TABLE OF CONTENTS

SUMMARY ASSESSMENT AND RECOMMENDATIONS

INTRODUCTION

This assessment of the Armenian financial system has been produced under contract to the United States Agency for International Development/Armenia by the Emerging Markets Group (associated with Deloitte Touche Tohmatsu). Findings and recommendations are the result of background research, in-country meetings, and presentations to various stakeholders, and are structured to mitigate identified financial sector deficiencies and vulnerabilities. Readers are encouraged to review annexes to the Main Report for greater detail, data and analysis.

DEFICIENCIES AND WEAKNESSES IN THE SYSTEM

A. General Economic and Institutional Weaknesses

- **Armenia suffers from a high level of poverty.** Of the total population, 43-49 percent lives in poverty, of which 7-17 percent lives in extreme poverty (2002-03 figures).
- **There has been a dichotomy in terms of macroeconomic indicators and monetization.** While the economy has grown in the last few years, financial intermediation ratios are among the lowest of transition and even CIS countries.
- **Tax administration is one of the most serious weaknesses in the Armenian economy, and methods employed weaken prospects for financial sector development.** This serves as a disincentive to investment and growth in the real sector, and keeps funds out of the banks in the financial sector.
- **The business environment is still weak.** There is still the broad challenge of developing a sound investment climate based on open competition, a fully functioning judiciary, a more professional civil service, and related institutions and infrastructure to support private sector development. Until progress is made, this will likely translate into a higher risk premium for credit and investment exposures.
- **Corporate governance needs strengthening in the financial sector, and is weak in other parts of the economy.** These weaknesses add to credit risk, make enterprises less attractive to banks as prospective borrowers, and consequently add to the cost of credit when made available.
- **In general, the judiciary is not trained in commercial affairs.** Alleged bribes, poorly administered case load, and inadequate infrastructure undermine the reputation and efficiency of the court system. Economic courts are not considered effective yet due to their caseload, which has also reduced the impact of recent reforms to promote alternative dispute resolution.
- **There is significant risk associated with investment in Armenia due to geo-political as well as structural factors.** The absence of a tradition of investor/creditor protection and contract enforcement adds to the risk associated with Armenia as an investment destination.

B. Banks and Banking

1. Overview

- **After years of instability, the banking system is showing signs of greater stability.** The system's key prudential ratios are sound, and banks are broadly in compliance with CBA requirements concerning capital adequacy, asset quality, liquidity management, and market risk exposures.

- **Financial intermediation is growing, albeit from a small base.** Data through 3Q 2004 show assets, credit (to enterprises and households), deposits and capital will all increase significantly (on an annualized basis) when compared with year-end 2003 results.
- **Armenian banks are small.** Annualized projected figures for 2004 show that the average Armenian bank will have only $40 million in assets, $15 million in loans to the real sector (not government securities), $24-$25 million in deposits, and $7 million in capital. Average regulatory capital at September 30, 2004 was $5 million, about the minimum required for July 1, 2005.
- **With prudential norms limiting individual loan exposures to 20 percent of capital, this means banks are only able to serve small and medium-sized enterprises.** However, these very same SMEs are often unable to comply with banks' underwriting standards for loan origination.
- **The small size of the banks reflects small earning asset bases, driving up net interest spreads.** In general, the quantum of earning assets is small, particularly when netting out HSBC from system totals.
- **The limited array of services limits non-interest earnings.** Non-interest income was only $23 million in 2003, and was projected to be $27 million in 2004. Thus, the average bank earns less than $1.5 million in pre-tax income from non-credit activities.
- **Given the small earning asset base, after-tax earnings are low.** Projections for 2004 show $18.5 million for the system as a whole (nearly $1 million on average). These figures are very small by comparison with other markets, even many CIS and transition markets.
- **Banks' costs are not high, but neither is their productivity.** Many banks have high staffing levels relative to income.
- **Banks do not actively seek out deposits or operate in a manner that is typical of commercial banks in market economies.** As an example, banks would benefit from greater long-term funding for housing loans and consumer finance loans, but rates paid on time deposits of one year or longer are too low to attract such funding.
- **Access to financial services outside Yerevan is very limited.** Most financial services outside Yerevan are supplied by one or two weak banks, donor-supported micro-finance groups, and the postal system. Bank accounts numbered about 500,000 in late 2004, almost all in Yerevan.
- **Concerns about account privacy may be a deterrent to deposit mobilization in the banking system.** There is a perception that accounts can be willfully garnished by the tax authorities, even though legally this is only possible via court action or by the CBA in the event that money laundering has been detected. Nonetheless, the perception persists, and is considered a constraint to deposit mobilization.
- **There is reported to be limited management capacity to operate banks (and enterprises) according to international standards and norms.** While improving, this reflects the need for new investment in the banking sector from those that are "fit and proper" and have the management capacity and systems to modernize the financial sector.
- **There has been modest development of risk management systems for credit risk, market risk, and general portfolio management.** However, there appear to be no immediate risks, and these kinds of developments are only expected to occur over a number of years as the system develops and diversifies.
- **Back office operations will likely need strengthening for better monitoring of suspicious transactions that could tarnish Armenia's reputation.** Strengthened systems will be needed to

increase efficiency, as well as to help with effective enforcement of anti-money laundering initiatives. Coordination of AML and related activities through the Financial Intelligence Unit (soon to be established) should help mitigate these weaknesses.

2. Legal and Regulatory Issues

- **CBA is open to foreign investment, with about half the banks having foreign shareholders.** However, there may be some confusion about the right of foreign bank branches to operate as they do internationally (without direct capital investment in the branch entity, and with the right to mobilize deposits).
- **While there are provisions permitting ownership of banks by non-banks and real sector enterprises/conglomerates, CBA has enforced a tight restriction on their involvement in core bank operations.** As of late 2004, non-bank ownership of banks is generally subordinated to a pre-approval process by CBA whenever individual shareholders assume stakes of 10 percent or more of a bank.
- **In general, banks have operated on a fairly narrow commercial bank basis in the last few years as part of the larger effort by CBA to stabilize the system.** Most banks consider themselves to be "universal", but in fact are fairly basic in terms of their activities.
- **The secured transactions framework is imperfect.** Secured transactions are undermined by fragmented and incomplete property registries, and traditional judicial protection of borrowers.
- **The banking sector will not benefit from changes in the legal framework until institutions are in place to help implement a modern secured transactions framework.** Institutional weaknesses have limited the supply of credit, reduced maturities (net of donor funding made available to provide term financing), and added to costs.
- **Loan recovery has been difficult for banks through the court system.** The inability to enforce judgments in many cases has been due to endless debtor appeals, flawed registration and title (without clear links to true owners), mobility/emigration and asset stripping, and allegations of corruption in the court system.
- **Even with improvements, many businesses lack adequate assets to pledge for anything but low levels of working capital.** The low level of reported assets reduces the collateral coverage of loans, thereby reducing loan amounts and maturities. In addition to low volumes of assets reported, there is limited variety of desirable collateral, usually apartments and vehicles.
- **The insolvency framework for enterprise and debt restructuring is underdeveloped, and therefore of limited use for debt resolution and contract enforcement issues.** The judiciary is not experienced in this domain, and there has been little exposure and training.
- **The CBA's mandate to supervise the banks has been strengthened in recent years, and this has been positive in stabilizing the system.** Next step areas of development among the banks and for the financial system (and economy) as a whole will include more effective board oversight and involvement, improved financial reporting and systems for internal management purposes as well as the general public, autonomous internal audit, risk management capacity on a portfolio basis as well as for individual loans/transactions, and movement to consolidated accounting and supervision.
- **CBA (and other financial regulators) should plan to adopt a series of protocols that facilitate coordination with other supervisory agencies.** CBA is encouraged to develop and implement inter-agency protocols on issues of surveillance, inspections, contingency planning, prompt corrective action, resolution, and suspicious transactions as other supervisory agencies increase capacity. This should supplement close coordination with the FIU and cross-border agencies.

- **Strong banking supervision is an essential precondition for the explicit deposit guarantee scheme.** In this regard, CBA should continue to focus on supervision as a basis for strengthening banks' governance practices. This includes tightening requirements for board members, encouraging the use of independent advisors, promoting ongoing professional development and certification of bank managers, upgrading requirements of internal audit and management information systems, and ensuring risk management systems and procedures are suitably in place and functioning properly.

3. Risks and Vulnerabilities

- **The level of banking sector penetration in the economy is so low that any bank failure would have little direct impact on the economy.** Nonetheless, any individual bank failure could potentially weaken overall confidence in the banking system.
- **The banking system is characterized by a small degree of concentration, namely in the area of deposit mobilization, largely attesting to the competitive advantage HSBC enjoys.** Other banking system measures show limited concentration, apart from earnings. The real threat is less the position of HSBC, and more the weakness of the other licensed banks.
- **Banks do not appear to have any major sector concentrations that pose risks.** Careful monitoring of consumer lending and exposure to commercial trade should continue. More detailed information on housing and commercial property loans (via the chart of accounts) should also be obtained. Likewise, in the future, CBA and the Insurance Inspectorate should monitor potential transfer risk through credit insurance and other enhancements that can be used to obscure underlying portfolio quality.
- **The system suffers from an absence of strategic investors, needed for capital investment, risk management, and general know-how.** Apart from HSBC, none is a major bank in international markets.
- **Donors may serve as a needed bridge for capital investment in domestic banks.** However, CBA should require that "donors" either have direct commercial bank market experience and a legitimate track record managing and investing in banks, or a reputable partner to cover for the lack of hands-on experience that characterizes donors themselves in commercial banking markets.
- **Additional foreign banks are not automatically good for the system, but prime-rated institutions should be encouraged to establish a presence.** Should domestic banks not be successful in attracting major foreign partners, CBA should be willing to have foreign bank branches establish a presence in Armenia (including the right to mobilize deposits) without direct capital investment or primary supervisory responsibility. CBA could subject licensing conditions to specific protocols with the host supervisor, investment-grade ratings as a requirement, and other prudent licensing conditions.
- **While some of the banks with less than $5 million are not expected to have a problem reaching and exceeding this requirement by July 1, 2005, others may face challenges complying with the requirement.** CBA should resist any pressures for forbearance.
- **Credit risk is high, which is one of the reasons why banks have been reluctant to lend.** On the other hand, banks themselves show modest capacity to evaluate credit risk.
- **Some of the donor programs (e.g., KfW-GAF) have lent on an unsecured (cash flow) basis (to micro-enterprises) with solid results.** This actually points to the larger need for the banking system to attract modern management and systems from abroad, rather than relying on piecemeal donor programs to slowly provide market examples of how to lend and manage risk.
- **There is a general risk that banks all want to be universal.** This process can be facilitated with

consolidation of the system, strategic investment from investment-grade institutions, and/or the presence of foreign branches to induce more competition and increase product offerings and service levels.

- **There is a risk of adverse selection in lending markets.** As banks move away from government securities and towards lending to increase earnings, there is a risk they will all do so at the same time.
- **If there is an increase in term lending by the banks (as needed for investment in the SME sector), this could introduce interest rate risk, as well as obvious maturity mismatches and potential foreign exchange risk.** Banks have been increasing their consumer lending, with maturities often running for up to three years. Likewise, there is reported to be some basic activity in housing finance for up to seven years. Both of these present possible risks relative to the predominance of the funding base which is for nine months or less. However, there are no serious maturity mismatches or interest rate risks currently reported, as most loans are short-term and the interest rate environment has been improving.
- **There is some exchange rate risk due to the dollarization of the economy.** Foreign currency deposits are nearly 80 percent of total deposits and about 50 percent of broad money.
- **Back office operations, information systems, and internal controls are all considered moderately acceptable, but underdeveloped by global standards.** The banks are reported to need more developed systems to handle an increased volume of future risks.
- **As with operational risk, reputation risk in the market has an impact on correspondent banking relationships, the risk premium assigned to international borrowings, and the country's ability to attract investment.** Notwithstanding the closure of a net 54 banks since 1993, low levels of capital and large numbers of small banks detracts from Armenia's overall banking sector reputation.
- **Banking system capacity to handle increased financial inflows remains underdeveloped.** There are few instruments available in Armenia for improved liquidity management (let alone long-term investment), credit risk remains high due to limits on transparency and creditor protection, capital markets are underdeveloped, other markets like real estate/property development remain cash-based, and banks have little experience with portfolio and investment management.

C. Insurance Sector Development

1. Overview

- **Based on market estimates for 2003, premium revenues were less than $4 million.** Armenia is among the smallest of insurance markets in the world, with estimated density per capita of less than $2, and annual premium revenues per active company of about $205,000.
- **Insurance is profitable despite being small, with many transactions thought to be unrecorded to avoid tax payments and reporting requirements.** Reinsurance outflows are very high and account for 97 percent of total revenues. Claims paid in 2003 were less than 20 percent of estimated gross premium revenues.
- **There is no compulsory insurance in Armenia, one of the reasons for its small size.** This is expected to change as Armenia introduces third party motor liability and possibly compulsory insurance for the health sector.
- **Insurance companies are small in assets and capital.** Capital was $3.2 million at year-end 2003, or less than $170,000 per active company.

2. Legal and Regulatory Issues

- **There is a new Law on Insurance adopted in August 2004 that provides a framework for insurance companies.** The new legislation seeks to bring solvency ratios, investment policies, reserve management, consumer protection and related provisions closer to international standards. However, there may be revisions with regard to solvency provisions, specification of the insurance supervisor's responsibilities and objectives, and protocols for the insurance supervisor to work closely and exchange information with other domestic and foreign financial supervisors.
- **Minimum capital for entry into the insurance sector has been $100,000.** However, new legislation adopted in August 2004 will bring this up to $1 million. With the increase in capital requirements, it is possible that some of the currently licensed companies will cease to exist, and/or operate in the market as brokers rather than underwriters.
- **The marketing and selling of insurance products through independent agents is prohibited.** This greatly reduces the use of insurance products because insurance companies are not likely to employ the required workforce.
- **Foreign insurers have limited access to the domestic market, although they receive most of the premium revenues generated in the system through reinsurance.** The Law on Insurance places unnecessary restrictions on insurance organizations with at least 49 percent foreign investment.
- **Armenia has also legally permitted insurance companies to sell life and non-life insurance products as one legal entity.** While only one company sells life insurance and the market is exceedingly small, Armenia's legal framework in this regard is inconsistent with international standards that call for separate legal entities to provide life and non-life products.
- **A weak insurance framework translates into the absence of institutional investors.** Insurance companies are needed as institutional investors for capital markets development, private placements, improved governance in financial institutions and strengthened financial discipline in companies.
- **The Ministry of Finance and Economy regulates the insurance sector, although not very actively.** Its budget in 2003 was reported to be $12,000. Moreover, there is little useful information or reporting, making it difficult to conduct off-site surveillance. Staff training is needed for skills development.
- **As the country moves ahead with modernization, the insurance framework will need to be brought closer to global standards, including coordination on a cross-border basis.** As part of this effort, the insurance supervisor should make it a condition for licensing a foreign insurance branch that the supervisor has (i) direct oversight over the insurance company's activities and financial soundness in its home country, and (ii) a framework is in place for cooperation with the foreign branch's home country insurance supervisor to ensure safety and soundness.

3. Risks and Vulnerabilities

- Underdevelopment of the insurance sector constrains business and financial sector development, while presenting no known systemic risk under current conditions.

D. Pension Reform

1. Overview

- **Armenia has an unsustainable pay-as-you-go pension system, although reforms are being discussed.** Reform will eventually help with fiscal issues as well as with the gradual development of institutional investment in the economy.

- **Some reforms have been introduced in the last five years with donor support.** This has resulted in improving contribution collections and a strengthened benefit payment system.
- **Notwithstanding improvements, Armenia's pension system is still in need of reform.** The government has announced its intention to introduce pension reform in the next few years, although no clear plans have yet been agreed to about the kind of system that would evolve, how and by whom it would be regulated, investment parameters for collected proceeds, etc.
- **Pension reform will require institutional investors, management and custodial capacity, new and longer-term financial instruments, and improvements in the way Armenia's securities market currently functions (to the extent that it does).** Broad improvements in governance, management, transparency, accountability, and consumer protection will be needed.
- **In terms of medium-term financial sector development, there is not likely to be much impact of pension reform in terms of lending and investment.** Privately managed pension funds should evolve over time as the system develops. However, the government has not yet agreed on policy objectives, let alone legal, regulatory or institutional requirements to support a reformed pension system. Moreover, it will take time for meaningful levels of contributions to accumulate.

2. Legal and Regulatory Issues

- **Introduction of a draft pension law, which describes the creation of special purpose pension companies, was expected in Parliament prior to the end of 2004.** Passage of this law would permit the creation of pension companies to manage pension contributions in the form of accumulation accounts for each employee.
- **There are several weaknesses that apply to existing draft legislation.** These weaknesses include (but are not restricted to) the absence of (i) provisions regarding the terms and conditions between the employer and the pension fund, (ii) a framework for the regulation of the pension business conducted by banks or insurance companies, (iii) clarity about contributions as well as benefits to be paid into and out of the funds, and (iv) tax provisions.
- **Overlapping features and functions of boards (Council), daily managers (Administrators), and Asset Management Companies are also unclear and will cause difficulties.** Investors who wish to prospectively assess the pension fund's chances for success are unnecessarily complicated by the existing proposed structure of pension funds.
- **Even with legal reform, there will be obstacles related to the financial sector in creating a system of accumulation accounts.** These include small market size, lack of investment options, political opposition to pension reform, lack of pension company experience, lack of insurance annuity product experience, lack of regulatory authority experience, and the risk of low public confidence if losses result from mismanagement, structural flaws, or regulatory lapses.
- **There are several regulatory and supervisory weaknesses.** The first weakness is the simple lack of experience. Moreover, the draft law provides no guidance for a regulatory framework for the pension business conducted by banks or insurance companies. Provisions are also unclear with regard to the setting of contributions as well as benefits to be paid into and out of the funds.
- **While the above referenced obstacles are important, they can be managed. The** market can encourage experienced and recognized pension companies in other countries to manage and administer funds and/or to partner with Armenian companies to ensure a transfer of knowledge and technology in a timely manner.

3. Risks and Vulnerabilities

- The risk of social insurance is that leakage will continue under the current arrangement, and that disbursements will remain so small as to induce low contribution levels. Additional risk/vulnerability relates to oversight of the system in the absence of developed supervisory capacity and established audit practices.

E. SECURITIES MARKETS

1. Overview

- **Armenia's capital markets are underdeveloped.** Market turnover was estimated to be about $700,000 in 2003, equivalent to less than $3,000 per trading day.
- **Domestic investment in securities is generally limited to T-bills and notes.** New annual issuance has been less than $80 million in 2003-04.
- **Rather than identifying a specific optimal amount of government securities that should be issued, the Ministry of Finance and Economy along with CBA should establish clear cost-benefit criteria as part of a long-term strategy for government securities market development.** There are numerous reference points for rough planning and asset-liability matching for major institutions, from which measures of non-government securities volume could also be extrapolated in the event that institutional demand exceeds government supply.
- **In terms of equities, privatization vouchers have been about the only securities traded.** However, there is no organized market, most transactions are unreported or carried out privately, pricing is distorted and liquidity is low.
- **There are no corporate bonds, municipal bonds, mortgage bonds, or active equities trading.** Only a handful of companies are in a position to issue corporate bonds, and these companies can borrow from foreign banks more cheaply than the costs and disclosure associated with bond issues.
- **Commercial banks are expected to be among those that will be able to list and issue bonds as they implement reforms.** This would be to obtain long-term funding for mortgage finance, leasing, and other credit activities that exceed one year terms. However, they will have to change their closed approach to information disclosure to successfully issue publicly traded instruments.
- **The corporate sector's financing needs have traditionally been met by bank loans or from other channels, reducing the demand for financing from the capital markets.** In general, there has been no active tradition of listing on securities exchanges, or meeting meaningful disclosure requirements to trigger corporate debt or equity activity.

2. Legal and Regulatory Issues

- **The Securities Market Regulation Law is well drafted.** However, refinements should be made regarding the definitions of a prospectus and "beneficial owner", and exemptions from having to publish a prospectus.
- **Legislation should be amended to provide capital adequacy requirements for broker-dealers, as broker-dealers are allowed to trade securities on their own account.** Imposing a capital adequacy requirement would also necessitate an amendment requiring that a broker-dealer must be organized as a joint-stock company or a limited liability company.
- **The Law should provide that one of the Securities Commission's objectives is to monitor the financial soundness of broker-dealers and trust managers.** It should also provide a practical and

effective legal basis for close cooperation and exchange of information with other domestic and foreign supervisors.

- **Several of the weaknesses associated with the functioning of the Armenian capital market relate to the Joint-Stock Company Law. Key weaknesses include issues related to share redemption, minority shareholder rights, asset stripping, and corporate governance.**

3. Risks and Vulnerabilities

- **Because the capital markets are undeveloped, there is no systemic risk.**

F. Non-Bank Credit Institutions

1. Overview

- **There is significant investment in housing and construction in Armenia, yet very little of it is run through the formal financial system.** Banks account for less than 10 percent of lending/investment in the housing market.
- **Leasing is nascent, with about $1.5 million in reported contracts.** Future development of leasing will be helpful to SMEs and general economic development. However, as of late 2004, the leasing market is currently at its beginning stages.
- **Micro-finance groups have made about $13 million in loans, about 5 percent of the banks' low totals.** While some of the MFIs have good management and are run commercially, others focus on humanitarian relief and poverty reduction, not commercial viability. This complicates the task of supporting commercial MFIs without diluting or undermining legitimate efforts of relief to improve the lot of the most impoverished in society.

2. Legal and Regulatory Issues

- **Leasing is a part of the non-bank credit framework, with CBA supervising leasing companies.** The leasing framework is consistent with international standards, although repossession issues have yet to be tested.
- **Mortgage finance is also covered under the Law on Credit Organizations, as well as the Law on State Registration to Rights to Property.** Improvements in the legal framework could be made by giving legal effect to registration of title and mortgages.
- **Outstanding issues and weaknesses in the legal framework include squatters' rights, which make foreclosure and eviction problematic, and undermine creditor rights and contract enforcement.** However, many of the changes envisaged in the amended Civil Code will change this on the condition that explicit references are made in contracts (loan agreements) about borrower obligations, methods of dispute resolution, and creditor rights.
- **The Government is reported to be considering tax-deductibility of mortgage interest expense.** Given that properties in Armenia are generally purchased on a cash basis and that mortgage loans are frequently paid down prior to maturity, it is unclear what the advantage would be for market development under current circumstances. Rather, the Government may want to consider more efficient targeting of property tax revenue collected to finance infrastructure needs (e.g., road, sewage, power maintenance) and energy conservation efforts (e.g., insulation, sealed windows, energy-efficient appliances and light bulbs).
- **Another issue is the prospective role of a Government-supported Enterprise in leading the way**

towards standardization of contracts and secondary market development in the mortgage finance market. A preferred approach would be for lenders in the housing finance markets to play an active role in developing standards and model contracts, having approved third parties involved in transactions as needed based on professional standards and criteria (e.g., appraisers, notaries, insurance firms), moving to syndication for larger exposures (e.g., commercial property), and selling assets to banks and others to free up capacity on their balance sheets for more loans. As inventory builds, there will be natural market pressure for secondary market development.

3. Risks and Vulnerabilities

- **There is no systemic risk given the limited impact and linkage of non-banks.**

G. Financial Infrastructure and Information

1. Payment System

- **There is a high level of money outside the banking/formal system, which reduces the level of volume for small value payments through the payment system.** This will not change until incentives for tax evasion decline, and inroads are made against poverty.

2. Accounting and Audit

- **While banks are required to present their financial statements according to IAS/IFRS, there are still gaps between local accounting standards and revised IAS and IFRS.** All together, there are reported to be inconsistencies in 31 RAAS principles of the 41 IAS principles. Likewise, RAAS has not yet been updated to reconcile with the five IFRS principles.
- **Banks focus on accounting and audit as reporting formalities more than strategic management tools.** Over time, banks will not only need to develop more comprehensive accounting systems, but also to treat external audits as part of a strategic exercise to improve governance, operations, systems, procedures, controls, etc.
- **There is little domestic accounting and audit capacity in Armenia.** There are only two international accounting firms in Armenia, and only about 20 accountants with comprehensive training in international standards. There are others capable of providing enterprises, government and financial institutions with better accounting services, but they lack the work experience needed to obtain professional certifications.
- **Part of the problem in building professional standards is that the effort to make domestic accounting standards consistent with IFRS (then IAS) has experienced a time lag.** A large part of the problem is that the approach to accounting and audit has been a legalistic and interventionist approach by government, rather than a more common standards-based approach in market-based economies in which professional associations are responsible for standards, certification, continuing education, ethics and compliance. A strengthened mandate for the AAAA can help bridge the accounting/audit gap, which will help with other issues related to transparency, disclosure, governance, and enterprises credit worthiness.

