ANNEXES

ANNEX 1: MATRIX OF DEFICIENCIES AND PROPOSED RECOMMENDATIONS

Table 1: Summary of Financial Sector Deficiencies & Vulnerabilities

Financial Area	Deficiencies & Vulnerabilities	Market Segment Most Impacted by Deficiency	Causes for Deficiencies	Organizations Currently Addressing Deficiencies or Best Suited to Do So
1. Financial System Composition & Structure (see Annex 3 for a full discussion of banking issues, Annex 7 for housing finance, Annex 8 for insurance, Annex 9 for pension, and Annex 10 for securities markets)				
General	Lack of financial services diversification and depth; banks are small, yet account for 90% of financial services; small size results in low after-tax earnings (<$1 million per bank in 2004; <$15,000 per active insurance company in 2003)	All financial institutions and the economy at large, since banks are also small; insurance is very small, capital markets virtually non-existent, and non-banks microscopic.	Lack of confidence in financial institutions, major lack of confidence in government institutions, fears of arbitrary tax garnishing of accounts, and low levels of savings and investment	IMF best suited for macroeconomic issues, World Bank for coordination on structural issues, CBA, USAID and IMF on banking supervision issues, MoFE, World Bank and USAID on insurance issues, KfW on deposit insurance issues; KfW has been most active with banks in terms of lending (GAF), and IFC in terms of leasing
Banks	Small financial measures reflect low levels of activity and market penetration; bank assets-to-GDP <25% (2004); average bank assets <$40 million (2004), loans about $15 million per bank (2004), deposits <$25 million per bank (2004), and capital <$7 million per bank	Small banks increasingly finding it harder to compete; HSBC dominates deposit mobilization, making it difficult for others to generate needed funding	Lack of experience with market-based banking, weak legal traditions re loan recovery, inadequate information, risk aversion during a period of tightened supervision from CBA, easy profits from low-risk securities in recent years while interest rates were high (DRAM), and unwillingness to lend due to perceived project and firm risk in an unstable environment	CBA, IMF, World Bank and USAID

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	Small scale of operations has limited earnings opportunities	Banks in general apart from HSBC and a few others that are generating earnings from relatively low-risk operations (Anelik)	Most banks are spin-offs from the earlier Gosbank system, or are relatively new banks; with stabilization in the last few years, banks' lending opportunities have been subject to exposure limits; weak earnings have also limited the amount of investment banks can make in their operations to increase efficiency and generate more scale; most of the market (real sector) is small, either households or very small businesses	CBA, IMF, World Bank and USAID
	Foreign investment from major banks has been limited to HSBC; while nine Armenian banks have foreign capital, only HSBC is considered a prime-rated bank	System generally shows a lower level of development in terms of products and services due to the limited amount of major foreign investment, reducing effective competition	The small market, limited purchasing power of most people, traditional cash orientation of transactions, political risk and corruption all reduce the incentive for investment	CBA, KfW (link to Pro-Credit or other possible bank investment), IFC and/or EBRD and/or Shorebank and/or others (on the condition they have a good strategic partner to manage operations and/or provide board oversight)
Insurance	Companies are small in assets and capital ($3.2 million at year-end 2003, or less than $170,000 per active company), show little in the way of premium revenues and earnings;	Virtually all insurance companies; only a few are expected to be able to operate competitively with the new legal and regulatory regime	There is no mandatory insurance, even for third party motor vehicle, resulting in lagging indicators and size relative to international norms	MoFE, World Bank and potentially USAID and/or EU
	Absence of major foreign investment in the insurance market (although high level of reinsurance) results in low levels of competition	All insurance companies show little in product array, service levels	Unattractiveness and political risk of the market has stifled foreign investment; inability of domestic insurers financially to handle potential claims in the event policy terms have to be honored has triggered major reliance on reinsurance	MoFE, World Bank and potentially USAID and/or EU

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Pension Funds	Absence of professional management, and no audit or public oversight of the first pillar	Capital markets do not have institutional investors, and retirees in general are vulnerable to misuse of collected funds	Concerns about fiscal transition in the event first pillar resource flows are diluted	IMF and World Bank; local counterpart to be defined
	Absence of institutional investors	Pensioners and capital markets	Fiscal worries (see above), small market, political risk, lack of regulation, political opposition, etc.	World Bank and USAID; Securities Commission and other local counterparts to be defined
Securities Markets	No real activity or debt/equity instruments apart from government securities despite infrastructure being in place	Large-scale enterprises, some medium-sized enterprises, some banks	Closely-held management of companies, lack of IAS/IFRS tradition, inability/unwillingness to meet disclosure requirements, weak financial condition	Securities Commission and USAID
	Small government securities market	Institutional investors	Limited flotation to date by GoA, limited volume of securities with maturities >1 year, absence of yield curve, no real capacity at municipal levels for bonds	Securities Commission and USAID
Non-bank credit organizations	Small in assets and capital	Banks as source of borrowers ready to "graduate" from micro-finance plus MFIs/others as potential clients for refinancing facilities	Non-bank credit organizations are generally small or nascent; leasing just beginning, formal housing finance just taking off	CBA, USAID, EU-Tacis, NGOs
2. Financial Sector Infrastructure (see Annex 4 for a full discussion of banking issues, Annex 7 for housing finance, Annex 8 for insurance, Annex 9 for pension, Annex 10 for securities, and Annex 11 for overall legal issues)				
General Legal and Judicial	Unreliable court system raises risks regarding creditors' rights and the rights of minority shareholders	Lenders and investors	Absence of training in commercial law and role of the courts in enforcing contracts under market-based terms	Ministry of Justice, World Bank and USAID

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	Collateral enforcement weak	Banks are more risk-averse with lending	Absence of a unified and digitally accessible registry for moveable and immoveable items, and title issues related to the ownership of property	State Cadastre and USAID
	Judicial capacity inadequate	Lending and investment in general, therefore economy as a whole	Orientation and experience not market-based (at least until very recently), insufficient capacity and support in the system (information systems, management and administrative training), time required to adapt to new legislation	Ministry of Justice, World Bank and USAID
	Alternative dispute resolution and arbitration underdeveloped	Economic Courts backlogged, slowing commercial dispute resolution and adding to perception of risk	Relatively new and underdeveloped, although reported to be working in some cases	Ministry of Justice and World Bank
Regulation and Supervision	Risk-based techniques new to Armenia, with most banks still operating on a rules-based approach	Regulated institutions operate on a rules-based approach, sometimes constraining willingness of inclination to assume risk	Natural evolution during stabilization period, particularly as non-banks underdeveloped	CBA, IMF, USAID and (potentially) BIS
	Supervision not consolidated	General economy due to underdevelopment of the system and limited risk-taking	Underdevelopment in non-bank financial services	CBA, MoFE, Securities Commission, IMF, USAID and (potentially) BIS as well as other local counterparts to be defined
	Mandate for supervision challenged by debtors and bankers with strong political connections (although supervisors' mandate has been strengthened in recent years)	Weaker mandate has added to risks and costs	Legal environment not always supportive or risk-takers' contractual rights or borrowers' contractual responsibilities	CBA, Ministry of Justice, IMF, USAID and (potentially) BIS

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	Partial compliance at best (or non-compliance) with some key Basel Core Principles in banking supervision, namely governance and consolidated accounting/supervision	Pervasive problem in economy; weak governance reflects small institutions and underdeveloped systems relative to potential risk-taking	Traditional management and board structures inconsistent with recommended standards of governance; accounting profession underdeveloped, and use for management purposes not actively supported or appreciated due to disincentives in the system (re tax avoidance, etc.); absence of legislation on consolidated (parent/holding) companies permits fragmentation and adds to difficulties	CBA, IMF, USAID and (potentially) BIS and other local counterparts (MoFE, Securities Commission, etc.)
	Securities and insurance regulators have had little market experience	Has stifled NBFI development	Real sector avoids needed financial disclosure for market purposes; absence of liquid investors in market; insurance sector regulator (MoFE Insurance Inspectorate) under-budgeted, under-equipped/staffed, and inexperienced re new regulations	MoFE, Securities Commission, World Bank (insurance) and USAID (securities markets)
	No structure or program in place for pension reform, including regulation and supervision	Has stifled institutional investor development and capital markets development	Government unwillingness to move ahead with anything bolder than administrative improvements to the first pillar	World Bank and USAID; local counterparts to be defined
Payment System	Low levels of usage relative to number and volume of transactions as a whole; small (low) value payments relatively new and underutilized	Most transactions occur outside the formal system	Tax evasion, concerns about disclosure that could trigger garnishing	CBA and IMF
Accounting and Audit	Presence of only two international firms, limited capacity in international standards, and legalistic/government-directed approach to professional development	Economy as a whole is adversely affected due to poor governance, absence of management capacity, weak internal audit, poor levels of transparency and disclosure	Small market and political risk result in low level of involvement of major accounting firms; MoFE control and failure to move to a standards-based approach has stifled domestic capacity and undermined general policy commitment to international standards	USAID (with AAAA)

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Credit Information	CBA registry mainly for supervisory use, and ACRA facing major challenges compiling information for comprehensive credit bureau	Economy as a whole as absence of reliable information makes credit risk evaluation more difficult, stifling lending and investment and adding to the risk premium	Traditional aversion to information disclosure makes this a challenge from the start; banks are reluctant to freely provide ACRA with internal information on prospective/existing borrowers, and then have to pay for services	CBA, World Bank, USAID
Associations	Bankers and insurance associations are playing role in evolving legal and regulatory framework, but do not appear to serve as clearinghouse for industry data/trends, market information, or professional development needs	Underdevelopment of financial services, including product and service development	Financial institutions are small, fragmented, and not used to collaborating on initiatives of joint interest for market development	USAID and (potentially) European Union with bankers, insurance, realty and appraisal associations.
Banking Legislation	Existing legislation (joint stock company law) does not recognize the principle of limited liability.	Stifles investment into banking.	CBA focus on adherence to fiduciary responsibilities of bank owners/managers.	MoJ, CBA, IMF, World Bank, USAID and (potentially) BIS.
	Foreign bank branches not permitted to mobilize deposits.	Adds disincentive to investment into banking sector.	CBA concerns about lead supervisory responsibility.	MoJ, CBA, IMF, World Bank, USAID and (potentially) BIS.
Insurance Legislation	Flawed definition of statutory capital in defining capital adequacy.	Insurance	Oversight in drafting due to inexperience with solvency provisions of insurance companies.	MoJ, MoFE, World Bank and (potentially) IAIS.

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	Unnecessary restrictions on foreign investment	Stifles investment into insurance sector and market development as a whole	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.	MoJ, MoFE, World Bank and (potentially) IAIS.
	The marketing and selling of insurance products through independent agents is prohibited.	Greatly reduces the use of insurance products because insurance companies are not likely to employ the required workforce.	Oversight in drafting due to inexperience with market development of insurance industry.	MoJ, MoFE, World Bank and (potentially) IAIS.
	No clear specification of the insurance supervisor's responsibilities and objectives.	Stifles investment into insurance sector and market development as a whole	Oversight in drafting due to inexperience with regulation and supervision of insurance industry.	MoJ, MoFE, World Bank and (potentially) IAIS.
	The absence of protocols for the insurance supervisor to work closely and exchange information with other domestic and foreign financial supervisors.	Stifles investment into insurance sector and market development as a whole	Oversight in drafting due to inexperience with regulation and supervision of insurance industry.	MoJ, MoFE, World Bank and (potentially) IAIS.
Pension Legislation	Draft Law does not provide a framework for the regulation of the pension business conducted by either banks or insurance companies.	Incomplete and fragmented regulation would create an uneven playing field.	Oversight in drafting due to inexperience with regulation and supervision of pension management and administration.	MoJ, World Bank, other local counterparts to be defined.
	Draft Law does not include any requirement to ensure the capital adequacy of pension funds.	Solvency is a must for sound pension management.	Oversight in drafting due to inexperience with solvency provisions of pension funds.	MoJ, World Bank, other local counterparts to be defined.

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	The draft Law does not contain any tax provisions, or make any statements about tax deductibility provisions for certain securities as opposed to others.	Absence of tax incentives will weaken participation in 3rd pillar and reduce prospects for institutional investment	Not yet specified as government policy.	MoJ, World Bank, other local counterparts to be defined.
	Draft Law has confusing provisions about governance and management of funds.	Needless layers and insufficient permanence of contract terms will undermine confidence and willingness to invest in 3rd pillar, and raise risks of solvency for 2nd pillar	Oversight in drafting due to inexperience with governance provisions of pension management and administration.	MoJ, World Bank, other local counterparts to be defined.
Securities Legislation	Several issuers of securities are exempted from having to publish a prospectus, such as banks, insurance companies, religious, educational, benevolent, and other non-commercial organizations. Short-term bond issues are also exempted from the prospectus requirements.	The exemptions from the prospectus requirements do not comply with internationally accepted principles	Incentive to list by easing entry requirements. However, this has proven ineffective.	MoJ, Securities Commission, World Bank and (potentially) IOSCO.
	Differing definitions of beneficial owner.	Adds confusion in knowing controlling interests in firms.	Inconsistency during drafting.	MoJ, Securities Commission, World Bank and (potentially) IOSCO.
	Inadequate provisions for capital adequacy of broker-dealers.	Small-scale brokers unable to make markets.	Oversight in drafting.	MoJ, Securities Commission, World Bank and (potentially) IOSCO.
	The Securities Law does not adequately clarify the securities supervisor's objectives re the financial soundness of broker-dealers and trust managers.	Limits securities market development.	Oversight in drafting, partly due to underdevelopment of market at the time.	MoJ, Securities Commission, World Bank and (potentially) IOSCO.

	Deficiencies & Vulnerabilities	Market Segment Most Impacted by Deficiency	Causes for Deficiencies	Organizations Currently Addressing Deficiencies or Best Suited to Do So
	Securities Law does not provide a practical and effective legal basis for close cooperation and exchange of information with other domestic and foreign supervisors	Stifles market development and investment.	Oversight in drafting, partly due to underdevelopment of market at the time.	MoJ, Securities Commission, World Bank and (potentially) IOSCO.
	Joint Stock Company Law allows payment of shares in kind, including money, securities and property rights, and intellectual property.	The option to pay in kind is regularly misused by majority shareholders to defraud the company and its minority shareholders because it is difficult to accurately price the value of the asset that is used to pay for the shares.	Oversight in drafting, partly due to underdevelopment of market at the time, and due to lack of traditional minority investor rights.	MoJ, Securities Commission, World Bank and (potentially) IOSCO.
	Company management typically conducts "asset stripping" or "tunneling" practices.	Weakens minority investor rights, and stifles investment into companies and the securities markets	Oversight in drafting, partly due to underdevelopment of market at the time, and due to lack of traditional minority investor rights.	MoJ, Securities Commission, World Bank and (potentially) IOSCO.
Legal and Regulatory Issues for Non-bank Credit Organizations	Underdeveloped legal framework for secondary mortgage markets	Primary market just beginning, but eventual movement to secondary market will need a better legal and judicial framework plus property registry and pledge registry	No structures currently in place for securitization, and uncertain legal environment for property sales into secondary market	MoJ, Securities Commission, IMF, World Bank, USAID and KfW; IFC interested in training
	Leasing repossession still untested	Leasing just beginning, but repossession cases still not tested if contract dispute	Uncertain legal environment, although law considered satisfactory for leasing	MoJ, IFC (with some USAID support)
	NBCOs such as MFIs fear over-regulation of CBA	MFIs not yet regulated by CBA	Shift from foundation status to status of financial institution regulated by CBA	CBA, USAID, NGOs

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3. Financial Sector Development Based on Prudential Norms (see Annex 5 for a full discussion of banking issues, Annex 7 for housing finance, Annex 8 for insurance, Annex 9 for pension, Annex 10 for securities, and Annex 11 for overall legal issues)				
Banking	Banking capital is low (not to exceed $7 million on average by year end 2004), although CARs are high (about 34%)	Limits opportunities for intermediation due to exposure limits	Typical of most CIS banks; also reflects lack of investment from major foreign banks, and limits to consolidation over the years (notwithstanding large number of bank closures)	CBA, IMF and USAID; IFC and/or EBRD and/or KfW and/or Shorebank and/or others if inclined to invest in existing banks with strategic partners
	After-tax earnings are low (<$1 million on average in 2004) due to small size and limited array of services, although RoA/RoE measures not bad	Limited earnings impedes capital formation needed for growth, product and service development	Reflects small size of banks, limited range of products and services; also reflects low productivity of employee base, mainly due to limited revenue generation per employee	CBA, IMF and USAID
	Net spreads are high, which is due to high interest rates charged on loans	Adds to costs to borrowers, but can also reduce credit quality if change in market reduces cash flow of borrower	Risk premium assigned to borrowers and business environment, combined with inefficiency of the loan origination process and small volume of funding (which drives up interest rates on loans due to scarcity of loans)	CBA, IMF and USAID
	Liquidity management less efficient than could be due to thin inter-bank market	Affects almost all banks	HSBC dominates deposit mobilization, and most banks do not trust other banks' credit worthiness, resulting in large cash balances held by banks for cover; little retail banking development, also contributing to low levels of deposit mobilization (apart from HSBC)	CBA, IMF and USAID; KfW helping with deposit insurance, which may help with deposits
	Funding base of banks largely deposits and capital, even though both are small	All banks apart from HSBC	Non-deposit liabilities are scarce for banks, and capital is small, increasing their reliance on deposits; reasons include traditionally weak service delivery, under-developed retail banking services, larger issues related to tax avoidance and the grey market, and troubled condition of many/most large-scale enterprises.	CBA, IMF and USAID; KfW helping with deposit insurance, which may help with deposits

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	Outstanding concerns about capacity for management of credit and market risk at banks, and sufficiently early detection at CBA as the systems becomes more complex in the coming years	Not a problem now, but could be in the future unless addressed now in anticipation of future risks	Lack of market development, and recent focus on stabilization	CBA, IMF and USAID
	Credit risk issues could emerge in the event of a political crisis in Armenia or Russia, or downturn in the economy	Banks have rudimentary risk management systems, and external forces or internal developments could expose asset bubbles (real estate), constrain export markets or lead to a reduction in remittance flows to Armenia	The legal framework still is to be tested in several cases that could involve loan recovery efforts; banks are lending for housing without fully protected positions	CBA, IMF, World Bank, USAID, KfW
	Banks have some market risk in their portfolios, although these are limited due to small size of long-term loans and prudent observation of open foreign currency positions	Growth in asset-liability mismatches could expose some banks to currency or interest rate risk	Banks still have low levels of funding with maturities of one year or more	CBA, IMF, World Bank, USAID, KfW (deposit insurance)
	Currency mismatches are a potential risk	This could add to market risk for some banks if they become more aggressive in lending or issuing guarantees/trade finance instruments	Banks' funding is largely in foreign currency, yet most enterprises' reported revenues and earnings are largely in local currency	CBA, IMF, USAID
	Country risk associated with Armenia is high, adding to costs	Risk premium associated with Armenia adds to transactions costs and the costs of credit for borrowers	Peer ratings point to uncertain protection against losses, limited safety, and vulnerability to losses from credit default. Other unofficial measures of risk for Armenia indicate moderately high political risk, low institutional investor credit ratings, and generally weak credit worthiness	CBA, IMF, World Bank

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Insurance	Low capital, weak earnings and inadequate supervision reflect lack of sustainability under current conditions	All insurance companies, along with pension reform (insurance companies potentially as asset managers or administrators) and securities markets (insurance as institutional investors)	Traditional approach to insurance which has been non-mandatory, resulting in very low penetration and density	MoFE, World Bank and USAID, possibly EU
Pension	Absence of political will undermines long-term sustainability and development of institutional investment	Contractual savings and securities markets	Resistance to change in status quo; vested interests benefiting from current arrangement	World Bank and USAID; local counterparts to be defined
Securities	Lack of free float in system reinforces general lack of transparency, making markets non-viable	Non-government securities market	Absence of adequate financial disclosure, non-observance of minimum free-float provisions, weak legal framework for minority rights, poor governance standards	Securities Commission, USAID and (potentially) IOSCO
Non-bank Credit Organizations	Low levels of capital can trigger small-scale insolvencies if problems emerge with portfolios, weakening confidence	Mortgage finance market is the most likely to be affected if there is a problem with asset values and secondary markets (securitized or not) are not developed	Nascent stages of development for most non-banks	CBA, World Bank, IFC, USAID, possibly KfW
4. Financial Sector Intermediation Indicators (see Annex 6 for a full discussion of banking issues, Annex 7 for housing finance, Annex 8 for insurance, and Annex 10 for securities)				
General	Lack of financial breadth and depth; bank assets <25% of GDP; M3-to-GDP will not likely exceed 21% in 2004; insurance premium revenues are among the lowest in the world, at about $205,000 per active firm (2003) or $2 per capita	All financial institutions and the economy at large	Key causes for deficiencies are low levels of deposits in banks, lack of confidence in financial and government institutions, fears of arbitrary tax garnishing of accounts, and low levels of savings and investment.	World Bank for coordination on structural issues; CBA, USAID, IMF on banking supervision issues; MoFE, World Bank, USAID on insurance issues; KfW on deposit insurance issues; KfW has been most active with banks in terms of lending (GAF), and IFC in terms of leasing

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Banking	Low levels of deposit mobilization limit funding, therefore available resources for intermediation are limited	Banks, particularly all but HSBC which is turning away depositors	General lack of trust and confidence in institutions making resource mobilization and intermediation more difficult; business environment still perceived to be unfavorable, resulting in high levels of tax evasion; fears of garnishing of accounts	CBA, IMF, World Bank, USAID, KfW (deposit insurance)
	Low levels of lending (about 9% of 2004 GDP)	Households and SMEs that are credit worthy	Traditionally weak creditor rights combined with recent prudential norms to stabilize banking have made banks particularly risk-averse, reinforced by easy earnings from what are perceived to be risk-free securities	CBA, IMF, World Bank, IFC, USAID, KfW, EU-Tacis (business outreach/advisory), EBRD
	Most banks are characterized by a paradoxical approach: the absence of specialization triggering a desire to become "universal" despite being undercapitalized.	Banks are only at the beginning of development to "full-service" banks, so developments need to be monitored relative to risks assumed	Low levels of capitalization, poor market data and limited tradition of catering on a service-oriented basis have prevented Armenian banks from emerging as effective full-service banks.	CBA, IMF, World Bank, USAID, KfW, GTZ (training)
	Risks associated with most large-scale enterprises and the banks' own lending limits (driven by prudential limits and small levels of capital) mean that banks have to pursue the SME and retail market to generate reasonable earnings.	Banks will need to provide a meaningful array of financial products and services and be more active in pursuing SMEs.	Banks' capital is generally insufficient to meet the borrowing and capital requirements of larger enterprises	CBA, IMF, World Bank, USAID, GTZ, possibly IFC and/or EBRD and/or KfW and/or Shorebank and/or others if they invest with strategic partners
	The system needs increased capital, improved technologies, and better management systems for the banking system to be competitive and to offer better products and services to the marketplace	Banks in general, with the exception of HSBC and perhaps a few others	Shortage of major foreign investment has slowed development of the system	CBA, IMF, World Bank, possibly IFC and/or EBRD and/or KfW and/or Shorebank and/or others if they invest with strategic partners

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	Market research has been hampered by the absence of viable market information. Combined with limited useful financial information and a fragmented market, such tendencies will keep banking fairly fundamental for the time being.	Banks have to rely on individualized requests, and most banks have shown little or no inclination to pursue business in an innovative way. This partly relates back to the traditional culture of most of the banks, closely held and tied to a few cronies.	Traditional non-disclosure has been the main constraint. The Armenian Bankers Association has not undertaken any major initiatives that would pool information for its members. The Armenian Credit Rating Agency could process systemic information, which could then be used by banks' internal data bases to develop new products or services. However, as of late 2004, most banks do not appear interested.	World Bank, IFC and USAID
	Access to finance remains difficult for many supply and demand reasons.	Generally low levels of intermediation across the economy, notwithstanding encouraging increases in 2004.	Underwriting standards have tightened, collateral requirements are in effect, and banks require reasonable disclosure and more business from clients to track cash. Demand-side obstacles are perceived to be collateral requirements, insufficient loan principal, expensive interest charges, insufficient maturities, and sometimes cumbersome reporting requirements.	Multitude of donors and government institutions working on enterprises and financial institutions
Insurance	Low penetration (revenues about 0.1% of GDP) and density ($2 per capita)	All financial services	There is no mandatory insurance, even for third party motor vehicle, resulting in lagging indicators and size relative to international norms; unattractiveness and risk of the market has stifled foreign investment and general role of insurance in the market	MoFE, World Bank, USAID, and (potentially) IAIS
Pension	No real role as only pension fund is PAYG and administered wholly by government	Contractual savings and securities markets	No professional management of pension system due to concerns about fiscal transition in the event first pillar resource flows are diluted, resulting in small market, lack of regulation, etc.	World Bank and USAID; local counterparts to be defined

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Securities	Very little role apart from potentially offering a small platform for government securities market trading	Large- and mid-sized companies as well as banks and other financial institutions	Closely-held management of companies, lack of IAS/IFRS tradition, inability/unwillingness to meet disclosure requirements, weak financial condition of most companies limit prospects for securities markets apart from government; unwillingness of local investors and diaspora community to invest limits prospects for local market to develop	Securities Commission, USAID and (potentially) IOSCO
Non-bank Credit Organizations	Low levels of lending outside the banks (NCBOs <5% of banks at about $13 million)	Micro-enterprises and poor households	Small size of loans characterize most micro-lending programs	CBA, USAID, humanitarian groups/NGOs, micro-finance groups
Housing Finance	Banks account for less than 10% of housing transactions, which are generally done on cash basis	Opportunity cost for banks	Banks lack long-term funding, and legal/institutional support structures (e.g., property registries) not adequately in place	CBA, IMF and USAID, potentially KfW, World Bank, IFC

Table 2: Summary of Recommended USAID Interventions

Financial Area	Deficiencies & Vulnerabilities to Be Addressed by USAID	Recommended Strategies to Address Deficiencies	Recommended Interventions & Tactics Associated With Strategies	Expected Results from Interventions and Tactics With Specific Commentary on Impact on Affected Market Segment
1. Financial System Composition & Structure (see Main Report for description of Recommendations and how they fit into the general financial sector diagnostic assessment; see Annex 3 for a full discussion of banking issues, Annex 7 for housing finance, Annex 8 for insurance, Annex 9 for pension, and Annex 10 for securities markets)				
Banking	Low intermediation levels	Focus on development of housing finance to build general systems for secured lending, and broader training to bankers via Armenian Bankers Association for improved governance and systems, credit risk management, new product development, etc.	Sound legal framework for primary and secondary market development. Comprehensive property and pledge registry system with clear ownership rights, electronic inter-face, and open digital access by creditors to records for credit risk evaluation. Training in underwriting standards. Strengthening of accounting and audit standards and capacity. Development of credit risk management systems. Standardization of mortgage finance procedures to increase primary market volume and stimulate movement to secondary market development. **This effort is expected to be short-, medium- and long-term.**	Increased supply of and access to financial services. Growth of loan syndication and securitization. Issuance of corporate and mortgage bonds to obtain term financing for lending, leasing and asset-liability matching. Evidence of increased investment from diaspora community.
		Strengthen property rights and contract enforcement via institutional framework for secured transactions	Short-, medium- and long-term assistance: Work with State Cadastre and Ministry of Justice to finalize a comprehensive immoveable property registry, and to establish a moveable property registry. Establish a comprehensive, real-time pledge registry. Ensure all records are digitally accessible and available to potential lenders and investors as part of the overall credit risk evaluation process. (See Main Report, Option #3.)	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.

Financial Area	Deficiencies & Vulnerabilities to Be Addressed by USAID	Recommended Strategies to Address Deficiencies	Recommended Interventions & Tactics Associated With Strategies	Expected Results from Interventions and Tactics With Specific Commentary on Impact on Affected Market Segment
		Increase inventory of bank and NBCO loan assets for housing and commercial property development.	Assist banks via Bankers' Association with product development, market research, valuation and appraisal, and general underwriting and credit risk management. (See above and Main Report, Options #1 and 3.)	Increased share of high quality housing loans (and commercial property loans over time) that could eventually be packaged into secondary market instruments.
		Evolution of secondary markets, and growing diversification of instruments (debt and equity), pricing, maturities, and related features	Assist banks via Bankers' Association and CBA with development of a legal and regulatory framework for secondary market development for mortgage-backed securities and mortgage bonds. (See above and Main Report, Option #2 and 3.)	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.
		Increase funding base of banks via private placements and bond issues.	Assist with prospectus development for issuance of corporate and mortgage bonds. (See Main Report, Options #2 and 3.)	Long-term funding via bank bonds and/or syndicated loan facilities instead of donor funds.
	Low confidence impedes deposit mobilization; risk of garnishing of accounts is reported to be a major contributor to perceived risks and reduced confidence in privacy of accounts	General statement of principles might be considered by government, including possible thresholds for an amnesty, and other measures before proceeding with a new framework for account garnishing.	Short-term assistance: Possible assistance on issues of protocols and judicial recourse regarding garnishing of accounts. (See Main Report, Option #1.)	Rising deposits, including on a term basis, and reduced concerns of most of the public of account garnishing.

Financial Area	Deficiencies & Vulnerabilities to Be Addressed by USAID	Recommended Strategies to Address Deficiencies	Recommended Interventions & Tactics Associated With Strategies	Expected Results from Interventions and Tactics With Specific Commentary on Impact on Affected Market Segment
	Small scale of operations and limited revenue sources apart from loans, currency exchange operations, and transfers	Promote consolidation via mergers and acquisitions, along with growth via new products, retained earnings and new investment, including from prime-rated foreign banks.	Short-, medium- and long-term assistance: Technical assistance as needed to bankers via Association (and CBA) to introduce new deposit and other liability instruments, and to encourage mergers and acquisitions. (See Main Report, Option #1.)	Well capitalized banks with adequate resources to generate sustainable earnings from diverse sources, and to generate RoA and RoE consistent with sound emerging markets norms. Increased interest registered from major foreign banks.
Insurance	Low penetration, density and product array	Encourage mandatory insurance and a sound legal and regulatory framework for a solvent, liquid and comprehensive insurance industry	Building up regulatory and supervisory capacity, and assisting market players via Insurers' Association to help set standards and build a viable market. 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. **This effort is expected to be short-, medium- and long-term.** (See Main Report, Options #1, 2 and 5.)	Greater insurance coverage and competition. Evidence of increasing financial discipline in the marketplace (in parallel with banks). Accumulation leading to institutional investment.

Financial Area	Deficiencies & Vulnerabilities to Be Addressed by USAID	Recommended Strategies to Address Deficiencies	Recommended Interventions & Tactics Associated With Strategies	Expected Results from Interventions and Tactics With Specific Commentary on Impact on Affected Market Segment
		Assistance to MoFE	Short-term assistance: Deliver an accrual-based accounting methodology training program for the supervisory authority. Develop a strategy and plan to introduce compulsory insurance. Assist in drafting law(s) and accompanying regulations. Assist with 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, and provide training. Develop insurance inspection manuals, and provide training. Create a new budgetary process for the supervisory authority free from political interference. (See Main Report, Options #1, 2 and 5.)	Modern accounting systems in place. Insurance sector modernization. Effective regulation and supervision. Narrowing of penetration and density gaps with other markets, with progress towards emerging market norms.
			Medium-term assistance: Develop a database to license and track insurance companies, brokers and agents. Develop actuarial capacity, and provide training. Prepare a supervisory authority training program in insurance market surveillance and regulatory enforcement. Training in financial reporting analysis for the Insurance Department. Auditing and valuation training for regulators 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. (See Main Report, Options #1, 2 and 5.)	Comprehensive and increasingly effective regulatory and supervisory oversight.

Financial Area	Deficiencies & Vulnerabilities to Be Addressed by USAID	Recommended Strategies to Address Deficiencies	Recommended Interventions & Tactics Associated With Strategies	Expected Results from Interventions and Tactics With Specific Commentary on Impact on Affected Market Segment
			Long-term assistance: Define insurance company information technology (IT) system capabilities. Revise rules regarding customer complaints, and statistical tracking of all claims made. (See Main Report, Options #1, 2 and 5.)	Convergence with international standards for operating systems, procedures, controls and accountability.
		Assistance to Insurers' Association	Short-term assistance: 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. (See Main Report, Options #1, 2 and 5.)	Increased provision of market information for market players, investors, and consumers.
			Medium-term assistance: Develop a customized insurance industry association training program. 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). (See Main Report, Options #1, 2 and 5.)	Implementation of international standards based on effective self-regulation as a complement to MoFE regulation and supervision.
Pension Funds	Assist with introduction of second and third pillar pension schemes	Work with local counterparts 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 PAYG system.	Develop adequate regulation and supervision, including in the fields of safekeeping, registration and reporting, investment policy, and consumer protection. **This effort is expected to be short-, medium- and long-term**. (See Main Report, Options #1, 2 and 4.)	Sound framework for a sound three-pillar pension system.

Financial Area	Deficiencies & Vulnerabilities to Be Addressed by USAID	Recommended Strategies to Address Deficiencies	Recommended Interventions & Tactics Associated With Strategies	Expected Results from Interventions and Tactics With Specific Commentary on Impact on Affected Market Segment
			Short-term assistance: Develop a project implementation plan with a recommended structure for pension companies, how contributions could be managed, and a sound structure for the supervisory authority for pension companies. (See Main Report, Options #1, 2 and 4.)	Effective strategic plan.
			Short-term assistance: Develop law and/or regulations which support the reformed system in terms of contributions, earnings, and benefit payments. (See Main Report, Options #1, 2 and 4.)	Effective legal and regulatory framework in place with sound prospects for long-term sustainability and clear stability during the transition.
			Short-, medium- and long-term assistance: Assist in the development of new financial institutions and/or financial products into which pension contributions are invested. (See Main Report, Options #1, 2 and 4.)	Evidence of movement to professional management and accumulation of assets in the second and third pillars.
			Short- and medium-term assistance: Develop and implement a public communication plan. (See Main Report, Options #1, 2 and 5.)	Increase public awareness and public confidence, with support for the second pillar and growth in voluntary third pillar contributions
			Short-, medium- and long-term assistance: Provide training for the regulatory authority on how to evaluate companies seeking to be licensed as a pension fund. (See Main Report, Options #1, 2 and 5.)	Strong reputation for licensing and oversight.
			Short- and medium-term assistance: Develop and implement a plan for flow of contributions for each voluntary occupational pension scheme. (See Main Report, Options #1, 2 and 5.)	Growth in voluntary third pillar contributions

Financial Area	Deficiencies & Vulnerabilities to Be Addressed by USAID	Recommended Strategies to Address Deficiencies	Recommended Interventions & Tactics Associated With Strategies	Expected Results from Interventions and Tactics With Specific Commentary on Impact on Affected Market Segment
NCBOs	Small in assets and capital	Development of mortgage finance markets	Assist banks via Bankers' Association with housing and commercial property loan product development, market research, valuation and appraisal, and general underwriting and credit risk management. (See above and Main Report, Options #1 and 3.)	Increased share of high quality housing loans (and commercial property loans over time) that could eventually be packaged into secondary market instruments.
2. Financial Sector Infrastructure **(see Annex 4 for a full discussion of banking issues, Annex 7 for housing finance, Annex 8 for insurance, Annex 9 for pension, Annex 10 for securities, and Annex 11 for overall legal issues)**				
Legal	Weak legal framework largely due to insufficient institutional support for effective enforcement in market-based context	Support for implementation of an effective secured transactions framework.	Short-, medium- and long-term assistance: Development of comprehensive, digitally accessible property and pledge registries. Assistance with judicial and extra-judicial (Economic Court) capacity enhancement for effective resolution of disputes and effective enforcement of contracts. (See Main Report, Option #3.)	Implementation of an effective legal framework consistent with commercial requirements of a market-based economy.
		Adopt customized Law on Collateral with focus on plans for secondary mortgage market development.	Short- and medium-term assistance: Develop adequate legislation on collateral to support secured transactions in general, but specifically to ensure there is a comprehensive legal framework in place for mortgage finance. (See Main Report, Option #3.)	Movement to secondary mortgage market products (bonds, MBS).
	Clarification of legislation and supporting by-laws in support of sound governance and ownership structures in support of increased investment and lending.	Assistance to help harmonize legislation and improve on existing shortcomings.	Short-term assistance: Work with local authorities and international organizations to facilitate adoption/amendments to legislation consistent with best practice. (See Main Report, all Options)	Comprehensive and consistent legal framework for banking, insurance, pension, capital markets, and non-bank credit organizations.

Financial Area	Deficiencies & Vulnerabilities to Be Addressed by USAID	Recommended Strategies to Address Deficiencies	Recommended Interventions & Tactics Associated With Strategies	Expected Results from Interventions and Tactics With Specific Commentary on Impact on Affected Market Segment
			Short- and medium-term assistance: Combine legal reform with commercial and financial training for effective enforcement. (See Main Report, Options #1, 3, 4 and 5.)	Responsible enforcement of comprehensive and consistent legal framework for banking, insurance, pension, capital markets, and non-bank credit organizations.
Regulation and Supervision in Support of Strengthened Governance	Risks to boost earning assets and after-tax returns will increase. As the financial system becomes more complex and risk-oriented, supervisory structures will need to be able to adapt to ensure underlying stability. Likewise, market players will require management and systems capacity, and effective board oversight, to manage these risks.	Assistance to CBA, MoFE, Securities Commission, and designated regulator for pension funds when reforms are put in effect, as well as Associations for observance and implementation by market players	Strengthen CBA contingency planning as part of a more developed corrective action framework in the event that key banks and/or the system at large encounter severe stress. Work with banks to identify, report and manage risks. Help MoFE, future pension regulator, Securities Commission and CBA with coordination as complexity increases and transfer risk opportunities emerge (in value and instruments). Help regulators to coordinate with the Financial Intelligence Unit. Encourage bank consolidation (e.g., mergers and acquisitions), and promote movement to consolidated supervision that is integrated and risk-based. **Assistance is envisioned as short-, medium- and long-term.** (See Main Report, Options #1, 2, 3, 4 and 5.)	Increased intermediation in banks, along with better risk management systems as the financial system becomes more complex and carries more risk; increased insurance activity backed by adequate solvency; movement to institutional investment, hopefully driving better standards for financial soundness and transparency as a condition for investment in non-government securities through the Armex
	Underdeveloped information and management systems for current and future risks to financial stability, particularly in anticipation of rising competitiveness and risk-taking.	Technical assistance via AAAA for consolidated accounting and supervision	Short- and medium-term assistance (possibly long-term): Establishment of a Steering Committee on Financial Services, for effective introduction and implementation of consolidated accounting and IAS/IFRS across all financial services. (See Main Report, Option #2.)	Effective implementation of consolidated accounting standards.

Financial Area	Deficiencies & Vulnerabilities to Be Addressed by USAID	Recommended Strategies to Address Deficiencies	Recommended Interventions & Tactics Associated With Strategies	Expected Results from Interventions and Tactics With Specific Commentary on Impact on Affected Market Segment
	Possible weaknesses to be strengthened re credit and market risk.	Technical assistance to CBA	Strengthen CBA contingency planning as part of a more developed corrective action framework. (See above and Main Report, Option #1.)	More advanced credit and market risk systems in place under more competitive banking conditions.
	Underdeveloped accounting systems for modern finance.	Technical assistance to market players, CBA, Association of Accountants and Auditors of Armenia, Ministry of Finance and Economy, Securities Commission, and future pension supervisory, along with cross-border supervisory counterparts	Promote movement to consolidated supervision that is integrated and risk-based. (See above and Main Report, Options #1, 2, 4 and 5.)	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.
	Weak governance capacity at banks, insurance companies and in the real sector, with a need for strengthened boards, management systems, internal audit, and more analytical use of detailed financial information	Technical assistance to market players via Associations, CBA, MoFE, Association of Accountants and Auditors of Armenia	Work with market players to strengthen governance standards and systems for support. (See above and Main Report, Options #1, 2, 4 and 5.)	Ensuring adequate corporate governance and management capacity in the banks, including clear ownership and avoidance of material conflicts of interest that can undermine stability.
Accounting and Audit	Under-developed accounting and audit profession.	Support movement to a standards-based organization.	Short-term assistance: Adoption of the EU 8th Directive as a model framework for the accounting and audit profession in Armenia. Mandatory membership of all auditors and accountants. (See Main Report, Option #2.)	Devolution to a standards-based regime via the AAAA, as opposed to the more politically direct (yet ineffective) approach exercised by the central government.
			Short-, medium and possibly long-term assistance: Responsibility to AAAA for ongoing certification and training, monitoring of performance by members and compliance with recommended professional standards, and discipline. (See Main Report, Option #2.)	More certified accountants and auditors. Evidence of increased use of financial information, higher levels of transparency and accountability in support of rising intermediation and investment.

Financial Area	Deficiencies & Vulnerabilities to Be Addressed by USAID	Recommended Strategies to Address Deficiencies	Recommended Interventions & Tactics Associated With Strategies	Expected Results from Interventions and Tactics With Specific Commentary on Impact on Affected Market Segment
	Weaknesses undermine governance, management and competitiveness of financial sector and economy at large	Assistance to relevant Associations for observance and implementation of sound governance by market players	Short-, medium and long-term assistance: Involvement of AAAA members in training market players, and implementing effective governance and management systems. (See Main Report, Option #2.)	Significant migration of accounting and audit professionals to enterprises, regulatory authorities, and financial firms to assist with regulatory compliance, improved governance, and increased lending and investment. Improved governance, modern management systems, and useful financial reporting in support of market development and regulatory compliance.
	Under-developed accounting and audit systems for modern financial sector.	Assistance to AAAA, CBA, MoFE, Securities Commission, designated regulator for pension funds, as well as relevant Associations for observance and implementation by market players	Establishment of a Steering Committee on Financial Services, for effective introduction and implementation of consolidated accounting and IAS/IFRS across all financial services. (See Main Report, Options #1, 2, 4 and 5.)	Effective implementation of consolidated accounting as part of the larger effort to increase financial market coverage and to implement consolidated supervision.
3. Financial Sector Development Based on Prudential Norms (see Annex 5 for a full discussion of banking issues, as well as stability issues for non-banks)				

Financial Area	Deficiencies & Vulnerabilities to Be Addressed by USAID	Recommended Strategies to Address Deficiencies	Recommended Interventions & Tactics Associated With Strategies	Expected Results from Interventions and Tactics With Specific Commentary on Impact on Affected Market Segment
Banking	Systemic risk is low, but increasing risks will emerge as banks grow, compete and assume new lines of business and introduce new products; capital and earnings are low, net spreads are high, liquidity management is less efficient than it could be, funding base is small, and credit, market and country risk add to overall costs and weaken competition	Assistance to banks via Bankers' Association, CBA, AAAA	Training and systems development to protect against credit and market risk. (See Main Report, Options #1-3.)	Stable banking markets despite growth in competition, product array, and risk-taking
Insurance	No current systemic threat as capital is low, earnings are weak, and general levels of penetration are very low. Future risks relate to affiliation with banks (even without cross-ownership), and transfer risks that may go unnoticed if not reported on a consolidated basis to regulatory authorities.	Assistance to MoFE and Insurers' Association	Training and systems development to protect against emergence of pocket insurance companies, hidden ownership, suspicious transactions, and general underwriting risk. (See Main Report, Options #1, 2 and 5.)	Solvent, liquid, well regulated insurance sector that shows increasing density and penetration ratios consistent with emerging market norms, and growing presence as institutional investors in domestic markets over time.
Pension	Risk to system is circuitous: mismanagement by government authorities of fiscal collections, and long-term deficits of first pillar in the event there is no reform.	Assistance to defined local counterparts to usher in pension reform, preferably for all three pillars.	Assistance for interim management and audit of pension collections/disbursements prior to full movement to second and third pillar. Assistance for development of adequate regulation and supervision, including asset management practices and reporting guidelines. (See Main Report, Options #1, 2 and 4.)	Fiscal stability, professional management, increasing coverage and benefits, strict adherence to fiduciary responsibilities to ensure safety of long-term savings (irrespective of status of domestic securities market).

Financial Area	Deficiencies & Vulnerabilities to Be Addressed by USAID	Recommended Strategies to Address Deficiencies	Recommended Interventions & Tactics Associated With Strategies	Expected Results from Interventions and Tactics With Specific Commentary on Impact on Affected Market Segment
Securities	No real risk in the system because of lack of liquidity and low capitalization.	Support for diverse financial system based on sound governance and accounting standards to promote the needed foundations for transparency, accountability and financial disclosure needed to make markets in bonds and equities.	Assistance via pilot listings and bond issues, including audit, prospectus, and marketing for open investment and trading. (See Main Report, Options #1-5.)	As government securities market grows and related financial sector reforms take hold, eventual issue of corporate (including bank) bonds, mortgage bonds, and equities to increase and diversify funding. Evidence of institutional investment in such securities, helping to reinforce needed governance principles consistent with fiduciary responsibilities.
Non-bank Credit Organizations	No systemic threat, as non-banks have low levels of capital. Potential risk is that one or more insolvencies (even if small) could weaken confidence as a whole.	Embedded in assistance to CBA and Associations (AAAA, NARA, ABA) as part of effort to ensure financial stability and confidence in financial institutions, as well as to promote housing and mortgage finance.	Assistance via AAAA to NARA and ABA to improve valuation and appraisal standards, and to increase information for market-making. Promotion of greater linkage between banks and MFIs to put the latter on more sustainable financial grounds, and to encourage increased access to bank finance for micro-enterprises. (See Main Report, Options #1-3.)	Growing markets for leasing, housing/mortgage finance, and other non-bank lending institutions. Growing links between non-bank credit organizations and banks to increase and sustain credit for households, micro-enterprises, and very small businesses.
4. Financial Sector Intermediation Indicators (see Annex 6 for a full discussion of banking issues, Annex 7 for housing finance, Annex 8 for insurance, Annex 9 for pension, and Annex 10 for securities)				
Banking	Banks need to have sound credit and market risk systems in place under more competitive banking conditions that include greater risk assumption for increased earnings.	Support for CBA and banks via ABA as part of the effort to institutionalize sound risk management systems.	Work with banks via ABA, AAAA and ACRA to develop better information systems so that banks are more able to assume and price risk. (See Main Report, Options #1-3.)	Increased lending to SMEs with more affordable pricing based on capacity of banks to better evaluate and price risk due to increased credit information.

Financial Area	Deficiencies & Vulnerabilities to Be Addressed by USAID	Recommended Strategies to Address Deficiencies	Recommended Interventions & Tactics Associated With Strategies	Expected Results from Interventions and Tactics With Specific Commentary on Impact on Affected Market Segment
	Banks need to offer more products and services to increase/diversify their funding base and earnings, and more broadly to increase their client base. Banks are not yet moving aggressively enough to attract term deposits.	Training via the Armenian Bankers Association, AAAA, CBA and the Securities Commission.	Training on new products and services, along with gathering and uses of market information for product development. Promotion for banks to issue corporate bonds for long-term funding, opening up new products and services. (See Main Report, Options #1-3.)	Increased variety of products and services as banks learn more about their customer base and become more active and aggressive in the market in developing their business. More "rational" pricing of deposit instruments to attract term funds.
Insurance	There is no mandatory insurance, even for third party motor vehicle, resulting in lagging indicators and size relative to international norms; unattractiveness and political risk of the market has stifled foreign investment and general role of insurance in the market; weak demographic data undermine actuarial foundation for risk assessments and pricing	Support for MoFE and Insurers' Association to promote a sound, well-regulated and self-regulated industry able to provide the insurance coverage needed for a vibrant economy	Promote foreign investment, accountability and information disclosure, governance, actuarial capacity, etc. for modernization of the sector. (See Main Report, Options #1, 2 and 5.)	Evidence of growth in premium revenues across product lines, and gradual convergence with emerging markets indicators for penetration and density; sound solvency indicators; credible framework for claims filing and resolution (including fraud prevention); emergence of insurers as institutional investors exercising governance and encouraging financial discipline
Pension	No professional management of pension system, and poor prospects for sustainability under current conditions	Support to government and designated counterpart institutions for development of soundly regulated pension system that stabilizes first pillar, and encourages accumulation accounts in second and third pillars to safeguard prospects for long-term savings	Assistance for management, audit and training in product development to meet the long-term needs of pensioners. (See Main Report, Options #1, 2 and 4.)	Stable transition financing plan for pillar one reform; introduction of mandatory pension scheme (second pillar) that is professionally managed; introduction of voluntary pension scheme (third pillar), largely backed by occupational plans that are also professionally managed

Financial Area	Deficiencies & Vulnerabilities to Be Addressed by USAID	Recommended Strategies to Address Deficiencies	Recommended Interventions & Tactics Associated With Strategies	Expected Results from Interventions and Tactics With Specific Commentary on Impact on Affected Market Segment
Securities	Virtually no market activity due to closely-held management of companies, poor disclosure, weak financial condition; unwillingness of local investors and diaspora community to invest	Training for market players to promote new products, and to float securities to bolster their funding.	Possible pilot project focused on new SME listings on Armex and/or issuance of corporate bonds for term funding for the banks/leasing companies. Support for mortgage company issuance of bonds, and eventual mortgage-backed securities. Support for implementation of international accounting and audit standards to make these feasible. Support for legal reform for more active and sufficiently capitalized broker-dealers to play a role in market-making. (See Main Report, Options #1-5.)	Growth in non-government securities markets, including bonds and equities; evidence of growth in secondary market trading; observance of free-float provisions to encourage liquidity in the market; protection of minority shareholder interests
Non-bank Credit Organizations	Small size of loans characterize most micro-lending programs	Work with ABA to encourage banks to finance MFIs.	Support for increased competition in the banking market to promote efforts to identify MFIs and other non-bank credit organizations as potential clients (refinancing facilities) and sources of new borrowers ("graduates"). (See Main Report, embedded as part of Option #1.)	Increased interaction between MFIs, credit unions, and other NBCOs with the banks to provide a more stable source of financing for non-banks for continued operations (that is less reliant on donors)

Financial Area	Deficiencies & Vulnerabilities to Be Addressed by USAID	Recommended Strategies to Address Deficiencies	Recommended Interventions & Tactics Associated With Strategies	Expected Results from Interventions and Tactics With Specific Commentary on Impact on Affected Market Segment
Housing Finance	Banks lack long-term funding, and institutional support structures (e.g., property registries) are not adequately in place	Work with banks via ABA, mortgage companies, the AAAA, NARA, the State Cadastre and possibly the Securities Commission to increase long-term funding	Support to banks via ABA and NBCOs (e.g., mortgage finance companies) to obtain long-term funding via corporate or mortgage bond issues and (for banks) new deposit products. Support to/for the State Cadastre (and possible other counterparts to be defined) to finalize the immoveable property registry, and to develop a comprehensive moveable property registry. Development of comprehensive pledge registry. Observance of international guidelines for asset valuation and appraisal practices. (See Main Report, Options #1-3.)	Evidence of increasing housing and commercial property transactions through formal financial institutions that are clearly owned, with financing arrangements under clear contractual terms; property exposures are adequately appraised and valued, and risks are properly provisioned; banks, non-bank credit organizations, and CBA have adequate risk management systems in place for potential price deflation/disinflation and the consequent impact on credit ratings (including collateral impact in secured transactions); more buoyant mortgage finance markets contribute to local government revenues via property tax assessments

ANNEX 2: ECONOMIC AND STRUCTURAL FACTORS[5]

2.1 GENERAL OVERVIEW AND CONDITION

2.1.1 MACROECONOMIC SUMMARY

After the newly independent Armenia contended with hyperinflation, structural dislocation, and the war in Nagorno-Karabakh in the early 1990s, the Government of Armenia (GoA) embarked on a reform program in the mid-1990s to stabilize the economy and put the preconditions in place for sustained growth. As elsewhere in the CIS, this was largely based on achieving monetary (pricing) and exchange rate stability, while slowly building the basis for a viable fiscal framework. GoA policy included:

- Strict monetary management that brought the inflation rate down to double digits by 1996 and single digits by 1998.
- Gradual depreciation of the DRAM against the dollar to increase export competitiveness, as shown in rising export earnings.
- Gradual reductions in budget deficits as a share of GDP, with deficits at 2 percent or less since 2002.
- Privatization in most of the economy.

While GDP and per capita incomes remain low, Armenia has succeeded in generating high real GDP growth rates since the mid-1990s. These have averaged 7.7 percent (on an unweighted basis) per year from 1995-2003, with particularly strong growth rates recorded in 2001-03. This has been accompanied by several favorable trends and indicators, including declining fiscal deficits relative to GDP, rising export earnings, and declining current account deficits as a share of GDP. However, investment levels remain low, and much of the economy remains informal and partly financed by remittances from abroad. The following table highlights some key macroeconomic indicators since 1998.

[5] Primary author: Michael Borish.

TABLE 2.1: MACROECONOMIC INDICATORS (1998-2004)

($ in millions)	1998	1999	2000	2001	2002	2003	2004
GDP	$1,892	$1,845	$1,912	$2,118	$2,367	$2,796	$3,151
Real GDP Growth	7.3%	3.3%	6.0%	9.6%	12.9%	13.9%	7.0%
PPP Per Capita Income	$2,080	$2,210	$2,420	$2,730	$3,230	$3,770	N/A
Average Inflation Rate	8.7%	-0.2%	-1.5%	3.9%	2.2%	4.7%	3.0%
DRAM to $1 (Average)	504.92	535.06	539.53	555.08	573.35	578.76	N/A
Real Effective Exchange Rate +/-	N/A	6.5%	-7.8%	-1.9%	-11.3%	-2.7%	N/A
Fiscal Deficit/GDP	-4.9%	-7.4%	-6.4%	-3.6%	-0.4%	-1.2%	-2.0%
Exports: Goods + Services	$359	$383	$447	$529	$689	$884	$990
Private Transfers	$65	$80	$86	$102	$119	$135	$155
Current Account/GDP	-22.1%	-16.6%	-14.5%	-10.0%	-6.6%	-7.2%	-5.8%
Foreign Direct Investment	$221	$122	$104	$70	$111	$136	$98

Notes: 2004 figures were projections consistent with IMF program targets, but likely exceeded; average inflation rate is GDP deflator; fiscal deficit is commitment basis, not cash basis

Sources: IMF, Central Bank of Armenia, World Bank, EBRD, author's calculations

2.1.2 Financial Sector Developments

Consistent with more disciplined monetary and financial management, GoA has moved ahead with fundamental banking reforms.

- First, there has been some consolidation in the banking sector, with the number of banks declining from 74 in early 1994 to 20 in 2004.[6] A handful of these have been merged or re-licensed as non-bank credit organizations, but most have been closed down or otherwise "resolved". This has freed the market of problems that have been found in many other transition economies, namely the continued existence of one or several troubled banks that have been merged and/or kept afloat because they were "too big to fail", ultimately leading to a distorted environment that has stifled banking and financial sector development. While banking statistics show very low levels of penetration into the economy, they have not been a major drag on the budget. Thus, the reasons for underdevelopment of the banking market point to other factors, not persistent state involvement through direct ownership or costly restructuring. (The Treasury bill market has been a vehicle for easy earnings to boost capital. Thus, if there has been a state cost, it has been more from the fiscal side, but limited in magnitude.)
- Second, there have been determined efforts to clean up bank loan portfolios. With non-performing loans (NPLs) as high as 36 percent of total in 1995, these have since come down to 5-6 percent since 1999 and even less in 2004 (based on preliminary 3Q 2004 data).[7] Tighter classification standards and practices have given greater credence to these figures, although there are still risks of miscalculation resulting from overvaluation of collateral, difficulties repossessing and selling collateral when

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[6] Among the 20 banks, one is in administration and subject to tightened supervisory control.

[7] Some of the figures in the late 1990s and early 2000s may underestimate the real NPL figures. However, since 2002, there has been a tightening of loan classification standards and practices.

difficulties of loan performance arise, rollovers, and inaccurate accounting. Nonetheless, with tightened discipline on the loan quality side, reported NPLs are relatively low, at 10-15 percent of capital. A stricter prudential framework reinforced by better banking supervision has helped with this process.

- Third, there has been steady movement towards higher capital requirements, reinforced by strict observance of capital adequacy ratios, to send a signal to the public that banks are solvent and worthy of confidence in their safekeeping capacity. This may also be a regulatory tool to promote further consolidation, as well as to ensure that the public links higher capital requirements with the introduction of the deposit guarantee fund, both of which become effective July 1, 2005.

Notwithstanding improvements and reforms, there are many weaknesses that persist. Full privatization of the system by 2001 and efforts to attract strategic investment have not led to a surge of major banks into the economy. Apart from HSBC (in Armenia since 1996), there are no major banks operating in Armenia.[8] This is largely due to Armenia's small population, limited purchasing power, small corporate sector, and broad distrust of the public in banks dating back to the early 1990s. The right of the tax authorities to garnish accounts adds to public distrust.

Meanwhile, the banks have little capital. Overall, banks averaged $4.85 million in capital as of year-end 2003,[9] although the average was expected to rise to about $6-$7 million by year end 2004. Armenia has raised the required minimum from $1 million in 2001 to $2 million in 2003, and full compliance with a minimum $5 million-equivalent is required by mid-2005 when a new deposit guarantee system becomes operational. However, with average after-tax earnings of about $564,000 (2003), banks remain very small and limited in their ability to provide anything but relatively small loans to the economy. While 2004 after-tax earnings are projected to be higher at nearly $1 million per bank, most of this has actually been generated by HSBC and a few other banks through 2004. As of September 30, 2004, unaudited figures show the top five banks' after-tax earnings approximated $10.5 million, or $14 million in total on an annualized basis. This is equivalent to 76 percent of total after-tax earnings, and would actually translate into an average figure of less than $750,000 in after-tax earnings per bank through three quarters. Thus, most banks remain limited in what they can do. Such small numbers also limit the range of products and services offered by the banks. The requirements of the prudential framework, an inconsistent judiciary, the inadequacy of the secured transactions framework, and limited familiarity with unsecured lending have all constrained bank lending to date, notwithstanding increases in loan exposures in 2004.

Macroeconomic policies have led to lower inflation rates and a relatively stable exchange rate in recent years. While the latter has broadly depreciated against the dollar in real terms until recently, the changes in value have been in the single digit range in all years since 1999 except 2002. Meanwhile, average inflation rates were negative in 1999-2000, and have not exceeded 4.7 percent since 1999. Considering the depreciation of the DRAM against the dollar in real terms until late 2003, a comparatively low and stable inflation rate has been a monetary policy success. However, it has not been without its consequences, namely a high level of dollarization in the economy. More than 70 percent of banks' assets and liabilities are foreign currency-denominated, and this has partly reflected concerns about purchasing power in the aftermath of the turbulent transition and subsequent ruble crises in the 1990s.

