17 and 18).

Figure 17. Sources of SME Financing – Fixed Assets

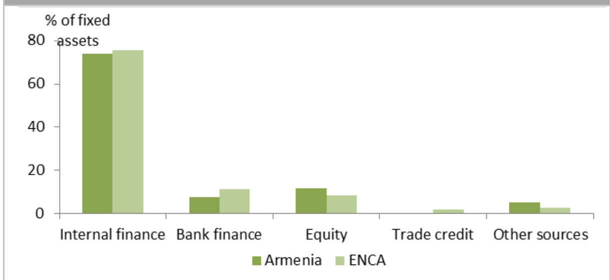
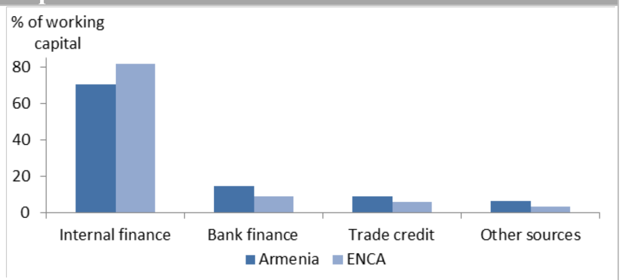


Figure 18. Sources of SME Financing –Working Capital



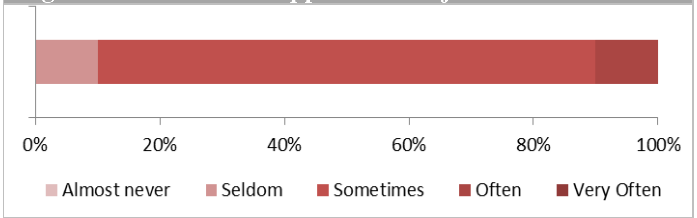
Source: BEEPS Survey

[25] BEEPS Country Profile. World Bank, International Financial Corporation

[26] BEEPS

Overall, rejection rates for SMEs are rather low in Armenia. According to the EIB Bank Lending Survey 10% of respondent banks 'often' decline loan application, while for another 10% of respondents loans are rejected on rare occasions (Figure 19). The remaining 80% indicated that loan application rejections are on occasional basis (sometimes). These results are in line with the BEEPS data, showing that rejection rates remain low while a self-selection process takes place among the SMEs even before applying for credit. As a result the number of discouraged SMEs is rather elevated.

Figure 19. SME Loan Application Rejection Rates



Source: EIB Bank Lending Survey

5.2 SME financing

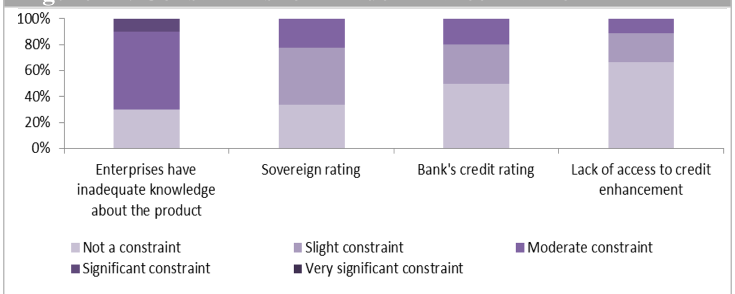
The EIB bank lending survey detects that almost all banks provide loans to SMEs in both domestic and foreign currencies. 90% of the surveyed banks in Armenia indicated that they offer loans as well as trade finance products to SMEs (Figure 20). The market for the latter product remains shallow largely due to its complexity relative to the average financial literacy in the country. About 60% of the banks indicated that inadequate knowledge about trade finance products represents a moderate or significant constraint to trade finance market development (Figure 21). This segment has potential to further expand, given that 6-7% of Armenian SMEs are directly involved in export activity and SME production has high import content[27].

Figure 20. Availability of Financial Instruments to SMEs

Source: EIB Bank Lending Survey

Commercial banks extend loans to SMEs on a short-term basis mostly for working capital or long-term for investment financing. Loans are offered both in local and foreign currencies. While loans in FX are available with both short-term and long-term maturities, local currency instruments are more limited. 50% of the banks indicated that local currency loans are occasionally available across maturities.

Figure 21. Constraints for Trade Finance Market



Source: EIB Bank Lending Survey

On average[28], about 74% of SME portfolio is long-term (> 1 year), with a high share of FX. However, long-term loans are still concentrated at a lower end of the maturity spectrum, predominantly with a maximum of three years. Very few loans were extended with the maturities over five years.