3. Transparency and Disclosure

- **Weak disclosure limits the information needed for additional market development.** The tendency in Armenia is closed, which also stifles risk-taking by banks and others as it undermines trust and fails to meet banks' underwriting standards for loan origination. Such closely held approaches also make it more difficult to launch a credit information bureau to help banks evaluate and price credit risk, reducing loan size and increasing interest rates charged. However, enterprises and households are not entirely to blame. Arbitrary and subjective tax treatment likewise serves as a disincentive for businesses and individuals to disclose sales, incomes, assets, and other basics of financial reporting.

RECOMMENDATIONS

A. General Recommendations

1. Strategy Development and Coordination

- **Linkages work across the board, and the absence of progress in one area can likewise stifle development in another.** For that reason, it is recommended that the Government pursue a diversified, market-based financial sector strategy that is stable, phased, and focused on developing a wide array of financial services to complement banking.
- **Cross-cutting areas such as legal reform, regulatory coordination, consolidated accounting and supervision, corporate governance, and institutional support systems (e.g., property and pledge registries) should each have customized strategies for each financial sub-sector (e.g., banking, pension reform, insurance sector development, securities market development, mortgage finance, leasing, factoring), while also having working committees to identify areas of convergence and needed coordination.** As an example, it is proposed as a function of accounting and audit reform that a specialized working committee focus on needed reforms and institutional development to effectively implement consolidated accounting and supervision, while providing a clear framework for investors and market players to pursue market development in a manner that is consistent with international standards of accounting, auditing, and financial reporting.
- **With comparatively abundant resources available from USAID and other donors, the importance of donor coordination needs to be stressed.** This could be done by establishing a working group composed of representatives of institutions that have been the most active and effective in the area of financial sector reform: CBA, Ministry of Finance and Economy, Securities Commission, IMF, World Bank, KfW, IFC and USAID. Monthly meetings and a policy/performance matrix for the tracking of activities and expected results would help as a management tool. Specific sub-committees for critical reform areas (e.g., corporate governance, accounting and audit, consolidated risk-based supervision, mortgage market development) could be structured to report to this policy-based working group.
- **Donors should apply tougher conditionality and performance requirements as a basis for assistance.** Greater strategic effort should be focused on results, rather than process.

2. Inter-Sectoral Linkages and Improved Access to Finance

- **Increasing access to finance will depend heavily on improvements in the real sector.** This will need to focus on matching credit worthiness considerations for real sector borrowers with underwriting standards of banks and other financial institutions. This will require a change in Armenia's business culture away from closely held operations to more transparent operations that rely on greater market and financial information flows, complementary management teams and structures, and sound advice from board members and private advisors.
- **Development of the financial sector will require simultaneous development across services, yet phased and careful approaches to ensure that regulatory and supervisory structures are**

adequately established. As more risk (including transfer risk) is assumed, regulatory structures will need to be monitoring for risk based on standard pools of information that reconcile on a consolidated basis.

- **Mandatory forms of insurance and savings are the fastest method of helping to provide depth and diversity to the currently narrow financial system. Mandatory third party motor vehicle insurance will boost the insurance sector.** The same trend will increase with businesses seeking loans and lease contracts (e.g., requiring property and casualty or vehicle insurance as a condition for bank loans). Second pillar pension reform is also key to building a viable pool of funds for market development, while also helping to provide a clear framework for collections and disbursements.
- **Capital markets development is required as a destination for eventual insurance and pension funds, although investment policy parameters should be risk-based and flexible to ensure that fiduciary responsibilities are the focal point of asset management.** The legal, regulatory and institutional framework needs to evolve so that investors have confidence in the market as a whole, as well as the individual instruments offered. When this occurs, money will move into these securities. Until then, the focus should be on adherence to fiduciary responsibilities to ensure that long-term contractual savings obligations will be fully met. This means that the proportion of securities permitted to be held in investment-grade instruments in OECD countries should initially be high, and then gradually reduced as the number and variety of safe instruments and institutional capacity emerge in Armenia.
- **Other infrastructure requirements are needed for markets to more fully develop.** Moving to a more comprehensive property registry and digitally accessible system will be indispensable to further development of a pledge registry in support of a viable secured transactions framework, with particular focus on mortgage finance (i.e., housing and commercial property development) as well as bank loans, leasing, and consumer finance.

3. Legal and Regulatory Standards

- **Throughout the reform process, Armenia should seek to adhere to international norms and become members of international organizations.** Coordination with IAIS in insurance/pension reform and IOSCO for capital markets development will help to provide meaningful guidance as these NBFI activities evolve. Harmonizing legislation and financial market practices with EU Directives can also provide Armenia with minimum requirements and benchmarks for international standards. This is true in individual sectors (with customization and adaptation of non-EU practices as desired), as well as in broader informational requirements needed for market development. As an example, adoption of the EU's 8th Directive on accounting would help provide Armenia with a framework for modernizing the accounting and audit profession.
- **To strengthen the institutional environment, judicial reform is needed.** This should include a comprehensive program to train judges and court officers in bankruptcy, secured transactions (based on effective legislation) and contract enforcement. It should also be accompanied by institutional support for better case management, court organization (types of disputes, amounts involved, levels of complexity, etc.), and electronic systems for increased access to information and decentralization.
- **Any movement of banks toward non-bank activities or "universal" status should be phased, and will require close regulation and supervision.** CBA has already done much in the banking sector to ensure that licensing is subject to higher capital requirements. In the future, CBA may want to consider a policy of subsequent capital increases for differing types of licenses, based on banks' demonstrated management and systems to assume new risks, and organizational/financial/regulatory firewalls to ensure that non-bank activity does not impair deposit safety or core banking activities.

4. Tax Policy

- **Tax preferences should be provided on pension contributions to stimulate long-term savings, as well as to serve as a catalyst for successful and sustainable pension fund development.**
- **The public perception that bank accounts can be subjected to the risk of garnishing without recourse is one of the reasons for fairly low levels of deposit mobilization in the banking system.** While there are legal prohibitions in place against this (apart from court orders or CBA intervention when suspicious transactions are detected), the authorities may still want to consider a statement of principles, possible thresholds for an amnesty, and other measures to clear the ranks before proceeding with a new framework for account garnishing.

5. Accounting and Audit

- **Armenia needs to develop a suitable audit and accounting profession for the development and maintenance of standards.** One way to do this is to move to a more standards-based system, rather than a government-controlled system.

6. Banking and Banking Supervision

- **CBA should continue to strictly enforce banks' compliance with minimum capital requirements (including capital adequacy).**
- **CBA may want to formalize how it plans corrective actions.** While the last several years have been focused on stabilizing the banking system, there should now be consideration of a more formal contingency planning exercise and appropriate corrective actions that would take place under differing levels of systemic stress or bank-specific capital depletion.
- **Risk-based supervision should be practiced increasingly and to the extent possible by CBA.** Greater focus on risk management should be the core of contingency planning and whatever organized program for corrective action that is conceptualized.
- **Building blocks for improved corporate governance should include protection of minority shareholder investment, and stiffening qualifications for board members.**
- **CBA will need to ensure that banks have sound risk management systems in place in anticipation of greater risk assumption in their loan portfolios and fee-based activities.** More developed systems, procedures and controls as a function of internal audit, credit risk, portfolio risk, and general risk management will be needed for banks to move ahead under more competitive conditions. Consolidated accounting will need to be introduced as a starting point, particularly if companies to which the banks lend have subsidiaries and affiliates. A tightening of legislation dealing with the role of consolidation (e.g., parent companies, holding companies) will also be needed for such practices to be consistent with the broader legal framework.

7. Insurance

- **Barriers to investment-grade insurance companies should be removed to accelerate reform, develop capacity, and modernize financial services.** This should include measures to attract reputable foreign insurers, including through branch operations on the condition that other licensing criteria are met.
- **Insurance sector development should follow IAIS principles.** This should include separation of life and non-life, clear investment policy guidelines, and consumer protection provisions that help to build credibility and accountability in the profession. Removal of barriers to prime-rated foreign insurers should be entirely removed. There will also need to be a strong effort that ensures "pocket"

insurance companies do not emerge as mandatory insurance is introduced. Thus, licensing standards will need to be strict, solvency closely monitored and accurately measured, and governance and management requirements consistent with international standards.

8. Pension Reform

- **Pension companies should be supervised and regulated by a separate pension supervisor or an existing financial sector regulator, but not by the current Ministry of Labor and Social Insurance or the current State Social Insurance Fund.** Neither of these institutions has experience regulating financial sector companies. A provision of this sort should be added to existing draft legislation.
- **Ideally, legislation should state that the Government of Armenia will act solely as a pension company regulator and supervisor, and that the State will not compete in this market.** If the Government chooses to have a State Fund during an interim period in which the current PAYG system is transformed into a multi-pillar system, this should be implemented under very strict conditions that address regulatory/supervisory weaknesses and can be easily transferred to the private sector when institutional capacity for effective regulation and supervision exists. This would render the State as "passive" owners of the Fund, with methods to include (i) outsourcing the second pillar fund management and administration to an internationally recognized fund manager to overcome regulatory/supervisory weaknesses, (ii) having strict audit conditions and controls on collections and adherence to investment policy requirements, (iii) segregating collected funds from normal government operations, (iv) guaranteeing safekeeping by permitting placement of collected funds in investment-grade securities in OECD markets, and (v) having a sunset provision of no more than five years to ensure fund management/administration is then divested as a "passive" State function and is transferred fully to the private sector.
- **Several modifications should be made to the existing draft legislation.** The Law on Pension Security should include (i) provisions regulating the relationship between the employer and the pension fund, (ii) regulations or by-laws covering banks and insurance companies that are licensed to market and sell pension products based on clear solvency guidelines, (iii) requirements that ensure the pension fund's financial soundness so that it can meet the future pension obligations, (iv) provisions that make permanent the pension fund's management and investment strategy (with participants having the right to change investments to another fund at any time), and (v) clear provisions for contributions and disbursements.
- **Draft legislation should also give favorable tax treatment to savings invested in pension funds.** Absent incentives, it may be very difficult to promote future savings in pension funds. Likewise, if mutual or investment funds emerge in the future, pension funds would be at a competitive disadvantage, as these allow investors to redeem their investments any time they choose (subject to conditions).
- **The structure of the pension system that is put forward in Armenia should be designed based on the World Bank's three-pillar model, using a system of defined contribution accumulation accounts.** In conjunction with the work of the World Bank assisting in the reform of the Pillar One pension system, a portion of the compulsory pension contributions should be re-directed into Pillar Two pension companies. It is also recommended that employees be permitted to make additional voluntary contributions (Pillar Three) into these pension companies if they are able and inclined.

9. Securities Markets

- **Securities market development should be guided by IOSCO and OECD standards.** Investment should be allowed in OECD country securities that are blue chip, prime-rated, and adequately hedged.

Consumer protection should be based on modern custodial services, electronic and verifiable recordkeeping, and regular disclosure. Stiff licensing requirements should be in place for collective investment vehicles, including high minimum capital, fit and proper standards, and compliance with general IOSCO guidelines. If a universal banking model evolves, there should be clear separation between bank and brokerage/investment arms, and capital should be measured and supervised on both unconsolidated and consolidated bases, with capital adequacy/solvency tests reflecting the specific risks of the core business activity. There should also be efforts to obtain ratings from internationally acclaimed rating agencies. (This has not yet occurred in Armenia on sovereign debt or for any other securities.)

- **Armenia can utilize its domestic securities market to establish a yield curve and pay down some of the external debt it carries to create a more active domestic market.** Government securities will be useful in providing a reference rate and benchmark for bank lending and other securities, which will be essential for more efficient pricing in the credit markets, and broader development of capital markets and contractual savings.
- **While issuing domestic debt to replace concessional external debt may make little sense in terms of fiscal cost and debt management, the decline in DRAM interest rates and real depreciation of the dollar against the DRAM may make this a rational move aimed at helping to establish a domestic capital market.** Once established, this would provide reference rates and benchmarks for banks, mortgage loan originators, leasing companies and other creditors to issue corporate bonds to obtain needed term funding for long-term loans and lease contracts.

10. Non-bank Credit Activities

- **Mortgage finance could emerge as a major catalyst for banking, securities, insurance, and pension fund development.** For banks, it offers the possibility of increasing earning assets and selling/syndicating primary originations as well as purchasing assets for portfolio purposes. For the capital markets, it offers the potential for instruments to be traded and invested. For insurance companies and pension funds, it offers assets to hold for asset-liability matching purposes.
- **The legal framework does not currently exist for secondary mortgage finance market activities.** Policy focus should be on correcting the existing inadequacies of the primary market and then moving to a framework for secondary market development as the primary market shows a build-up of inventory and value.
- **Institutional capacity needs to increase for mortgage finance markets to evolve more comprehensively.** Both public sector institutions (Ministry of Urban Affairs) and private sector players (National Association of Realtors and Appraisers) can do more to obtain and disseminate data and information on real estate trends. This would be helpful for economic analysis and planning in the public sector, as well as for financial institutions in developing credit and investment strategies.
- **Leasing, factoring and commercial finance operations should be encouraged. However, as risk-takers, their operations should not be permitted to undermine deposit safety.** This would mean banks active in these fields should continue to be subject to prudential regulations governing these activities as part of their overall credit risk management function. Meanwhile, the limited licensing approach of the CBA for most non-bank credit organizations (preventing them from mobilizing deposits or accessing any deposit guarantee coverage) should be continued.

B. Specific Recommendations For USAID

There are five key initiatives recommended for USAID to pursue (in no particular order). These include:

- **Banking supervision and commercial bank corporate governance**, as the banking system becomes more complex, supervision evolves in a more risk-based fashion, and commercial banks seek to professionalize operations while introducing new products and services for increased earnings.
- **Accounting and audit reform**, to help Armenia move away from a legalistic, government-oriented approach to accounting and audit that has proven ineffective, and towards a more standards-based approach that focuses on professionalism, improved governance and management systems, and development of risk management capacity.
- **Housing finance development**, with a combined focus on a comprehensive property and pledge registration system to make mortgage finance more feasible, for primary markets to develop, and for the economy to move increasingly to secondary markets over time.
- **Pension reform**, with specific focus on evolution of professional fund management to manage resources, and for supervision to provide trust and confidence.
- **Insurance sector modernization** under a sound legal framework, and based on effective supervision and active market participation in the setting of standards, guidelines, and codes of conduct.

Readers are encouraged to obtain the Main Report for a broader discussion of points summarized above, as well as core recommendations and other options reviewed. Readers are also encouraged to obtain copies of the Annexes for detail on issues raised.

I. INTRODUCTION

A. PURPOSE

The following assessment of the Armenian financial system has been produced for the United States Agency for International Development/Armenia, under contract with Emerging Markets Group, Ltd. (an independent firm associated with Deloitte Touche Tohmatsu). This financial sector assessment has been carried out as a diagnostic for USAID to serve as a basis for developing a revised assistance strategy that would possibly include increased resources and activities to support continued movement to a viable banking and financial system. This follows previous support provided by USAID in recent years focused on banking sector development and banking supervision, capital markets development, micro-finance, SME development, and accounting and legal reform.

Findings and recommendations are the result of background research, in-country meetings, and presentations to various stakeholders, and are structured to mitigate identified financial sector deficiencies and vulnerabilities. Recommendations are intended to focus on areas where USAID assistance is considered to be most potentially useful and effective. The recommendations seek to take into account other initiatives undertaken by donors active in the financial sector of Armenia, the most prominent of which have been the World Bank, IFC and KfW at the structural level and the IMF in its work with the CBA.

The final report also takes into account comments and constructive criticisms received from various stakeholders after the draft report had been reviewed and presentations made in Yerevan in December 2004. By and large, the draft report was well received and the diagnosis broadly accepted as accurate. Likewise, recommendations were generally accepted as a way to move the financial sector reform process along in a constructive and meaningful way towards the achievement of poverty reduction, job creation, sustainable growth, and competitiveness. Some factual errors with regard to the legal framework have been corrected, while modifications to initial recommendations primarily involved a broadening of participants in reform efforts (e.g., greater involvement of market players in strengthening banking supervision and governance) and interim flexibility in approaches to pension reform (e.g., the role of the state in movement to a second pillar in the next three to five years).

B. ORGANIZATION OF THE REPORT

The report is structured as follows:

- The Main Report serves as the summary of the diagnostic, identification of key deficiencies and gaps, a cursory review of other donors' activities, and then recommendations for USAID and other stakeholders.
- Annex 1: Summary template of key deficiencies/gaps and proposed recommendations.
- Annex 2: Review of macroeconomic developments, economic structure, and private sector development issues.
- Annex 3: Review of the financial sector (banks and non-banks) in terms of structure and composition.
- Annex 4: Review of financial sector infrastructure.
- Annex 5: Review of soundness indicators and risk issues for the financial system.
- Annex 6: Review of financial sector intermediation, including levels, indicators, products, trends and access.
- Annex 7: Basic overview of the housing finance market.

- Annex 8: Assessment of the insurance sector.
- Annex 9: Plans for pension reform.
- Annex 10: Securities market assessment.
- Annex 11: Legal framework assessment.
- Annex 12: Summary of Armenia's tax rates by instrument and entity.
- Annex 13: Bibliography.
- Annex 14: List of those attending workshop presentations and others attending meetings during the information-gathering process.

C. ACKNOWLEDGEMENTS

The assessment has been directed by Michael Borish, President of Michael Borish and Company, Inc., under contract to Emerging Markets Group, Ltd. (EMG). While the team overlapped in many functional areas, primary responsibility for insurance and pension issues was handled by Martha Kelly (Annexes 8-9), securities markets development by Eugene Callan (Annex 10), and legal issues by Erik Huitfeldt (Annex 11). Collin Kenney of EMG provided overall project management and support. The team was supported by two Armenian consultants—Vardan Markosyan of VGM Partners, and Anna Sedrakyan (private consultant)—both of whom provided valuable assistance with data collection and logistics, and helpful and useful feedback on the feasibility of differing options for the Armenian marketplace.

EMG would like to thank Robin Phillips (USAID/Armenia Country Director), Haikanush Bagratunyan (Chief Technical Officer/Banking and Accounting Specialist), Thomas Morris (Director, Economic Restructuring and Energy Office), and Michael Blackman (Deputy Director, Economic Restructuring and Energy Office) of USAID/Armenia for their kind support and guidance.

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- Alan Kutchukian and associates at KPMG-Armenia.
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- Jonathan Stark of the Armenian Association of Insurers and Cascade Insurance/Reinsurance (CIRCO).
- Neil Wallace of the Institute of Chartered Accountants of Scotland (working with the Armenia Accountants and Auditors Association).

A list of the people with whom the team met as well as those who attended workshops is found in Annex 14. The team visited Armenia from October 18-November 6, 2004, in conjunction with this project. A follow-up visit by Michael Borish and Collin Kenney occurred from December 13-17 to conduct workshops, present findings and recommendations, and to gather comments from public and private sector officials prior to finalizing the assessment and recommendations.

II. DEFICIENCIES AND WEAKNESSES IN THE SYSTEM

A. GENERAL ECONOMIC WEAKNESSES

Armenia suffers from a high level of poverty. Of the total population, 49 percent live in poverty, of which 17 percent live in extreme poverty (2002 figures). While these figures may have declined based on the most recent living standards survey, there are still many poor regions and citizens. Recent data from the 2003 living standards data show a decline to 43 percent below the poverty line, and extreme poverty of 7.4 percent. However, the Ministry of Finance disputes this, and believes the ratios are higher, albeit possibly lower than the 2002 figures. Moreover, with permanent employment prospects often uncertain or poorly compensated, and significant emigration in recent years reflecting better opportunities elsewhere, the underpinnings of a stable society are lacking in Armenia.

There has been a dichotomy in terms of macroeconomic indicators and monetization. In the case of the former, the economy has grown in the last few years while also benefiting from increasing price stability (lower inflation rates), lower fiscal deficits, and reasonably stable exchange rates for a free-float regime. On the other hand, financial intermediation ratios are among the lowest of transition and even CIS countries. While increasing in 2004 (and earlier years), broad money is still reported to be only about 20 percent or so of GDP.1 Loans to enterprises and households are still less than 10 percent of GDP. Total deposits in the banking system are projected to be only $24-$25 million-equivalent per bank by year-end 2004, almost all of it short-term.

Tax administration is one of the most serious weaknesses in the Armenian economy, and methods employed weaken prospects for financial sector development. Despite recent changes to simplify tax administration for SMEs and reasonable tax rates, the actual methods used to generate fiscal revenue are perceived by many in the private sector to be selective, subjective, arbitrary and unfair. As such, Armenian enterprises and households spend enormous time and effort bypassing the formal system, suppressing and distorting truthful information, and hiding assets. This serves as a disincentive to investment and growth in the real sector, and keeps funds out of the banks in the financial sector. Such practices also provide an incentive for bribes by businesses to reduce potential arbitrary tax treatment, leading to additional distortions in the competitive environment. Anti-corruption legislation has been adopted, but successful implementation will take time and will also require a change in traditional practices.

The business environment is still weak. While there has been some progress with a range of business licensing and registration issues, there is still the broader challenge of developing a sound investment climate based on open competition, a fully functioning judiciary, a more professional civil service, and related institutions and infrastructure to support private sector development. Armenia is hamstrung by a number of factors, including its small market, closed borders with neighbors, lack of strategic commodities, limited corporate sector, and difficulty attracting foreign investment. Until progress is made, this will likely translate into a higher risk premium for credit and investment exposures.

Productive employment opportunities in the formal sector outside a few export-oriented and construction-related businesses appear limited. There is substantial confusion about statistics regarding unemployment, with underemployment being far more difficult to assess. Official unemployment rates are about 10 percent, while living standards surveys estimate 30 percent. Other people consider the actual unemployment figure to be higher, along with a significant degree of underemployment in several

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[1] This is an estimate as of 3Q 2004 based on September 30, 2004 broad money figures and projected 2004 GDP. Current estimates are that broad money-to-GDP will be slightly above 21 percent of GDP at year end 2004, and possibly lower if the early projection of GDP is exceeded.

quarters.2 Yet other parties believe the official rates reasonable based on wage trends and labor supply in certain sectors, particularly construction-related. (Part of this may relate to emigration.) The high levels of informal sector activity (estimated to be nearly 50 percent or more of GDP) attest to productivity and sustainable employment challenges.

Corporate governance needs strengthening in the financial sector, and is weak in other parts of the economy. Governance weaknesses in financial markets include the role and capacity of boards to exercise oversight over management, management conflict of interest, lack of familiarity with or use of IAS/IFRS, lack of autonomy of the internal audit function (if it exists), weak protection of minority shareholders, and a lack of tradition of open information flows and disclosure of potential problems and risks. Boards are often considered to lack qualifications and sufficient independence for a modern financial sector, and they continue to have close ties to specific industries, families and friends that result in patronage. Committees are not usually set up to deal with critical strategic issues on a consistent and systematic basis. MIS is weak in most cases, and not used effectively for management purposes. Business cultures are generally closely-held. While the banks are slowly moving away from these characteristics due to prodding by CBA, the real sector is reported to have more serous governance and management challenges. These weaknesses add to credit risk, make them less attractive to banks as prospective borrowers, and consequently add to the cost of credit when made available.

There is significant risk associated with investment in Armenia due to geo-political as well as structural factors. External and internal risk factors weaken prospects for Armenian trade, investment, and growth. Armenia's borders with Turkey have been closed since 1993. Borders remain closed with Azerbaijan as well, and the conflict in Nagorno-Karabakh remains officially unresolved. Its main export traffic runs through the port of Poti in Georgia, with unofficial taxes and related transactions costs equivalent to 10-18 percent of GDP. Georgia's borders with Russia (on which some of Armenia's merchandise exports depend) are also not always open, given periodic feuds between the two countries. Broader regional instability remains a point of vulnerability. Internally, there are high levels of corruption, and the public has little trust in many government institutions, undermining fiscal soundness and prospects for financial sector development. Such distrust manifests itself in high levels of tax avoidance by keeping funds outside financial institutions, thereby reducing the funding base and resource flow needed for banking and other financial services. Beyond that, enterprises are closely held in Armenia, and the scale of operations is very small. There is also a limited resource base, with nothing strategic in high volume. The absence of a tradition of investor/creditor protection and contract enforcement adds to the risk associated with Armenia as an investment destination.