Under such circumstances, banks have relatively low levels of funding, particularly term funding (e.g., time deposits greater than one year, syndicated loans from abroad, bonds, equity). While deposits from households and enterprises have increased in the first three quarters of 2004 to $426 million (from about

[8] Vneshtorgbank of Russia, with about $7-8 billion in assets (2003), recently bought the Armsavings Bank, and may compete in some areas with HSBC and others. However, they were not yet competing actively in late 2004.

[9] Financial figures are derived from International Financial Statistics of the IMF. Balance sheet figures are in local currency, and converted to dollars using year-end exchange rates. Any income statement figures are converted to dollars using average exchange rates.

$323 million at year-end 2003), this still translates into only about $22 million per bank. This has meant the banks generally lack a large quantum of available resources for on-lending to the real sector, also culminating in high interest rates charged on loans and resulting net spreads (given low interest paid on deposits).

Beyond the resource constraints (albeit being liquid according to regulatory ratios), the banks have been hesitant about lending due to the comfortable spreads earned on safe securities, and the costs and potential risks associated with loan exposures. As of year-end 2003, banks had only $183 million in loans outstanding to enterprises (including NBFIs) and households, or about $9 million per bank. However, as interest rates have begun to come down in 2003-04, the banks have shown a willingness to lend more. Thus, as of 3Q 2004, bank loans had increased to $264 million by 3Q 2004, for an annualized average of nearly $15 million per bank (compared with only $9 million at year-end 2003).

With loan interest rates at 21-22 percent in 2003, loans were expensive for most borrowers. Although T-bill rates have come down, loan rates have stayed roughly in the range of 2003 lending rates. Local currency loans in 2004 have ranged from 16-23 percent for enterprises and 20-29 percent for individuals, while dollar loans have been 18-21 percent for enterprises and 22-25 percent for individuals. In effect, the market risk premium has not come down significantly despite improving macroeconomic conditions. This may simply be due to demand in the market, with customers willing to absorb the costs due to the rapid turnover of goods (if a commercial trade enterprise) or desire for increased consumption of appliances, vehicles and other consumer goods (if individuals or small enterprises).

Because banks are small and limited in their array of services, their earning asset base is small, making growth a more difficult challenge. This is further compounded by the scale of most private businesses, which are small in size, and therefore have limited assets to collateralize for secured loans. With tighter prudential norms now in place and enforced, this makes banks more risk-averse, and wary of lending. When they do lend, loans are rarely for large enough amounts or for long enough maturities to meet SME needs for investment and growth, particularly as collateral enforcement is difficult even when the enterprises have the assets to pledge. Thus, small businesses have had little incentive to place funds with banks, as their access to loans and other products/services is limited. This is beginning to change, as banks are showing an increasing willingness to lend in 2004. Moreover, with growing use of plastic (debit and credit) cards, banks are now beginning to offer more products and services. Nonetheless, with less than 500,000 bank accounts in the entire country[10], most people remain outside the banking system. Even when funds are transferred through banks (particularly via their money transfer systems, such as Western Union and Money Gram), the recipients of these funds do not place them in accounts.[11]

Apart from the banks, there is virtually no capital markets activity. A few of the larger enterprises are reported to be able to borrow from abroad. (Non-bank private entities had $396 million in gross external debt at year end 2003, about 22 percent of gross external debt and 31 percent of net external debt after accounting for foreign assets.[12]) In some cases, this is because the prudential norms limiting the size of individual loans to 20 percent of capital have meant that loans are not large enough for enterprise investment needs—based on year-end 2003 figures, this would put a ceiling of $970,000 on the average bank,[13] and a projected $1.2 million for year end 2004.[14] Moreover, given that only seven banks had more than $6 million in capital as of 3Q 2004, most of the banks have lending limits of less than these figures,

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[10] According to CBA, there were 405,600 customers and 406,800 accounts in the banking system at year-end 2003.

[11] This is typical of most remittance flows, as they generally serve as income supplements from family abroad.

[12] See *Armenian Trends, Q2 04*, AEPLAC.

[13] Average capital at year-end 2003 was $4.85 million. At a 20 percent ceiling for single external borrower exposure limits, this would equal $970,000. This has increased in 2004 with banking sector growth in assets and capital.

[14] Capital for year 2004 is estimated to be about $120 million, depending on which capital measures are utilized from September 30, 2004 figures. This approximates $6.0 million per bank. A 20 percent exposure limit would bring the exposure limit on individual loans to $1.2 million.

and thereby lack the resources to cater to the larger enterprises. On the other hand, most enterprises are small-scale and have been unable to borrow. The result is that lending to the enterprise and household sectors in Armenia (including NBFIs) was only 6.4 percent of GDP in 2003, with another $52 million (1.8 percent of GDP) representing bank claims on government. Initial projections for year end 2004 put these figures at $284 million in lending to enterprises and households, or about 9 percent of GDP. Thus, there is progress, but it still represents very little banking sector penetration in the economy at large.

Such low levels of lending are actually indicative of a cash-based economy that largely operates outside formal channels. The informal economy is estimated to approximate 46 percent of GDP.[15] One source[16] reports that 81-85 percent of enterprises' financing (working capital and new investment) comes from internal sources and retained earnings. Only about 4 percent comes from bank borrowings. Thus, there is very limited credit from banks, and other non-bank suppliers likewise provide very little trade credit. Almost all sales and purchases (94 percent) are made in cash.

The following table illustrates some fundamental measures of financial sector depth (discussed more broadly in Annex 6). From the trends, it shows that Armenia's economy and banking system have strengthened since 1998, but that intermediation rates remain low. In fact, Armenia's broad money-to-GDP ratio of 14.7 percent of GDP (2003) places it at the lower end of transition economies.[17] The bank assets-to-GDP ratio likewise confirms this position.

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[15] See *Doing business in 2004*, World Bank, 2004.

[16] See EBRD-World Bank Business Environment and Enterprise Performance Survey (2002). Results may be slightly different today, although banking data do not show a major increase in outstanding loan figures.

[17] Only Georgia, Tajikistan, Uzbekistan, and possibly Serbia and Montenegro and Tajikistan have broad money-to-GDP figures lower than those in Armenia. Azerbaijan and Armenia are similar. (See Table 6.2 in Annex 6.)

TABLE 2.2: MONETARY AND BANKING PENETRATION INDICATORS (1998-2004)

	1998	1999	2000	2001	2002	2003	2004
Banking Indicators:							
Banking Assets	$243.1	$287.8	$347.8	$332.7	$376.3	$460.4	$733.5(e)
Bank Assets/GDP	12.85%	15.59%	18.20%	15.71%	15.90%	16.47%	21.39%(e)
Monetary Indicators:							
Broad Money in $ millions	$191.2	$205.9	$279.1	$284.6	$368.9	$402.8	$462.2
Broad Money to GDP:	10.11%	11.16%	14.60%	13.43%	15.59%	14.41%	14.67%
o/w currency outside banks	4.33%	4.32%	5.77%	5.53%	6.53%	5.69%	4.84%
o/w DRAM deposits	1.69%	1.39%	1.67%	1.57%	2.65%	2.52%	2.23%
o/w foreign currency deposits	4.08%	5.46%	7.16%	6.34%	6.41%	6.21%	7.60%

Notes: Bank asset and GDP figures are from IFS from 1998-2003, while 2004 figures for bank assets are year-end estimate based on September 30 data from CBA. CBA bank asset figures are higher, and would approximate 18 percent of GDP in 2003. Monetary and GDP figures for 2004 are projections for the year or at year end from IMF. Broad money figures are from CBA, while broad money percentages are derived from CBA (1998-2000) and IMF/IFS (2001-04).

Sources: IMF, CBA, author's calculations

2.1.3 Incomes, Poverty and Development

Armenia has benefited from increases in real GDP growth since the mid-1990s. However, per capita incomes remain low, at about $900 (2003). On a purchasing power parity basis, the figures are higher, at $3,770 in 2003,[18] up from $3,230 in 2002.[19] These figures have been rising gradually, including preliminary estimates for 2004 of per capita incomes approximating $1,000, which would likely propel PPP incomes per capita to above $4,000. Furthermore, there are other indicators of well-being, such as high literacy rates (99 percent in 2001, and nearly 100 percent for youth) and life expectancy at 75 (2002). Nonetheless, income figures are low, and other indicators point to the prevalence of poverty—43-49 percent live below the poverty line (2002-03 data), 51 percent of the population is below recommended minimum dietary levels, and Armenia's 3.4 percent infant mortality rates are higher than norms in transition countries (on average) as well lower-to-middle income countries around the globe.

Average real growth (on an unweighted basis) from 1998-2003 was 8.8 percent, and a 7 percent growth rate was projected for 2004.[20] (As of late 2004, these projections were being revised upward to as high as 9 percent.) Real growth has been particularly strong since 2001, essentially in double digits. This has translated into a sizeable percentage increase in per capita incomes, rising from about $500 in 1996-97 to $894 in 2003[21] and a projected $996 (or more) in 2004. As there are differences in figures from various sources, per capita incomes are now expected to exceed $1,000 from 2004 on. However, even if impressive in terms of growth, Armenia remains far behind most countries in terms of per capita GDP. Assuming the projected figure for 2004 is met in Armenia, this would be higher only than GNI per capita

[18] PPP figures are from 2003, as cited in *World Development Report 2005*, World Bank, 2004.
[19] PPP figure for 2002 from *World Development Indicators*, World Bank, 2004.
[20] See "Fifth Review Under the Poverty Reduction and Growth Facility", IMF, May 2004.
[21] Measures vary. The World Bank reported GNI per capita at $950 for 2003.

in Azerbaijan ($810), Georgia ($830), Kyrgyz Republic ($330), Moldova ($590), Tajikistan ($190), Ukraine ($970) and Uzbekistan ($420) when compared with 2003 data from the other transition economies.[22]

Meanwhile, income distribution remains a challenge, as an estimated 49 percent of the population remains below the poverty line of $21 per month, of which 17 percent live in extreme poverty at $14 or less per month.[23] (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.) Based on consumption patterns, the highest quintile accounts for 45 percent of consumption, whereas the lowest quintile accounts for only 7 percent of total consumption. The overall Gini income coefficient of 45 percent indicates a fairly high level of income inequality.[24] In particular, extreme poverty and high structural unemployment (based on living standards surveys) are most pronounced in urban areas apart from Yerevan. The war with Azerbaijan over Nagorno-Karabakh has intensified these problems, as it displaced some people, triggering a flow of refugees that added to the ranks of the poor. Moreover, the conflict has since interfered with traditional trade patterns and transport routes, as borders with both Turkey and Azerbaijan have been closed. This has added 10-18 percent of GDP in costs for merchandise trade transactions, largely in the form of higher transport costs through Georgia.[25] It is also a reason for low levels of foreign direct investment into the economy, notwithstanding the significant inflows of financial assistance from the diaspora community.

Broad money approximated $403 million at year-end 2003, about $135 per capita, a small base for economic development. (The projected figure for year-end 2004 is about $462 million, or about $150 per capita.) While 2003 purchasing power parity figures show higher financial measures—nearly four times GDP per capita figures at $3,770—the economic base is still small and largely informal. As noted above, about 46 percent of the economy is considered to be in the grey market, and almost all transactions are conducted in cash. Armenians rely partly on remittances from abroad for subsistence, and net current private transfers have exceeded foreign direct investment figures for years.[26] This trend is expected to continue for the foreseeable future, thus adding to the cash-oriented nature of the economy. In general, most real sector transactions are carried out by individuals and businesses that have traditionally bypassed the banking sector. This is partly due to poverty at the base level, partly the result of shaken confidence after the transition, and largely due to efforts to avoid paying taxes. Notwithstanding some encouraging trends and structural reforms in recent years, financial indicators show only nascent financial sector development. Poverty remains widespread, investment prospects are still weak, and many households remain dependent on remittances that could slow if the Russian economy were to face difficulties. The economy is also vulnerable to price swings in the wheat and diamond markets—the former can lead to rapid price increases internally (as in 2003), while any decline in international diamond prices would adversely affect what has become the source of about half of Armenia's merchandise export earnings in recent years. These and other issues are discussed below.

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[22] 2003 figures for countries from *World Development Report 2005*, World Bank, 2004.
[23] These are 2002 figures from the 2001-02 living standards survey, cited in the Country Assistance Strategy of the World Bank, May 2004. The monthly benchmark figures changed slightly in 2004 based on the 2003 living standards survey, to $23.53 and $15.65 per month-equivalent, respectively, for poverty and extreme poverty.
[24] See "Country Assistance Strategy for Armenia", World Bank, May 20, 2004.
[25] See "Country Assistance Strategy for Armenia", World Bank, May 20, 2004.
[26] Officially recorded remittances (net private transfers) may be well below the actual flow of remittance income from abroad. One report cites current remittance flows at about $900 million, or nearly seven times the official figures reported in 2003. See "Remittances in Armenia: Size, Impacts and Measures to Enhance Their Contribution to Development", Bearing Point (under contract to USAID), October 1, 2004.

2.2 ECONOMIC STRUCTURE

2.2.1 Sector Distribution of the Economy

Armenia's economic structure has been relatively diversified and balanced, and growth in recent years has been in food production, light manufacturing, construction, and services. There are some encouraging signs with regard to types of imports (intermediate and capital goods) that point to future competitiveness, although Armenia is still vulnerable to price swings or supply constraints in the international diamond market, which accounts for about half of merchandise export earnings. While diamond production/processing have been positive in boosting jobs, output and incomes, the high proportion relative to merchandise transaction values does subject Armenia to some of the vulnerability that other economies face when heavily dependent on one or two commodities, as is so prevalent in Russia, Azerbaijan, and some of the Central Asian economies. However, with export growth also occurring in mineral production, food processing, light (non-precious) metals, and textiles, there are prospects for reduced dependence on diamond-related earnings over time. The decline in diamond imports from Russia in 2004 will test this, although this will also likely lead to reduced exports to Belgium and Israel which, in recent years, have become Armenia's major destinations for merchandise exports.

Notwithstanding improvements in economic structure and the business environment, Armenia continues to face many challenges. Because Armenia lacks critical strategic resources, it is more difficult to attract needed investment that would generate export earnings for sizeable increases in income and GDP. With a small population in a landlocked country that is mountainous and limited in natural resources, there are fewer incentives to invest than in other markets. Moreover, the continued border restrictions with Azerbaijan and Turkey add to transport and other costs, making it more difficult to be competitive and adding to the risk premium associated with any investment. These tensions are further compounded by political tensions between Georgia and Russia (Armenia's main route for exports to Russia), international concerns about Iran (as another potential outlet route for goods), and the generally high cost of transport to/from and maritime shipping from the Poti port in Georgia,[27] on which Armenia depends for merchandise exports. On the other hand, Armenia is showing increased evidence of export competitiveness in its medium-sized enterprise sector, and trade continues to increase with EU and other Western markets. As a reflection of this, Belgium (18 percent), the UK (10 percent), the US (8 percent) and Germany (5 percent) represented four of the six leading export markets for Armenia in 2003, with the EU and US accounting for 46 percent of total exports and 37 percent of total imports.

Based on 2003 data from the National Statistical Service, agriculture accounted for 21 percent of GDP, a figure that continues to decline (e.g., from 41 percent in 1995 and 31 percent in 1998). The percentage decline reflected the overall decline in the primary sector through 2000, as agricultural output actually decreased on a value basis from $585 million-equivalent in 1998 (including forestry) to $445 million-equivalent in 2000. However, figures since 2001 have shown improved agricultural output, partly triggered by rising competitiveness and exports in the agro-processing sector. Projections from the World Bank show agriculture at about 23-24 percent of GDP in the medium term, which portends overall output gains from about $600 million in 2003 to $949 million by 2007.[28] Growth has come from rising volume of horticultural products and some dairy, although severe frost periodically cripples fruit production and the country remains dependent on grain and cereal imports. Recent liberalization of the land market may stimulate investment into the sector, although most agriculture remains small-scale and limited in terms of commercialization.

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[27] See A. Iskandaryan, "The Economic Costs of Being a Landlocked Country," *Armenia Trends, Q2 04*, AEPLAC.

[28] Percentage growth figures cited from World Bank (CAS, 2004), and applied to dollar-based GDP figures projected by IMF. However, NSS cites agriculture at 21 percent of GDP as compared with the Bank's 24 percent figures.

After a difficult period for the industrial sector, industry appears to be gaining competitiveness. Like its counterparts in several CIS economies, Armenia experienced a difficult period in the industrial sector characterized by layoffs, severe under-utilization, ineffective restructuring exercises, and disappointment in attracting investment and know-how for turnaround. However, aggregate industrial output along with the industrial sector's share of GDP have both been increasing in recent years. According to NSS,[29] the industrial sector accounted for 21 percent of GDP in 1999, or about $390 million. This has steadily risen in dollar value to $558 million, although the industrial share of GDP at market prices was estimated to be only 20 percent as of 2003.[30] Sectors that have done comparatively well in recent years are consumer goods, food processing, beverages, non-precious metals (metallurgy), polished diamonds (jewelry production), and mining. Some building materials, home furnishing, and construction implement categories have shown growth due to the construction boom of the last two to three years (e.g., road construction, housing). The role of foreign investment has been helpful in some of the mining and manufacturing sectors, whereas non-investment (grant) financing from the Lincy Foundation has been a major source of funding for road and other construction.

Services have shown growth as well in Armenia, a trend that is consistent with most CIS economies as well as economies around the globe. In this regard, the key challenge is the actual value-added from those services. In Armenia's case, construction has been the major driver in services growth. According to NSS, services continue to show steady growth as a share of overall GDP. In percentage terms, services have increased from about half of GDP in 1998 to 60 percent in 2003. This has translated into a value increase from $931 million in 1998 to $1,648 million in 2003.[31] Key drivers for growth are expected to be transport and telecommunications (particularly if border tensions ease in the region), retail trade, real estate development (mainly housing), and potentially financial services.

Financial services only account for about 1.3 percent of GDP, equivalent to about $37 million in 2003. This trend has shown a gradual decline over the last decade, owing to efforts to tighten standards and conditions as a basis for improving quality and prospects for sustainability. Output has been almost exclusively recorded as credit, with virtually no contribution to GDP from insurance or other sectors. The following table shows shares of GDP in dollars by sector, as well as a general sector distribution.

[29] There are significant differences in NSS sector distribution percentages when compared with World Bank distributions, which put the industrial sector at far higher shares than does NSS. However, because NSS data are more abundant, they are used. Efforts to reconcile differences between World Bank and NSS methodologies could not be finalized due to the lack of available information.

[30] By contrast, the World Bank puts these figures at 32 percent of 1999 GDP, or $591 million. According to the Bank, this has since risen to about 41 percent of GDP in 2003, or equivalent to about $1,146 million in output.

[31] The World Bank's data show different trends. In general, aggregate figures show that services have begun to decline as a share of GDP in Armenia, from 39 percent in 2000-01 to about 35 percent in 2003. However, according to the Bank's statistics, this reflects more the restoration of industrial production, rather than a decline in services output. In total value, Bank figures show services increased from $720 million in 1999 to an estimated $979 million-equivalent in 2003. Leveling off at a projected 35 percent of GDP through 2007 would bring services output to $1.4 billion that year, less than the figure cited by NSS for 2003.

TABLE 2.3: ECONOMIC STRUCTURE (1999-2004)

(millions of US$)	1999	2000	2001	2002	2003	2004
Agriculture	$497.5	$443.7	$541.0	$556.0	$598.0	$469.5
Industry	$390.4	$418.1	$425.9	$448.1	$557.9	$819.3
Services	$957.5	$1,049.7	$1,151.5	$1,372.2	$1,648.9	$1,862.2
Financial Services	$39.0	$35.7	$39.8	$36.1	$37.3	N/A
Construction	$153.2	$197.1	$205.7	$300.4	$435.7	$330.9
Transport/Communications	$139.8	$138.1	$148.6	$145.9	$164.3	$132.3
Trade	$166.4	$179.7	$215.2	$251.2	$300.1	$349.8
Government/Social Services	$314.4	$333.0	$344.7	$402.6	$446.1	N/A
Other	$144.7	$166.1	$197.5	$236.0	$265.4	N/A
TOTAL GDP at Market Prices	$1,845	$1,912	$2,118	$2,367	$2,796	$3,151
As percent of GDP at Market Prices:						
Agriculture	27.0%	23.2%	25.5%	23.4%	21.3%	14.9%
Industry	21.2%	21.9%	20.1%	18.9%	19.9%	26.0%
Services	51.9%	54.9%	54.4%	57.7%	58.8%	59.1%
Financial Services	2.1%	1.9%	1.9%	1.5%	1.3%	N/A
Construction	8.3%	10.3%	9.7%	12.6%	15.5%	10.5%
Transport/Communications	7.6%	7.2%	7.0%	6.1%	5.9%	4.2%
Trade	9.0%	9.4%	10.2%	10.6%	10.7%	11.1%
Government/Social Services	14.7%	17.0%	17.4%	16.3%	16.9%	N/A
Other	7.8%	8.7%	9.3%	10.0%	9.5%	N/A
TOTAL	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Notes: dollar figures derived from NSS sector GDP figures; 2004 figures are based on preliminary projections for the year (IMF), and sector distribution as of August 31, 2004 (NSS); Financial Services are credit and insurance based on National Statistical Service figures

Sources: National Statistical Service, IMF, World Bank, author's calculations

2.2.2 Leading and Lagging Sectors

In the last two years, real GDP has increased 12.9 percent (2002) and 13.9 percent (2003). Early estimates for 2004 point to real GDP growth of up to 9 percent. The highest levels of sector growth have been recorded in construction and industry. Construction, in particular, has grown substantially, at 47.0 percent and 44.4 percent growth, respectively, in 2002-03. This has mainly been to build roads throughout the country, as well as for home/apartment construction (mainly in Yerevan). This has served as an important source of funding for interim employment, helping to reduce poverty (at least for the time being) and improve transport and distribution networks. It also has been a key point of consumption for building materials, namely cement, steel products, and some electrical and plastics. Thus, growth in construction

has been a catalyst for industrial growth, which experienced annual real increases of 14.2 percent and 15.4 percent, respectively, in 2002-03. Preliminary indications point to a possible slowdown in 2004 after major activity in the previous two years. Approximately half of construction activity is housing-related, and there is reported to be substantial unrecorded activity in the sector as well.

Additional growth in the industrial sector has come from consumer goods, food processing and beverages, metals, jewelry production, tobacco, textiles and other activities. Only the chemical industry appears to be in a steady state of decline, although it is now showing some increases in output (in 2003). Preliminary indications for 2004 show that industrial output has increased significantly, thus continuing an upward trend that has been sustained for several years. This is particularly encouraging in light of the decline in imports of diamonds from Russia in 2004.

In 2002, commercial trade also increased substantially, by 15.2 percent (after buoyant real growth in 2001 of 15.5 percent). However, growth slowed to 8.2 percent in 2003, less than overall real GDP growth. Commercial trade continues to grow as a share of the economy, as shown by modest growth in 2004.

Transportation and communications have shown fluctuation, with high growth in 2001 (16 percent), slower growth in 2002 (6 percent), and then higher growth again in 2003 (10.1 percent). There has been a decline in 2004, likely related to the impasse regarding the telecommunications monopoly (through 2013) that was recently resolved between the Government and Armentel.

In general, all major sectors have shown real growth since 2001. However, agriculture has experienced the weakest levels of real growth, at about 4.4 percent in 2002-03 (after 11.6 percent real growth in 2001). There may have been a decline in 2004 from 2003 levels, although seasonality issues may level these figures by late 2004. In any event, there is a very real possibility that the rural economy is suffering an outflow of people to Yerevan and other countries, thereby reducing fundamental productivity and potential for output.

Other services have shown slow but steady real increases, at 7.2 percent in 2002 and 7.5 percent in 2003. Financial services have generally stagnated in terms of DRAM output, although this has very likely increased in 2004 with the growth of credit activities.

In terms of employment, construction has served as a catalyst for growth. However, official statistics appear to underestimate these figures, probably due to the amount of informal contracting taking place. In fact, through 2002 (the last year for which sector distribution data are available), construction showed declines each year from 1999. This does not appear accurate, particularly with trends in the last two years. In general, employment data are not considered reliable, as noted below with regard to the variation of unemployment figures.

Investment figures by sector are also considered unreliable, incomplete or out of date. However, food processing, construction, mining, precious and semi-precious stones, textiles and other export-oriented and high growth domestic sectors have increased investment. Likewise, banks have increased investment in systems technology and networking, making plastic cards available to the public and better MIS for reporting purposes. Retailers have also invested in POS terminals as systems technology has become increasingly available and affordable.

2.2.3 Employment and Productivity

Unemployment statistics are uncertain, as are underemployment indicators. With nearly half of the economy in the informal sector, a significant amount of work and number of transactions occur off the books. Thus, formal unemployment data do not capture economic impact.

In general, the labor force and number of employed continue to decline in Armenia. Official statistics indicate the unemployment rate has been relatively stable, ranging from 9-12 percent since 1996, and estimated at 10.1 percent at year-end 2003. About 1.1 million are employed, while about 125,000 are

unemployed (depending on circumstances). However, the living standards survey conducted in 2001-02 shows unemployment rates of approximately 30 percent of the labor force, with rates as high as 40 percent in cities and towns outside of Yerevan. More recent estimates put the figure at about 30 percent in Yerevan,[32] which may mean that unemployment is actually higher overall. At 30 percent, this would mean that as many as about 400,000 people remain unemployed, rather than the official figure of 125,000. It is noteworthy that the labor force figure declined from more than 1.4 million in 2002 to 1.2 million in 2003.[33] This suggests that about 200,000 unemployed were no longer recorded as they stopped looking for formal employment. Along with the 125,000 officially recorded as unemployed, this would bring the unemployment rate to more than 20 percent. If this figure is added to others who earlier ceased to be recorded, the 30 percent estimate becomes more plausible, particularly as the labor force-to-total population ratio is very low (38.5 percent). The debate is made all the more confusing when reviewing labor scarcity trends in construction and other more buoyant sectors of the economy and the wage increases that were reported in 2003-04, raising the possibility that official unemployment figures may not be wholly inaccurate.

Based on 2002 employment data, agriculture and services were the main sectors of employment, accounting for about 1.14 million jobs, or 89 percent of total employment (in 2003). Agriculture represented about 500,800 jobs in 2002, or about 39 percent of total. Industry provided 143,100 jobs. The industrial sector has experienced declining jobs since 1998 despite steady increases in output. Thus, the industrial sector accounted for only 11 percent of total employment. Services accounted for the rest, with the largest single sector being education, culture and art at 138,300. Commercial trade provided 99,600 official jobs. Government (public sector) was not a large employer, as it had only 23,800 staff. However, this appears to be inaccurate, given that so many of the services that are run as non-commercial organizations are supported by government budgets. A separate estimate put aggregated public sector jobs (including non-commercial organizations) in total at 23.3 percent of employees in 1Q 2004, or about 255,000 jobs.[34]

Overall productivity has increased significantly in the industrial sector, while there have been more recent productivity gains in agriculture after a decline in 1999-2000. Meanwhile, services have shown fairly consistent increases through 2001, and then a leveling of individual productivity in 2002. The real gains have shown up in the industrial sector, with per capita output about 1.7 times the overall average. The following table highlights employment, productivity and labor force trends.

[32] See D. Melikyan, "An Overview of the Yerevan Labor Market", *Armenia Trends, Q2 04*, AEPLAC.
[33] This number continues to decline, and was reported to be 23,500 less as of 1Q 2004, bringing this to 37.7 percent of the resident population. See *Armenia Trends, Q2 04*.
[34] At 1Q 2004, the total active population was 1,212.9 thousand, of which 90.2 percent were employed (about 1,094 thousand). Of these, 23.3 percent were employed in the public sector, or 254,910. See H. Khachatryan, "The Macroeconomic Situation in Armenia During January-March 2004", *Armenia Trends, Q2 04*, AEPLAC.

TABLE 2.4: EMPLOYMENT, PRODUCTIVITY AND LABOR FORCE TRENDS (1998-2003)

	1998	1999	2000	2001	2002	2003
Total Employed by Sector (thousands):						
Agriculture	567.8	562.4	566.7	570.0	500.8	N/A
Industry	209.4	195.2	179.7	169.6	143.1	N/A
Services	560.1	540.6	531.3	525.3	638.0	N/A
TOTAL EMPLOYED	1,337.3	1,298.2	1,277.7	1,264.9	1,281.9	1,107.6
Proportional Share of Employment by Sector:						
Agriculture	42.5%	43.3%	44.4%	45.1%	39.1%	N/A
Industry	15.7%	15.0%	14.1%	13.4%	11.2%	N/A
Services	41.9%	41.6%	41.6%	41.5%	49.8%	N/A
TOTAL EMPLOYED	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
GDP per Employee per Sector:						
Agriculture	$1,028.0	$884.6	$783.0	$949.1	$1,110.2	N/A
Industry	$1,797.2	$2,000.3	$2,326.6	$2,510.9	$3,131.5	N/A
Services	$1,664.3	$1,771.2	$1,975.8	$2,192.1	$2,150.8	N/A
WEIGHTED AVERAGE	$1,414.9	$1,421.6	$1,496.1	$1,674.8	$1,853.8	$2,524.4
General Demographic and Labor Figures:						
Total Population	3,798,200	3,803,400	3,213,000	3,213,000	3,210,800	3,212,200
Working Age Population	2,245,800	2,283,500	2,350,700	1,932,600	1,968,100	N/A
Total Labor Force	1,476,400	1,462,400	1,447,200	1,411,700	1,415,600	1,236,400
Registered Unemployed	139,100	164,200	169,500	146,800	133,700	124,800
Unemployment Rate	9.4%	11.2%	11.7%	10.4%	10.8%	10.1%
Pensioners—NSS	512,200	520,000	499,900	427,500	425,900	N/A
Beneficiaries—SSIF	N/A	N/A	N/A	N/A	485,500	485,800

Notes: In GDP per Employee per Sector, taxes are not included as part of Government employees' output measure; pensioners are "over able-bodied age" according to NSS at year end; beneficiaries are those receiving benefits payments (of any kind) according to the State Social Insurance Fund. Among these, old-age pensioners are estimated to number about 383,500 (2002), with the other 100,000 or so comprised of the disabled, widows, orphans and others.

Sources: National Statistical Service, author's calculations

One additional point regarding the labor force is the estimated number of pensioners. As of 2003, there were about 426,000 of them, representing a steep decline from 1998-2000 figures. This approximates 13.3 percent of the total population, and points to the need to consider pension reform for future generations. (SSIF figures indicate that 14.3 percent of the "labor force" is between 64 and 74 years of age, thus of retirement age. In total, and allowing for an earlier retirement age for women and qualification as well for a minimum 20 years of service, this equates with 12.4 percent of the male labor force and 4.3 percent of

the female labor force.) While pension costs have generally ranged from 3-4 percent of GDP since 1998-2003,[35] which is not high and has been offset by a small deficit relative to collections, the actual amount of benefit paid to the average pensioner is low. Moreover, because Armenia has lost (at least temporarily) a substantial portion of its younger and potentially upwardly mobile labor force, the PAYG system will eventually run into difficulties meeting the payments it is required to make even with a decline in pensioners. There is already a deficit of contributors relative to those collecting, and contributions are considered to be a fraction of requirements. Many people outside the official labor force subsist on agriculture, small trade and light services. This provides a bit of a social safety net. Likewise, remittances from Russia and elsewhere have substantially helped. However, with per capita incomes still relatively low and life expectancy of 75 years, reforms will be needed for long-term sustainability. These issues are discussed more fully in Annex 9.

2.3 PRIVATE SECTOR DEVELOPMENT

2.3.1 General Strategy for Private Sector Development

The Government issued a poverty reduction strategy paper in 200336 to map out a long-term approach to help eradicate poverty. Key goals and objectives focus on the reduction of poverty and inequality, both in the economic and incomes sphere as well as health, education and water quality. Key targets by 2015 include:

- Per capita PPP incomes of $6,775.
- No more than 19.7 percent of the population living in poverty.
- No more than 4.1 percent of the population living in extreme poverty.
- Reduced income inequality, with a Gini coefficient of no higher than 44.6 percent (income basis).

The strategy depends on macroeconomic stability and private sector development as one of its key components, with further development of the financial sector being one of the key factors for overall private sector-led economic growth. Major features of the poverty reduction strategy include:

- Sustainable economic growth and jobs creation resulting from macroeconomic stability and private sector development, largely predicated on an improved business and investment climate.
- Better governance, based on implementation of the government's anti-corruption strategy along with gradual movement to e-government (use of "redistribution technologies").
- Improving social safety nets with more efficient administration and management of social assistance and social insurance.
- Implementing prudent fiscal policies, including improvements in tax and customs administration.
- Fostering an environment that leads to an increase in rural incomes, and permits the self-employed and micro-enterprise sector to grow.
- Improving public and social infrastructure, with strong emphasis on health, education and access to clean drinking water.

[35] Ratios based on State Social Insurance Fund expenditure divided by GDP at current market prices from NSS data. Ratios were 3.05 percent in 1998, 3.78 percent in 1999, 3.63 percent in 2000, 3.52 percent in 2001, 3.38 percent in 2002, and 3.44 percent in 2003.
[36] See "Poverty Reduction Strategy Paper", Government of Armenia, 2003.

The role of the financial sector is mentioned sparingly in the document. Key points include the need to increase access to finance, and many of the firm-specific weaknesses and legal/judicial constraints that impede lending, secured transactions, and investment. Pension reform is noted as part of the larger effort to strengthen social and incomes policies. Other indirect references would emerge from the implementation of strategies, such as fiscal and debt policies that would affect the government securities market, improvements in the business and investment climate that might portend the issuance of corporate bonds and equities, and fiscal decentralization that may lead to opportunities concerning the municipal finance market.

2.3.2 Constraints to Private Sector Development

Armenia has made progress in terms of macroeconomic stability, with declining inflation rates, lower fiscal deficits, and manageable levels of debt. Structural reforms have also helped with business establishment, permits and licensing, etc. However, there are many persistent problems that slow further growth. Apart from financing issues, which are very briefly mentioned here and described in greater detail throughout the report, these include:

- *Weak purchasing power.* With PPP per capita incomes of only $3,770, this limits opportunities for sales. The aggregate figure has declined due to the out-migration of about 700,000 people in the last decade. While many of these are working abroad and sending back funds to family (for income supplements as well as investment into businesses), the remaining population of 3.1 million (or less, depending on estimates and season), remains relatively poor or lacking income and consumption capacity. As a result, the top quintile of the population accounts for 45 percent of total consumption. By contrast, in 2002, 17 percent of the population lived on $14 or less per month, and 49 percent of the population lived on $21 or less per month.
- *Limited resource base.* Armenia is a mountainous, landlocked country, lacking in strategic commodities and poorly endowed in terms of natural and energy resources. This serves as a disincentive to investment and growth prospects. Periodic earthquakes also add to operating risk, particularly concerning industrial enterprises that would require major investment in fixed assets and have high property and casualty and catastrophic risk insurance costs.
- *Political risk.* Armenia's borders with Turkey and Azerbaijan have been closed as a result of the recent conflict in Nagorno-Karabakh and other issues that have persisted for decades. The immediate economic effect on Armenia is that closed borders have added a political risk premium to investment, and the cost of international trade has increased 10-18 percent of GDP (2003)37 as a result of illicit payment requirements for transport of merchandise to/from Georgia.
- *Sensitivity to international grain prices (and impact on local inflation rates).* This is a periodic risk that can challenge macroeconomic stability. As an example, higher prices for imported wheat flour and cereals raised year-end CPI inflation rates to 8.6 percent in 2003 against a planned rate of 4 percent.
- *Interim dependence on grant financing.* Six percent of 2001-03 GDP has come from grant financing from the Lincy Foundation, partly used to finance construction (on a tax-free basis). Other private foundation sources of funding have also helped to supplement budgetary items. However, over time, such grant financing can be expected to decline. This will require that Armenia expand the fiscal base, and generate a more reliable revenue stream for needed expenditure.
- *Weak and underdeveloped financial sector.* Most enterprises are self-financing, with little contact with formal financial institutions. Bank lending remains low, and banks in general remain small, at

[37] Cited from *Country Assistance Strategy*, World Bank, May 20, 2004.

about $25 million in assets on average in 2003. While this is projected to rise to about $39 million by end 2004, most of the increase will be in HSBC and a small number of other banks, leaving most of them with a very small asset base. Despite banks being small, the banking sector accounts for most formal financial sector assets. The insurance sector is small and underdeveloped, which also limits the array of products and services needed for companies to be more competitive. It also forces dependence on re-insurers in EU and other markets, adding to costs for those taking out insurance policies. The securities markets are limited in terms of turnover and capitalization, with no active institutional investors and a very narrow array of instruments. Other financial services remain limited as a share of GDP.

- *The scale of enterprise is small.* Most enterprises in Armenia are micro or very small in scale. This means the firms have limited assets to collateralize, often lack needed management and marketing skills to convince banks of their prospective credit worthiness, and frequently cannot produce in the volume needed for banks to believe it is worth the administrative cost of underwriting the loan. While there are some fairly sizeable companies in Armenia, most are not. Even Armenia's largest companies are relatively small in reported sales. In 2003, the 15 largest companies (among those reporting) averaged only $40 million-equivalent in sales. By global standards, this is small.
- *Relatively weak levels of direct investment, and virtually no portfolio investment.* Foreign direct investment was only $136 million in 2003, of which $94 million applies to the debt-equity swap with Russia. Portfolio investment was nearly zero. In general, Armenia's direct investment figures have been fairly low. This not only reduces financial flows, but also limits market linkages, management and marketing know-how, and related systems and expertise needed for competitiveness. Likewise, from the debt side, there is very little long-term funding with the banks, let alone from the banks. There are no corporate bonds. Foreign borrowings make up for some of these gaps, but most measures are low.
- *Reliance on remittances.* Armenians working abroad have benefited from the buoyant economy in Russia. Should commodity prices drop and demand for Armenian goods and services diminish within Russia, this would reduce a major source of funds (not all of which are captured in the balance of payments). However, for the moment, this is not considered a potential threat, and much of the economic and small-scale investment in Armenia is currently derived from these sources of funds.
- *Weak capacity in the judiciary.* Courts are generally viewed as slow, inadequate, and vulnerable to corruption. There are concerns about a lack of independence, as well as influence peddling by companies with close government contacts. Financial institutions criticize the courts as unreliable with regard to loan recovery and contract enforcement. An inconsistently enforced legal framework, inadequate creditor rights, and sheer capacity weaknesses in the settlement of contract disputes induce risk aversion, thereby inhibiting lenders and investors from taking risk. Reforms are under way to change this, but they will not likely resonate in the market until 2005-06.
- *Insufficient capacity in public administration, including customs and tax administration.* With the informal sector approximating 46 percent of GDP, much of this has to do with efforts to avoid tax payments. Part of this evasion also relates to perceptions of corruption, unequal treatment, and poor administration. Key weaknesses are found in tax administration, namely VAT, personal income and payroll, and customs. Notwithstanding simplification of the tax code in 2000, there are reports of excessive complications with regard to exemptions and corporate taxes.
- *Telecommunications is considered sub-optimal.* The monopoly position of Armentel (effective through 2013 by original agreement, but recently amended to allow for issuance of a second mobile license) has been considered a significant obstacle to competition, investment and service, thus resulting in high costs and lower service levels than might be achieved with a more competitive environment. Higher costs and insufficient service levels constrain market development and enterprise competitiveness.

- *Transport and electricity costs are high and reduce competitiveness.* Transport costs in Armenia are more than double the world average, and high even by regional standards. This adds to the price of imports, and makes it costlier and more difficult to compete in export markets. Electricity costs are also considered high, and this makes it more difficult for industrial enterprises to be competitive in export markets. In particular, high transport and electricity costs add to the competitiveness burden in textiles, footwear, food processing, furniture manufacturing, and other industrial goods.[38]
- *Corruption in the public and private sectors add to overall costs in the economy.* The government adopted an anti-corruption strategy in late 2003, yet it will take time for incentives and behavior to change. This is not only concerning tax inspections and other government functions, but also in the private sector. This is also a regional issue, given similar problems in Georgia and the impact this has on cross-border transactions.[39] Within Armenia, arbitrary and discretionary taxation provide no consistency or protection for businesses with regard to cash management, budgeting and planning. This keeps businesses informal and/or small and/or focused on high-turnover activities that conceal assets to avoid unnecessary attention.[40] Such behavior is also reported to affect management and administration of the PAYG pension system, with high levels of leakage reported.

Armenia has made some progress toward creation of an environment conducive to private sector development. Licensing procedures have been simplified, resulting in business environment indicators that show that business start-up is not too cumbersome (10 procedures in 25 days) or costly (8.7 percent of per capita income, or about $68[41]). This puts Armenia roughly in the middle of about 135 economies in terms of procedures, and the lower end in terms of time and cost. Likewise, contract enforcement is reported to be fairly efficient, involving 22 procedures in only 65 days at a cost of about $80. This is reasonably favorable when compared to most other countries. Construction and building renovation permits now take less time as well, and the number of goods subject to mandatory certification at the border has declined. Amendments to the Law on Facilitated Tax are meant to simplify the tax payment system for businesses with annual sales of less than $10,000-equivalent (DRAM 50 million).

Notwithstanding progress, there are still many problems reported with regard to the judiciary, levels of corruption, creditor rights and debt recovery, and simple avoidance of governmental and bureaucratic structures. Improvements to date in the business environment have not been enough to create a dramatic shift from the informal to the formal sector. This has meant a perpetuation of the vicious circle whose nexus is found in the weak fiscal position of the government and economy, and the relatively low investment flows into the country. Likewise, many banks have complained about problems associated with contract enforcement, namely when borrowers have defaulted on their loans. Thus, it is uncertain if the figures above related to contract enforcement are directly relevant to larger issues affecting secured transactions and the willingness of banks to lend. By extension, this has ramifications for minority shareholder rights and equity investment in firms.

As for infrastructure, the government is slowly introducing less centralized and more market-based approaches to service provision. In general, quasi-fiscal deficits have diminished significantly, although there are still some weaknesses in the water sector. New regulatory approaches are being put in place for energy, water and telecommunications. Privatization of Armelnet in 2002 has reduced losses in the

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[38] See A. Iskandaryan, "The Economic Costs of Being a Landlocked Country", *Armenia Trends, Q2 04*, AEPLAC.
[39] For instance, unofficial charges add 6-13 percent to rail charges and as much as 22-25 percent on land transport costs for Armenian exports through Georgia. Figures like this for trade through Iran were not disclosed, although the conclusion of the report is that direct access to Mediterranean ports through Turkey via rail would be the most efficient method of facilitating international transactions for merchandise goods. See A. Iskandaryan, "The Economic Costs of Being a Landlocked Country", *Armenia Trends, Q2 04*, AEPLAC.
[40] As of 2004, Transparency International ranked Armenia 78th among 133 countries in its corruption ratings.
[41] At the time, GNI per capita was $790. All figures are from or derived from *Doing business in 2004*, World Bank, 2004.

electricity sector, partly based on a doubling of collections in 2003. There are also plans to privatize the water and waste company, which should lead to a reduction in losses and an improvement in services over time. However, in general, water and irrigation show losses estimated at about 0.6 percent of GDP in 2003 (about half the fiscal deficit in 2003), and are projected to be 0.4 percent in 2004 (about 20 percent of the projected fiscal deficit). Meanwhile, the battle between the Government and OTE with regard to the monopoly position of Armentel was only recently settled, and there is broad consensus that telecommunications represent an obstacle to enhanced competitiveness.

2.3.3 Planned Government Reforms and Prospects for Private Sector Development

Looking ahead, the government is aware of changes that are still needed to improve the business and investment climate. As noted, some changes have already been made, and additional reforms are expected to provide an environment conducive for investment and growth. Key reforms are expected to include:

- *Financial sector development.* Now that banks have stabilized, the government is interested in promoting growth in assets (based on increased funding from deposits and other liabilities as well as equity investment to boost capital), along with a wider variety of services that will stimulate increased trade and investment. A new credit information bureau will be introduced to assist with credit risk evaluation, with the objective of providing more risk-related information to banks to better judge credit risk. (In the long run, this may also help to bring banking supervision closer to Basel II guidelines, although it will take years for banks to be able to assign reliable risk weights according to the new Basel Capital Accord.42) Likewise, modernization of the insurance sector based on legislation and regulations consistent with international standards will promote this sector's development. Pension reform is being contemplated. Promotion of better standards of governance, accounting, transparency and disclosure are being contemplated as a necessary precondition for future issuance of corporate bonds, equities, and potentially mortgage securities (bonds or mortgage-backed securities) when a sound framework is in place.
- *Introduction of deposit insurance.* A deposit guarantee scheme will become operational on July 1, 2005. This development is expected to help restore confidence in the banking sector, leading to an increase in deposits and maturities, thereby increasing the supply of funds for long-term exposures. Coverage will be for up to DRAM 2 million ($4,000-equivalent) in local currency accounts and/or up to DRAM 1 million ($2,000-equivalent) for foreign currency accounts per depositor.43 Thus, the scheme is particularly designed to promote confidence among households and very small businesses, and is focused on providing double the coverage for DRAM accounts than for foreign currency accounts.
- *Establishment of a Financial Intelligence Unit (FIU).* The government plans to set up a FIU to help coordinate efforts (domestically and internationally) to reduce the incidence of financial crime. This includes money laundering and other activities.
- *Changes in tax policy and tax/customs administration.* This includes reduced profit tax exemptions, increased coverage of VAT, introduction of a deferral payment system for VAT on large imported capital goods (not currently taxed), faster refunds on VAT claims,44 better excise collections, resolution of tax arrears,45 strengthened audit function in customs operations, and penalizing tax

[42] Basle II recommends that banks assign internal risk ratings, while supervisory agencies evaluate the adequacy of such systems. For more on the suitability of credit information bureaus as a function of overall risk-based supervision, see C. Artigas, "A Review of Credit Registers and their Use for Basel II", BIS, September 2004.
[43] Most customers have only one account.
[44] VAT claims were 1.3 percent of GDP in 2003.
[45] Tax arrears were 5.3 percent of GDP in 2003.

officers for abuses.

- *Improvements in budget management and expenditure control.* This includes strengthened financial audit standards, better systems and controls, and broader efforts to reduce corruption. Procurement practices are expected to become more transparent.
- *Judicial capacity enhancement.* Government plans to support broad efforts to provide training in commercial law, and to promote initiatives that help judicial officials more efficiently manage caseloads and enforce legislation in a consistent manner.
- *Establishment of sound regulatory structures for utilities.* This will include regulations concerning licensing, market structure and rules, tariff-setting, services, connection policies, and financial and operational audit procedures.
- *Privatization in the water and waste water utilities.* The Armenian Water and Waste Company has issued management contracts to European firms for the 12 districts of Yerevan, and then the rest of the country. Water tariffs will gradually rise in an effort to recover maintenance costs by 2007. This will apply to bulk and end-use irrigation users, not just households. These measures will eventually be followed by privatization.
- *Market-based practices in the energy sector.* The government has moved to direct contracting between the electricity distributor, power generators and other service providers. This deviates from traditional practices of a single purchaser for electricity.
- *Improving transport infrastructure.* The government plans to improve the quality of rural roads, which will help those in the farm and agro-processing sector.
- *Improving the telecommunications sector.* The government and international donors recommended that new licenses be issued to telecommunications providers to stimulate competition, improve service levels, and reduce costs. Through 3Q 2004, Armentel still had a monopoly (originally promised through 2013). The two parties apparently reached agreement in November 2004 to permit competition in the mobile communication services market.

There is still significant work that remains to be done for the private sector to develop in Armenia. Most small-scale enterprises have been privatized, and the private sector has accounted for most employment since 1996. The most recent figures for private sector employment were about 78 percent of total in 2002 (excluding non-commercial organizations), while the private sector was estimated to account for about 82 percent of GDP in 2002.[46] While the landscape for private sector growth and development is significantly different from what it was in the early and mid-1990s, there is clear strategic recognition that the private sector needs to grow and diversify for economic development to be sustainable. This will require a change in business culture away from the predominantly privately-held, tightly controlled enterprise to a more modern approach that relies on management teams with a range of skills and experience, good governance, sound systems, better market research and information, and transparency to attract outside sources of funding (debt and equity).

2.3.4 State Enterprises

There are still many state enterprises, including some in critical sectors of the economy (e.g., energy and power), while other privatized companies operate as monopolies that impede competitiveness and service delivery (e.g., telecommunications). In several cases, explicitly government-owned companies have been transformed into closed joint-stock companies. However, they are still often majority or wholly state-owned companies, with weak standards of governance and questionable movement in several cases to

[46] Figures from National Statistical Service.

effective commercialization. The one area where substantial progress has been reported has been the electricity sector, where a mix of public and private initiatives have reduced costs, increased collections, and helped to make the system more efficient. On the other hand, part of the effect of reform in this sector has been to protect the sector with fairly high domestic tariffs. While helping to reduce vulnerability to outside power sources, the effect has also been to drive up costs for domestic industry, reducing international competitiveness.

Armenia recently privatized several companies via the debt-equity swap with Russia in 2003, in which net arrears positions of Armenian state enterprises were swapped for equity to Russian entities. However, state enterprises still play a significant role in the economy. In some cases, such as in the electricity sector, they have stifled competition. This is now being addressed and changed in favor of a less centralized system. In other cases, many SOEs are, in fact, non-commercial organizations in the health and education fields that rely on government financing, but operate fairly autonomously.

The government is currently in the process of tightening financing and audit procedures to ensure that non-commercial organizations are able to operate efficiently in support of social needs, yet also in a manner that is consistent with fiscal discipline. In addition, reforms have been introduced in recent years in the energy and utilities sectors. As a measure of this, quasi-fiscal deficits have diminished in recent years, largely due to improvements in the electricity and power sector. In general, the role of state enterprises has been diminishing as a share of GDP, although it remains important given the number of large closed joint stock companies and their (undisclosed) contribution to GDP.

2.4 MONEY, SAVINGS AND CREDIT

2.4.1 Macroeconomic and Monetary Policy

Macroeconomic policy has been fairly stable in Armenia since 1998, when average inflation rates dropped to single digits, the exchange rate showed relatively limited changes in nominal terms, and the fiscal deficit was less than 5 percent. Considering the hyperinflation, war and socio-economic turmoil of the early 1990s, this represented a strong effort to enforce sound monetary and fiscal policies in support of long-term growth.

While the CBA has followed a disciplined monetary policy since the mid-1990s (to bring down inflation rates) and notwithstanding relative exchange rate stability, Armenia's economy is substantially dollarized. About 50 percent of total broad money and nearly 80 percent of deposits were held in foreign currency, mostly dollars, as of 3Q 2004. These ratios have changed little from 1999.

Money supply has fluctuated over the years, with average growth of broad money at only $31 million from 1996-2001. However, this has increased in recent years, and total money supply is expected to reach $462 million at year-end 2004, equivalent to about 14.7 percent of GDP (similar to the 14.4 percent ratio in 2003) and more than 62 percent higher than year-end 2001 money supply (in dollar terms). In general, monetary policy has included a measured increase in the broad money-to-GDP ratio, rising from 8-9 percent in 1995-97 to 10-16 percent from 1998-2002. More recently, CBA appears to have settled on a 14.5-15 percent target for the current period.

Armenia's policy to date has resulted in modest inflation rates (changes in CPI) since 1998, ranging from negative rates in 1999-2000 to an average of 3.45 percent since (on an unweighted basis). The highest rate since 1999 was 4.7 percent in 2003, largely due to higher imported wheat prices and the impact it had on Armenia's CPI at the end of 2003. In general, CBA is targeting a 3 percent inflation rate from 2004 to the medium term, although it is not completely certain that this target will be achieved. As in 2003, external factors can change the pricing with only limited direct influence from monetary policy.

2.4.2 Savings

National savings have increased dramatically in recent years. As a share of GDP, this has increased from only 2 percent in 1999 to an average 15 percent from 2002-04. Higher rates are projected from 2005 on. This translates into an increase in dollar terms from only $37 million in 1999 to $445 million in 2003.

2.4.3 Investment and Credit

In terms of investment, Armenia has experienced an increase as a percentage of GDP as well as in dollar terms. Investment to GDP was reasonably high at 19.5 percent of GDP in 1999, declining one year later, and then increasing to as high as 23 percent in 2003. In dollar terms, this means investment increased from $360 million in 1999 to $643 in 2003. Most of this has been reported to be in export-oriented businesses, construction, and banking, although specific investment data by sector are not available. Average rates of about 22 percent investment–to-GDP are projected through 2008.

As for credit, there was very little change until 2004, when lending figures showed a significant increase (albeit from a small base). Earlier low lending figures were largely due to efforts to stabilize the banking system, work out (or write off) bad loans, and introduce financial discipline for long-term stability. As such, net domestic credit (lending to enterprises, NBFIs and households plus investment in government securities) averaged $216 million from 1999 to 2003, and neither increased nor decreased by more than $20 million during that period. As such, bank credit was only a small fraction of investment into the economy. Relative to GDP figures, bank credit was about 10 percent of GDP from 1999 to 2003 when including investment in Government securities (net domestic credit). These figures have increased in 2004, with loans to the real sector rising to a projected $284 million by year end 2004. Along with banks' investments in government securities (estimated to be $77 million at year end 2004), this would bring banks' net domestic credit to about $361 million, or 11.5 percent of GDP. While low by international standards, this still constitutes a considerable increase from earlier years.

2.4.4 Financial Intermediation Costs

The costs of intermediation are still considered high by the real sector, with nominal interest rates in the 21-22 percent range in 2003 and only marginally lower in 2004. Enterprises in Armenia have seen interest rates on DRAM loans range from 16.3 percent to 22.8 percent through the first three quarters of 2004, and 14.9 percent to 20.6 percent on dollar loans. Meanwhile, individuals are charged higher rates, ranging from 20.1 percent to 29.5 percent for DRAM loans, and 22.1 percent to 25.2 percent for dollar loans. Thus, in general, individuals pay a premium of about 4-7 percent on DRAM and dollar loans when compared with enterprises.

Notwithstanding the lower rates charged to enterprises, banks consider their opportunities for profitability to be limited in terms of the number of credit worthy firms, partly due to the weak framework for debt recovery and secured transactions. SMEs have traditionally complained of the high cost of bank credit resulting from high rates, high levels of collateral required, and insufficient amounts for long-term investment purposes. This is partly rooted in the shortage of long-term funds held by the banks, as well as the general perception of credit risk by the banks and past difficulties with loan recovery. Such problems are common to the CIS and elsewhere when systems are underdeveloped and confidence is low.

In general, Armenian banks claim that existing spreads barely cover deposit rates and operating costs, although spreads have increased since 2002. Given that net spreads are high, this generally reflects high comparative operating costs. Armenia's banks have had relatively low levels of NPLs since 1999, so provisions have not been as costly as an expense as otherwise might have been assumed. High costs relate to reserve requirements (6 percent since 2003, after 8 percent from 1999-2003) as well as staffing costs

and investments needed to modernize operations. Thus, in many ways, weak margins actually derive from operating inefficiency, with after-tax earnings-per-employee only about $4,500-equivalent.[47] The small amount of lending and limited array of services has also kept earnings down, while scarce funds have put upward pressure on lending rates despite a reduction in NPLs in recent years. Provisions for loan losses were less than 2 percent of total loans as of 3Q 2004, and overdue loans were about 3.3 percent of total loans. Neither of these figures is particularly high. However, given limited lending opportunities and a small securities market, banks do not feel they have many safe sources of earnings. This puts pressure on banks to increase rates to compensate for small earning asset volumes.

TABLE 2.5: NOMINAL AND REAL INTEREST RATES (1999-2003)

	1999	2000	2001	2002	2003
Money and Quasi-Money/GDP	11.08%	14.71%	13.45%	15.61%	14.45%
Treasury Bill Rate	55.10%	24.40%	20.59%	14.75%	11.91%
Nominal Bank Rates:					
o/w deposits	27.35%	18.08%	14.90%	9.60%	6.87%
o/w lending	21.62%	22.10%	19.65%	21.14%	20.83%
Net Spreads on Nominal Bank Rates	-5.73%	4.02%	4.75%	11.54%	13.96%
Net Spreads less Inflation Rates	-5.53%	5.52%	0.85%	9.34%	9.26%

Notes: Nominal lending rates from IFS, not slightly higher 3-month commercial bank lending rates

Sources: IMF, author's calculations

2.5 FISCAL POLICY

2.5.1 Fiscal Policy

With the exception of 1999, the Government of Armenia has shown reasonable fiscal discipline since 1997 and strong discipline since 2001. On a cash basis since 2001, fiscal deficits have averaged 2.7 percent of GDP (unweighted), with the average being about 2 percent in 2002-03. Projections for the next several years anticipate cash deficits of 2.8 percent on average.

Armenia has cut expenditure in recent years to bring fiscal deficits down, while also trying to collect on arrears. For instance, expenditure was $556 million-equivalent in 1999, and then dropped to an average $467 million from 2000-03. Declines were most conspicuous in capital expenditures and employee wages. Meanwhile, efforts have been made to clear arrears, amounting to about $72 million, or 3 percent of average GDP from 2001-03. No subsequent arrears clearance is expected to be required in 2004.

Projections for 2004 show fiscal expenditure approximating 1999 levels, and growing thereafter. More recently, the fiscal position has been assisted by donor grant financing equivalent to 6 percent of GDP and 15 percent of total fiscal expenditure, although much of this has been for capital expenditure (e.g., construction) rather than regular operating costs.

Recent reforms have included:

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[47] Calculation based on annualized estimate of after-tax earnings for 2004 ($18.5 million) divided by total bank head count (4,073).

- A reduction in the number of VAT exemptions.
- Minimum profit tax of 1 percent of sales turnover for small businesses.
- Tightened conditions for profit tax enforcement, including limits on deductions, reduced scope for tax loss carry-forwards, and clearer depreciation schedules.
- Right of the State Tax Service to seize debtors' bank assets and receivables to reduce arrears (garnishing).