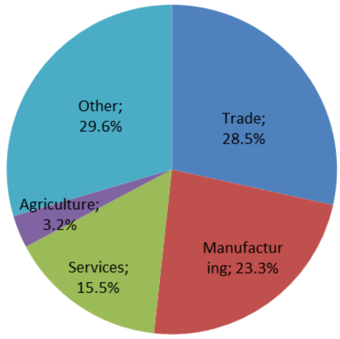
[27] BEEPS Country Profile. World Bank, International Financial Corporation

[28] Weighted by the banks' SME portfolio shares. EIB Bank Lending Survey

Accordingly BEEPS survey data highlight that the original duration of recent credit on average was roughly 40 months.

The recent slowdown in the overall economic activity had a mixed impact on SMEs demand for loans. The EIB bank lending survey detects that half of the respondents indicated that a demand for loans has somewhat decreased during past 12 months, while another 40% reported an increased demand. To the contrary, demand for micro loans have been perceived to grow. The survey responses suggest that the SME portfolio increased by around 15% in drams terms in 2015 (year-on-year) as opposed to 29% growth of the micro loans. As for the sectoral composition, SME loans are dominated by trade sector, accounting for roughly 29% of the total portfolio of the surveyed banks (Figure 22). It is followed by manufacturing with a 23% share. The services sector makes up another 16%.

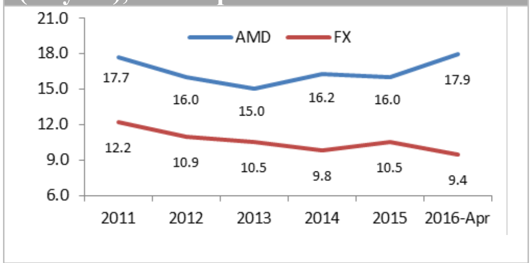
Figure 22. SME Portfolio by Sectors, 2015



Note: Bank responses were weighted by SME portfolio size Source: EIB Bank Lending Survey

Looking at banking sector assets, 66% of the portfolio was denominated in foreign currency at the end of April 2016. However, dollarization level varies across segments, with non-financial corporations representing 85% of foreign currency loans, as opposed to 39% in the households segment. During the first four months of 2016, growth in foreign currency portfolio was higher compared to local currency, particularly for loans to non-financial corporations. In general, AMD-denominated loans have been much more expensive, with spreads widening in recent years (Figure 23). For example, average interest rates on AMD loans with a maturity less than 1 year were around 17.9% as opposed to 9.4% on FX loans (April 2016). This is also reflected in the deposit interest rates. Average market interest rates on FX-denominated deposits with a maturity of over one year stand at around 7.7% and in AMD at 13.7% (April 2016). For the shorter term (<1 year), respective rates are 5.3% and 10.8%. On average, spreads between FX and AMD deposits widened during 2013-2015, reaching 8%. However, as of April 2016, average spreads declined to 5-6%. The exchange rate pressures and tightening monetary conditions pushed up interest rates on dram loans. Importantly, the effective interest rates can be as high as double the nominal rate due to non-interest charges associated with credit disbursements.

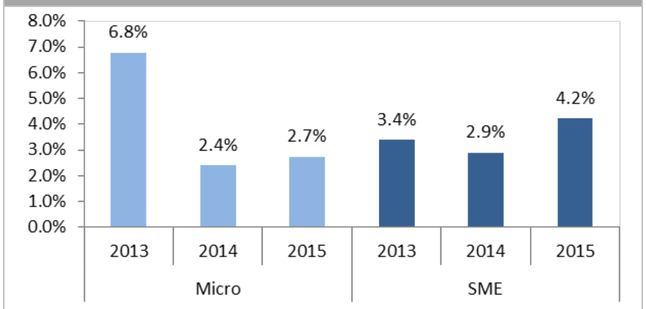
Figure 23. Average Interest Rates on Loans (<1 year), end-of-period



Source: Central Bank of Armenia

Quality of SME portfolios: At the end of 2015 the share of non-performing loans in the SME portfolio was at 4.2%, while it was at 2.7% in the micro segment, as reported by the banks in the EIB Bank Lending Survey (Figure 24). This compares to overall banking sector NPL ratio of 8.0% at the end of 2015, as reported by the Central Bank of Armenia. In 2015 loan portfolio quality deteriorated, largely due to a combination of local currency depreciation against USD (given unhedged FX positions of borrowers) and weaker economic performance of enterprises as the economy slowed down. The increased volatility of regional currencies has heightened the currency induced credit risks on SME loans. The SME portfolio is highly dollarized, whilst SME revenues are