B. BANKS AND BANKING

1. OVERVIEW

After years of instability, the banking system is showing signs of greater stability. The system's key prudential ratios are sound, and banks are broadly in compliance with CBA requirements concerning capital adequacy, asset quality, liquidity management, and market risk exposures.

Financial intermediation is growing, albeit from a small base. Data through 3Q 2004 show assets, credit (to enterprises and households), deposits and capital will all increase significantly (on an annualized basis) when compared with year-end 2003 results. This appears to reflect rising confidence in the banks, greater willingness of the banks to lend, and efforts by banks to meet the CBA's minimum

[2] This has been shown in productivity measures, where industrial productivity has gone up, but only affects about 11 percent of the total employed work force. Productivity measures in other sectors or specific sub-sectors has often been flat or declined.

capital requirement of $5 million-equivalent by July 1, 2004. However, total assets and other measures still remain small. Building on recent achievements by CBA in banking (and making progress on the legal and regulatory front in insurance and pension reform) is critical for underlying development of the financial sector.

Armenian banks are small. Annualized projected figures for 2004 show that the average Armenian bank will have only $40 million in assets, $15 million in loans to the real sector (not government securities), $24-$25 million in deposits, and $7 million in capital. Average regulatory capital at September 30, 2004 was $5 million, about the minimum required for next year. It is currently unknown how many will fail to meet the $5 million minimum and/or seek/require forbearance if their capital or CAMELS ratings fall below CBA minimum requirements, although several were below the figure as of late 2004.

With prudential norms limiting individual loan exposures to 20 percent of capital, this means banks are only able to serve small and medium-sized enterprises. However, these very same SMEs are often unable to comply with banks' underwriting standards for loan origination. To the extent that banks choose to meet SME financing needs in the next few years, it will likely be for small levels of working capital financing and trade finance. However, long-term finance will be in relatively short supply unless donor funds or guarantees are made available, as is currently the case, or banks choose to float bonds in the local market. Bank issuance of corporate bonds has not yet occurred in Armenia, although it would represent a logical move by banks seeking long-term funding.

The small size of the banks reflects even smaller earning asset bases, driving up net interest spreads. As banks have limited resources and have to contend with a host of other risks, they charge a premium for their loans. This makes loans costly when accessible to SMEs. The high degree of concentration in deposit mobilization at HSBC makes this even more challenging for the other 19 banks (of which one is under administration). Thus, in general, the quantum of earning assets is small, particularly when netting out HSBC.

The limited array of services limits non-interest earnings. Most banks only offer a limited variety of services, although this has increased recently with improvements in the payment system and greater use of electronics. Non-interest income was only $23 million in 2003, and projected to be $27 million in 2004. Thus, the average bank generally earns less than $1.5 million in pre-tax income from non-credit activities. In most cases, these are from transfers and net income from foreign exchange purchases and sales. Meanwhile, costs are high relative to business volume, further reducing the scope for after-tax earnings.

Given the small earning asset base, actual earnings are low. While RoAA and RoAE measures are not bad, actual after-tax earnings were only $11 million for the entire banking system in 2003. Considering HSBC's net profits were $3 million, this means the remaining 19 banks in 2003 averaged little more than $400,000 in after-tax earnings. Projections for 2004 show improvement, at $18.5 million for the system as a whole (nearly $1 million on average). Nonetheless, these figures are very small by comparison with other markets, even many CIS and transition markets.

Banks' costs are not high, but neither is their productivity. Revenue (gross income) per employee averaged only $15,262 in 2003, which is low by comparison with most banking systems. This is projected to increase to about $18,695 in 2004, a strong per-employee increase. Nonetheless, many banks appear to have high staffing levels relative to income. This is mainly because of the limited array of products and services, and low levels of earning assets. It is also because most banks are still partly manual in their orientations due to the use of multiple software programs and systems that are not effectively integrated, thereby requiring greater time for processing. Data for 2004 show that apart from interest expense (30 percent of operating expenses), most expenses are for salaries and benefits (26 percent) and "other" unspecified items (15 percent).3 Other activities show fairly low levels of expenditure, such as audit and consultation, equipment maintenance, training, and other areas where systems improvements and human capital formation might lead to new product/service applications or higher levels of overall productivity. Considering that additional resources will need to be spent for better systems and controls, banks will need to broaden their products and services to generate the needed earnings to be competitive in these areas. In this regard, efforts will need to be made to assist banks to determine how to design and introduce new products and services by gathering better market information, costing products and services, and evaluating potential investment and support requirements as well as profitability prospects.

Banks do not actively seek out deposits or operate in a manner that is typical of commercial banks in market economies. As an example, banks would benefit from greater long-term funding for housing loans and consumer finance loans, but rates paid on time deposits of one year or longer are too low to attract such funding. Meanwhile, borrowings from the syndicated loan market abroad are low, and there are no mezzanine or bond instruments to provide needed funding. In this regard, as an unintended consequence, donor funding to the banks may be distorting pricing in the deposit market and inadvertently keeping mobilized deposits lower than might otherwise be achieved.

Access to financial services outside Yerevan is very limited. While some banks are slowly adding ATMs outside Yerevan, most fundamental services apart from Yerevan are limited to a handful of weak banks, donor-supported micro-finance groups, and the postal system. In the case of the banks, Armsavings has the largest branch network (101 of a total of 230 in Armenia), but is not known for having modern systems. As an example, it only has four ATMs. With Vneshtorgbank's acquisition of Armsavings in early 2004, there are now plans to bridge this gap, but it will likely take at least one to two years before Armsavings has an impact on retail banking in Armenia. Micro-credit groups are not considered to be financially sustainable, meaning they would fail if donor funds were terminated. Some are reported to suffer from weak management, while others complain that commercial viability is undermined by some that offer subsidized rates on loans, thereby reducing earnings and eliminating prospects for financial sustainability. In the case of the postal system, there is very little available in terms of financial services, and this is mostly focused on small payments (e.g., pension, disability, money transfers). For now, many households and small businesses still fall outside the network of formal financial services. Bank accounts numbered about 500,000 in late 2004.

Concerns about account privacy may be a deterrent to deposit mobilization in the banking system. There is a perception that accounts can be willfully garnished by the tax authorities, even though legally this is only possible via court action or by the CBA in the event that money laundering has been detected. Nonetheless, the perception persists, and is considered a constraint to deposit mobilization. (There may also be residual concerns about bank safety with some people as a result of losses from the 1990s due to hyperinflation, pyramid schemes, collapsed banks, and legacy of fraud and mismanagement.) On the other side, the number of accounts is growing, as is the value of overall deposits. As an example, enterprise deposits increased from $149 million at year-end 2003 to $203 million by September 30, 2004, while individuals increased their deposits from $174 million to $223 million during the same period.

There is reported to be limited management capacity to operate banks (and enterprises) according to international standards and norms. While improving, this reflects the need for new investment in the banking sector from those that are "fit and proper" and have the management capacity and systems to modernize the financial sector. Weaknesses are particularly prevalent in the enterprise sector, making risk-taking for the banks more of a challenge.

[3] Discussion of operating expenses relates to interest and non-interest expense, but does not include gross or net provisions, nor does it include income taxes (although it does include contributions to the Social Security Fund and other mandatory tax/duty payments).

There has been modest development of risk management systems for credit risk, market risk, and general portfolio management. This will come with time, but as of now, these are relatively new concepts to the banking market in Armenia. As macroeconomic fundamentals continue to improve and interest rates come down, the system will begin to open up to more competition. As this occurs, more developed risk management systems and skills will be needed to sustain a strong and soundly regulated market. This will require that supervisory authorities coordinate their risk detection and surveillance efforts as the system becomes more complex and intertwined (e.g., transfer risk). However, there appear to be no immediate risks, and these kinds of developments are only expected to occur over a number of years as the system develops and diversifies.

Back office operations will likely need strengthening for better monitoring of financial crimes that could tarnish Armenia's reputation. While the remaining licensed banks are reported to be transparent and CBA is confident there is little if any problem of money laundering run through the banking system (except in a few instances), the risk and challenge is there (as in all banking systems). Strengthened systems will be needed to increase efficiency, as well as to help with effective enforcement of anti-money laundering initiatives. Coordination of AML and related activities through the Financial Intelligence Unit (soon to be established) should help mitigate these weaknesses.

2. RISKS AND VULNERABILITIES

The level of banking sector penetration in the economy is so low that any bank failure would have little direct impact on the economy. The only exception might be HSBC, whose assets were about 23 percent of total as of year end 2003 and 19 percent at 3Q 2004. However, this is only 4 percent of GDP, and the likelihood of a failure is virtually zero. Thus, this is not considered a risk to the system.

Nonetheless, any individual bank failure could potentially weaken overall confidence in the banking system. Even if such a bank or banks were very small, the public would not necessarily discern the financial impact relative to the system as a whole. Rather, it might simply raise concerns about the safety of deposits in any domestic bank, thereby potentially slowing deposit mobilization in the banks.

The banking system is characterized by a small degree of concentration, namely in the area of deposit mobilization, largely attesting to the competitive advantage HSBC enjoys due to its global presence and international reputation. HSBC accounts for more than half of retail deposits, and this limits the funding base of the other banks, resulting in partial constraints in the competitive environment. Moreover, as HSBC (and others) generally transfer these funds for safekeeping to accounts in New York and London, 28 percent of total bank assets are in correspondent accounts abroad (as of 3Q 2004). This ratio has come down as banks lend more, but still indicates the need for a more competitive banking environment.

Other banking system measures show limited concentration, apart from earnings. The real threat is less the position of HSBC, and more the weakness of the other licensed banks. HSBC appears to capture most of the earnings on an after-tax basis. Based on 2003 figures, it accounted for more than a quarter of after-tax earnings for the banking system as a whole. Unaudited figures through 3Q 2004 show HSBC with about 20 percent of system earnings after-tax, as other banks increase their share. Nonetheless, annualized averages for banks in 2004 show the average bank generating about $820,000-equivalent in after-tax earnings, as compared with HSBC's $3.8 million. Thus, HSBC continues to dominate in terms of profitability. Otherwise, the next four banks account for about 38 percent of assets, and the top 10 banks account for 74 percent of assets. Capital is concentrated, as the top 10 banks account for 56 percent of total, and HSBC only accounts for 9 percent. The degree of concentration enjoyed by HSBC concerning deposits and earnings are less a challenge to the system than is the inability of the remaining banks to attract deposits, increase productivity, and generate greater after-tax earnings.

Banks do not appear to have any major sector concentrations that pose risks, although careful monitoring of consumer lending and exposure to commercial trade should continue. More detailed information on housing and commercial property loans (via the chart of accounts) should also be obtained. Likewise, in the future, CBA and the Insurance Inspectorate should monitor potential transfer risk through credit insurance and other enhancements that can be used to obscure underlying portfolio quality. These are not current problems, but could pose risks in the future, particularly if there is a decline in GDP growth and incomes (possibly undermining credit quality and/or introducing greater market risk), or if other sources (e.g., remittances, donor financing) decline.

The system suffers from an absence of strategic investors, needed for capital investment, risk management, and general know-how. About half of Armenia's banks have foreign participation, which is positive in that fundamental barriers to foreign investment are not problematic. On the other hand, apart from HSBC, none is a major bank in international markets. Above all, banks should be seeking international partners to increase capital and strengthen systems, possibly by more actively marketing through correspondent banking networks. This is particularly important at a time when HSBC is trying to deflect new deposit accounts.

Donors may serve as a needed bridge for capital investment in domestic banks. This can be helpful when reputable foreign banks are unwilling to invest directly in domestic banks. However, CBA should require that "donors" either have direct commercial bank market experience and a legitimate track record managing and investing in banks, or a reputable partner to cover for the lack of hands-on experience that characterizes donors themselves in commercial banking markets.

Additional foreign banks are not automatically good for the system, but prime-rated institutions should be encouraged to establish a presence. Should domestic banks not be successful in attracting major foreign partners, CBA should be willing to have foreign bank branches establish a presence in Armenia (including the right to mobilize deposits) without direct capital investment or primary supervisory responsibility. Instead, CBA could subject licensing conditions to specific protocols with the host supervisor, investment-grade ratings as a requirement, and other prudent licensing conditions. This would include potential interest from major banks operating in Russia, Kazakhstan or the Caucasus region (e.g., Citigroup, Deutsche Bank, ABN-Amro, ING, Société Générale).

While some of the banks with less than $5 million are not expected to have a problem reaching and exceeding this requirement by July 1, 2005, others may face challenges complying with the requirement. This may create additional pressure on CBA for forbearance. This should be resisted by CBA, and there is no indication that CBA would provide any degree of forbearance. However, contingency planning might include the option of a re-licensing procedure that includes restricted activities, including placement of all household deposits with CBA or with a licensed bank until a new bank license can be issued once the legal entity meets minimum CBA requirements.

Credit risk is high, which is one of the reasons why banks have been reluctant to lend. On the other hand, banks themselves show modest capacity to evaluate credit risk. Non-performing loan figures are low, largely due to strict oversight by CBA. But such low levels of poor quality loans also indicate that banks have avoided making loans. This has been prudent as a means of recapitalizing and meeting capital adequacy standards in recent years. On the other hand, with interest rates and inflation rates declining, there is less money to be made from investments in government securities and bank securities abroad. As such, banks will need to lend more to generate the earnings they need to become "universal" banks. This will require more tools and capacity for credit risk evaluation as a means of countering the inherent credit risk assumed in most lending activities.

Some of the donor programs (e.g., KfW-GAF) have lent on an unsecured (cash flow) basis (to micro-enterprises) with solid results. This actually points to the larger need for the banking system to attract modern management and systems from abroad, rather than relying on piecemeal donor programs to slowly provide market examples of how to lend and manage risk. The five banks participating in the KfW-GAF program will help the system with basic credit risk management practices. However, until such practices are more widely practiced and lending is more competitively pursued, the system will remain small and limited in its impact on economic and business development.

There is a general risk that banks all want to be universal. This is understandable, in light of the limited investment opportunities most of them have. However, because they also lack the experience and management systems, there is a risk that banks might seek to move into non-traditional markets prior to having the experience needed for sound risk management. To date, this has been mitigated by strict limits on what banks and non-banks can do in terms of cross-ownership, affiliated activities, etc. However, there is a challenge of how to maximize earnings opportunities for banks so they can get to a threshold where they can boost earnings without undermining financial stability. This is all the more so due to the absence of a corporate market for banks, limiting their real opportunities to small-scale clients. Given the low level of earning assets and aggregate earnings in the system, banks will be tempted to take on more risk over time to increase profits. This should not occur until adequate systems are in place to monitor and contain risks that help to ensure adequate capital and asset quality. On the other hand, this process can be facilitated with consolidation of the system, strategic investment from investment-grade institutions, and/or the presence of foreign branches to induce more competition and increase product offerings and service levels.

There is a risk of adverse selection in lending markets. As banks move away from government securities and towards lending, there is a risk they will all do so at the same time. Net of traditional relationships that have governed most banks' activities, lending to the private sector more aggressively but at the same time may be perceived as a means of increasing earning assets. However, the likely effect is that banks will then book assets at lower interest rates to capture the business, and then potentially face defaults if there is an economic downturn. Given weaknesses in the business environment, the best way for banks to manage this risk is to know customers well, build value chain relationships, track cash movements, increase credit exposures on a gradual basis, and introduce systems that regularly test the portfolio for credit and market risk.

If there is an increase in term lending by the banks (as needed for investment in the SME sector), this could introduce interest rate risk, as well as obvious maturity mismatches and potential foreign exchange risk. Banks have been increasing their consumer lending, with maturities often running for up to three years. Likewise, there is reported to be some basic activity in housing finance for up to seven years. Both of these present possible risks relative to the predominance of the funding base which is for nine months or less. However, there are no serious maturity mismatches or interest rate risks reported, as most loans are short-term and the interest rate environment has been improving. If anything, banks have increased their net spreads, despite declining interest rates. There is also no reported foreign exchange risk, except in cases where all earnings are in one currency (e.g., DRAM) and loans are in another. However, with the decline of the dollar since late 2003 and the relative stability of the DRAM (low levels of DRAM depreciation) prior to that, this risk has been monitored by CBA and, by extension, the banks. In time with additional competition, banks will need to have systems in place for fundamental market risk under increasingly competitive conditions. This is currently not the case.

There is some exchange rate risk due to the dollarization of the economy. Foreign currency deposits are nearly 80 percent of total deposits and about 50 percent of broad money. If anything, the risk may be more related to seasonal fluctuations and resulting foreign exchange rate volatility, and the need for more instruments at CBA to sterilize inflows. However, on the whole, monetary management has stressed price stability, with a fairly stable exchange rate regime resulting despite free float. Banks themselves have shown a relatively high degree of matching, adherence to fairly conservative open currency exposure limits, and generally low net current open positions. Current risk has more to do with the slide of the US dollar worldwide, and the opportunity cost of this slide relative to other major currencies. On the other hand, for an open economy that is seeking to increase international transactions, the weaker dollar has not translated into large opportunity cost for Armenia. With nearly 40 percent of its total trade with EU markets, the euro has appreciated more in real terms against the dollar than has the DRAM.

Back office operations, information systems, and internal controls are all considered moderately acceptable, but underdeveloped by global standards. The banks are reported to need more developed systems to handle an increased volume of future risks. There have been improvements, largely triggered by regulatory pressures and prudential requirements from the CBA. Some banks recognize the benefits of operational efficiency and the need for a sound reputation, while others simply consider it necessary for CBA and correspondent banking relationships. Irrespective of differences and approaches to date, this will be a critical issue in implementing systems to identify suspicious transactions.

As with operational risk, reputation risk in the market has an impact on correspondent banking relationships, the risk premium assigned to international borrowings, and the country's ability to attract investment. Ensuring a reputation of safety and stability will be necessary if Armenia is to diversify and develop its economy successfully. For this reason, notwithstanding the closure of a net 54 banks since 1993, low levels of capital and large numbers of small banks detracts from Armenia's overall banking sector reputation. The persistence of a "pocket bank" market with only one reputable foreign bank raises doubts about corporate governance standards, management capacity and systems, creditor and investor protection, and likely returns from such a small market. In this regard, successful implementation of policy reforms in the overall business environment will be needed to correct this. Such a challenge transcends financial sector developments, yet failure to progress with civil service reform, judicial capacity enhancements, and improvements in the business and investment climate will slow progress and achievements in the financial sector.

It is unclear whether banks that barely meet minimum capital requirements should be permitted to participate in the deposit guarantee scheme, or if they should be re-licensed as non-banks (e.g., commercial finance companies). In one sense, there should be no discrimination on the condition that licensed banks meet conditions for participation in the deposit guarantee scheme, including acceptable CAMELS measures. Since banks are generally above 20 percent CARs, there appears to be little risk to the deposit guarantee fund on the condition that high CARs are maintained, irrespective of actual capital levels. Likewise, without participation in the deposit guarantee fund, they are unlikely to attract needed funding for growth. On the other hand, their asset exposures should be monitored closely to avoid any early depletion of guarantee funds that would result from rapid deposit withdrawals, triggering a liquidity crisis at the bank, particularly if driven by solvency concerns.

Banking system capacity to handle increased financial inflows remains underdeveloped. There are few instruments available in Armenia for improved liquidity management options (let alone long-term investment), credit risk remains high due to limits on transparency and creditor protection, and capital markets are underdeveloped. Other markets like real estate/property development remain cash-based. In general, banks have little experience with portfolio and investment management. Should banks not accelerate modernization of operations and grow to manage/intermediate more resources, there is a good chance that most of these resources will go offshore, as they do at the moment, or remain in the informal sector. All of this is at the expense of domestic investment and/or visible activities/assets that would increase growth and employment.

C. Insurance Sector Development

Based on market estimates for 2003, premium revenues were less than $4 million. By comparison, the 88th largest country in the world for insurance premium revenues was Latvia, at $220 million. Armenia is among the smallest of insurance markets in the world, with estimated density per capita of less than $2, and market premiums per active company of about $200,000.

Insurance is profitable despite being small, with many transactions thought to be unrecorded to avoid tax payments and reporting requirements. Reinsurance outflows are very high and account for 97 percent of total revenues. Claims paid in 2003 were less than 20 percent of estimated gross premium revenues. In general, the sector reports after-tax profits.

There is no compulsory insurance in Armenia, one of the reasons for its small size. This is expected to change as Armenia introduces third party motor liability. Other compulsory insurance is being contemplated for the health sector. Some market transactions serve as a stimulus for insurance sector development, such as housing loans that require property insurance.

Barriers to foreign investment in the underdeveloped insurance sector have stifled growth. Armenia remains one of the least dense and penetrated insurance markets in the world, with per capita premium revenue of less than $2. Most of the insurance activity is effectively in Europe through reinsurance channels.

A weak insurance framework likewise translates into the absence of institutional investors. Insurance companies are needed as institutional investors for capital markets development, private placements, improved governance in financial institutions and strengthened financial discipline in companies. Absent meaningful reforms and change in the insurance sector, their presence as institutional investors will not occur. Absent institutional investors, the economy will not diversify and grow.

Insurance companies are small in assets and capital, and limited in terms of premium revenue and earnings. Capital was $3.2 million at year-end 2003, or less than $170,000 per active company. A new framework is evolving that will require firms to adhere to sound regulations regarding solvency and liquidity. However, until new investment enters the marketplace (largely based on the incentive of compulsory insurance), insurance will remain small and underdeveloped. From a policy standpoint, it will be essential to eliminate barriers to entry for reputable foreign firms, and to present a framework to make it possible to evolve to a multi-pillar pension system with well managed life insurance companies potentially playing a role in asset management in a second and/or third pillar.

Rather than being vulnerable to systemic risk, the underdevelopment of the insurance sector simply constrains business and financial sector development. Businesses that lack certain kinds of insurance also lack protection against unforeseen events. Individuals are constrained from housing loans if they are unable to obtain the appropriate insurance policies.

D. PENSION FUND DEVELOPMENT

Armenia has an unsustainable pay-as-you-go pension system, although reforms are being discussed. Reform will eventually help in the long run with fiscal issues as well as with the gradual development of institutional investment in the economy. However, for now, people are used to receiving their social insurance payments from the state fund without any commissions. Meanwhile, because of alleged corruption and mismanagement, erosion in value occurs through leakage.

Some reforms have been introduced in the last five years with donor support. This has resulted in improving contribution collections and a strengthened benefit payment system. Reforms have also led to a system of social security numbers, which has been introduced and implemented nationally. As a result, virtually all workers carry a uniquely numbered social security card, and the system will soon issue test reports of employer and employee data reflecting an employee’s work and contribution payment history.

Notwithstanding improvements, Armenia’s pension system is still in need of reform. The government has announced its intention to introduce pension reform in the next few years, although no clear plans have yet been agreed to about the kind of system that would evolve, how and by whom it would be regulated, investment parameters for collected proceeds, etc. Any reforms will require changes in the traditional pay-as-you-go (PAYG) system to make the first pillar more sustainable, while also setting the foundation in the long term for movement to a second and/or third pillar. This will require a review of eligibility criteria (e.g., extending the age at which benefits are paid, reducing incentives for early retirement), payment requirements (e.g., within a specified time period), guidelines for value preservation and/or indexation, benefits levels to protect people against poverty without being overly generous, and making benefits funded on a Pay-As-You-Go basis relatively flat, means-tested, or based on a minimum pension guarantee.

For sound implementation and sustained public confidence, pension reform will also require institutional investors, management and custodial capacity, new and longer-term financial instruments, and improvements in the way Armenia's securities market currently functions (to the extent that it does). Broad improvements in governance, management, transparency, accountability, and consumer protection will be needed.

In terms of medium-term financial sector development, there is not likely to be much impact of pension reform in terms of lending and investment. Privately managed pension funds should evolve over time as the system develops. However, the government has not yet agreed on policy objectives, let alone legal, regulatory or institutional requirements to support a reformed pension system.

Because of severe underdevelopment, there is very little vulnerability in the non-bank financial system. Pension reform is the most explicitly needed change at the moment for financial sector development. This is because introduction of a second pillar pension scheme would provide a mandatory vehicle for future savings that would also serve as a pool for investment under regulated conditions. At the moment, payments into the first pillar are not subject to audits or scrutiny, and payments are exceedingly low. This reduces the incentive to pay into the system, which has also served as a disincentive to present long-term investment instruments for sound management and safekeeping of peoples' savings.