These measures are intended to broaden the fiscal base and increase revenues, while introducing rates that are not onerous for households and enterprises. However, with nearly half the economy in the grey market, there is still considerable weakness in fiscal matters. Moreover, tax inspection procedures are considered subjective and prone to illicit payments, and constitute possibly the largest obstacle to market development in the economy. The degree to which the market formally avoids making tax payments undermines financial market development in general. Much of the avoidance is based on perceptions of selectivity, unfairness, and poor use of resources once collected.

2.5.2 Revenues

Revenue sources are almost exclusively from taxes, although grant financing accounts for about 18 percent of total consolidated revenues when grants are included. Non-tax revenue sources apart from grants are virtually non-existent. In 2003, tax revenues were 96 percent of total revenues (excluding grants), and 79 percent of total revenues including grants. This represents a point of vulnerability for Armenia, as grant financing cannot be assured in subsequent years, which could make it more difficult to keep the deficit under control.

Of Armenia's tax revenue sources, VAT is by far the largest source of revenue, accounting for about 45 percent of total fiscal revenue in 2003. This was followed by excise taxes (16 percent of revenues), and then income taxes on companies and individuals (14 percent). Social security contributions and expenditures were not reported.

As noted, VAT is the main revenue generator, at 20 percent. This is fairly standard and at the low end compared with other transition economies. However, conditions are tightening, and recent changes have included a reduction in many exemptions. Moreover, at 20 percent in a country that is dependent on many imports and is seeking to increase re-export capacity and channels, the high level of VAT makes export competitiveness more of a challenge. Other tax rates48 include:

- Personal income tax: 10 percent up to DRAM 80,000 ($160) in monthly income, and 20 percent above that level.
- Corporate profit tax of 20 percent (applicable to resident and non-resident organizations).
- Simplified turnover tax (as interim substitute for profit tax: 1 percent of turnover).
- Employer Social Security Payments: DRAM 5,000 ($10) for monthly gross income up to DRAM 20,000 ($40); DRAM 5,000 plus 15 percent of the amount exceeding DRAM 20,000 up to DRAM 100,000 ($200); DRAM 17,000 ($34) plus 5 percent of the amount exceeding DRAM 100,000 ($200).
- Employee Social Security Payments: 3 percent.
- Individual (Self-Employed) Entrepreneurs: 15 percent, but not less than DRAM 60,000 ($120) on

[48] Much of the summary of statutory tax rates is based on "Investment in Armenia", KPMG, May 2003. Subsequent correspondence with the KPMG office in Yerevan confirmed updated figures were accurate as of November 2004.

gross annual income up to DRAM 1.2 million ($2,400); on gross annual income above DRAM 1.2 million, DRAM 180,000 ($360) plus 5 percent on the amount exceeding DRAM 1.2 million.

- Property taxes: 0.3 percent of building value annually.
- Land taxes: 15 percent on agricultural land (net cadastral value); 0.5-1.0 percent on urban land, non-urban industrial land, and forested land.
- Excise taxes: various rates applied to alcoholic beverages, tobacco products and fuels.
- Export tax: zero percent.
- Import duty: 0-10 percent.
- A comprehensive table of tax rates as they apply to individuals, companies and a variety of financial instruments is presented in Annex 12.

2.5.3 Expenditure

On the expenditure side, about 68 percent is current expenditure (2003), and 32 percent investment expenditure. Netting out grant financing, and assuming most of it is for capital expenditure, this would shift the proportion to about 82 percent current expenditure and only 18 percent capital expenditure. Among current expenditures, the largest share (54 percent in 2003) is for goods and services, with wages, subsidies and interest all fairly similar. As noted, social insurance figures have been omitted from the budget figures as the government seeks to stabilize the social insurance system. However, transfers approximated $82 million in 2003. Capital expenditure totaled $159 million in 2003, about three quarters of it foreign-financed grant money used for the construction of roads and housing.

Extra-budgetary figures have come down in recent years. Quasi-fiscal losses at several SOEs continue to burden the budget, but have been put under greater control as privatization and competition increase in the energy/power markets, and as non-commercial organizations (e.g., health, education) are subject to stricter audit procedures.

Armenia’s prudent debt management policies have kept interest expense low. As a result, there is very little funding of government operations by the banking sector. Interest expense was only 3.7 percent of government expenditure in 2003, equivalent to about $19 million.

2.5.4 Government Financing and the Banking System

Banks have played a minor role in government financing over the years, although the share of bank financing relative to the cash deficit is rising and could play more of a role over time. However, the role of Treasury bills has actually been less for the government’s needs, and more for the banks to permit them to generate easy earnings to recapitalize, while also making it possible to easily comply with capital adequacy requirements. Since 1998 (and before), bank financing of government securities has not exceeded 2 percent. As a share of total expenditure, bank financing has not exceeded 10 percent. However, bank financing did exceed the cash deficit in 2003, thus helping to finance this gap. Moreover, as the government securities market expands (see Securities Markets discussion in Annexes 3 and 10) and grant financing diminishes, banks will likely play a greater role in the financing of government operations. This will provide the government with a more reliable source of financing, while providing the banks with greater income-earning instruments in which to invest. The latter will also provide longer maturities as GoA develops a yield curve.

Banks’ limited role in the financing of government operations has been a function of monetary policy since the mid-1990s. Neither commercial banks nor the CBA have played much of a role in the financing of fiscal deficits. This is reflected in the low level of T-bill activity, which only amounted to about $53 million outstanding in late 2003, of which nearly $52 million was held by the banks and only about $1

million was held by CBA. In dollar terms, these levels are little different from 1999, when banks had only $23 million in government securities on their books and the CBA had its highest level of investment at $35 million. Thus, combined monetary and bank financing of government operations has been fairly consistent and low over the years.

Meanwhile, there has been virtually no portfolio investment, with less than $3 million in debt securities reported at year-end 2002. Armenia's net international investment position shows that the stock of debt and equity securities was a negative $2.1 million, as compared with a $1.3 million deficit in 2002. Thus, investment inflows have had virtually no effect on government deficits or enterprises. This may be partly due to the grant financing that has been provided as a substitute. Privatization proceeds have also been very minor as an extraordinary cash injection in the balance of payments. Cumulative privatization revenues approximated 10 percent of GDP as of 2002,[49] or only about $230 million, equivalent to only 29 percent of cumulative fiscal deficits from 1995-2002. The following table shows that the role of banks in financing government has been minimal.

TABLE 2.6: COMMERCIAL BANK FINANCING OF GOVERNMENT EXPENDITURE

	1998	1999	2000	2001	2002	2003
Total GDP (billions of DRAM)	955	987	1,031	1,176	1,357	1,618
Bank Financing of Gov't (billions of DRAM)	15	12	17	18	26	29
Bank Financing of Government/GDP (%)	1.62%	1.24%	1.64%	1.55%	1.94%	1.80%
Bank Fin'g of Gov't/Gov't Expenditure (%)	6.10%	4.21%	6.99%	7.37%	9.85%	9.71%
Bank Financing of Gov't/Cash Deficit (%)	31.89%	17.14%	34.79%	37.40%	73.11%	122.94%
Notes: bank financing = net claims on government						
Sources: IMF; author's calculations						

2.6 EXCHANGE RATES

Armenia's policy towards exchange rates has been a function of broader monetary policy focused on price stability. The Law on Central Bank states that the primary objective of the independent CBA is to ensure price stability, with the exchange rate coming under the broader umbrella of policies and instruments of the monetary program. As such, CBA establishes aggregate monetary and inflation targets, with some sterilization based on inflows of foreign currency.

In general, CBA has followed a free-float exchange rate regime since 1997. The DRAM experienced gradual depreciation against the US dollar in real terms from 2000 to 2003 (despite nominal appreciation by year end 2003[50]), although there has been a reported increase in 2004. The nominal exchange rate increase in 2004 has helped to offset some of the inflationary effects that would otherwise come with the large and heretofore underestimated inflows of dollars resulting from the significant volume of remittances being sent from Russia and elsewhere.

[49] See *Transition report*, EBRD, 2003.
[50] See *Annual Report*, Central Bank of Armenia, 2003.

2.7 BALANCE OF PAYMENTS

2.7.1 General Trends

Armenia's balance of payments reflect growing merchandise trade exports, much higher levels of imports (much of it intermediate and capital), and rising remittance levels to help reduce the current account deficit. Meanwhile, in the financial and capital accounts, investment remains relatively low, debt payments pose a very limited burden, and the financing gap can be covered by donors without major requirements.

The medium-term prognosis is that current account imbalances will stabilize at about $180 million from 2004-06, little different from 2003 levels. As a share of GDP, these deficits are projected to be about 4-6 percent from 2004-08, diminishing year on year. Some of the reason for a gradually declining current account deficit originates in the structure of imports, a sizeable portion of which is for intermediate goods that are processed/finished and then re-exported (e.g., polished diamonds) and for capital goods imports. The latter constitute investments in metals and other industries that could bolster Armenia's merchandise exports in the coming years.

One point of vulnerability is the fate of Russia, and the ability of Armenia to diversify its trading partners. Armenia has done so in recent years, with an increasing shift in trade away from CIS countries and to Western markets. However, Russia is important as a destination for exports, a source of key intermediate imports (e.g., diamonds), and as a major source of remittance inflows. Should there be a shift in Russia's economic fortunes, Armenia might encounter balance of payments challenges, particularly in terms of export earnings and remittance flows. Likewise, the dispute with Azerbaijan over Nagorno-Karabakh could prove problematic at some future point, with significant economic and other consequences. Armenia has also not been able to attract major direct investment, and it will likely take time for portfolio investment to flow into the country, something that may be needed if grant financing from the diaspora community dissipates. The closed borders with both Azerbaijan and Turkey make Armenia that much more dependent on Georgia and Iran as transport channels for international transactions involving merchandise goods, although the recent invitation by the EU to Turkey to negotiate accession may also lead to an improved geo-political climate.

2.7.2 Current Account Developments

Current account deficits have been fairly stable in Armenia in recent years, averaging $212 million from 2000-03, and not exceeding $278 million since 2000. As noted above, projections show lower deficits in the coming years, averaging $184 million from 2004-08.

As a share of GDP, Armenia's deficits have been high. They were in double digits from 1997-2001, and averaged 6.9 percent (unweighted) in 2002-03. Thus, considering that current account deficits above 5 percent are considered worrisome in many economies, Armenia's ratios are fairly high. Nonetheless, current trends indicate stabilization of the deficits over time.

Merchandise exports have increased significantly in recent years, mainly in the diamond trade and, to a lesser extent, foodstuffs, metals, minerals and textiles. Merchandise exports since 2001 have averaged $508 million per year, with 2003 figures double those in 2001. Major markets for exports in 2003 (in order of value) were Israel, Belgium, Russia, the US, Germany, the UK and Switzerland. Combined, these seven countries accounted for $532 million in exports, or 78.5 percent of total. As a trade bloc, the EU accounted for 38 percent of total exports, as compared with only 16 percent in 1994.

Meanwhile, services have accounted for a significant share of export earnings, averaging $192 million, or about 27.5 percent of total exports of goods and services. Key earning services include transportation, travel and communication services. Financial services constitute very little value in this domain.

While exports have been rising, so have imports. In fact, and as noted above, some of this is linked to the import and re-export of intermediate goods, mainly involving precious and semi-precious stones. Armenia's merchandise imports have also increased in recent years in machinery and equipment, foodstuffs, chemicals, transportation equipment, and metals. Merchandise imports since 2001 have averaged $923 million per year, with 2003 figures about 44 percent higher than those recorded in 2001.

Meanwhile, imported services account for about 20 percent of total imports of goods and services, averaging $233 million annually from 2001-03. Key imported services include transport, engineering and reinsurance. Thus, Armenia runs a slight services deficit each year, which is expected to stabilize at about $60 million per year for the next few years. Major import markets in 2003 (in order of value) were Russia, Belgium, Israel, the US, Iran, the United Arab Emirates, and the UK. Combined, these seven countries accounted for $744 million in imports, or 59 percent of total. Thus, import sources are a bit more diversified, and there is less concentration as a result in particular imported goods/services categories. As a trade bloc, the EU accounted for 29 percent of total imports, as compared with only 9 percent in 1994. The CIS accounted for about 24 percent of total imports, mainly goods supplied by Russia.

Armenians benefit from remittance inflows, largely from family members working in Russia. Net current transfers from 2001-03 were $545 million, or about $182 million on average. Most of this has been from remittances ($356 million, or $119 million annually), with the balance from official (government and donor) sources. Remittances are actually estimated to be far higher, as remittances from Armenians abroad also enter the country through informal channels. Neither customs authorities nor the banking system capture much of this in their data. The presence of Western Union and improvements in the payment system may provide better statistics in the future to assess the magnitude of remittances. However, even if the number of bank accounts increases in the next few years, evidence elsewhere suggests that most remittances are used as income supplements and will not stay in the banking system as long as poverty is widespread. Armenia's current account also shows $254 million in net income for 2001-03 ($85 million per year). Net income is expected to remain above $100 million per year for the next few years, and official transfers are expected to stabilize in the $50-$55 million range. Remittances are projected to increase, staying well above foreign direct investment figures for the next several years.

2.7.3 Investment and Debt

Investment has been fairly low in Armenia since 1999, with total investment to GDP averaging 20 percent. This approximates $2.3 billion, or an average of $455 million. Of this, foreign direct investment (FDI) has played a very small role, accounting for less than a quarter of overall investment. From 1999-2003, FDI was only $543 million, or an annual average of $108 million. Per capita figures show FDI at $35 per year from 2001-03. Estimates and projections show that FDI should approximate $543 million from 2004-08, or $107 million per year. This would approximate only 3 percent of GDP, and shows that Armenia's economy will not likely benefit from any major investments or start-ups.

Offsetting weak investment trends is the prudent debt profile Armenia has. Nominal external public debt outstanding is relatively low. As of end 2003, the figure was $1,065 million, or about 38 percent of GDP. Consequently, debt service has declined, and was only 8.7 percent of exports in 2003. This is projected to decline in the coming years to about 5 percent in 2006. These are manageable ratios, and reflect prudent debt management strategies. Again, the risk is if export markets contract due to a dramatic decline in commodity prices in strategic markets. However, actual debt levels are considered reasonable.

On top of the public and publicly-guaranteed debt is $678 million in private debt (2003 data). This consists of $396 million in real sector borrowings, $188 million in inter-company credits, and $94 million in bank debt. Only about $180 million of this is long term.

Reserves have been stable in recent years at about 3.7 months' imports. This increased slightly in 2003 to about 4.1 months. However, projections point to a return to the 3.7 month target from 2004-06. In dollar terms, gross international reserves were $504 million at year-end 2003.

TABLE 2.7: DEBT, INVESTMENT AND RESERVE TRENDS: 2001-2007

($ figures in millions)	2001	2002	2003	2004	2005	2006	2007
Nominal External Public Debt	$906	$1,026	$1,065	$1,109	$1,154	$1,193	$1,256
Public External Debt/GDP	42.8%	43.4%	38.1%	35.2%	33.3%	31.6%	30.4%
Public External Debt Service	$53	$68	$77	$72	$59	$60	$50
Public EDS/Total Exports	10.0%	9.9%	8.7%	7.3%	5.4%	5.1%	4.0%
Present Value of Public Debt/Exports	132%	131%	89%	74%	66%	62%	N/A
Total Private Debt	N/A	N/A	$678	N/A	N/A	N/A	N/A
Gross External Debt	N/A	N/A	$1,788	N/A	N/A	N/A	N/A
Net Foreign Direct Investment	$70	$111	$136	$98	$105	$108	$110
FDI/GDP	3.3%	4.7%	4.9%	3.1%	3.0%	2.9%	2.7%
Per capita FDI	$23	$36	$45	$32	$35	$36	$37
Gross Official Reserves	$329	$430	$504	$492	$509	$537	$566
Gross Official Reserves in months' imports	3.6	3.7	4.1	3.7	3.7	3.7	N/A

Notes: Present value ratio is based on a three-year rolling export figure for the current year and two previous years; figures from National Statistical Service and IMF differ slightly

Sources: IMF; National Statistical Service; author's calculations

ANNEX 3: FINANCIAL SYSTEM COMPOSITION AND STRUCTURE[51]

3.1 General Overview

Banks dominate the formal Armenian financial sector, accounting for about $460-$500 million in total assets[52] at year end 2003, and projected to be about $733 million by year-end 2004. However, while bank assets constitute more than 90 percent of total financial sector assets comprised of banks, non-bank credit organizations, and insurance companies, banks still are small overall. This is reflected in the modest after-tax earnings recorded by the banks, roughly about $11.3 million in 2003 ($564,000 per bank). Even with significant growth in 2004, after-tax earnings are projected to be $18.5 million in 2004, less than $1 million per bank.

As is common in most transition countries, the non-bank part of Armenia's financial sector is less developed than the country's banking system. Notwithstanding banking sector weaknesses, Armenia has virtually no securities/capital markets, no private pension funds, and a very limited insurance sector. Non-bank credit organizations likewise accounted for only 1.3 percent of banks' assets in 2003, attesting to their very small size. There is some new activity in 2004 in leasing and housing finance. However, this is embryonic, and will remain small relative to banking assets until access to long-term funds can be assured.

The insurance sector was composed of 19 active companies in 2003, and three others were licensed but not active. The number of active firms is now down to about 17 in late 2004. Premium revenues were about $4 million-equivalent in 2003 based on market estimates.[53] As such, premium revenues in Armenia approximated $205,000 per active company. After-tax profits were only about $279,000, or less than $15,000 per active firm. (Mid-year 2004 figures show revenues and after-tax profits increasing, but still remaining fairly low.) Insurance density and penetration measures are very low, with per capita insurance at about $2, which is below most transition economies. Meanwhile, as a share of GDP, premium revenues of about $4 million are well below 1 percent of GDP.

Life insurance is underdeveloped, with only one Armenian company offering such products. As such, life insurance only accounts for a small fraction of what are already low levels of insurance revenues. It is possible that life insurance companies may establish operations, essentially to manage/administer second pillar pension funds or occupational insurance plans. However, for now, only one company is active in life insurance. Restrictions on foreign insurers have limited modernization of the insurance sector, although this was set to change in late 2004 or shortly thereafter when legislation was reviewed and presumably revised. (See Annex 8 for a discussion of insurance.)

There are plans to develop a multi-pillar pension scheme in the coming years. The current pension system, which consists solely of a compulsory Pay-As-You-Go system, is inadequate and unsustainable. Today's pensioners are paid benefits that are below the poverty level and barely considered subsistence. Contributors (employers and employees) to the system routinely evade their obligations to fund the system, operating outside the formal sector and simply not contributing. When they do contribute, they do so at less than required levels by under-reporting wages. Contributions and benefits are not linked, and a

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[51] Primary authors: Michael Borish (banking, securities markets, non-bank credit) and Martha Kelly (pension and insurance).

[52] IFS figures put assets at about $460 million when converted to dollars at year-end exchange rates. The CBA figures put total assets at $498.5 million for 2003.

[53] Official statistics show about $1.2 billion-equivalent in total sums insured, of which 97 percent was reinsured. However, market participants believe the figures are overstated.

large number of exceptions provide service credits for certain employee groups, referred to as "privileged" pensioners, enabling them to retire earlier, which reduces collections and adds to costs (as they collect more benefits over time).

The State, through the Ministry of Labor and Social Insurance and the State Social Insurance Fund, currently manages and regulates the only social insurance pension program. The State Social Insurance Fund has not been independently audited, and its finances are not made public. Nor does the Fund follow generally accepted international accounting principals, disclosures or financial reporting rules. (See Annex 9 for a discussion of pension reform.)

The securities markets in Armenia are very small, essentially comprised of a limited government securities market and virtually nothing in equities. The Armenia Stock Exchange does not serve as a source of investment capital for Armenian companies, and most trading is carried out off-market under less than transparent conditions. Only $700,000 in market turnover was reported in 2003, and activity in 2004 was not reported to differ in terms of trends or levels of activity. Total volume of government securities issued was $76.5 million (in 2003). Meanwhile, equities are generally not traded, and open market trading is rare and miniscule in value and volume. There is very little secondary trading reported apart from T-bill activity. Market capitalization as a whole is roughly estimated to be $78 million-equivalent, or less than $400,000 per listed firm. However, none of the listings meets 25 percent free float provisions. (See Annex 10 for a discussion of securities markets.)

3.2 THE BANKING SYSTEM

3.2.1 General Profile of the Banking System

According to CBA data as of September 30, 2004, there were 19 banks with a total of 230 branches in Armenia, down from 74 banks in early 1994. This reflects consolidation in terms of the number of banks in the country, mainly by the elimination of several troubled pocket banks over the years. In a limited number of cases, the authorities encouraged the merger of small banks that were considered potentially viable if they could achieve a larger capital base.

Yet, the system remains small. The largest bank—HSBC Armenia—has only a total of about $132 million in assets at September 30, 2004, equivalent to about 4 percent of projected 2004 GDP. The top five banks (by category) account for 57 percent of assets,[54] 62 percent of loans,[55] 66 percent of deposits,[56] and 41 percent of capital.[57] Netting out HSBC, the other four comparatively large banks averaged $66 million in assets, while the other 14 banks account for only 43 percent of assets in total, equivalent to $21 million per bank. (These figures exclude Armcommunicationsbank, currently in administration.) Thus, the system is small in size, yet relatively concentrated. Further consolidation is anticipated in the coming years to boost earnings and efficiency, particularly as supervision tightens with the introduction of deposit insurance. That several banks are still barely at the minimum capital requirement (for mid-2005) of $5

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[54] In order, these are HSBC, Converse, Armsavings, Ardshininvest, and Armeconombank.

[55] In order, these are Armsavings, Ardshininvest, Converse, Agricultural Cooperative, and Armeconombank.

[56] In order, these are HSBC, Ardshininvest, Armsavings, Artsakhbank, and Converse and Armeconombank (the last two having 8.04 percent each). Taking into account all six banks, this brings their collective total to 74 percent of system deposits as of September 30, 2004.

[57] In order, these are Agricultural Cooperative, HSBC, Ardshininvest, Converse, and Armeconombank.

million[58] suggests the need for continued consolidation or outside capital injections from strategic investors if they are to render needed services and survive in a competitive environment.[59]

Smaller banks have traditionally been linked to families and friends, and/or centered on transactions in Yerevan. CBA supervision has tightened in recent years, and the closure of several pocket banks has reduced the insider profile of most banks. Efforts to contain money laundering and other criminal activities have also served as a catalyst to clean up the banks' governance standards, management systems, and general mode of operation. In this regard, CBA claims that all banks present their financial statements according to international standards.

With the exception of Armsavingsbank, recently acquired by Vneshtorgbank (Russia), and a couple of other banks (Ardshininvest and Armeconombank), there is limited branch coverage outside of Yerevan. In fact, these three banks accounted for 177 of 230 banking system branches as of 3Q 2004. In general, the services rendered by banks are limited to fundamental safekeeping, small loans, plastic cards (debit and credit with small overdraft facilities), transfer services, and some off-balance sheet activities (e.g., trade finance guarantees, letters of credit).

A look at most banks' balance sheets shows key activities are the mobilization of deposits, investment of these resources in government securities or low yield foreign assets abroad (with parent or correspondent banks), and the origination of some loans to real sector clients. Most recently, loans have been in the consumer lending/commercial trade sector, mostly for appliances and automobiles.

The income statement shows low interest expense paid on deposits, reasonable interest income generated from loans, and fee/commission income from transfers and other services. As elsewhere in the CIS region (and other transition countries), the small banks have traditionally been commercial finance companies, with little capacity, effort or desire to mobilize deposits or to develop corporate or retail financial services for the broader market. This is gradually changing, partly due to new prudential requirements and tightened CBA supervision. However, with such low levels of capital in the system, even banks that aspire to be more commercial, professional and diversified in their orientation have difficulty achieving these objectives.

Some of the underlying conditions are changing, as shown in the growth in assets and earnings in 2004. An improved payment system has made it possible for banks to issue credit and debit cards, and to provide payroll and other electronic services. A new credit registry at the CBA has helped with some banks' credit risk evaluation, although this system is supervision-oriented and will be accompanied by a more comprehensive credit information bureau—the Armenian Credit Rating Agency (ACRA)—in the near future if it can obtain sufficient information from and subsequently provide sufficient information to potential users.[60] The tightening of prudential requirements has encouraged banks to begin to develop better risk management systems, all of which will be essential for the restoration of confidence via the deposit guarantee scheme to be introduced in 2005. However, there is limited capital and intermediation, and other problems persist. Key among these challenges are:

- *Governance* is still a weakness throughout the economy, including at some of the banks.
- *The legal framework for secured transactions* is unreliable and time-consuming. Changes are underway, but those involved in the process think an effective framework will not be fully in place and operating until 2006, even if new legislation is passed before then.

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[58] Only 7 of 19 banks had more than $6 million in capital as of 3Q 2004. Five were below the $5 million minimum.
[59] Not everyone agrees with this approach. Some believe minimum capital should be lower to promote entry and competition, on the condition that capital adequacy and other CAMELS requirements are adhered to.
[60] ACRA is reportedly facing challenges in being able to access information from the banks, particularly those with the most information on clients.

- *Banking supervision may still require some strengthening* in certain areas, including early detection of credit and market risk as banks eventually assume more risk in different areas of exposure. This may lead to a resurfacing of challenges surrounding prompt corrective action and bank resolution when the system assumes more risk and becomes more complex.
- *Accounting and audit standards are still comparatively weak*, making it more difficult for bank managers, internal auditors and boards as well as CBA supervisors to detect risk, manage portfolios, and monitor the effectiveness of strategic plans. This is particularly problematic in the real sector, complicating banks' credit risk evaluation efforts.
- *Payment systems are underutilized*, and most transactions are still in cash.
- *Public confidence* in the banks has not been fully restored, limiting long-term funding available for lending.
- *Banks are not aggressive*, as banks often do not pay adequate rates to increase term funding via long-term deposits.
- *The public stays away from banks to avoid potential garnishing of accounts*, meaning that until general tax administration is sufficiently reformed, many people will remain disenfranchised from the formal financial system out of fears of arbitrary confiscation of assets. The reputation of the court system reinforces this sense of vulnerability, and makes it very difficult for banks to mobilize savings, particularly long-term deposits.
- *Limited experience with market-based credit risk evaluation or the determination that most applicants are not credit worthy in the current environment* prompts banks to invest in low yield government securities and bank notes, mainly abroad, which constrains earnings.
- The *small scale of operations* constrains lending and earnings prospects.
- There is a *limited supply of long-term funds*, making it difficult for banks to meet long-term financing needs of the enterprise sector. (Banks can meet mortgage finance needs of households, which are smaller than the value of loans required by most enterprises for new plant and equipment.)
- Potential *currency mismatches* could intensify credit risk, as banks' assets are mainly in dollars and companies' earnings are often in DRAM.

The banking system had a total of about $460 million in assets (end 2003) according to IFS, equivalent to a low penetration ratio of about 16.5 percent of GDP (2003 figures). (Alternative figures from CBA put these at $498 million in assets, or 17.3 percent of GDP.) Of these assets, about $236 million were in the form of loans (including to government), or 51 percent of total. Netting out government (bank purchases of T-bills and other government securities), loans to the real sector were $183 million, or about 40 percent of total assets. However, figures through 3Q 2004 show significant increases in loans and total assets (all discussed below), and projected annualized figures for 2004 should put banking system assets-to-GDP at more than 20 percent.

On the funding side, deposits (net of Government) were about $323 million at end 2003, about 54 percent of assets. (Likewise, in 2004, there has been a major percentage increase in funding for the banks, mostly from increased deposits.) Thus, there is a virtual matching of loans (including investment in government securities) and deposits. Data from 2004 actually show deposits attracted to be far above levels of loans made, and slightly in excess of loans plus investments in government securities. According to IFS, gross capital was $97 million ($88.5 million according to CBA) for a straight capital-to-assets ratio of 21.2 percent at year-end 2003.[61] As of 3Q 2004, CBA figures show capital was equivalent to $117 million, or

[61] Separate CBA figures would put capital-to-assets at 17.8 percent.

17.4 percent. More importantly, regulatory capital is higher than this figure, at 33.7 percent on a risk-weighted basis.[62]

These figures translate into the following averages per bank[63] in 2003-04:

- Assets: $25 million in 2003, projected to rise to about $39 million by year end 2004.
- Loans (to enterprises, households and NBFIs): $9 million in 2003, rising to about $15 million by year end 2004.
- Loans (to government, enterprises, households and NBFIs): $12 million in 2003, rising to about $19 million by year end 2004.
- Deposits: $17 million, rising to a projected $24-$25 million by end 2004.
- Gross Capital: $5 million, rising to nearly $7 million at end 2004.
- Net Capital: $3.5 million, rising to about $5 by end 2004.

Netting out HSBC from the other 19 banks at year end 2003, the system would show the average bank with about $20 million in assets, $9 million in loans, $7.5 million in deposits, and $4.3 million in capital. Developments in 2004 show several other banks are capturing market share in terms of assets and loans, although HSBC still attracts about one quarter of total deposits and reportedly a particularly large share of household deposits. Overall, banks are now better capitalized, have more in assets and deposits, and have made more loans in 2004. On the other hand, notwithstanding these favorable trends in terms of asset growth, lending, and competition, the banking system remains small in total, very small on average, and concentrated in the top five banks, all of which are small by global standards apart from HSBC.[64]

The average bank at year-end 2003 was also below the minimum required capital to be in effect as of July 1, 2005. While the licensed banks are expected to comply with this requirement by then, there is the possibility of one or more banks seeking some form of forbearance. As of 3Q 2004, five banks were below the $5 million mark, including one below $4 million and three below $3 million. Any request for forbearance would present the CBA with challenges related to mergers and/or re-licensing of such banks as non-bank credit institutions. In the case of the former, mergers and acquisitions have not traditionally been carried out in Armenia, although there has been a little merger activity orchestrated by the CBA.[65] In the case of the latter, re-licensing would raise the issue of how to transfer household deposits at a time when the deposit guarantee fund is just commencing operations. Straight forbearance (albeit with a restriction on activities until reaching at least $5 million in capital) would send a signal that the playing field is still not level, even after several years of phasing in minimum capital increases. Difficulties faced by the banks in simply getting to this level point to the small size and weak earnings that characterize most banks' operations. At 3Q 2004, average capital was only $6.2 million per bank. The low values are a function of limited banking sector depth and financial intermediation. The following table highlights the distribution of balance sheet values in the Armenian banking system as of year-end 2003 and at September 30, 2004:

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[62] Almost all of this was Tier I capital (32.2 percent for the system as a whole). Figures apply to 19 banks, net of Armcommunications, as of September 30, 2004.
[63] Figures include 20 banks for 2003 and 19 banks for 2004.
[64] HSBC is part of the second largest bank in the world, with global assets exceeding $1 trillion at year-end 2003.
[65] One CBA-driven "purchase and assumption" transaction involved Arshininvestbank and Armagrobank.

TABLE 3.1: BALANCE SHEET DATA FOR BANKS IN ARMENIA: 2003-04

($ millions)	HSBC $	HSBC %	Next 4 Banks $	Next 4 Banks %	Other 15 Banks $	Other 15 Banks %	Totals $	Totals %
Year-end 2003 data								
Assets	$118.8	23.4%	$156.8	30.9%	$231.5	45.7%	$507.1	100.0%
Loans	$8.4	4.9%	$92.2	53.4%	$72.1	41.7%	$172.7	100.0%
Deposits	$110.3	26.5%	$134.3	32.2%	$172.1	41.3%	$416.7	100.0%
Capital	$8.5	9.4%	$27.3	30.2%	$54.5	60.4%	$90.3	100.0%
September 30, 2004								
Assets	$131.7	19.1%	$262.1	38.0%	$296.1	42.9%	$689.9	100.0%
Loans	$16.2	6.6%	$151.2	61.5%*	$78.3	31.9%	$245.7	100.0%
Deposits	$113.4	25.9%	$174.7	39.8%	$150.6	34.3%	$438.7	100.0%
Capital	$10.8	9.2%	$37.8	32.3%	$68.4	58.5%	$117.0	100.0%

Notes: "Next 4 Banks" refer to the second to fifth largest banks based on that category. In the case of loans (*), this actually means the top five banks, as HSBC is not among the top five. Loans are to/from enterprises, households and NBFIs, but not investment in government securities. Deposits include deposits from households, enterprises, banks and government. Capital is total shareholders' equity. Dollar figures converted from DRAM at year-end or prevailing exchange rates that day. There are minor discrepancies in bank-specific data from CBA aggregated data, resulting in different totals from CBA system data as a whole. This is also true relative to published IFS data.

Sources: CBA; banks' data reported in local newspapers; banks' annual reports; author's calculations

3.2.2 Ownership Structure and Consolidation of the Banking System

There were 74 banks as of 1993, and only 20 ten years later. Thus, Armenia has consolidated its banking system since 1993-94. The average size of bank has grown from $4 million in 1995 to about $23 million at year-end 2003. (Alternative CBA figures would put the figure at about $25 million.) With current projections of average bank assets of $39 million by year-end 2004, this means the average bank is about 10 times the average from a decade ago.

Many of the banks that failed or were closed down did so as a result of insider/connected lending and the inability of these banks to comply with prudential requirements. As elsewhere in the transition economies, several of the failed banks were established to finance state enterprises and/or were overly specialized and/or dependent on government financing. When the rules changed, they were unable to adapt and compete. In many other cases, small pocket banks were established with little capital. Many have since failed or been closed due to insufficient capital, insolvency, and/or concerns about possible criminality. Many banks have barely stayed afloat as they have struggled to attract new investment and generate earnings to bring them to minimum levels of $5 million, effective July 1, 2005.

As of late 2004, Armenia had 20 banks, including one under administration.[66] Among these, nine had foreign capital of more than 50 percent, including HSBC and the recently acquired Armsavingsbank. In terms of overall bank capital, these nine institutions accounted for about 59 percent of assets, 47 percent of loans, 63 percent of deposits, and 47 percent of capital, and 45 percent of after-tax earnings as of

[66] The bank under administration, Armcommunicationsbank, is not included in 2004 statistics.

September 30, 2004. Thus, the banking system is fairly balanced in terms of ownership. The CBA lifted restrictions on foreign ownership in the banks in 1996. However, apart from HSBC (1996) and Vneshtorgbank (2004), no large banks have invested in Armenia.[67]

The presence of foreign banks can be expected to grow. HSBC has experienced growth in all key balance sheet measures, including lending. Meanwhile, Vneshtorgbank's purchase of Armsavings includes acquisition of a nationwide network that comprises 101 branches, by far the largest in the country. Thus, there is considerable scope for impact with this new acquisition, particularly at a time when HSBC openly admits it does not have capacity to handle all the deposit inflows it is currently taking in. One private financial firm currently getting established was interested in acquiring a small bank as of late 2004. Donors may also play a role in this trend as well.[68]

Meanwhile, increased competition may also portend further consolidation among the smaller banks. Most of Armenia's banks are barely above the minimum capital requirement of $5 million (in 2005), or still below it (as of late 2004). At that level, and with fairly strict exposure limits, it will be hard for such small banks to compete. As such, the government/CBA anticipates the possibility of further consolidation to promote efficiency, increase earnings, and boost capital. (Anecdotal reports are that the number could decline to as few as 10-12 banks in the next few years.)

Even with additional consolidation in the number of banks, the average bank would remain small. Such limited assets raises the question of whether these banks will be able to compete in anything but very small-scale lending (e.g., working capital financing), or in more specialized areas of financing such as consumer lending and trade finance. Rather than evolving as corporate banks, most can be expected to provide housing loans, consumer loans, and other kinds of financing targeting households and small businesses. This way, the banks can make loans within their exposure limits, even with low levels of capital. Investment in electronic systems is already permitting banks to seek out higher income individuals and to provide them with services not available to the mainstream (e.g., credit cards, debit cards with overdrafts, targeted savings instruments that can be used to secure loans). However, many of these prospective clients lack confidence in the banks, or are unwilling to place their deposits in any bank apart from HSBC. This may be slowly changing in a few cases, but remains the general rule.

Another challenge is 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). The latter has been used in one case involving a troubled bank.[69] 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. Likewise, without it, they are unlikely to grow. On the other hand, their asset exposures should be monitored closely to avoid any early depletion of insurance funds that would result from rapid deposit withdrawals, triggering a liquidity crisis at the bank, particularly if driven by solvency concerns.

Even if such small banks are not systemic threats, the mere perception of problems can adversely affect confidence in the system as a whole. Putting such small banks outside the deposit guarantee system eliminates this risk, while also sparing CBA valuable time and resources dedicated to the supervisory function of larger banks.[70] However, this is a draconian regulatory approach that could be abused.

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[67] HSBC had $1,034 billion in global assets at year-end 2003. Vneshtorgbank had about $8 billion.
[68] EBRD is reported to have recently expressed interest in taking a 25 percent investment stake in Armeconombank, although the details of any planned investment have not been divulged.
[69] Gladzorbank was re-licensed as a non-bank credit institution in 2003.
[70] Some countries have sought to re-license smaller banks to reduce the disproportionate amount of time dedicated to small banks that account for only a small percentage of assets, lending, deposits, capital, and transactions.

Probably the best approach is to have a comprehensive contingency planning vehicle in place as a function of continuing supervision. This could guide CBA thinking and approaches to corrective actions as problems are identified. Development of a systematic approach could include a 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, albeit under tightened conditions. 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.

As noted, Armenia has had no state banks since 2001. In fact, apart from Armsavings and one or two other banks, Armenia's banking system was wholly private in the 1990s. However, most of these banks were either spin-offs from the old Gosbank system ("ownership transformation"), and/or established with little or no capital. Moreover, as elsewhere in CIS and other transition countries, the system suffered from an insufficient legal and regulatory framework, inadequate accounting and audit standards, weak standards of governance, underdeveloped management systems, and a general lack of experience in market-based banking. This ultimately led to problems with loan portfolios, particularly as Armenia's macroeconomic policies tightened in the mid- to late-1990s. From the monetary perspective, CBA tightened refinancing requirements. From the fiscal side, government reduced subsidies and quasi-fiscal losses. Thus, most banks were unable to obtain relief, and ultimately became undercapitalized, in many cases to the point of technical insolvency. Thus, since the late 1990s on, CBA has spent many years restructuring, merging and liquidating troubled banks. Over the last decade, a net 54 banks have gone through some kind of closure process.

Because of the limited presence of state banks in the 1990s, the banking system has been essentially a privately owned one. As such, Armenia has not had to go through an ambitious privatization exercise in its banking sector. Rather, the challenge has been to attract strategic investment into the sector from "fit and proper" owners, and to strengthen governance and management so that licensed banks can manage portfolios, introduce new products, and generate sufficient earnings to boost capital without assuming dangerous levels of risk. Now that CBA has gotten the system to a point where it has banks that generally meet capital and other prudential requirements, the next step is for them to be able to assume higher levels of risk and to introduce new products/services to increase earnings. There is some evidence in 2004 that this is beginning to happen.

3.2.3 Concentration

As noted above, there is some balance sheet concentration in the banking sector. By category, the five largest banks account for about 57 percent of total assets, 63 percent of total loans, 66 percent of deposits, and 42 percent of capital. The top 10 banks generally account for more than 80 percent of each of these measures. Nonetheless, the system is not overwhelmingly concentrated, as there is some variation in rankings of individual banks by category. For instance, HSBC is the largest bank in assets and deposits, but not in capital. It is also not among the top five in loans. The real challenge is for the other larger banks to demonstrate capacity that wins the trust of the public to be able to attract deposits and additional funding, thereby reducing HSBC market share as the overall market grows. This has begun to happen in 2004 in several areas, although not yet in the household and small business deposit mobilization field.

The banks offer some fee-generating services (e.g., trade finance, credit cards), although these figures are low on a system-wide basis. As of September 30, 2004, banks had generated $11.2 million in commission income, or $15 million annualized. Commission income was about 30 percent of interest income.

Meanwhile, the largest corporate firms (e.g., beverages, diamond polishing, metals, energy) have access to loans and other financing abroad. Private external debt was $678 million at year-end 2003, of which $396 million was for enterprises and another $188 million represented inter-company financing. (Banks accounted for $94 million in international borrowings.[71]) The combined figures net of the banks were more than bank balance sheet values at year end 2003, showing there are other mechanisms for large enterprises to arrange for financing outside the domestic banking system. However, in general, intermediation levels are low and banking is underdeveloped. As elsewhere throughout the CIS region, banks (and formal financial markets in general) play a marginal role relative to the overall economy.

3.2.4 Governance, Boards and Internal Oversight

While improving in recent years, corporate governance standards are not considered strong in Armenia when compared with recommended practices.[72] This is largely due to the underdevelopment of financial markets, limited board and management capacity, lack of familiarity with IAS (now IFRS) and the use of such information for financial management purposes, underdeveloped information systems, the nascent autonomy and reporting modalities of internal audit functions, weak protection (to date) of minority shareholder rights and creditor rights (the latter resulting from a traditionally weak framework for secured transactions and loan recovery), and a general lack of tradition with regard to open information flows and disclosure of problems for the early detection of risks. This is changing in some cases, particularly as regulatory requirements have tightened over the years. For instance, it is now mandatory for banks to present their financial statements according to standards consistent with IFRS. Likewise, efforts are currently underway to strengthen creditor rights. In some cases, with prodding from the CBA and incentives from prospective investors in the donor community, banks are taking the initiative and improving standards. However, as of 2004, corporate governance weaknesses were still reported to be fairly common in the banking sector.

Boards are not considered to have the capacity to satisfactorily play their roles in overseeing management performance once the system becomes more complex. At the moment, banks are generally small, tightly controlled, and run more like commercial finance companies for the benefit of family and cronies than as market-based commercial banks. Thus, boards have not had to develop the kinds of skills, capacity, procedures and systems to operate as elsewhere in the world where markets are more developed. Board members are appointed to serve as allies of management or controlling shareholders, rather than to exert serious governance. In some cases, there are key weaknesses in terms of professional qualifications and experience, notwithstanding academic or other credentials that might seem to be suitable on paper. In other cases, those qualified are unable to dedicate the time needed for serious focus on management performance and financial operations. As the macroeconomic and financial fundamentals push banks to take on more credit risk to sustain high net spreads, both boards and management will need to focus more attention on credit and market risk.

Independent board members and special advisers are not common in banks in Armenia, partly because the banks are small, and the one bank that is comparatively large (HSBC) either does not need such members and/or is able to hire them if needed. However, as a general practice, independent board members and special advisers are not found for purposes of strengthened governance within banks, although they are

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[71] IFS data show banks had $102 million in foreign liabilities at year-end 2003, slightly higher than the reported $94 million.

[72] See the original "OECD Principles of Corporate Governance" issued in 1999, as well as the more recently released version for guidance on fundamental principles in 2004 at www.oecd.org.

hired for advice on other matters. In the banking sector, there is some discussion about requiring independent board members, particularly with regard to audit and supervisory functions. However, to date, this has not been the practice. Likewise, banks generally do not have special committees set up for legal, credit, audit, risk management, and other common functions addressed by boards. This will be essential for banks, but also for CBA as it gradually moves to strengthen contingency planning in due course and to develop a policy with regard to lender of last resort financing.

Minority shareholders face challenges resulting from the right of large or majority shareholders to redeem shares through "put options", as well as from the right of majority shareholders to decide on large-scale purchases without consulting with other shareholders. In effect, such rights can dilute the value of shares in general, deplete assets, undermine future prospects for competitiveness, and leave minority shareholders with little or no salvage value in the event of bankruptcy.

Although CBA has toughened reporting requirements over the years, bank information is still often incomplete or flawed. This is reported to be less an issue of the banks, and more an issue of weak accounting and auditing standards in the real sector. With financial information not considered trustworthy from real sector clients, banks have generally shied away from making loans in recent years to avoid the risk. High net spreads resulting from relatively safe securities investments mitigated the need to risk asset quality or to absorb the higher costs of loan origination. However, now that T-bill rates have declined and yields on securities in Western markets remain low (albeit rising slightly), banks will need to look increasingly at the potential loan market. In fact, this is already happening, with a fairly significant increase in loan volume to the real sector in 2004 as compared with prior years. The existing CBA credit registry combined with the new ACRA credit information bureau (to be introduced in the coming months) will help with information quality, timing and veracity (if ACRA is able to obtain the information needed from banks). However, more generally, enterprises and households lack a tradition of transparency and disclosure in Armenia. This will need to be overcome for market development to proceed.

The role of external audit has been used to supplement the regulatory/supervisory role as a basis for strengthening banks' internal information systems, building up capacity to report regulatory financial information, and increasing capacity for banks to disclose financial information to the public. For instance, banks are now required to publish their audited financial results on a quarterly basis, and to provide notes in their annual statements. Published quarterly reports also require that banks disclose non-compliance with any key prudential measures. As banks mature, they will also begin to treat the external audit function as a strategic exercise, not just a reporting formality. Presumably, this will lead to strengthened governance and oversight capacity.

Internal audit and controls are monitored by CBA as part of the supervisory function. This effort started in the 1990s after banking problems surfaced, and as part of the global effort to address the Y2K challenge. Since then, this function has been strengthened as part of the effort to develop risk management functions. However, autonomous internal audit systems are just beginning to play their role in the banking sector. With assistance from multilateral and bilateral organizations, CBA has worked with the banks to help introduce adequate internal audit, systems and controls. This is part of the regular on-site examination that CBA conducts every year or two on the banks, and can be the subject of a targeted inspection if a problem emerges. However, reports indicate that capacity is limited, and significant work is needed to ensure banks have the internal information needed to monitor and manage risk, as well as to properly communicate with CBA to protect against institutional problems that could undermine overall financial stability. While there is little potential systemic risk at the moment due to the size of the system, this will become an issue over time as banks assume more risk and grow, and as operations and the market become more complex.

MIS has improved in recent years as the banks have moved to strengthen the timeliness, accuracy and volume of financial information. This has also been driven by CBA and the tighter prudential framework. Some of this relates to the chart of accounts, introduced in 1998 (and amended more than once, most

recently in 2003[73]) to facilitate the preparation and electronic submission of uniform bank performance reports (UBPRs). The chart of accounts is generally considered to follow IFRS, and most of the banks along with CBA have come to recognize the importance of these reports. However, their degree of usage for financial management purposes remains an open question. For now, the general view is that they are regulatory reporting formalities, not tools for risk or portfolio management and strategic planning in a competitive market.

3.2.5 Management Capacity

As with governance, management capacity has been strengthened in recent years. However, management is reported to still be relatively weak in terms of capacity and systems regarding credit and market risk. While HSBC has generally accepted practices in place, most banks operate strictly on a collateralized basis. Until 2004, banking decisions in recent years have been carried out in a fairly rules-based manner. Small loan requests were denied because households and enterprises making those requests did not have adequate assets for cover. For mid-sized and larger companies, should collateral not equal or exceed at least 150 percent of loan principal, credit requests were routinely denied and liquid resources net of reserves were put into safe government securities or low yielding bank securities abroad. More recently, banks have been willing to assume credit risk in the areas of consumer lending (e.g., to finance white goods), commercial trade and housing finance. For instance, in the first three quarters of 2004, consumer loans have increased from $41 million-equivalent at year end 2003 to $71 million as of September 30, 2004. At such a pace, that would mean a doubling of consumer loan exposures within one year. Considering that these loans are generally for up to three years and banks have limited term funding, this suggests the banks are beginning to assume greater risk with regard to asset quality as well as asset-liability management. Likewise, loans for commercial trade have increased from $37 million at year end 2003 to $56 million as of September 30, 2004. While these are shorter-term loans than consumer lending, the key here is that banks are taking on a bit more risk as resources flow into the system and as earnings from government securities diminish. Likewise, loans to industry have increased from nearly $53 million at year end 2003 to $70 million by September 30, 2004. As part of the effort to bolster earnings, bank management will need to be more risk-oriented in the future. Nonetheless, this will require greater capacity and systems to monitor for asset quality.

With high real GDP growth in the last few years and substantial cash running through the system, bankers are finding they have opportunities to finance with reasonable assurance of being repaid on time. However, in the future, there will be a point when the economy slows a bit, and/or collateral values are determined to be overvalued for borrowers having problems meeting the terms of their loan agreements. Thus, bank management will need to be prepared for when these conditions emerge.

Moreover, with time, the banking system will become more competitive. There are already indications of this occurring, as HSBC now accounts for less in terms of loans and capital than it did at year-end 2003. Anelik is already the market leader in terms of non-interest income among banks, while Armsavingsbank also generated more in commission income in 2003 than did HSBC. Converse and Armeconombank also are not lagging too far behind HSBC in commission income measures (2003 data). A revitalized Armsavingsbank could intensify some of these competitive challenges at the retail level if Vneshtorgbank invests sufficiently and is aggressive in pursuing this market. Other banks either have investment or are negotiating capital injections from multilateral institutions, foreign banks, and regional development

[73] Changes in 2003 largely related to accounting changes concerning foreign currency swaps. See "The Banking System of Armenia: Development, Regulation, Supervision", CBA, 2003.

banks.[74] Should conditions markedly improve, there is also the possibility of other banks appearing on the scene.

As competition unfolds, bank management will also need to prepare for new approaches to the market. This includes an eventual (partial) migration to unsecured loans based on accurate cash flow projections per project. It also includes market-based strategies (e.g., value chain analysis) that evaluate client credit worthiness and management of accounts based on a more comprehensive relationship with that client, and the total value the relationship represents in terms of bank income. Thus, in the last case, the bank may make a loan that it would otherwise turn down because the borrower also uses the bank for a number of other services that generate significant commission or fee income. When doing so, the bank will need to be able to manage those risks carefully.

3.2.6 Human Capital

The banking system had 4,073 employees as of September 30, 2004, or about 214 per bank. The banks are considered to be able to attract professionals for needed services. This includes former employees of the CBA, which is positive in terms of helping the banks comply with the prudential framework and typical of hiring patterns in transition economies (and elsewhere).

In terms of compensation, no specific information is available on employee packages. However, as of September 30, 2004, salary and other remuneration expenses were nearly $13 million on an annualized basis for the banks. This would be equivalent to about $3,159 per bank employee.

More broadly in the marketplace, people with financial backgrounds are better paid than other sectors. In the banking sector, senior bankers are paid comparatively well, which is one of the reasons why people at CBA sometimes migrate to the banks. On the other hand, lower level bank staff may not be paid as well as lower level staff at CBA. Thus, the private sector does not automatically pay more than the public sector, particularly when other compensation aspects are taken into account.

Outside the banking sector, financial professionals have average salaries more than two times the overall average, at DRAM 129,000 (about $250/month) against an overall average of DRAM 55,609 (about $110/month).[75] However, as these are figures in Yerevan, averages are likely less outside the capital. Most financial professionals appear to be working in telecommunications (and transport), rather than the financial sector.

3.3 NON-BANK FINANCIAL INSTITUTIONS AND MARKETS

3.3.1 General Overview of NBFIs

The non-bank market is small in Armenia. It includes the insurance sector, securities markets, unfunded social insurance fund, a small number of non-bank credit institutions, and several micro-finance groups supported by donors. The postal system also has a small role, disbursing pension payments and, along with money transfer companies, handling domestic and international money orders. (Other NBFIs not included in the scope of this assignment include casinos and pawn shops, which are overseen by the same office at the Ministry of Finance that supervises the insurance sector.)

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[74] For instance, Acbabank's leasing operation (non-bank credit organization) has received investment from IFC. Armeconombank has apparently negotiated with EBRD for a 25 percent stake. Inecobank was in discussions with a foreign bank as of late October 2004. Likewise, Cascade Capital Holdings reportedly acquired Emporiki in late 2004.

[75] See D. Melikyan, "An Overview of the Yerevan Labor Market", *Armenian Trends Q2 04*, AEPLAC.

3.3.2 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. At the moment, the Ministry of Finance and Economy oversees the sector, although not very actively. Its budget in 2003 was reported to be $12,000-equivalent, well below CBA for banking on a per-employee or per firm basis. 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.

Insurance companies are small in assets and capital, and limited in terms of premium revenue and earnings. 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. (See Annexes 8 and 9 for a discussion of these issues.)

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 regulatory authority is in the Ministry of Finance and Economy. 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.

In general, Armenia is underdeveloped in terms of life and non-life insurance. Barriers to entry have been in place for foreign insurers, although they are dominant in some ways through the reinsurance market. (Only one or two of the active companies have some foreign investment.) However, no major international insurance company has an active presence in Armenia.

Based on estimated market figures 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,76 although it is unclear from the figures how much of Latvia's premiums are reinsured. In any event, it shows Armenia is among the smallest of insurance markets in the world. Armenia's density per capita approximates $2,77 and revenues per active company were about $205,000. The following characterize the insurance sector in Armenia:

[76] See "World insurance in 2003", Swiss Re, No. 3/2004.
[77] Density is defined as premium revenues per capita.

BOX 3.1: SUMMARY OF THE INSURANCE SECTOR IN ARMENIA

Number of companies	24 licensed companies as of November 2004, of which 17 are considered active as of mid-2004.
Ownership	All insurance companies are privately owned.
Market share	There is no compulsory insurance in Armenia, one of the reasons for its small size. This is expected to change as more motor vehicles enter Armenia and Armenia introduces third party motor liability. Other compulsory insurance is being contemplated. Some market transactions serve as a stimulus for insurance sector development, such as housing loans that require property insurance.
Types of insurance	Life insurance is available, as well as a wide variety of non-life insurance products. However, only one company sells life insurance, and the market is small. Non-life insurance products include accident, aviation, financial, medical travel, property, and cargo.
Reinsurance	Reinsurance outflows are very high and account for 97 percent of total sums insured.
Claims	Claims paid in 2003 approximated $812,000, about 20 percent of total estimated premium revenues.
Assets	Assets were reported to be DRAM 4.2 billion (about $7.5 million, or about $395,000 per active company) as of year-end 2003. However, market players consider these figures to be overestimated. Thus, average assets are likely far less, and closer to capital figures.
Paid-up Capital	Capital was $3.2 million at year-end 2003, or less than $170,000 per active company.

Sources: Insurance Inspectorate (MoFE), Insurance Statistical Yearbook of Armenia 2004, CIRCO estimates, SIL Insurance (from published sources)

3.3.3 Pension Reform and Pension Funds

One of the most acute problems in Armenia is the public welfare system inherited from the Soviet period, designed to provide “cradle to grave” protection to the population. Early retirement conditions were historically generous to compensate for the inadequacies of Soviet socialism. Soviet women endured long hours of work at home, and predominantly female occupations were awarded early retirement. Miners and many industrial workers suffered dangerous and unhealthy conditions, so they were also given early retirement, though it would have been more socially efficient to improve working conditions and keep skilled workers at their jobs longer. Invariably, the higher ranks of the military likewise receive higher benefits. On the revenue side, these systems offered little encouragement to work or to pay contributions for long-term financial sustainability. On the benefit side, they offered too much, for too many, too early.

Some reforms have been introduced in the last five years with donor support. A World Bank strategy paper was produced in 1999 that identified improving contribution collections and strengthening the benefit payment system as key objectives. USAID also provided direct technical assistance that successfully delivered improvements in the number of employees for whom contributions are being made, and in some cases increases in the amount of reported income. It created 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. The ability to track and report this information, referred to as a system of personified accounts, is being completed through the

State Social Insurance Fund, although there is still assistance needed regarding additional computer support. The project has also started to support the social security offices' need for automating functions associated with social security cards and history-gathering process by delivering computer technology.

Perhaps the biggest change has been the reported surplus in collections for 2003, whereby revenues exceeded expenditures by DRAM 521 million (about $900,900). While cash-based deficits have not been high and have declined in recent years, part of this is related to the simple fact that payments made are so small.

Notwithstanding improvements, Armenia's pension system is still in need of reform. The system is considered unsustainable, and at risk as large-scale emigration by younger workers seeking employment opportunities abroad reduces potential contributions. Demographics show the need to initiate pension reform in Armenia. About 23 percent of the population is younger than 15 years of age, more than 13 percent is 63 or older (generally the point at which people are or will be entitled to retire), and life expectancy is high at 75. While structural measures have been taken to streamline the pension system (e.g., increasing the retirement age), the retirement age of 63 for men and 59 for women in 2003[78] (or after 20 years of service) is still early relative to resource flows.

Over the years, pension expenditure has risen, but remained around 3-4 percent of GDP. While social security contributions are not reported to be in deficit (as of 2003), there are reports of mismanagement of cash proceeds received. Moreover, deficits are partly avoided by maintaining such low payments, equivalent to less than $16 per month on average.[79]

From a long-term fiscal standpoint, pension reform is needed. The government has announced its intention to introduce pension reform in the next few years, although no clear plans have yet been decided about what kind of system, 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. Some or all of the following measures will need to be considered:

- Redefining eligibility criteria (e.g., extending the age at which benefits are paid, reducing incentives for early retirement), and tightening the eligibility criteria for paid benefits.
- Re-setting payment requirements (e.g., within a specified time period).
- Establishing clear guidelines for management, reporting, and decisions on value preservation.
- Setting benefits at a realistic level to protect people against poverty without being overly generous.
- Making benefits funded on a Pay-As-You-Go basis relatively flat, means-tested, or based on a minimum pension guarantee.
- Indexing benefits to prices (rather than wages) so they retain their purchasing value over time.

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 also be needed.

[78] There are plans to increase the eligible retirement age by 0.5 years per year until the age for women converges with the age for men, at 63.

[79] This figure is based on a monthly average of DRAM 8,350 in 2004. With an estimated average exchange rate for 2004 of DRAM 533 per $1, this is $15.67.

Operationally, pension reform is likely to focus on building up more reliable information systems, namely individualized records so that all existing pensioners have computerized records in the coming years. This will help provide a more stable foundation for social insurance. However, in terms of medium-term financial sector development, there is not likely to be much impact 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.

Pension reform will be challenging and will take time. Given the depressed level of wages in Armenia, it is difficult to envision that a robust voluntary pension system could develop without first reforming the compulsory pension system. One proposal under consideration, which is receiving technical support from the World Bank, is re-directing a portion of the existing contributions funding the current PAYG, also referred to as a Pillar One pension. If the Government of Armenia and the World Bank proceed with this plan, one option is the creation of special purpose funds, referred to as pension funds or pension companies, to manage the portion of compulsory contributions that will be used to fund accumulation accounts in each employee's name. Introduction of a draft pension law, which describes the creation of special purpose pension companies, was expected before 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. The law does not address whether and how much of current compulsory contributions could or would be directed to pension companies, but in its present state the law does not currently block or prohibit such a re-direction of contributions. 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 be directed into Armenia's capital markets.