Figure 24. Credit Quality by Segments



Note: weighted by 2015 SME/Micro portfolio
Source: EIB Bank Lending Survey

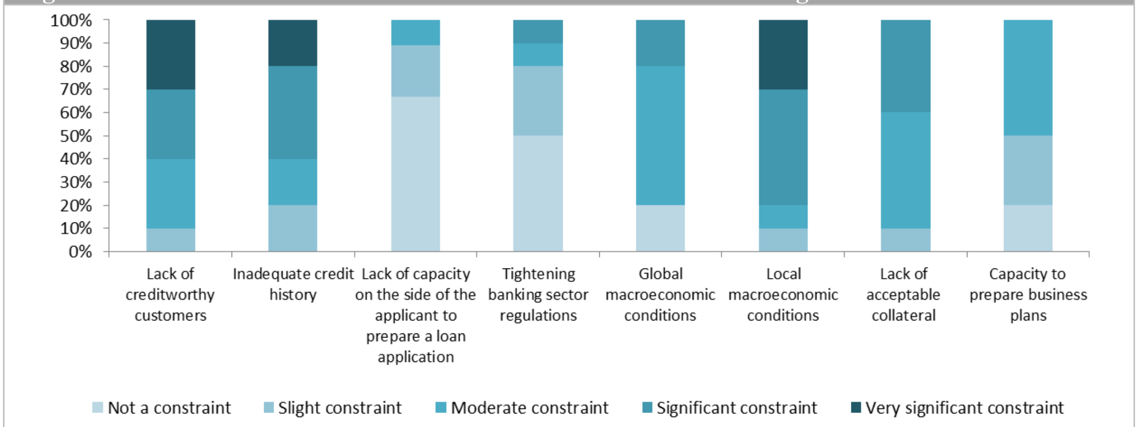
predominantly coming from the domestic market; only a small share of firms are directly involved in export activities. Earnings are denominated mostly in domestic currency. Therefore SMEs are exposed to the local currency depreciation risks. As a result demand for local currency loans is high, and particularly in the SME segment. However, intermediaries have limited availability of long term dram funding. Consequently, demand for local currency loans remains greatly unmet.

5.3 Factors affecting credit extensions to SMEs

The results of the EIB Bank lending survey indicate that credit developments have been determined by both demand and supply sides. In detail, about 44% of respondents report that demand for the credit is a constraining factor to the expansion of SME credit portfolio whilst another 22% link it to supply components. The remaining 33% reported a combination of demand and supply-side factors. The dominance of demand-related issues is largely linked to the current turbulent macroeconomic conditions domestically as well as globally and is more of a cyclical nature. To the contrary, supply related issues can be considered rather structural.

Macro-environment and customer related factors: Credit to SMEs is mostly constrained by local macroeconomic conditions, the lack of creditworthy customers and lack of acceptable collateral (Figure 25). Given current economic conditions and increased uncertainty, a number of banks have somewhat tightened terms, conditions and standards for approving a loan or a credit line, even more so for micro enterprises and SMEs; whilst to a lesser extent for mid-caps. Furthermore, the EIB survey revealed that lack of collateral is a significant constraint to lending activity for 90% of respondents. Another issue limiting SMEs' access to credit is related to inadequate credit history of potential borrowers.

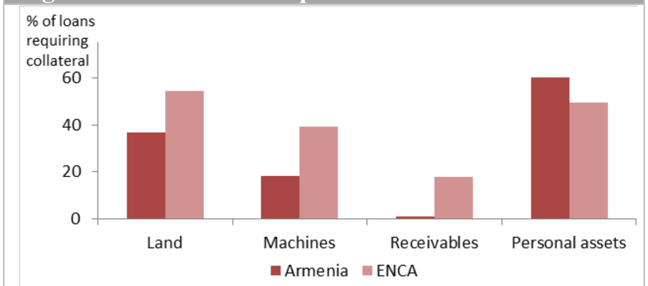
Figure 25. Macro-environment and Customer-related Issues Limiting SMEs Access to Credit



Source: EIB Bank Lending Survey

Collateral requirements: Real estate is the main asset demanded as collateral (Figure 26). This restricts the collateral base available to companies, especially for micro enterprises and SMEs which primarily own movable property. In general, collateral serves as a buffer to tap the uncertainty surrounding clients' financial statements. Often SMEs annual budgets are unaudited. This is also an issue in the mid-caps segment, albeit to a lesser extent. Many banks apply a haircut (around 25%) to the market value of an asset to estimate its liquid value. In the end, as some respondents indicated, they disburse a loan in the amount of up to 40-60% of the collaterals' liquid value. Some banks accept movable property (e.g. machinery or equipment) and personal guarantees (for micro loans) as collateral. Expansion of credit guarantee schemes for SMEs could reduce existing information asymmetry problems and assist sound SMEs with limited collateral to access credit.