E. Securities Markets

Armenia's capital markets are underdeveloped. There has been virtually no activity in the securities markets, be it for debt or equities. Market turnover was estimated to be about $700,000 in 2003, equivalent to less than $3,000 per trading day. There has been little volume and turnover in the government securities market, although the government is now contemplating the issuance of more debt securities to develop the market and establish a yield curve.

Rather than identifying a specific optimal amount of government securities that should be issued, the Ministry of Finance and Economy along with CBA should establish clear cost-benefit criteria as part of a long-term strategy for government securities market development. From the supply side, targets, maturities and parameters should be mapped out in terms of Government borrowing needs for current and capital expenditure and the associated interest burden relative to donor funding. Supply side considerations should also account for CBA sterilization requirements. From the demand side, notional indicators of potential institutional (and retail) investment can be established relative to anticipated resource mobilization by pension funds, insurance companies, financial firms, corporate treasuries, individual investors and others. There are numerous reference points for rough planning and asset-liability matching for major institutions, from which measures of non-government securities volume could also be extrapolated in the event that institutional demand exceeds government supply.

There are no corporate bonds, municipal bonds, mortgage bonds, or active equities trading. Only a handful of companies are in a position to issue corporate bonds, and these companies can borrow from foreign banks more cheaply than the costs and disclosure associated with bond issues. Thus, while the government securities market is small, the non-government securities market is even smaller and barely exists.

Securities markets are broadly underdeveloped for several reasons related to financial condition, governance and management, and lack of transparency and disclosure to make markets. Key weaknesses have been slow and/or non-strategic privatization in the medium- and large-scale SOE sector, the nature of privatization (e.g., vouchers, management-employee buyouts) in other sectors, tightly held control of closed joint stock companies, weak role of minority investors, weak financial condition of many medium- and large-scale companies (which precludes corporate bonds and equities), the absence of capacity and size at local government levels (which precludes the issuance of municipal bonds), and an underdeveloped housing finance and commercial property market (which precludes mortgage bonds or mortgage-backed securities). Other factors include unwillingness to disclose essential financial information and notes based on international standards of auditing, and the absence of adequate information for ratings.

Commercial banks are expected to be among those that will be able to list and issue bonds as they implement reforms. This will be to obtain long-term funding for mortgage finance, leasing, and other credit activities that exceed one year terms. However, there has been no movement to date by banks to consider issuing a bond or equities on the local exchange.

The corporate sector's financing needs have traditionally been met by bank loans or from other channels, reducing the demand for financing from the capital markets. More recently, many of these companies have simply operated on a cash basis and/or borrowed abroad, bypassing the formal domestic financial system. In general, there has been no active tradition of listing on securities exchanges, or meeting meaningful disclosure requirements to trigger corporate debt or equity activity.

Domestic investment in securities is generally limited to T-bills and notes. Non-residents are permitted to participate in the T-bill/note/bond market. However, given the small size of the market, there has been virtually no international investment in these securities. Portfolio investment has been low for years.

In terms of equities, privatization vouchers have been about the only securities traded. However, there is no organized market, and most transactions are unreported or carried out privately without meeting basic standards of transparency and disclosure. Pricing is distorted and liquidity is low.

Because the capital markets are undeveloped, there is no systemic risk. As with the other parts of the financial system, development of the capital markets is needed for the economy to diversify, have a broader range of financial products and services, and to pre-empt dependence on the banks (or informal sector) for financing.

F. NON-BANK CREDIT INSTITUTIONS

Apart from small savings and credit unions, non-bank credit institutions are not permitted to mobilize household deposits. While credit unions and related institutions have not had a strong track record in CIS, over time, it will be essential to have alternatives to banks for deposit safekeeping, particularly as banks are not particularly keen to open up branches outside of Yerevan.

There is significant investment in housing and construction in Armenia, yet very little of it is run through the formal financial system. One non-bank institution focused on mortgage finance commenced operations in 2004. Its loan exposure was projected to reach $1 million by April 2005, after about one year of operations. While specific bank figures are not available, even 5 percent of bank loans (annualized at year-end 2004) plus the $1 million in projected exposure of First Mortgage would constitute a 0.5 percent mortgage debt to GDP ratio. Compared with 5-10 percent ratios in some of the transition countries that recently acceded to the EU (in May 2004), this shows the mortgage market is just beginning to develop in Armenia.

Leasing is nascent, with about $1.5 million in reported contracts. Recent reforms in the legal and accounting framework have made leasing feasible. However, leasing contracts absorb VAT, putting such credit vehicles at a disadvantage when compared with bank loans, the interest of which is not subject to VAT. Future development of leasing will be helpful to SMEs and general economic development. However, as of late 2004, the leasing market is currently at its beginning stages.

Micro-finance groups have made about $13 million in loans, about 5 percent of the banks' low totals. On the other hand, they have had direct contact with thousands of small businesses that would not be able to access finance from a licensed institution. While some of the MFIs have good management and are run commercially, some of the market has been slow to move to commercial self-sufficiency. Many of the organizations depend on donor assistance, and some offer subsidized loans that distort the market. Grant financing and non-commercial humanitarian assistance also distort the market. The MFIs do not mobilize deposits, thus reducing prospects for building a funding base without dependence on donors. Until a more commercial approach is taken, it is less likely that banks will provide these groups with back-up facilities. Thus, a number of obstacles have made achievement of self-sufficiency more difficult. On the other hand, the mandate of many MFIs is to focus on humanitarian relief and poverty reduction, and not commercial viability. As such, this complicates the task of supporting commercial MFIs without diluting or undermining legitimate efforts of relief to improve the lot of the most impoverished in society.

G. Financial Sector Infrastructure Issues

1. The Legal Framework

1.1 Banking

CBA is open to foreign investment, with about half the banks having foreign shareholders. However, there may be some confusion about the right of foreign bank branches to operate as they do internationally (without direct capital investment in the branch entity, and with the right to mobilize deposits). Foreign bank branches should be encouraged to operate in Armenia consistent with international best practice. This could be structured to easily conform to CBA licensing standards by requiring minimum ratings from one of the three or so major rating agencies and clear information exchange with host supervisory agencies to ensure financial stability.

While there are provisions permitting ownership of banks by non-banks and real sector enterprises/conglomerates, CBA has enforced a tight restriction on their involvement in core bank operations. Moreover, CBA has regulatory and licensing tools to prevent effective control of banks by non-banks based on licensing standards and requirements for bank ownership. As of late 2004, non-bank ownership of banks is generally subordinated to a pre-approval process by CBA whenever individual shareholders assume stakes of 10 percent or more of a bank.

In general, banks have operated on a fairly narrow commercial bank basis in the last few years as part of the larger effort by CBA to stabilize the system. Over time, increasing complexity is anticipated. However, at the moment, most banks consider themselves to be "universal", but in fact are fairly basic in terms of their activities.

There are restrictions on banks being engaged in non-bank activities. The Securities Market Law permits banks to underwrite securities, although this is not explicitly permitted in the Law on Banking. While there is a legal reconciliation needed on this point, it is moot for now because of the limited market to date. Banks have done very little in recent years apart from mobilize deposits, invest in government securities, make small loans, wire transfer funds in and out of the country, and purchase/sell foreign exchange. More recent issuance of credit and debit cards has opened up new opportunities, and basic services tied to these products (e.g., payroll services for donors, large enterprises) are beginning to emerge. This is in keeping with banks' legal mandate.

In general, the judiciary is not trained in commercial affairs. Alleged bribes, poorly administered case load, and inadequate infrastructure to support a more productive judiciary undermine the reputation and efficiency of the court system. Economic courts are not considered effective yet due to their caseload, which has also reduced the impact of recent reforms designed to promote alternative dispute resolution.

The secured transactions framework is improving, but is still imperfect. Secured transactions are undermined by fragmented and incomplete property registries. The State Cadastre has registered about 60-65 percent of immoveable properties, and apart from vehicle registration, there is no organized registry for moveable items that could be pledged as collateral for loans.

Loan recovery has been difficult for banks through the court system. The inability to enforce judgments in many cases has been due to endless debtor appeals, flawed registration and title (without clear links to true owners), mobility/emigration and asset stripping, and allegations of corruption in the court system. The judicial system in general is considered to have difficulties with caseload management. This is also reported to be true of the Economic Courts.

Personal property issues are reported to be complicated by errors, omissions and substitutions. Fraudulent signatures have been reported. In other cases, disputes have emerged as families have added/subtracted family names as owners of specific properties. In some cases, there are reports that payments to judges have determined the outcome of such disputes, rather than the legal rights of creditors. With respect to flats/residential properties, squatters' rights have made eviction difficult. All of this has reduced the willingness of banks to make secured loans.

Even with improvements, many businesses lack adequate assets to pledge for anything but low levels of working capital, and this does not help them to obtain needed long-term loans. Recent legal reform has included empowering notaries to help with contract enforcement on an out-of-court basis on the condition that agreements have been mutually accepted by counterparties. This has helped to clarify creditor-debtor rights and responsibilities, and makes it possible to enforce contracts and resolve disputes through notaries and other out-of-court mechanisms. This is positive, and should help to reduce the unwillingness of banks to make loans. Nonetheless, the low level of reported assets reduces the collateral coverage of loans, thereby reducing loan amounts and maturities.

In addition to low volumes of assets reported, there is limited variety of desirable collateral. Collateral tends to be limited to apartments and vehicles. There are reports that the system of registration with the police (Ministry of Internal Affairs) works adequately, and that cars can be repossessed. However, none of the banks reported major incidents of this occurring. As for flats, there is little desire to repossess, as there are legal as well as social barriers to repossession as well as re-sale. In a rising housing market during a period of GDP growth and significant financial flows coming into the country (e.g., remittances, donor funds, grant financing from foundations and diaspora communities abroad), there has been little problem for the banks. However, should prices decline and/or defaults increase, this will create potential problems for the banks in terms of actual physical repossession, and the auctioning off of these properties and/or attractiveness of such pledges to secondary market buyers.

The judiciary is not experienced in this domain, and there has been little exposure and training. There is no real tradition of utilizing courts or specialized out-of-court adjudication to resolve problem loans, although alternative dispute resolution processes through Economic Courts were recently introduced. However, there is a general lack of experience in using these techniques to induce needed corporate restructuring when financial conditions dictate, or to move forward with liquidation (for at least partial recovery) when corporate (or debt) restructuring is not feasible.

The banking sector will not benefit from changes in the legal framework until institutions are in place to help implement a modern secured transactions framework. Lending and credit risks are distorted in Armenia due to the weakness of the courts, incompleteness of the property and pledge registry system, and susceptibility to corruption of some of the agents responsible for enforcement. This has limited the supply of credit, reduced maturities (net of donor funding made available to provide term financing), and added to costs. All of this weakens prospects for economic competitiveness and diversification.

In general, many of the residual problems associated with financial sector development are more closely related to problems in the broader legal and economic framework of the country, rather than the specific legal framework for banking. These include improving the functioning of the courts when commercial disputes arise, enhancing capacity for alternative dispute resolution, reducing the scope for corruption, and finalizing the work begun with regard to property and pledge registries. Accounting and audit reform is also needed to help promote sound governance in the public and private sectors.

While not an immediate priority, the banking system remains vulnerable to additional credit risk unless the insolvency framework is upgraded. Banks are currently not making large loans due to their own lack of financial capacity. Likewise, there is currently no syndicated lending. In the future, particularly if and when banks want to make loans to larger enterprises, they will need to have greater assurance that the legal framework is protective of their rights. This is not a substitute for credit risk management. Rather, it is simply an understanding that the framework provides creditors with reasonable protection against the risk of default. (In this regard, banks will also need to more fully develop their credit risk management capabilities, and ensure they have adequate, appropriate, and complete information to assess such risks in advance of making any loans, as well as receive required information on a regular basis to monitor for compliance with agreed loan covenants.)

With regard to bank bankruptcy, there have been 10 bank closures in the last few years and a net 54 since 1993. However, there have been some reported limitations on the role of administrators to carry out an orderly reorganization of a bankrupt bank. The main issue has been the mandate of bank administrators to perform their functions in a fair and professional manner without vulnerability to prosecution. At this point, few problems are reported, as most cases have not run into legal or prosecutorial problems. However, past violations of immunity have raised the risk that administrators are not fully protected in the discharge of their duties. Barring any personal improprieties, administrators should be permitted to operate professionally without threat of legal action for unpopular choices made. Specific duties and responsibilities within the mandate of bank administrators that should be permitted without political interference should include the right of the administrator to invalidate illegal transactions (e.g., fraudulent conveyances) and to terminate contracts consistent with defined duties.

1.2 Insurance

There is a new Law on Insurance adopted in August 2004 that provides a framework for insurance companies. However, there may be revisions made to the legislation and general insurance framework as new prudential norms are implemented. These include solvency provisions, no clear specification of the insurance supervisor's responsibilities and objectives, and the absence of protocols for the insurance supervisor to work closely and exchange information with other domestic and foreign financial supervisors. A Law on Licensing also exists, a Law on Bankruptcy of Insurance Companies is being prepared, and legislation regarding third party motor vehicle insurance is being discussed (but not yet drafted).

Minimum capital for entry into the insurance sector has been $100,000. However, new legislation adopted in August 2004 will bring this up to $1 million. The new legislation seeks to bring solvency ratios, investment policies, reserve management, consumer protection and related provisions closer to international standards. With the increase in capital requirements, it is possible that some of the currently licensed companies will cease to exist, and/or operate in the market as brokers rather than underwriters.

The marketing and selling of insurance products through independent agents is prohibited. This greatly reduces the use of insurance products because insurance companies are not likely to employ the required workforce.

Foreign insurers have limited access to the domestic market, although they receive most of the premium revenues generated in the system through reinsurance. The Law on Insurance prohibits insurance organizations with at least 49 percent foreign investment (shares in their statutory capital) to sell life insurance, mandatory insurance, mandatory state insurance, or insurance for the "property interests" of state and local organizations in Armenia. Selling foreign insurance through a local insurer, agent or intermediary is also prohibited.

Armenia has also legally permitted insurance companies to sell life and non-life insurance products as one legal entity. While only one company sells life insurance and the market is exceedingly small, Armenia's legal framework in this regard is inconsistent with international standards that call for separate legal entities to provide life and non-life products. It is necessary to keep these two forms of insurance business separate to ensure that their solvency standards correctly reflect the different risks posed by differing forms of insurance. This principle is expected to be adopted, as provisions in the new legislation call for separation of legal entities and relevant balance sheets, solvency ratios, etc.

1.3 Pension Reform

Introduction of a draft pension law, which describes the creation of special purpose pension companies, was expected before Parliament prior to the end of the calendar year 2004. Passage of this law would permit the creation of pension companies to manage pension contributions in the form of accumulation accounts for each employee. The law does not address whether and how much of current compulsory contributions could or will be directed to pension companies, but in its present state the law does not currently block or prohibit such contribution redirection. If the law passes and there is a further directive to allow the re-direction of compulsory contributions, a portion of compulsory pension contributions could be managed by the financial sector and ultimately directed into Armenia's capital markets.

There are several weaknesses that apply to existing draft legislation. These weaknesses include (but are not restricted to) the absence of provisions regarding the terms and conditions between the employer and the pension fund, the absence of a framework for the regulation of the pension business conducted by banks or insurance companies, an absence of clarity about contributions as well as benefits to be paid into and out of the funds, and the absence of tax provisions.

Overlapping features and functions of boards (Council), daily managers (Administrators), and Asset Management Companies are also unclear and will cause difficulties. Investors who wish to prospectively assess the pension fund's chances for success are unnecessarily complicated by the existing proposed structure of pension funds. Not only do the provisions allow Council members to change frequently, but also the investment strategy itself may continually be subject to change at the whim of the Council.

1.4 Securities Markets

The Securities Market Regulation Law is well drafted and contains all provisions one would expect in a securities law. However, there are some definitions and concepts that need to be revised, amended, clarified or revisited. These include (but are not restricted to) the definition of a prospectus, exemptions from having to publish a prospectus (such as banks, insurance companies, religious, educational, benevolent, other non-commercial organizations, and short-term bond issues), and differing definitions of "beneficial owner".

Legislation should be amended to provide capital adequacy requirements for broker-dealers, as broker-dealers are allowed to trade securities on their own account. Imposing a capital adequacy requirement would also necessitate an amendment requiring that a broker-dealer company must be organized as a joint-stock company or a limited liability company.

The Law should provide that one of the securities supervisor's objectives is to monitor the financial soundness of broker-dealers and trust managers. It should also provide a practical and effective legal basis for close cooperation and exchange of information with other domestic and foreign supervisors.

Several of the weaknesses associated with the functioning of the Armenian capital market relate to the Joint-Stock Company Law. Key weaknesses include issues related to share redemption, minority shareholder rights, asset stripping, and corporate governance.

1.5 Non-bank Credit Organizations

Non-bank credit organizations (NBCOs) are licensed and supervised by the CBA. The prevailing legislation is the Law on Credit Organizations, signed into law in 2002. Provisions are fairly similar to banking, taking into account the smaller size and lower risk profile of the non-bank credit organizations.

Leasing is a part of the non-bank credit framework, with CBA supervising leasing companies as well. The legal framework consists of the Law on Credit Organizations, as well as related provisions for leasing in other legislation. The framework is consistent with international standards, although repossession issues have yet to be tested as leasing is nascent.

Mortgage finance is also covered under the Law on Credit Organizations, as well as the Law on State Registration to Rights to Property. Improvements in the legal framework could be made by giving legal effect to registration of title and mortgages. The law should state that a person who purchases property from the registered owner(s) will receive legal title to the property. The law should also provide that a good faith creditor does not have to yield priority to mortgage holders who are not registered at the time of registration. Mortgages that are not registered prior to registration should receive lower priority.

Outstanding issues and weaknesses in the legal framework include the continued use of the Soviet Housing Code, which has permitted squatters' rights, makes foreclosure and eviction problematic, and undermines creditor rights, contract enforcement, and general willingness of banks to make secured loans for housing. However, many of the changes envisaged in the amended Civil Code will change this on the condition that explicit references are made in contracts (loan agreements) about borrower obligations, methods of dispute resolution, and creditor rights.

This raises an important issue with regard to foreclosure. The Civil Code has recently been amended to provide for a speedy foreclosure procedure allowing a secured creditor to foreclose on a property without having to resort to a court if he has a notarized agreement to this effect. However, to date, this article has had little effect, because the debtor has the right to require that the foreclosure sale must be conducted through a regular court proceeding. The judicial system should be strengthened so it can process foreclosure actions in an orderly and predictable manner based on clearly understood contractual terms. (In many countries with strong mortgage finance markets, these steps are mapped out with specific time lines. In other countries, restructuring options are widely used to reduce the need for foreclosure.)

The Government is reported to be considering tax-deductibility of mortgage interest expense at a time when GoA needs to expand its fiscal base, reduce exemptions, simplify procedures, and improve administration. Several countries have successfully introduced this deductibility as a stimulus to home ownership, construction activity, job creation, and eventual secondary market development. However, the policy is far from universally adopted, and some argue that an equity-based system reduces overall costs and accelerates the point at which free and clear ownership is achieved. Given that properties in Armenia are generally purchased on a cash basis and that mortgage loans are frequently paid down prior to maturity, it is unclear what the advantage would be for market development under current circumstances. Rather, the Government may want to consider more efficient targeting of property tax revenue collected to infrastructure needs (e.g., road, sewage, power maintenance) and energy conservation efforts (e.g., insulation, sealed windows, energy-efficient appliances and light bulbs).

Another issue is the prospective role of a Government-supported Enterprise in leading the way towards standardization of contracts and secondary market development in the mortgage finance market. In general, a preferred approach would be for lenders in the housing finance markets to play an active role in developing standards and model contracts, having approved third parties involved in transactions as needed based on professional standards and criteria (e.g., appraisers, notaries, insurance firms), moving to syndication for larger exposures (e.g., commercial property), and selling assets to banks and others to free up capacity on their balance sheets for more loans. As the primary market develops, this will push secondary market development. However, for secondary markets to expand, a more developed legal and regulatory framework should be in place to introduce new instruments, to offer protection for those investing debt- and equity-related instruments, and to have clear rights and responsibilities spelled out in contracts so that conditions applying to the tradability of such instruments are straightforward. Such initiatives are better led by market players, but done so in a manner that is coordinated with regulatory authorities. This should be mainly CBA, but also the Securities Commission and potentially others when pension and insurance reforms take effect, in support of stable market structures. The involvement of CBA with regard to contract standardization will be essential, although the process should be led by market players.

2. REGULATION AND SUPERVISION

2.1 Banking Supervision

The CBA's mandate to supervise the banks has been strengthened in recent years, and this has been positive in stabilizing the system. Next step areas of development among the banks and for the system as a whole will include more effective board oversight and involvement, improved financial reporting and systems for internal management purposes as well as the general public, autonomous internal audit, risk management capacity on a portfolio basis as well as for individual loans/transactions, and movement to consolidated accounting and supervision. In particular, given the small earning asset base of the banks, there will be interest in becoming more "universal". This will put pressure on the system to become more "complex", adding to potential income streams, but also adding to potential risks.

Movement to a unified supervisory framework is considered premature, notwithstanding many advantages when compared to a multi-institutional approach. There are several attractive features to establishing a unified framework at this juncture, not the least of which are reduced cost, enshrined independence and comparative institutional strength of the CBA, untested and underdeveloped supervisory capacity outside the CBA, potential for entrenched political divisions within a future framework that could be pre-empted with rapid movement to a unified structure, and prevention of "pocket" institutions in the non-bank areas where supervision lacks effective capacity. Nonetheless, while CBA has increased capacity in recent years, there are many risks and complexities that will emerge in the coming years on which CBA will need to focus. Meanwhile, other regulatory bodies will need to hone their capacity for respective risks in their sectors, which may benefit institutionally with a focused and more independent approach than if currently blended into a unified framework. Developing such capacity across regulators and effectively implementing protocols of cooperation and coordination across supervisory agencies within Armenia as well as on a cross-border basis will be needed, and these challenges would emerge irrespective of the organizational structure(s). Likewise, this will be an ongoing challenge as an increasingly risk-oriented basis of supervision across financial services takes hold. Effective, integrated, risk-based supervision will take several years, and convergence to a unified framework will be more feasible when such capacity has been established. The establishment of the Financial Intelligence Unit will also serve as a testing ground for effective coordination in banking, insurance and other financial services. Armenia may want to consider establishing a coordination council across regulatory agencies in the financial sector for this phase.

CBA will need to adopt a series of protocols that facilitate coordination with other supervisory agencies. As a matter of course, CBA is encouraged to develop and implement inter-agency protocols as other supervisory agencies increase capacity. Close coordination with the FIU along with cross-border agencies is of critical importance for effective coordination, and eventual convergence into a single regulator should this be the organizational model adopted at a future time. Meanwhile, a framework for coordination on issues of surveillance, inspections, contingency planning, prompt corrective action, resolution, and suspicious transactions should be developed for effective supervision as the financial system becomes more complex and introduces new risks. This process is expected to last several years, particularly given the underdevelopment and untested supervisory capacity of regulatory structures outside of the banking and credit system.

CBA supervisory capacity has made great progress in recent years, and is the key catalyst for Armenia's more stable banking system. However, there are still some reported weaknesses, mostly focused on credit and market risk, lack of experience with consolidated supervision, and issues of corporate governance in the banking system. CBA has established effective off-site surveillance capacity at given levels of banking activity, introduced on-site inspections (including targeted inspections), developed a framework for corrective action, and has worked with banks to ensure that regulations can be implemented within reasonable time frames. In some cases, banks complain that CBA is overly strict. However, this is considered justified in light of the difficulties the banks faced in earlier years, and the need for stability prior to greater market competition and product/service offerings. On the other hand, some weaknesses remain, including the areas noted above (e.g., credit and market risk, consolidated accounting and supervision, corporate governance) that point to the need for strengthening in the market as well as among regulatory/supervisory institutions. The absence of consolidated accounting, and the expertise that comes from oversight and evaluation of risks over longer periods of time will need to be developed for a more risk-oriented culture to emerge. As with other matters related to financial sector development, this is expected to take several years.