Even with legal reform, there will be obstacles related directly affecting the financial sector in creating a system of accumulation accounts. These include:

- *Small market size.* Armenia has a small population, which limits its ability to reach critical mass quickly. Critical mass helps keep costs manageable. Thus, there is a risk that per unit (account) costs in Armenia would be high.
- *Lack of investment options.* The capital market lacks long-term financial instruments (e.g., government/corporate/mortgage/municipal bonds, blue chip equities) into which the pension company could invest contributions.
- *Lack of pension company experience.* Armenian institutions have little to no experience receiving contributions and allocating them among individual employee accounts, processing earnings, calculating and paying benefits, issuing statements, producing public information, and preparing regulatory reports.
- *Lack of insurance annuity product experience.* Armenian companies would need to create insurance annuity products, calculate life expectancy data, carry out pricing and product risk management, market the products, and other related activities in which they have little or no experience.
- *Lack of regulatory authority experience.* A framework and institutional capacity will be needed to regulate and supervise pension companies. This will require the design of tight regulations describing the functions of accumulation fund management to be carried out, and the ability to evaluate whether a company meets the requirements.
- *Public confidence and possible losses resulting from mismanagement, structural flaws, or regulatory lapses.* Assuming employees will be permitted to redirect a portion of their contributions into pension companies, there is a risk that these special purpose funds are poorly designed or improperly regulated and supervised. If that happens, this may result in losses and reduced public support.

- *Political opposition to pension reform.* Another obstacle to growth of the pension sector is if the government does not permit the re-direction of a portion of the compulsory contributions from the State Social Insurance Fund to a system of accumulation accounts for each worker.

While the above referenced obstacles are important, they can be managed. The market can outsource to experienced pension companies, or encourage the teaming of experienced pension companies in other countries 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. Some of the functions needed for a licensed pension company are already being carried out in Armenia. As examples, asset management firms are in the process of designing and creating investment products similar to those of pension funds, and a bank and postal outlets are currently disbursing pension benefits from the Pillar One system.

3.3.4 Securities/Capital Markets

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.

Securities markets are broadly underdeveloped for several reasons. Key factors have been:

- Slow privatization in the medium- and large-scale SOE sector, while the nature of most other privatization transactions in the 1990s (management-employee buyouts and vouchers) did not lend itself to the attraction of new capital injections.
- The tightly held control of closed joint stock companies, marginalizing the role of minority investors.
- Weak financial condition of many medium- and large-scale companies, which has constrained development of a viable corporate bond and equities market. The number of potential issuers that are financially sound is limited, and few could likely comply with the listing requirements of the Armenia Stock Exchange.
- The absence of capacity and size at local government levels, which precludes the issuance of municipal bonds.
- An underdeveloped housing finance and commercial property market, with an inadequate legal framework, underdeveloped market infrastructure, insufficient inventory of bank loans, and lack of standardization, all making it premature to introduce mortgage bonds or other instruments at the moment.
- Unwillingness to disclose essential financial information and notes based on international standards of auditing.
- The absence of adequate information for ratings.
- The predominance of the informal sector in the economy for tax avoidance purposes.

Commercial banks are expected to be among those that will be able to list as they implement reforms. Meanwhile, the corporate sector's financing needs have traditionally been met by bank loans or from other channels. 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, notes and bonds (limited issues). Non-residents are permitted to participate in the T-bill/note market. However, given the small size of the

market, there has been virtually no international investment in these markets. Portfolio investment has been low for years.

The government securities market consisted of about DRAM 52.5 billion ($105 million) in issued volume as of early 2004. During 2003, DRAM 44.2 billion were allocated in 54 issues, equivalent to about $77 million, or about $1.4 million per issue. About 56 percent were for maturities of up to one year. Average maturities were 332 days in 2003. There was some secondary market activity, equivalent to about $85 million. In 2004, about three quarters of government securities volume issued has been for maturities exceeding one year. The longest, a $3 million bond, has a range of seven years. Secondary market activity for government securities was equivalent to about $70-$75 million annualized for 2004,[80] about the same as in 2003.

Weighted average yields declined steadily through 2003, and ranged from 9.68 percent for short-term T-bills and 14.30 percent on medium-term instruments. In 2004, yields have come down steadily on T-bills, starting at 7.53 percent on a January 27, 2004 issue and coming down to as low as 3.97 percent on October 7, 2004 and October 21, 2004. Yields have generally been consistent with refinancing costs of borrowings from the CBA, which were 4 percent as of September 2004.[81]

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. Average capital per listed company is about $390,000.

3.3.5 Non-Bank Sources of Credit: Credit Unions, Savings and Loans, and Microfinance

According to CBA as of late 2004, there were eight licensed non-bank credit organizations. Of these, four are "universal", two are leasing companies, one is a credit union, and one is a specialized mortgage finance company. These groups had about $6.2 million in assets and $3.9 million in capital at year-end 2003 (when only six were licensed), or average assets and capital, respectively, of about $1 million and $650,000.

Since 2004, two new credit organizations have opened up operations. These include First Mortgage Corporation, which had about $500,000 (about 20 housing loans at $25,000 per loan on average) in assets as of late 2004. (There were no reports of active or material levels of lending yet from the second.) Thus, non-bank credit organizations are very small, albeit comparatively large when compared to many other non-credit organizations in CIS countries.

Among the non-bank credit organizations, one is a former bank that was re-licensed in 2003. However, relative to the banks, they account for very little in the way of assets, loans and deposit mobilization. Likewise, in terms of GDP, their contribution is small, with assets about 0.22 percent of GDP (2003). The Law on Credit Organizations is similar to most banking rules, except that minimum capital is lower, and these credit organizations are not allowed to mobilize household deposits (except for credit unions and savings unions). The following highlights key prudential requirements of various NBCOs.

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[80] Based on results through October 2004 and converted from DRAM 31.76 billion at average exchange rates of about DRAM 533 to $1.

[81] Refinancing rates from the CBA have been 13.5 percent in early 2003, declining to 7 percent by end 2003, and as low as 4 percent in September 2004.

BOX 3.2: SUMMARY OF PRUDENTIAL STANDARDS FOR NON-BANK CREDIT ORGANIZATIONS

Minimum Statutory Capital					
DRAM millions	50	50	100	150	150
$ thousands	100	100	200	300	300
Minimum Total Capital					
DRAM millions	50	100	200	250	300
$ thousands	100	200	400	500	600
Minimum Risk-Weighted CAR	2%	6%	8%	10%	10%
Maximum Risk on Single Borrower	10%	20%	20%	20%	20%
Maximum Gross FX to Total Capital	30%	30%	30%	30%	30%

Notes: A rounded DRAM 500:$1 ratio is used

Source: CBA Regulation 14

There are several micro-finance institutions (MFIs) in Armenia, largely supported by donor funds. Total loans outstanding are reported to be about $13 million in total, with five groups accounting for most of the loan exposures. Loan size varies, but generally ranges from as low as $50 to as high as $15,000. Maturities are generally for up to one year. Interest rates vary, with some groups charging rates of 30-36 percent annualized (often amortized on a weekly or monthly basis), while others charge lower rates due to grant financing which provides a basis for subsidizing loan rates. The effect of the latter is to undermine the market basis for long-term sustainability of micro-finance groups, as inability to cover operating costs (e.g., salaries, computers, communications, transport, utilities) from interest income and fees reinforces dependence on donor funds and grant financing.

As noted, the micro-finance groups have differing areas of focus and modes of operation. Some are largely viewed as agents of humanitarian assistance, making small loans to help people start a small cottage business. In other cases, the MFIs are seeking to meet the needs of micro-enterprises that are largely unmet by the banks, but on commercial terms. They are frequently working in collaboration with business advisory services in the regions.

In general, MFIs are perceived to be weak in management capacity, and would not likely be able to sustain themselves without donor assistance. However, there is differentiation, with about four or five considered to be reasonably sound in terms of management capacity and operations. Some of these have shown a clear interest in operating on a commercial basis, including sharing data and information with each other to promote sound lending practices and positive portfolio performance. For instance, three microfinance groups—MDF Kamurj, FINCA and the Horizon Fund (Oxfam)—produce monthly financial information on a disaggregated basis, but on a common spreadsheet, so that market participants are aware of market developments. However, other groups have either chosen not to participate in such efforts and/or have relied on donor funding without moving ahead with clear plans for self-sustainability in the absence of donor resources. There is currently an effort to clarify the legal framework for MFIs which, to date, have gone unregulated.

3.3.6 Postal Financial Services

The postal network consists of 901 permanent post offices (2003 data), with coverage ratios of about 33 square km and 3,400 people on average.[82] There are no mobile post offices for rural areas, but the entire country has access to services. About 70 percent of households are reported to receive direct delivery.

At the moment, about half of the postal network's income is derived from financial services. These generally comprise small money and payment orders, but little else in terms of financial services. (The postal system is also responsible for the disbursement of pension payments, unemployment benefits, and other social assistance items.) As a percent of total transfers, the postal system accounted for only 0.4 percent in 2003.

There were only 26,015 domestic and international money order transactions in 2003 (dispatch and receipt), down from 2002 due to reduced use of the postal network for domestic payments. This suggests that there is very little usage of the system for financial services, and that the trend is generally declining as banks slowly expand their offerings outside of Yerevan and as money transfer companies make their services more available to the public. Only one in 118 people engaged in a single money order transaction once in 2003 (on average). With the weighted average value of these money and payment orders at $36, this indicates that the postal system is used infrequently for money/payment orders, and that these transactions are for very small amounts. Money orders are received from abroad, and are likely remittance flows that come in to remote areas from family members working or living overseas.[83] However, these are small, with an average of $58. There was also little change in 2003 compared with 2002 in volume or value. The following table provides basic figures for 2002-03 on the volume and value of money and payment orders through the Armenian postal system.

TABLE 3.2: MONEY ORDER TRANSACTIONS THROUGH ARMENIA'S POSTAL SYSTEM (2002-03)

	2002	2003
Number of Domestic Money Orders	18,200	8,544
Number of Int'l Money Orders Sent	2,000	1,769
Number of Int'l Money Orders Received	12,000	10,897
Number of Domestic In-payment Money Orders	1,800	4,805
Total Value of Domestic Money Orders	$211,041	$140,822
Total Value of Int'l Money Orders Sent	$71,509	$81,275
Total Value of Int'l Money Orders Received	$601,726	$634,379
Total Value of Domestic In-payment Money Orders	$19,186	$78,270
Avg. Value of Domestic Money Orders	$11.60	$16.48
Avg. Value of Int'l Money Orders Sent	$35.75	$45.94
Avg. Value of Int'l Money Orders Received	$50.14	$58.22
Avg. Value of Domestic In-payment Money Orders	$10.66	$16.29

Notes: dollar figures derived from SDR figures at average exchange rates

Sources: Universal Postal Union; IMF; author's calculations

[82] These are 2003 data from the Universal Postal Union. See www.upu.int.

[83] There are an estimated 1 million or so Armenians living and working in Russia and other parts of the CIS. There is also a large diaspora community in North America, Europe and the Middle East. Thus, the larger "global" community of Armenians and ethnic Armenians is larger than the Armenian population in Armenia.

There are currently no official plans to provide financial services through the postal system apart from the fundamental money and payment orders currently provided, and the disbursement of pension, unemployment, and other benefits. It remains to be seen if the near-monopoly on pension disbursements will remain with the postal system. Armsavings has expressed possible interest in taking over some of the postal system's current (limited) financial functions. Unless there are plans to change the approach to postal finance, the government might want to consider having pension disbursements run through the banks, possibly via tender, and with more than one bank involved. On the other hand, as Armsavings has the largest network in the country, and most other banks show little or no interest in retail banking operations outside of Yerevan, optimal conditions for competitive procedures may not be attainable. (Adshininvest and Armeconombank have sufficient networks to bid and provide services if they are interested. Thus, the potential for competitive bidding is there.)

As the energy sector tightens up its collection practices, there may also be some scope for the postal service to play a more active role in offering expanded payment services. Pension reform may eventually usher in new possibilities, both in terms of contributions as well as disbursements. Likewise, government efforts to improve tax administration and collection may look to the postal network as part of its overall effort, particularly if government administration experiences a consolidation of offices and services. However, with efforts under way to strengthen local administration and the potential for electronic provision of government services, the potential role of the post office is not likely to move much beyond the limited role it currently plays. Moreover, if Vneshtorgbank decides to pursue these retail options through its vast Armsavings branch network and other banks expand their branch and ATM operations/services, there may be little reason to pursue this option. On the other hand, if the government moves increasingly to the provision of e-government, they may still want to provide a personalized point of contact for people unable to use the internet, etc. The postal network may provide an outlet for such service renderings, at least in some of the more remote areas and smaller towns.

3.3.7 Leasing and Factoring

According to CBA, there are only two licensed leasing companies in Armenia, of which only one has shown signs of activity. Contracts/assets/revenues were a little more than $1.5 million-equivalent as of late 2004. Banks' general exposures to leasing and factoring were only $8 million at September 30, 2004, little changed from year end 2003. Most of it is considered "factoring" in the form prepayments made on behalf of consumers for their loans for household appliances and cars. (This is actually more similar to installment finance rather than factoring.)

Leasing is only beginning to develop in Armenia. Developing the leasing market is an effective tool for lending to SMEs, as lenders (lessors) retain ownership of the assets and prospective borrowers (lessees) do not ordinarily have to provide collateral for the lease contract (as the lender retains ownership). For this reason, banks also generally express interest in leasing, as they view leasing as easier to manage than secured lending in the current environment. However, to date, banks have limited exposure to the leasing market, and Acbabank Leasing is the only active company in the market to date.

Acbabank's leasing activity has involved agricultural and industrial equipment leasing, as well as various services (e.g., medical and dental equipment, taxi services, pizza parlor). This differentiates Armenia from many other markets where leasing is often driven by captive finance companies associated with auto producers. In Armenia, these finance companies have not located, perhaps explaining why auto does not currently dominate the leasing market. To the extent that auto leasing is beginning to occur, one bank (Converse) is reported to have utilized auto dealers to help originate loans. This practice has apparently slowed, and leasing in this area has likewise shown little growth through the banking system.

Existing legislation provides adequate accounting and tax treatment, including accelerated depreciation on all leasing assets. The main challenge for leasing development is the 20 percent VAT that applies to imports. Armenia does not manufacture much of the agro-processing, industrial or other equipment it needs to bolster enterprises. Thus, the 20 percent VAT significantly adds to the contract costs of the lessees, stifling some contracts that otherwise might be transacted.

Factoring is likewise nascent in Armenia. Factoring may grow over time as banks introduce credit cards. However, given the limited issuance of such cards to date (61,100 as of December 31, 2003), and the generally small credit limits on these, there is little supply available for building factoring packages. There is also no organized market for their purchase or syndication.

3.3.8 Mortgage Finance

Banks have reportedly begun to increase their loans to households for mortgage finance, although the CBA figures for September 30, 2004 do not point to any major exposures in this area. Based on existing data, banks had a combined $20 million in exposure to construction and other sectors of the economy. It is unclear how much of these were actually for housing loans, as such data are not specified in the CBA bank chart of accounts. In any event, while banks may be lending for housing and apartment construction, purchase, and renovation, almost all transactions in this field are considered to be in cash. One report indicated in April 2004 that banks covered less than 10 percent of effective demand for housing loans.[84]

There is a new non-bank credit institution, First Mortgage, which established operations in 2004 and had $500,000 in housing loans as of late 2004. Much of this was originated by First Mortgage, although some loans were also purchased from other originators. The loan figures represent an average of $25,000 per loan. First Mortgage anticipates $1 million in housing loan assets by April 2005. In addition, a new financial institution (Cascade Capital Holdings) anticipates entering the market in 2005, with mortgage-related activities a possibility for them. However, as of late 2004, most housing finance is cash-based and conducted outside the formal financial system.

The government is aware of interest in this area, and several reforms are underway to stimulate a more formal mortgage finance market. (See Annex 7 for fundamental requirements for a primary and secondary housing finance market.) Key trends to date are as follows:

- Contribution to GDP from housing-related construction approximated $193 million in 2003, about half of total construction. Housing was thus equivalent to about 6.9 percent of GDP at market prices.
- Armenia is in the early stages of a real estate expansion cycle, although some market players predict a significant decline in two to three years. This current boom is due to earlier housing privatization (in the 1990s) and longstanding interest on the part of people to refurbish and upgrade their premises. There is also interest from the diaspora community in the US, as well as reported interest from Armenian communities in Iran and elsewhere about possible return (part-time or full-time). It is unknown how much money from Armenians working in Russia and other markets is being put into housing, although this is also reported to be a contributing factor.
- One of the reasons why people are investing in housing is because of a lack of confidence in financial institutions and instruments. Housing is perceived to be tangible, useful, and likely to appreciate. Banks and financial instruments are not yet trusted, while people broadly anticipate better returns from their real estate investments. Much of the investment is reported to be inside the premises (e.g., apartments), rather than on the outside to avoid attracting the attention of the tax authorities.
- Rising real estate prices result from pent-up demand and investment flows, as well as overall economic growth and density factors. Rising prices in Yerevan are not due to internal migration.

[84] See "Review of Mortgage Market in Armenia", Bearing Point memo, July 27, 2004.

Rather, prices are driven by external interests, particularly in the center of Yerevan and the Arabkir district.

- There is significant price differentiation within Yerevan, as well as across Armenia. For instance, a recent survey[85] of housing prices put the average market price per square meter for an apartment in Yerevan at $206. In the other major cities of each marz, the range was as low as $30-$31 in Kapan and Gavar to as high as $72 in Gyumri. Thus, even the highest average outside Yerevan was only 35 percent of the average in Yerevan. Moreover, in Gyumri, the maximum per square meter was $100, which was about 10 percent of the maximum in the center of Yerevan. Thus, secondary towns have less range between minimum and maximum prices for apartments when compared with Yerevan.
- The same trends are true for free-standing houses (cottages). The average for Yerevan was $223 per square meter, not much different than prices for apartments. Outside Yerevan, Gyumri averaged $91, and Kapan averaged only $31. In other markets, there is a slight premium paid for cottages as opposed to apartments.

[85] See “Main Trends in the Real Estate Market”, *Armenian Trends Q2 04*, AEPLAC.

ANNEX 4: FINANCIAL SECTOR INFRASTRUCTURE[86]

4.1 POLICY/SYSTEM

Armenia's financial system has been market-oriented in legal orientation for years, but has been challenged by long standing financial weaknesses due to the absence of institutional strength, a weak legal environment for creditors, poor governance standards and practices, underdeveloped management systems, and a tendency towards patronage and connected lending. The traditional legacy of pocket banks and Soviet-styled banks has largely given way to a more modern concept of commercial banking. However, these efforts are now stymied by the penchant for informal transactions, limited balance sheet resources, and problems in the real sector with regard to transparency and disclosure.

The banking sector enjoys a reasonably sound legal framework in terms of specific legislation focused on banking. However, banks have faced difficulties with secured transactions and loan recoveries, a weakness that has reduced the willingness of banks to lend. In effect, while legislation is sound, the court system is not as consistent with regard to creditor rights as is needed for increased risk-taking. Recent reforms to encourage out-of-court dispute resolution and arbitration help to correct this problem. Nonetheless, there are still numerous procedural opportunities for delinquent borrowers to delay court judgments related to contract disputes. This adds to cost and risk for creditors, and explains part of the reason why lending has been low compared to most other transition countries.

The CBA has strengthened supervision in recent years. CBA has focused on closing troubled banks, encouraging remaining banks to strengthen capital and asset quality, and enforcing new prudential norms that help to assure greater stability. This is all considered indispensable for the sustainability of the planned deposit guarantee fund, which in turn is considered essential in the effort to restore public confidence, increase term funding for the banks, and ultimately raise intermediation to levels that will sustain private investment for economic growth. Nonetheless, most of the banks are small and barely able to meet minimum capital requirements of only $5 million. The net result is low levels of intermediation and penetration, with the vast majority of funds and economic activity still outside the banking system. Lack of public confidence in banks is reinforced by concerns about the tax authorities arbitrarily garnishing accounts. Thus, implementation of anti-corruption measures and modernization of tax administration is essential for restored confidence in the banking system.

Other financial services are underdeveloped. The insurance sector is tiny, with revenues of less than $4 million in 2003. This puts insurance sector density and penetration at very low levels—about $2 per capita, and 0.1 percent of GDP—comparable to the weakest markets on a global basis. There have been discriminatory provisions against foreign insurance companies, resulting in no investments in the sector from any major insurance companies. (The lack of major foreign investment has also been true in the banking sector apart from HSBC, the result of diaspora commitment more than commercial decision-making. While nine banks have foreign capital, none is from a major bank apart from HSBC.) Rather, the insurance firms in Armenia rely on reinsurance firms, mostly in the UK and on the European continent.[87] This has much to do with an unreliable legal framework, underdeveloped regulatory and supervisory apparatus, and general concerns about creditor (insurers') rights and contract enforcement. At a minimum, major investors will need an adequate legal framework and regulatory structure to ensure stability and competition in the insurance sector. In the case of the former, a law has been presented that is still reported to have weaknesses with regard to solvency, investment policy, consumer protection, and other

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[86] Primary authors: Michael Borish (all but legal for insurance, pension and securities markets) and Erik Huitfeldt (legal for insurance, pension and securities markets).
[87] Reinsurance firms prominent in the Armenian market include Lloyds, AIG, SCOR, Hannover Re, Polish Re, and the Kiln syndicate.

core areas of insurance. As for regulation, the Ministry of Finance and Economy is responsible, yet is not given adequate budgetary resources, personnel and equipment to effectively do the job it will need to do for a viable insurance sector to operate. New regulations have been drafted which are reported to be adequate for market development. However, the supervisor will need more resources and people for effective supervision.[88]

Pension reform is planned, but neither a second nor third pillar is yet in effect. There are plans to introduce such options for retirement savings in the coming years. However, to date, the main focus has been on stabilizing the first pillar social insurance fund. (See Annex 9 for a discussion of pension issues.)

The securities market shows virtually no activity in terms of volume and turnover. Turnover in 2003 was only $700,000 for the entire year. Even the government securities market is small, and has operated as much to help the banks recapitalize as to provide the government with budgetary resources. For the time being, there is little prospect for capital markets to develop. (See Annex 10 for a discussion of the capital markets.) Other segments of the financial sector, such as non-bank credit organizations (e.g., credit unions, micro-credit, mortgage finance and leasing) are nascent and financially microscopic.

As an extension of the underdeveloped market, general levels of institutional and infrastructure support are only partly achieved. The payment system has improved in recent years, yet most transactions occur outside the formal payment system. Improvements in the payment system are making it possible for banks to offer debit and credit cards. However, the number of transactions remains small when compared with developed markets.

Only two of the five largest international accounting firms are located in Armenia—KPMG and Grant Thornton. International standards have been introduced for banks and listed companies. However, apart from the banks, there is no real observance of IFRS. This is a contributing factor to low levels of risk-taking by the banks.

Other supporting institutions, such as financial media, the CBA credit registry, business associations and training institutes are relatively new in terms of their involvement in the financial system. There is an active press that reports basic information, including the requirement to publish quarterly balance sheets and income statements of the banks. Other very basic information can also be obtained, such as the T-bill market. However, there are no domestic credit rating agencies operating yet (although one is in the process), and there are no international ratings for sovereign paper, let alone ratings for any Armenian businesses or banks. There is an effort under way to introduce a comprehensive credit information bureau, the Armenia Credit Rating Agency (ACRA). While it is facing difficulties obtaining the information it needs to be useful to creditors in general, it will supplement the more limited credit registry at the CBA once established.

There are 60 universities and institutes of higher education in Armenia, and education and training are generally strong points for Armenia. However, specialized courses for bankers, insurance and other financial players and exposure to market-based practices in the financial sector will require on-the-job training to capitalize on the wealth of human resources available in Armenia. Distance learning is currently underutilized as an option, and developing a reliable certification and continuing education program (driven by the private sector) will be essential for market development. Business associations and training facilities exist, many of which have the potential to assist with market development. However, to date, their contribution has not been as strong as found in other economies where markets are more developed.

The Armenian Bankers' Association represents the banking sector, and there is also the Insurers' Association as well as associations in real estate and appraisals. The Bankers' Association has had some

[88] The total annual budget for the Insurance supervisor is reported to be only about $12,000-equivalent.

input into the legal and regulatory process with CBA. However, their contribution has otherwise been fairly limited, partly due to the difficulties Armenian companies (including banks) seem to have in working together on issues of common interest. This is a corporate culture issue that permeates Armenia, weakening prospects for competitiveness and market development in favor of closely-held marginalization.

There is an Association of Accountants and Auditors of Armenia, an outgrowth of the earlier Chamber of Auditors. Few of the 800 or so members are certified in international standards of accounting or auditing. There has been some technical assistance provided to remedy these weaknesses. Nonetheless, the effectiveness of such assistance has been undermined by the ongoing political control exercised by Ministry of Finance and Economy in preventing the association and profession from moving to a more standards-based approach. As such, very few audits do more than provide companies with the financial information they wish to present to the authorities to keep tax liabilities low, adding to the cycle of distrust between the real sector and the tax authorities. A consequence of this approach is that the profession has not made the contribution it could make to firm-specific competitiveness and managerial effectiveness.

Many of the constraints to financial market development are found in the real sector. In the case of companies, there are problems of governance, management, and information dissemination. There is no tradition of open disclosure, and accounting standards are inconsistent with international standards. As such, even if banks evaluated credit risk based on audited financial statements, there is insufficient information and notes. Thus, banks are faced with companies that are not always willing or able to meet the information needs of banks for banks to comply with their own underwriting criteria. The desire of potential borrowers in the enterprise sector to avoid taxation also adds to this challenge for banks. A weak institutional environment and judicial framework compounds the problem. While progress has been made in some areas, it will take time to correct these problems.

These weaknesses adversely affect banking and financial sector development because they constrain the market, limit investment, reduce confidence for long-term planning, and add to risk and cost. This reduces opportunities for lenders and investors in the private sector, restricting the number of viable companies and providing incentives for firms to stay small in assets and short-term in focus. All of this is reinforced by the broad context of a small market (2-3 million people), low per capita incomes and purchasing power, regional risk, a landlocked position, and opportunities for investors elsewhere where uncertainty and risk are not as great or the potential return is higher. The following table provides a synopsis of key environmental factors and challenges related to financial sector development, all of which are discussed more fully below.

BOX 4.1: A SNAPSHOT OF ENVIRONMENTAL CHALLENGES IN THE ARMENIAN FINANCIAL SECTOR

Issues	Challenges
Legal & Judicial	Collateral enforcement weak due to the absence of a unified and digitally accessible registry for moveable and immoveable items, and title issues related to the ownership of property Judicial capacity inadequate due to issues of orientation and experience, corruption, insufficient capacity and support in the system, and time required to adapt to new legislation Alternative dispute resolution and arbitration relatively new and underdeveloped, although reported to be working in some cases Economy and governance (public and private) still weak and lacking in transparency and managerial professionalism Business environment still perceived to be unfavorable, resulting in high levels of tax evasion General lack of trust and confidence in institutions, making resource mobilization and intermediation more difficult
Regulatory & Supervisory	Risk-based techniques new to Armenia, with most banks still operating on a rules-based approach Supervision not consolidated (although system still far from complex) Mandate for supervision challenged by debtors and bankers with strong political connections, although supervisors' mandate has been strengthened in recent years Partial compliance at best (or non-compliance) with some key Basel Core Principles in banking supervision, namely governance and consolidated accounting/supervision Outstanding concerns about capacity for management of credit and market risk at banks, and sufficiently early detection at CBA as the system becomes more complex in the coming years Securities and insurance regulators have had little market experience No structure or program in place for pension reform, including regulation and supervision
Payment & Settlement	Low levels of usage relative to number and volume of transactions as a whole Most transactions occur outside the formal system Small (low) value payments relatively new and underutilized
Accounting & Information Disclosure	No real tradition of transparency or disclosure of information No real tradition of use of accounting information for management uses Limited capacity of the domestic accounting/audit profession in monitoring performance and adherence to RAAS, let alone international standards of accounting and audit Tradition of widespread tax avoidance Insufficient mandate for Armenian Accounting and Audit Association to advance professional capacity and certification of practitioners
Rating Agencies & Systems	Independent credit bureau and/or agency not yet operating CBA credit registry limited as tool of credit risk evaluation for banks because it lacks information on non-bank creditors New credit information bureau will help, but not yet set up and facing difficulties obtaining needed information
Financial Media	Limited financial intermediation and capital markets activity reduces the flow of information and role played by financial press (net of quarterly results, balance

Issues	Challenges
	sheets and prudential indicators of the banks, and some basic government securities data)
Professional Associations	Associations exist (including in banking, insurance, real estate and accounting/auditing), yet their involvement in practical enforcement of legislation has been limited
Academic Capacity	Universities have capacity in many areas, but more market experience and on-the-job training is needed Management training in business and finance relatively new Distance learning not used as much as it could for continuing education by private sector
Other	Telecommunications sector is considered a weakness due to monopoly status (through late 2004) of Armentel Opening up to competition (wireless) is needed to improve electronic systems, which are underdeveloped and a constraint to competitiveness Postal network lacks capacity as point of outreach for financial services in areas where banks not present

4.2 Legal Framework

4.2.1 Legal Framework for Banking

In addition to the Civil Code, the legal framework for banking is based on four key pieces of legislation and about 20 or so regulations, and additional guidelines that define the scope of practice for banks based on prevailing legislation. Armenia adopted the Central Bank Law in 1996, which was subsequently amended as recently as 2002. The Law provides the CBA with responsibility for devising and implementing monetary policy, licensing and supervising banks, designing prudential norms to be followed by banks, and otherwise regulating and monitoring the banking system to ensure it remains stable and solvent.

The Law on Banks and Banking, also adopted in 1996 and subsequently amended, established the basic guidelines for commercial banking in a two-tier system. This Law specifies objectives, regulatory and licensing requirements, permitted activities (including mergers, acquisition of other banks'/enterprises' shares), organizational and managerial issues, capital requirements and ownership provisions, bank administration and reorganization, and liquidation. Some of these issues were reconciled with and superseded by the Law on Bankruptcy of Banks and Credit Institutions, adopted in 2001, which dealt with bank bankruptcy, financial rehabilitation of problem banks, and orderly resolution of outstanding claims.

Key legislation and by-laws for banking and non-bank credit organizations as of end 2004 include the following:

- Law on the Central Bank of the Republic of Armenia
- Law on Banks and Banking
- Law on Bankruptcy of Banks and Credit Institutions
- Law on Banking Secrecy
- Law on (non-bank) Credit Organizations
- Twenty regulations dealing with registration and licensing, prudential norms, financial reporting, bank insolvency and rehabilitation, currency regulation and control, foreign exchange transactions,

money transfers, payment and settlement, debit/credit cards, and deposit guarantees.

Additional implementing regulations are being drafted or have already been approved to be consistent with new legislation, including anti-money laundering provisions consistent with FATF principles.

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. For instance, one bank is 90 percent owned by an insurance company, yet there is no cross-selling. 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. Banks are permitted to establish brokerages and underwrite securities (according to the Securities Market Law, but not banking legislation). However, because of the limited market as well as CBA oversight, banks have done very little in recent years apart from mobilize deposits, invest in government securities, make small loans, and wire transfer funds in and out of the country. 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.

There appears to be some confusion with regard to foreign investment. CBA is clearly open to foreign direct investment into the banking system, particularly if it originates from a prime-rated institution. Likewise, the law permits the establishment of foreign bank branches, but CBA imposes restrictions on deposit mobilization. To date, only HSBC has invested to date among the world’s prime-rated banks, and this was largely inspired by a member of the diaspora community. Nine banks in total have majority foreign investment, but none is considered a major international bank apart from HSBC. The confusion may be concerning the requirement that all foreign financial institutions be resident Armenian companies, more like subsidiaries, rather than having the option of establishing foreign bank “branches” that generally are not required to have specific capitalization for that branch’s operations and are permitted to mobilize deposits. Instead, foreign bank branches are responsible to the host country supervisor, rather than the domestic supervisory authority, although there are ongoing reporting requirements in the country of operation as well. Under such conditions, the latter coordinates with the former to obtain adequate information and understanding of how the branch’s operations impact the market in the country of operation (i.e., foreign branch impact in Armenia). In light of the numerous risks and vulnerabilities associated with the Armenian market, CBA might want to simply stipulate that any foreign bank branch (and similarly in insurance) be restricted to companies with high investment-grade ratings by internationally recognized rating agencies, and by establishing clear communications protocols with the host supervisor. Such an approach might then provide an incentive for major international banks to take another look at establishing an operation in Armenia. This is sorely needed, particularly as HSBC is limited in its own capacity in Armenia, and then is very little trust among the public in other banks. To happen, it appears CBA would need to cede primary supervisory responsibility to the host country supervisor.

Meanwhile, in terms of banking supervision, CBA will eventually need to introduce policies and procedures to carry out consolidated supervision. At the moment, this is not a major problem, as banks are fairly limited in their activities and risk profiles. However, because their earning opportunities are also fairly limited, banks will need to pursue other activities to generate greater earnings. Over time, this will translate into greater complexity and risk assumption. As such, both banks and the CBA will need to enhance capacity to manage these risks while gradually expanding the parameters of transactional

activity. For banks, this will also mean greater capacity to anticipate and manage credit and market risk. For CBA, this will mean sufficient capacity to evaluate banks' risk management capacity as CBA becomes more risk-oriented in its supervisory practices.

Another 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. At a minimum, banks will need to disclose more information over time on their affiliates and subsidiaries as they expand and diversify. 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 assess and manage 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. However, for now, banks are generally considered to lag these standards.

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 limitations on the role of administrators to carry out an orderly reorganization of a bankrupt bank in the past. This has included the right of the administrator to invalidate illegal transactions (e.g., fraudulent conveyances) and to terminate contracts consistent with defined duties. On the other hand, there has also been a gap in terms of court review when decisions of this sort are made. While the courts in Armenia have been notorious for backlog, eventually, there will be a need for an appeal process for shareholders of a bankrupt bank once the CBA has declared the bank insolvent and bankrupt. In one sense, the right of CBA to declare a bank insolvent is an advance from the earlier prudential framework, when shareholders alone had the right. This weakened the role of the CBA in supervision, and was subject to abuse. On the other hand, now that CBA does have this mandate, due process (as in functioning market economies) permits the right of appeal. This also calls for the need for enhanced capacity in the court system to adjudicate on such matters. Court capacity has been called into question in the past, particularly concerning the role of the Ministry of Justice prosecutor's office on some commercial cases.[89]

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. There are still problems in the legal system for banks with regard to secured transactions, creditors' rights, enforcement through the court system, underdeveloped vehicles for out-of-court dispute resolution, political patronage and vested interests, and weak infrastructure in the form of property registries. Progress is being made in several of these areas, although more needs to be done to shift the business environment to be more conducive to risk taking. These include improving the functioning of the courts when commercial disputes arise, further enhancing capacity for alternative dispute resolution, reducing the scope for corruption, and finalizing the work begun with regard to property and pledge registries.

4.2.2 Legal Framework for Insurance

There are two key pieces of legislation concerning the insurance sector. These include the Law on Insurance, and the Law on Licensing. A Law on Bankruptcy of Insurance Companies is also being

[89] As one example, the administrator in the Credit Bank Yerevan cases was imprisoned while discharging duties of bank administration. CBA claims this was an abuse of MoJ authority, and reflects the need for commercial training in the Prosecutors Office, particularly given the power that office wields.

prepared (the draft is not yet available in English), and legislation regarding third party motor vehicle insurance is also being discussed (but not yet drafted).

The new Insurance Law came into effect on August 1, 2004, and the regulations for this law are being prepared. Regulations for the previous Insurance Law from 1996 are still being used to the extent that they apply to the new law.

The legal framework for the insurance sector has certain shortcomings that may be in the process of correction. Key weaknesses have included:

- The restriction on significant ownership (Law on Insurance) was undercut by the right to establish nominee accounts (Securities Market Regulation Law) until recently, with modifications made regarding nominee accounts to reduce the potential for money laundering.
- No clear specification of the insurance supervisor's responsibilities and objectives.
- The absence of protocols for the insurance supervisor to work closely and exchange information with other domestic and foreign financial supervisors.

Other practices, partly driven by the existing legal framework, also undermine market development. In Armenia, the marketing and selling of insurance products through independent agents is prohibited. Instead, the insurance company must employ its sales force. By contrast, in most countries, insurance companies pay their agents on the basis of earned sales commissions instead of taking the risk of having to pay salaries to a large number of sales representatives under an employment contract. The approach in Armenia greatly reduces the use of insurance products because insurance companies are not likely to employ the required workforce. Insurance products need to be actively sold by a strong sales force that can create demand for insurance products. (They do not sell themselves in the same way a bank's loan products sell.) Permitting insurance sales through independent agents will boost use of insurance products, while also having the potential beneficial effect of decreasing unemployment.

Meanwhile, 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. These are needless obstacles and constraints in a segment of the financial sector that is seriously underdeveloped and in need of competition, capital, management expertise, integrity, product development, and general know-how. Such prohibitions also weaken prospects for effective supervision and public confidence.

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.

4.2.3 Legal Framework for Pensions

The Ministry of Finance is preparing a Law on Non-State Pension Security (the "Law on Pension Security") and there were plans to deliver this draft law to the first reading in the Parliament in December

2004.[90] It contains provisions that are partly consistent with the legal framework of other countries with professionally managed pension funds. However, there are also clear gaps.

The draft Law on Pension Security includes provisions allowing employers to make contributions to the pension fund. However, it does not contain any provisions regarding the terms and conditions between the employer and the pension fund (commonly called the pension scheme).

The draft Law envisions an active market, authorizing insurance companies, banks and pension funds to offer pension products. However, it does not provide a framework for the regulation of the pension business conducted by either banks or insurance companies. Instead, the draft legislation only provides for regulations applicable to pension funds offering pension products.

Pension benefits are to be calculated and paid on the basis of a formula prescribed by the bank supervisor, the insurance supervisor, or the securities supervisor. The Law also includes contradictory provisions stipulating a minimum wage-based maximum for pension contributions, as well as stating that pension contributions cannot be confined. Thus, there is an absence of clarity about contributions as well as benefits to be paid into and out of the funds.

The law authorizes the pension fund to invest in government securities, securities listed on a stock exchange registered by the Securities Commission, and securities "circulating outside the Republic of Armenia". However, it does not include any requirement to ensure the capital adequacy of pension funds. The Law also does not contain any tax provisions, or make any statements about tax deductibility provisions for certain securities as opposed to others.

A Council elected by the members of the pension fund is to manage the pension fund, with powers to decide the investment strategy for the pension fund. The Council is also empowered to elect an Administrator for the pension fund, with the Administrator being responsible for the daily running of the pension fund. (The Administrator can be a person or a company.) Meanwhile, the law assumes that the pension fund retains an Asset Management Company, and states that the Asset Management Company shall implement investment and management functions for the pension fund. In practice, the Asset Management Company will be much less involved in running the pension fund than is customary practice in other countries, because it is left to the Council to decide on the investment strategy for the pension fund, and for the Administrator to oversee actual management of the fund. These provisions will cause difficulty for investors who wish to prospectively assess the pension fund's chances for success. 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.

4.2.4 Legal Framework for Securities Markets

Along with the Civil Code, there are two relevant laws that apply to securities markets. These are the Securities Market Regulation Law, and the Law on Joint-Stock Company. A Draft Investment Fund Law is also being prepared.

Overall, the Securities Market Regulation Law is well drafted and contains all provisions one would expect in a securities law. Recent elimination of nominee accounts brings the legislation closer to international standards. However, there are some definitions and concepts that need to be revised, amended, clarified or revisited. These include:

- The definition of prospectus should clarify that it is a specific document that must satisfy information requirements provided by the law. A company must publish a detailed prospectus when it is conducting a public offering by issuing and selling securities.

[90] For this analysis, the October 23, 2003 draft law has been reviewed.

- Several issuers of securities are exempted from having to publish a prospectus, such as banks, insurance companies, religious, educational, benevolent, and other non-commercial organizations. Short-term bond issues are also exempted from the prospectus requirements. The exemptions from the prospectus requirements do not comply with internationally accepted principles.
- The definition of beneficial owner refers to 10 percent ownership. However, elsewhere in the legislation, the term "beneficial owner" is used to describe the real owner of the security. The latter is preferred, and "beneficial owner" should be amended to make clear that it refers to the person who controls and obtains benefits from owning the security.
- Legislation provides the requirements that apply to broker-dealers, namely that a broker-dealer should be organized as a partnership or a company. This 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. Examples include the following:

- The term "put option" is used to describe a shareholder's right to redeem his share(s) in the company. (A put option normally means a contract entered into by a share owner that gives him the right to sell his share to the seller of the put option at a determined share price at a certain time or within a stipulated period.) However, providing a shareholder with the right to redeem shares in this manner runs counter to the concept of shareholding, makes it more difficult for the company to survive through difficult times, and will limit the company's access to loans and credit. At a minimum, a more transparent approach to buying and selling shares should be required, including for treasury shares in which the company openly buys back its shares at a publicly advertised and disclosed price, rather than an automatic right of redemption by shareholders that can impose a burden on the company and remaining shareholders, endangering the value of their residual shares.
- Payment of shares can be made in kind, including money, securities and property rights, and intellectual property. The option to pay in kind is regularly misused by majority shareholders to defraud the company and its minority shareholders because it is difficult to accurately price the value of the asset that is used to pay for the shares. The option to pay in kind should be prohibited. This will help prevent majority shareholder abuse by selling ownership in the company for assets with highly inflated value.
- Legislation aims to protect minority shareholders by requiring heightened scrutiny in connection with large transactions conducted by the company. The law also seeks to prevent fraudulent transactions, such as purchasing assets with overstated values or selling assets at understated values. However, company management typically conducts such "asset striping" or "tunneling" practices. For example, the management board is required to establish the price at which the company is buying property. Only when the company is buying property for a value that is equal to 50 percent or more of the book value of the company is a shareholder's meeting required to make the decision regarding the purchase. Since it is typically management that is conducting the asset stripping of the company, this provision will not effectively prevent fraud. Shareholders must be involved in the decision to ensure that transactions are properly monitored.
- Legislation regulates several conflict of interest situations. While these provisions are useful, they

would be more effective in protecting shareholders if the law were to define "conflict of interest."

- Legislation includes provisions regarding preferred shares that are intended to regulate bonds and other types of debt securities. However, there is confusion between preferred shares and debt securities, particularly as non-payment of dividends to the holders of preferred shares for a consecutive three-year period can serve as a basis for liquidating the company in court.

4.2.5 Legal Framework for Other Financial Services

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. The legislation covers credit unions, leasing and factoring companies, and other credit organizations (e.g., commercial finance, mortgage finance). However, it explicitly does not apply to banks, insurance, pension, securities, investment funds, "lombards" (pawn shops) and agricultural credit clubs. It has also not included micro-finance institutions, although a new law regarding micro-finance may lead to amendments/revisions to the Law on Credit Institutions. Key provisions in the legislation include:

- Licensing and registration standards.
- Accounting standards and reporting requirements.
- Regulation and supervision, which is the responsibility of a dedicated department at CBA, including corrective actions when/as needed.
- Permissible financial activities, as well as restrictions on certain activities (e.g., mobilization of household deposits).
- Prevention of criminal activities.
- Management requirements and qualifications, as well as those not permitted to serve as managers of NBCOs.
- Limitations on capital participation, and qualifications of owners (based on negative list, such as criminal record, etc.).

Leasing is a part of the NBCO framework, with CBA supervising leasing companies as well. The legal framework consists of the Law on Credit Organizations, as well as provisions for leasing found in other legislation and the tax code. Key provisions include:

- Ownership rights to leased equipment.
- General rights and responsibilities between contracting parties.
- Tax provisions assigned to lessors and lessees.
- Accounting standards that describe the deductibility of depreciation as a recognized expense.

Mortgage finance is also covered under the Law on Credit Organizations. There is additional reform work underway, or recently introduced, to strengthen the legal framework for mortgage finance.91 This includes:

- Draft law to amend the Law on State Title Registration to clarify and simplify title registration procedures, and to reduce related charges (e.g., stamp duties). This includes maintaining registration of title at regional State Registry offices.

[91] See P. Badalyan, "Philosophy of Legislative Changes Targeted at Development of a Mortgage Loan Market in Armenia", *Armenia Trends Q2 04*, AEPLAC.

- Draft law to amend the Civil Code, Civil Proceedings Code and Mandatory Implementation of Court Decisions to simplify the legal framework for real estate lending, and to facilitate contract enforcement (including foreclosure when disputes emerge between borrower and lender). This includes involvement of notaries to allow for systematic processing and recording without having to go through the court system.
- Draft law to amend the Personal Income Tax Law that would make interest expense on mortgage loans tax deductible.
- Initiatives to promote standardization of mortgage finance contracts.

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. Article 249 in 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. Creditors should not be permitted the right to force a public foreclosure auction, as that level of authority runs counter to the principle that the land and mortgage registry have legal effect. Legal title should only be bought from the registered titleholder. Rather, 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 prevent the need for foreclosure.)

A second issue, highlighted by the first and its relation to default and foreclosure, relates to access to information on registration of properties, title and claims on related mortgaged properties. As of late 2004, the State real estate cadastre was about two thirds completed (1.1 million immoveable properties registered against an estimated 1.5 million). However, only automobiles are adequately registered (with the Ministry of Internal Affairs) among moveable properties that could be pledged in secured transactions. It will take time to finish the real estate (land and premises) cadastre, as well as to move ahead with a moveable property registry. Once done, it is currently envisioned that such information will be available electronically (digitally) to prospective creditors to avoid multiple claims/liens being placed on the same pledged property. However, Armenia is several years away from making this registry complete. This will add further time and transactions costs to mortgage loan processing. In this regard, the immoveable property registry is more important for secured mortgage finance transactions. However, in some cases, movables will also factor in to the extent that households borrow for renovations and repairs, possibly collateralized by moveable items.

A third issue is the 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.

A fourth issue is the prospective role of a Government-supported Enterprise to lead the way to secondary market development. In general, a preferred approach would be for market players to play an active role in developing standards, and to use this as a basis for fine-tuning the legal and regulatory framework to be

sure such approaches are consistent with broader mandates related to financial stability and implementation of monetary policy. There does not appear to be a need for any public sector institution to take a lead role in this endeavor, although CBA should be involved with market players in coming up with standards needed for orderly market development.

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.

4.3 REGULATORY/SUPERVISORY SYSTEM

4.3.1 Overview

Since adoption of the Law on the Central Bank in 1996 (and subsequently amended on a few occasions, most recently in 2002), CBA has been empowered with the design and implementation of monetary policy. This has included responsibility for monitoring banks' (non-)compliance with prudential norms, and general supervisory responsibilities.

The process of strengthening regulatory and supervisory capacity has been ongoing for several years. The revised Law on Banks and Banking (1996, and subsequently amended thereafter, most recently in 2002) led to a strengthening of regulations and supervision, including tightened licensing and minimum capital requirements. Since 2000-01, there has been demonstrable progress with loan classification, provisioning practices, adherence to exposure limits, and closer monitoring of risks and risk weights. However, because banks do not yet fully observe consolidated accounting, some of the risks and exposures in the system may be more connected than recognized. This has been one of the reasons for the banks becoming exceedingly risk-averse, resulting in low levels of lending. In addition, the application of loan classification standards has been rules-based, and does not yet allow for risk-based judgment by bankers. This is prudent, but eventually will give way to a more risk-based approach when CBA is satisfied risk management systems are sufficiently in place at the banks.

Notwithstanding limited lending, an improved regulatory and supervisory framework has made it possible to better assess the underlying condition of banks. This has included more regular and timely information to assess liquidity management practices and capital adequacy, tighter asset classification standards, and movement towards more accurate provisioning requirements.

Since 1994, a net 54 banks have closed down. Many of these were shut down in the 1990s due to initial reforms and requirements after the hyperinflation period. As an example, Armenia went from 74 banks in 1994 to 30-35 banks from 1995 to 2001 (with 30 banks in 2001). However, many of the net 10 banks merged or shut down since 2001 have been larger or more challenging to resolve. For this purpose, the Law on Bankruptcy of Banks and Credit Institutions was passed in 2001 to provide a framework for resolution. Since then, CBA has focused on administering problem banks, closing them down, and preparing the system as a whole to follow norms that enhance prospects for long-term financial sector stability and growth among remaining and newly licensed institutions. This has focused on getting banks to be able to comply with:

- Minimum capital requirements of $5 million by mid-2005 following an increase to $2 million in July 2003.
- Minimum CARs of 12 percent, and minimum core (Tier 1) CARs of 8 percent.
- Concentration and exposure limits for external and internal borrowers.
- Asset quality standards, such as bringing down the share of NPLs to manageable and controllable

levels to minimize the need for corrective actions.

- Sound liquidity ratios, such as liquid assets as a share of deposits and assets.
- Market risk measures, namely containment of net open foreign exchange positions.

There are still weaknesses faced by CBA and the banks with regard to financial stability. Governance practices are not always strong, partly due to weaknesses at the board level, as well as shortcomings in terms of management capacity and support systems. Accounting and audit standards are not as strong as needed, partly due to problems with regard to borrower/enterprise disclosure, let alone internal issues at banks concerning the completeness of their own information. Autonomous internal audit functions are new to Armenia. These and other issues present risks, even when there is management support and enthusiastic effort to meet prudential and reporting requirements.

4.3.2 Banking Regulation and Supervision

CBA is the regulatory and supervisory authority in Armenia for banking. It has exclusive responsibility for the licensing of new banks, ongoing regulation and supervision of operating banks, resolution of problem banks, and removal of licenses for banks that are unable to comply with system requirements. CBA also oversees non-bank credit organizations.

CBA has 71 staff focused on banking supervision, comprised of 49 focused on off-site surveillance and on-site inspections, 18 focused on "methodology" (system evaluation and analysis), and four on legal matters. As in most other markets, CBA faces challenges in hiring and retaining qualified staff due to the superior compensation provided elsewhere, often banks or international donors. However, average tenure for banking supervisors was 5.5 years as of late 2004, up from 3.5 years at 2001. This is positive, and CBA is generally considered to be a good place to work. The budget for banking supervision approximates DRAM 110-120 million per year, or about $240,000 at current exchange rates, which is consistent with average commercial bank salaries on a per-employee basis. However, at senior levels, CBA may need to increase compensation packages to retain senior staff in the future.

As elsewhere, effective supervision relies on adequate information sharing and coordination between the off-site surveillance and on-site inspection functions. Each bank is visited at least once every two years for a full-scope on-site inspection. CBA also conducts targeted inspections as needed. In 2003, CBA conducted seven full-scope examinations and 10 targeted inspections, covering about one third of banking assets in total. In 2004, about eight or nine full-scope examinations will take place. The data raise questions of whether CBA has sufficient resources, and if additional resources may be needed to conduct annual full-scope examinations for all banks. While smaller banks should not be complicated, even as full-scope examinations, CBA may want to plan for a more frequent schedule as banks take on more risk over time. This is particularly important due to the banks' own weaknesses regarding internal systems and corporate governance.

Off-site surveillance relies on monthly reporting based on electronic uniform bank performance reports (UBPRs) and other reports (e.g., chart of accounts). CBA receives balance sheets, foreign exchange exposure positions, interest rate information on loans and deposits, maturity structure information on loans and deposits, and most other critical financial information on a monthly basis. Quarterly reports come in on staffing and training issues, while other information that is less critical is reported annually. In the future, CBA may want to consider having more frequent liquidity management reports, although there is no risk at the moment as banks are very liquid.

While off-site reports are adequate for fundamental supervisory needs, they are not fully understood or utilized by the banks as management tools. The UBPRs are considered adequate for the identification of current risks that could trigger targeted inspections and corrective actions. CBA has also updated accounting standards and the chart of accounts to enhance the quality of information flows. However, the

banks themselves have had difficulties with some of these changes. As such, remedial measures are under way in coordination with the Armenian Bankers' Association to strengthen professional management standards in the banking system.

The CBA has also instituted a CAMELS system in which banks are evaluated from various data (e.g., UBPRs) and other sources for capital adequacy, asset quality, management capacity, earnings, liquidity, and market risk. This has led to a monthly scoring exercise that is slowly transforming CBA's approach to a more risk-oriented method of supervision. CAMELS scores can now be used by CBA to initiate supervisory actions, including actions prior to insolvency, as well as declaring a bank bankrupt. Formerly, only shareholders could declare a bank bankrupt.

Quarterly financial information of the banks is published in newspapers. This includes balance sheets, income statements, and cash/funds flows. Banks are required to publish their key prudential ratios (e.g., capital adequacy, liquidity), and to disclose any violations. Banks are also required to disclose the names of owners with more than 10 percent ownership stakes in the banks. All of this is intended to restore public confidence, particularly in advance of the deposit guarantee scheme coming into effect in 2005. However, mandatory disclosure does not include individual bank CAMELS ratings assigned by CBA, nor have any Armenian banks been rated by an international rating agency. CBA plans to put the quarterly financial information of banks on its web site in the near future. Meanwhile, the public is entitled to request such information directly from the banks, including notes associated with the reports.

Given the low level of intermediation in the economy, it is unlikely that banks or CBA are fully prepared for more complex risks that might eventually be assumed under more developed conditions. As noted, the banks themselves are assuming very little risk. While earnings are low, the banks are largely compliant with prudential norms, ROA and ROE measures are respectable, and there is very little uncertainty for them in the near term. However, as macroeconomic fundamentals continue to improve and there is compression in interest rates on government securities, there will be even lower earnings from what is a very narrow earning asset base. As noted, HSBC and some other banks also generate earnings from safe securities abroad. However, these rates are low.[92] At some point, to boost earnings, banks will eventually need to assume more risk. This, in turn, will require that CBA develop the capacity to oversee such developments as banks seek out more risk. This will involve fundamental credit exposures (on- and off-balance sheet), trading activities, and new products (e.g., credit cards) that assume a measure of risk.

There is also the issue of governance, management, systems, and the desire of some banks to become more "complex" by engaging in non-bank activities. Over time, this should be permitted, on the condition that both CBA and the banks have the capacity to manage the risks, including early detection of how risks in one sector can affect risks in other financial services and the financial system as a whole. CBA is mindful of this. However, any contemplation of movement to a unified supervisory framework should first ensure that the procedures and systems are in place for risk detection. At the moment, due to the absence of a legal framework and tradition, resources, staff capacity, and market practice, this is not yet in place in the insurance or pension sector. Likewise, due to the near absence of activity involving securities markets, supervisory capacity of the capital markets is largely untested. Rather, a more prudent approach would be to focus on introducing consolidated accounting systems, having CBA pursue a consolidated supervisory approach in its regulatory oversight of the banks, boosting coordination and cooperation with other regulators (e.g., securities, insurance, pension) as they evolve and build capacity, institutionalizing

[92] According to the HSBC annual report for 2003, the average interest rate on placements with banks and other financial institutions was 1.1 percent. As most of HSBC's securities are in dollars and the Fed has raised rates on several occasions in 2004, this has likely increased in 2004. Nonetheless, it is still a low figure, particularly when compared with double-digit interest rates on DRAM investments, and loans to customers in dollars, DRAM and other currencies.

an increasingly risk-oriented approach to all financial services, and then moving to an institutional convergence if this is a preference at that time.

In the past, supervisors themselves have faced challenges with regard to their mandate to enforce prudential requirements. This has reportedly occurred when some bank managers and/or owners/connected parties have had strong political ties. However, more recently, CBA supervisors have had an adequate legal mandate for supervision. In theory, according to civil law in Armenia, the CBA (and not individual supervisors) is liable for any potential issues apart from criminal behavior perpetrated by CBA staff. On the other hand, at least one incident involving a bank administrator has led to prison under questionable circumstances, and the prosecutor's office is considered to be sufficiently strong as to potentially compromise the CBA administrator's authority needed for successful bank reorganization.93 Thus, measures may still need to be taken to strengthen the mandate and legal protection of supervisors and administrators to permit adequate oversight and financial restructuring, although more recent reports suggest that CBA's mandate has been strengthened in recent years. In this regard, commercial training specializing in banking supervision and resolution could be useful for prosecutors. Key regulatory and supervisory provisions are summarized below:

[93] Despite all of this, the bank was actually liquidated in 2001.