Figure 26. Collateral Requirements for SMEs

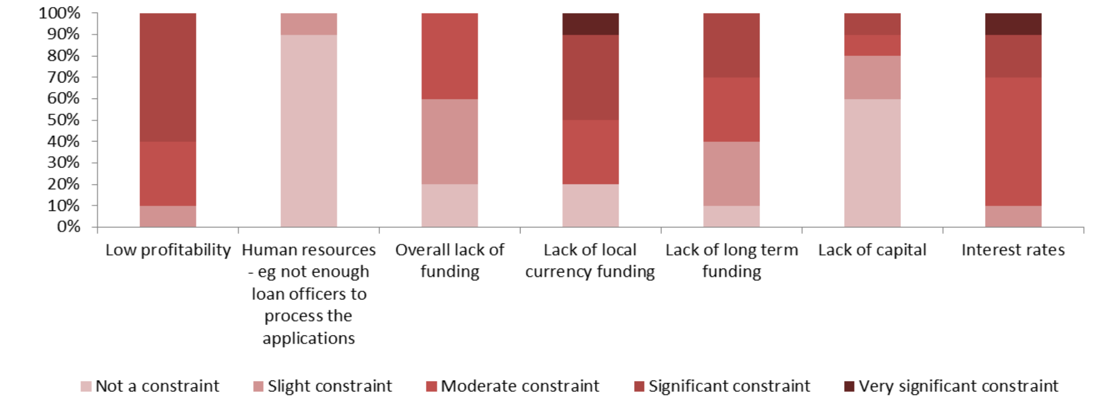


Source: BEEPS Survey

Bank-related issues: Among bank-specific factors constraining credit growth, the most prevalent are: (i) high market interest rates; (ii) low profitability; (iii) lack of local currency funding (Figure 27). High interest rates (especially for dram-denominated loans) are linked to the funding structure of banks and to the lack of local currency resources. Low profitability has been largely influenced by weak macro environment, high competition among banks and low margins. A generalised lack of long-term funding is also limiting banks' capacity to extend loans.

The currency mismatch between assets and liabilities in SMEs balance sheet is an important factor constraining the capabilities of SMEs to take up credit. For some banks, the dollarization of SME portfolio can be as high as 85%, while such enterprises FX proceedings are minimal. Therefore, the exchange rate depreciation pressures in recent periods had a negative balance sheet effect for unhedged borrowers, thus contributing to a deterioration of SME portfolios and eroding enterprises' leverage. Banks' capabilities to generate local currency funding are limited, whilst demand for local currency loans is high. However, it remains largely unmet due to limited dram resources. The local currency lending support schemes that operate under the Central Bank of Armenia somewhat helped to reduce this funding gap.

Figure 27. Bank Specific Factors Limiting SMEs Access to Credit



Source: EIB Bank Lending Survey

Annexes

A. Prudential ratios for banks

Ratio	Criteria
Capital adequacy ratio (as a % of risk-weighted assets) /1	≥ 12%
Capital stock (in Armenian Dram/AMD) Statutory fund Total capital	 ≥ 50 million ≥ 5 billion (≥ 30 billion from 1 January 2017)
Credit risk concentration (as a % of total capital; refers to funded and off-balance sheet exposure) Single borrower All major borrowers /2 Single related party All related parties	 ≤ 20% ≤ 500% ≤ 5% ≤ 20%
Liquidity Highly liquid assets (as a % of total assets), general liquidity /3 Highly liquid assets (as a % of demand liabilities), current liquidity /4	 ≥ 15% ≥ 60%
Reserve requirements Reserve requirement (as a % of funds attracted in local currency) Reserve requirement (as a % of funds attracted in foreign currency and dematerialized metal accounts, to be held in local currency) **Note:** There are some exceptions depending on the term of attracted funds and on resources attracted in bonds. In that cases, the minimum reserve requirement will vary in the band of 0-10%	 ≥ 2% ≥ 20%
Currency risk exposure (as a % of total capital) Foreign currency position Any individual currency /5	 ≤ 10% ≤ 7%