Licensing has slowed in recent years as CBA has focused on reducing the number of troubled banks, and stabilizing the system. This is prudent under the circumstances. CBA should continue its policy to ensure any domestic or foreign institutions that apply for a license are formidable in terms of management capacity and systems. Movement to comply with strict AML/CFT guidelines will likewise make entry subject to stricter conditions. In this regard, close coordination with the FIU and cross-border supervisory institutions will be important to ensure that investment into the banking sector remains sound. At a minimum, this will include continued verification that "fit and proper" owners/managers are the real players, that sources of funds used as capital are legitimate, and that such individuals and institutions are not in any way implicated in money laundering, fraud, or other suspicious transactions or crimes.

Banks have moved to strengthen systems and internal controls, largely at the urging of the CBA. Moving forward, closer coordination between CBA and the banks is needed to ensure that risks are identified early enough for remedial action, and well before technical insolvency becomes a threat. At the moment, CARs are high, and banks are highly liquid. Nonetheless, as macroeconomic indicators stabilize and nominal interest rates decline, there should be pressure on margins, prompting banks to lend more. This, in turn, will add to potential credit and market risk. At the moment, these appear to be under control. On the other hand, as the market becomes more competitive, banks in particular will need more capacity to identify potential credit risks, as well as all of the market risks associated with these exposures.

In general, a key issue for banks and CBA will be corporate governance, currently viewed as weak and underdeveloped in the financial sector (and even more so in the real sector). The two international accounting firms in Armenia are able to conduct audits according to international standards, including sufficient notes and validation of management information presented. However, evolution of a more standards-based approach to audit and accounting practices in Armenia will also be needed to ensure daily operations, back-office systems and controls, MIS, and related elements of financial reporting are sufficiently in place for boards and management to handle such risks in a prudent manner. Combined with more banking professionalism at the board and management level, autonomous internal audit functions, dedicated risk management departments, and well-trained compliance officers, Armenian banks will be able to move closer to international standards of governance. For now, banks are generally considered to lag these standards.

CBA should have a comprehensive contingency planning vehicle in place as a function of continuing supervision, as well as input into resolution and potential consolidation issues. Contingency planning could guide CBA thinking and approaches to corrective actions as problems are identified. Development of a systematic approach could include building on CBA's existing purchase and assumption framework prior to a bank's technical insolvency that would allow larger banks with CAMELS ratings of "1" or "2" to bid on smaller banks. In this way, continued mobilization of household deposits could continue for solvent banks that are legally compliant, yet below minimum CAR ratios for Tier I and Tier II capital. This could be done quickly within a least-cost framework, with mechanisms in place for retroactive compensation in the event that criminal activity or material misrepresentations were made by the troubled bank's board or management. Additional consideration would then need to be put to consequences if such banks showed no interest in the inadequately capitalized bank. This could include a direct line (e.g., mezzanine financing, such as subordinated debt) from other banks with restrictive conditions (e.g., reversal of dividend payments to shareholders and managers, reduced compensation for board members and senior managers) approved by CBA and very high levels of collateral coverage from liquid assets.

Strong banking supervision is an essential precondition for the explicit deposit guarantee scheme. In this regard, CBA should continue to focus on supervision as a basis for strengthening banks' governance practices. This includes tightening requirements for board members, encouraging the use of independent advisors, promoting ongoing professional development and certification of bank managers, upgrading requirements of internal audit and management information systems, ensuring risk management systems and procedures are suitably in place and functioning properly, and that the deposit guarantee fund to protect depositors will not be depleted.

2.2 Insurance Supervision

The Ministry of Finance and Economy regulates the insurance sector, although not very actively. Its budget in 2003 was reported to be $12,000. Moreover, there is little useful information or reporting, making it difficult to conduct off-site surveillance. Meanwhile, staff have limited budget and training, and are thus unable to adequately supervise the insurance sector. With an eye towards eventual pension reform, it remains to be seen how the insurance regulatory framework will be structured in the future, and where it will be placed institutionally.

Inadequate resources are dedicated to the supervisory function. The Insurance Inspectorate (supervisory authority) of the Ministry of Finance and Economy is understaffed. The regulatory staff lacks sufficient training in insurance, financial analysis and product innovations. Compensation of the staff and management is inexplicably below that of other supervisory authorities. These factors contribute to the general public's perception that the supervisory authority cannot oversee the industry. Without a dramatic increase in budget and training for the Insurance Department of MoFE, it cannot be expected to provide effective supervisory oversight of the insurance sector.

As the country moves ahead with modernization, the insurance framework will need to be brought closer to global standards, including coordination on a cross-border basis. As part of this effort, the insurance supervisor should make it a condition for licensing a foreign insurance branch that the supervisor has (i) direct oversight over the insurance company's activities and financial soundness in its home country, and (ii) a framework is in place for cooperation with the foreign branch's home country insurance supervisor to ensure safety and soundness. (This is similar to practices recommended to CBA with regard to banking.)

2.3 Pension Supervision

Even with legal reform, there will be obstacles related directly to the financial sector in creating a system of accumulation accounts. These include small market size, lack of investment options, political opposition to pension reform, lack of pension company experience, lack of insurance annuity product experience, lack of regulatory authority experience, and the risk of low public confidence if there are losses resulting from mismanagement, structural flaws, or regulatory lapses.

There are also several regulatory and supervisory weaknesses. The first weakness is the simple lack of experience. Moreover, the draft law provides no guidance for a regulatory framework for the pension business conducted by banks or insurance companies. Provisions are also unclear with regard to the setting of contributions as well as benefits to be paid into and out of the funds.

While the above referenced obstacles are important, they can be managed. The market can encourage experienced and recognized pension companies in other countries to manage and administer funds and/or to partner with Armenian companies to ensure a transfer of knowledge and technology in a timely manner. This applies to the capital markets, insurance companies, and bank custodians, and can also be applied with regard to regulatory/supervisory oversight of the second and/or third pillar of the future pension system.

2.4 Securities Markets Supervision

Supervision needs to be tightened for broker-dealers and trust managers, as well as to improve coordination with other supervisory authorities in Armenia and abroad. The Securities Market Regulation Law should provide that one of the securities supervisor's objectives is to monitor the financial soundness of broker-dealers and trust managers. It also should provide a legal basis for close cooperation and exchange of information with other domestic and foreign supervisors.

3. Payment System

There is a high level of money outside the banking/formal system, which reduces the level of volume for small value payments. This will not change until corruption diminishes, incentives for tax evasion decline, and inroads are made against poverty. This calls for a wholesale change in the business environment so that small businesses do not feel that disclosure will create problems with regard to the tax authorities. While garnishing is also a well-established practice in many economies, the perception of account vulnerability serves as a disincentive to deposit mobilization in the banking system. This is one of the reasons why enterprise deposits in the banking system were only about $200 million as of 3Q 2004.

Insufficient investment in telecommunications systems by enterprises, partly (but not exclusively) due to the legal monopoly enjoyed (until late 2004) by Armentel, has also reduced transactions volume through the payment system. While small value payment transactions have shown increases since introduction in the last few years, the use of the payment system is still low due to a cash-oriented economy preoccupied with avoiding tax payments. However, there is also criticism at the lack of investment by OTE (Greek owner of Armentel), as well as poor systems integration. Increased investment in capacity to accommodate greater participation is considered needed. This should be a function of increased competition, which is currently not the case. Again, part of an improving business environment is one in which there is sufficient market competition, rather than a tendency toward monopoly.

4. Accounting and Audit

While banks are required to present their financial statements according to IAS/IFRS, there are still gaps between local accounting standards and revised IAS and IFRS. All together, there are reported to be inconsistencies in 31 RAAS principles of the 41 IAS principles. Likewise, RAAS has not yet been updated to reconcile with the five IFRS principles.

Banks focus on accounting and audit as reporting formalities more than strategic management tools. Over time, banks will not only need to develop more comprehensive accounting systems, but also to treat external audits as part of a strategic exercise to improve governance, operations, systems, procedures, controls, etc.

There is little domestic accounting and audit capacity in Armenia. There are only two international accounting firms in Armenia, and only about 20 accountants with comprehensive training in international standards. There are others capable of providing enterprises, government and financial institutions with better accounting services, but they lack the work experience needed to obtain professional certifications. This partly reflects hiring practices in the labor market that fail to recognize certain training and skills in favor of personal contacts and connections.

Part of the problem in building professional standards is that the effort to make domestic accounting standards consistent with IFRS (then IAS) has experienced a time lag. None of the IFRS principles has been adopted. Even translation is an issue, as existing Armenian-language versions of international standards (for accounting and audit) are now at least three years out of date. A larger part of the problem is that the approach to accounting and audit has been a legalistic and interventionist approach by government, rather than a more common standards-based approach in market-based economies in which professional associations are responsible for standards, certification, continuing education, ethics and compliance.

The weakness of the accounting profession and limited number of qualified accounting firms drives up the costs of international audits. It will take many years to expand capacity sufficiently to induce competition for the business of medium-sized enterprises. In the meantime, the Association of Accountants and Auditors of Armenia is in the process of providing professional training for up to 800 auditors and accountants. A strengthened mandate for this association can help bridge the accounting/audit gap, which will help with other issues related to transparency, disclosure, governance, and credit worthiness when presenting loan requests to banks.

5. Transparency and Disclosure

Other components of financial sector infrastructure are weak or underdeveloped, reflecting weak disclosure and limiting the information needed for additional market development. There is no tradition of open information disclosure. In fact, the tendency in Armenia is closed, which also stifles risk-taking by banks and others as it undermines trust and fails to meet banks' underwriting standards for loan origination. Such closely held approaches also make it more difficult to launch a credit information bureau to help banks evaluate and price credit risk, reducing loan value and increasing interest rates charged. However, enterprises and households are not entirely to blame. Arbitrary and subjective tax treatment likewise serves as a disincentive for businesses and individuals to disclose sales, incomes, assets, and other basics of financial reporting.

6. PROFESSIONAL TRAINING

While Armenia has many universities and training institutes, it does not appear to have had an organized and systematic approach to bank and financial services professionalization. There has been some work on this with the help of some donors, and the CBA has played a key role in getting banks to adhere to more professional standards. However, with new risks and developments bound to emerge in the coming years, there may be a benefit to having a more coordinated approach to technical, financial and management training. In some cases, this should involve market players as well as regulators. In other cases, it may be more specific to bankers, insurance professionals, accountants/auditors, actuaries, etc. Ultimately, investment-grade institutions and standards are the best catalysts for such training and human capital formation to occur. However, this can be supplemented by broader management training courses for those in financial services, often coordinated through professional associations, with a combination of domestic and international experts, and based on tried and tested curricula that have raised management and technical skills. In Armenia, there is demand for practical training customized to the extent possible for the Armenian marketplace.

III. RECOMMENDATIONS

A. BACKGROUND

1. USAID EXPERIENCE IN ARMENIA

1.1 Background Performance to Date

USAID has been active in Armenia since 1992. At the time, most of the assistance program focused on relief efforts and humanitarian assistance during a period of war, hyperinflation, industrial collapse, and general economic dislocation. Since then, the USAID assistance program has evolved to make inroads in economic growth and development, democracy and the rule of law, social support for vulnerable communities and populations, capacity enhancement for local government, and a wide variety of financial sector and private sector development initiatives to increase access to finance, markets, skills, and goods and services. Thus, USAID assistance has sought to support efforts and institutional strengthening for sustainable structures and a market-based economy.

As part of the effort, economic growth has included support for an improved environment for SMEs and micro-enterprises, with particular focus on agro-processing, other light industry and services (e.g., tourism, information technology, and jewelry). Additional assistance has included technical assistance provided to the CBA to enhance banking supervision capacity, the Securities Commission to develop capital markets, the Ministry of Finance and Economy to implement tax, fiscal (budgetary and treasury) and customs systems, and the Ministry of Justice to help develop a legal framework for a market-based economy and to support development of a property registry system. USAID has also worked with the Association of Accountants and Auditors of Armenia to strengthen accounting and audit standards and capacity.

Results to date have been mixed. Recognizing that Armenia has been a difficult environment in which to operate (as are most CIS environments), successes have clearly been achieved. These include policy reforms in a number of key areas. However, results have also been offset by a weak institutional environment and distrust of some government institutions.

- *Private sector orientation:* Private ownership is now dominant in the economy, including land and housing along with almost all enterprises. This is partly obscured by the closed joint stock companies that are technically private, yet run on a closed basis without any serious market scrutiny. Privatization also did not focus on strategic investment, so there has been a shortage of cash injections, new management teams and approaches, and new technologies and market linkages. On the other hand, many of the "large" companies have closed due to the heavy industrial nature of their structures that rendered them obsolete and uncompetitive under market conditions. As such, the last decade has been a period of realignment for enterprises, shifting increasingly to light industry and services, neither of which tends to attract major direct investment in small economies. Successes are beginning to appear in food and beverage processing and precious stones, along with some services (e.g., information systems) that will help with overall competitiveness and performance. In the end, Armenia has made progress in moving to private sector development. However, SMEs often find it difficult to expand, partly due to concerns about tax enforcement, as well as from management and market information shortcomings. Armenian enterprises in general are still challenged by a number of governance, management and competitiveness issues that will limit growth and potential unless corrected. Outreach efforts have had some successes, but these have been limited due to capacity constraints (supply) as well as difficulties finding acceptance among enterprises for implementation (demand).

- *Financial sector liberalization:* Armenia's financial sector architecture is broadly consistent with recommended standards and norms in the banking and capital markets areas, as well as in some of the non-bank credit areas (e.g., leasing). However, insurance reform has been slow, pension reform practically non-existent, and other reforms partial. Banking has been the most important, and here there have been successes achieved. The system is more stable than it was three to four years ago, and current increases in financial measures (e.g., loans, deposits) indicate favorable trends are emerging. As competition increases, new products and services will be available, and Armenia's banking system will slowly narrow the gap between its ratios and non-CIS ratios. Likewise, the legal framework for leasing is now sound, and non-bank credit should increase via equipment leasing activity. (USAID support for Acba Leasing has helped activate the market.) Primary mortgage lending is also beginning to increase, largely based on market demand and a willingness of lenders to provide credit despite remaining imperfections in the legal environment. Insurance reform is now under way, and this may correct some of the weaknesses in the financial markets (e.g., products/services, evolution of potential institutional investors). However, apart from seeking to make the pension system less administratively inefficient, there has been sluggish movement to pension reform. Numerous problems are reported with regard to statistics, and the collection and disbursement of funds. The unwillingness of the Government to move ahead with professionally managed pillars represents one of the gravest structural weaknesses in the financial system. Likewise, there is little activity in the capital markets due to supply and demand conditions. While the government is now moving to establish a yield curve by issuing securities with longer maturities and to trade these on the local exchange, there has been virtually no movement to transparency in the real sector markets. The result has been zero corporate bonds and no real equity issues of any importance.

- *Tax rates:* Armenia has a fairly straightforward and clear tax code. Rates are reasonable, and certain exemptions are permitted as an incentive for foreign direct investment. (The latter is not necessarily desirable. However, it is noted as a policy incentive to attract greater direct investment from abroad.) While Armenia's tax rates are reasonable for enterprises and financial institutions, the country is a good example of how implementation is a complex endeavor and dependent on sound public institutions, low levels of corruption, and a trusted legal environment to be effective. These have not yet been achieved in Armenia, and such weaknesses undermine development of a viable fiscal base. Capacity constraints at local government levels also mean that implementation of property tax reform and municipal development will take time.

- *Legal and institutional framework:* The Government has adopted numerous laws over time, often with input from the IMF, World Bank and other donors. As such, the legal framework is considered less of a problem than the effectiveness of judicial institutions, and the support structures in place for commercial transactions. In this regard, the framework for secured transactions is improving, but it remains to be seen if contract enforcement will be upheld in a manner consistent with market norms based on clear contractual rights. In the past, creditors have complained about problems faced in the court system, reducing their willingness to make loans. Likewise, shareholder rights have been called into question, reducing investment (including from the diaspora community) into the country. Secured transactions are also undermined by the incompleteness of the property registry system. The immoveables registry is reported to be about 60 percent completed, while moveables are generally unregistered apart from automobiles. Thus, the system is manual, digitally inaccessible, and incomplete. All of this makes secured transactions less feasible and/or more costly and time-consuming.

- *Accounting:* The Government is on record (since 2000) as committed to international standards of accounting. RAAS and associated audit provisions have been adopted to conform to what were then prevailing internationally accepted standards of accounting and audit. However, there has been no significant movement forward to a standards-based profession, and the government (via Ministry of Finance and Economy) still retains legal control of the profession. While some progress has been made towards capacity building in the field, results have been undermined by limited movement to a standards-based approach. Larger constraints in the business environment (mainly tax-related) and business culture (closely-held) constrain meaningful financial disclosure. Meanwhile, general internal audit capacity and modern standards of governance are new to Armenian enterprises and financial institutions, reducing the effectiveness to date of financial information for management purposes.

Based on the above, USAID (and other donors) have made some progress in helping the Government and market achieve reforms that will help the economy grow on a sustainable basis, and achieve poverty reduction goals and objectives as stated in policy documents. However, the success and effectiveness of past and ongoing initiatives has been undermined by more deep-seated problems that will take time and political initiative to resolve. In the absence of such resolve, donor assistance will be less effective in helping to achieve results. On the other hand, it is also broadly perceived that political resistance to many reform initiatives is due to vested interests who benefit from the status quo. This clearly complicates the issue of political resolve on the part of the Government, and cannot be detached from discussions of fiscal policy, pension reform, and general market development.

1.2 Current Strategic Focus

USAID's current strategic approach is focused on a competitive private sector-based economy in Armenia, specifically "increased employment in a competitive private sector" based on "creating the economic conditions necessary to provide Armenians with the opportunity to find sustainable employment" as a critical input to the country's long-term success (SO 1.3).4 This approach is based on several key building blocks:

- Strong growth in the micro and small-/medium-sized enterprise sector in support of near-term job creation and productivity.
- Effective public investment.
- A climate of governance conducive to public and private investments.
- Transparent, accountable institutions that respond to the needs and demands of an informed, market-based society.

The 2004-08 efforts focus on "second generation" issues related to an improved business environment, and growth opportunities for the micro-enterprise and SME sector. **Recommendations in this report apply most specifically to increasing the range of financial instruments, and increasing access to financial services on a sustainable and commercially viable basis in support of an improved business environment.** The recommendations take note of the problems described above with past or ongoing USAID-supported initiatives, and seek to ensure that "second generation" issues are largely resolved or in the process of being resolved by 2008.

The current five-year program, from 2004-08, envisions a period in which Armenia continues to make progress towards self-sustainability. This is based on continued legal, regulatory and institutional reforms, improved public sector management of resource flows and an expanded fiscal base, and broad support for continued economic diversification and competitiveness, productive employment, job creation, income growth, and increased investment for sustainable development. These areas potentially include continued support for financial sector stability, secured transactions, accounting and audit reform, housing/mortgage finance, pension reform, and insurance sector development. Support in these areas would be expected to provide the architecture, incentives and framework for sustainable growth of an increasingly capitalized, liquid, diverse and safe financial sector. This would provide a reliable basis for small and mid-sized

[4] See "USAID/Armenia Strategy for 2004-08", USAID, March 19, 2004.

businesses in and out of Yerevan to be able to access finance on a commercially viable and sustainable terms, thus enhancing prospects for productivity growth, employment, and competitiveness.

2. EXPERIENCE OF OTHER ACTIVE DONORS IN THE FINANCIAL SECTOR

Apart from USAID, there have been four other key donors active in the financial sector. These have been the IMF, World Bank, IFC, and KfW. Their experiences are briefly highlighted below, and are also factored into recommendations for USAID involvement in the financial sector.

- *IMF:* The IMF has largely focused on macroeconomic issues of critical importance to stability. This has mainly comprised monetary and fiscal matters, along with statistical work. Monetary policy at CBA has focused on price stability, consistent with best practice, and assisted by the IMF. This has included policy and operations, research, and foreign exchange operations. As an extension of monetary policy implementation, the IMF has been active with banking supervision, deposit insurance, and prospective mortgage finance markets. Fiscal matters have involved treasury management, tax policy and tax administration. Statistical work has included national accounts, balance of payments, and general data dissemination standards. Overall, monetary policy implementation has shown effectiveness, and the quality of statistics has improved, including in the banking sector. However, as elsewhere in the CIS, fiscal policy has been a major challenge, largely due to the weakness of government institutions and the lack of public trust.
- *World Bank:* The World Bank has been active with structural reform in Armenia. This has included legal reform, efforts to strengthen the business environment, public-private partnerships in the energy and infrastructure fields, and initial improvements in pension administration. Active projects of relevance to financial sector reform include agricultural reform, municipal development, title registration, judicial reform, irrigation development, and an enterprise incubator project. As a result of these and other initiatives, a core legal framework is in place for a market economy, including recent improvements in the secured transactions framework that will encourage lending. Bureaucratic obstacles to business formation have eased significantly, and there are now reported improvements in the overall business environment. However, significant institutional obstacles remain, most notably tax and customs issues, outstanding weaknesses in the judicial system to resolve commercial disputes, governance and ownership structures, levels of transparency and accountability, and corruption. With regard to energy and infrastructure, there have been improvements in the power sector. However, comparable progress is needed in the water and waste water management sectors. Likewise, improvements have been made with regard to pension administration. However, significant challenges remain in putting the system on a sustainable path that is professionally managed and inspires public confidence. To date, the Bank has achieved some successes, but the effectiveness of its initiatives has been partly offset by continued institutional weaknesses. The Bank's current plans focus on reducing these obstacles, namely improving tax and customs administration, strengthening property rights for secured transactions, and encouraging insurance sector development to assist with an improved business climate. Support for the new credit rating agency is also intended to support market-based information flows for credit risk evaluation.
- *International Finance Corporation:* The IFC has been the institutional leader in helping to develop a framework for leasing in Armenia. Efforts to strengthen the legal framework for leasing received IFC support, and this was followed by investment in Armenia's first commercial leasing company. (Another agricultural leasing company had earlier been set up with USDA support, but was subsidized by grants and not considered fully commercial in its operations.) That company is Acba Leasing, a legal entity affiliated with Acba Bank. It has support from Crédit Agricole's leasing subsidiary, as well as management and investment from a Lebanese leasing company founded in 1996 with IFC support. The market is nascent, but beginning to show movement. Continued movement towards a modernized property registry system will help with leasing market development. Apart

from leasing, IFC tried to establish a $25 million SME risk capital fund, but it was unable to generate interest from prospective investors, namely members of the diaspora community. Reasons for this were the closely held nature of almost all Armenian enterprises (into which the Fund would have invested), and perceptions of investment risk (resulting in donations instead of investments).

- *KfW:* The main contribution from KfW in the financial sector has been its successful German-Armenian Fund, a revolving loan fund that has provided loans to small businesses in Armenia. The program has involved credit training to five banks (Acba, Anelik, Armeconombank, Converse, Inecobank) since 1999. Loans are made largely on an unsecured basis due to problems associated with the secured transactions framework in Armenia. As such, these loans have been fairly small, with amounts generally up to about €10,000 (about $13,000). Most of the loans have been for commercial trade (47 percent), agriculture (23 percent) and industry (18 percent), with construction (2 percent) and other services (10 percent) accounting for the balance. Maturities are up to five years, interest rates are considered to be at market prices, and all loans are in local currency. The program claims virtually all loans (99.6 percent) are serviced and repaid on schedule, partly because of the bonus system in place for loan officers that rewards performance along with volume. As of late 2004, total exposure of the GAF approximated €16.7 million (about $22 million). While KfW plans to exit the loan program, it is now also providing technical assistance to the Deposit Guarantee Fund as well as providing €3.5 million (about $5 million) to capitalize the Fund (to supplement contributions from the banks to the guarantee fund). KfW is also looking at a regional credit guarantee fund, as well as possible initiatives in housing finance.

Apart from these four institutions and USAID, no other institutions were considered prominent or active in the financial sector. EBRD is reported to have small exposures to a few banks and recently committed to an investment in Armeconombank. GTZ has provided assistance for the Bank Training Center. EU-Tacis has been active in providing business advisory services to SMEs. However, in discussions with market players and Government institutions, the IMF, World Bank, USAID, KfW and IFC were considered the main donors active in the financial sector.

B. RATIONALE FOR RECOMMENDATIONS

Recommendations for increased access to financial services have been made based on the need for such access and services on a sustainable, commercially viable, and competitive basis under stable conditions. Increasing access alone is not sufficient to support accelerated growth and development of productive employment generation by competitive private enterprises (SO 1.3). Otherwise, grant money, generous guarantees and/or heavily subsidized loans/credits would fulfill this objective. However, as has been documented in just about every market around the world, such an approach does little to create competitive and sustainable structures for medium- and long-term growth. More often than not, such soft approaches distort market development, send out the wrong signals, lead to financial waste and poor performance, and make it more difficult for banks and other intermediaries to lend/invest on commercially viable and sustainable terms.