BOX 4.2: REGULATION AND SUPERVISION FRAMEWORK FOR BANKING IN ARMENIA

Supervisory Authority and Mandate:	The CBA is the licensing authority for banks, as well as the regulatory and supervisory authority. The head of banking supervision and other directors are appointed by the Chairman of the CBA and confirmed by parliament. Removal follows the same process. As of 3Q 2004, there were 49 professional bank supervisors focused on off-site surveillance and on-site inspections/examinations. Banking supervision is supported by several departments, including four staff in the Legal Department and 18 staff in the Analytical and Statistical Department known as Bank Methodology. The annual budget for CBA's banking supervision department is DRAM 110-120 million. Supervisors are legally liable for their actions if they engage in criminal activity. Thus, they do not have full legal immunity. On the other hand, they cannot be prosecuted for non-criminal activity. Only CBA remains liable for such infractions, not the individual supervisor.
Licensing and Bank Entry:	Minimum capital is $2 million-equivalent for existing banks, and $5 million-equivalent for new banks. The $5 million minimum-equivalent will apply to all banks as of July 1, 2005. Required information includes draft by-laws, organizational structure, market plans, financial information on shareholders, and background and experience of the proposed bank's managers as well as future directors. Financial projections for the first three years of operations are not required, although CBA has it within its power to request such information if deemed necessary. All applications for a license must include information on sources of capital. Sources of funds used as capital were not verified as of 2001, nor were law enforcement authorities consulted. However, consistent with Armenia's efforts to prevent money laundering and other financial crimes, sources are now expected to be verified. This will likely be done in consultation with the Financial Intelligence Unit to be set up in the coming months.
Ownership:	Legislation from 1996 required that single owners and related parties obtain CBA approval to own as much as 50 percent of a bank. As of 2004, CBA now operates on a pre-approval basis, making it mandatory for owners to request approval from CBA for threshold ownership positions of 10 percent, 15 percent, 25 percent, and 50 percent. Non-financial firms have been permitted to own banks, including 100 percent ownership (subject to CBA approval).[94] On the other hand, there have been limitations on ownership of banks by securities firms, insurance companies, and real estate firms. In general, most of the banks are small and closely linked to family and friends,[95] although the larger banks are considered to have more transparent ownership structures. According to CBA, ownership structures of the banks are now transparent.
Disclosure:	Bank directors are legally liable for presenting erroneous and misleading information to the public. When this occurs, penalties can be put in force, including job loss and possible criminal prosecution. Supervisors can also require changes in a bank's organizational structure, a power that has been utilized. External auditors are

[94] For instance, prior to any EBRD investment if it materializes, SIL Insurance owns 90 percent of Armeconombank.
[95] In many countries, it is commonly reported that ownership records are falsified, with "fronts" and "shell companies" obfuscating the real controlling interests. This has been alleged in some of Armenia's smaller banks as well, although many of these have been shut down over the years, as have "pocket banks" in many CIS and other transition countries. CBA maintains they have a clear understanding of ownership in the banking sector.

	required to report alleged misconduct to the CBA. CBA can also request information from external auditors if it suspects misconduct or criminal behavior at the bank. Off-balance sheet items are disclosed to supervisors as well as to the public. The framework for classification of off-balance sheet risks has been tightened, as has loan classification standards and rules for on-balance sheet risks. Risk management procedures are also required to be publicly disclosed. However, there are still reported to be weaknesses with many banks' internal systems, as well as deficiencies in auditing capacity and, therefore, some of the information presented by enterprises to banks. Likewise, general habits of non-disclosure weaken the quality, timing, completeness, and veracity of information presented. Even with most banks seeking to comply, there are weaknesses and flaws in information reported by real sector clients. There are no domestic credit rating agencies to assume rating responsibility for smaller banks. One group, ACRA Credit Reporting, is seeking to establish a comprehensive credit information bureau for banks (and other creditors) to use as a source of information on existing and prospective borrowers. No Armenian banks have received a rating from an international rating agency. The closest banks get to receiving ratings are CAMELS ratings assigned by CBA. These CBA ratings take into account bonds, commercial paper and other securities, as well as loans and other assets held on the books of the banks.
Audit:	Annual external audits are compulsory for banks, and audits are required to be consistent with IFRS and international standards of audit (ISA). Auditors are required to be licensed, but as of 2001, requirements on the extent of the audit did not exist. Since 2002, there has been assistance provided to the Association of Accountants and Auditors of Armenia by the Institute of Chartered Accountants of Scotland to boost domestic audit capacity. However, several initiatives are required for the audit profession to comply with international standards. The CBA receives annual external auditors' reports on banks, and has had the power to force changes in banks' internal organizational structures when determined necessary. However, as of 2001, there were severe weaknesses in terms of information disclosure to CBA. CBA supervisors were not permitted to meet with auditors to discuss banks' annual reports without banks' approval. Auditors were not legally required to report misconduct, nor could legal action be taken against external auditors for negligence. Since then and as of 2004, CBA's mandate has been strengthened, and external auditors are required to respond to inquiries from CBA. Auditors are also required to report specific misconduct to CBA, particularly if such behavior could induce bank insolvency.
Surveillance and Oversight:	Infractions of prudential norms detected by a supervisor must be reported, in which case mandatory corrective actions are triggered. These are based on CAMELS and other information. CBA has a number of options for corrective action, and its approach depends on the magnitude of the infraction. Off-site surveillance is ongoing and continuous, with regular monthly CALE[96] reports generated from required information submitted by the banks to CBA. Major reporting requirements include monthly balance sheets, foreign exchange exposure positions, interest rate information on loans and deposits, maturity structure information on loans and deposits, and related information on liquidity and asset quality. Banks are inspected on site at least once every two years. Targeted inspections occur as needed based on off-site findings. In addition, supervisors rely on the annual bank audit reports prepared by the licensed external auditors to reconcile their evaluation of banks, and to determine strategies for supervisory approaches.

[96] CALE = Capital, Asset Quality, Liquidity and Earnings.

Administrative and Corrective Actions:	The CBA is legally mandated to issue cease and desist orders for serious violations of laws and regulations, and this can lead to the automatic imposition of civil and penal sanctions on banks' directors and managers. These include requiring that banks' management/boards constitute provisions to cover losses, and suspension of decisions to distribute dividends, bonuses and management fees. In 2001, CBA was not empowered to declare a bank insolvent. Rather, this was reserved as a right for the shareholders, and prevented CBA from being able to supersede bank shareholder rights by declaring the bank insolvent. However, since then, and according to the Law on Bankruptcy of Banks, CBA has been empowered to declare a bank bankrupt, and to initiate supervisory actions when insolvency is determined. Further, CBA has been allowed to suspend some or all ownership rights when a bank is insolvent and/or considered a problem bank. CBA does not have a strict schedule of prompt corrective actions to be taken to restore solvency. Rather, it has a basket of options it uses matched with the magnitude of the challenge. These include replacing some/all management and directors, intervening to introduce cost controls, reversing dividend payments and other compensation, and implementing forbearance as needed with regard to prudential norms.
Capital and Capital Adequacy:	Minimum regulatory capital is $5 million-equivalent for new banks and $2 million for existing banks. This will become a uniform $5 million for all banks by July 1, 2005. Minimum capital-to-assets on a risk-weighted basis (capital adequacy) is 12 percent, with risk weights consistent with Basle guidelines. Likewise, revaluation gains are limited to 50 percent of core capital, which is also consistent with Basle guidelines (and less of an issue today now that inflation is increasingly under control). Future fluctuations in real estate asset values may need scrutiny to the extent banks increase their real estate holdings, either directly or via affiliate companies. Some financial information is subject to doubt and error due to the limited experience banks have with IFRS. On the other hand, loan classification standards have tightened and improved in recent years. Likewise, external audit standards have been tightened to assess internal systems and controls, and to try to quantify credit and market risk. CBA also conducts stress tests on a regular basis. There are reported to be weaknesses in the credit and market risk calculations of several banks. As of 2001, unrealized foreign exchange losses were deducted from capital, but the market value of loan losses and unrealized securities losses were not. In 2004, these practices have been brought more closely under control, although valuation standards and mark-to-market accounting are not widely practiced. However, with loan exposures relatively low, loan classification standards tightened, and a major share of assets in short-term liquid securities held by HSBC and others, there appears to be little systemic risk at the moment regarding credit or market risk.
Liquidity:	Mandatory reserve requirements are in effect, at 6 percent of total deposits. These requirements have been in effect since 2003. Reserves are remunerated at 3 percent annualized. In the future, it is expected that the remuneration level will equal the inflation rate. Reserve requirements are met by DRAM cash only held by banks in their correspondent accounts at CBA. There are no plans to use T-bills or related securities as acceptable instruments to meet reserve requirements. There are no guidelines from CBA on asset diversification for banks to manage liquidity.
Deposit Insurance:	There is no explicit deposit guarantee protection yet, although a new system will be introduced on July 1, 2005. Banks have been paying into the planned fund since 2002 at 0.5 percent of individual customer accounts per year. Nonetheless, the public has limited confidence in the banks, as indicated by relatively low levels of deposits and high levels of money held outside the banks. This is partly due to concerns about tax authorities violating account confidentiality and arbitrarily

	garnishing accounts to reduce tax arrears. The planned deposit guarantee fund will have a limit of DRAM 2 million (about $4,000) coverage per local currency account and DRAM 1 million (about $2,000) for foreign currency deposits, with total coverage at DRAM 2 million per depositor. Guarantee coverage has been funded from banks' contributions into the fund at an average annual rate of 0.5 percent of deposits attracted during a reporting quarter. This contribution rate is expected to decline to 0.2 percent as of July 1, 2005. The administrators of the guarantee fund will initially be in the CBA, and then possibly be spun off in the future. CBA retains the exclusive right to intervene in a bank's affairs if there is a problem with contributions to the fund. In the event of needed deposit payout, this is supposed to occur over a period of 14 days to three months.
Loan Quality and Provisioning for Loan Losses:	Non-performing loans are defined as loans that are past due more than 90 days. This includes those that are non-accrual, and/or with interest and/or principal past due more than 90 days, and/or interest that is refinanced/capitalized/rolled over, and/or overdrafts with interest payments past due more than 90 days and principal that has no pre-defined repayment schedule. There are three categories of classification for loans in arrears—sub-standard (up to 90 days in arrears), doubtful (90-180 days for loans in arrears), and loss assets (more than 180 days in arrears). The classification categories also include monitoring of secured loans when performing. Minimum provisioning requirements are: satisfactory (0 percent), substandard (20 percent), doubtful (50 percent), and loss (100 percent). As of late 2001, non-performance of one particular loan did not trigger a reclassification of other loans for multiple-loan customers. This changed after 2001 as loan classification standards tightened.
Income and Expenses:	The income statement includes accrued but unpaid principal and interest when loan is performing, but not when it is non-performing. Interest ceases to accrue after 90 days of arrears. Loan loss provisions are expensed and tax-deductible.

Sources: www.cba.am; discussions with CBA; CBA-IMF survey (October 2001).

4.3.3 Insurance Market Regulation and Supervision

The Ministry of Finance and Economy regulates the insurance sector, although not very actively. Inadequate resources are dedicated to the supervisory function, with its budget in 2003 reported to be $12,000.

The Insurance Inspectorate (supervisory authority) of the Ministry of Finance and Economy is understaffed. The regulatory staff also lacks sufficient training in insurance, financial analysis and product innovations.

Compensation of the staff and management are well below that of other supervisory authorities. As an example, CBA's banking supervision department has a budget of about $24 million with 19 banks (and a handful of smaller non-bank credit organizations). This approximates $1 million per licensed bank or credit institution. By contrast, the Insurance Inspectorate budget is less than $700 per active insurance firm. These factors contribute to the general public's perception that the supervisory authority cannot oversee the industry. Without a dramatic increase in budget for Insurance Department of MoFE, it cannot be expected to provide effective supervisory oversight of the insurance sector.

There is also little useful information or reporting, making it difficult to conduct off-site surveillance. As such, accounting and audit standards need to be strengthened for adequate market information to be made available. This will be essential as well for development of the actuarial profession, which remains undeveloped.

4.3.4 Current Status of Regulation and Supervision of Existing and Future Pension System

As there is no second or third pillar, there is no regulatory function established for pension oversight. Current draft legislation envisions an active market involving banks, insurance companies and private pension funds. However, there are currently gaps in the legislation with regard to how non-pension fund activities would be regulated. Other issues relate to a lack of clarity with regard to (i) how formulas would be set by the respective regulatory agencies in banking, insurance and pension market, (ii) the measurement of solvency and capacity to assure that pension funds and those active in managing pension funds were sufficiently solvent and liquid to meet all obligations, and (iii) governance and management of pension funds, including potential changes in strategy that would be inconsistent with the original understanding of pension fund contributors and served as a basis for those contributions in the first place.

4.3.5 Securities Market Regulation and Supervision

The Securities Market Regulation Law provides the basis for Securities Commission oversight of the capital markets. Most fundamental provisions are in place, including scope for the Armex to operate as a self-regulatory organization under guidelines provide for a safe and orderly market. However, the legislation does not state that one of the securities supervisor's objectives is to monitor the financial soundness of broker-dealers and trust managers. It also does not provide for a sufficient legal basis for close cooperation and exchange of information with other domestic and foreign supervisors. However, with limited trading and transparency, there has been little test of supervisory effectiveness or protocols due to inactivity.

4.3.6 Regulation and Supervision of Non-bank Credit Organizations

The CBA is responsible for supervision of licensed credit organizations. While direct supervision is not as tight as it is with the banks, the non-bank credit organizations are still required to comply with legal and regulatory requirements. Many of the prudential requirements are similar in form to those of the banks, including observing capital requirements (albeit lower than banks), adhering to asset quality and loan classification standards, managing liquidity, and submitting regular reports for off-site surveillance.

The exception to date has been the micro-finance sector, which has been treated more as NGOs engaged in humanitarian relief and funded by donors or foundations. As such, they have not had to obtain licenses from CBA to operate, nor have they been required to report to CBA. However, given that their activities are financial in nature, there is now discussion under way to establish a more coherent legal framework for these institutions. This would likely bring them under some kind of supervisory framework of the CBA.

4.4 Payment and Settlement System

The payment system in Armenia was outdated until fairly recently. However, since 1997, Armenia has had a real time gross settlement system (RTGS) that allows for immediate exchange, and inter-bank settlement to be confirmed within seconds for large value payments. It is based on a central accounting system that conducts payment functions, with links to SWIFT for real time international payments. A central interface module links the central accounting system with SWIFT, to which CBA and 17 commercial banks are linked. The threshold for large value payments in Armenia has been DRAM 5

million, or about $10,000-equivalent (at current exchange rates in late 2004) that can be taken out of Armenia by individuals on a monthly basis. (However, suspicious transactions have no minimum and maximum legal limit.)

Electronic payments and transfers through the banking system have been increasing steadily since 2000. That year, there were nearly 854,000 electronic transactions valued at $1.5 billion, or about $1,759 per transfer. Annualized figures for 2004 would put these at more than 957,000 transactions valued at $3.5 billion, or about $3,649 per transfer. Thus, volume and value are both increasing, and these now account for the vast majority of transactions in the banking system, outpacing paper-based credit transfers, checks and other debit transfers.

Advancements in the payment system have only begun to have a material impact on the financial sector. This is primarily through the ability of banks to issue debit and credit cards, as well as greater efficiency of transactions and improved systems that help to monitor suspicious transactions. Nonetheless, the payment system has not yet had a major impact on how most banks manage their liquidity.

For banks, earlier inefficiencies in the payment system were a contributing factor to banks holding a high proportion of liquid assets on their balance sheets, thus serving as a disincentive to efficient liquidity management. However, banks still retain very high levels of liquid assets in low yielding instruments, raising questions about the efficiency of banks' liquidity management. While there are many other reasons for the high level of liquidity in the banking system, improvements in the payment system do not seem to have made much of a contribution to the liquidity management and treasury functions of the banks. This has also meant that potential improvements in servicing bank clients have not yet had as much of an impact in the economy. For capital markets, it has also meant limited liquidity and turnover, and low levels of capitalization. Again, there are many other reasons contributing to sluggish capital markets development in Armenia. However, earlier inefficiencies in the payment and settlement system were part of the problem. These have since been corrected, yet the virtual non-existence of the securities markets means the potential benefits of enhanced infrastructure and RTGS have not yet had a major impact on the economy. In the enterprise and household sector, most transactions are done on a cash basis, bypassing the formal payment system.

The next step for CBA is to broaden participation in the system to promote increased use for small value payments. This will ultimately help to reduce the per-unit cost of financial services as volume builds. Over time, this will increase the service offerings and earnings of the banks. While some banks already derive a significant portion of their revenues from payment/transfer services,97 greater use of the system as a whole will benefit the banks in terms of volume. Additional benefits include facilitating automatic payments to/from utilities and the tax authorities, as well as providing households with additional income supplements as a result of remittances sent back from Russia and elsewhere.

The prospect of e-government can help to dematerialize transactions, reduce opportunities for corruption, and thereby help to restore confidence and expand the fiscal base. Meanwhile, there has been progress in some utilities (e.g., electricity) in terms of collections, some of which can be made even more efficient if run through the payment system. Increased use of the payment system can be made via the banks for enterprises, such as direct deposits for payroll, pension obligations, etc. This is already beginning to happen, and has served as a basis for bank approval of credit cards with overdraft facilities.

[97] Anelik and Unibank are reported to generate substantial fee income from such services. As an example, Anelik's 2003 income statement indicates that fees and commission income, largely from transfers, was nearly three times interest income, and net fee/commission income was four times net interest income.

4.5 ACCOUNTING, TRANSPARENCY AND DISCLOSURE

4.5.1 Overview of Accounting and Audit Principles and the Impact on Banking

Accounting standards in Armenia are based on the Law on Accounting (2001), as well as provisions in the Companies Law and a Law on Audit Activities. As elsewhere in the CIS (and transition countries in general prior to conversion to IAS or IFRS), local accounting standards have traditionally been tax-oriented. The new law attempted to bring Armenian Accounting Standards largely in line with IAS. However, since then, IAS has evolved into IFRS. This translates into local accounting standards (RAAS) diverging from IFRS in certain areas. Among other problems associated with these shortcomings, the accounting and audit deficit relative to IFRS has been a contributing factor to Armenia's relatively low level of foreign direct investment. Key differences in the domestic accounting framework from international standards[98] are generally the result of RAAS not having been updated since adoption. These are shown in the box below prepared by AAAA and the Institute of Chartered Accountants of Scotland.

BOX 4.3: INCONSISTENCIES IN ARMENIAN AND INTERNATIONAL ACCOUNTING STANDARDS

IAS	RAAS	Difference in RAAS Principle from International Standards
1	1	Revised version (December 2003) of IAS 1 Presentation of Financial statements now prohibits extraordinary items. New IAS to be applied on January 1, 2005, but no corresponding plans to adjust RAAS.
2	2	Revised version (December 2003) of IAS 2 Inventories does not allow "last in first out" as a method of inventory valuation. New IAS to be applied on January 1, 2005, but no corresponding plans to adjust RAAS.
7 (not revised)	7	IAS 7 Cash Flow Statements. RAAS principle does not allow indirect method. IAS allows direct and indirect methods.
8	8	Revised version (December 2003) of IAS 8 Net Profit for the Period states that any changes in accounting policy should be applied retrospectively with any adjustment being made against the opening profits of the company. Also, it sets out what should happen if there is no IFRS to help determine a company's accounting policy. New IAS to be applied on January 1, 2005, but no corresponding plans to adjust RAAS.
10	10	Revised version (December 2003) of IAS 10 Contingencies and Events Occurring After the Balance Sheet Date requires that dividends declared after the balance sheet date should not be recognized as a liability, but shown as a note on the financial statements. New IAS to be applied on January 1, 2005, but no corresponding plans to adjust RAAS.
11 (not rev)	-	IAS 11 Construction contracts.
12 (not rev.)	12	IAS 12 Income Taxes.
14 (not rev.)	14	IAS 14 Segment reporting.
15	15	IAS 15 Information Reflecting the Effects of Changing Prices has been withdrawn.

[98] The authors of this report wish to thank the Association of Accountants and Auditors of Armenia, the Institute of Chartered Accountants of Scotland, and the Yerevan office of KPMG for their help in specifying these differences.

IAS	RAAS	Difference in RAAS Principle from International Standards
16	16	Revised version (December 2003) of IAS 16 Property, Plant and Equipment now recommends that the residual value and useful economic life of an asset should be reviewed at each financial year end (at least). New IAS to be applied on January 1, 2005, but no corresponding plans to adjust RAAS.
17	17	Revised version (December 2003) of IAS 17 Leases normally classifies the land element of a lease (of land and buildings) as an operating lease unless title passes to the lessee at the end of the contract. New IAS to be applied on January 1, 2005, but no corresponding plans to adjust RAAS.
18	18	IAS 18 Revenue Recognition is expected to be revised.
20	20	IAS 20 Accounting for Government Grants and Disclosure of Government assistance is being considered for withdrawal.
21	21	Revised version (December 2003) of IAS 21 The Effects of Changes in Foreign Exchange Rates adjust goodwill and fair value translated at closing rates and not historic rates. New IAS to be applied on January 1, 2005, but no corresponding plans to adjust RAAS
22	22	IFRS 3 Business Combinations supersedes IAS 22 Business Combinations. However, RAAS appears to plan retention of IAS 22.
24	24	Revised version (December 2003) of IAS 24 Related Parties Disclosures enhances the disclosure of the nature of related-party relationships as well as information about transactions. New IAS to be applied on January 1, 2005, but no corresponding plans to adjust RAAS.
27	27	Revised version (December 2003) of IAS 27 Consolidated and Separate Financial Statements account for investments in subsidiaries, jointly-controlled entities, and associates at cost or in accordance with IAS 39 in the holding company's financial statements. New IAS to be applied on January 1, 2005, but no corresponding plans to adjust RAAS.
28	28	Revised version (December 2003) of IAS 28 Investments in Associates accounts for all investments in associates using the equity method, irrespective of whether the investor also has investments in subsidiaries or prepares group accounts. New IAS to be applied on January 1, 2005, but no corresponding plans to adjust RAAS.
30	30	IAS 30 Disclosures of Financial Statements of Banks and Similar Financial Institutions is proposed to be revised.
31	31	Revised version (December 2003) of IAS 31 Interest in Joint Ventures requires the disclosure of the method used to account for joint ventures, either proportionate consolidation or the equity method. New IAS to be applied on January 1, 2005, but no corresponding plans to adjust RAAS.
32	32	Revised version (March 2003) of IAS 32 Financial Instruments: Recognition and Presentation.
33 (rev. Dec.2003)	33	Revised version (December 2003) of IAS 33 Earnings per Share gives additional guidance and illustrative examples on selected complex matters. New IAS to be applied on January 1, 2005, but no corresponding plans to adjust RAAS.
34 (not rev.)	34	IAS 34 Interim Financial reporting.
35	35	IFRS 5 replaces IAS 35. However, RAAS appears to plan retention of IAS 35.

IAS	RAAS	Difference in RAAS Principle from International Standards
36	36	Revised version (December 2003) of IAS 36 Impairment of assets has changed the way that value in use is calculated, and the way goodwill is allocated to cash generating units. Additionally, it has changed the timing of impairment tests for goodwill, and the rules relating to reversals of impairment losses for goodwill. New IAS to be applied on January 1, 2005, but no corresponding plans to adjust RAAS.
37	37	IAS 37 Provisions, Contingent Liabilities and Contingent Assets amendments are being considered.
38	38	Revised version (December 2003) of IAS 38 Intangible Assets has clarified the definition of an intangible asset and the criteria for initial recognition. The assumption that intangible assets have a finite life has been removed, and the treatment of intangible assets with indefinite useful life is set out. New IAS to be applied on January 1, 2005, but no corresponding plans to adjust RAAS.
39	39	Revised version (March 2003) of IAS 39 Financial Instruments: Recognition and Measurement allows the use of fair value hedge accounting for a portfolio hedge of interest rate risk – "macro hedging". Recent IAS changes regarding collateral accounting have not been reflected in RAAS. New IAS to be applied on January 1, 2005, but no corresponding plans to adjust RAAS.
40	40	Revised version (December 2003) of IAS 40 Investment Property now allows a property held under an operating lease to be accounted for as an investment property subject to certain conditions. New IAS to be applied on January 1, 2005, but no corresponding plans to adjust RAAS.
41	Not adopted	IAS 41 Agriculture.
IFRS		
1 (June 2003)	-	First Time Adoption of IFRS explains how the entity should make the transition to IFRS from another basis of accounting.
2		Share-Based Payment deals with the situation where a company receives or acquires goods or services as consideration for its equity capital, and applies to all entities.
3		Business Combinations: The purchase method must be used and uniting of interests is prohibited. All assets, liabilities and acquired contingent liabilities are measured at 100 percent of their fair values. Goodwill is not amortized, but tested for impairment annually. Negative goodwill is recognized in the Income Statement immediately. Restructuring costs are only recognized to the extent that a liability exists at the date of acquisition.
4		Insurance Contracts: This is the first guidance on insurance contracts.
5		Non-Current Assets Held For Sale And Discontinued Operations defines a discontinued operation. When non-current assets are "held for sale", they are not depreciated, but treated as impaired, where the carrying amount exceeds the fair value less selling costs.

Sources: AAAA; Institute of Chartered Accountants of Scotland; KPMG

In many ways, incentives do not exist for businesses to follow IAS/IFRS. Armenian enterprises generally do not borrow from abroad, nor do they float bonds in domestic or international markets. Meanwhile,

banks themselves do not necessarily require audited statements consistent with international standards of auditing (ISA) for prospective borrowers, knowing that this is difficult for smaller companies. Credit risk evaluation by the banks is largely based on cash flow projections and collateral coverage as well as assessed character of the borrower and permanence of employment. The financial statements presented are often discounted by the banks due to their awareness that reports generally understate revenues to reduce tax payments and/or incorrectly value pledged assets.

External audits of banks by licensed firms are mandatory. Only the two major auditing firms in Armenia appear to have sufficient familiarity with these standards. As such, they audit all the banks, as well as the CBA. Legislation requires that banks present their financial statements according to IAS/IFRS, and that audits be compliant with international standards. Notwithstanding capacity constraints of auditing firms, financial information presented by most of the banks is considered acceptable relative to current patterns of investment. These audits are also measured by CBA against the information they receive for verification and possible identification of risks. The challenge will be when banks assume greater risk and financial institutions become more complex.

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 disclosure and transparency will contribute to more and better information for market purposes. However, this will also require time and money. Meanwhile, the costs of an annual audit based on IAS/ISA are expensive for most firms in Armenia, including most of the banks. Nonetheless, as the economy moves forward, these will be necessary costs if banks want to remain licensed and compliant with prudential norms, and if enterprises (including financial institutions) want to have access to debt and equity financing in domestic and international markets.

Accounting capacity and information disclosure has traditionally been weak in Armenia, although progress has been made in the last few years. The CBA chart of accounts is considered broadly in line with IAS/IFRS and is periodically updated to be consistent with these standards, although it does not yet include an approach to consolidated accounting and may need to add some line items as specific credit exposures increase (e.g., housing loans, commercial property exposures). However, the chart of accounts has improved the quality of information provided by banks to CBA for regulatory purposes. This has also helped the banks structure their own internal information and data base systems, providing banks with more guidance in terms of what is required of their own internal audit systems, controls and MIS. Continuous strengthening of the autonomous internal audit function and more regular reporting to management and boards will also help to mitigate risks assumed by the banks that could seriously impair their financial condition.

As elsewhere in transition (and other) economies, banks have benefited from the periodic migration of some CBA supervisors to the commercial banking system. Banks apparently pay their staff more than CBA at senior levels, although more junior levels at CBA may enjoy better overall compensation and stability. In the end, while it taxes the CBA budget and requires additional hiring and outreach efforts, the out-migration of CBA personnel may be beneficial to the system as a whole as it helps banks to understand regulations and to comply. An example of this is found in what is reported to be banks' better loan classification and provisioning practices. CBA today feels that banks' asset quality figures are more accurate than they were a few years ago, providing it with greater confidence in the quality of banks' loan portfolios and underlying capital positions. This will help with financial reporting, including what is required from borrowers to banks as part of the underwriting exercise. Eventually, this will translate into the adoption of better accounting standards at the enterprise level.

There are no provisions that restrict the number of years in which an audit firm can carry out the external audit of a bank. Annual reports are reviewed by the CBA. These reports are made public, although banks

have not been required to make earlier annual reports available to the public. Banks also publish quarterly results in local newspapers, and soon, CBA plans to post these results on its web site.

4.5.2 Professional Capacity and Mandate

IAS/IFRS is relatively new in Armenia, and practiced (to the extent it is practiced) by the banking sector and few other business concerns in the economy. By extension, the domestic accounting/audit profession is underdeveloped, notwithstanding progress with professional development in the last few years.

There are reported to be about 20 Armenians trained and certified in standards consistent with IAS/IFRS/ISA.[99] They currently work for the two multinational accounting firms located in Armenia. An additional 750-800 or so members of the Association of Accountants and Auditors of Armenia (AAAA) are trained with varying degrees of expertise.

Current efforts supported by the Institute of Chartered Accountants of Scotland are focused on continuing education, and eventually obtaining the right (from Ministry of Finance and Economy) to assume greater responsibility for ongoing certification and training, as well as monitoring of performance by members in compliance with recommended professional standards. Anticipated membership in the International Federation of Accountants (IFAC) may help pave the way for what is internationally recognized as best practice, namely performance-based continuing education (with exams) and professional oversight of members through associations like AAAA, rather than regulatory control more directly exercised by the central government.

4.6 Rating Agencies/Credit Registry

There are no domestic rating agencies in Armenia. Nor have the major international rating agencies been active in Armenia. Even sovereign debt ratings are unavailable for Armenia, let alone ratings for individual banks or companies. (The closest example to ratings for banks is the CAMELS ratings assigned by CBA for supervisory purposes.)

The CBA maintains a basic credit information registry, which was introduced in January 2003. The system contains information on the credit worthiness of existing customers of banks and credit institutions, namely on all loans exceeding DRAM 1.5 million (about $3,000) as well as all loans (including below this threshold) that are overdue. The registry provides these institutions with information on, and loans extended to, borrowers. This includes loan histories for each borrower. However, it does not include payment information on borrowings from trade suppliers or other liabilities incurred outside the banking (and credit) system overseen by the CBA. As such, the information provided is focused on supervisory requirements, and limited in terms of the creditor's capacity to fully evaluate the prospective borrower's credit worthiness. Records also do not include unconsolidated companies (e.g., affiliates). Thus, one company with an adequate history may actually request a loan for a second company which is fundamentally lacking in credit worthiness. As such, while the credit registry is a start towards an organized credit risk information and evaluation system, it is fragmented and incomplete.

Recognizing these shortcomings, a new credit information bureau is being established with the support of the CBA, World Bank and private investors. The ACRA Credit Bureau began in early 2004, and has focused in its first year in obtaining information from the banks, other financial institutions (e.g., micro-finance institutions, insurance companies), utility companies, and government offices. This information

[99] The 20 or so licensed accountants familiar with international standards have been certified via the UK-oriented framework (ACCA, or Association of Chartered Certified Accountants) rather than the actual application of this framework to Armenia (including domestic tax provisions). Nonetheless, ACCA provides a sound framework that can then be customized for Armenian conditions.

would be part of a comprehensive and centralized data base for banks (and other creditors) to access as part of their credit risk evaluation. However, ACRA has had difficulties constructing the data base, largely because most banks do not appear to be willing to provide their information to ACRA for free, and then have to pay for services.

As for prospective investment into the banks, the CBA does present monetary and macroeconomic information, including some banking data on its web site. CBA also has a bulletin that is published and presented on its web site, as well as legal/regulatory information, statistics, the annual report, and various thought pieces/publications. These data sources provide basic information, but are not enough to do any serious evaluation of banks on a comparative or peer basis for investment or market analysis purposes.

4.7 Financial Media and Think Tanks

There are several newspapers in Armenia, including some English-language newspapers for the business community (domestic and expatriate). However, these papers include very little information on financial markets, and tend to focus more on international and regional issues of interest to Armenians. The exception is the reporting of quarterly results by the banks in local journals, and some information on the Treasury bill market or exchange rate issues.

The CBA and most/several banks have web sites where additional information is made available. However, as noted above, the CBA web site does not include individual bank information. On the other hand, the CBA will be posting individual bank results on a quarterly basis, as is currently required of the banks in local journals.

Other parts of financial infrastructure are developing, but remain insufficient for a diversified and advanced financial services industry to prosper. As the securities markets are moribund and institutional investors are not active, there is no active market in bank shares. This means there is no serious market scrutiny of the banking system from an investor standpoint. This is even less the case in the insurance sector, where there are no major foreign investors. By and large, there is little market information on the banks, and even less on the non-banks. The exception to this is the presence of some think tanks in Armenia that regularly produce insightful discussion papers on the financial sector and other issues.

4.8 Professional Associations

The Armenian Bankers' Association (ABA) is organized to represent the banks in Armenia. The association has been involved with CBA in providing comments from the banking community on draft legislation and regulation. There has also been some organized training. In some countries, bankers' associations have jointly financed (as equity investors) products that have helped to enlarge the role of banking in the economy. In other cases, they have played a role in coordinating banks' involvement in clearing houses. In Armenia, this has not been the case. Most of the ABA's involvement in banking reform has been as an industry voice on proposed legal and regulatory measures.

The Association of Accountants and Auditors of Armenia has been set up to develop the domestic accounting and audit profession. However, as elsewhere in the CIS, its role has been relatively modest in efforts to move the system increasingly to IAS/IFRS and ISA. As reported above, there is limited capacity in the domestic accounting and audit profession. Capacity has been developed with donor support and on-site assistance from the Institute of Chartered Accountants of Scotland. However, perhaps most importantly, AAAA lacks a mandate to play the lead role in professional formation, development, monitoring and compliance. Instead, this is with the Ministry of Finance and Economy. Armenia could easily remedy this situation by amending the Law on Accounting to be consistent with the EU 8th Directive on Accounting, closing the gaps in RAAS with IAS/IFRS, and permitting the AAAA to handle ongoing professional development responsibilities while reporting to the Ministry of Finance on performance and results.

There is an Insurer's Association of Armenia, which serves as the insurance industry group. It has an open and continuing dialogue with the Insurance Inspectorate of MoFE. This has included input into issues that may surface with the introduction of mandatory third party motor liability insurance and other forms of insurance. However, in general, it is considered to be ineffective in changing the lack of understanding by the general public of insurance products.

There are also two associations relevant for mortgage finance. These include the National Association of Realtors and Appraisers, and the Appraisal Development Center.

4.9 ACADEMIC INSTITUTIONS AND HUMAN CAPITAL FORMATION

There are several universities and institutes that provide degrees or training in banking, finance, and related areas. They are potentially a resource for institutional development, capacity building, consulting, etc. However, formal business management and executive training courses are relatively new to Armenia, and the market generally believes they are limited in capacity and impact. As noted above, Armenia benefits from the presence of several think tanks that conduct research, sponsor seminars, and regularly publish occasional papers on topics of importance to financial sector and economic development.

4.10 MISCELLANEOUS

The postal network is limited in terms of infrastructure capacity. There are no plans being considered to provide financial services through the postal system apart from existing pension disbursements and general money orders and transfers. However, this might become more of an issue if Armsavings Bank decides to close down many of its branches in towns where there is little business. The offset may be that other banks would locate in some of these secondary cities, or at least put ATMs in these cities and towns as a substitute for the higher fixed costs of an expanded branch network. In any event, should Armenia give consideration to this option, it would require increases in electronic capacity, and a clear work plan to sort out ownership, agency relationships, security requirements, and suitability of products/services rendered. As of 2004, the postal system's only financial activities for the public involved relatively small money orders and the disbursement of pension payments and other state benefits.

ANNEX 5: FINANCIAL SECTOR SOUNDNESS[100]

5.1 SUMMARY OF FINANCIAL SECTOR STABILITY INDICATORS

Because Armenia's banks are small and have shown little penetration in the market, there is very little potential for systemic risk. However, the failure of many banks to date and amount of time required to rehabilitate others has had the lingering effect of dampening confidence. This has made it difficult to attract funding into the system, be it from households or enterprises. As such, the economy tends to operate outside formal channels on a cash basis, meaning outside the banking and payment system. Progress is being made, as shown in financial results through 3Q 2004. Nonetheless, banking sector penetration remains low, as does overall financial intermediation.

In general, the Armenian banking system is stable based on capital adequacy measures, asset quality, and liquidity. However, earnings and capital are low, albeit increasing. This makes it difficult for banks to provide much in the way of loans or to boost capital via retained earnings. The following basic indicators present a brief synopsis for 2003 and 3Q 2004:

- Capital adequacy ratio: 33.8 percent (2003) and 33.7 percent at September 30, 2004.
- Average Bank Capital: $4.9 million (2003), projected to be $6.7 million by year end 2004.
- Non-performing Loans/Total Loans: 5.4 percent (2003) and 4.7 percent at September 30, 2004.
- Non-performing Loans/Gross Capital: 11.0 percent (2003) and 10.6 percent at September 30, 2004.
- Average After-tax Earnings per Bank[101]: $563,638 (2003) and projected to be about $975,000 in 2004.
- Liquid Assets/Total Assets: 47.5 percent (2003) and 52.0 percent at September 30, 2004.

It will take some time for intermediation (broad money-to-GDP) and penetration ratios (banking assets-to-GDP) to increase to levels found in middle income or advanced economies, generally above 50-60 percent. However, CBA and the banks have worked through a number of problem situations, and the system is certainly more stable than it was just a few years ago. Moreover, there has been demonstrated improvement in intermediation ratios in recent years, and the year-end figure for 2004 is expected to climb above 20 percent for the first time. Likewise, banking assets are of higher quality, thus ratios are at least supported by better prospects for sustainable growth.

The next wave of challenges will be on the banks as well as CBA to manage increasing levels of risk. This will be needed for banks to strengthen earnings. On the other hand, it will also present new opportunities for mismanagement or miscalculation to weaken individual institutions. In addition, given levels of dollarization in the economy, there will continue to be external challenges to Armenia's financial stability, although the gradual decline in dollarization along with real exchange rate appreciation also points to slow but rising confidence in the DRAM (and, by extension, CBA monetary policy).

Meanwhile, the level of non-bank development is miniscule. As such, there is little prospect in the medium-term for non-banks to undermine financial stability in Armenia. However, this is largely due to underdevelopment. As the insurance sector evolves and banks increase exposures to non-banks, CBA will need to be on guard against any consolidated risks that would run through the system. Likewise, should there be any equity or corporate bond activity in the securities markets, this will likewise present new opportunities as well as risks to which banks may become exposed. Over time as institutions become

[100] Primary author: Michael Borish.
[101] Figures derived from CBA data, and converted to dollars at average exchange rates for 20 banks (2003). The same methodology is used in 2004 for 19 banks, with a projected average exchange rate of DRAM 533:$1.

more complex, this will be a challenge. However, at the moment, there is little risk of this occurring. As such, it is an appropriate time to begin developing additional regulatory/supervisory capacity that will be needed in the non-bank sector so that a gradual increase in financial sector complexity is also a seamless evolution.

Non-bank credit organizations will need to be scrutinized to protect against any problems in performance that could reduce public confidence. In this regard, smaller credit organizations will need to learn how to take on more credit risk. However, for now, capital-to-asset ratios at these institutions are high, and the limited scope of their licenses mitigates the risk of instability. Most importantly, mortgage loan exposures and linkages to banks or other financial institutions will need to be monitored for potential asset bubbles or exposure concentrations. However, at the moment with only one licensed mortgage bank, this is not a problem in 2004.

5.2 CAPITAL AND CAPITAL ADEQUACY

5.2.1 MINIMUM AND AVERAGE CAPITAL

Minimum capital for the banks was raised to $2 million in 2003, and is required to be $5 million for all banks by July 1, 2005. As of year-end 2003, the average bank was below the $5 million figure, although this was expected to be corrected by 2005. Projections for gross capital by year end 2004 are nearly $7 million per bank. However, it was considered possible that several smaller banks would seek some form of forbearance due to their inability to meet the $5 million minimum threshold. As of 3Q 2004, five banks were below the $5 million minimum, and several were barely above it.

As noted elsewhere, the average bank in Armenia is small. The five largest banks account for 41.5 percent of system capital or $9.7 million on average, while the 14 additional banks only have 58.5 percent of system capital or $4.9 million on average. Given their small size, it remains to be seen if the smaller banks will be able to compete. In some cases, particularly banks with barely $5 million in capital, mergers would make sense. This has already been carried in at least one recent case,102 although most bankers are not interested in merging with other institutions despite their small size.

In the meantime, CBA will need to continue to monitor the condition of these banks, their suitability for participation in the deposit guarantee fund, and whether a re-licensing exercise makes sense. The re-licensing exercise could apply to solvent institutions that are legally in good standing, and demonstrating movement towards sound standards of management and governance. Such “banks” could be re-licensed as non-bank credit organizations, and essentially function as commercial finance companies. This would permit them to continue as businesses, but not as deposit-taking banks. However, the offset to this is that several institutions have complied with prudential requirements, made progress towards reaching the minimum capital figure, and would experience a decline in their business if they were not permitted to mobilize household deposits. Thus, CBA may want to have an additional option that introduces very restricted licenses for small banks (e.g., less than $10 million in capital), but provides continued license to mobilize household deposits (and other deposits) on the condition they retain sound CAMELS ratings (“1” or “2”). Restrictions on activities could be drawn from the menu of options CBA has as part of its corrective actions (e.g., freeze/reverse dividend payments, limit compensation for board members and management, limits on lending exposures).

[102] In 2003, CBA carried out a purchase and assumption involving Ardshininvestbank and Armagrobank.

5.2.2 CAPITAL ADEQUACY

Capital adequacy is required to be at least 12 percent of risk-weighted assets in total. According to CBA, a minimum of 8 percent Tier I capital must be maintained. As of year-end 2003, the system's CAR was well above these levels. System CAR was nearly 34 percent, of which Tier I measures were 32.2 percent. Figures for 3Q 2004 show that there was virtually no change from year-end 2003 figures, although CARs have experienced a slight decline since 2Q 2003. Nonetheless, CARs remain high and more than adequate for some additional risk-taking by the banks.

One risk to these measures is that the calculations may not be entirely accurate, as some of the banks report information that is unconsolidated and incomplete relative to risk exposures. However, because of the number of banks that have been merged, liquidated or otherwise resolved, the scope for miscalculation appears to present less of a risk than before. Moreover, supervision now has better information than in earlier years. The assumption here is that there is activity off the books that does not directly imperil the financial condition of the banks. On the other hand, as such activity reportedly still exists (albeit outside the banks), it could potentially weaken banks and the system if such activities are permitted to be woven back into the formal system—via banks, insurance companies, or other financial services providers.

More recently, efforts have been made to begin to account for affiliates and subsidiaries (previously undisclosed or unaccounted for), as well as off-balance sheet items that represent contingent liabilities that need to be accounted for to arrive at more accurate capital adequacy ratios. As such, information is now considered to be more accurate than before, and less prone to error. Moreover, loan classification standards have been tightened to provide a greater sense of confidence in the risk weights and quality of assets reported. In real terms, much of this has resulted in banks simply placing their funds abroad in rated (and liquid) bank securities or domestically in government securities. Thus, from a regulatory reporting perspective, this is easier and more reliable, as well as less risky and a major factor behind high CARs. However, in market terms, it also is a substitute for lending, and one of the reasons why banks' earnings are low.

Based on year-end 2003 data, CBA believed that all banks' CARs were above 12 percent, and that all but two banks' CARs were above 20 percent. Thus, only two banks had CARs in the 12-20 percent range, all well above the minimum 12 percent. Likewise, all banks were above the minimum 8 percent Tier I requirement, with 16 of 20 above 20 percent. If these indicators are accurate and remain the case, banks' capital positions are relatively low risk. Data as of 3Q 2004 show that at least 17 banks had CARs and Tier I capital exceeding 20 percent. However, as noted, capital is low in the aggregate, earnings are weak, and there is little prospect for growth if banks remain as risk-averse as they have been in recent years. Indications in 2004 are that banks are beginning to lend more, largely driven by their need to generate stronger earnings in a declining interest rate environment.

Given that the level of banking sector penetration in the economy is so low, any bank failure would have little direct impact on the economy. HSBC is the largest bank, and there is virtually no risk of it failing. Other banks are generally small, even the other four comparatively large banks. Off-balance sheet items are not reported to be of such magnitude that it would create major problems should there be a scandal or failure. As in other markets, one of the key challenges for Armenian banks and regulators in the coming years will be building capacity to manage assets properly, including assuming more credit risk. Additional challenges include banks' capacity to introduce new products and services that bring more funding into the banks. For both to occur, the public has to have confidence in the banks, including management and systems. When that occurs, there will be higher levels of monetization, intermediation and banking penetration. However, until then, such figures will remain low. Perversely, this will reduce the potential for systemic risk in Armenia.

5.2.3 ASSET QUALITY AND CAPITAL

In terms of asset quality issues and the sufficiency of bank capital, the ratio of real sector loans-to-net capital[103] decreased significantly in 2003 after having been about six to seven times in 2000-02. Total real sector loans to net capital increased from about five times net capital in 1998 to more than seven times net capital in 2000-01. Since then, the ratio has come down, and it was fairly low at the end of 2003, at less than three times.

Figures from CBA for 3Q 2004 show that real sector loans have increased slightly to 2.25 times shareholder equity, as compared with a 2.04 ratio at year-end 2003. Thus, lending is increasing in 2004, although the total ratio is lower than in earlier years.

Part of the reason for the lower ratio today than in earlier years may be due to a more accurate accounting of loan quality, combined with recent efforts by banks to increase capital as they get closer to the July 1, 2005 trigger date for minimum capital. Adherence to high CARs, risk aversion, and safe earnings from low risk securities are also reasons why the ratio declined in recent years (notwithstanding a slight increase in 2004).

CBA restructuring efforts have also had an impact. CBA has liquidated some banks, and the resolution process has removed some of the non-performing loans that existed in the system in previous years. This is reflected in the ratio of non-performing loan ratios relative to net capital. The NPL ratio ranged from 54.5 percent in 1998 to a low 14 percent in 2003. While these have fluctuated in recent years, the trend is increasingly favorable. Using slightly different data from CBA, NPLs approximated 10.6 percent of capital (shareholder equity) as of 3Q 2004, about the same as the 11 percent figure at year-end 2003. In general, risk adjusted capital coverage of loans is stable and adequate.

TABLE 5.1: BANK LOANS TO ENTERPRISES AND HOUSEHOLDS RELATIVE TO NET BANK CAPITAL

	1998	1999	2000	2001	2002	2003
Real Sector Loans/Net Capital	523.7%	481.8%	748.0%	711.6%	637.4%	259.0%
NPLs/Net Capital	54.5%	22.6%	46.4%	42.7%	31.2%	14.0%
Net Loans/Net Capital	469.2%	459.2%	701.6%	668.9%	606.2%	245.0%

Notes: Ratios only include loans to enterprises, households and NBFIs. Net capital is “capital” plus/minus other items (net).

Source: IMF (IFS); EBRD; author’s calculations

5.3 ASSET QUALITY AND CONCENTRATION

5.3.1 ASSET QUALITY

As noted above, asset quality has improved since 1995-96, when NPLs were 22-36 percent of total loans. By 1998, non-performing loans had declined to about 10 percent of total loans. At the time, this was equivalent to only $16.4 million. However, this also approximated 30 percent of banking system gross capital and 55 percent of net capital. By year-end 2003, NPLs were about 5.4 percent of real sector loans, or about $10 million. This is less in absolute terms, and approximated 10 percent of gross capital and 14

[103] These figures do not include banks’ investments in government securities, which are assumed to be safe. Rather, these ratios only include loans to enterprises and households. Net capital is “capital” plus/minus other items (net) as reported in IFS.

percent of net capital. The figure was little changed in 3Q 2004 in dollar value (about $12 million), and lower as a share of total loans, assets and capital. Thus, in terms of volume and value, asset quality has improved. On the other hand, there is a limit to portfolio quality, in that earnings are meager due to the high level of low risk assets.

TABLE 5.2: NON-PERFORMING LOANS (NPLS) IN THE REAL SECTOR (1998-2003)

	1998	1999	2000	2001	2002	2003	2004
NPLs ($ millions)	$16.4	$8.1	$12.3	$10.4	$8.2	$9.9	$12.4
NPLs/Total Loans	10.4%	4.7%	6.2%	6.0%	4.9%	5.4%	4.7%
NPLs/Total Assets	6.73%	2.82%	3.54%	3.12%	2.18%	2.15%	1.83%

Note: Loans apply to real sector. Loans to government (banks' investment in government securities) are not included in the ratios. 3Q 2004 figures are calculated from CBA data.

Source: IMF; CBA; EBRD; author's calculations

Most other assets (39 percent of total, or $181 million at year-end 2003, and 28 percent of total, or $188 million at 3Q 2004) are in foreign assets, mainly bank paper in money center banks. This ratio has increased steadily over the years, rising from as low as 14 percent in 1998. However, with banks now lending more, the trend is starting to reverse relative to total assets in 2004. There may be some risk associated with investments in banks in Moscow (as well as in New York and London), although CBA generally believes these investments are safe and secure. Thus, particularly taking stricter loan classification standards into account, asset quality has improved in Armenia in recent years. However, again, there is still very little risk-taking in the system, resulting in low levels of intermediation and weak earnings for the banks.

The low value of assets in the system reflects the general lack of risk-taking. Banks' loans to households and enterprises were only 6.4 percent of GDP at year-end 2003, with the ratio likely to rise to 8-9 percent by year end 2004. While increasing, the ratios still reflect a very limited contribution to economic growth. As noted before, this is largely due to the small resource base available to the banks, particularly as individual loans are not permitted to exceed 20 percent of capital. A tightened prudential framework has also shifted the incentives, at least temporarily, away from risk-taking. However, as banks are now considered somewhat "over-capitalized" on a risk-weighted basis albeit "under-capitalized" in aggregate financial terms, there is some scope for banks to increase their assumption of credit risk. The evidence from 2004 is that this is beginning to occur.

One of the factors constraining increased risk-taking is the poor legal/judicial framework that has traditionally limited creditor rights in the courts. Banks have faced difficulties with loan recovery in general. Difficulties enforcing collateral claims when borrowers have defaulted and launched appeals in the courts have been the major challenge. Thus, combined with the need for banks to comply with stricter prudential norms and their own funding constraints, they have little incentive to take on added risk. This is particularly the case with loan exposure to large enterprises that may have strong political ties. As such, banks have turned away from such lending, and are now only beginning to lend to SMEs and households.

Meanwhile, banks' non-lending services are increasing, but remain limited. There is very little trading and investment, as the securities markets are underdeveloped. This is true for companies and the stock exchange, as well as for the government securities market. Most commission income is derived from transfers. Off-balance sheet items are generally restricted to performance guarantees, some trade finance, and unused lines of credit. Looking ahead, banks will need to lend more in subsequent years to boost earnings. This will make it all the more important for banks to be able to manage the credit risk they assume, particularly when competition picks up and margins tighten.

Beyond loans and foreign assets, most of the other assets on banks' balance sheets are reserves and properties. As noted above, some of the overseas placements may not be in investment-grade paper, raising doubts about quality. However, much of this group of assets is reported to be in OECD countries with correspondent banks, mostly in New York and London. The foreign currency breakdown of assets shows almost all investments are in dollars (85 percent) or euro (10 percent), with only 5 percent in rubles. There has been slight movement to the euro (from 7 percent at year-end 2003 to 10 percent at September 30, 2004) and ruble (from 3 percent to 5 percent in 2004) in 2004, although the majority foreign currency assets remain in dollar-denominated instruments.

With regard to properties, it is difficult to know what the actual value of such properties is. Fixed assets were valued at only $36 million as of 3Q 2004, little more than 5 percent of total assets. Many banks in transition economies have recorded high property values to obscure problems with other assets, thereby presenting solvent or overvalued balance sheets when they faced financial difficulties.[104] However, most countries have introduced tougher requirements and valuation standards to reduce this misrepresentation. In Armenia, current norms restrict banks' real estate assets to 25 percent of total capital. While fixed assets exceed this, it appears that the actual real estate component is compliant on a system-wide basis, and that banks are not over-valuing propertied assets.

As there have been restrictions on banks' real estate activities in the past, it is unclear the extent to which these issues are relevant. On the other hand, while banks have not necessarily engaged in a major amount of property development or construction,[105] affiliates or other connected entities may have. Yet again, because bank lending has been so low, even exposures to property development are not considered to be sufficiently high to pose a systemic threat. At a minimum to offset future risks, accurate asset values (to the extent possible) should be captured in the financial and regulatory data to prevent excess concentration in such potentially risky areas of financing. CBA should consider amending the chart of accounts to capture banks' investments in properties as well as credit exposures in housing and commercial property markets. This should be implemented as consolidated accounting is increasingly observed, and as consolidated supervision gradually comes into effect.

5.3.2 CONCENTRATION

In terms of institutions, the main concern for systemic stability is HSBC. As noted above, HSBC accounts for a sizable share of assets and deposits. However, its market share has decreased in 2004. Moreover, as part of the second largest bank in the world, its collapse would pose a global challenge rather than simply a challenge for the Armenian financial sector and economy. There have been no reports of troubles at HSBC, and its ratings remain investment-grade.

Net of HSBC, the next four banks (or five in terms of loans) account for more than 61 percent of loans, nearly 40 percent of assets and deposits, and nearly a third of capital. Thus, even the collapse of one or two of these would pose little systemic risk. Moreover, these banks are considered to have sufficient capital adequacy and asset quality to weather any downturn in the economy. However, given how fragile public confidence is in the banking system, a bank failure would raise doubts about safekeeping capacity at the banks as well as supervisory capacity at the CBA.

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[104] Most banks have properties in Yerevan, which should be more valuable than structures outside the capital. On the other hand, in the case of bank premises, these are not always easy to refurbish or convert for other purposes. Thus, appraising "market value" may be difficult. Likewise, some properties are used for operations (and, therefore, are non-earning assets), whereas other properties may be held for investment.

[105] Construction companies are reported to have significant cash resources, mitigating their need for banks. Demand is also high for new housing in Yerevan, resulting in the ability of developers to pre-sell flats. This generates cash for builders, reducing their borrowing needs for property development.

Regulatory (Tier I and Tier II) capital figures for the largest five banks show all of them are well above the 20 percent mark. With about 40-50 percent of assets of these banks in loan exposures, this implies that most of their loan portfolios would have to completely collapse in performance for the banks to face significant stress. However, to date, there has been no information that would suggest this would happen.

The audited statements from 2003 noted (in at least two of the cases involving the top five or six banks[106]) the potential vulnerability of banks in general to political and economic changes in Armenia, particularly with regard to taxation contingencies, and risks in the business, legal and regulatory environment that are not necessarily found in better functioning markets. Risk management notes (when presented) generally alluded to standard credit and market risk issues, as well as possible liquidity issues.[107]

Sector trends indicate some diversification in lending patterns, although most appear to focus on high turnover, short-term activities. Based on CBA data at 3Q 2004, only $138 million-equivalent of total loans were for maturities exceeding one year. This approximated 44 percent of total, which seems high compared with discussions with the banks. Nonetheless, most of this is the result of funding from donors' lines of credit that are often explicitly intended to finance activities with longer-term requirements. Some banks are actively seeking to finance industrial activities and construction, although the largest share of loans is in the consumer loan segment ($71.5 million at 3Q 2004), followed by industry ($70 million) and trade ($57 million). Construction exposures were only $12 million, indicating that most of this activity is being funneled through other institutional vehicles or being carried out privately. Exposures to financial institutions (e.g., banks, insurance, leasing) were $17.5 million, and bank loan exposures to the agricultural sector were about $15 million. Such diversification will help offset concentration risks should asset quality in a particular sector decline. However, as loan values are still low, this is not anticipated as a problem any time soon.

Average loan size is small, largely due to the low level of capital of the banks and regulatory restraints on the size of individual loans. As noted, with average capital of less than $5 million at year-end 2003, the average bank would not be able to make a loan larger than about $970,000. A projected average $6.7 million per bank would raise this to $1.3 million as of year-end 2004. While these are large loans for most banks, they are still small for most large-scale enterprises and many medium-sized enterprises. In general, many of the export-oriented and potentially competitive companies in Armenia need larger loans for longer periods to increase their operating efficiency and scale of operations. On the other hand, there is a benefit for financial stability under such conditions. While the small scale of banks' lending resources is negative for overall economic growth, it does mean that when individual loans turn bad, they are generally not large enough to materially impact the overall portfolio. Most loans are reported to be far smaller than $1 million.

The banking system shows that a high proportion of overall assets are held in reserves and investments in securities abroad. This suggests that the impact of any deterioration in loan quality could be contained by calling in liquid assets available offshore. Meanwhile, the diversification of lending away from troubled enterprises in the 1990s has helped with loan quality, as reflected in the lower NPL figures. The challenge for banks now is to be able to reorient their lending practices to accommodate smaller enterprises based

[106] See 2003 Annual Reports for HSBC and ACBA banks. Such notes were omitted from other annual reports.

[107] Other possible risks (not mentioned in banks' annual reports) focus on war, or a severe deterioration in oil and gas prices in Russia. The former is considered unlikely, as is the latter. The impact of any decline in commodity prices in Russia would be to reduce export markets for Armenian firms and employment opportunities for Armenians sending back remittances. However, the opposite occurred in 2004 due to high levels of demand in China and the West, difficulties in Iraq, hurricanes in the Gulf of Mexico, and the government clampdown of Yukos in Russia (all of which have had the effect of raising oil prices in international markets). A lesser risk would be a substantial decline in diamond prices, which would adversely affect Armenia's major source of export earnings. However, this has not been the case, nor are the larger banks reported to be materially exposed in these areas.

on market standards. Given that most banks have limited experience in this domain, there is a risk that loan portfolio quality could decline in subsequent years as banks presumably take on greater risk to boost assets and earnings. Recent developments indicate that banks are beginning to take on this challenge in the consumer goods and commercial trade sectors, the two areas where growth has been greatest in 2004. In this regard, the long-term nature (up to three years) of nearly half of consumer loans may also present a challenge to the banks in the future if distributors become over-extended and have to liquidate inventories at low prices. This is also a risk in commercial trade, of which more than half of exposures are now beyond one year in maturity.

There are numerous techniques banks in market economies have perfected over the years that can help mitigate these risks. These include increasing loan limits and lengthening maturities of loans to preferred borrowers based on performance. However, even more importantly, banks that are able to offer a range of simple services (e.g., electronic payroll, cash management, custodial) are also in a position to monitor client cash flows. This is on the assumption that banks encourage the use of compensating balances[108] and other incentives (e.g., demand deposit accounts that households and enterprises use for business operations) to attract as much potential business from borrowers as is possible. This, in turn, provides banks with additional information on the working capital patterns of companies (and households), their seasonal needs (if any), and over time, their capacity for larger loans and appropriate mixes of maturities, interest rate formulas and currency denominations. These and other techniques are particularly useful when the secured transactions framework is weak and credit information is in short supply, as has been the case in Armenia.

5.3.3 Asset Quality and Deposit Safety

In terms of asset quality issues and the safety of deposits, the ratio of real sector loans-to-deposits has decreased in recent years as banks have shown limited appetite for lending, and as more accurate accounting of loan quality has materialized (net loan figures). This is reflected in loan-to-deposit ratios both before and after accounting for performance. Gross loans relative to deposits have diminished substantially, from 1.5 times deposits in 1998 to less than half that level in 2003-04. In general, since 2001, ratios have been relatively matched or less than 1:1. From a safety and stability standpoint, this is positive, as any decline in loan performance would have a bit of a funding buffer. On the other hand, if major problems were detected, this could trigger a panic, and lead to significant deposit withdrawals that would shift the ratios. However, here again, the risk of such a development is mitigated by the low level of deposits in the banks in the first place, the high level of "mattress" money in the system, steps taken by CBA to stabilize the system in recent years, and the potential beneficial effects of having a deposit guarantee fund to provide payout to individual depositors (up to $4,000-equivalent, or DRAM 2 million) in the event of a failure. In the end, the underdevelopment of the financial system mitigates the risk of systemic problems.

Trends in 2004 suggest that loans-to-deposits are low and still declining. This actually reflects an increase in deposit mobilization, given that lending has increased in 2004. Again, despite the small base on which the comparison is made, this indicates a favorable trend.