Notes:

/1 The ratio of core capital to risk weighted assets is set to be 10% from January 1, 2020
/2 A major borrower is a party on which the exposure exceeds 5% of total capital of the bank.
/3 The minimum ratio of banks highly liquid assets expressed in first group currencies to total assets of Group I currencies shall be 4%. In case when liabilities expressed in any Group II currency exceed 5% of banks total liabilities according to the month's average daily calculation, for each Group II currency shall be calculated normative for the period of month following the relevant month, which is the average ratio of US dollars, Euro and highly liquid assets expressed in those currencies to US dollars, euro and total assets expressed in those currencies. The minimum ratio shall be 4%.
/4 The minimum ratio of banks highly liquid assets expressed in Group I currencies to demand liabilities expressed in Group I currencies shall be 10%. In case when liabilities expressed in any Group II currency exceed 5% of banks total liabilities according to the month's average daily calculation, for each Group II currency shall be calculated standard for the period of month following the relevant month, which is the average ratio of US dollars, Euro and highly liquid assets expressed in those currencies to demand liabilities in US dollars, euro and demand liabilities expressed in those currencies.
/5 The position in any particular foreign currency shall be calculated by type of foreign currency both including and excluding the financial derivatives expressed in the currency in question and reviewed by two foreign currency groups. Each foreign currency position equals the open position in each foreign currency, which shall be the difference between assets and liabilities in a particular foreign currency.

B. Key banking regulations

Category	Brief description
Financial reporting standards	Dual reporting, under IFRS and CBA regulations, is required and enforced by CBA supervisors. Accounting standards, disclosure and reporting requirements are regulated by “Law on Accounting”. Pursuant to procedure established by this law, Armenia adopted international accounting standards, as well as principles of developing and introducing financial reports published by the International Accounting Standards Board, guidelines for application of the standards and other documents of mandatory use.
Corporate governance standards	There is no requirement for there to be an independent director on the supervisory board of CJSC banks, although OJSC banks require at least one. There is no maximum limit to length of service for board members. Board size must be between five and 15 members (inclusively), the average across the banking sector being seven to eight as estimated by the CBA. Board meetings are to be held at a minimum once every two months and the CEO must provide performance reports to the board at least once a quarter. The internal audit function must be supervised by the board and be independent from management. The CBA vets all prospective board members and senior management personnel for suitability, and requires that there is a clear division between the board chairman and CEO.
Ownership restrictions	None
Capital adequacy standards	The requirements for regulatory capital were amended in 2014 and Basel III requirements have been introduced, however full implementation of Basel III requirements is expected by the end-2019. As for measuring credit risk and market risk, respectively, the standardised approach and standardised measurement method are applied. As for measuring operational risk, basic indicator approach or standardised approach is applied. Risk weighting for FX assets is higher than for dram-denominated assets to discourage further dollarization of balance sheets. Capital entry requirement, liquidity risk standards, counterparty credit concentration limits and FX position limits are also defined.
Minimum capital requirements	The minimum total capital requirement for a bank is AMD 5.0 bn (USD 10mln). From 1 January 2017, the minimum capital requirement is increasing to AMD 30 bn (USD 60mln).
Definition of NPL	According to local regulations, loans are classified as non-performing starting form the first day of becoming overdue.
Provisioning policy	Banks shall form a general provision in the amount of 1% of standard assets and may at their own discretion, without any interference of the CBA Bank Supervision Department, increase the allowances to the general provision by 2% for standard assets.
Deposit insurance	The Deposit Guarantee Fund of Armenia, established by the CBA, covers AMD-denominated deposits of up to AMD 4.0 million (EUR 7,400) and FX-denominated deposits of AMD 2.0 million (EUR 3,700).
Reserve requirements	The minimum reserve requirement with the CBA is 2% for AMD resources and 20% for FX resources as well as dematerialized metal accounts (although reserves must be placed in AMD). There are some exceptions depending on the term of attracted funds and on resources attracted in bonds. In those cases, the minimum reserve requirement will vary in the band of 0-10%
Foreign currency operations	The maximum ratio of foreign currency position to total capital is 10%. By types of foreign currencies the maximum ratio of each foreign currency to total capital is 7%. Starting from August 1, 2010 onward each foreign currency position shall equal to the open position in each foreign currency.
Related party transactions	Exposure to related parties is limited, as per the previous table.

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