Rather, the provision of financial services needs to be sufficiently voluminous and diversified to have a material economic impact. This means a range of financial institutions to meet differing needs under competitive conditions, as well as stable and sound conditions for financial intermediation to increase on a continuous basis as a component resource for economic growth. This also means responsible, accountable and disciplined households and enterprises that borrow or receive equity investment on the basis of meeting repayment/return obligations on time and on a best efforts basis. In the past, financial discipline has been called into question, adding to risk aversion by banks once the prudential framework and CBA supervision eliminated such scope for abuse. Meanwhile, investment has been low (including from the diaspora community) for much of the same reason, translating into transitory grants/donations rather than investment resources that help to sustain a dynamic and viable economy.

Armenia has now made it to the point where fundamental banking is stable, and poised for increases in overall levels of financial intermediation. The evidence from 2004 indicates this has begun, including in terms of lending to small businesses and households. However, the banks are still small and limited in overall impact on the economy, non-bank services are very limited, and most financial transactions are cash-based and conducted outside formal channels to avoid scrutiny by the tax authorities.

Ideally, over time, Armenia will move to a financial sector that includes a variety of financial institutions, including banks, mutual funds, pension funds, insurance companies, leasing companies, commercial finance companies, credit unions (or savings and credit institutions), micro-finance institutions, factoring companies, and other specialized institutions (e.g., mortgage finance). However, in most emerging markets, weaknesses and gaps in the institutional framework usually translate into stunted growth in most of these areas. This is true in Armenia as well.

To compensate for the gaps, there are different approaches that can be taken. The approach recommended to USAID consists of the following:

- Identify areas of strategic or comparative advantage for USAID.
- Focus on long-term impact that can be sustained.
- Generate major results from dedicated budgetary resources.
- Fill major gaps that need correcting and where there has been little/no effort to date from other donors, and no plans made known.
- Pursue initiatives where there is a strategic fit with all components of the strategic objective.
- Initiate the assistance strategy with high confidence of success.

In the case of Armenia, special recognition of the presence of comparatively abundant financial resources needs to be taken into account. In one sense, this can be a great benefit to the economy. On the other hand, it adds to the risk of waste, corruption, and mismanagement. Effective and active implementation of Armenia's anti-corruption strategy along with other efforts to combat financial crime, money laundering, and resource misallocation are needed for successful implementation of financial sector reform initiatives. Thus, **the financial discipline expected of borrowers in the commercial marketplace should also be a precondition in the public sector for assistance.** Better coordination among donors (discussed in recommendations) should focus on this to ensure productive use of resources in support of accepted goals and objectives.

In general, the approach taken has been to strengthen the institutional framework for effective implementation on a long-term basis in support of a stable financial system able to provide needed resources for accelerated growth and development of competitive private enterprises. The approach extends beyond the private sector, and involves a strengthening of public sector functions (e.g., legal, regulatory, supervisory) where these clearly have an impact on the incentive structure and functioning of the financial markets. On the other hand, the approach also seeks to reduce the direct role of the state where private and self-regulatory initiatives are better suited to handle these functions. All components are focused on building on progress to date to broaden and deepen financial markets, with increased access to financial services under sound, stable and commercially viable conditions. This approach is based on USAID experience elsewhere that has been successful, affordable, recognized for impact, and a major contributor to stable market development. This particularly applies to continued support for financial sector supervision, assistance with the insurance and pension framework, a framework for housing finance development, and accounting/audit reform that will help with governance, management capacity, and underlying competitiveness.

C. General Recommendations to USAID, GoA, Other Donors and Market Players

1. Key Deficiencies and Constraints

As is commonly found in the Caucasus and other CIS and transition economies, Armenia faces a wide range of banking sector weaknesses and underdeveloped non-bank financial services. The *supply side* is characterized by limited lending relative to GDP, weak skills development and training, little investment in product development and service innovation, and weak capacity among market players for risk management. The *demand side* is undermined by a historically flawed framework for creditor rights, underdevelopment of modern contractual savings (e.g., pension), and a substantial shadow economy that avoids information disclosure. This results in several key problems, which include:

- *Weak funding*, as most people/businesses keep their funds outside the banking system. As noted elsewhere in the report, nearly half the economy is outside the formal system, largely due to efforts to avoid tax payments. This harms banks' prospects for mobilizing long-term funds, as the banks remain dependent on deposits for most of their funding, most of which are for less than one year.

- Banks have *low levels of capital.* While banks have high CARs, their aggregate and average capital is small. This limits what banks can do in terms of loan size. It also limits their earnings, which, in turn, limits funds available for investment in new systems and technologies, market research, and other activities needed for a dynamic and competitive system able to create innovative products/services and cost-effective means of delivery.

- *Management* is considered a weakness due to traditional approaches to banking that have focused on connected lending and other kinds of relationships that are substitutes for risk evaluation. This may be changing. Nonetheless, the general perception is that most bank management is not sufficiently trained to handle the kinds of risks that are present in more developed, competitive and diversified financial systems. In addition, there is a common perception that banks do not have sufficiently trained staff, and that product/service development is not as innovative as it needs to be. Productivity measures for bank staff are fairly low, partly due to the limited array of financial instruments/services offered by the banks, resulting in low revenue generation. On the other hand, improvements have been noted in the last couple of years as banks continue to invest in systems, as they make more loans to consumers, and as they offer new products and services (e.g., plastic cards, direct payroll).

- *Earnings* are currently limited, partly due to opportunities and partly due to the small size of the banks. Opportunities for banks are focused on comparatively well off households and small businesses engaged in high turnover businesses. With poverty affecting nearly half the population and income inequality a problem, this limits the high end of the market segment targeted by banks. Wealthy individuals either do not need the banks, or choose to avoid the banks because of the perceived risk of tax authorities garnishing their accounts. Likewise, large-scale firms either do not need the banks, or avoid them for similar reasons (to avoid confrontations with the tax authorities). This leaves a small segment of the population and registered business community as a target for the banks. Meanwhile, banks themselves have limited earnings opportunities because of prudential norms that limit their large loans to 20 percent of capital, and because their non-credit products/services are limited in scope and/or do not earn much in commissions.

- A *weak business environment* limits the availability of credit, and/or raises the costs of borrowing. At a minimum, it adds to the risk premium for borrowers, as shown in the fairly high net spreads banks earn on their loans.

- *High intermediation costs* make borrowing less attractive to enterprises and households, resulting in almost all financing needs being met from internal sources, be it working capital or investment capital. Even with credit being made increasingly available in 2004, most people and enterprises bypass the banking system. Informal sector (grey market) transactions account for about half of total transactions, and maybe more.

- A more *creditor-friendly incentive system* will be needed for banks to assume risk. This is starting to happen, with legal refinements and efforts to strengthen the property registry system. However, bankers still have little confidence in the court system and clearly seek to avoid it. This may become a challenge in the next few years if the economy slumps, defaults mount, and banks seek recovery through court processes. This could also be a testing ground for the Economic Courts and efforts to implement alternative dispute resolution. As of now, the Economic Courts are currently experiencing a backlog of cases.
- The *development of non-lending services* will be needed for modernization. As of now, Armenia has a small insurance sector, some limited Treasury securities market sales, a few non-bank credit organizations generally unable to mobilize household deposits, and a small micro-finance sector. There are no corporate, municipal or mortgage bonds, and equities trading is virtually non-existent.

While it will take time to reverse some of these weaknesses, there are areas where progress can be made fairly quickly. Measures that can be taken or initiated over the next year and then sustained are discussed below with appropriate time lines. (All initiatives are short-, medium- and long-term for long-term sustainability unless specified otherwise. Short-term = ST, or the next year; medium-term = MT, or 1-3 years required; long-term = LT, or longer than three years required are noted.)

2. Approach to Donor Resources and Coordination

With comparatively abundant resources available from USAID and other donors, the importance of donor coordination needs to be stressed. In many cases, there appear to be parallel activities, while in other cases, gaps remain unfilled. While bilateral and multilateral agencies do not always have the same goals, objectives or performance targets, there is more in common than what separates these groups in the area of financial sector reform. As such, efforts to coordinate on a more regular basis are recommended to all parties as a basis for moving ahead with sound stewardship and proposed resource allocation in the field of financial sector reform. This could be done by establishing a working group composed of representatives of institutions that have been the most active and effective in the area of financial sector reform: CBA, Ministry of Finance and Economy, Securities Commission, IMF, World Bank, KfW, IFC and USAID. Monthly meetings and a policy/performance matrix for the tracking of activities and expected results would help as a management tool. Specific sub-committees for critical reform areas (e.g., corporate governance, accounting and audit, consolidated risk-based supervision, mortgage market development) could be structured to report to this policy-based working group.

Donors should apply tougher conditionality and performance requirements as a basis for assistance. Many in Armenia have criticized the donor community for accepting changes in the legal framework as a basis for increased assistance. At this point, changes in the laws are important, but these should be accompanied by an increased focus on institutional implementation of the intent of legal reform. As such, greater strategic effort should be focused on results, rather than process.

3. Inter-Sectoral Linkages and Requirements

The importance of inter-sectoral linkages cannot be overstated. At the moment, Armenia has an emergent banking system with very low levels of penetration and intermediation, yet it is the pillar of the existing financial system. As a result, while the situation is improving, there is little alternative for most enterprises and households to finance businesses and purchases apart from informal or privately sourced funds.

Increasing access to finance will depend heavily on improvements in the real sector. This will need to focus on matching credit worthiness considerations for real sector borrowers (e.g., financial, operational, managerial) with underwriting standards of banks and other financial institutions. For debt financing, this applies to those seeking leasing contracts, housing loans, and future issuers of bonds (e.g., corporate) in addition to bank borrowers. Likewise, moving away from debt instruments, enterprises will also need to demonstrate competitiveness and efficiency if they are ever to consider efforts to attract equity investment. In general, all of this will require a change in Armenia's business culture away from closely held operations to more transparent operations that rely on greater market and financial information flows, complementary management teams and structures, and sound advice from board members and private advisors.

Development of the financial sector will require simultaneous development across services, yet phased and careful approaches to ensure that regulatory and supervisory structures are adequately established. Banks are expected to play a key role in the financing of enterprises and households over time. However, businesses will also require certain forms of insurance to obtain needed loans. This is already in place with many housing loans. As more risk (including transfer risk) is assumed, regulatory structures will need to be monitoring for risk based on standard pools of information that reconcile on a consolidated basis.

Mandatory forms of insurance and savings are the fastest method of helping to provide depth and diversity to the currently narrow financial system. Mandatory third party motor vehicle insurance will boost the insurance sector. The market will continue to promote insurance sector development as other parts of the market evolve, as noted with regard to housing finance. The same trend will increase with businesses seeking loans and lease contracts (e.g., requiring property and casualty or vehicle insurance as a condition for bank loans). Second pillar pension reform is also key to building a viable pool of funds for market development, while also helping to provide a clear framework for collections and disbursements. While the government has not yet made any decisions on the future of its pension system, establishing a transparent, professionally managed system is needed to restore confidence and increase contributions. Introducing only a third pillar is likely to have less impact on financial sector development than establishing a three-pillar approach. **[ST/MT]**

Capital markets development is required as a destination for eventual insurance and pension funds, although investment policy parameters should be risk-based and flexible to ensure that fiduciary responsibilities are the focal point of asset management. As pension funds and insurance companies accumulate savings over time, they will need instruments in which to invest for sound asset-liability matching, and to preserve and build capital for savers without assuming excess levels of risk that would jeopardize their ability to observe legal and fiduciary responsibilities. Development of the government securities market is a start. However, moving into other securities should not be "force fed". Instead, the legal, regulatory and institutional framework needs to evolve so that investors have confidence in the market as a whole, as well as the individual instruments offered. When this occurs, money will move into these securities. Until then, the focus should be on adherence to fiduciary responsibilities to ensure that long-term contractual savings obligations will be fully met. This means that the proportion of securities permitted to be held in investment-grade instruments in OECD countries should initially be high, and then gradually reduced as the number and variety of safe instruments and institutional capacity emerge in Armenia.

Other infrastructure requirements are needed for markets to more fully develop. The property registry is incomplete for immoveable properties, and virtually non-existent for moveable items apart from automobiles. Moving to a more comprehensive and digitally accessible system will be indispensable to further development of a pledge registry in support of a viable secured transactions framework, with particular focus on mortgage finance (i.e., housing and commercial property development) as well as bank loans, leasing, and consumer finance.

Linkages work across the board, and the absence of progress in one area can likewise stifle development in another. For that reason, it is recommended that the Government pursue a diversified, market-based financial sector strategy that is stable, phased, and focused on developing a wide array of financial services to complement banking. In this regard, cross-cutting areas such as legal reform, regulatory coordination, consolidated accounting and supervision, corporate governance, and institutional support systems (e.g., property and pledge registries) should each have customized strategies for each financial sub-sector (e.g., banking, pension reform, insurance sector development, securities market development, mortgage finance, leasing, factoring), while also having working committees to identify areas of convergence and needed coordination. As an example, it is proposed as a function of accounting and audit reform that a specialized working committee focus on needed reforms and institutional development to effectively implement consolidated accounting and supervision, while providing a clear framework for investors and market players to pursue market development in a manner that is consistent with international standards of accounting, auditing, and financial reporting.

4. Legal and Regulatory Standards

Throughout the reform process, Armenia should seek to adhere to international norms and become members of international organizations. Armenia has no real securities, insurance or pension markets. Coordination with IAIS in insurance/pension reform and IOSCO for capital markets development will help to provide meaningful guidance as these NBFI activities evolve. Harmonizing legislation and financial market practices with EU Directives can also provide Armenia with minimum requirements and benchmarks for international standards. This is true in individual sectors (with customization and adaptation of non-EU practices as desired), as well as in broader informational requirements needed for market development. As an example, adoption of the EU's 8th Directive on accounting would help provide Armenia with a framework for modernizing the accounting and audit profession.

To strengthen the institutional environment, judicial reform is needed. This should include a comprehensive program to train judges and court officers in bankruptcy, secured transactions (based on effective legislation) and contract enforcement. It should also be accompanied by institutional support for better case management, court organization (types of disputes, amounts involved, levels of complexity, etc.), and electronic systems for increased access to information and decentralization. The World Bank has apparently begun work in this area, and other donors have likewise provided support. Commercial training for prosecutors should also be a part of the effort. This will also need to be broadened to ensure special protocols are in place for anti-money laundering efforts, and that work with/through the Financial Intelligence Unit has a sound legal framework for effective and vigorous implementation. Encouragingly, these processes have already begun.

Any movement of banks toward non-bank activities or "universal" status should be phased, and will require close regulation and supervision. CBA has done much to stabilize the system. At the same time, banks are small and need more opportunities to increase earnings from their small asset base. This will mean the banks will seek direct and indirect exposures to new lines of business, adding to their potential risk profiles. Supervisory capacity will need to be enhanced at CBA and developed at the other existing/potential regulatory institutions to ensure these risks are properly identified across sectors, communicated across regulatory authorities, and mitigated before undermining financial stability. CBA has already done much in the banking sector to ensure that licensing is subject to higher capital requirements. This might be followed by subsequent capital increases for differing types of licenses, based on demonstrated management and systems to assume new risks, and organizational/financial/regulatory firewalls to ensure that non-bank activity does not impair deposit safety or core banking activities. **[ST/MT]**

5. TAX POLICY

Tax policy issues are not a major constraint in the market. However, the Government should seek to equalize tax treatment to the extent possible so there is little (if any) discrimination across financial instruments. The one clear exception is that tax preferences should be provided on pension contributions to stimulate long-term savings, as well as to serve as a catalyst for successful and sustainable pension fund development. For example, VAT on leasing contracts makes leasing less attractive when compared with bank debt, as interest on bank debt is tax-deductible. Likewise, companies can offset income from losses on securities sales (e.g., government securities, corporate bonds, equities), whereas individuals can not. There are many differentials that apply to individuals as opposed to companies, each seeking to provide benefits and incentives. Meanwhile, the Government is contemplating interest expense deductibility for housing loans, but not necessarily for the purchase of life insurance. In the end, the Government may want to review the suitability of differential treatment, and possibly consider a simple approach with minimal differentiation and exemptions.

The public perception that bank accounts can be subjected to the risk of garnishing without recourse is one of the reasons for fairly low levels of deposit mobilization in the banking system. While there are legal prohibitions in place against this apart from court orders or CBA intervention when suspicious transactions are detected, the authorities may still want to consider a statement of principles, possible thresholds for an amnesty, and other measures to clear the ranks before proceeding with a new framework for account garnishing. At a minimum, some effort may be needed to reduce public concerns about account privacy. Garnishing is a recognized right in advanced countries. However, there are also protocols and judicial recourse that are clear and transparent. Absent the perception of reasonableness, prospective depositors may stay away from the banking system, perpetuating its difficulties in mobilizing long-term funding. **[ST]**

6. ACCOUNTING AND AUDIT

Armenia needs to develop a suitable audit and accounting profession for the development and maintenance of standards. One way to do this is to move to a more standards-based system, rather than a government-controlled system. In the banking sector, the effect has been recognized and remedied in recent years with problems regarding loan classification, provisioning, earnings and capital. However, problems are endemic and more severe in the enterprise sector. Concerted movement towards IAS/IFRS and ISA will be needed to produce better information for more effective management. This will also be needed for more effective internal audit, and general governance and oversight. Regular updating of standards in Armenian is also needed on a continuous basis.

7. BANKING AND BANKING SUPERVISION

CBA should strictly enforce banks' compliance with minimum capital requirements (including capital adequacy). Minimum capital will soon be $5 million for all banks. Capital adequacy is expected to be at least 12 percent based on BIS guidelines. While banks are in compliance with capital adequacy requirements, several banks are well below the $5 million minimum. Whether they achieve these levels by July 1, 2005 remains to be seen. Establishing an environment in which banks have sufficient capital, not just adequate capital, is needed. This should be structured to accommodate banks that are making a strong effort to accumulate capital, observing CAR requirements, and seeking to maintain high CAMELS ratings. (This recommendation is consistent with stated CBA policy, including resistance to any forbearance for capital-deficient banks.) **[ST]**

CBA may want to formalize how it plans corrective actions. While the last several years have been focused on stabilizing the banking system, there should now be consideration of a more formal contingency planning exercise and appropriate corrective actions that would take place under differing levels of systemic stress or bank-specific capital depletion. In the case of the latter, actions should be taken promptly, and prior to the point where the bank's solvency and liquidity are endangered, including (but not restricted to) suspending bank dividend payments, freezing or reversing pay increases for boards and management, auditing bank expenditures, increasing fines, initiating bankruptcy procedures, and appointing liquidators.

Risk-based supervision should be practiced increasingly and to the extent possible by CBA. While CBA has made great strides in the last few years, there is also work that reportedly remains in areas of credit and market risk, corporate governance (at banks and elsewhere throughout the economy), and consolidated supervision (as the system gradually becomes more complex). Greater focus on risk management should be the core of contingency planning and whatever organized program for corrective action that is conceptualized.

Building blocks for improved corporate governance should include protection of minority shareholder investment, and stiffening qualifications for board members. To date, CBA has limited banks' activities. This has been prudent for stability, but has also resulted in a fairly narrow range of products and services offered through/by the banks. Creditor rights are a key priority for future lending and investment. However, minority shareholder rights will also need to be balanced to ensure governance practices are fair and do not overwhelmingly bias conditions in favor of management and controlling shareholders at the expense of minority shareholders, particularly if banks are permitted to invest in other activities via subsidiaries and engage in "non-bank" financial services. Insofar as this relates to banks and financial institutions, corporate governance should be a key priority of the CBA's banking supervision department. This is already recognized by CBA as an area that requires further improvement. Regular off-site surveillance and on-site inspections should continue to assess governance and management capacity. This should be done as part of CBA's increasingly risk-oriented approach to supervision. However, this will also require time, as banks themselves have shown little initiative on this front apart from what has been required by the CBA.

CBA will need to ensure that banks have sound risk management systems in place in anticipation of greater risk assumption in their loan portfolios and fee-based activities. A credit information bureau is being developed, although it s facing difficulties obtaining the information to be useful and comprehensive. Even if the credit rating agency becomes operational and successful, enhanced risk management capacity at the banks will require more than this. More developed systems, procedures and controls as a function of internal audit, credit risk, portfolio risk, and general risk management will be needed for banks to move ahead under more competitive conditions. Consolidated accounting will need to be introduced as a starting point, particularly if companies to which the banks lend have subsidiaries and affiliates. A tightening of legislation dealing with the role of consolidation (e.g., parent companies, holding companies) will also be needed for such practices to be consistent with the broader legal framework.

8. INSURANCE

Barriers to investment grade insurance companies should be removed to accelerate reform, develop capacity, and modernize financial services. This should include measures to attract reputable foreign insurers, including through branch operations on the condition that other licensing criteria are met. At a minimum, MoFE should make it a condition for licensing a foreign insurance branch that the supervisor has (i) direct oversight over the insurance company's activities and financial soundness in its home country, and (ii) a framework is in place for cooperation with the foreign branch's home country insurance supervisor to ensure safety and soundness. MoFE may also want to consider inclusion of a test for foreign insurers seeking to open branches by requiring an investment-grade rating from one of the three major international rating firms. [ST]

Insurance sector development should follow IAIS principles. This should include separation of life and non-life, clear investment policy guidelines, and consumer protection provisions that help to build credibility and accountability in the profession. Removal of barriers to prime-rated foreign insurers should be entirely removed. There will also need to be a strong effort that ensures "pocket" insurance companies do not emerge as mandatory insurance is introduced. Thus, licensing standards will need to be strict, solvency measures closely monitored and accurately measured, and governance and management requirements consistent with international standards.

9. PENSION REFORM

Pension companies should be supervised and regulated by a separate pension supervisor or an existing financial sector regulator, but not by the current Ministry of Labor and Social Insurance or the current State Social Insurance Fund. Neither of these institutions has experience regulating financial sector companies. This provision should be added to existing draft legislation. **[ST]**

Ideally, legislation should state that the Government of Armenia will act solely as a pension company regulator and supervisor, and that the State will not compete in this market. Draft legislation does not make this explicit, and creation of a state-owned pension company to compete with private sector pension companies should not occur. Nor should a state-owned pension company be established to manage a portion of re-directed compulsory contributions from Pillar One to Pillar Two pensions. **[ST]**

If the Government chooses to have a State Fund during an interim period in which the current PAYG system is transformed into a multi-pillar system, this should be implemented under very strict conditions that address regulatory/supervisory weaknesses and can be easily transferred to the private sector when institutional capacity for effective regulation and supervision exists. This would render the State as "passive" owners of the Fund, with methods to include (i) outsourcing the second pillar fund management and administration to an internationally recognized fund manager to overcome regulatory/supervisory weaknesses, (ii) having strict audit conditions and controls on collections and adherence to investment policy requirements, (iii) segregating collected funds from normal government operations, (iv) guaranteeing safekeeping by permitting placement of collected funds in investment-grade securities in OECD markets, and (v) having a sunset provision of no more than five years to ensure fund management/administration is then divested as a State function.

Several modifications should be made to the existing draft legislation. The Law on Pension Security should include (i) provisions regulating the relationship between the employer and the pension fund (e.g., to ensure the vesting requirements to benefit from the pension fund are clear, participation is open to all employees but not a condition of employment), (ii) regulations or by-laws covering banks and insurance companies that are licensed to market and sell pension products based on clear solvency guidelines (e.g., the legal entity's ability to meet pension obligations when due, include disclosure requirements to inform participants about the pension product and financial status), (iii) requirements that ensure the pension fund's financial soundness so that it can meet the future pension obligations, (iv) provisions that make permanent the pension fund's management and investment strategy (with participants having the right to change investments to another fund at any time), and (v) clear provisions for contributions and disbursements. **[ST]**

Draft legislation should also give favorable tax treatment to savings invested in pension funds. This should include a reduced contribution from employers (e.g., payroll contribution from 23 percent to 3 percent), and income tax relief for individuals in exchange for assuming a higher individual payroll contribution (e.g., from 3 percent to 16 percent). Absent these incentives, it may be very difficult to promote future savings in pension funds. Likewise, in the future if mutual or investment funds emerge, pension funds would be at a competitive disadvantage, as these allow investors to redeem their investments any time they choose.