Table 5.3: Real Sector Bank Loans Relative to Deposits (1998-2003)

	1998	1999	2000	2001	2002	2003	2004
Gross Loans/Total Deposits	151.9%	136.3%	119.1%	104.6%	79.7%	73.4%	60.5%

[108] Compensating balances are deposits placed by borrowers in the bank which are used to reduce their borrowing costs or fees. The bank can use these free balances for loans to others and/or investments in securities or other income-generating uses.

NPLs/Total Deposits	15.8%	6.4%	7.4%	6.3%	3.9%	4.0%	2.8%
Net Loans/Total Deposits	136.1%	129.9%	111.7%	98.3%	75.8%	69.4%	57.7%

Notes: These figures do not include banks' investments in government securities, which are assumed to be safe. Rather, these ratios only include loans to enterprises, households and NBFIs. On the deposit side, central government deposits placed with the banks deposits are also excluded from the equations through 2003. Data for 2004 are from September 30, and are based on loan figures strictly for individuals and enterprises, and deposit figures that are demand liabilities plus deposits from individuals and enterprises (from CBA data).

Source: IMF; CBA; EBRD; author's calculations

5.4 EARNINGS

5.4.1 EARNINGS PROFILE

Earnings for the banking system have been low for years. After-tax earnings for the system in 2003 were $11.3 million, or less than $564,000 on average per bank. Through 3Q 2004, earnings were $13.9 million. Thus, annualized for 2004, after-tax earnings are projected to be about $18.5 million. This translates into the following earnings indicators for 2003-04:

- After-tax earnings per bank: $564,000 (2003), rising to $975,000 in 2004.
- RoAA[109]: 2.5 percent (2003), rising to about 3.0 percent in 2004.
- RoAE[110]: 14.7 percent (2003), rising to about 17.2 percent in 2004.

Thus, return ratios are reasonable by advanced market measures[111] as well as transition country measures.[112] Moreover, because non-performing loans have been largely addressed, provisions for loan losses in 2003 did not substantially detract from earnings, nor are they expected to in 2004. In fact, provisions and NPLs have both declined in recent years, while loan classification standards have tightened. However, aggregate and average figures are exceedingly small. The following profiles banks' earnings in recent years.

TABLE 5.4: EARNINGS INDICATORS FOR ARMENIAN BANKS (2000-04)

(millions of US$, %)	2000	2001	2002	2003	2004
After-tax Earnings from ROA	-$6	-$31	$14	$11	$18.5
After-tax Earnings from ROE	-$9	-$54	$14	$11	$18.5
Return on Average Assets	-1.9%	-9.1%	3.9%	2.5%	3.0%

[109] Average assets based on 2002-03 year-end asset figures from CBA. Ratio for 2004 based on CBA asset figures for 2003-04, with 2004 assets annualized (projected for year end) at year-end exchange rates (assumed at DRAM 500:$1).
[110] Average gross capital based on 2002-03 year-end capital figures from CBA. Ratio for 2004 based on CBA shareholder equity figures for 2003-04, with 2004 equity annualized (projected for year end) at year-end exchange rates (assumed at DRAM 500:$1).
[111] For instance, ROA and ROE figures were 1.4 percent 15.2 percent, respectively, in the United States (2003); and 0.4 percent and 8.9 percent, respectively, in the Euro zone (2003). See "Global Financial Stability Report", IMF, September 2004.
[112] Among the 13 transition countries reporting, Armenia's RoA was highest in 2003. However, RoE was lower than most. See "Global Financial Stability Report", IMF, September 2004.

Return on Average Equity	-12.3%	-78.6%	21.6%	14.7%	17.2%
Avg. After-tax Earnings from ROA	-$0.20	-$1.04	$0.71	$0.51	$0.98
Avg. After-tax Earnings from ROE	-$0.27	-$1.80	$0.69	$0.57	$0.98
Interest Margin to Gross Income	30.7%	27.8%	37.6%	42.0%	44.6%
Interest Income to Gross Income	84.3%	77.8%	63.1%	62.7%	64.6%
Non-interest Expense/Gross Income	36.4%	42.7%	48.3%	48.5%	45.5%
Provisions for Loan Losses	$5.71	$4.69	$3.30	$3.39	$5.08
Provisions/NPLs	46.4%	45.2%	40.2%	34.3%	20.5%

Notes: 2000-03: Derived from CBA RoAE figures or figures cited in IMF Staff Report (May 2004). Data for 2004 are annualized projections based on 3Q 2004 CBA data.

Sources: CBA; IMF; authors' calculations

Banks' earnings are constrained for a number of reasons. First, loans to the real sector are less than 40 percent of total assets. Adding investment in government securities, net domestic credit is about half of total assets. Thus, while loan and asset quality have improved in recent years, the actual base of earning assets is small in value. Investment in government securities plus most foreign assets are relatively low yielding. After-tax earnings for the banks in 2003 were only $11 million, a very small amount by global standards. With assets of about $500 million, this represents little more than a 2 percent after-tax return on year-end assets. The ratio is not bad, but aggregate earnings are low. Moreover, given that net interest margins are considered reasonably strong (due to high nominal and real rates charged on loans and low rates paid on deposits), this suggests that the earning asset base is too small for significant earnings to be generated. Figures for 2004 suggest improvement, yet small aggregate figures on average.

The cost of operations is generally considered to be too high in light of the low income. However, the non-interest expense ratio to gross income has improved in 2004, and this is a sign of increasing productivity. Rising commission income as a share of total income also points to better prospects for banks that have made investments in new technologies, namely related to plastic cards. However, these earnings need to increase to further bring down a range of cost-to-income ratios.

Thus, rather than expense loads being high, Armenian banks are faced with the challenge of developing non-credit sources of income. They have begun to do this via the issuance of plastic cards and fees from payments and transfers. As a result, non-interest income was 37 percent of total income in 2003, but only 35 percent through 3Q 2004. Because banks offer very little in the way of non-lending services, non-interest sources of income are limited. There is no real securities market in Armenia, and most investors tend to hold these securities for investment and regulatory purposes rather than trading in the secondary market. As such, earnings from government securities and low risk securities abroad mean that Armenian banks are stable, but earnings remain low because the earning asset base is small. The weak securities market also reduces earnings opportunities for banks' brokerages to make any money. This will change in the future as the government seeks to more fully develop the government securities market, as well as when mortgage bonds/mortgage-backed securities are made available. However, these are likely to be long-term developments. In the meantime, there will be little income derived from such activities.

Banks also make some money on guarantees and money transfers, but these fees are not high value. There is little money made in foreign exchange trading. Direct payroll has been introduced, although it is relatively new. There is virtually no use of banks for custodial services, although this may change in the future when pension reform is introduced, and second and/or third pillar pension funds eventually emerge later in the decade (see Annex 9). There are also fees from plastic cards and electronic payments/transfers,

and these will grow in the coming years. However, for now, there is little income derived from such services. All together, CBA reports that commission income from client services approximated $16.6 million in 2003, about $830,000 per bank. The market leader in this regard is Anelik Bank at $4.8 million, largely due to its prominent role in transferring remittances from Moscow and catering to other needs of Armenians in Russia. Armsavings and HSBC each generated nearly $2 million in commission income, with Converse and Armeconombank also generating nearly $1.5 million on average. Thus, the five banks leading the commission income market in Armenia accounted for 68 percent of total. In general, opportunities are constrained by the degree to which the grey market permeates the economy in Armenia. With most transactions carried out off the books and in cash, there is little opportunity for the banks to generate earnings apart from lending and investing.

Armenian banks are considered low in productivity, which reflects higher costs than they should have relative to income generation. This does not mean that Armenia's costs are excessively high. Its ratio of non-interest expense to gross income was 48.5 percent in 2003 and down to 45.5 percent in 2004, not too different from advanced country ratios. For instance, such ratios were about 56.6 percent in the US, and 67.8 percent in the 50 largest euro area banks.[113] However, the point of differentiation is productivity, as measured by income per employee. In this regard, some banks appear to have high staffing levels relative to income, namely Armsavings and Ardshininvest. These two banks accounted for 42 percent of head count as of year end 2003, yet were only responsible for 15.5 percent of assets, 23 percent of loans, and 15 percent of net interest income. In the case of Armsavings, it posted after-tax losses, while Ardshininvest had a reasonable profit. Nonetheless, income per employee was lower at these two banks than at any other bank apart from Prometey, one of the smallest banks in the system. Most banks are considered to be relatively low in productivity and income generation. HSBC is the exception, with an average income-per-employee of $55,538. Only Arminvestbank and Armimpexbank had ratios of $30,000 or more, with all other banks below the $30,000 average. This is partly because banks are still manual in some of their orientations and operations, and because there are more support functions than direct marketing functions. Investment in more advanced systems and technologies to introduce new products and augment earnings sources will change this. However, for now, operations are still very manual, even when bank staff are able to access computers and modern IT systems. Thus, if banks were more information systems-intensive in their operations, and/or if they deployed their staff more directly in income-generating activities, they would likely have higher earnings-per-employee ratios.

5.4.2 MARGINS AND SPREADS

Nominal net spreads approximated 14-15 percent in 2003 and have been roughly in that range in 2004. There is significant variation in terms of maturities. As an example, net interest spreads between loans and deposits were as low as 10.14 percent on maturities exceeding one year, yet as high as 22.72 percent on maturities of 60 days. In general, Armenia's banks are able to generate fairly high net interest margins. For instance, in the first three quarters of 2004, net interest income (interest income less interest expense) was 69 percent of total interest income. However, as noted earlier, the volume of loans is so low that aggregate earnings are limited.

Spreads actually increased in recent years to boost earnings. Loan rates in 2004 have come down fairly significantly on loans up to 30 days, fluctuated significantly in the 60-90 day range, and declined or been fairly stable on loans of 180 days or longer. Meanwhile, rates paid on deposits have declined over the years with lower inflation, although they have shown increases in the 15-day range in 2004 as well as for time deposits exceeding one year. For those depositing with the banks, safety appears to be more important than rates paid. HSBC has been the main recipient of individual deposits, on which it has paid virtually nothing. More recently, HSBC has begun to charge individuals for the opening of an account as

[113] See "Global Financial Stability Report", IMF, September 2004.

a means to stopping the flow of funds into the bank due to limits in its own capacity to handle such accounts. At some point, it can be expected that the banking system will become more competitive, which would then lead to a compression of rates and spreads. However, for now, this is not yet in effect.

5.5 LIQUIDITY

5.5.1 GENERAL LIQUIDITY AND LIQUIDITY MANAGEMENT FEATURES

Liquidity is stable on a regulatory basis, although the system as a whole is poorly funded. Banks are required to comply with 6 percent reserve requirements on all deposits, including foreign currency deposits. The banks' loan-to-deposit ratio was about 0.73:1 at the end of 2003 when excluding investment in government securities. (Including government securities[114] brings the year end 2003 ratio to about 94 percent.) The figure was even lower at 3Q 2004, approximating 60.5 percent as a result of an increase in deposit mobilization. Adding government securities brings the domestic credit-to-deposit ratio to 77 percent as of 3Q 2004.

Key liquidity measures indicate that net liquid assets (net position in domestic inter-bank market, net position overseas, net position with CBA plus vault cash) are more than adequate for withdrawals, and securities (including foreign assets) provide additional cushion in the event of banks facing major deposit withdrawals. However, this is not considered to be much of a risk issue given that most people and enterprises bypass the banks. On the other hand, managing such liquidity will be essential to the task of restoring confidence through the deposit guarantee scheme. Key liquidity ratios and figures at the end of 2003 and September 30, 2004 were as follows:

- Liquid Assets ($ millions): $219 million (2003), and $351 million at September 30, 2004.
- Liquid Assets/Total Assets: 47.5 percent (2003), and 52.0 percent at September 30, 2004.
- Liquid Assets/Deposits: 63.5 percent (2003), and 78.7 percent at September 30, 2004.
- Customer Deposits/Inter-bank Loans: 177.1 percent (2003), and 388.3 percent at September 30, 2004.
- Net Liquid Assets: $185 million (2003), rising to $228 million at September 30, 2004.
- FX Liabilities ($ millions): $337 million (2003), and $384 million at September 30, 2004.
- FX Liabilities/Total Liabilities: 73.2 percent (2003), and 68.8 percent at September 30, 2004.
- Net International Liquidity Position: $79 million (2003).

From a liquidity management standpoint, banks are under less pressure than they were a few years ago. The refinancing rate has declined significantly, from 43 percent in 1999 to 7 percent in 2003 and 4 percent in late 2004. T-bill rates continue to decline. Reserve requirements have likewise come down in recent years to the current 6 percent. The payment system is also now more efficient with the introduction of RTGS in the last few years. Thus, the system shows fewer challenges to liquidity management than just a few years ago.

However, the inter-bank market is thin, and many banks have limited resources. In general, banks continue to hold large cash balances or maintain very liquid positions for transactions. Most banks are located only in Yerevan, and generally do not have extensive branch networks apart from Armsavings and, to a lesser extent, Ardshininvest and Armeconombank. The first two banks already have challenges

[114] This would be net domestic credit, whereas the exclusion of banks' exposure to government securities would be a real sector credit exposure measure. Both ratios reflect high levels of liquidity, particularly as there are only limited maturity mismatches.

with regard to employee head count, partly reflecting the inefficiency of the branch networks they have. Notwithstanding improvements in 2004, funding remains low, with limited deposits and even less in the form of non-deposit liabilities. Investment opportunities are also limited, and the weakness of the securities markets only makes more open access to liquidity more difficult. All of this detracts from efficient liquidity management.

5.5.2 LIQUIDITY AND RISK INDICATORS

As noted above, Armenia's liquidity ratios show there is little problem with regard to systemic risk. However, aggregate funds in the system are limited, and this makes liquidity management more of a challenge. The banks' loan-to-deposit ratio was about 73 percent at the end of 2003, a very low ratio that has come down further to about 61 percent in 2004. Key liquidity measures indicate that net liquid assets[115] have increased from $185 million-equivalent at year-end 2003 to $228 million as of September 30, 2004. Total liquid assets were about 52 percent of deposits, and a little higher than the value of total short-term liabilities. These have since risen to $351 million as of 3Q 2004, or about 80 percent of total deposits. This suggests the banks were sufficiently liquid in 2003, partly due to the perceived absence of sound lending opportunities relative to risk. While lending has increased in 2004, banks remain very liquid. The ratio has risen in recent years, as liquid assets have increased relative to deposits. Meanwhile, gross securities (foreign assets plus investment in government securities) were valued at 94 percent of total deposits at year-end 2003. While this has come down to about 87 percent in the first three quarters of 2004, the ratio still provides additional cushion in the event of banks facing major deposit withdrawals. Again, this is not considered to be much of a risk since most people and enterprises bypass the banks.

Only major withdrawals from HSBC or a couple of other banks would constitute a challenge to the system as a whole. The five banks with the highest deposits account for two thirds of all deposits. HSBC, in particular, has the greatest share at 26 percent. However, the risk of a panic run is limited. First, HSBC is part of the second largest bank in the world, with access to resources from abroad. Likewise, several of the other banks have access to unused lines of credit, or fairly tight control over asset exposures. Beyond that, the deposit guarantee fund will have resources for such problems, and CBA could intervene as a lender of last resort if it appeared that any of its major banks was in trouble such that it would reverse confidence-building measures from the last few years.

Under crisis conditions, net liquid assets plus a discount (haircut) of 50 percent on securities values would bring banks' coverage of demand liabilities and individual deposits to 53 percent. Likewise, withdrawals of about half of total deposits (demand liabilities, plus individual and enterprise deposits), an extremely unlikely prospect, would still leave banks with a positive net liquid asset position.

5.6 DEPOSITS AND OTHER FUNDING

5.6.1 TRADITIONAL CONSTRAINTS TO DEPOSIT MOBILIZATION

Apart from 2001 when deposits declined, Armenia's banks have increased their deposits year to year since 1995, when total deposits were only $37 million. Based on CBA data (which differ from figures presented in IFS), deposits were $205 million in 1999, and $436 million as of 3Q 2004. Thus, funds mobilization by Armenian banks increased nearly 70 percent from 1999 to 2003, and the trend has shown a strong increase in 2004.

[115] These are defined as net position in domestic inter-bank market, net position overseas, net position with CBA plus vault cash.

Despite the favorable trend, deposits remain small in total and on a per capita basis. Netting out government deposits (which are generally small), year end 2003 figures indicate the average bank had only $16 million in deposits, and per capita deposits were only $106. At September 30, 2004 (again, CBA data as opposed to IFS data), the average bank had nearly $23 million in deposits, and per capita deposits approximated $140.

There are several factors behind the banks' weak funding bases. The most important are:

- Limited public confidence in the aftermath of turmoil rooted in the early stages of the transition, and subsequent closure of most banks.
- Traditionally weak service delivery, and underdevelopment of retail banking services.
- Larger issues related to tax avoidance/evasion and the grey market.
- Troubled condition of many/most large-scale enterprises.

The public has had little confidence in the banks, as a net 54 have been shut down in the last decade. Many people have had limited if any resources to place, while those with funds have felt little incentive to place funds with the banks due to potential tax liabilities and garnishing. More recently, nominal interest rates paid on deposits have declined, and real rates paid on demand deposits are generally negative. As found elsewhere in the CIS region, confidence was undermined in the early 1990s by hyperinflation and exchange rate instability. The war in Nagorno-Karabakh added to the impact. While these pressures have all abated since 1996, and the exchange rate has been relatively stable for years, most people and small businesses have had little perceived incentive to place their funds with banks. Meanwhile, enterprise deposits are increasing, but the small number of comparatively large enterprises along with their tendency to understate revenues and conduct transactions in cash (all to avoid taxation) keeps these figures relatively low.

The failure of so many banks since the mid-1990s and the absence of deposit insurance have kept people from depositing their funds with banks. Even more of an issue is tax avoidance and concerns people have about arbitrary treatment by the tax authorities. Nonetheless, as the remaining banks have begun to stabilize and tighter regulations have been enforced by CBA, the rise in aggregate deposits appears to suggest that confidence is slowly returning. People still do not trust the banks in broad numbers, as reflected in the number of accounts at less than 20 percent of the total population. They are not likely to have greater confidence until they are sure their account privacy will be respected, which may also be challenged with the introduction of tighter scrutiny of money laundering and related financial crime. On the other hand, efforts in the last three years to stabilize the system combined with increasing willingness of banks to issue plastic cards and make small loans is beginning to bring more people into the banking system, indicating as well there is some underlying confidence in the system.

The government's plan to introduce a deposit guarantee scheme in 2005 is partly designed to provide greater confidence in both the banks and the local currency.[116] The scheme will come into effect after years of bank restructuring and closures, a strengthening of regulations and supervision, and with better management systems in place at the banks. However, it remains to be seen if this will generate a new spike in deposits. More likely, confidence will return more gradually as there is increasing evidence of underlying stability, demonstration of banks' capacity for safekeeping and prudent management practices, and incentives related to loan products (e.g., credit cards with overdraft facilities).

The main issue concerns government tax administration, and whether depositors will feel that they benefit from account confidentiality. The public believes their deposit account information is vulnerable to garnishing. While this practice is common around the globe, it serves as a disincentive for people to place

[116] Depositors' coverage of local currency deposits is two times the maximum coverage provided for foreign currency deposit accounts.

funds with banks when they believe the tax authorities are selective, discriminatory and unfair in their treatment of those in arrears on tax obligations. This is a clear problem in Armenia, and one of the main reasons why banks have played a very small role in the country's savings mobilization.

With high levels of tax avoidance/evasion by citizens and corporate entities, concerns about account confidentiality have served as a disincentive to keep funds in banks. Informal sector turnover is estimated to be nearly half of GDP, so many people and businesses have long kept cash out of the banks for liquidity needs as well as for tax avoidance purposes. With Armenia's tax rates considered reasonable, there is little the government can do apart from removing this tainted reputation as an inducement to small enterprises and households to increasingly place their funds in banks. However, this will take time, particularly if there are still concerns about account confidentiality. The policy to not tax interest earnings from deposits is an incentive for people to place funds in the banks. However, the limited access that most households and small businesses have traditionally had to loans provides them with little incentive to place funds with banks. As banks become more interested in extending housing loans and consumer loans, these trends and perceptions should change, as indicated by the increase in deposits and loans in 2004.

The lack of effort on the part of banks to more fully develop retail banking until recently also plays a role, with much of the population being relatively poor. Recent efforts by some banks to establish ATMs and to introduce plastic cards represent a change in direction. As of 3Q 2004, 12 banks had about 61 ATMs in total, and there were about 100,000 plastic cards in circulation. These numbers have increased year to year since 2000. However, consumer banking is still generally underdeveloped in Armenia. Banks have been deterred from developing a retail network due to limited net returns, and costly investment requirements for other purposes that have been greater priorities during a period of stabilization (e.g., internal controls and systems, risk management capacity). Only in Yerevan is there a reasonable choice of banks with retail options, although a few secondary towns now have ATMs and plastic card services offered by bank branches.[117]

There has also been the issue of the troubled condition of many enterprises, particularly state-owned or formerly state-owned enterprises. In many cases, they have been/were kept afloat from the build-up of arrears on various payments, including on utility bills as well as to employees and for taxes. More recently, the government has stepped up efforts to reduce these arrears. Partial privatization in the electricity sector has also led to a tightening of collection practices, and this will continue as other energy and utility companies tighten their operations. The net effect on troubled enterprises is that it makes it more difficult for these enterprises to maintain positive cash balances, thus reducing their prospects for entering into commercially-driven banking relationships. In many of the CIS countries, the broken link with the enterprise sector is a major problem for most domestic banks, with funding primarily from the household sector. In Armenia, the ratios are not so low, as about 47 percent of total deposits are from the enterprise sector. However, the aggregate figures remain low at about $203 million at 3Q 2004, roughly equivalent to 2002 figures but higher than previous years' enterprise deposits.

Another key point based on the figures below is the rise in foreign currency-denominated deposits. In one sense, the opposite movement should be occurring, given weakness of the dollar combined with real appreciation of the DRAM. Moreover, deposit guarantee incentives will provide twice the coverage for DRAM deposits when the program begins in mid-2005. However, the influx of deposits has largely been in foreign currency, and thus has shifted the alignment of banking statistics. It remains to be seen if there will be a subsequent shift to DRAM in the coming months as the dollar shows no sign of strengthening, and as deposit guarantee incentives come into effect.

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[117] However, Armsavings, Ardshininvest and Armeconombank combined had only 15 ATMs as of 3Q 2004, almost all in Yerevan. These three banks account for 177 of Armenia's 230 branches.

TABLE 5.5: DEPOSIT DISTRIBUTION BY SOURCE: 1999-3Q 2004

(millions of $, %)	1999	2000	2001	2002	2003	3Q 2004
Individuals	$52.8	$88.6	$70.4	$68.2	$173.7	$222.8
o/w DRAM	$5.3	$17.6	$7.7	$5.8	$15.6	$21.2
o/w foreign currency	$47.5	$71.0	$62.7	$62.4	$158.1	$201.6
Enterprises	$142.4	$174.8	$173.0	$203.5	$149.5	$203.3
o/w DRAM	$31.7	$30.8	$37.7	$57.5	$59.6	$61.9
o/w foreign currency	$110.7	$143.9	$135.2	$146.1	$90.1	$141.4
Government	$9.9	$28.8	$30.5	$28.5	$21.7	$10.2
Total	$205.1	$292.2	$273.8	$300.2	$344.9	$436.3
Individuals	25.7%	30.3%	25.7%	22.7%	50.4%	51.1%
o/w DRAM	2.6%	6.0%	2.8%	1.9%	4.5%	4.9%
o/w foreign currency	23.1%	24.3%	22.9%	20.8%	45.8%	46.2%
Enterprises	69.5%	59.8%	63.2%	67.8%	43.4%	46.6%
o/w DRAM	15.5%	10.6%	13.8%	19.1%	17.2%	14.2%
o/w foreign currency	54.0%	49.3%	49.4%	48.7%	26.1%	32.4%
Government	4.8%	9.9%	11.1%	9.5%	6.3%	2.3%
DRAM	22.9%	26.4%	27.7%	30.6%	28.0%	21.4%
Foreign Currency	77.1%	73.6%	72.3%	69.4%	72.0%	78.6%

Notes: Deposit figures from 2004 as of September 30. All data from CBA in DRAM, converted to US dollars at year-end exchange rates. (2004 data at 3Q converted at DRAM 505 per $1.) CBA does not have separate data for individuals' and enterprises' demand deposits before 2003, resulting in distorted distributions. Figures in table for enterprises' demand deposits from 1999-2002 are total demand deposits (including individuals')[118]. Individual deposits from 1999-2002 are strictly time deposits. Government deposits from IFS (all local currency) except 3Q 2004, where they are derived from CBA data.

Sources: CBA; IFS; author's calculations

5.6.2 CURRENT TRENDS AND PROSPECTS FOR DEPOSIT MOBILIZATION

Despite problems noted above, deposit trends have shown some favorable developments in recent years. Total deposits have increased consistently since 1995, with the sole exception of 2001 when they declined by $18 million-equivalent. As noted above, deposits at year-end 2003 were nearly 70 percent of deposits in 1999, and equivalent to more than nine times deposit figures in 1995. Trends have been even more favorable in 2004. However, also as noted above, deposits remain small in the aggregate and on a per capita basis.

Meanwhile, the distribution of deposits is beginning to show some movement towards confidence in the DRAM. While most deposits are still held in foreign currency,[119] the foreign currency share has gradually

[118] The reason for this arbitrary distribution is because enterprises have traditionally held more demand deposits than individuals, although the significant increase in foreign currency demand deposits in recent years is thought to have derived more from individuals than enterprises. Thus, the figures prior to 2003 are not considered exact.

[119] This partly reflects traditional hedging patterns in dollars. This was for protection against earlier hyperinflation, as well as against currency risk. Year end CPI rates reached 10,896 percent in 1993, and were 1,885 at the end of

diminished, from 77 percent in 1999 to as low as 68 percent in 2002. However, this distribution reversed in 2003, and has increased to as much as 78 percent in 2004 due to the increase in foreign currency deposits mobilized that were previously outside the system. This still translates into a substantial increase in local currency demand deposits, which were three times' 1999 levels by the end of 2003. During that period, time/savings deposits in local currency have remained fairly flat, and even most foreign currency deposits remain fairly short term. (Foreign currency deposits have more than doubled since 1999.) This signals slow but emerging confidence in the DRAM, but a continued preference for dollars. This may portend slow but eventual willingness of depositors to place funds for longer periods, particularly when banks start to compete on rates and pay more for medium- and long-term funds. However, for the moment, the problem banks face is the perception of limited investment and lending opportunities. Thus, they have little incentive at the moment to raise rates paid on deposits due to their highly liquid balance sheets. Meanwhile, banks continue to complain that they lack long-term funds.

TABLE 5.6: DEPOSIT STRUCTURE AND GROWTH TRENDS: 1999-3Q 2004

(millions $; %)	1999	2000	2001	2002	2003	3Q 2004
Domestic Currency	$46.9	$77.3	$75.9	$91.7	$96.7	$93.4
o/w Demand Deposits	$20.2	$23.6	$22.2	$43.8	$56.5	$63.4
o/w Time/Savings Deposits	$16.8	$24.9	$23.2	$19.4	$18.6	$19.8
o/w Government	$9.9	$28.8	$30.5	$28.5	$21.7	$10.2
Foreign Currency	$158.2	$214.9	$197.9	$208.5	$248.2	$343.0
Total	$205.1	$292.2	$273.8	$300.2	$344.9	$436.3
Changes in Domestic Currency		$30.3	-$1.4	$15.8	$5.0	-$3.3
o/w Demand Deposits		$3.4	-$1.4	$21.5	$12.7	$6.9
o/w Time/Savings Deposits		$8.0	-$1.7	-$3.7	-$0.9	$1.2
o/w Government		$18.9	$1.7	-$2.0	-$6.8	-$10.5
Changes in Foreign Currency		$56.7	-$17.0	$10.6	$39.7	$94.8
Total Change from prior year		$87.0	-$18.3	$26.4	$44.7	$91.4
Domestic Currency	22.9%	26.4%	27.7%	30.6%	28.0%	21.4%
o/w Demand Deposits	9.9%	8.1%	8.1%	14.6%	16.4%	14.5%
o/w Time/Savings Deposits	8.2%	8.5%	8.5%	6.5%	5.4%	4.5%
o/w Government	4.8%	9.9%	11.1%	9.5%	6.3%	2.3%
Foreign Currency	77.1%	73.6%	72.3%	69.4%	72.0%	78.6%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Real Sector Deposit Figures (net of Government Deposits in Banks):						
Avg. Deposits per Bank	$6.1	$8.5	$8.1	$13.6	$16.2	$22.4
Change in Avg. Deposits/Bank		$2.4	-$0.4	$5.5	$2.6	$6.3
Per Capita Deposits	$62.2	$84.7	$78.8	$88.4	$105.6	$139.7
Change in Per Capita Deposits		$22.5	-$5.9	$9.6	$17.2	$34.1

1994. Rates have been in single digits since 1998. Most foreign currency transactions remain dollar-denominated. About 85 percent of the volume of the foreign currency market (as of September 30, 2004) was for US dollars. This was followed by euro, at 10 percent, and then rubles at 5 percent of total. There has been slight movement away from the dollar. Notwithstanding the decline in the value of the dollar against other hard currencies, it still remains the currency of choice in most foreign exchange transactions and asset denominations.

Notes: 2004 figures are from 3Q 2004 data. Per capita deposit figures are actual dollar figures based on estimated population at year-end exchange rates.
Source: IMF; CBA; author's calculations

One of the crucial issues that banks will face is the role of the deposit guarantee scheme to commence effectively in 2005, and the impact it will have on the volume, currency and maturity of deposits. With underlying macroeconomic indicators improving, it follows that the business environment for investment and growth is improving. This should create better conditions for project finance, and term investment in a number of different business lines. Nonetheless, the "over-liquidity" of the banking system reflects a lack of demand by banks for such deposits, as reflected in the low interest rates paid on deposits. Thus, reducing the risk aversion of banks will be essential to ultimately clarifying the environment for intermediation, both in terms of supply of and demand for funds.

5.6.3 OTHER LIABILITIES AND CAPITAL

Despite relatively low levels of deposits in the aggregate, deposits accounted for about 54 percent of total balance sheet funding for banks at year-end 2003.[120] (If central government deposits are included, the figure rises to 58 percent.) This represents a major increase from end 1995-97, when deposits accounted for 29-37 percent of total funding. Figures at 3Q 2004 approximated 65 percent (including government deposits), signifying a further increase in 2004.

Since 1998, the contribution of deposits to total funding has gradually increased, albeit showing a slight decline in 2003 (54 percent) when compared with 2002 (56 percent). The major offsetting change has been with the decline in foreign liabilities, which were 39-42 percent of total funding from 1996-99, and have since gradually declined. Thus, other liabilities and capital have generally diminished as a share of total bank funding, although there has been an increase in dollar terms in 2004.

As of 3Q 2004, other liabilities and capital accounted for $174 million, or 26 percent of total balance sheet funding for the banks. These other liabilities still largely consist of foreign liabilities, at 8 percent of total funding at year-end 2003 as well as 3Q 2004 (against a high of 42 percent in 1997). Thus, other liabilities are relatively insignificant, reflecting the unwillingness of government and CBA to finance bank activities. This is largely rooted in the tough monetary policies implemented in the post-hyperinflation period.

Meanwhile, CBA figures put capital at $88.5 million at year-end 2003, or 17.8 percent of assets.[121] This has increased to $117 million as of 3Q 2004, or 17.4 percent of total assets. While CARs are high, regulatory capital was only $77 million at year-end 2003, about $3.9 million on average, and $94.5 million at 3Q 2004, or $5 million on average. The following table presents relative shares of banks' balance sheet funding.

TABLE 5.7: COMMERCIAL BANK FUNDING: 1998-2004

	1998	1999	2000	2001	2002	2003	3Q 2004
ASSETS							

[120] These figures do not include off-balance sheet items, including unused lines of credit from other banks. Nor do they include government deposits. Figures from IFS and CBA differ. The 54 percent figure in the text is from IFS.
[121] According to IFS, gross capital (shareholder equity) amounted to 21.2 percent of the total funding base of the banks, or $97 million, at end 2003. After accounting for other items, net capital was 15.4 percent, or $71 million-equivalent.

Reserves	$23	$21	$23	$26	$38	$45	$54
Foreign Assets	$33	$70	$96	$101	$126	$181	$192
Claims on Government	$30	$23	$31	$32	$45	$52	$72
Claims on non-Government	$136	$165	$185	$163	$160	$172	$313
Claims on NBFIs	$22	$8	$13	$10	$8	$12	$8
Total Assets	$243	$288	$348	$333	$376	$460	$675
LIABILITIES AND EQUITY							
Deposits (Non-government)	$104	$127	$167	$165	$210	$249	$469
Money Market Instruments	$0	$0	$0	$0	$0	$1	N/A
Foreign Liabilities	$96	$111	$120	$105	$93	$102	$89
Government Deposits	$7	$10	$29	$30	$28	$22	N/A
Credit from CBA	$6	$3	$6	$7	$18	$16	N/A
Total Liabilities	$213	$252	$321	$308	$350	$390	$558
Gross Capital	$55	$69	$69	$68	$61	$97	$117
Other Items, net	-$25	-$34	-$43	-$44	-$34	-$27	N/A
Equity (Net Capital)	$30	$36	$27	$24	$26	$71	$117
ASSETS							
Reserves	9.48%	7.35%	6.56%	7.87%	10.04%	9.78%	8.00%
Foreign Assets	13.62%	24.44%	27.62%	30.35%	33.49%	39.26%	28.44%
Claims on Government	12.16%	8.14%	8.79%	9.76%	11.96%	11.20%	10.67%
Claims on non-Government	55.78%	57.18%	53.32%	49.13%	42.48%	37.25%	46.37%
Claims on NBFIs	8.96%	2.89%	3.72%	2.89%	2.04%	2.52%	1.19%
Total Assets	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
LIABILITIES AND EQUITY							
Deposits (Non-government)	42.62%	44.08%	47.90%	49.71%	55.88%	54.15%	69.48%
Money Market Instruments	0.02%	0.13%	0.00%	0.05%	0.00%	0.22%	N/A
Foreign Liabilities	39.53%	38.74%	34.47%	31.64%	24.74%	22.17%	13.19%
Government Deposits	2.89%	3.45%	8.27%	9.16%	7.57%	4.71%	N/A
Credit from CBA	2.57%	1.13%	1.74%	2.13%	4.82%	3.40%	N/A
Total Liabilities	87.62%	87.54%	92.38%	92.69%	93.01%	84.65%	82.67%
Gross Capital	22.60%	24.13%	19.86%	20.42%	16.12%	21.16%	17.33%
Other Items, net	-10.24%	-11.66%	-12.24%	-13.11%	-9.14%	-5.81%	N/A
Equity (Net Capital)	12.36%	12.47%	7.62%	7.31%	6.98%	15.35%	17.33%

Notes: 2004 data from CBA at September 30. However, table is according to IFS format, therefore some assets are not included in the table in 2004 (e.g., fixed assets). Likewise, some items are

included in certain categories that make figures inconsistent compared with 1998-2003 data.[122] Data from 1998-2003 are mainly derived from IFS. Claims on non-government = enterprises, households, and NBFIs. Percentages are as a share of total assets.
Sources: IMF; CBA; author's calculations

5.7 Sensitivity to Credit, Market and Foreign Exchange Risk

5.7.1 Credit Risk

Credit risk has been addressed over the years with a tightened prudential regime, increased banking supervision capacity, greater enforcement powers, and better accounting standards. The main areas of improvement with regard to credit risk have been tightened loan classification standards, earlier recognition of risks to loan quality, and fully tax-deductible provisioning for loan losses. These are generally in line with recommended standards and practices. The result has been an improvement in loan performance, with a shift increasingly towards investment in low-risk securities through 2003 that has since begun to shift in favor of increased lending and risk-taking in 2004. As an indication, as of year-end 2003, asset quality measures based on the share of non-performing loans to total loans indicated the following:

- Nine banks had NPLs at less than 2 percent of total, up from six banks at year-end 2002.[123] These nine banks accounted for about 53 percent of total assets.
- Three banks had NPLs between 2 and 4 percent of total, up from two banks at year-end 2002. These three banks accounted for about 21 percent of total assets.
- One bank had NPLs between 4 and 6 percent of total, down from five banks at year-end 2002. This bank accounted for about 8 percent of total assets.
- Two banks had NPLs between 6 and 10 percent of total, the same as at year-end 2002. These two banks accounted for about 7 percent of total assets.
- Four banks (excluding Armcommunications, currently under administration) had NPLs of greater than 10 percent of total, down from seven banks at year-end 2002. These four banks accounted for about 11 percent of total assets.

The above asset quality trends are favorable, and these trends have continued into 2004. Preliminary indications from September 30, 2004 suggest that 13 of 19 banks had NPLs of less than 4 percent of total loans, as compared with 12 banks (74 percent of assets) at year end 2003. These 13 banks accounted for 85.5 percent of system assets. Two banks (3 percent of assets) had NPLs of 4-6 percent of total loans, while another four banks had NPLs exceeding 6 percent of total loans. Among the latter group (11 percent of total assets), three banks had NPLs exceeding 10 percent. These three banks accounted for 8 percent of banking system assets at 3Q 2004. Thus, more banks accounting for more assets have fewer problem loans, while banks with severe portfolio problems have diminished in number and share of banking system assets.

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[122] As an example, claims on non-government in 2004 include deposits with banks. On the liability side, "deposits" include most liabilities apart from foreign currency liabilities in bank correspondent accounts and liabilities to banks, as well as "other liabilities".
[123] Twelve banks had less than 2 percent ratios in 2001. However, CBA and bankers have reported that loan classification standards tightened after 2001. Thus, the 2002-03 trend is viewed as favorable, and not necessarily comparable with 2001 data.

Other key ratios in which all banks were in compliance as of year-end 2003 and September 30, 2004 included:

- Single internal borrower exposures restricted to no more than 5 percent of capital.
- Total internal borrower exposures restricted to no more than 50 percent of capital.
- Only one bank (as of year-end 2003 and September 30, 2004) was not in compliance with:
- Single external borrower exposures restricted to no more than 20 percent of capital. This is down from four banks at the end of 2002.

5.7.2 Market Risk

Asset-liability management with regard to maturities and the avoidance of maturity mismatches has been fairly prudent in Armenia in recent years, largely due to better reporting and tighter CBA scrutiny. As noted, despite donor support, there is a shortage of long-term funding in the system, which has reduced the scope for long-term lending. On the other hand, banks' highly liquid balance sheets reflect the management of resources that has made term exposures relatively small as a risk.

Foreign exchange risk has been contained in recent years by reducing Armenia's gross open foreign exchange position to capital, which was high in 2001 at 88 percent. Since then, it has been brought down to 14-15 percent. With about 69 percent of total liabilities being foreign currency-denominated (3Q 2004), Armenia's banks remain vulnerable to changes in international interest rates, exchange rates, and commodity prices. However, its open positions are now contained and modest, reducing this risk. Likewise, both assets and liabilities are relatively current, reducing the potential risk of maturity mismatches. All banks complied with requirements that net open foreign currency positions to non-convertible currencies be restricted to 5 percent of capital. Only one bank (as of year-end 2003) was not in compliance with the requirement that net open positions to all foreign currency positions be restricted to 25 percent of capital. Preliminary indications from 2004 suggest that all banks are now in compliance.

In general, there appears to be limited market risk in the Armenian banking system. In one sense, this reflects the stable macroeconomic fundamentals of the country. Interest rates have gradually come down, the exchange rate has been reasonably stable against major international currencies, and the majority of exposures are short-term (up to one year). Above all, the banks remain very liquid. However, most Armenian companies do not have sizeable foreign exchange earnings, thus any loans made in foreign currency or indexed to foreign currencies will present some degree of exchange rate risk. If assumed by the banks, it is direct risk for the system. If assumed by borrowers, this will constitute credit risk for the banks (on the assumption that the DRAM depreciates). Notwithstanding these and other risks, there is little likelihood that any major maturity, interest rate, or exchange rate mismatches would imperil bank portfolios or jeopardize banking system stability (although there is an opportunity cost to banks for issuing dollar-denominated loans or making dollar investments, given its slide in the last two years). The following summarizes key risks:

Box 5.1: Synopsis of Credit and Market Risks in the Armenian Banking System

Credit risk	Banks appear to be somewhat diversified in their portfolios, with relatively quick turnover businesses (e.g., commercial trade) accounting for 22 percent of loan value, yet several other categories (e.g., consumer loans at 27 percent of total, agriculture, construction) likely reflecting a mix of short-term and long-term exposures. To the extent long-term loans are made, these are usually funded by donors. Lending to the industrial sector accounts for 27 percent of loans, and is mainly concentrated in the food processing and energy sectors. While there is risk inherent in these exposures, banks are not particularly vulnerable to any major concentration risk. Loan loss reserves are only about 1.6 percent of total loans and off-balance sheet items,

which is little changed from figures at year end 2003. Almost all provisions are the result of the standard 1 percent provision required of standard loans. Only a small fraction is for doubtful loans more than 90 days in arrears requiring 50 percent provisions.

Credit risk is perceived to be high by the banks, which is one of the reasons why banks have been reluctant to lend. Credit risk will increase as the market becomes more competitive. However, improvements in the institutional framework (e.g., improved legal/judicial framework, secured transactions framework, better information) will help to mitigate these risks. Moreover, as the system opens up to competition, banks will be required to develop better systems of credit management as part of a larger effort to develop sound underwriting standards and adequate risk management capacity. As of 2004, there has been some willingness of banks to make more loans. However, it is still unclear if the banks have made sufficient movement to manage credit risk when the economy eventually slows. There is also insufficient movement towards credit worthiness by many enterprises in the real sector, above all in meeting accounting and disclosure requirements needed for banks to comply with underwriting standards (and prudential requirements).

Interest rate risk

Interest rate risk is relatively low due to the stable monetary policy implemented in the post-hyperinflationary period. With some justification, companies complain that interest rates on loans are high. Nominal rates have not come down much in recent years, even though the inflation rate has been declining. From a risk management standpoint, this means there is less interest risk due to the small volume of loans made. Short-term maturities of loans and deposits make interest rate management feasible for lenders and borrowers. However, if there is an increase in term lending by the banks (as shown in recent lending for housing finance and some consumer lending, and needed for investment in the SME sector), this may introduce some interest rate risk. But as of 2004, there is little risk.

Exchange rate risk

With about 69 percent of loan values in foreign currency (mainly dollars), any major shift in exchange rates could be destabilizing. However, banks actually had a $200 million surplus of foreign currency deposits compared with loans, as most foreign currency holdings are safely held in correspondent bank accounts in New York and London. Armenia's net international liquidity position was more than $78 million at year-end 2003, although this is projected to decline somewhat in 2004.

There is little FX risk at the moment as the dollar has not shown signs of strengthening, the DRAM has appreciated, and other fundamentals remain stable. Cash and reserves are abundant as a share of assets, and gross international reserves are likewise projected to increase gradually in the coming years.

Maturity risk

About 56 percent of loans are short-term (up to one year, as of 3Q 2004), and deposits are primarily foreign currency-denominated and short-term (47 percent) or local currency demand deposits (15 percent). Because of the prevalence of short-term liabilities, banks are reported to follow fairly conservative matching strategies. Over time, banks can be expected to develop more modern treasury management practices, not only for liquidity management, but also to help develop more efficient portfolio management strategies. However, under current circumstances, there are few long-term instruments available. There is little in the way of government securities beyond one year, and no corporate, municipal, or mortgage securities market has evolved yet. As such, banks themselves have kept maturities relatively short on most loans, despite recent increases in 2004 with regard to maturities and loan exposures for consumer goods (often appliances with up to three-year maturities and/or for vehicles with four-year maturities) and some housing finance (with maturities of five to seven years, although these are usually paid down before maturing).

Historically, enterprises and some individuals benefited from rollovers, which effectively meant that short-term loans became long-term loans. In some of these cases, the long-term status of the loans resulted from inability to meet payment requirements. However, CBA has tightened up on these practices, and rollovers are thought to be less prevalent or

	are subject to provisioning requirements.
Pricing risk	Given the short-term maturities that prevail, there is limited pricing risk. Variable pricing can be employed for longer-term loans. Where pricing risk is an issue (indirectly) is with regard to credit risk and exposures of banks in areas where prices on commodities may fluctuate. For instance, there is direct risk to banks with exposures to the diamond polishing and metals export business. Likewise, the economy is indirectly vulnerable to pricing risk if there is a material decline in oil and gas prices, because of the effect it would have on Russia. However, for now, there is little exposure to pricing and commodity risk in the system for Armenian banks.

5.8 COUNTRY RISK

5.8.1 COUNTRY RISK RATINGS

There is no current sovereign debt rating for Armenia to use as a proxy for country risk (as well as a proxy for local currency risk). However, using information available from Fitch IBCA's web site,[124] a series of ratings for other transition countries can be used for comparison with Armenia. The table below presents Fitch IBCA's ratings for sovereign transition country issuers as of late September 2004.

[124] Of the three major rating agencies, Fitch IBCA is the only one that presents its sovereign ratings on its web site without additional requirements (e.g., logging in, subscribing).

BOX 5.2: COUNTRY RISK MEASURES

Country	LT Foreign Currency	ST Foreign Currency	LT Local Currency	Country Ceiling	LT Rating Alert
Azerbaijan	BB-	B	BB-	NR	Outlook Positive
Bulgaria	BBB-	F3	BBB	BBB-	Outlook Positive
Croatia	BBB-	F3	BBB+	BBB-	Outlook Positive
Czech	A-	F2	A	A+	Outlook Stable
Estonia	A	F1	A+	AA-	Outlook Positive
Hungary	A-	F2	A+	A+	Outlook Negative
Kazakhstan	BB+	B	BBB-	BB+	Outlook Positive
Latvia	A-	F2	A	A+	Outlook Positive
Lithuania	A-	F2	A	A+	Outlook Positive
Moldova	B-	B	B	B-	Outlook Stable
Poland	BBB+	F2	A	A	Outlook Stable
Romania	BB	B	BB+	BB	Outlook Positive
Russia	BB+	B	BB+	BB+	Outlook Stable
Slovakia	A-	F2	A+	A+	Outlook Stable
Slovenia	AA-	F1+	AA	AA+	Outlook Positive
Turkmenistan	CCC-	C	NR	CCC-	NR
Ukraine	B+	B	B+	B+	Outlook Stable

Notes: When cell is NR, nothing has been rated.

Source: www.fitchibca.com

While not an exact measure, the closest peer for Armenia based on per capita incomes is Azerbaijan, at $3,010, as compared with Armenia at $3,230 (2002 figures; both are higher in 2003). However, this is partly distorted by Azerbaijan's oil and gas sector, which has received significant investment and is generating major export earnings. By contrast, the non-oil and gas part of the economy in Azerbaijan is poorly developed, and not altogether different from much of Armenia's economy outside of Yerevan. However, even here, there is a difference, as Azerbaijan has at least received ratings. Despite these differences, using Azerbaijan's rating as a very rough proxy, this would signify the following:

- LT Foreign Currency: BB-
- ST Foreign Currency: B
- LT Local Currency: BB-
- Country Ceiling: not available.

These ratings generally point to uncertain protection against losses, limited safety, and vulnerability to losses from credit default. Other unofficial measures of risk for Armenia indicate moderately high political risk, low institutional investor credit ratings, and generally weak credit worthiness.[125]

Country risk associated with Armenia appears to be structural and political. Structural weaknesses include the absence of critical resources, small size and capacity of the financial sector, weak levels of investment

[125] See *World Development Indicators*, World Bank, 2004.

in the financial and real sectors, weak tax base and tax administration that is not trusted, high levels of grey market activity, and low levels of public confidence in major institutions (e.g., banks, courts, government administration). Political risk is primarily focused on the unresolved conflict in Nagorno-Karabakh, and/or that relations with unstable neighboring states would deteriorate further and serve as a trigger for renewed hostilities. There is also the risk that a macroeconomic downturn, perhaps triggered by a sudden decline in commodity prices in major export markets (e.g., Russia, where Armenia exports goods and people), would adversely affect the current account, resulting in a worsening of poverty (more people affected, and those currently affected becoming more deeply affected). While these risks are not considered high at the moment, they underline perceptions of potential country risk.

Structural risks are currently mitigated by strong economic growth in recent years, gradual improvement in the functioning of formal institutions, low levels of systemic risk in the financial system, and a significant safety net due to the amount of cash held outside formal channels and reinforced by high remittance flows. Political risk is mitigated by continuing mediation of the dispute in Nagorno-Karabakh with no near-term risk of renewed hostilities,[126] relatively stable relations with neighboring states at the moment, a reasonably strong international liquidity position, and no apparent easing of commodity prices in Russia and other markets that are essential to Armenian exports of goods and people.

Country risk can be overcome if there is progress with policy reforms at the structural level. In the financial sector, this will include improved risk management as the system increases risk-taking. In the enterprise sector, this will include better financial management and marketing, and demonstrated ability and willingness to meet underwriting standards of various financial sector institutions. However, if Armenia is slow to reduce corruption, reform the judiciary, improve corporate governance, and stimulate greater investment, then perceived country risk will remain.

5.8.2 Operational Risk and Financial Crime

Back office operations, information systems, and internal controls are all considered to have improved in recent years, largely at the urging of CBA. Banks increasingly recognize the benefits of operational efficiency, the need for a sound reputation to attract investment, deposits and borrowings, and the importance of maintaining strong and reputable correspondent banking relationships. This has been true with regard to transfers as well as the growing list of products and services linked to plastic cards.

More recently, banks have begun to address the critical issue of implementing systems to identify money laundering, fraud, and other suspicious transactions. The closure of some of the smaller banks reflects this concern. Establishment of a Financial Intelligence Unit in 2005 will also encourage banks to continuously upgrade systems to contain these risks.

5.8.3 Reputation Risk

As with operational risk, reputation risk in the market has an impact on correspondent banking relationships, the risk premium of international borrowings, and a country's ability to attract investment. As of 2004, with virtually no portfolio investment and very little direct investment, this suggests Armenia has a poor reputation and/or is fraught with risk investors do not want to undertake. For Armenia to strengthen its reputation in international markets, it will need to ensure a reputation for safety and stability. This is particularly essential for the domestic market initially, as a means of attracting grey market resources into the formal system. Eventually, with some progress in mobilizing domestic funding, it is then anticipated that additional private sector financing from abroad would follow. This will be necessary for Armenia to further diversify and develop its economy.

[126] While relations with Azerbaijan remain tense, there are ongoing efforts through the Minsk Group of the OSCE to mediate the dispute.

Initial progress has been made in scaling down the number of banks unable to comply with prudential norms. Raising additional capital from reputable sources represents a subsequent challenge for know-how, financial capacity, systems, and as a sign of international confidence. Much of this will depend on further improvements in implementing corporate governance standards, strengthening accounting/audit capacity as well as transparency and disclosure standards, and improving the legal framework for creditors and loan recovery. These measures, along with improvements in back office operations to prevent criminal activity, will help Armenia strengthen its international and domestic reputation.

5.9 Soundness of Non-Bank Financial Institutions and Micro-Credit Organizations

5.9.1 Insurance

There is inadequate information on the insurance sector to determine soundness. However, with 97 percent of premium revenues reinsured, there seems to be adequate coverage for most policies. Capital is low, at less than $170,000 per active company at year-end 2003. However, there also seems limited risk in the system. With only $4 million in premiums, there would be little impact of any insurance company failures. Moreover, claims are reported to be low. Should there be a major catastrophe, such as another earthquake, it is unclear whether reinsurance would provide full coverage for the magnitude of destruction. However, given that most people and businesses are uninsured, this is more of an individual risk assumed by households than it is an insurance sector risk. With a growing housing finance market, there is a possibility that closer scrutiny will need to be applied on property and casualty policies underwritten. Likewise, mandatory auto insurance will also need to be carefully scrutinized, as claims are likely to increase with the rise in motor vehicles and accidents.

5.9.2 Non-Bank Credit Organizations

Non-bank credit organizations are generally regulated in a manner similar to banks in that there are various prudential norms associated with their asset management practices. These include capital adequacy ratios, large exposure limits, and limits on open foreign currency positions.

Because credit unions and savings unions are the only NBCOs permitted to mobilize individual (household) deposits, there are few possible ways in which NBCOs can directly weaken financial stability. At the moment, there is only one credit union, and it is reported to be very small. As for indirect effects on financial stability, the other NBCOs are relatively small, and all have limited exposures (if any) that are linked to banks. As such, NBCOs are not currently viewed as a threat to banking sector stability. As individual entities, none is reported by CBA to be a problem institution.

ANNEX 6: INDICATORS OF FINANCIAL SECTOR INTERMEDIATION[127]

6.1 TRENDS IN FINANCIAL INTERMEDIATION

6.1.1 BASIC TRENDS IN FINANCIAL INTERMEDIATION

Since 1996, there has been a gradual increase in financial intermediation, as measured by broad money-to-GDP ratios. While measures in the early 1990s fluctuated wildly due to the volatility of the environment, these measures began to stabilize in 1995 and then grew in small increments thereafter. By year-end 2003, broad money-to-GDP was 14.5 percent. This was nearly double levels in 1995, but still one of the lowest among transition economies. Figures at 3Q 2004 suggest the ratio has increased slightly in 2004 based on broad money data and projected GDP of about $3.15 billion.

In general, bank credit to enterprises, households and NBFIs approximated $179 million per year from 1999-2003. The peak was $198 million in 2000, but many of these loans were problem loans. In particular, with a tightening of loan classification standards, banks further tightened their underwriting criteria. As such, credit to the real sector diminished in dollar terms in 2001-02, and then increased in 2003 to $183 million, slightly above the five-year rolling average. As of 3Q 2004, the figures has grown significantly, rising to about $272 million, about a 50 percent increase in just three quarters.

As a share of GDP, bank credit to the real sector averaged 8.3 percent from 1999-2003, a fairly low figure. As with the dollar value of bank credit, the peak was in 2000, at 10.4 percent of GDP. It declined thereafter, including in 2003 when bank credit to enterprises, households and NBFIs was only 6.4 percent of GDP. Figures at 3Q 2004 (including exposures to leasing and factoring) put this at about 8.6 percent of projected 2004 GDP. Thus, intermediation remains low, but is clearly increasing through the banking system.

As noted elsewhere in the assessment, banks place a large share of their assets in low yielding but safe bank securities, mainly in New York and London. This has helped with financial stability measures, but reflects a high degree of risk aversion that has translated into relatively limited levels of credit exposure. However, as banks make more loans, these assets are declining as a share of total assets, although their aggregate value continues to increase.

The private sector share of bank lending accounts for most credit to the real sector. As of 3Q 2004, bank loans to private enterprises were $129 million, and to households (individuals) about $100 million. This compares with only $16 million to state enterprises. This trend has been under way for years, as banks' loan exposures have increasingly gravitated to private companies and households, and away from the state sector. Domestic credit to the private sector approximated an average of $115 million per year from 1998-2002, nearly two times credit (average annual $59 million during the same period) to the state enterprise sector. Considering that banks also averaged holdings of about $32 million per year in government securities, this means that banks' net domestic credit flows from 1998-2002 were approximately 56 percent to the private sector, 28.5 percent to the SOE sector, and nearly 16 percent directly to government. One caveat is that many of the "private" companies may, in fact, be closed joint stock companies with partial or even total state ownership. Nonetheless, banks have generally moved away from loan exposures to these companies as CBA has tightened its monitoring of large loan exposures.

[127] Primary author: Michael Borish.

Building and restoring confidence in banking has been a difficult task in Armenia, as elsewhere throughout much of the CIS (and discussed in several sections of the report). Money held outside of banks remains high, at 34 percent of total broad money at 3Q 2004. However, it has declined in the last few years, and this has continued in 2004 when compared with the 39.5 percent figure at year end 2003. The ratio has come down gradually since 1998. Thus, while money held outside the system remains high, the trend is a favorable one. (Figures may not be entirely accurate due to the high level of informal transactions in the economy.)

All together, Armenia has rising but still low levels of financial intermediation. These low levels partly reflect underdevelopment of the banking sector. As noted above, banks have faced numerous structural issues, and developing a sound and stable banking environment has taken time. This is a precondition for confidence which is still lacking. However, the lack of confidence in banks is only part of the problem. Much of the economy remains informal, and it is tax avoidance and potential garnishing of accounts as much any other factor that contributes to funds being kept outside the banking system. As it has only been about a decade since hyperinflation wiped out many peoples' savings, it will take time to reverse this loss of confidence. Nonetheless, a reversal is a prerequisite to Armenia achieving intermediation ratios more consistent with middle income countries.