The structure of the pension system that is put forward in Armenia should be designed based on the World Bank's three-pillar model, using a system of defined contribution accumulation accounts. In conjunction with the work of the World Bank assisting in the reform of the Pillar One pension system, a portion of the compulsory pension contributions should be re-directed into Pillar Two pension companies. It is also recommended that employees be permitted to make additional voluntary contributions into these pension companies if they are able and inclined.

10. SECURITIES MARKETS

Securities market development should be guided by IOSCO and OECD standards. Investment should be allowed in OECD country securities that are blue chip, prime-rated, and adequately hedged. Consumer protection should be based on modern custodial services, electronic and verifiable recordkeeping, and regular disclosure. Stiff licensing requirements should be in place for collective investment vehicles, including high minimum capital, fit and proper standards, and compliance with general IOSCO guidelines. If a universal banking model evolves over time, there should be clear separation between bank and brokerage/investment arms, and capital should be measured and supervised on both unconsolidated and consolidated bases, with capital adequacy/solvency tests reflecting the specific risks of the core business activity. There should also be efforts to obtain ratings from internationally acclaimed rating agencies. This has not yet occurred in Armenia on sovereign debt or for any other securities.

Armenia can utilize its domestic securities market to establish a yield curve and pay down some of the external debt it carries to create a more active domestic market. Government securities will be useful in providing a reference rate and benchmark for bank lending and other securities, which will be essential for more efficient pricing in the credit markets, and broader development of capital markets and contractual savings. Maintaining a reputation for financial stability will be essential to achieving success in these areas.

While issuing domestic debt to replace foreign debt may make little sense in terms of fiscal cost and debt management, the decline in DRAM interest rates and real depreciation of the dollar against the DRAM may make this a rational move aimed at helping to establish a domestic capital market so that potential institutional investors have instruments to purchase. Armenia's domestic debt market is currently miniscule, and there is no real portfolio investment from abroad. However, this may change over time. First, any move to increase the supply of domestic instruments will be needed for pension funds and insurance companies that would want to purchase these securities for ALM purposes. Second, there is a diaspora community that may be persuaded to invest as opposed to donate in the future. (The current tendency towards the latter may be partly due to the absence of product available for investment.) Once established, this would provide reference rates and benchmarks for banks, mortgage loan originators, leasing companies and other creditors to issue corporate bonds to obtain needed term funding for long-term loans and lease contracts. [ST/MT]

11. NON-BANK CREDIT ACTIVITIES

Mortgage finance could emerge as a major catalyst for banking, securities, insurance, and pension fund development. For banks, it offers the possibility of increasing earning assets and selling/syndicating primary originations as well as purchasing assets in the future. For the capital markets, it offers the potential for instruments to be traded and invested. For insurance companies and pension funds, it offers assets to hold for asset-liability matching purposes.

The legal framework does not currently exist for secondary mortgage finance market activities, and barely exists for primary markets. While CBA and MoFE have both commissioned studies on how to move to secondary market development, policy focus should be on correcting the existing inadequacies of the primary market and then moving to a framework for secondary market development as the primary market shows a build-up of inventory and value. The existing legal and institutional framework needs to be perfected for greater primary market development, and for eventual linkage to secondary market outlets. This includes an increasing proportion of housing loans through the banking and non-bank credit sector, prudent management of commercial property exposures, and demonstrated proof that contract disputes on such loans (and potential equity stakes) can be resolved consistently and justifiably through judicial and extra-judicial channels. These developments may take years to materialize as a forerunner to mortgage-backed securities (including the institutions and information flows for successful implementation). However, initial refinements for primary market activity can be initiated in the near term to move the process along. Given the amount of private money already in the market for housing-related finance, many of these reforms may want to focus on commercial property development to stimulate market activity in this area. However, the latter needs a more buoyant market to drive demand for hotels, warehousing, office space, etc. In the meantime, issues related to property tax administration and condominium fees for needed infrastructure maintenance and related services should also apply to the framework to focus on housing stock issues. [ST/MT]

Institutional capacity needs to increase for mortgage finance markets to evolve more comprehensively. Both public sector institutions (Ministry of Urban Affairs) and private sector players (National Association of Realtors and Appraisers) can do more to obtain and disseminate data and information on real estate trends. This would be helpful for economic analysis and planning in the public sector, as well as for financial institutions in developing credit and investment strategies.

Leasing, factoring and commercial finance operations should be encouraged. However, as risk-takers, their operations should not be permitted to undermine deposit safety. This would mean banks active in these fields should continue to be subject to prudential regulations governing these activities as part of their overall credit risk management function. Meanwhile, the limited licensing approach of the CBA for most non-bank credit organizations (preventing them from mobilizing deposits or accessing any deposit insurance coverage under the deposit guarantee scheme) should be continued.

D. Specific Recommendations For USAID

There are five key initiatives recommended for USAID to pursue (in no particular order). These are broadly consistent with work done successfully by USAID in the past in other transition countries (and elsewhere) in building sound institutional structures for sustained (and stable) market development.

However, there is no particular order to these recommendations due to the overlap in themes and characteristics for their success. For instance:

- Corporate governance standards in the banking system are essential for improved performance in the real sector, as in other financial services. These are partly driven and frequently shaped by regulatory institutions, and increasingly across sectors as systems develop. For this reason, observing standards and developing adequate structures in all financial services is needed for a vibrant economy. In the case of banking, future risks need to be anticipated. In the case of other financial services, particularly pension and insurance, capacity needs to be developed for the market to evolve. In this regard, pension and insurance sector development should be high priorities. At the same time, the financial system will continue to be dominated by the banking system for the foreseeable future, making the focus on banks and banking supervision equally as important for the near term.
- Without adequate governance and management, as well as the information and systems to achieve these, it is rare to find a viable pension system in place, confidence by the public in insurance, or supply of and demand for non-government instruments in the capital markets. This, in turn, affects the development of the capital markets, including instruments to be made available for institutional investors when they eventually emerge. Thus, accounting and audit constitute building blocks for

information disclosure needed for markets to develop, without which instruments are not feasible. There has been significant discussion of the need for pension reform as a top priority to accelerate financial sector development. This is important and necessary. However, given the primacy of the banking system to date and likely continued prominence in lending, bridging the gap between banks and borrowers is essential. Transforming the business culture of Armenia into one that values open information disclosure for market purposes is critical to this effort. Having credible financial information is a prerequisite for this to happen.

- Without adequate laws, regulations and supervisory capacity, employees and employers generally shy away from making voluntary contributions through occupational or individual plans (third pillar pension system). Mandatory (second pillar) defined contribution pension systems are important for financial sector development, yet need ironclad protection for safety and confidence. Without adequate structures in place, it is not possible to provide this confidence. On the other hand, "jump-starting" the process through safe means is needed for late reformers (like Armenia) due to the amount of time it takes to accumulate meaningful savings levels. This can be done via outsourcing of fund management by internationally recognized and rated institutions. However, where the informal sector is prevalent and fiscal authorities are not trusted, as in Armenia, mandatory contributions are often still fairly low, with the impact on savings mobilization disappointing in the near term. Pension reform needs to be implemented swiftly and comprehensively. Yet expectations of near-term impact on financial market development may be optimistic, particularly given the high level of informal transactions in the economy.
- Better accounting and audit standards are preconditions for modern financial services and competitive enterprises in general, and are indispensable to modern standards of governance and management in all public and private sector endeavors. Likewise, they are indispensable for viable capital markets, even when savings accumulate in pension funds and there is clear need for instruments in which to invest. Without adequate trust and confidence in the markets, investments in domestically available instruments may lack the safety needed for professional managers to meet their fiduciary responsibilities. Likewise, with movement to mandatory forms of insurance, insurers will need instruments in which to invest. Yet, they will also need professional management capacity to safeguard these assets, along with adequate actuarial, regulatory and supervisory capacity to ensure contracts are complied with and portfolios are prudently managed.
- A modern secured transactions framework is needed for credit and investment in general, with housing and commercial property development a subset of the larger whole. Likewise, the institutional framework to support secured transactions includes more than just registries, and involves legal and judicial structures for support and consistency. Thus, movement to secondary mortgage finance markets will be helpful in modernizing the financial system, and a vision should be mapped out for this to happen. However, as with pension reform, these should be understood to be long-term developments that take time to become a normal part of the legal and financial landscape.

Thus, in making the core recommendations, they are stated in no particular order because of the overlapping importance of governance standards, management capacity and institutional structures in achieving success. Recommendations for priority USAID support include (i) **banking supervision and commercial bank corporate governance**, as the banking system becomes more complex and supervision evolves in a more risk-based fashion; (ii) **accounting and audit reform**, to help Armenia move away from a legalistic, government-oriented approach to accounting and audit that has proven ineffective, and towards a more standards-based approach that focuses on professionalism, improved governance and management systems, and development of risk management capacity; (iii) **housing finance development**, with a combined focus on a comprehensive property and pledge registration system to make mortgage finance more feasible, for primary markets to develop, and for the economy to move increasingly to secondary markets over time; (iv) **pension reform**, with specific focus on evolution of professional fund management to manage resources, and for supervision to provide trust and confidence; and (v) **insurance sector modernization** under a sound legal framework, and based on effective supervision and active market participation in the setting of standards, guidelines, and codes of conduct.

Other options may also be feasible depending on the interests and willingness of USAID to be involved. This may include targeted interventions that are relatively limited in budgetary requirements. Likewise, these options may be considered supplemental or complementary to others' activities in the event that resources are committed and priorities are aligned. However, the five key recommendations presented below are the ones where USAID would be most likely to make an impact, bring to a successful conclusion some of the earlier work begun, and address its strategic objectives in a manner that is sustainable in the long term.

#1: BANKING: STRENGTHENING BANKING SECTOR SUPERVISION AND CORPORATE GOVERNANCE IN THE COMMERCIAL BANKING SECTOR

CBA has made significant progress in recent years in developing capacity and stabilizing the banking system. Its success has also triggered discussion of creation of a unified supervisory framework, given the small size of the Armenian financial sector, cost-savings that derive from such a structure, and underdevelopment or non-existence of regulatory capacity in other financial services. There are also risks posed by not pursuing a unified framework, including potential political interference in the regulation and supervision of the insurance sector where the budget of the Insurance Inspectorate is dependent on fiscal resources, and therefore potentially less independent than CBA. Nonetheless, it is currently recommended that CBA focus on numerous challenges in the coming years, including better coordination with other supervisory agencies, so that movement to a unified framework is based on a convergence with other agencies when capacity is sufficiently developed. At that juncture, it is believed that the development of core supervisory capacity across diverse financial services will be in place, and that this will benefit the system as a whole.

Meanwhile, regulators and supervisors can only push the system so far in terms of modernization and sound management. In the end, market players will need to ultimately drive standards as the market develops, with regulators playing their respective and coordinated roles in supporting a competitive market under stable conditions. Thus, the onus will be on market players (banks and other financial institutions) to have adequate governance, management, systems and resources in place to compete within stable market parameters. Much of this work can be done by seeking to involve a more active banking association.

Key objectives for strengthening banking supervision and corporate governance in banking markets would include the following:

- Having sound credit and market risk systems in place at banks (and building on existing systems at CBA) under more competitive banking conditions.
- Implementing consolidated supervision based on consolidated accounting, and reinforced by sound cooperation/coordination with domestic and cross-border supervisory institutions as well as evidence of adequate systems and compliance at the banks.
- Ensuring adequate corporate governance and management capacity in the banks, including effective board oversight, autonomous internal audit capacity, and sound MIS.
- Institutionalizing strong risk management systems and practices at banks, and making sure that CBA systems evolve as market players assume greater risks.

USAID support would be expected to offer:

- Assistance to CBA for contingency planning (as needed), particularly as part of a more developed corrective action framework in the event that key banks and/or the system at large encounter severe stress. (In this regard, key protocols should be in place and enforced for CBA-bank relations, putting the onus on banks to report on risks that could be damaging to their financial condition and banking system stability at large.)

- Coordination with other supervisors as complexity increases and transfer risk opportunities emerge (in value and instruments).
- Coordination with the Financial Intelligence Unit to ensure that anti-money laundering and other anti-crime measures are strictly enforced.
- Movement to consolidated supervision that is integrated and risk-based.
- Training for bankers via the Armenian Bankers Association (ABA) in corporate governance, including the role of boards, management, internal audit, MIS, and other preconditions for effective governance.
- Training for bankers via the Armenian Bankers Association in mergers and acquisition, design and costing of new products and services, market research and development, etc.

All of these would be expected to be continuous, meaning short-, medium- and long-term in scope. A more detailed work plan for specific tasks and outputs would be needed as part of a larger effort to structure a budget and the appropriate mix of short- and long-term advisory assistance, systems, and other resource needs. This assistance would be closely tied to the accounting reform and insurance market development initiatives. Effective implementation would require a high level of cooperation between CBA and the ABA.

STRENGTHENING BANKING SUPERVISION AND CORPORATE GOVERNANCE IN THE COMMERCIAL BANKING SECTOR		
Summary: USAID assistance would involve: (i) CBA contingency planning needs, particularly as part of a more developed corrective action framework; (ii) coordination with other supervisors, namely the Insurance Supervisor and Securities Commission, as well as foreign supervisory bodies, as complexity increases and transfer risk opportunities emerge; (iii) coordination with the Financial Intelligence Unit to ensure that anti-money laundering and other anti-crime measures are strictly enforced; (iv) movement to consolidated supervision that is integrated across sectors and financial services, and increasingly risk-based with a focus on threats to systemic stability as well as deviation from legal and corporate governance standards; and (v) training for commercial bankers in corporate governance, mergers and acquisitions, and basic product and market development. Underlying all of these efforts would be continuous updating and improvement of information flows between banks and CBA to ensure that risk identification occurs early, and that potentially adverse affects on banking system stability are contained and remedied.		
Strategic Consideration	**Prospects**	**Comments**
Comparative Advantage for USAID	High	Clear USAID advantage; should work with IMF, BIS, FATF and others
Sustained Long-term Impact	High	Very probable
Major Results from Budgetary Resources	High	Expensive; needs resources
Fill Major Gaps	Moderate to High	Nobody else active apart from IMF with supervision and KfW with the Deposit Guarantee Fund
Strategic Fit with SO 1.3	High	Provides stability for sustained access
Confidence of Success	Moderate to High	Tried and tested; moderate risk of resistance from CBA, and lack of initiative from ABA

2: ACCOUNTING AND AUDIT REFORM: CREATING A STANDARDS-BASED ACCOUNTING/AUDIT PROFESSION IN SUPPORT OF INTERMEDIATION AND GOVERNANCE

USAID has already provided support for accounting and audit reform, with only partial success achieved. However, much of the reason for slow reform is the nature of the profession, which has not been permitted to evolve as a standards-based profession (as is the practice in advanced economies). Rather, the profession still operates as if it were similar to the old Chamber of Auditors, with some adjustments in 2000 with the adoption of RAAS which, at the time, was largely consistent with IAS. However, since then, numerous revisions have been made to IAS, and IFRS has been introduced. RAAS has not been updated to account for these changes.

More significantly, incentives do not exist for businesses to follow IAS/IFRS, as they do not borrow from abroad or float bonds/equities in domestic or international markets. When financial statements are presented, they are often discounted by the banks due to their awareness that financial reports generally understate revenues, earnings and assets to reduce tax payments, and/or incorrectly value pledged assets due to questionable appraisal practices.

Much of the problem in accounting and audit relates to the lack of professional/institutional capacity. Recommendations to strengthen internal audit functions at banks and enterprises (and government), ensure the independence of auditors, enforce a code of conduct that is consistent with international standards, and observe more open standards of transparency and disclosure will contribute to more and better information for market purposes. However, this will also require time and money.

Not only are IAS/IFRS relatively new in Armenia (and practiced to the extent it is practiced by the banking sector and only a few other business concerns), but there are reported to be only about 20 Armenians trained and certified in standards consistent with IAS/IFRS/ISA. Additional accountants and auditors are trained, but are often unable to find relevant work to obtain the needed experience for professional certifications.

Current efforts supported by the Association of Accountants and Auditors of Armenia and the Institute of Chartered Accountants of Scotland are focused on continuing education. To make their efforts more effective, and to move the AAAA to a more professional standing, several reforms are recommended. These include:

- Adoption of the EU 8th Directive as a model framework for the accounting and audit profession in Armenia.
- Responsibility of the association for ongoing certification and training, monitoring of performance by members in compliance with recommended professional standards, and discipline.
- Establishment of a Steering Committee on Financial Services, for effective introduction and implementation of consolidated accounting and IAS/IFRS across all financial services.
- Mandatory membership of all auditors and accountants.

Key objectives to be achieved as a result of these reforms would be:

- Devolution to a standards-based regime via the AAAA, as opposed to the more politically direct (yet ineffective) approach exercised by the central government.
- Significant increase in professionalization relative to accounting and audit capacity and practices.
- Migration of accounting and audit professionals to enterprises, regulatory authorities, and financial firms to assist with regulatory compliance as well as increased lending and investment.

- Evidence of improved governance, modern management systems, and useful financial reporting in support of market development and regulatory compliance.
- Effective implementation of consolidated accounting as part of the larger effort to increase financial market coverage and to implement consolidated supervision.
- Possible pilot project working with large-scale or mid-sized firms and/or financial institutions (e.g., banks, leasing companies, mortgage finance companies) to have their financial statements conform to IAS/IFRS (as required for banks), develop a comprehensive prospectus, and ultimately issue shares or bonds on the local exchange.
- Assistance to associations (bankers, insurance, real estate appraisers, etc.) to help with dissemination of standards and application by market players.

Most of these would be expected to be continuous, meaning short-, medium- and long-term in scope. However, movement to adopt the EU 8th Directive would not require major time, nor would establishment of a Financial Services Steering Committee. As with other proposed assistance, a more detailed work plan for specific tasks and outputs would be needed as part of a larger effort to structure a budget and the appropriate mix of short- and long-term advisory assistance, systems, and other resource needs. With advisors on site, this would not require major time or effort. This assistance would be closely tied to project components focused on banking, insurance and pension fund development.

DEVELOPING A STANDARDS-BASED ACCOUNTING AND AUDIT PROFESSION		
Summary: USAID efforts would focus on: (i) adoption of the EU 8th Directive as a model framework for the accounting and audit profession; (ii) transfer of responsibility to the association for ongoing certification and training, monitoring of performance by members in compliance with recommended professional standards, and discipline; (iii) establishment of and advisory support to a Steering Committee on Financial Services, for effective introduction and implementation of consolidated accounting and IAS/IFRS across all financial services; (iv) evidence of migration of accounting and audit professionals to enterprises, regulatory authorities, and financial firms to assist with regulatory compliance as well as increased lending and investment; (v) improved governance, modern management systems, and useful financial reporting in support of market development and regulatory compliance; (vi) effective implementation of consolidated accounting as part of the larger effort to increase financial market coverage and to implement consolidated supervision; (vii) pilot project to promote compliance with IAS/IFRS tied to issuance of securities in the local capital market; and (viii) direct outreach to associations for effective observance and implementation of standards.		
Strategic Consideration	**Prospects**	**Comments**
Comparative Advantage for USAID	Moderate to High	USAID advantage (along with others)
Sustained Long-term Impact	High	Very probable
Major Results from Budgetary Resources	Moderate	Results to date have been less than expected; proposed approach would better align the profession with desired practice; time will be required, and better than moderate prospects would likely need more time than currently projected due to resistance from the real sector
Fill Major Gaps	Moderate to High	Clear gap in financial sector, particularly non-banks, as well as virtually the entire real (enterprise) sector; migration of professionals would bring practices closer to compliance with international standards
Strategic Fit with SO 1.3	Moderate to High	Contributes to competitiveness and financial market development; impact on SMEs comes later
Confidence of Success	Moderate to High	Takes significant time and resources to institutionalize new standards; political resistance may occur, although this is not justified

#3: MORTGAGE FINANCE: COMPREHENSIVE MORTGAGE FINANCE PROJECT IN SUPPORT OF INTERMEDIATION, EFFECTIVE PROPERTY REGISTRATION, AND CONTRACT ENFORCEMENT

A housing finance project, or larger mortgage finance project, would be attractive in many ways. USAID has had substantial recent success in this field in transition countries, and Armenia's current housing finance market is starting to emerge. While most transactions remain outside the formal system, there is ample proof that this is one of the key areas where banks and other financial institutions can play a key role in providing financing, upgrading asset stock quality, helping to improve the economic and social landscape, increasing asset values of households and small businesses, expanding the fiscal base, providing local government with a larger property tax base, and serving as a catalyst for primary credit market activity and movement to secondary markets in debt and equity instruments. Beyond the financial market indicators, sustained support for housing finance is also a contributor to sustained employment and skills development.

Mortgage finance likewise can serve as a basis for setting "strategic vision" with regard to an improved secured transactions framework. This would include support for efforts currently proposed and supported by the World Bank to strengthen property and pledge registry systems and modernize foreclosure procedures. At a minimum, this should include comprehensive property and pledge registries for immoveable assets as well as moveable properties that are electronically accessible for credit risk evaluation purposes.

The authorities may want to consider a new Law on Collateral focused specifically on the subject of secured transactions, and with a view to preparing a legal framework for secondary market development in mortgage finance markets. As the primary markets evolve in the next two to three years, legal and institutional development for secondary markets would presumably include a framework for mortgage bonds and mortgage-backed securities, all of which will depend heavily on cash flows but will also be dependent on underlying collateral for most payment obligations to be fulfilled in the event cash flows are insufficient. Combined with efforts to standardize underwriting procedures, establish adequate valuation and appraisal standards (part of the Accounting Reform initiative proposed for support), and build systems in support of needed lending into the housing and commercial property sectors, this would all be advantageous for Armenia's efforts to promote market development.

Such an initiative would support efforts to increase access to financial services. Moreover, it would serve to support the increase in financial instruments available in the market, as build-up of loan inventory would lend itself to the eventual packaging and bundling of loan pools for investment in the form of mortgage-backed securities. Banks (and other credit organizations in the market) would want to consider the issuance of mortgage bonds to obtain needed term financing for such credit activities, and for asset-liability matching purposes. The availability of such instruments would likewise facilitate the development of the insurance and pension fund sectors, as both would be searching for medium- and long-term instruments for portfolio needs. Meanwhile, the availability of such instruments would reduce dependence on bank financing in the private markets, and also alleviate pressure on government to issue a higher volume of debt securities in the domestic market for markets to effectively function. It is thought that the availability of such instruments might also serve to help shift the willingness of the diaspora community to invest in Armenia, rather than just provide donations or grant financing due to concerns about how investment proceeds would be managed.

Key objectives would include:

- Material increases in housing and commercial property loans through the banking and non-bank credit system, with eventual movement to capital markets instruments supported by institutional investment.

- Long-term funding via bank bonds and/or syndicated loan facilities instead of donor funds.
- Increased share of high quality housing loans (and commercial property loans over time) that could eventually be packaged into secondary market instruments.
- A comprehensive and electronically accessible property and pledge registry system that provides complete and accurate information to creditors as part of the credit risk evaluation process.
- Low incidence of deviation from contractual responsibilities, and more efficient court and out-of-court processes when disputes emerge.
- Possible preparation of a framework for mortgage default insurance (but only after the other preconditions have been implemented).
- Sustained employment in housing-related activities (e.g., building materials production, construction, and services such as plumbing, electrical, insulation, roofing, etc.).
- Contribution to development of a viable property tax base.

To be effective, there are several initiatives that can and should be supported by USAID. These include:

- Development of a sound legal framework for primary and secondary market development based on clear rights and responsibilities and standardized contracts.
- Institutional and infrastructure support, namely a comprehensive property registry system for immoveable items with clear ownership rights, electronic inter-face with the pledge registry system, and open digital access by creditors to records for credit risk evaluation.
- Training in underwriting standards, coordinated through the bankers' association as well as CBA.
- Strengthening of accounting and audit standards, with focus on asset valuation and appraisal standards, and effective implementation via licensed appraisers. This would be coordinated through the National Association of Realtors and Appraisers as well as the Appraisal Development Center.
- Enhancing information flows for market-making, including housing data, pricing data, demographic data, commercial property trends, and related realty data that provide needed stimulus for markets to function. This would involve the National Association of Realtors and Appraisers if it shows a willingness to organize and play a key information clearinghouse role, a critical ingredient for active real estate markets. The effort would also involve the Ministry of Urban Affairs, as it shifts its focus away from housing subsidies and more to helping to ensure a stable environment for housing markets and infrastructure development and maintenance.
- Development of specialized credit risk management systems for real estate transactions and portfolios, to closely monitor for potential asset bubbles and market risk, and to contain the potential impact of such risks on portfolio quality once identified. This effort would be linked to broader commercial bank training (discussed in Option #1), and coordinated with CBA.
- Standardization of mortgage finance procedures to increase primary market volume and to stimulate movement to secondary market development.
- Eventual consideration of mortgage default insurance.