TABLE 6.1: INDICATORS OF FINANCIAL INTERMEDIATION (1999-2004)

($ figures in millions)	1998	1999	2000	2001	2002	2003	2004
Broad Money	$191.2	$205.9	$279.1	$284.6	$368.9	$402.8	$462.2
o/w currency outside banks	$81.9	$79.6	$110.3	$117.2	$154.5	$159.0	$152.5
o/w domestic currency deposits	$32.0	$25.6	$31.9	$33.2	$62.8	$70.4	$70.2
o/w foreign currency deposits	$77.3	$100.7	$136.9	$134.2	$151.7	$173.5	$239.5
Change in end-period broad money	$47.1	$14.4	$76.5	$3.8	$84.6	$34.4	$58.2
Broad Money/GDP	10.11%	11.16%	14.60%	13.43%	15.59%	14.41%	14.67%
o/w currency outside banks	4.33%	4.32%	5.77%	5.53%	6.53%	5.69%	4.84%
o/w domestic currency deposits	1.69%	1.39%	1.67%	1.57%	2.65%	2.52%	2.23%
o/w foreign currency deposits	4.08%	5.46%	7.16%	6.34%	6.41%	6.21%	7.60%
Change in end-period broad money	36.71%	13.97%	38.56%	4.28%	33.98%	10.35%	10.50%
As share of Broad Money:							
Currency outside banks	42.9%	38.7%	39.5%	41.3%	43.7%	39.5%	34.2%
Domestic currency deposits	16.8%	12.4%	11.4%	11.7%	17.4%	17.7%	15.7%
Foreign currency deposits	40.4%	48.9%	49.1%	47.0%	38.8%	42.9%	50.1%
Notes: 2004 data are for September 30, apart from GDP, which is the projected figure for the year.							
Sources: CBA, IMF, author's calculations							

Armenia's low financial intermediation ratios of about 15 percent are particularly glaring when compared with other transition countries. Among the transition countries for which reasonable data are available, 15 of 26 had about two times or higher Armenia's level of financial intermediation. Thus, Armenia's overall

level of financial intermediation is low by most transition country standards, and below average relative to the CIS at year-end 2003. As examples, the unweighted average in 2003 for 10 CIS countries was 20.8 percent, with Ukraine and Moldova skewing the average. Armenia's ratio was lower than that of Belarus, Kazakhstan, the Kyrgyz Republic, Moldova, Russia, Ukraine and possibly Turkmenistan,[128] and almost the same as that of Azerbaijan. Thus, in terms of overall average as well as number of countries, Armenia remains in the lower half of performance among CIS countries. Meanwhile, as the entire CIS is lower than the Baltic states and other transition countries,[129] Armenia's performance relative to the transition countries as a whole is poor. The following table presents some ratios of financial intermediation based on broad money to GDP.[130]

TABLE 6.2: BROAD MONEY-TO-GDP IN SELECTED TRANSITION ECONOMIES (1998-2003)

	1998	1999	2000	2001	2002	2003
Albania	52.0%	57.9%	60.1%	66.7%	63.3%	68.6%
Armenia	10.1%	11.2%	14.6%	13.4%	15.6%	14.4%
Azerbaijan	11.0%	10.9%	11.0%	12.9%	13.3%	14.7%
Belarus	32.8%	17.5%	17.7%	14.9%	15.4%	15.7%
Bosnia-Herz.	24.5%	27.0%	27.2%	48.0%	49.3%	55.0%
Bulgaria	29.6%	31.7%	37.3%	40.7%	37.9%	54.7%
Croatia	41.6%	39.4%	46.1%	64.9%	66.6%	74.0%
Czech Republic	67.5%	68.0%	75.7%	73.9%	74.7%	84.2%
Estonia	29.1%	35.1%	39.3%	42.3%	42.9%	48.4%
Georgia	7.6%	8.1%	10.3%	11.1%	11.8%	13.1%
Hungary	45.5%	46.3%	46.4%	47.0%	47.2%	50.4%
Kazakhstan	8.6%	13.6%	15.3%	14.6%	20.4%	22.2%
Kyrgyz Rep.	14.5%	13.6%	11.3%	11.1%	14.7%	19.2%
Latvia	26.7%	26.6%	30.4%	32.8%	36.5%	44.2%
Lithuania	19.4%	21.0%	23.3%	26.7%	29.3%	34.9%
Macedonia	15.0%	19.3%	21.0%	25.3%	28.3%	34.6%
Moldova	19.3%	20.4%	22.4%	25.5%	30.5%	33.8%
Poland	39.9%	42.8%	42.7%	45.2%	42.8%	44.4%
Romania	24.9%	24.9%	23.2%	23.2%	25.7%	21.6%
Russia	22.9%	20.7%	22.1%	23.5%	26.8%	28.3%
Slovak Rep.	59.7%	64.1%	67.8%	68.0%	65.3%	73.1%
Slovenia	45.4%	46.5%	49.6%	55.2%	55.5%	62.6%
Tajikistan	7.1%	6.7%	8.2%	7.9%	8.4%	10.2%
Turkmenistan	14.9%	14.9%	20.3%	17.6%	16.6%	N/A
Ukraine	15.2%	17.2%	18.1%	22.4%	30.2%	35.8%
Uzbekistan	15.4%	13.6%	12.2%	12.6%	10.6%	N/A

[128] Turkmenistan's ratio has consistently been higher than Armenia's.
[129] The only exception is that Ukraine's ratio is marginally higher than that of Lithuania, which has the lowest ratio among non-CIS transition economies apart from Serbia-Montenegro.
[130] Figures are calculated from money and quasi-money as listed in IFS.

	1998	1999	2000	2001	2002	2003

Notes: Figures calculated from money and quasi-money to GDP from IFS. When not available, EBRD figures are used (Turkmenistan and Uzbekistan). Data for Armenia from CBA and IMF (GDP). 2003 ratios based on money and quasi-money (IFS) divided by year-end exchange rates (IFS) and then divided by US$ GDP figure from World Bank. Ratios from 1998-2002 calculated from IFS on a local currency basis. This, along with changes in exchange rates relative to the US dollar, may explain some of the increases in intermediation rates.

Sources: IMF/IFS; World Bank; EBRD; CBA; author's calculations

6.1.2 LENDING: STOCKS AND FLOWS

Patterns in the stock of loans show that bank lending is a large and increasing share of total bank assets, but remains small as a share of total GDP. Figures for year-end 2003 indicate that net domestic credit, including the low figure for bank investment in government securities, was only $235 million, or 8.2 percent of GDP. These figures have risen in 2004 such that September 30 data show loans and investments in government securities to be $335 million, or 10.7 percent of projected 2004 GDP. This represents an increase of $100 million in the first three quarters of 2004, and at that pace would approximate 12 percent of GDP by end 2004. Notwithstanding this favorable trend, this would still only be equivalent to about $19 million per bank by the end of 2004. This indicates that the average bank remains exceedingly small in Armenia, and that banking sector penetration in the economy is very limited.

In general, bank credit (including investments in government securities) as a share of GDP is returning to levels achieved in 1998-2000, when the bank credit-to-GDP ratio was routinely in the 10-12 percent range. After that, from 2001-03, with a tightening of loan classification standards, a desire to comply with key prudential solvency and liquidity norms, and investments in low risk securities abroad, the ratio declined. (Likewise, GDP has experienced significant year-on-year growth, in many ways from financing outside formal institutional channels.) However, with an increase in bank lending in 2004, the ratio is now returning to earlier levels, and on a more sustainable basis due to the improvement in loan quality.

In many transition countries where hard budget constraints have been imposed on state enterprises, precipitous year-to-year declines in bank credit have occurred. However, in Armenia, the decline in overall credit from 2001-03 had less to do with declines in exposures to state enterprises, as declines were more broadly distributed. Thus, while there was a significant decline in bank credit to SOEs in 2001, there was also an increase in 2002. Bank credit to the private sector actually declined in both 2001 and 2002. By contrast, investment in government securities (as well as in low risk, low yield foreign assets) has increased year to year since 2000. Thus, earlier declines in real sector loan exposure were fairly broad based, with banks seeming to be more influenced by prudential requirements and safety than any form of risk-taking in the private or state-owned enterprise sector. Now that asset quality has improved and interest rates on securities have declined or remain low, banks are beginning to feel more comfortable lending for consumer goods, commercial trade, housing, construction, food processing, and some energy-related areas.

According to the banks, in addition to the prudential framework, weaknesses in the legal framework (for creditors' rights and loan recovery) have also served as a disincentive to take on credit risk. Recent reforms may have contributed to the increase in lending, although bankers claim the increase has more to do with greater confidence in the credit worthiness of targeted borrowers (e.g., salaried employees) than improvements in the secured transactions framework. As such, bank portfolios are relatively safe, yet their earnings are poor in the aggregate.

In light of limited funding combined with credit limits of 20 percent of bank capital on individual loans, banks are irrelevant for many large and medium-sized firms in Armenia that need greater financing than the roughly $1 million maximum on average that banks can provide. Also, as syndicated lending has not taken hold in Armenia (or elsewhere in CIS markets), there has been little grouping of creditors to meet such needs. In particular, larger loans would also need longer periods for amortization. Given the scarcity of long-term funding (apart from that provided by donors), there is an additional risk of maturity mismatches that banks are unwilling to assume, even if they can provide for sufficient amounts of loan funding requested by prospective borrowers.

TABLE 6.3: BANKS' NET DOMESTIC CREDIT: STOCK FIGURES (1998-2004)

(millions, US$)	1998	1999	2000	2001	2002	2003	2004
Total GDP	$1,892	$1,845	$1,912	$2,118	$2,367	$2,796	$3,151
Claims on Government	$30	$23	$31	$32	$45	$52	$96
Claims on State Enterprises	$53	$44	$40	$19	$12	$13	$16
Claims on the Private Sector	$78	$114	$140	$133	$135	$157	$326
Bank (Net Domestic) Credit	$161	$181	$211	$184	$192	$222	$438
Per Bank Credit	$5.2	$5.7	$6.8	$6.1	$9.6	$11.1	$23.1
Government % of Bank Credit	18.6%	12.7%	14.7%	17.4%	23.4%	23.4%	21.9%
State Enterprise % of Bank Credit	32.9%	24.3%	19.0%	10.3%	6.3%	5.9%	3.7%
Private Sector % of Bank Credit	48.5%	63.0%	66.4%	72.3%	70.3%	70.7%	74.4%
Private Sector Share/GDP	N/A	N/A	79.7%	80.4%	81.5%	N/A	N/A
Bank (Net Domestic) Credit/GDP	8.5%	9.8%	11.0%	8.7%	8.1%	7.9%	13.9%

Notes: 2004 data are annualized from September 30 figures relative to increases/decreases through the first three quarters; CBA data are slightly lower than IFS data

Source: CBA; IMF; National Statistical Service; author's calculations

Based on CBA figures for September 30, 2004, bank credit (to enterprises and households, but not including bank investment in government securities) showed the following characteristics:

- Real sector credit was primarily to private enterprises (53 percent) and individuals (41 percent), with only 7 percent to the state enterprise sector.
- In terms of economic sub-sectors, credit was primarily for consumer loans (27 percent), commercial trade (21 percent), and food processing (11 percent).
- Industry as a whole accounted for 27 percent of total loans, with agriculture only 6 percent. Thus, most lending is for services. Apart from consumer loans and commercial trade, key service sector exposures were to other financial services (7 percent) and construction (4.5 percent).
- Bank credit was about 67 percent in foreign currency, and one third in DRAM.
- Bank credit is surprisingly about half short-term (up to one year), and half for longer than one year. When such loans have been made, they have usually been for consumer goods (e.g., appliances), housing or vehicle purchases.
- As of September 30, 2004, about 3 percent of loans were prolonged or overdue, equivalent to about 7

percent of capital.

The following table shows the general shift in lending flows in recent years, which are consistent with changes in stock figures above. While year-to-year patterns show differences—increases in 1998-2000 and 2004, compared with decreases in 2001-03—the flow figures indicate that incremental lending has been virtually non-existent in value terms, and actually negative as a share of GDP until 2004. Cumulative incremental bank credit figures (including investment in government securities) from 1998-2004 were $287 million, or an average of $48 million per year. However, the bulk of the increase has been in 2004. From 1999-2003, incremental net domestic credit was only $71 million, or $14 million per year. Netting out investment in government securities (claims on government), the figures show that bank lending to the real sector (enterprises and households) showed virtually no net increase from 1999-2003, at only $49 million, or $10 million per year. On the other hand, current trends are favorable, with a projected annualized increase in 2004 bank lending to $172 million, more than three times the total increment from 1999-2003.

TABLE 6.4: CHANGES IN BANKS' NET DOMESTIC CREDIT: FLOW FIGURES (1999-2004)

(millions of US$, %)	1999	2000	2001	2002	2003	2004
Increase/(Decrease) in:						
GDP	($47)	$67	$206	$249	$429	$355
Claims on Government	($7)	$8	$1	$13	$7	$44
Claims on State Enterprises	($9)	($4)	($21)	($7)	$1	$3
Claims on the Private Sector	$36	$26	($7)	$2	$22	$169
Total Bank Net Domestic Credit	$20	$40	($27)	$8	$30	$216
Increase/(Decrease) in:						
Government Share of Bank Credit	(5.9%)	1.3%	2.7%	6.0%	0.0%	(1.5%)
State Enterprise Share of Bank Credit	(8.6%)	(6.2%)	(8.7%)	(4.0%)	(0.4%)	(2.2%)
Private Sector Share of Bank Credit	14.5%	0.4%	5.9%	(2.0%)	0.4%	3.7%
Net Bank Credit/Incremental GDP	1.3%	1.8%	(1.2%)	(0.6%)	(0.2%)	6.0%

Notes: All figures are incremental as compared with prior year (increase = positive increment; decrease = negative increment). 2004 data are annualized from September 30 figures relative to increases/decreases through the first three quarters; CBA data are slightly lower than IFS data.

Source: CBA; IMF; author's calculations

6.2 OTHER ASSETS

Total assets for the banks approximated $498 million at year end 2003, or about $25 million per bank. By 3Q 2004, the figure was $675 million, or nearly $36 million. At such a rate of growth, this would mean that year-end 2004 assets would be $733 million, or nearly $39 million per bank. As noted elsewhere, the five largest banks accounted for about 57 percent of assets at 3Q 2004, or $79 million per bank. Thus, the other 14 banks average about $21 million in total assets, which is very small by global standards.[131] Ten banks (of 19 in total) had less than $25 million in total assets at 3Q 2004.

[131] There are slight differences from the individual bank data and consolidated figures for the system presented by CBA. For instance, total assets of the individual banks were $690 million, whereas the CBA figure is $675 million. Nonetheless, the differences are not material.

Based on year-end 2003 figures, the largest component of bank assets was credit, or loans to customers.[132] This has increased as of 3Q 2004, from 36-37 percent at year-end 2002-03 to 39 percent at September 30, 2004. Thus, as of late 2004, other assets approximated 61 percent of total assets. The main “other assets” are:

- Foreign reserves held in correspondent accounts (most of it presumed to be with HSBC), equivalent to $149 million at 3Q 2004, or 22 percent of total assets.
- DRAM investment in government securities, equivalent to $72 million at 3Q 2004, or 11 percent of total assets.
- Foreign currency cash of $44 million, or 6.5 percent of total assets.
- DRAM reserves held in correspondent accounts equivalent to $42 million at 3Q 2004, or 6 percent of total assets.
- Foreign currency deposits held with other banks of $39 million, about 6 percent of total assets.
- Fixed assets at $36 million, or about 5 percent of total assets.

6.3 Product Diversity, Development and Competition

6.3.1 Banks’ and Credit Organizations’ Product/Service Ranges

Most Armenian banks are relatively basic in terms of the services they offer. Their small funding base and the small size of the market has also meant that resources available for investment in systems have been constrained. Apart from cash transfers and some trade finance, the larger banks provide very limited services. As elsewhere in CIS markets, most banks are characterized by a paradoxical approach: the absence of specialization triggering a desire to become “universal” despite being undercapitalized. Low levels of capitalization have prevented them from emerging as effective full-service banks. On the other hand, risks associated with most large-scale enterprises and the banks’ own lending limits (driven by prudential limits and small levels of capital) mean that banks have to pursue the SME and retail market to generate reasonable earnings. This means they will need to provide a meaningful array of financial products and services and be more active in pursuing this client base. On a positive note, banks have begun to do so to some degree in the last year via consumer loans and commercial trade, and also by issuing plastic cards, opening up ATMs, and increasing their POS network.

While CIS countries have lagged their non-CIS counterparts in foreign ownership of banks and other financial services, CBA recognizes the need for increased capital, improved technologies, and better management systems for the banking system to be competitive and to offer better products and services to the marketplace. As noted, this is beginning to happen with some banks, with the offer of internet banking, plastic cards, ATMs, and other modern services. Most of this is restricted to Yerevan, and general levels of intermediation remain low. For instance, of Armenia’s 61 ATMs as of September 30, 2004, 48 are in Yerevan and only 13 are outside the capital city. However, even with increased activity in 2004, banks still are reliant on secured loans for most of their earnings. Low levels of productivity relate to the limited revenues from lending as well as non-lending sources (e.g., commission-generating services) as opposed to high cost structures.

As competition unfolds, bank management will need to prepare for new approaches to the market. This will involve unsecured loans based on accurate cash flow projections per project. In some measure, this is

[132] Net domestic credit (including bank investment in government securities) approximated $236 million, or about 51 percent of bank balance sheet values. Most of this was to enterprises (state and private), equivalent to about $184 million, or 40 percent of total assets.

beginning to occur, as banks lend to small businesses on what is technically a secured basis (e.g., by inventories), but recognizing that loan recovery faces numerous obstacles once it goes to the courts. Hence, in many current cases, banks are issuing plastic cards and lending to people with what are perceived to be secure and steady incomes, particularly when banks handle their companies' payroll accounts.

More broadly, banks are beginning to approach the market with strategies that are based on the total value of income that can be generated from the relationship. Thus, rather than segregating lending from non-lending activities, banks are evaluating client credit worthiness and the management of such accounts on a more comprehensive relationship basis with that client, meaning the total value the relationship (potentially) represents in terms of bank income. However, because banks only offer a small variety of services, there is a limit to how much they can pursue this approach. Moreover, given concerns about account garnishing for tax purposes, people and firms that would otherwise place funds with banks and seek loans and other services from them do not do so, partly due to their (potential bank clients') efforts to avoid possible garnishing.

Non-banks provide mainly what banks provide, except on a smaller scale. For instance, the one active leasing company is actually part of a bank (Acba), even if registered as a separate credit organization. The First Mortgage Company offers housing loans not much different from those offered by the banks (average of $25,000), although it claims to be the most affordable (lowest interest rates), and to offer faster processing time and more convenience (e.g., preparation of needed documentation from State cadastre, insurance). As a specialized credit organization, First Mortgage may eventually lead the market in product/service innovation, and serve as a driver for movement to secondary markets. However, as of 3Q 2004, it had only operated for about six months, and its loan portfolio was not expected to exceed $1 million until after April 2005. Apart from these two credit organizations, the remainder is basically similar to banks except they do not have capital of $5 million, and in most cases (apart from savings and credit unions) are not permitted to mobilize individual deposits.

6.3.2 Market Research and Product/Service Development

Market research has generally been hampered by the absence of viable market information. Traditional non-disclosure has been the main constraint. As a result, banks have to rely on individualized requests, and most banks have shown little or no inclination to pursue business in an innovative way. This partly relates back to the traditional culture of most of the banks, closely held and tied to friends, specific industries/enterprises, and connected parties.

There are exceptions. One bank in particular has made an effort to construct a data base that has permitted it to capture market share and assume more risk relative to its asset base. However, most banks' systems appear more geared to regulatory requirements and reporting, rather than market research and analysis for product/service development or innovation.

Another challenge is the reluctance to move ahead with broader sector initiatives. For instance, the Armenian Bankers Association has not undertaken any major initiatives that would pool information for its members. Likewise, the efforts of the Armenian Credit Rating Agency could conceivably be used as a tool to process systemic information, and then be used by banks' internal data bases to develop new products or services. However, as of late 2004, most banks do not appear interested. Combined with limited useful financial information and a fragmented market, such tendencies will keep banking fairly fundamental for the time being. As long as the market is growing, this may be adequate for shareholders. However, down the road, it would be expected that banks would need to expand capacity in these areas, particularly if the interest rate environment tightens margins.

6.4 Consumer Demand and Access to Finance

6.4.1 Consumer Demand, including Mortgage Finance

Lending figures indicate that most loans are being allocated to consumer finance and commercial trade. A small but apparently growing proportion of loans are to the housing sector. With total loans expected to be about 61 percent more in dollar value at year-end 2004 compared with year-end 2003, a significant portion of the $110 million increase in lending has gone to consumer loans and commercial trade. In general, the distribution of loans to individuals and enterprises (net of investment in government securities) at 3Q 2004 was as follows:

- Consumer loans: $71.5 million, or 27.4 percent of total.
- Commercial trade: $57 million, or 21.8 percent of total.
- Food processing: $29 million, or 10.9 percent of total.
- Energy: $23 million, or 8.8 percent of total.
- Financial sector: $17 million, or 6.7 percent of total.
- Agriculture: $15 million, or 5.8 percent.
- Construction: $12 million, or 4.5 percent.
- Other: about $36.5 million, or 14 percent.

Thus, assessing this distribution, a substantial share of bank loans are focused on meeting consumer demand. Housing loans are not specified, so it is uncertain how much banking exposure exists in this domain, although most housing loans are long-term loans. On the other hand, most housing transactions are done on a cash basis, rather than through the banking system.

Lending to industry is 27 percent of total. There are limits to what banks can actually do for the industrial sector apart from very small-scale lending (e.g., working capital financing) and trade finance. Rather than evolving as corporate banks, most banks appear to be focusing on consumer loans and other kinds of financing targeting households and small businesses. This way, the banks can make loans within their exposure limits, even with low levels of capital. Investment in electronic systems is making it feasible for banks to seek out higher income individuals and to provide them with credit/debit cards with overdrafts, targeted savings instruments that can be used to secure loans, etc. However, many of these prospective clients still lack confidence in the banks or are seeking to shield their assets from the tax authorities. Thus, the banks themselves face challenges in capturing these markets.

6.4.2 Loan Features

Pricing on loans varies significantly, as shown in the range of interest rates in 2004. However, this has less to do with bank competition, and more to do with general macroeconomic trends. Rates have shown the following ranges in 2004:

- *Enterprises:* 16.3-22.8 percent on DRAM loans, and 14.9-20.6 percent on dollar loans. As of early October 2004, these were 20.4 percent and 17.9 percent, respectively, on DRAM and dollar loans. Netting out deposit rates paid, this translates into a range of 11.3-13.9 percent on net DRAM loan spreads and 12.1-14.2 percent on dollar loan spreads when comparing low and high rates between loans and deposits.

- *Individuals:* 20.1-29.5[133] percent on DRAM loans, and 19.6-25.2 percent on dollar loans. As of early October 2004, these were 22.9 percent and 22.1 percent, respectively, on DRAM and dollar loans. Netting out deposit rates paid, this translates into a range of 13.7-20.8 percent on net DRAM loan spreads and 16.1-18.3 percent on dollar loan spreads when comparing low and high rates between loans and deposits.
- *Comparison between enterprises and individuals:* Net spreads are generally higher on loans made to individuals, although they remain in double digits on loans to all borrowers. This is consistent with income statements that show high net interest margins on a percentage basis, but low values in dollar terms due to the relatively small volume of loans made.

Fees appear to be modest, and depend on the type of loan. For instance, for housing loans, fees will include costs associated with getting needed documentation on the property from the State cadastre, arranging for insurance, and having documentation and loan contracts notarized.

Interest and principal payments tend to be on a monthly basis, although this depends on the nature of the loan. In particular where donor funds have been provided for maturities exceeding one year, there are frequently grace periods before principal (and sometimes interest) payments need to be made. In general, principal and interest payments are specified in an annex to the loan agreement indicating due date and amount.

Maturities show a broader range than is ordinarily assumed. Given the lack of term funding on banks' balance sheets, the common assumption is that most banks lend only for a matter of weeks or months. However, CBA figures indicate that nearly half of loans exceed one year. Banks are now routinely lending to consumer goods distributors for three years, to individuals for auto loans for years, and housing loans to families for five to seven years. The challenge is primarily for industrial enterprises that need additional funding for investment periods exceeding one year. Donor funds have helped in this regard, although constraints to bank lending (e.g., exposure amounts, difficulties recovering loans) have also meant that most enterprises finance their operations outside the banking sector.

6.4.3 REQUIREMENTS FOR ACCESS TO FINANCE

According to the banks, access to finance for households and SMEs has been constrained by the *traditional orientation of banks to large enterprises and/or cronies*. However, since conditions have tightened from 2001 on, the main constraint has been the weak legal framework for creditors' rights and loan recovery. As such, until 2004, banks generally avoided taking on credit risk, and instead generated fairly safe earnings from bank securities abroad and government securities in Armenia. As such, their portfolios are relatively safe and CARs are high. The offset is that their earnings are poor in the aggregate. As the interest environment shows declining rates, they will likely shift resources out of safe securities and increasingly into higher-earning assets.

Volume of loans has increased in 2004, the first year in several when lending flows have shown significant year-on-year increases. However, the *size of individual loans* is limited by prudential norms to how much the banks can expose their balance sheets in terms of risk. In light of banks' limited funding combined with credit limits of 20 percent of bank capital on individual loans, banks are irrelevant for many large and medium-sized firms in Armenia that need greater financing than the roughly $1 million maximum on average that banks can provide. As such, banks have not been able to lend for much more than small amounts, which now explains why banks are lending increasingly to consumers and commercial traders rather than large-scale or even medium-sized industries. It should be noted that many

[133] This was a bit of an outlier. Apart from one week in January 2004, DRAM interest rates on loans to individuals did not exceed 27.8 percent, and more generally has been in the 20-25 percent range. As such, the normal net spreads have been lower than when comparing highs and lows throughout the course of the year.

of the larger enterprises are also the ones that have political clout that would make it difficult for banks to recover loan value (principal and interest) if problems of credit quality emerge. Thus, banks actually have more clout vis-à-vis smaller borrowers. Also, as syndicated lending has not taken hold in Armenia (or elsewhere in CIS markets), there has been little grouping of creditors to meet larger loan needs. In particular, larger loans would also need longer periods for amortization. Given the scarcity of long-term funding, there is an additional maturity mismatch risk banks are unwilling to assume, even if they can provide for sufficient amounts of funding demanded by prospective borrowers.

Underwriting standards/requirements have become more rigorous in the last few years as banking supervision has tightened, prudential norms have been followed, and borrowers have become more aware of the need to service and repay loans. In one sense, tougher underwriting criteria explain part of the reason why bank lending has been limited until 2004. On the other hand, as banks improve their own systems of credit risk evaluation, they are increasingly willing to make loans to targeted individuals and businesses on a cash flow basis, with some underlying collateral for comfort. In particular, the KfW-German Armenian Fund appears to have been effective in training several banks[134] on how to evaluate and administer micro-loans on a de facto unsecured basis. This bodes well for future lending in Armenia, but also puts responsibility on borrowers for providing sufficient and accurate information for credit risk evaluation, as well as early indications of potential problems should there be difficulties in complying with loan covenants. Until this happens, unsecured lending is only likely to occur in small amounts.

Methods of *tracking cash* have improved at banks, which is also one of the reasons why banks can focus increasingly on cash flow. Starting with key target market segments, such as professionals with good salaries and regular pay or enterprises in high turnover/high margin and export-oriented businesses, banks are able to monitor cash flow based on monthly or seasonal loan uses. Over time, these practices will become more refined, and competition will encourage banks to pursue others currently unable to access loan finance. However, banks will also be justified in turning down clients unable to comply with basic underwriting standards. The banks themselves have obligations to adhere to these standards for their own portfolio quality reasons as well as regulatory prodding. This will continue to require good use of electronics, particularly in putting packages of services together for borrowers and borrowers' firms (when employees are the borrowers), as well as a willingness of borrowers to provide information for credit approval and to work with banks when credit quality might potentially deteriorate.

Most banks require *collateral* for loans, although the collateral requirements are not excessive when compared to other banking markets in the transition economies. More often than not, banks request collateral coverage of 1.5-2.0 times loan principal. While they are perceived as a barrier to SME or micro-enterprise access to credit, these collateral requirements are not excessive by comparative standards. The problem may lie more in the unwillingness of firms to declare their assets and/or to properly value their assets, largely due to tax avoidance purposes. Moreover, given the nature of most bank loans at this point that are focused on consumer loans and commercial trade, liquid assets such as inventories financed are often the collateral used. As such, the issue of fixed assets for collateral coverage is less of an issue. To the extent that industrial enterprises are the prospective borrowers, they are generally permitted to secure their loans with equipment or useful immovable assets. However, their usefulness can be undermined by difficulties of repossession and resale, and the shortage of secondary market interest and mechanisms. Thus, the constraint is less the banks per se, and more the overall underdevelopment of open market structures and mechanisms for the disposal of repossessed assets. This risk aversion by banks has been reinforced by difficulties faced in the court system. Recent changes to introduce out-of-court settlement mechanisms may ease this as a barrier, although there has been little reported to date on how alternative

[134] The five banks that have participated in the KfW-GAF program are Acbabank, Analek, Armeconombank, Converse, and Inecobank.

dispute resolution is working. What is reported is that the Economic Courts are backlogged, slowing the process of dispute resolution when these disputes arise.

Credit ratings are also a tool used in market economies to evaluate credit worthiness. This applies to more than banks, and effectively applies to all creditors, as well as involves other contingencies such as lawsuits. In the end, these systems require more open information flows than exist in Armenia. For this reason, the Armenia Credit Rating Agency (ACRA) would be helpful if it is able to obtain the needed information. However, as noted elsewhere in the report, it has been facing difficulties gathering information due to banks' proprietary views of their data bases, and the unwillingness of banks to pay for credit ratings after providing information to ACRA for free.

In this regard, problems of financial disclosure and other important information relate to a larger issue in Armenia of *business culture* and its impact on management and operations. Most enterprises in Armenia are "one-man" operations, rather than companies run by complementary management teams comprised of a broad range of skills and specializations. Thus, enterprises in Armenia are closely held, limited in transparency, and consequently unable to access formal financing in most cases. This is an issue that transcends firm size, as large-scale firms are also reported to be lacking in transparency in a number of ways (e.g., governance structures, financial reporting). This makes it risky for banks and investors to expose resources to such firms, effectively making the prevailing business culture a constraint on access to finance.

Other characteristics from the business environment are also important, and have had a major impact on banks' unwillingness to lend to SMEs and other small enterprises in Armenia. Transition country enterprises are usually weak in terms of *management and marketing*, including the use of market information to develop strategies that then provide useful parameters for financial management, investment decisions, and operational focus. Armenia falls into this category, notwithstanding the strong analytical capacity of certain institutions and individuals in the private sector. Such weaknesses have clearly had an impact on banks' unwillingness to make loans and increase overall credit exposures.

Banks are not the only obstacle that exists in the financial system. *The underdevelopment of non-bank financial services (e.g., varied insurance products) undercuts enterprise credit worthiness, thereby reducing credit and investment.* As an example, the underdevelopment of the insurance sector has limited fundamental coverage and transfer risk options such as crop insurance that could help agricultural producers and, by extension, food processors. This reduces the willingness of banks to lend, or adds to the risk premium and, consequently, the interest charge.

The general underdevelopment of one financial sub-sector undercuts development of others. Following the example of agriculture and food processing, less insurance has meant less willingness on the part of banks to lend. This has also meant that there is less output available for warehouse receipts that could be floated on the local exchange. In turn, this has reduced collateral coverage as well that could lead to larger loans or longer maturities. All of this has meant the primary sector is less attractive, reducing the prospect for agricultural leasing to become commercially viable. Thus, while using just this one example, there are numerous supply constraints that reinforce each other, reducing access to formal finance in the end, and contributing to a more fragmented economy.

6.4.4 Obstacles to Businesses in Accessing Finance

In most developing and emerging markets, businesses traditionally report difficulties in accessing affordable finance for sufficient maturities in needed currencies. In some cases, these reports are wholly justified. In other cases, their failure to understand the risks involved and to meet fundamental underwriting criteria justifiably disqualifies them from obtaining financing. In Armenia, the major obstacles to finance appear to be collateral requirements of banks that are largely related to firm size,

availability and use of meaningful financial information (for debt and equity purposes), variety and suitability of instruments, and affordability.

In Armenia, most firms are self-financing, meaning reliant on their own resources or those of families and friends. This has traditionally related to firm size, with larger firms able to access financing from abroad, mid-sized firms able to access financing from domestic banks, and most small-scale and micro-enterprises left to find alternative sources. Thus, for most firms, *one of the key impediments appears to be firm size*. In the manufacturing sector, this means they require export markets to be competitive, or need to produce high margin products to compensate for lower volume in a country where purchasing power is limited. This is hard to do. Moreover, when they approach banks, they often need long-term loans to finance needed equipment. However, in the absence of contracts in export markets and/or favorable prospects in the domestic market, this is risky for banks. Meanwhile, even working capital financing is challenging because of the need for imports (sometimes intermediate) to sustain operations. This can be costly, depending on supply availability, transport issues, and commodity prices. The absence of domestic resources can make these exposures riskier for banks and investors. Meanwhile, in many of the services, taxation and transport costs weaken commercial prospects, as do import costs. As such, many such enterprises find it difficult to obtain bank loans. When they are able to access credit, it is often because they are larger firms with contracts, credit histories, and connections.

The issue of *collateral requirements of banks*, which are perceived by most firms to be high, is particularly relevant to firm size issues. As noted, larger enterprises are thought to be able to access resources from abroad, while mid-sized firms are able to access loans from banks. However, because of the small number of these firms, there is a broad perception that credit is limited to firms able to pledge assets. Low financial intermediation and bank penetration rates confirm this. At the same time, many SMEs consider their operations to be profitable and credit worthy. However, because they do not have significant assets to pledge, they are often bypassed by banks. This may be changing as banks shift their lending to consumer goods and commercial trade sectors. Moreover, with competition, there will eventually be rising loan exposures to manufacturers as well as in transport. However, for now, collateral requirements are perceived to be a problem for many prospective borrowers, often correlated with firm size.

The issue of collateral requirements is partly related to larger issues of *financial disclosure and distrust of the tax authorities.* Beyond basic accounting and audit standards, distrust of the tax authorities manifests itself in major incidence of tax evasion and avoidance.[135] As such, there is little incentive for visible asset growth in enterprises, or accurate financial reporting of revenues and pre-tax income. In effect, these problems keep formal investment down, and provide incentives for households and businesses to conduct their transactions off the books, either purely in cash and/or through barter (goods and services). The end result and consequence is:

- Understated revenues and income to reduce tax payments, which also understates cash flows that would help some businesses to obtain bank loans or off-balance sheet facilities (e.g., trade finance, performance guarantees). For those who obtain, more truthful financial disclosure would also increase loan size, and possibly extend maturities.
- Lower visible investment, keeping firms small and reducing the asset base for secured loans from banks. Again, this reduces loan size, shortens maturities, or disqualifies SMEs from access to credit in the first place.

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[135] The public generally views the tax burden as one that is excessive and/or applied arbitrarily and selectively without providing adequate services in exchange. In effect, taxes are often paid, although they are not always recorded in the treasury. That taxes paid do not always find their way to the government treasury to finance needed infrastructure and services reduces confidence in public institutions, likewise reducing the willingness of the public to pay taxes in the first place as they feel they are not benefiting from needed services.

- Greater focus on short-term, high-turnover operations (e.g., trade, low value services) as opposed to higher value-added activities that depend on greater investment and fixed asset bases. This is evident in current lending patterns in Armenia, where most loan exposures are now for consumer goods and commercial trade.
- Informal transactions, shrinking the fiscal base and keeping information flows limited. (Informal GDP is nearly 50 percent of total.) This disqualifies many SMEs from access in the first place.

Because enterprises keep their reported revenues, cash flows and assets small, *this makes them less attractive as potential bank clients.* First, the smaller the enterprise, the smaller the asset base for secured loans. Second, the per-unit cost of loan processing is higher for smaller enterprises, given that more administrative cost is involved relative to loan size. This challenge is compounded by the few enterprises that present credible financial statements and business plans (as well as the general lack of capacity at the banks to adequately evaluate those plans and financial statements.) Given the perception of such small numbers of credit worthy SMEs, banks have broadly ignored these enterprises until recently.

However, *this does not mean that larger enterprises have an easy time accessing credit*. In recent years, banks have had limits placed on their loan exposures relative to capital. Given that most banks' capital is small, their ability to provide large loans is limited. Moreover, large companies pose problems for banks in terms of governance structures, which are more problematic and complex at larger companies. This can put banks in a weaker position unless they have offsetting legal and political powers to ensure contract enforcement. As such, firm size, collateral, information flows and per-unit costs of loan processing are not the only factors that constrain access to credit.

These and other issues (including broader market risks, limited funding sources, etc.) have led to fairly *high loan interest rates and loan spreads*. Net spreads are high (about 14-15 percent or more, depending on the client), nominal interest rates exceed 20 percent, and additional fees add to the burden companies have to assume in a difficult environment. Thus, while there have been improvements in the macroeconomic framework, bank loans remain expensive for firms. In addition to general and firm-specific market premiums, part of the reason for high net spreads is the result of banks' inefficiencies, low productivity relative to revenues, and limited volume of loans to date. In recent years, banks have become accustomed to placing funds in low-risk securities. Now that nominal interest rates are declining, banks are beginning to look to new areas to generate income. This has resulted in an increase in loans in 2004, with banks charging rates based on what the market will bear. These rates are high relative to inflation rates and deposit rates, particularly for individuals. However, some small businesses and households are willing to take on loans at these rates. Over time, as competition increases, loan rates will come down. However, for now, they are costly, raising issues of affordability to SMEs that do seek out bank loans.

Another obstacle to finance has been the *variety and suitability of instruments*. As banks are beginning to make more loans, they are increasing the variety and features of their loan products. However, apart from short-term loans (less than one year) with fairly straightforward collateral requirements and repayment/debt service terms, there is little product variety. This will also change over time. However, for now, many enterprises want to access long-term loans for plant and equipment or vehicles (transport), while others seek out more customized trade finance products. In both cases, the absence of foreign exchange earnings makes this more challenging, as many of the key needs for enterprises to become more efficient and competitive are imported plant and equipment. However, this challenge is mitigated by the proportionally high percentage of dollar accounts in the banks, although currency exposure limits keep exposures fairly small. This is another example of how the lack of foreign investment from major international banks has constrained market development. On the other hand, with most banks unable to finance larger enterprises and major foreign banks usually entering the market to capture corporate business, SMEs would still likely be left with a limited array of financing products. For now, the key is increasing access, with the expectation that increasing variety and customization will follow as competition ensues, and as SMEs themselves build up credit histories.

6.5 GENDER ISSUES

There are no systematic data on gender issues as they relate to access to finance. Anecdotal evidence suggests there is little discrimination against women, although men tend to dominate senior management positions in banks and insurance. There is survey evidence that shows women with equal or greater amounts of education are paid less than men.[136] However, there is also clear evidence of women playing key roles on some bank boards and management teams (e.g., head of strategic planning, marketing department), as well as being fairly prominent at CBA. Women are also often found running small businesses, and therefore are among those obtaining loans from banks for consumer finance, commercial trade, and other growing areas of banking activity.

[136] For instance, one survey based on 396 observations showed women with 13.7 years of education earned DRAM 236 per hour, whereas men with 13.1 years of education earned DRAM 368.4 per hour. See Hayk Barseghyan, "Is There Discrimination in the Yerevan Labor Market?", *Armenian Trends Q2 04*, AEPLAC.

ANNEX 7: CONSIDERATIONS FOR HOUSING DEVELOPMENT IN ARMENIA[137]

7.1 BACKGROUND

Only a few transition countries have developed organized and sustainable housing finance markets, although trends are increasingly favorable in several Central European transition countries. However, to the extent that development has occurred, most major commercial development has been limited to a handful of capital cities. This has certainly been the case in Yerevan, where housing and most non-road commercial construction has been in the capital city. Anecdotally, significant renovation and repair is reported to have occurred for residential properties in most locations. However, in terms of formal financing through the banking system, very little of it occurs. To the extent that it does, most of this is in Yerevan.

Unlike trends in the Central and Southeast European region where there are rising lending flows, Armenia has not been able to attract major foreign investment. This is true in banking, where HSBC is the only major foreign investor. Likewise, the economy as a whole has registered little foreign direct investment. These traditionally have served as major sources of demand and financing in housing and commercial property development. Both are lacking in Armenia, accounting for one of the major reasons why there has been little movement in the primary markets, and why there has been less pressure to move ahead in an orderly manner to create the conditions necessary for an effective secondary market. To the extent that there is investment in housing markets from abroad, much of this is reported to be from diaspora communities purchasing properties in cash, rather than obtaining loans from the domestic banking system.

While overall mortgage finance remains small relative to GDP in Armenia, it is growing. Housing construction accounted for nearly 7 percent of 2003 GDP. Banks report lending more for housing loans, and a specialized mortgage finance company has likewise been licensed by CBA. With other financial companies assessing the market, there is expected to be more interest in this sphere over time. However, as of early 2004, banks accounted for less than 10 percent of market financing, and most transactions are done privately on a cash basis.

One of the key hurdles for banks and other market players will be obtaining long-term funding from domestic and international sources to finance these long-term assets. Currently, banks are heavily dependent on deposits for their funding. Most of these tend to be for one year or less, and are small in overall value (albeit increasing). There is also a fairly high concentration of deposits in HSBC, which has generally transferred these funds to New York and London for safekeeping, rather than putting these funds at risk through the credit markets. This has been prudent, but has done little to stimulate mortgage markets. In general, housing transactions have been carried out on a cash basis, rather than through the banks. More positively, households are now beginning to obtain housing loans of reasonable size and adequate maturities if they are credit worthy. This trend should continue, particularly for those with regular salaries.

The absence of foreign investment has translated into a weak rental market. The out-migration of Armenians has likewise eased demand for housing stock, partly containing the effects of what might otherwise become a bubble. This has been partly offset by the presence of donors and NGOs who do rent flats and houses for living and office space. As such, this kind of “business tourism” adds to some of the other commercial opportunities in Yerevan. However, all together, there is only a small rental market. Ordinarily, this is a significant part of the real estate market, and often correlated with developments in

[137] Primary author: Michael Borish.

the commercial property market. Without significant economic growth and foreign investment, the weakness of rentals will likely be correlated with limited development of hotels, office space, retail space, and other commercial property development.

From a policy standpoint, Armenia is open to investment, including from abroad. However, its foreign direct investment figures are poor due to a mix of political instability, institutional weaknesses, and the small size of the market. It benefits significantly from remittances and grant financing from abroad. Some of this has also spilled over into investment in residential premises in Yerevan. However, ownership is sometimes unclear due to the incomplete real estate cadastre. Traditional judicial practices and insufficient creditor rights and foreclosure procedures have likewise reduced investment in the past, although housing privatization in the 1990s has not led to major challenges. Rather, this has been more an issue when properties have been used as collateral for loans, loans have been called, and then borrowers have initiated appeals and hidden behind anti-eviction practices largely rooted in the old Soviet housing code.

Part of the challenge all along has been the legal framework and support systems. Not only have debtors traditionally been protected through the court system, but legal records of property ownership have been less than complete. As such, lenders have encountered problems in the past when properties have been pledged as collateral for loans. This has meant that banks have had difficulties foreclosing on properties to be able to sell into the market to generate proceeds for loan recovery. Anecdotally, this is particularly difficult with regard to housing, which is true in most parts of the world. On the other hand, difficulties faced by banks have led them to stop lending until recently for housing loans. Meanwhile, difficulties related to foreclosure on commercial properties have had more to do with the absence of a resale market.

There is movement to strengthen capacity at the local government level in Armenia. In most cases, this can be a catalyst for housing market development as well as municipal bond market development. However, in the case of Armenia, this is less the case due to the small size of towns outside of Yerevan. NSS data (from 2001) indicate that there are only two towns with populations in excess of 100,000 outside of Yerevan, and only two others with barely in excess of 50,000. Apart from Yerevan, there are no marzes (regions) with more than 284,000. Considering these census data are from 2001,[138] it is entirely conceivable that the numbers are smaller today. As such, the property tax base for most towns is weak, particularly considering that collection, budgeting and related fiscal management tasks are new. Much of the challenge is expected to involve zoning restrictions, permit processes (e.g., for electricity, water), general land use management/planning, transport, environmental conditions, and related infrastructure issues. All of these are in the domain of the public sector, although how these issues are managed represents a challenge for both public and private sector players. In most transition countries, these tasks are not well managed, owing to the decades of central control that left municipal and local governments with limited capacity to manage such affairs in the aftermath. This has led to the dual effect of the real estate market accounting for a very small share of overall economic statistics, while significant informal construction activity proceeds. However, user fees, more effective targeting of ad valorem property taxes, maintenance of sound zoning and permit processes, and the provision of effective transport and social infrastructure (e.g., hospitals, schools, park maintenance) will be necessary for such expansion to be successful. Sound stewardship of resources to accommodate these considerations will be essential for housing and commercial property markets to function well. At the moment, this is not likely to occur for some time.

7.2 Preconditions for Effective Mortgage Finance Markets

In general, the most important elements of mortgage finance development include:

[138] Data from the *marzes* are reported as of September 2004.

- A sound legal framework with clear creditor rights and standardized contracts.
- A stable macroeconomic environment in which inflation rates are low and the market faces limited interest rate, exchange rate, and pricing risk.
- Underwriting standards and credit risk management systems that are sound and well managed based on accurate information flows.
- Standardization of mortgage finance procedures to increase primary market volume and to stimulate movement to secondary market development.
- Well established traditions of borrower interest service and principal repayment on a timely and complete basis, with performance fed into accessible credit information systems.

A checklist of features that commonly contribute to a successful and developed mortgage finance market include the following (with most, but not all, required):

- Political stability and an environment conducive to long-term investment.
- A targeted and focused housing strategy that reinforces sound development of the commercial property market as well.
- Macroeconomic stability on a long-term basis, with an emphasis on the benefits of maintaining low inflation rates and low interest rates.
- Sound legal framework and judicial capacity based on strong creditor/investor rights and clear foreclosure procedures.
- Property rights and systems (e.g., updated cadastres, effective titling, access to information that helps to avoid multiple claims and clarifies hierarchies regarding claims, prompt and fair dispute resolution).
- Sound underwriting and actuarial standards for effective credit and market risk management (including foreign exchange, interest rate, maturity, pricing).
- Competition among mortgage finance institutions (banks, etc.).
- Effective appraisal systems, and accurate valuation and accounting standards.
- Access to real estate information to stimulate market activity (listings, web sites, mortgage calculators, contingencies, legal claims/proceedings, etc.).
- Domestic capital markets and investors, including cross-border access to stimulate investment (into Armenia), long-term funding, diverse funding tools, increased pools of long-term funds for ALM, and institutional investors.
- Competent and professional regulatory and supervisory capacity, with the onus on effective risk management systems in place at lending institutions and close coordination with regulatory authorities to ensure compliance with prudential norms.
- Financial sector infrastructure (e.g., credit information, rating/scoring systems for risk, IT systems).
- Fair and transparent property tax assessments.
- General regulatory framework for land development and real estate, including clear and predictable rules for land development, use and maintenance, consistent and sound building codes and real estate standards, and sustainable tax systems.
- Productivity gains in the construction sector via strengthened codes, certification/apprenticeships for standards, use of new technologies, open trade for building materials, responsible procurement procedures and practices when the public sector is involved, and involvement of insurance companies

for risk mitigation.

- Consumer information for lenders (including payment history).
- Consumer protection (including provisions for loan restructuring and workout prior to foreclosure).
- Enhancements, such as mortgage insurance, for partial or full coverage based on accurate, precise, comprehensive and timely information.

Armenia has made progress in some of these areas. For instance, macroeconomic indicators are increasingly favorable, the legal framework has improved in recent years, most enterprises and all banks have been privatized, land and property is mostly privately owned, banks are now more stable and showing signs of management capacity and financial discipline, banking supervision has been strengthened, and lending for housing finance has finally commenced through the formal financial system. However, in most of the other areas, Armenia is weak and needs improvement for the market to develop. Key areas of focus should be on:

- Effective judicial enforcement of a sound legal framework based on strong creditor/investor rights and clear foreclosure procedures.
- Comprehensive property and pledge systems for contract enforcement and property rights (e.g., updated cadastres, effective titling, access to information that helps to avoid multiple claims and clarifies hierarchies regarding claims, prompt and fair dispute resolution).
- Sound underwriting and actuarial standards for effective credit and market risk management.
- Competition among mortgage finance institutions (banks, etc.).
- Effective appraisal systems, and accurate valuation and accounting standards.
- Access to real estate information to stimulate market activity (listings, web sites, mortgage calculators, contingencies, legal claims/proceedings, etc.).
- Capital markets products to attract investors (e.g., insurance companies, pension funds), including from abroad, to stimulate investment (into Armenia), long-term funding, diverse funding tools, and increased pools of long-term funds for asset-liability management purposes.
- Financial sector infrastructure, including better credit information, rating/scoring systems for risk, and more advanced IT systems.
- Fair and transparent property tax assessments, and enhanced capacity to collect and manage tax proceeds for development purposes.
- General regulatory framework and administrative management capacity for land development and real estate, including clear and predictable rules for land development, use and maintenance, consistent and sound building codes and real estate standards, and sustainable tax systems.
- Consumer information for lenders (including payment history).
- Consumer protection (including provisions for loan restructuring and workout prior to foreclosure).

ANNEX 8: INSURANCE IN ARMENIA[139]

I. INTRODUCTION

Insurance products are tools that help households and businesses manage risk. To the majority of Armenians being able to identify and manage one's own risk, let alone using insurance to do it, is unknown. Identifying risk factors is a new concept for many living in the former Soviet command economy countries. Questioning how to compensate for the income loss of a family's breadwinner or how to balance the risk of the loss of an auto or home against the monthly premium cost of insuring against such a loss is the first step to finding solutions through a country's developing insurance sector. Armenians are behind on this trend and have few opportunities presently to learn and limited income to direct to insurance products.

The Armenian insurance market is undeveloped – few products are offered, there is limited industry technical knowledge, the industry's marketing and sales abilities are unformed and unevenly applied. The insurance industry is comprised of 19 active insurance companies offering limited range of products to a restricted geographic base. The market is served almost exclusively from Yerevan, leaving much of the country few product options and fewer competitors.

Insurance sold in Armenia is targeted primarily to related business interests of the insurance companies, foreign firms and associations with foreign governments and their project staffs. Over 90 percent of paid insurance premiums in Armenia are reinsured in the UK, Russia and Europe, which results in greater diversification of underwriting for those who purchase insurance but little of the insurance premiums remain in Armenia to grow the industry.

The Armenian public has a long history of distrust of the banking and overall financial sector, of which the insurance industry is guilty by association. There have been accusations of failure of Armenian insurance companies to pay claims and references continually point to lack of confidence by the general public. There have been cases reported of fraud against insurance companies in which policy holders were ultimately paid for claims not believed by the underwriters to be genuine. Insurers assert a failure by the regulators to protect them against such fraud. The insurance industry reports that the staff of the regulatory authority is so underpaid that they resort to requests for payment from the industry. For all of these reasons there is a need to rebuild the credibility of the regulator with the industry and the industry has to improve the quality of its product, pricing and ability to grow the market. There is also a need to educate the public in managing risks and of the benefits of insurance.

The insurance supervisory authority, the Ministry of Finance and Economy, Insurance Department, is understaffed. The regulatory staff lacks sufficient training in insurance, financial analysis and product innovations. It is inadequately equipped to oversee and regulate the insurance industry. The compensation of the staff and management of the Insurance Department 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 for Insurance Department it cannot fairly be expected to assist the Armenian public by providing supervisory oversight of the insurance sector.

The remainder of this report details more information on the Armenian insurance sector and recommendations for USAID to provide technical assistance to strengthen the regulator and strengthen the market.

[139] Primary author: Martha Kelly.

II. OVERVIEW OF THE INSURANCE MARKET

The insurance sector in Armenia is small, with only 19 active companies selling insurance at year end 2003, and down to 17 in late 2004. There are also currently two firms licensed and operating as insurance brokers. Armenia is one of the few countries in the region that does not have a compulsory insurance law, which is regarded as one of the obstacles to overcome. Available types of insurance include accident, aviation risk, financial risk, medical travel, property, and cargo.

Since the insurance law of August 1, 2004 became effective, four new insurance companies have made application and been awarded a license to operate in the insurance sector in Armenia. The total number of insurance companies in early November 2004 is 24. Prior to passage of the current Insurance Law, the Insurance Department received on average one application annually for an insurer's license. With the passage of the new law and discussions of compulsory insurance and reforms to the state pension system, this number has increased. The following table profiles the insurance market in Armenia.

TABLE 8.1: OVERVIEW OF ARMENIAN INSURANCE MARKET

	Year-End 1997	Year-End 1998	Year-End 1999	Year-End 2000	Year-End 2001	Year-End 2002	Year-End 2003
Licensed insurance companies	20	21	21	25	25	23	22
Active insurance companies	11	15	21	22	22	19	19
Active insurance policies	39,037	47,761	49,339	97,686	37,687	27,105	16,760
Total paid-up capital	Not applicable	$1,853,482	$2,482,905	$2,719,351	$3,103,842	$2,988,789	$3,214,285
Written premium	$121,547,472	$571,286,969	$1,605,889,532	$537,446,879	$1,126,028,181	$2,035,524,208	$1,180,357,142
Sum reinsured	$110,322,541	$535,435,819	$1,555,138,942	$501,546,778	$1,086,027,740	$2,000,856,948	$1,144,946,428
Reinsurers' premium	Not provided	$420,951	$1,365,195	$1,464,726	$2,588,883	$3,315,876	Not provided
Paid claims	$255,050	$208,653	$97,344	$636,505	$234,464	$305,719	$811,964
Profit							$279,107
Profit (DRAM)							156,300,000
Source: Ministry of Finance and Economy, Insurance Department, 2004.							

Risks situated in Armenia can only be insured by an Armenian insurance company but can be reinsured up to 100 percent internationally. There are no restrictions on reinsurance. While the majority of insurance is reinsured outside of Armenia, there is no reinsurance market inside of Armenia. Most of the insurance companies and both brokers have relationships with the large reinsurance companies. The UK, Russian and European reinsurance companies regularly travel to Armenia to meet, train and help attract business to the local insurance companies.

The distribution of insurance products is through insurance company staff and a network of agents and brokers. Selling is in-person and done face to face, and generally through personal or business relationships. There is no use of direct mail, internet distribution or mass marketing to sell insurance in Armenia today. The system of captive insurance agents exclusively representing one firm and its product line does not exist in Armenia as it does in some markets. One of the challenges of the industry and the supervisory authority is the oversight, testing, licensing and monitoring of employees of the insurance industry. In many countries there is a database of all employed by an insurance sector, allowing both firms and the supervisor to ensure an employee operating outside of the rules of the industry is not let go by one firm only to be hired a short time later by a different firm.

The majority of insurance sold in Armenia consists of: auto, property (primarily commercial), construction risks, aviation (at least until the domestic air carrier filed for bankruptcy and Siberian Air, the replacement carrier, purchased its insurance through its parent company), marine cargo and travel medical. There is virtually no life insurance sold in Armenia. There is little industry compilation of and access to statistical data on mortality tables, necessary for pricing of life insurance.

There are many types of insurance not currently available in Armenia: professional indemnity, product liability, pollution or environmental liability, directors and officers insurance (D&O). Kidnap and ransom, extended warranties, contingency business and legal expenses coverage are not written in Armenia today.

While insurance companies are interested in underwriting life insurance and annuities, very little efforts are underway on these products. In part, there is a lack of long term investments that are suitable to be in an insurance company's portfolio.

Insurance business in Armenia can be profitable as little risk is actually retained domestically and there is no limit on commissions earned for reinsurance. Overhead is extremely low by international standards. Collective profit for the industry for 2003 was almost $280,000. The deputy minister of Ministry of Finance and Economy proudly points out that no insurance company has failed in Armenia. Technically he is correct, insurance companies have closed and more are expected with the increase in capital reserve requirements effective 2005. Closed insurance companies have been orderly and overseen by the Insurance Department.

III. Insurance Regulator

One of the key success factors identified for Armenia is an effective and trusted insurance regulator in which the oversight to the industry is applied in a uniform and consistent manner. A strong regulatory environment attracts financial institutions able to compete on a level playing field – a market in which they believe their superior capabilities, innovative products, competitive pricing and better customer service will allow them to distinguish themselves. A strong and effective regulator does not drive out market competition – it raises the bar and improves the profile of firms in the market.

The Ministry of Finance and Economy, **Insurance Department**, is the supervisory and regulatory authority of the insurance industry and many parts of the non-bank financial institutions. The Insurance Department is currently comprised of three areas:

- **Methodology** and **regulation**, which includes drafting of laws and regulations;
- **Licensing** and **supervision**, which oversees the application and product registration functions; and supervision of the insurance companies;
- **Reporting**, which is responsible for collecting insurance company quarterly and annual financial reporting from the industry.

The Insurance Department has communicated a commitment to improving the insurance industry. Accomplishments to date include:

- Passage of new insurance law, effective August 1, 2004, which has strengthened many aspects of the insurance companies through increased reporting disclosures and includes increasing the minimum capital reserves in 2005.
- Work with the World Bank FIRST program and its insurance consulting team to prepare and introduce revised regulations for all aspects of the insurance industry.
- Utilization of a peer review consultant, an advisor directly to the deputy minister who assists in coordinating all consulting and technical assistance activities of USAID, World Bank and other multi lateral donor agencies.

IV. Financial Independence

Currently, the Insurance Department is dependent on the Ministry of Finance for its operating budget. A generally accepted international standard is for financial sector oversight authorities to generate a portion or all of their operating budgets from fees generated from the industry they supervise. The accepted approach is that the supervisory authority and industry have a connected goal in seeing the industry expand and each will work to the common end in such a scenario. Under the current situation the Insurance Department and insurance industry do not share a common goal nor is the budget dependent on the success of the industry.

V. International Accounting and Auditing Standards

Notwithstanding progress initiated by the Ministry of Finance and Economy in the last two years, the insurance market in Armenia is underdeveloped and savings and investments into voluntary pension schemes are non-existent. Following an international accounting and audit standard of financial reporting and disclosures is a requirement for all countries as they reform their financial sector. This is especially true in Armenia with the public's distrust in financial institutions and the state pension system and lack of confidence in the regulators' ability to protect the public and oversee the financial industry.

Distrust runs between the Insurance Department to the industry members it supervises and of the insurance companies toward the regulator. Deficiencies identified by each group about the other may be valid and impose a drag on the industry's ability to grow unencumbered. A good beginning point is with the accounting and financial disclosure requirements.

The Insurance Department has formalized and standardized insurance company financial reporting, which appears to be taking place, but there does not appear to be any real analysis by the Insurance Department of the information being presented. For example, financial reporting submitted today is input into a computer and verification is made that each institution files in a timely manner. But the actual data presented is an opportunity for the regulator to create a risk profile of the industry, and on a company-by-company basis; this is not taking place. We recommend that the Insurance Department be provided technical assistance to carry out needed accounting, auditing and financial analysis functions.

VI. Market and Product Expansion

The Armenian insurance industry is served exclusively by the private sector. There are no state-owned insurance companies, underwriters or brokers in Armenia.

Private sector development is heavily influenced by legislative changes and viewed by the industry as creating opportunities, such as proposed third party liability compulsory insurance requirements, and through the removal of obstacles, such as limiting the types of products that insurance companies can register and sell, if they exceed certain percentage levels of foreign ownership.

Compulsory insurance, common in most countries today, takes several forms ranging from third party auto liability coverage to health care to insuring cargo and property against accidents and natural disasters. The Insurance Department of the Ministry of Finance and Economy, has been in active discussions with the insurance industry and the public since 1998 on the creation of the first compulsory program that auto owners purchase third party liability insurance. Introduction of compulsory insurance is regarded as a next step for Armenia and continued lack of progress on this advancement is regarding as a key obstacle to overcome. In a regional review, Armenia is the only remaining former Soviet republic to delay compulsory insurance.