Most of these initiatives would be expected to be continuous, meaning short-, medium- and long-term in scope. In some cases, work to finalize the real estate cadastre would build on initial efforts, which remain about 60 percent finalized. In other cases, such as mortgage default insurance, this would only come towards the end of the project. Meanwhile, legal and regulatory issues would take time and require active working groups. Other issues such as accounting and audit practices in real estate finance would be linked to the Accounting Reform initiative. Information flows for real estate-related information would likewise need time for accuracy, completeness, and coordination between public and private sector participants.

As with other proposed assistance, a more detailed work plan for specific tasks and outputs would be needed as part of a larger effort to structure a budget and the appropriate mix of short- and long-term advisory assistance, systems, and other resource needs. This assistance could be closely tied to World Bank efforts in support of a strengthened secured transactions framework, and UNDP focus on new tax systems being introduced at local government levels. The assistance in this field would also coordinate with banking and real estate-related associations, CBA, the State Cadastre, Ministry of Urban Affairs, Ministry of Justice, as well as eventually with the Securities Commission and regulatory authorities for insurance and pensions.

Establishing a Sound Mortgage Finance Market		
Summary: USAID efforts would focus on (i) development of a sound legal framework for primary and secondary market development based on clear rights and responsibilities and standardized contracts; (ii) finalizing a comprehensive property registry system for immoveable items with clear ownership rights; (iii) working to establish an electronic inter-face with the pledge registry system for accurate and real-time information so that contract terms are based on sound information, and consistent with legal framework provisions; (iv) assisting with efforts to ensure open digital access by creditors to property and pledge records for creditors to assess risk when loan requests are made; (v) training in mortgage underwriting standards; (vi) strengthening accounting and audit standards with regard to asset valuation and property appraisals; (vii) enhancing information flows for market-making, including housing data, pricing data, demographic data, commercial property trends, and related realty data that provide needed stimulus for markets to function; (viii) working with banks and CBA to develop credit risk management systems for close monitoring of asset bubbles and market risk impact on portfolio quality; (ix) working with market players and lawyers to encourage standardization of mortgage finance procedures and contracts for efficient processing in support of increasing primary market volume, and to pave the way for movement to secondary market development; and, if these initiatives show effective implementation; (x) development of a possible framework for mortgage default insurance.		
Strategic Consideration	**Prospects**	**Comments**
Comparative Advantage for USAID	High	USAID advantage
Sustained Long-term Impact	Moderate to High	Timing for secondary markets currently premature, but long-term benefits would materialize; significant work required to develop primary markets
Major Results from Budgetary Resources	Moderate	Legal and institutional capacity still weak; will need major effort to generate results
Fill Major Gaps	Moderate to High	Lending and construction taking place, but outside the banking sector; successful implementation would serve many purposes, including providing needed instruments in the market for prospective institutional investors (e.g., pension funds, insurance)
Strategic Fit with SO 1.3	High	Increases access for households and small businesses, potentially others; catalyst for increased productivity and employment, including building materials, construction, maintenance, financial services, etc.
Confidence of Success	Moderate	Results generally favorable across countries, but could be slower to achieve due to legal and institutional weaknesses

#4: PENSION REFORM: SUPPORT FOR EFFECTIVE PENSION REFORM

As noted, pension reform is being contemplated. There have already been improvements made to assist with collections and disbursements. Nonetheless, numerous weaknesses persist, not the least of which are the paltry payments made, low level of participation in the system (under-payment of contributions), and low levels of confidence in the management of the PAYG system. The absence of audit standards, reporting requirements, and general disclosure of cash in and out is symptomatic of a troubled system. Moreover, demographic issues point to long-term vulnerability of the existing system, as elsewhere around the globe.

There are many areas in which USAID can be effective in assisting with pension reform. Moreover, given the interest and focus of the World Bank, there is scope for cooperating on needed reforms, particularly if GoA is willing to borrow from the Bank for a transition period in which a second pillar scheme (and possibly third pillar) is introduced.

Any reform effort in this field will require adequate regulation and supervision, including in the fields of safekeeping, registration and reporting, investment policy, and consumer protection. This will involve institutional support, as found elsewhere in the world. Nonetheless, because so many models exist and systems have been perfected elsewhere, there is little reason for GoA to shy away from such needed reform. Rather, efforts should focus on the type of model to be introduced, system requirements for effective implementation (private sector management combined with public sector oversight), and financing for the transition away from the existing system. Recommendations in the Main Report have included some proposed conditions for an interim period of management and administration of a second pillar while regulatory and supervisory capacity is developed.

USAID can assist in helping Armenia create a system of voluntary pensions (third pillar) and improve the compulsory pension system (first and second pillar) by directing technical assistance as follows:

- Develop a project implementation plan working from a government approved consensus from an agreement on the goals and principles of a reformed pension system (e.g., World Bank goal of a target of 60 percent old age income replacement program). This would include a recommended structure for pension companies, how contributions could be managed by the financial sector, and a sound structure for the supervisory authority for pension companies (drawing on experience of regulators in overseeing other financial sector institutions).
- Determine the estimated borrowing costs associated with transition to a second pillar, taking into account tax incentives that would stimulate rapid development and accumulation of private savings.
- Establish guidelines for interim professional management of a second pillar under "passive" State control (while regulatory and supervisory capacity is built), including outsourcing and evaluation criteria, audit requirements, non-use by the State of funds collected, investment policy, fiduciary responsibilities, and a sunset provision for continued State association with second pillar fund administration.
- Develop law and/or regulations which support the reformed system in terms of contributions (e.g., amounts of employer and employee contributions and tax incentives on voluntary contributions), earnings (e.g., how and when to credit, how to calculate, how to report, how to disclose), and benefit payments (e.g., calculation of annuity payments for retirement, disability payments, inheritance at death).
- Assist in the development of new financial institutions and/or financial products into which pension contributions are invested. This would include developing specifications required to be licensed as a

pension fund; advising on legal structure, tax status, and management structure; accounting, transaction record-keeping capabilities and IT records; asset management functions and credentials; and payment of benefits (e.g., transfer account balance to annuity underwriter at retirement age).

- Develop and implement a public communication plan.
- Provide training for the regulatory authority on how to evaluate companies seeking to be licensed as a pension fund.
- Develop and implement a plan for the flow of contributions for each voluntary occupational pension scheme.

PROMOTE EFFECTIVE AND SUSTAINABLE PENSION REFORM		
Summary: USAID efforts would focus on (i) developing a project implementation plan with GoA and the World Bank; (ii) determining transition costs with introduction of a second pillar; (iii) helping with guidelines for interim management as supervisory capacity develops; (iv) legislation and/or regulations which support system reform in terms of contributions, earnings, and benefit payments; (v) assist in the development of new financial institutions and/or financial products into which pension contributions are invested; (vi) developing and implementing a public communication plan; (vii) providing training for the regulatory authority on how to evaluate companies seeking to be licensed as a pension fund; and (viii) developing a plan for the flow of contributions for each voluntary occupational pension scheme.		
Strategic Consideration	**Prospects**	**Comments**
Comparative Advantage for USAID	Moderate	USAID advantage, along with others
Sustained Long-term Impact	Moderate to High	Will take time and resources, but is needed; will generate major long-term benefits, including strong contribution to financial market development
Major Results from Budgetary Resources	Moderate to High	Time and resources will be needed to generate a major impact in the third pillar; substantial impact may come from a bold shift to second pillar pension reform; IBRD resources for GoA transition borrowing would provide needed leverage for USAID effectiveness
Fill Major Gaps	High	No other donors appear to have plans to advance the pension sector apart from IBRD
Strategic Fit with SO 1.3	Moderate to High	Main impact would be increasing financial services if 2nd pillar is introduced, requiring asset management capacity and serving as a catalyst to introduce new financial instruments
Confidence of Success	Moderate	Pension reform will help with long-term fiscal soundness, financial market development, and investment; short-term impact unclear

#5: INSURANCE SECTOR MODERNIZATION: SUPPORT FOR EFFECTIVE INSURANCE SECTOR REGULATION, SUPERVISION, AND MARKET DEVELOPMENT

The insurance sector is underdeveloped in Armenia. Development will assist businesses with needed insurance coverage. Likewise, the development of modern life insurance capacity will also help with pension reform in the future if/when the country moves to a second pillar and/or third pillar pension system.

There is a clear benefit to having a viable insurance sector function in a market economy. In addition to helping to defray risk for individual policy holders, the presence of strong insurers can help to assert financial discipline in the marketplace (in parallel with banks) as well as provide institutional investment. Thus, insurance companies that are well managed play a key role in strengthening governance standards in an economy. While these attributes are largely assigned to life insurance companies due to the long-term nature of their assets and liabilities, this is also true for non-life groups with shorter maturity issues in their portfolios. This is because insurance companies have a tendency to build up assets over time with annual renewals, effectively triggering portfolio management practices that, in many ways, are similar to those of life insurance companies. (For instance, annual property insurance policies are frequently rolled over, particularly when rates show little or no increase. Thus, one-year policies effectively become long-term assets over time.)

With these benefits in mind, USAID is encouraged to support development of a market-based insurance sector. Key areas of support should focus on building up adequate capacity in the regulatory and supervisory field, and also assisting market players with capacity to help set standards and build a viable market. Particular focus needs to be placed on avoiding emergence of “pocket” insurance companies, strictly observing sound standards in mandatory lines that could be introduced (e.g., third party motor, health), and sustaining appropriate solvency ratios so that responsibilities regarding claims can be fully met without triggering instability. Insurance companies will also need to develop capacity to manage risks, which will also require greater actuarial capacity. Meanwhile, regulatory authorities will need significant increases in budget, and improvements in training and information systems to be effective. Efforts by USAID should be coordinated with the World Bank, which has also shown interest in the field. USAID efforts should also be closely linked to efforts in the fields of banking supervision and accounting and audit reform, particularly as linkages increase between bank credit exposures and insurance products.

Recommended assistance to the Insurance Department of the Ministry of Finance and Economy could include the following:

Short-term assistance:

- Create and deliver an accrual-based accounting methodology training program for the staff and management of the supervisory authority to understand the account method of the insurance industry.
- Develop a strategy and plan to introduce compulsory insurance: develop strategy plan with goals, objectives and process; assist in drafting law(s) and accompanying regulations; and assist in development and implementation of a public communication plan on compulsory insurance.
- Develop an economic model for tracking insurance sector developments and exposures that create an early warning system on potential industry problems by modeling financial assumptions and risk ratios; develop training on how to use and how to train others.
- Develop insurance inspection manuals, train in the use of inspection manuals, take inspectors out on inspections, and mentor them through a complete inspection and follow-up report and communication.

- Create a new budgetary process for the supervisory authority, based on a collection of fees and charges related to the amount of insurance sold, which enables an independent budget process free from political interference.

Medium-term assistance:

- Develop a licensing database to license and track insurance industry members and intermediaries: companies, brokers and agents. Eventually this information must be disseminated and shared between/among financial sector regulators.
- Create a position of regulatory insurance actuary, develop roles and functions of the actuary, and develop plans to transfer knowledge and the position after a set time period to complete control of the Ministry of Finance and Economy.
- Prepare a supervisory authority training program in insurance market surveillance (identifying, tracking and monitoring allowable processes and reporting) and application of warnings, fines, sanctions and enforcement of rules and, if needed, prosecution of insurance law violations.
- Training in financial reporting analysis by the Insurance Department on how to create a financial risk profile of the industry, of each company, and of each line of insurance with the industry (e.g., auto, property, cargo, aviation, marine).
- Training in actuarial valuations, modeling and projections, including basic insurance and reinsurance practices; and analysis of product pricing to risk valuations.
- Auditing training and understanding of financial reports prepared by insurance companies.
- Training in the valuation of insurance company holdings (current value, projected values, discounted values, losses and depreciation) to be able to evaluate an insurer's ability to match assets to liabilities.
- Training in investment policies, investment instruments, investment diversification balance, risk-reward trade-offs, and general asset management functions.

Long-term assistance:

- Define insurance company information technology (IT) system capabilities, such as system back-up minimum requirements, and annual reporting of IT capabilities.
- Revise and update rules regarding customer complaints to include maintaining copies of all written complaints and their disposition, and statistical tracking of all claims made (currently only doing this on claims paid).

In addition to support for the regulatory authority, USAID is encouraged to assist the insurance industry. The Insurer's Association of Armenia is the insurance industry group, which has an open and continuing dialogue with the Insurance Department of MoFE. Because of the lack of understanding by the general public of insurance products, it is recommended that technical assistance be directed to the Association as well. The Insurance Department of MoFE has expressed a preference that functions related to public education be directed to the Association, and not the supervisory authority. Thus, technical assistance should be provided to complete the following tasks:

Short term recommendations:

- Communicate with businesses and households by educating them on insurance protection, insurance products, and assessing and managing risks.
- Track, analyze and report industry statistics.
- Create links to industry member websites.

Medium-term recommendations:

- Develop a customized insurance industry association training program (assessment, customized materials development, training classes, transfer continuity of training program to association) focused on: establishing and maintaining adherence to international accounting and audit standards and of internal controls; evaluating reinsurance options and building relationships with re-insurers; asset management functions, developing an investment policy, and understanding settlement and transactions; operating manuals, claims handling and back office processing, and customer service training; developing underwriting and premium rating skills; marketing, new product introduction, and risk assessment and management; and management and team-building, management systems, hiring and staffing, training and testing.
- Act as self-regulatory organization (SRO) for industry members.
- Act as a central source for a national market database for demographic data (for costing life insurance).

PROMOTE DEVELOPMENT OF AN EFFECTIVELY REGULATED INSURANCE SECTOR		
Summary: USAID assistance would be twofold: to the supervisory authority at MoFE, and to the industry itself. Assistance to MoFE would focus on (i) creation and delivery of an accrual-based accounting methodology training program for the staff and management of the supervisory authority; (ii) development of a strategy and plan to introduce compulsory insurance; (iii) development of an economic model for tracking insurance sector developments and exposures that create an early warning system on potential industry problems by modeling financial assumptions and risk ratios, and associated training; (iv) strengthening inspection policy and procedures, backed by manuals, training, etc.; (v) creation of new budgetary processes for the supervisory authority; (vi) development of a licensing database to license and track insurance industry members and intermediaries; (vii) establishment of actuarial capacity; (viii) training in insurance market surveillance and enforcement measures; (ix) training in financial reporting analysis, actuarial valuations/modeling/projections, auditing, valuation of insurance company holdings, and investment policies/instruments, etc.; (x) definition of insurance company information technology (IT) system capabilities; and (xi) revision of rules regarding customer complaints and claims paid. Assistance to the MoFE would be complemented and reinforced by assistance to the industry focused on (i) communication with businesses and households on insurance protection, insurance products, and assessing and managing risks; (ii) industry statistics; (iii) links to industry member websites; (iv) development of a customized insurance industry association training program; (v) capacity to act as self-regulatory organization (SRO) for industry members; and (vi) capacity to serve as a central source for a national market database for demographic data.		
Strategic Consideration	**Prospects**	**Comments**
Comparative Advantage for USAID	Moderate	USAID advantage, along with others
Sustained Long-term Impact	Moderate	Will help over time, but will take time and resources
Major Results from Budgetary Resources	Moderate	Density and penetration are so low that significant time and resources would be needed to generate a major impact
Fill Major Gaps	Moderate to High	Other donors may have plans to advance the insurance sector; USAID should coordinate to avoid duplication of effort
Strategic Fit with SO 1.3	Moderate to High	Main impact would be increasing financial services, possibly introducing capacity for asset management (e.g., in the pension field), and possibly providing an opportunity for institutional investors to utilize the capital markets; would indirectly increase access to credit for some enterprises, as well as housing finance for households
Confidence of Success	Moderate	Insurance sector development will help with overall competitiveness, but unclear how long this will take

E. Additional Options for Consideration

Other areas of importance and institutional considerations are mentioned below. In some cases, they are not recommended for USAID involvement at the moment due to timing issues and resource requirements (time and money). In other cases, they are rejected as stand alone projects, but recommended as partners/components of some of the initiatives described above.

Capital Markets Development: The capital markets are underdeveloped in Armenia. In the long run, securities market development will assist businesses with needed additional financing, and reduce the risk of becoming excessively dependent on bank financing for term credit. However, USAID has had poor success in stimulating securities market development in small and largely uncompetitive economies, including Armenia. USAID is encouraged to bypass capital markets development as an area of focus for now. Rather, preconditions for a viable market (e.g., accounting and audit to meet market disclosure standards) are needed for corporate and mortgage bonds, and equities and asset-backed securities. It is uncertain if any municipalities apart from Yerevan would have the capacity to issue municipal bonds, at least for the foreseeable future given underdevelopment of capacity, absence of experience with property tax collection, and the small size of towns outside of Yerevan. Once basic banking is in place, a broader government securities market is in play through the local exchange, and there is movement in the insurance and pension fields, securities markets will then be worth a look. However, for now, USAID resources should be prioritized based on the recommendations listed above, rather than pursuing a comprehensive capital markets development project. (Specific pilots projects have been noted in the five core recommendations regarding listings and the issuance of either equity or bonds (e.g., corporate, mortgage) by SMEs, banks and credit organizations as part of a concerted effort to improve governance and accountability as a function of increasing funding, credit and investment.)

In the event that USAID does choose to pursue a broader capital markets development initiative, recommendations for assistance are noted in Annex 10. These include:

- Standardization of listings.
- Trading government securities on the local exchange.
- Product development.
- Establishing Government Securities (“Gilt”) Funds.
- Developing a municipal bond market, particularly linked to a strategy to develop “Special Enterprise Zones”.
- A program of borrowing and lending securities to encourage market liquidity.

Establishment of an Enterprise Fund: USAID-supported enterprise funds have achieved notable successes in many transition countries. They provide a market-based approach and flexibility with regard to the kinds of enterprises and financial institutions in which to invest and manage. In general, this would make an Armenian-American Enterprise Fund, or Caucasus-American Enterprise Fund attractive. On the other hand, because resources are already widely available from donors and the diaspora community, it is recommended that USAID not pursue this approach. Rather, the recommended approach is to strengthen the system so that private capital from domestic and foreign sources will locate in Armenia based on confidence in expected returns. However, if USAID decides it does want to support a Fund, there are suggestions on the establishment of Closed-End Funds in support of investment in government securities, municipal bonds, and potentially other securities by focusing on the diaspora community (see Annex 10). Likewise, if USAID wants to pursue a Fund, the SME listing initiative and preparatory work for secondary mortgage market development could be embedded as part of this initiative.

Lines of Credit: Lines of credit are not recommended for USAID. Other donors have them in place, or are contemplating them. There are banks with donor funds made available. The KfW-GAF project has provided an example of practices that work in the system. Meanwhile, USAID has not always had success with such projects. As such, USAID's resources would be more useful supporting the initiatives identified above.

Guarantee Fund: As with lines of credit, USAID and others have not always had success with guarantee funds. As such, there has been movement (along with other donors) to introduce or make available a range of guarantee facilities in support of increased trade and investment. Some of these guarantee facilities already exist for Armenia, including from the USAID (DCA facilities). There are ample sources of guarantee facilities, including from OPIC, MIGA, IFC, and many European and other OECD countries. Moreover, most of Armenia's larger enterprises, and many of its export-oriented enterprises, have access to foreign loans or other credit sources (e.g., trade credit). Banks should be encouraged to strengthen internal systems, seek out lines of credit from correspondent banks (for off-balance sheet services to companies such as performance guarantees), and retain earnings to boost capital, rather than relying on donor guarantee facilities to defray risk or to top up loan facilities. To the extent these are unavailable there may then be a role for the use of provided facilities. However, as DCA is already available, USAID is encouraged to dedicate future resource flows for alternative purposes.

Leasing: Leasing is underdeveloped in Armenia, and there is clear demand coming from enterprises as well as the banks. The IFC has taken the lead on this issue, and Acba Bank has already established a leasing company. USAID's contribution to leasing development, particularly as a vehicle for SME leasing, should be reinforced through any work carried out in legal reform and the secured transactions framework, including assistance (if offered) in developing moveable property registry systems and their uses as pledges. However, there is no clearly identified need for direct financial or technical assistance from USAID in leasing market development.

Micro-Finance Institutions: USAID has supported five MFIs to date, with variable success. The work of some of the MFIs has been reported to be good. Total MFI loan volume approximated 5 percent of total bank credit as of late 2004. However, MFIs generally have small loan limits, and they are prevented from mobilizing deposits. Some donors are reported to be interested in providing some of the MFIs with additional funds. At a minimum, USAID should promote a policy of commercialization and financial sustainability to the extent possible, recognizing that the mandate of some MFIs is less commercial in orientation, and more focused on humanitarian relief. To advance potential for sustainability, linkage to the banking system in seeking out back-up financing facilities (similar to what banks consider "factoring") should be encouraged. Likewise, banks should be encouraged to work with MFIs to co-finance from a credit standpoint, given that MFIs often have a documented track record of performance for individual borrowers over time. A possible role for AAAA in preparing statements for banks by MFI borrowers might also help as some of the larger MFI borrowers increase their demand for funds and begin to exceed loan limits available from MFIs. In general, as a form of income relief and small credit, MFIs can be helpful. However, their contribution to secular levels of productivity and employment are unclear. Thus, in terms of financial sector development, USAID should be focusing more on building the banking system where most resources will flow over time, and where intermediation will eventually have a material impact on the economy.

Expanding Financial Services via the Postal Network: One of the main constraints in Armenia is the lack of access to financial services outside of Yerevan. This is largely due to the weak level of purchasing power, and general concentration of people, businesses and resources in the capital city. However, it is also a function of a weak branch system, with only two banks having a major presence outside of Yerevan and those banks having limited investment in electronics and technologies to date. With that context, modernizing the postal system might be an option. However, because ATMs represent a cheap method of deposit mobilization, and because there are such limited credit and investment opportunities outside of Yerevan, a major initiative at this point is not recommended. However, one alternative that USAID could consider supporting would be a pre-feasibility study on how the postal network could lease out space or issue management contracts to one or more market players as a basis for enhancing the range of financial services provided. This would serve as a way to provide financial products and services not currently offered, and to stimulate competition. It could be structured on a low- or no-risk basis to the postal system, with commercialization of additional products and services simply bringing in more traffic and increasing revenue flows that otherwise would not occur.

Deposit Insurance: The deposit guarantee fund is slated for introduction on July 1, 2005. It is currently being monitored by CBA, and receiving useful technical and financial assistance from KfW. Thus, there is no current reason for USAID to include deposit insurance in its assistance program. Any overlap between CBA supervision and the deposit guarantee fund should be coordinated through CBA with KfW and the IMF.

Payment and Settlement System: The only activity recommended for support by USAID would be efforts to tighten controls on money laundering and other financial crimes. However, this is currently being carried out by the Council of Europe in conjunction with FATF. Should there be a need for assistance and training in this area, USAID should consider this. This could be tied to efforts to strengthen banking supervision and outreach to the banking community as a function of larger efforts to strengthen the reputation of Armenia's banking system. If so, this would all obviously be coordinated with/through CBA, as well as the FIU and the IMF.

Credit Ratings and Information Disclosure: There is a need for credit ratings and information to help raise intermediation levels in Armenia. Initial efforts are under way via ACRA, with CBA and World Bank support. There may be a role to play, but for now ACRA has received private investment and is in the process of trying to put its information systems together. Thus, there is no currently identified need for USAID assistance at this juncture.

Associations: There should not be a stand alone project with business associations. However, training needs have been identified in each of the five core recommendations, and these can and should be coordinated through the various associations identified in banking, insurance, accounting/audit, and real estate development and appraisal.

Training Institutes and Management Capacity: There is a Bank Training Institute that has received mixed reviews. There may be scope for increasing USAID's role in this area, particularly if linked to the Financial Stability Institute in Basle, IAIS and IOSCO, and coordinated through CBA, MoFE and the Securities Commission. However, with support from other donors, there is no pressing need for USAID to support a broad effort at the moment. On the other hand, given the substantial training and institutional capacity-building components mapped out in the recommendations, there may be a role for one or more institutes to play in boosting capacity.