The insurance industry, through the Insurer's Association of Armenia, has voiced its support of compulsory insurance. It has also identified possible obstacles to effective implementation once the law is developed and passed. The scenario outlined by the Association, which appears valid, questions the adequacy of current rules and procedures surrounding auto accidents, with or without human injury or death, and the rules for insurance company payment of claims in the case of auto accidents. We were told that currently a police report is required, in which only a small number of select trained accident report writers are authorized to carry out and must be made at the site of an auto accident involving human injury or death. Without such a report, the current law restricts insurance companies from paying a claim. We were told anecdotally that there are fewer than 10 such designated police officers, a number considered inadequate for Yerevan. We were unable to have this figure officially validated during our stay in-country.

So the very purpose of the compulsory insurance – to provide a means to manage risk involving third party liability claims – potentially would be restricted by a bottleneck resulting at an accident's report writing and claims-making stages. The compulsory insurance law has not yet been prepared or introduced before Parliament and presumably technical assistance can identify the extent of obstacles, possible options to overcome them and outline an implementation plan to bring about needed improvements. For example, some countries permit a claim to be paid, regardless of whether human injury was involved, if the amount is below a specific threshold, up to $500. Alternatively, more police officers could be trained and designated for the report writing functions.

The passage of the current Insurance Law, effective August 1 2004, has had a positive impact on the insurance industry in Armenia. Since the decree date, four additional insurance companies have made application and been granted insurance licenses. Public discussions on compulsory insurance laws have also had a positive impact on the insurance market. Some industry members estimate that a compulsory third party insurance law alone could generate up to another $50 million in annual premiums.

As the statistical overview of the Armenian insurance markets indicates, the insurance industry is small and insurance companies are not well capitalized. The 19 active insurance companies operating in Armenia at year-end 2003 together hold less than $3 million in capital reserves. (Figures for the 17 active companies in late 2004 were not made available, although it may have increased given the increase minimum requirements effective in 2005.) Currently most insurance bought in Armenia is reinsured in the UK, Russia or Europe and is being underwritten by foreign insurance companies. There is no restriction on the amount of policies reinsured abroad. In fact, the use of reinsurance while the Armenian companies are ill-equipped and holding minimal capital reserves may act as a measure of safety diversifying risk to better capitalized insurance companies.

The main lines of insurance include: cargo (incoming and outgoing), automobile, aviation, property and medical travel. Most insurers generate revenues by selling policies to related businesses and foreign companies and governmental agencies in Armenia.

As a result of the new Insurance Law, which became effective August 1, 2004, the capital reserve requirement will increase in 2005. After January 1, 2005 each insurance company must maintain a minimum capital reserve requirement of $1 million. This action is expected to strengthen the industry, although the initial result will probably be a decrease in the number of insurance companies. The

expectation is that some licensed insurers will not continue operating in Armenia under the revised capital reserve minimums. We believe that the Insurance Department is aware of this and appears prepared to discontinue operations of insurers that fail to meet to the new requirements.

The Armenian insurance industry has been slower to grow than other former Soviet countries. This seems to be in part a result of the lack of compulsory insurance (third party auto liability, workman's compensation, health care and natural disasters, e.g. earthquake) and in part because of limited product introductions made by the industry. While many consider this chicken and egg question of which comes first to a nascent market such as Armenia, there is a growing consensus for the introduction of compulsory policies and it seems likely that the third party auto will lead the way. We believe that this market will continue to struggle with limitations imposed by its small size until an introduction of the compulsory insurance and/or the passage of a new law creating accumulation pension funds for voluntary and compulsory pension contributions.

In 2003, there was barely $2 premium purchased per capita in Armenia. Until the average household begins to purchase insurance, make claims and be paid, the market is not likely to grow much beyond where it is today. Thus, there is urgency to the need for the government to introduce compulsory insurance and reforms to the state insurance fund to promote growth.

Although Armenia has a small insurance market, the 17 active companies licensed as of late 2004 represent a diverse enough industry that competition, product innovation and pricing differences can exist. Product development is strongly influenced by legislation at this point, although once a new law on compulsory insurance passes, it will be incumbent on insurers to be creative in pricing and distribution, and to further distinguish themselves in the marketplace.

Another obstacle to growing the insurance business in Armenia is access by the insurance industry to data on financial losses and insurer's experience in underwriting risks of any kind. Because so little risk is actually underwritten in Armenia the data in many cases simply doesn't exist. The lack of accurate, relevant and timely data has a negative effect on any insurance market. New product development and accurate product risk management pricing is stifled. As the insurance market grows, especially under a compulsory product scenario this lack of data will continue to be felt. Statistics are also drawn from the National Statistics Office, which independently compiles other data sets which make up the collection of information managed by the insurance industry and while it is more readily available the insurance industry is still lacking in familiarity with maintaining and tracking pricing and loss data.

The international standard for insurance and pension accounting is the accrual based method. Currently in Armenia, there seems to be an understanding of cash based accounting, but not of accrual methods. This is a key deficiency at the regulator's office but can be addressed relatively easily through training programs. Already underway in Armenia higher education is advanced accounting, including accrual methods. Extension of this training to the Insurance Department staff is the next step.

VII. Recommendations

A. Support to the Insurance Department of the Ministry of Finance and Economy

Continued support can be made by directing technical assistance to the Insurance Department.

Short-term recommendations include:

- 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; assist in development

and implementation of public communication plan on compulsory insurance.

- Develop economic model for tracking insurance sector that creates 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 on 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 recommendations include:

- 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 financial sector regulators.
- Create a position of regulatory insurance actuary, develop roles and functions of actuary and develop plan to transfer knowledge and position after set time period to complete control of Ministry of Finance and Economy.
- Prepare 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, ultimately prosecution of insurance law violations.

Other accounting and auditing training needs:

- Analysis of financial reporting 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.
- 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.
- 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.
- Investment policies, investment instruments, investment diversification balance, risk and reward trade-offs and general asset management functions.

Long-term recommendations include:

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

B. Strengthening the Insurance Industry

The Insurer's Association of Armenia is the insurance industry group, which has an open and continuing dialogue between the Association and Insurance Department. Because of the lack of understanding by the general public of insurance products, it is recommended that technical assistance be directed to the Association. The Insurance Department 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 the public – targeting businesses and households – and educating them on insurance protection, insurance products, assessing and managing risks. This is a function not sought by the Insurance Department.
- Track, analyze and report industry statistics; create links to industry member websites.

Medium-term recommendations:

- Develop customized insurance industry association training program (assessment, develop custom materials, conduct training classes, transfer continuity of training program to association):
    - 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, customer service training.
    - Developing underwriting and premium rating skills.
    - Marketing, new product introduction, risk assessment and management.
    - Management and team building, management systems, hiring and staffing, training and testing
- Act as self-regulatory organization (SRO) for industry members and act as central source for national market database for demographic data (for costing life insurance).

ANNEX 9: PENSION REFORM IN ARMENIA[140]

I. INTRODUCTION

Armenia's pension system is important to creating financial sector stability and growth as identified by a broad base of government officials representing multiple ministries, financial sector executives and the general public.

The current pension program is inadequate. It consists solely of a compulsory Pay-As-You-Go system. Today's pensioners are paid benefits that do not meet the poverty level and are barely considered subsistence. Contributors (employers and employees) to the system routinely evade their obligations to fund the system by operating outside the formal sector, by simply not contributing or, if they do contribute, they contribute on a less than required basis by under-reporting true wages.

The Pay-As-You-Go system, referred to as both the State Pension Fund and the State Social Insurance Fund, is not open with its finances, shrouding itself in a lack of disclosure of exactly how much money it has. We were told that the State Social Insurance Fund has not been independently audited and its finances are not made public. The Fund does not appear to follow generally accepted international accounting principals, disclosures or financial reporting rules.

Most importantly the current pension system, a heritage from the former Soviet era, is plagued by a non-sustainable formula. Contributions and benefits are not linked, and a large number of exceptions provide service credits for certain employee groups, referred to as "privileged" pensions enabling them to retire earlier, which results in collecting more benefits over time. The World Bank is currently working with a number of the ministries involved in the calculations of the annual transfer from the State budget to cover current pension liabilities. The government is using the World Bank's Proust model, which provides for accurate actuarial valuations and future projections of benefit costs. The Proust model permits illustration of multiple reform options and a series of "what if" scenarios modeled for purposes of identifying the future costs of alternatives to the current state pension.

The World Bank, working directly with the State Social Insurance Fund and a USAID project, recommended parametric changes designed to improve the sustainability of the current system. Specifically the retirement age for women is being increased to create parity with men's retirement age. By 2011, the men and women's retirement age will be the same, age 63, based on staggered increases for the women's retirement age.

Despite shortcomings, improvements to the current pension system have been underway for more than five years. A World Bank strategy paper was developed in 1999 that identified improving contribution collections and strengthening the benefit payment system. USAID has also provided direct technical assistance through a USAID funded project managed by PADCO on the social insurance sector. This multi-year project has successfully delivered improvements in the number of employees for whom contributions are being made, and in some cases increases in the amount of reported income. It created a system of social security numbers, introduced and implemented nationally. Today, 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. The ability to track and report this information, referred to as a system of personified accounts, is being completed through the State Social Insurance Fund, although there is still assistance needed regarding additional computer support. The project has also started to support the social security offices need for automating functions associated with the social security cards and history gathering process by delivering computer technology.

[140] Primary author: Martha Kelly.

II. REFORMING THE PENSION SYSTEM

The real opportunity to assist in improving the pension system in Armenia is in the design of the overall reforms. The most reform options commonly discussed in Armenia were based on a system of accumulation accounts. A draft pension law has been prepared, also based on a system of accumulation accounts. The following explanation relies on the draft law and references areas where improvements should be considered.

What are accumulation accounts?

Basically, accumulation pension accounts work similar to a bank account. A portion or all of an employee's contribution into the compulsory system are directed and accumulate in an account registered in the worker's name. The assets of all of the accumulation accounts with any one pension fund or pension company are invested according to a pre-determined (in the law, the regulations or as set by the pension supervisory authority) investment policy and are commonly invested in market securities. Some countries, like Armenia, do not have a fully developed securities market offering a range of investment products at the time of their pension reforms. Despite this drawback pension reforms have been successfully implemented and investments were directed into more limited options until the market created an adequate supply of investments.

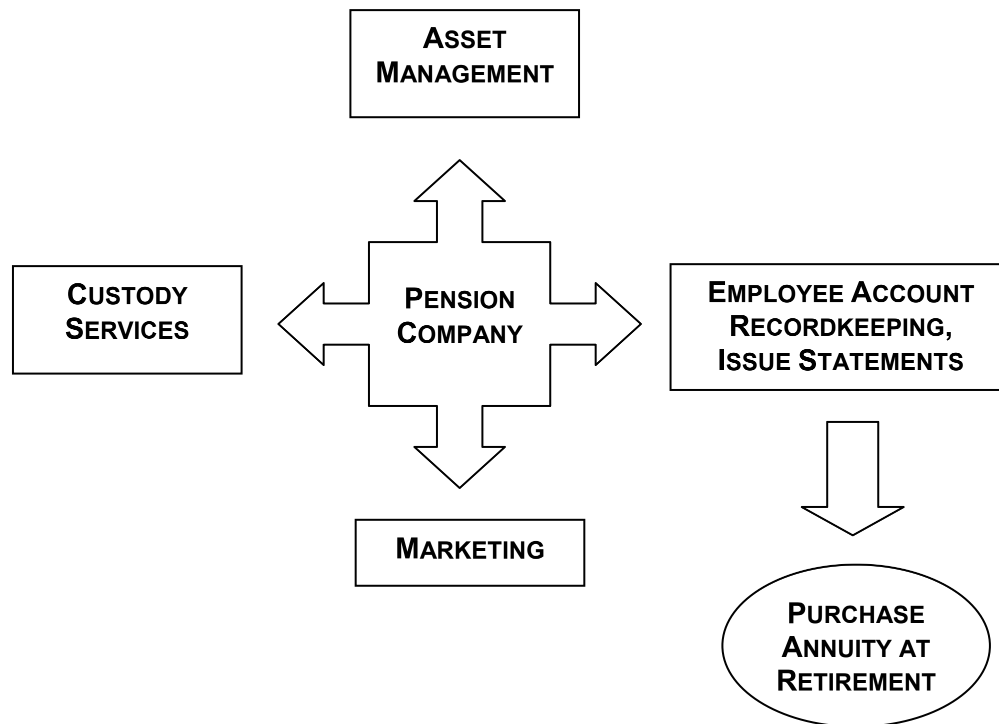
Who decides which accumulation to invest a worker's contributions?

Generally, the employee exercises control by designating one pension company over another. The draft pension law in Armenia has been structured to permit such employee choices. Typically, larger population countries license multiple pension companies with the intent of creating a competitive environment designed to maintain low cost, high levels of customer service and competitive investment returns. A smaller population country, however, is more restricted in that its market cannot support a large number of competitors, given the expenses associated with starting and managing a pension company. In such cases a public tender process of issuing pension fund licenses may be more appropriate.

What is the structure of a pension company?

A pension company, as described in the Armenia draft pension law, is a not-for-profit entity that contracts services required from experienced firms. The following illustrates a basic pension company structure:

FIGURE 9.1: BASIC PENSION COMPANY STRUCTURE



The Pension Company contracts with an asset manager to collectively manage the investments of the employees' accumulation accounts. The underlying securities of the investment pool are held in custody, another service contracted for by the Pension Company. The securities are held in the name of the Pension Company but not held by the Pension Company. Holding securities is one role of the Custodian Bank. Separating these functions is designed to add an additional layer of security. Other Custodian services include generally calculating the investment returns, net asset value and other portfolio accounting. The Pension Fund contracts with a Recordkeeping Company to establish one account for each employee. Data managed include indicative information on each employee: name, address, date of birth, social security number, and beneficiary designation. Also, it tracks the percentage of the investment pool owned by each employee account.

Typically an insurance annuity is purchased with the accumulation account balance at the employee's attainment of retirement age, or disability, or for a beneficiary in the event of the employee's death. Although the draft pension law did not specify, it is common to permit each employee at retirement to receive quotes from more than one insurance company for an annuity and to permit the employees to select their annuity choice.

The above illustration and accompanying explanation reflect how pension reform affects the overall financial sector providing opportunities for more one type of financial institution to benefit from the management of the pension system switching from government control to being privately managed. Further details on the three pillar pension system, and defined benefit and defined contribution programs are included in the Annex on pension reform.

What is best for the reforms in Armenia – defined benefit or defined contribution?

The costs associated with the reforms will drive part of this response. Once the World Bank and the teams working with the Proust model develop a model and its transition cost, that will greatly affect how the pension reform will be structured. Most likely employees will be able to benefit from a defined benefit

through the continuation of the Pillar One pensions. Thus, the reforms will involve the establishment of a new kind of pension – defined contribution in the form of an accumulation account. It is unlikely that the reforms will be designed around two defined benefit schemes – one from the old Pillar One and another with a redirection of contributions under Pillar Two.

How do pension companies operate?

It is generally accepted that the structure and design of the pension companies operate similar to a mutual fund or pooled investment trust, more so than like an insurance company. But at retirement, it is recommended that the accumulated account balance be used to purchase an insurance annuity for the employee, or if married for the joint lives of the employee and spouse and beneficiary. The purchase of a pension annuity can be compulsory or optional or may be compulsory for an interim period of starting the new reforms, for example for 10 years.

If the accumulation accounts under the reforms are not structured like an insurance company, how are guarantees made?

Typically, a defined contribution scheme with a system of accumulation accounts does not make guarantees, nor does it ask the pension company to underwrite risk. Once an employee reaches retirement age and an annuity is purchased, then the insurance company makes a guarantee of a specified monthly pension amount. But during the accumulation period the pension company acts more like a mutual fund or pooled investment scheme, which is being managed by a licensed asset manager.

III. The Current System

The State, through two groups: the Ministry of Labor and Social Insurance; and the State Social Insurance Fund, both manages and regulates the only social insurance pension program. Given the depressed level of wages in Armenia, it is difficult to envision that a robust voluntary pension system could develop without first a reform of the compulsory pension system. One proposal under consideration, which is receiving technical support from the World Bank, is re-directing a portion of the existing contributions funding the current Pay-As-You-Go system, also referred to as a Pillar One pension. If the government of Armenia and the World Bank proceed with this plan, one option is the creation of special purpose funds, referred to as pension funds or pension companies, to manage the portion of compulsory contributions that will be used to fund accumulation accounts in each employee's name. 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 financial sector and ultimately directed into Armenia's capital markets.

There are obstacles related directly to the financial sector in creating a system of accumulation accounts:

- **Market size.** Armenia has a small population, which limits its ability to reach critical mass quickly, which helps keep costs manageable.
- **Lack of investment options.** The capital market lacks long-term investment options, such as stocks, bonds and long-term government bonds, into which the pension company can invest contributions.
- **Lack of pension company experience** in Armenia: receiving contributions and allocating them among individual employee accounts, processing earnings, calculating and paying benefits, issuing statements, producing public information and general reporting.

- **Lack of insurance annuity product experience** in the market: create insurance annuity products, calculate life expectancy data, pricing and product risk management, marketing.
- **Lack of regulatory authority experience** to supervise and regulate pension companies: design tight regulations describing functions of accumulation fund management to be carried out and the ability to evaluate whether a company meets the requirements.

While the above referenced obstacles are important, they can be managed. The market can permit teaming of experienced pension companies in other countries to partner with local 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. There is also the outsourcing option that would permit an interim management contract to foreign professionals with a recognized reputation for managerial and administrative excellence in the field, while regulatory and supervisory capacity is developed in the public sector and institutional capacity is developed by prospective pension fund managers for the future. Today in Armenia many of the functions needed for a licensed pension company are already being carried out: asset management firms are in the process of designing and creating investment products similar to pension funds. Banks are currently paying pension benefits from the Pillar One system and so on. Also, ultimately whichever supervisory authority oversees the new pension companies will not have previously carried out this work, but hopefully it will have previously supervised other financial institutions.

Another obstacle to growth of the pension sector is if the government does not permit the redirection of a portion of the compulsory contributions from the State Social Insurance Fund to a system of accumulation accounts for each worker. Another risk is over the structure of pension companies. Assuming employees will be permitted to redirect a portion of their contributions into pension companies the risk is if these special purpose funds are not well designed, poorly regulated and supervised resulting in the loss of pension funds and ultimately public support for the financial sector.

A key success factor in creating a system of Accumulation Accounts is the opportunity for the employee to earn a higher rate of return over the life of their account – the longer the employee has for contributions and earnings to accrue, the larger the account balance. Thus, the availability of investment options for the asset managers to investment contributions is critical. However, this also requires responsible oversight and supervision by a respected regulatory authority over the pension companies ensuring that employees' account balances are safe until paid out in benefits. There is also presently no association for the pension industry in Armenia. Establishment of such capacity would help with industry development.

Below are some indicators and scenarios of how a three-pillar system could potentially evolve:

TABLE 9.1: CONTRIBUTIONS TO ACCUMULATION ACCOUNTS IN A THREE PILLAR SYSTEM

	Pillar I		Pillar II		Pillar III	
Contributions	**Today**	**Future**	**Today**	**Future**	**Today**	**Future**
Employer	23%	13%	0%	10%	0%	5%
Employee	3%	0%	0%	3%	0%	3%
Note: This table reflects no increase in compulsory contributions to the current system. It does reflect a redirection of contributions from Pillar I into Pillar II and additional voluntary contributions into Pillar III.						

TABLE 9.2: BASIC VARIABLES FOR THE ASSESSMENT OF TOTAL CONTRIBUTIONS

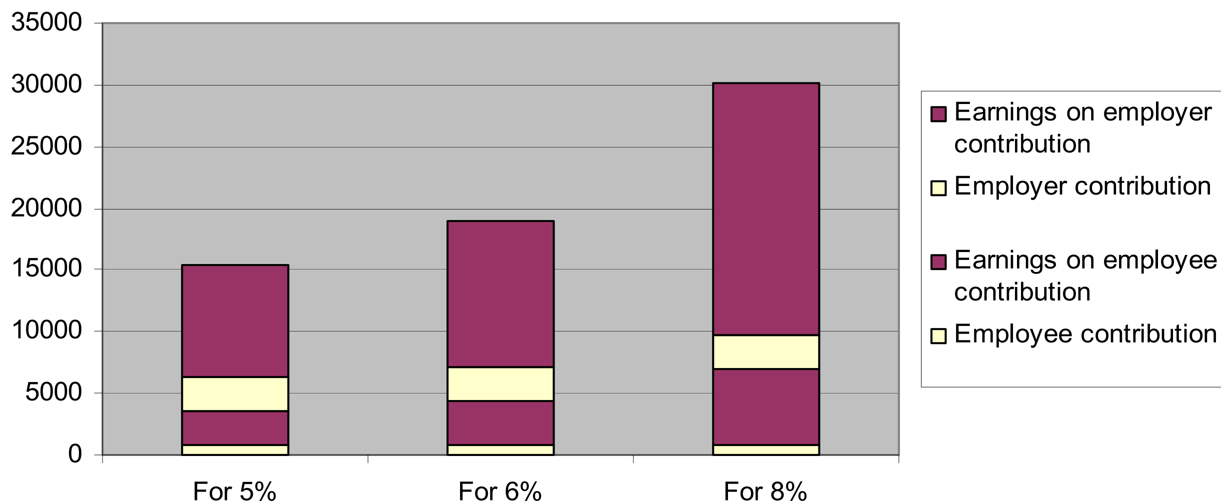
Starting age	22		Annually ($ US)
Retirement age	63	Employer contribution under Pillar II (10% of total salary)	$67

Difference 41	Employee contribution under Pillar II (3% of total salary) $20
As a base for calculation, the average salary for the year 2003 was $56 monthly, using an exchange rate of DRAM 579 per $1 for the same period. Source: NSS. Future growth of salary was not included.	

TABLE 9.3: RESULTS FROM 41-YEAR ACCUMULATION

	5% earnings rate	6% earnings rate	8% earnings rate
Employer contribution	2,764	2,764	2,764
Earnings on employer contribution	9,051	11,796	20,447
Employee contribution	829	829	829
Earnings on employee contribution	2,715	3,539	6,134
Total Account Value at Retirement	$15,360	$18,929	$30,175

FIGURE 9.2: ILLUSTRATION OF GROWTH OF CONTRIBUTIONS AND EARNINGS IN AN ACCUMULATION ACCOUNT



An alternative approach that may be proposed by others in Armenia active in policy and pension reform includes a possible interim transition strategy prior to setting up an effective supervisory body for the pension sector. This would involve transforming the existing system from a poorly administered defined benefits system (with low levels of payments and contributions) into a defined contribution accumulation accounts' system. This would initially be under State administration (although not the State Social Insurance Fund) modeled on the Swedish approach for an interim (preparatory) period before full privatization of the second pillar. Estimates are that this would require three to five years, during which needed regulatory and supervisory capacity could be built prior to full privatization. Such an approach is also considered potentially useful in providing the Government and other institutions with a better understanding of actual transition costs during the first decade or more of the shift to the second pillar. At

such a point, there would no longer be any State involvement in this pillar, apart from regulatory oversight.

This possible interim strategy includes rates shown below. These would effectively reduce employer contributions, raise employee contributions, provide third pillar options and incentives, and offer income tax relief to ensure that contributions are promoted and made. At the current time, neither employers nor employees make necessary contributions.

TABLE 9.4: PAYROLL CONTRIBUTION REQUIREMENTS UNDER AN ALTERNATIVE MODEL

	Pillar I		Pillar II		Pillar III	
Contributions	Today	Future	Today	Future	Today	Future
Employer	23%	0%	0%	10%	0%	5%
Employee	3%	0%	0%	16%	0%	3%
Note: Pillar I assumed to be financed from general income tax. In the distant future, Employers' 10% in Pillar II should be moved to the Employees' line in Pillar II, or eliminated, which might go to Pillar III.						

According to those working on different scenarios and approaches, this option would help solve several problems associated with tax and social insurance collections. First, tax administration deficiencies would not discourage employers from cooperating. Based on this scenario, employers would contribute 15 percent instead of 23 percent, and better administration and management would reduce the risk of leakage. Second, pension administrators and employees themselves would become better control mechanisms concerning both contributions and disbursements. In this regard, employed people would feel a bit more in control of the management of their future savings, and thus would be less supportive of efforts of employers to understate their salary bill. At the same time, employers themselves would have less incentive to understate the salary bill as the payroll contributions paid by employers would be less. This would open up a new avenue to enforce personal income tax collections, which would potentially be able to cover the minimum security benefit of Pillar I, which is assumed to be no more than 5 percent of GDP in the long term, similar to the current levels.

Whether this will occur remains to be seen. There are outstanding issues, such as the use by Government of second pillar funds (by virtue of its direct access to such interim savings accumulation), actual levels of contributions by employees since their payroll contribution rates would increase, actual restoration of confidence in administration and management, etc. However, in light of the absence of regulatory and supervisory capacity, such an interim approach may be justified on the condition it is subject to strict audit conditions, possible outsourcing to professional managers from abroad, and a sunset provision.

General Recommendations:

Short-term recommendations include:

- To minimize such risks, clarifications should be added to the draft pension law on two main points:
  - a) Requirement that the pension companies be supervised and regulated by a separate pension supervisor or an existing financial sector regulator, not the current Ministry of Labor and Social Insurance or the current State Social Insurance Fund, neither which has experience regulating financial sector companies;
  - b) Requirement that the Government of Armenia act solely as a pension company regulator and supervisor and specifically that the State not compete in this market. Ideally, we do not support the creation of a state-owned pension company to compete with private sector pension companies to manage a portion of re-directed compulsory contributions from Pillar One to Pillar Two

pensions. If the State is to remain involved, one approach would be to outsource the management contract to an internationally recognized management firm, and with explicit audit requirements to effectively insulate collected funds from any State use or control.

- In conjunction with the work of the World Bank assisting in the reforms of the Pillar One pensions, a portion of the compulsory pension contributions should be re-directed into Pillar Two pension companies. We also recommend that employees be permitted, if they are able and inclined, to make additional voluntary contributions into these pension companies.
- 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.

IV. Competition in the Pension Market

The most common financial stability indicator in pension and insurance is the arrival of experienced pension providers and insurance companies to a nascent market. A general rule of thumb is that when the large regional and multinational firms examine a market's potential and decide to enter a new market, it is a sign that the market has achieved a level of predictability. Although the large multinationals have not made foreign direct investment in one of the existing insurance companies or made application to become licensed as a new insurer, there are signs that this is possible in the relatively immediate future. The introduction of compulsory insurance and redirection of the compulsory pension contributions into Pillar Two type accumulations are both expected to trigger multinationals to review more closely the Armenian insurance and pension markets.

The pension market requires reaching critical mass in order for pension companies to overcome the initial start-up costs of servicing the market. With Armenia's small population and limited growth of new entrants into the contribution paying market, it is expected that Armenia can realistically only support a small number of providers. In markets such as this, an open tender process to award pension company licenses may make more sense than assigning licenses to all firms making application. A tender process to award licenses for pension companies would ideally consist of two tiered competition. In the first round firms interested in being awarded a license would indicate how they meet very specific functional requirements: ability to hire a licensed asset manager, ability to evaluate and select a pension record-keeper for purposes of establishing individual employee accounts, issuing statements and providing customer service and to contract with a bank custodian. Firms meeting this initial requirement would be permitted to bid on the licenses, using the lowest fee offering basis for selecting the winning bid. The two firms offering to perform the services in conformance with technical requirements at the most competitive price would be awarded the licenses. For pricing uniformity purposes the second lowest bidder would be asked to conform to the pricing of the lowest bidder. If this were not agreeable, then the third lowest bidder would be offered the option to lower its price and so on until a bidder agrees to create a situation of price parity. By using this method, rather than having the government attempt to set price limits can generally result in far more favorable pricing without government intervention.

By using the tender process, the supervisory authority can license the most qualified firms offering to provide services at the most competitive prices in exchange for a period of limited access to the market by new providers. One option is to offer the bidders a five year non-compete environment in exchange for pricing concessions.

Given the limited growth opportunity of new accumulation accounts (equal to the number of new workers entering the workforce annually), the Armenian market may otherwise be too small to permit more traditional methods of open licensing, similar to the current process in insurance company and banking licenses.

Although about 25 percent of workers' reported income is supposed to be contributed monthly into the national compulsory pension system, the monthly pension benefits paid from the compulsory system fall

so far below the poverty level, that the system is regarded by most in Armenia as grossly inadequate. Through a series of improvements in collecting contributions into the national pension system a larger number of employees are paying into the system than ever before. Also, a slight increase in reporting of average wages has been realized. The initiatives are being managed by the Ministry of Labor and Social Insurance and a USAID-funded contractor, PADCO. This group has created a project for improving contributions made into the State Social Insurance Fund through a series of tactics:

- Creating and managing a system of unique social security numbers for each worker, of which the majority of workers in Armenia now have and use.
- Creating a system of personified accounts, basically an accounting of each employee's relationship with an employer, an accounting of the employee's wage and contribution history.
- Working to improve the collection rate of contributions to the State Social Insurance Fund.

These improvements are logical first steps to allowing diversification of Pillar One compulsory contributions to a Pillar Two system of accumulation accounts.

Regarding the current pension system, there is no mechanism for employers or workers to save for retirement except through the state compulsory system.

- There is no opportunity to voluntarily establish or contribute to an occupational voluntary pension savings scheme in Armenia; and as such there can be no pensions paid from those contributed to on a voluntary basis.
- There is no system of incentives for employers to create and contribute to occupational pension schemes and workers have no easy method to make long-term investments for their own retirement.

The compulsory pension system is not well functioning:

- Contributions are not efficiently, fairly or correctly collected, accounted for or reported (allocated to correct employer and workers)
- Pension payment calculations appear to be correct and in conformance with regulation, however, the amount is so low – not yet level with the poverty rate in Armenia – that it hardly seems a positive point to be making.
- Process to pay the benefits appears costly, prone to human error or worse, fraud.

Short-term recommendations

- USAID can assist in creating a system of voluntary pensions and improve the compulsory pensions by directing technical assistance as follows:
    - Develop a project implementation plan working from a government approved consensus from an agreement on the goals and principals of a reformed pension system, e.g., World Bank goal of a target of 60 percent old age income replacement program
    - Recommend structure of pension companies.
    - Recommend structure of how contributions could be managed by financial sector.
    - Recommend supervisory authority for pension companies drawing on experience of regulators in overseeing other financial sector institutions.
- Develop law and/or regulations which support the reformed system:
    - Contributions: amounts of employer and employee contributions and tax incentives on voluntary contributions.
    - Earnings: how and when to credit, how to calculate, how to report, how to disclose.

- o Benefit payments: 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:
  - o Develop specifications required in order to be licensed as a pension fund
    1. Legal structure, tax status, management structure.
    2. Accounting, transaction recordkeeping capabilities and IT records.
    3. Asset management functions and credentials.
    4. Payment of benefits, e.g., transfer account balance to annuity underwriter at retirement age.
  - o Develop and implement a public communication plan.
  - o Provide training for the regulatory authority on how to evaluate companies seeking to be licensed as a pension fund.
  - o Develop and implement a plan for flow of contributions for each voluntary occupational pension scheme.

V. BACKGROUND AND OVERVIEW OF PENSION REFORM

A. INTRODUCTION

Why do social insurance programs exist? This question is especially appropriate in Armenia following the collapse of the former Soviet Union and its emergence as a market-driven economy.

The basis of many market economies – including Armenia's – is reliance on the self, and less on the state, both in purchasing goods and services and in earning income. This philosophy extends beyond the provision of goods and services to include safety net and social insurance activities. However, state welfare programs require the continued exercise of state power to redistribute revenue, from those with income to program beneficiaries. Moreover, almost all modern industrial nations have extensive social assistance programs of some kind, even those with deeply entrenched market economies.

Some argue that public social insurance programs make capitalism politically viable. Unfettered markets are efficient, highly productive, but potentially merciless towards those unable to compete. Social programs assist in these situations. Therefore, the relevant question policymakers face is not whether to have such programs, but how much and in what form.

B. THE THREE PILLAR SYSTEM

The three pillar system, a model put forward by the World Bank, separates the major objectives of social security into three tiers, each with its own source of funding. This system borrows components of both defined benefit and defined contribution systems (see Annex). Virtually all existing social insurance programs include components of the three pillars, albeit in many forms and under many names.

The main characteristics of a typical three pillar system are shown below.

BOX 9.1: A TYPICAL THREE PILLAR SYSTEM

	Pillar One	Pillar Two	Pillar Three
Participation	Mandatory	Mandatory	Voluntary
Goals	Redistribution	Savings, investment	Savings, investment

	and insurance	and insurance	and insurance
Funding	Pay-As-You-Go unfunded	Fully Funded	Fully Funded
Structure	Defined Benefit System	Defined Contribution System	Defined Contribution and/or Defined Benefit System
Management	Publicly managed	Privately managed	Privately managed

Pillar One

Pillar One addresses redistribution and social safety net issues directly, and provides basic support or insurance for everyone. In developing countries, "basic" support would typically mean subsistence-level assistance, whereas in developed countries it could mean assistance to provide at least a poverty-threshold standard of living.

Everyone in society participates, whether or not they have worked in the formal economy. In virtually all versions of this model, this pillar is publicly managed and funded from general revenues, because it is almost universally recognized that redistribution is best achieved through government intervention.

Few developing countries include the provisions of this first pillar in their current public social security systems. However, many developed countries use public insurance programs to redistribute income to low-wage earners.

Armenia has a basic Pillar One.

Pillar Two

Pillar Two is the core of the three pillar system, and it is here where versions of this system differ most from each other.

Pillar Two must be mandatory for many reasons. These include the problems associated with adverse selection[141], economies of scale, paternalism and the free-riding by people who save too little during their working lives knowing that social programs will take care of them when they are old, whether or not they save.

Linking contributions to benefits is critical to discourage tax evasion and to encourage labor force participation. employees are more likely to work in the formal sector and to pay their contributions when they perceive that these contributions are not a tax and relate directly to the benefits to be received later. Those who avoid contributions – for example, by working in the informal sector or by retiring early – and those who evade their contributions – for example, by arranging with their employers not to pay legally mandated contributions – receive smaller benefits during retirement when contributions are linked to benefits. When there is no connection, as in a purely Pay-As-You-Go system, an employee's evasion pass the system's costs on to other taxpayers.

The defined contribution benefits can be provided through either personal plans – when employees are usually able to choose which fund they join – or through occupational plans – when an employee's employer chooses or establishes a pension fund.

Armenia does not currently have a Pillar Two.

[141] Adverse selection is a problem stemming from an insurer's inability to distinguish between high and low risk individuals. The price for insurance then reflects the average risk level, which leads low-risk individuals to opt out and drives the price of insurance still higher until insurance markets break down.

Pillar Three

Pillar Three in almost all variations of this system is voluntary, fully funded and privately managed. Until recently assets in pillar three have been under the defined benefit structure. Increasingly, however, they are being established under the defined contribution structure. Further to this trend in many countries, defined benefit pillar three schemes are being converted to defined contribution. The voluntary pension trend is moving away from defined benefit to defined contribution for several reasons. The employer is a key driver in establishing and funding voluntary pensions and employers find the defined contribution schemes permit more manageability of costs and benefits. But defined contributions result in the shift of responsibility on some of the pension decisions from the employer to the employee that requires a proper employee education and communication program be created and maintained.

In many countries there are occupational pension plans, other retirement savings vehicles (such as company-sponsored, tax-deferred, retirement savings plans), individual retirement accounts, and other retirement savings vehicles. In some cases contributions, and their earnings, are given favorable tax treatment as an incentive to save. These incentives are frequently provided to be employer and employee contributions and earnings thereon.

Armenia does not currently have a Pillar Three.

C. Goals of a Pension System

Saving for future retirement means forgoing income today. This is not something that either employees or government officials are routinely willing to do. So pension systems must be designed to include incentives that will encourage employees to make contributions and participate in the system. Failure to adequately address the importance of incentives will greatly diminish the likelihood of pension reform success.

To determine the best use of incentives, it is necessary to first understand the sort of behavior that the government seeks to achieve and reward as a result of the reform.

Social Goals

The social goals of a reformed pension system can include:

- Provision of **adequate, minimum protection** for individuals against economic hardship caused by factors beyond their control (such as longevity, disability and inflation risks).
- **Redistribution of wealth** to the lifetime very poor. Unless this is deliberately targeted, the opposite will occur as the rich tend to work for fewer years (and so have lower total contributions), retire earlier, and live longer. This means that they receive higher benefits.
- **Increased benefit replacement rate**[142] (without increased social taxes).
- **Improved certainty** that benefits due will be paid.
- Provision of similar **benefits for individuals in similar circumstances**. This is not as easy as it would seem at first – the focus can be on the annual payment or on the total lifetime value of the pension.
- **Simplicity and transparency** to enable employees, citizens and policymakers to make informed decisions.
- **Insulation from political manipulation** that could lead to poor economic outcome.

[142] This is defined as a retiree's final benefit as a percentage of his/her final salary.

- Provision of a system that enables and encourages those who can to **voluntarily save more** than the mandated minimum.

Economic Goals

The economic goals of a reformed pension system can include:

- **Sustainability** (expected revenues should cover expected pay-outs in the long run **even** after allowing for anticipated changes in demographic and economic conditions).
- **Increased national savings**.
- **Decreased burden on national treasury**.
- **Decreased evasion of taxes** by both employees and employers.
- **Attraction of experienced, international pension companies**, administration companies and investment managers to the country's new market - the pension fund industry.
- **Increased flow of investments** into the capital markets.
- **Assured flow of contribution revenue** to purchase government bonds.
- **Increased rate of return** on investment portfolio without increased risk.
- **Decreased risk of fluctuation** of principal.
- **Decreased account fees** paid by employees.

Designing the System to Meet the Goals

Some examples of incentives that will encourage the results discussed above include:

- **Tax-exemptions** for contributions made to a pension scheme are a wonderful incentive for both employers and employees to contribute more to the program than they are otherwise required. Currently tax-exemptions exist for compulsory contributions to the Pillar One system in that employees and employers are not taxed on each others' contributions.
- **Preferential tax treatment** – in most countries the tax paid on contributions, investment earnings and benefits is at a lower rate than normal income. This is to encourage employees to participate in the system. Today this issue is not addressed in Armenia as there is no opportunity for compulsory contributions to Pillar One to earn in an accumulation mode. In the process of reforming the system we recommend that preferential tax treatment be considered as an incentive to encourage participation and funding into the system.
- **Access to investment opportunities** – by allowing pension schemes to invest in domestic and international capital markets, an employee's savings can gain access to a diversified portfolio of assets that s/he is not otherwise be able to do. In addition, s/he gains access to potentially higher earnings rates, without increased risk, than would otherwise be available. Contributions under Pillar Two or Three pensions have the opportunity to create a sustainable flow of domestic investment into the Armenian financial sector. There does not appear to be another source of domestic investment that can have the same impact on growing the financial sector.
- **Private management** – by allowing private pension companies to participate in the reformed system, administration costs are lowered, investment returns are increased and the system is rendered more efficient. Furthermore, this allows the government to concentrate on the task of regulating and supervising the industry, and not on the day-to-day management. We strongly recommend that the government of Armenia not compete in this industry, nor that it act as both regulator and financial

institution as part of the reforms.

- **Legislated maximums and minimums** – some countries have legislated maximum fee levels and minimum interest rates with mixed results. Setting such limits is often done to bolster public confidence in the pension system. However, the maximums and minimums should be reasonable to ensure that internationally experienced firms are attracted to the system. Another option that also has achieved results is to set a public tender for the licensing of pension companies. In such a process qualified firms first attain approval demonstrating that they meet stringent experience requirements for managing pension assets and completing pension transaction recordkeeping functions. From the list of approved firms, a public tender is conducted, allowing firms competing for two licenses to propose their most competitive prices with the firm proposing the lowest fee as the first license winner. The second license winner (the next highest fee proposal) would be asked to agree to the lowest fee – so as to ensure a single national fee for all employees and pensioners. Such a tender process would be appropriate for Armenia as the market of pension companies will naturally need to be limited due to the small size of the number of employees who will have pension fund accounts and the cost of managing such accounts. In markets of this size, a limited number of pension licenses will allow participating firms the opportunity to more quickly reach critical mass and, therefore, to more quickly charge competitively lower fees.
- **Redirected contributions** – the most common way of financing a new Pillar Two or Pillar Three contribution is by redirecting contributions from the current Pillar One pension system. This recognizes that social taxes are already too high in almost all countries in which reforms are being contemplated, or have begun, and ensures that social taxes are not increased further as a result of the reform. This option is under discussion in Armenia. With the assistance of the World Bank's Proust model, calculations are being made to determine the transition cost of redirecting contributions into Pillar Two pension companies. The transition cost is the amount needed to fund the difference between payments to today's pensioners and disabled and the contributions remaining in Pillar One. For example, if the government of Armenia approved a 10 percent redirection of contributions from Pillar One to Pillar Two, the transition cost would be amount needed to continue to pay pensioners and disability benefits.
- **Additional voluntary system** – by providing a system that allows people who can save more to do so, the financial burden on the state is further reduced. This also permits a quicker growth of the overall system, thereby assisting in reaching economies of scale at a more rapid pace. Attainment of economies of scale is important in a small population country in which growth through new employees entering the workforce is otherwise limited.

VI. Reforming the Pay-As-You-Go System

One of the goals of reforming the current Pay-As-You-Go system in Armenia is restructure in such a manner as to avoid many pitfalls and weaknesses of the current system. It is recommended that the following changes be incorporated to avoid contribution evasion, overly generous benefits (referred to as privileged pensions in Armenia) and economic transition.

A. Contribution Evasion

Problem

In Armenia tax evasion is a huge problem. Employees avoid paying contributions for many reasons:

- They see no connection between the contributions they pay and their resultant benefit.
- They feel the contribution rate is too high relative to the benefit they will finally receive.

- They value present consumption more than a future pension.

A World Bank study showed that each 1 percent rise in the contribution rate typically led to a 2 percent drop in total contribution receipts due to increased evasion.

Workers evade by:

- Escaping to the informal sector, or shadow economy. Informal estimates indicate that this could account for more than half the labor force wages.
- Under-reporting earnings (requiring the workers and employers to be in cahoots which is very common).
- Simply refusing to comply, which seems to have little consequence which indicates that enforcement is lax and penalties are low.

High levels of evasion undermine the whole economy. Labor productivity suffers as people operate in the shadow economy. The social security system runs into serious financial problems, especially as many workers still qualify for benefits despite not having made contributions. This can then cause further problems as the public's faith in the system is weakened and evasion increases.

Solutions

Some ways of solving this problem in a reformed system are:

- Demonstrating a strong link between contributions and benefits.
- Making parametric changes, such as basing benefits on lifetime earnings to encourage people to make contributions.
- Paying lower benefits to people who have not contributed (this occurs automatically in a defined contribution system).

B. Overly Generous Benefits

Problem

One of the most acute problems in Armenia is the public welfare system inherited from the Soviet period, designed to provide "cradle to grave" protection to the population.

Early retirement conditions were historically generous to compensate for the inadequacies of Soviet socialism. Soviet women endured long hours of work at home, as such predominantly female occupations were awarded early retirement. Miners and many industrial workers suffered dangerous and unhealthy conditions so they too were given early retirement, though it would have been more socially efficient to improve working conditions and keep skilled workers at their jobs for longer. Further, invariably the higher ranks of the military receive higher benefits even though few of them actually see dangerous duty.

On the revenue side, these systems offered little encouragement to work and pay contributions. On the benefit side, they offered too much, for too many, too early.

Solutions

The systems are no longer sustainable. Some ways of solving this in a reformed system are:

- Setting benefits at a realistic level to protect people against poverty but not to be too generous.
- Making benefits funded on a Pay-As-You-Go basis relatively flat, means-tested, or a minimum pension guarantee.
- Indexing benefits to prices (rather than wages) so they retain their purchasing value over time.

- Raising the retirement age.
- Reducing opportunities and incentives for early retirement.
- Tightening the eligibility criteria for benefits.

C. ECONOMIC TRANSITION AND/OR INSTABILITY

Problem

Although public welfare systems are under scrutiny worldwide, the decision regarding the trade-off between spending on social security and investing in economic growth is particularly difficult in Armenia's economy because of the fragility of the financial and social situation, and the pressures on expenditures resulting from economic transformation.

Armenia's system is managed on a Pay-As-You-Go basis. As the system matures, and contributions fall short of the amount required to pay benefits, the Implicit Public Pension Debt (the transfer from the national budget needed to fund the difference to pay benefits) grows to such an extent that the system is no longer sustainable and great uncertainty surrounds its future. This is one of the main reasons any country seek to reform its pension system.

Solutions

Some ways of solving this problem in a reformed system are:

- Moving to partial or full funding.
- Investing the reserves of partially funded schemes.
- Keeping pension reserves separate from general government revenue.

VII. TRENDS IN PENSION

There are several principals at play in examining options for the best reform in Armenia. The trend in pension reforms around the world is to make the following changes:

- From a Pay-As-You-Go to Full or Partial Funding
- From Defined Benefit to Defined Contribution System
- From Publicly Managed to Privately Managed

A. FROM PAY-AS-YOU-GO TO FULL OR PARTIAL FUNDING

The first main change is from Pay-As-You-Go to a Fully Funded or Partially Funded system.

The advantages of this change are:

- The costs of the system are made clear up front so governments are not tempted to make promises today that they will be unable to keep tomorrow.
- A funded system provides transparency by explicitly distinguishing between the saving-insurance functions of a pension system and those of distribution and social protection.
- Under a Pay-As-You-Go system, contribution rates are often high, changing contributions into "taxes" which reduces employment, and encourages evasion and movement into the shadow economy. By allowing workers to see that their contributions will be used for their own retirement, these trends can be reversed.
- Funded systems cause pools of money to be built up which are typically used to strengthen local

equity markets and financial infrastructure.

- As benefits are pre-funded, the system is self-sustaining. Under a Pay-As-You-Go system, as the system matures and contributions fall short of what is needed to pay benefits, the additional (often large) cost falls to the government, which builds uncertainty and unsustainability into the system.
- The political risk is lower as the ultimate pension benefits are a function of the accumulation of a worker's pension savings. Under a Pay-As-You-Go system, workers' benefits are subject to the risk that the government, at the time of retirement, may be unwilling or unable to levy the taxes required to finance the earlier promised level of benefits. Also, workers own contributions pay for their own retirement.

B. From a Defined Benefit to a Defined Contribution System

The second change is from a Defined Benefit System to a Defined Contribution System or to a Mixed System.

The advantages of this change are:

- A defined contribution system clearly demonstrates a direct link between the contributions made and the benefit ultimately received. This increases the likelihood of compliance. In contrast, a defined benefit system is typically seen as payroll taxes that bear no relationship to the end benefits.
- Workers can see the value of their portfolio at all times and make judgments as to its adequacy. Under a defined benefit system they know their ultimate end benefit but not whether there will be money to pay for it.
- Workers are encouraged to stay in the workforce and extend their working lifetimes as they see their benefits correspondingly increase.
- The system automatically adjusts to changes in average life expectancy since when a worker's ultimate lump sum is converted to an annuity, allowance will be made for any improvement in mortality.
- The system is immunized from political interference as any promised special treatment must be followed by explicit additional contributions.
- There is an expectation that there will be higher rates of return on pension savings relative to what would be implicitly earned on contributions in a defined benefit system.

C. From Publicly Managed to Privately Managed

Public systems are subject to political risks, and hence unstable, as future levels of contributions and benefits can be altered since no government can guarantee that subsequent governments will follow its policies. On the other hand, the state is seen as being inherently stable because it is perceived as being in perpetuity.

The primary advantage of the move to a privately managed system is to maximize the likelihood that economic – rather than political – objectives determine the investment strategy. The goal is to ensure the best allocation of capital and the highest return on savings, for the lowest risk. The available data, compiled by the World Bank, show that publicly managed funds earned less than privately managed funds through the 1980's, and in many cases lost money. This is largely because public managers were required to invest heavily or exclusively in government securities or loans to failing state enterprises. By contrast, privately managed funds are more likely to diversify their portfolios, and include international equities and bonds – thereby providing against inflation and other risks.

In addition, private management of pension funds can foster the development of financial markets within a country by creating demand for financial products and institutions.

When considered with the move from Pay-As-You-Go to full funding, private management alleviates the fear that some people have about large amounts of capital being accumulated in the hands of a centralized public system subject to political pressures.

One argument raised against privately managed funds is that the administration costs are often higher than under a publicly managed system. While this has some validity, the investment returns, even when the administration costs are netted off, are still higher than those that would be earned under a public system.

VIII. Typical Features of a Pension System

The main features of a pension system are: Structure, Funding, Participation, Contributions, and Benefits.

- A pension system is A Defined Benefit System, A Defined Contribution System or A Mixed System.
- Funding is either on a Pay-As-You-Go, Fully Funded or Partially Funded basis.
- Participation is either Mandatory or Voluntary.
- Contributions are Mandatory, Voluntary or both and may be made by the Employer, the employee or both.

This section explains these terms in detail and compares the alternatives.

A. Benefit Design

A Defined Benefit System

In a Defined Benefit system, the employee is promised a payment, expressed as a formula of benefits that is specified (or "defined") in detail. This benefit may be one or more of the following:

- A percentage of final earnings for each year of employment.
- A percentage of final average earnings (e.g., the last 3 or 5 years of a employee's career) for each year of employment.
- A percentage of lifetime earnings.
- A fixed currency amount.
- A fixed currency amount for each year of employment.

The contributions that are required to fund these benefits are determined. The total cost is then split between employees, employers and sometimes the government.

The promise made to the employee is often from the government in the case of a pension with mandatory participation. The promise is often from the employer in the case of an occupational pension scheme. One role of the Supervisory Authority is to see that the promise is kept.

So, benefits are defined – contributions are calculated to arrive at the amount needed to pay the benefit. This type of system is said to be "input driven".

A Defined Contribution System

In a Defined Contribution system, the contribution rate is defined, not the benefit. This is typically a percentage of taxable wages. In this case, the employee is *promised a contribution* and generally an opportunity to earn on that amount as an investment.

These contributions, made by the employee and / or the employer, are invested for the employee until s/he reaches retirement age. Both contributions and earnings are usually exempt from tax. The employee's retirement benefit is then determined as the amount of accumulated contributions and investment earnings. At retirement, a lump sum is either paid out in full and used to purchase an insurance annuity or converted to an annual pension.

The promise made to the employee is often from the employer in the case of an occupational pension scheme. One role of the Supervisory Authority is to see that the promise is kept.

So contributions are defined – benefits are then calculated. This type of system is said to be "output driven".

The Two Systems Compared

The advantages of a Defined Contribution system are:

- It is a relatively easy concept for people to understand since it works in much the same way as a bank account.
- As each employee's contributions are set aside for their own retirement, employees can be assured that there will be money for them when they do finally retire.
- Benefits are closely linked, in an obvious way, to contributions.
- Employees participate in their retirement account accumulation and regard the benefits as no longer a promise from a government official or politician.

The disadvantages of a Defined Contribution system are:

- Redistribution of income is not automatic, since an employee's contributions are put into an account for his/her use upon retirement, disability, or death. Those who contribute more during their working lives receive higher benefits later. However, a defined contribution system can offer a minimum pension benefit, which will redistribute income. We propose the inclusion of such a minimum benefit as part of the reforms in Armenia.
- An employee's final benefit depends heavily on the investment returns earned over his/her working lifetime. This can make future financial planning difficult, as an employee cannot know precisely, in advance, how much s/he will receive on retirement. Thus the importance of the role of the pension company supervisor and the structure of the requirements of companies which seek to become licensed to manage pension assets. (An illustration of the importance of the role of earnings in determining the employee's final is shown earlier in the report.)

In contrast, the advantages of a Defined Benefit are:

- An employee's promised final benefit is known precisely (or at least in relation to final salary).
- The system can be designed to redistribute income by helping some groups more than others. For example, income is typically redistributed from high-income people to low-income people, from men to women, and from young to old.

The disadvantages of a Defined Benefit system are:

- An employee's contributions are not necessarily closely linked to his/her own benefits. Contributions

typically go into a large trust fund, or into general revenues, and are not linked to the person who made the contribution. Benefits are defined by a formula, which may bear little or no relationship to the person's payment into the system.

- Since contributions under a defined benefit system are generally pooled, an employee cannot be sure that there will be sufficient money to pay for his/her own retirement.
- The cost of the system will change with changing economic or demographic conditions. This means a change to employees' and employers' contributions, and/or a change to the government's liabilities. This can introduce instability and uncertainty into the system.
- Favorable economic and/or demographic changes (which lower the cost of the system) are not generally passed onto employees in the form of higher benefits. Unfavorable changes will almost certainly be passed on in the form of higher contributions.

A Mixed System

As is clear from above, each of the two systems has advantages and disadvantages. One way of overcoming the disadvantages is to combine the beneficial features of a defined benefit and a defined contribution system into one mixed or hybrid system. The Three Pillar System is an example of such a mixed system.

Other Benefit Design Issues

Flat or Means Tested Benefits

This issue primarily affects defined benefit systems, since under a defined contribution system pensioners have property rights to their own accumulated contributions.

Under a flat benefit structure, the same benefit is paid to everyone regardless of their income or work history. This has the advantage of requiring minimal record keeping and thus administrative costs are kept to a minimum. Also, a basic minimum benefit is provided to all old people, which can be widely politically popular.

The major disadvantage is that this type of system costs more, which means contributions, or taxes, must be higher. Higher taxes act as an incentive to find ways to avoid or evade them. Without an incentive to properly report their full income – as all employees' benefits are equal regardless of wage earning level – those with higher incomes are not motivated to honestly report and pay taxes/contributions on their higher income levels.

Although this method seems to provide the advantage of ensuring minimal benefits, the devastating effects on the national economy of creating incentives for Contribution Evasion outweigh the desired benefits. Since other methods permit a minimum benefit payment, this benefit design does not seem worth the higher cost.

Under a means tested benefit structure, benefits are reduced if other income – usually labor income – is above a specified level. Means testing is a different issue to taxing all or part of a retirement benefit, but in combination with taxation, the reduction can be a large fraction of earned income. Means testing is most successful when used in A Mixed System, and the means tested benefit comes from the defined benefit component of that system.

The main advantages of means tested systems are that the overall cost of the system is lower, or larger benefits can be paid out for the same expenditure. They also prevent the rich from collecting larger lifetime transfers than the poor.

Means tested systems have some disadvantages, however:

- They can have higher administrative costs.
- There can be stigma and take-up problems with people drawing benefits.
- People can be encouraged not to save when young or work when old and near the income threshold.
- They are politically unpopular in times of budgetary stringency since middle-income groups do not benefit.

Employment Related Benefits

Another option under a defined benefit system is to provide benefits calculated as a percentage of earnings for each year of employment. This system:

- Costs less.
- Does require more record keeping.
- Disadvantages women (who tend to work for fewer years).
- Is more likely to be successful in deterring evasion (as people only receive a benefit for the years they have worked and contributed).

Care must be taken, though, to ensure that the benefits:

- Are not unsustainably high.
- Do not go disproportionately to high-income earners.
- Do not encourage early retirement or strategic manipulation.

Indexation

Most countries index their pensions to either wages or prices.

Under price indexation, pensions are adjusted with price levels. This means:

- Their absolute real value remains unchanged.
- The risk of changes in the standard of living is borne by the young whose contribution rates would need to increase if the economy slowed.
- The old do not share in any productivity growth that occurs after they retire.

The argument in favor of price indexation is that old people are less able to adapt to falling real incomes than young people are, and are less concerned about rising real income since their consumption habits are already established.

Under wage indexation, pensions move with changes in wages. The argument for wage indexation is that young people should not be expected to bear the full brunt of drops in real per capita income, and that old people should share in the fruits of any economic growth. Wage indexation:

- Helps keep pensions equal for all beneficiaries (as benefits are usually linked to wages).
- Makes the system resilient to external shocks that affect wages as both inputs (contributions) and outputs (benefits) are usually linked to wages.

When productivity is rising, wage indexation holds the required contribution rate constant if all else remains unchanged, while price indexation allows the contribution rate to fall.

If people care about their relative and absolute positions, while the government wants to capture some savings from productivity growth, one successful solution is a fifty-fifty combination of wage and price indexation. This is practiced in Switzerland.

Changes to Earnings

Defined benefits systems based on final earnings have to allow for the possibility of a employee's earnings falling near retirement. This can happen for business reasons (such as working part-time or changing career) or personal reasons (such as illness).

The best ways around this problem are to:

- Adjust the service or employment period (so that, for example each year worked part-time counts as half a year) and use an adjusted full-time equivalent salary.
- Use lifetime earnings rather than final earnings.
- Use the highest three or five-year average annual earnings over the employee's lifetime, adjusting past earnings to the retirement date with average wage inflation.

B. FUNDING

Pay-As-You-Go

In almost all countries with unreformed pension systems, the existing, mandated systems are unfunded arrangements. Pay-As-You-Go, or PAYGO, is a generic term for pension systems whose costs are not amortized or financed in advance. Rather, the money necessary to fund the system each year is simply found during that year. Contributions from employees and/or employers alone are usually insufficient to pay for benefits, so the responsibility of financing the shortfall rests on the government, which will tax its citizens to cover this cost.

Pay-as-you-go systems face a number of problems:

- *Incentive to grant excessive benefits* – as future costs are not made explicit and may prove to be unaffordable.
- *Dependency on the government* – as money is not set aside each year for future retirees, their benefits depend on the future financial strength of the government. However, benefits are frequently manipulated by politicians who promise to pay more in exchange for securing votes or support from pensioners.
- *Higher ultimate costs* – as contributions are not invested, the benefit of compound interest is lost and more must be contributed.
- *Increased risk of Contribution Evasion* – as employees do not perceive a strong link between their contributions and their benefits.
- *Lack of development of capital markets* – as contributions are not invested.
- *Inequitable distribution of benefits* – as employees typically pay in more as contributions than they receive as benefits especially as the system matures.
- *Intergenerational Distribution* – as current employees pay for current retirees rather than for their own retirement.

Fully Funded

The alternative is a fully funded system. Under this type of system, contributions from current employees and/or their employers are saved and invested to pay for those employees' retirement benefits when required in the future. This has the advantages of:

- *Making the system actuarially sound* – that is, expected payments from the system equal expected

contributions into the system.

- *Providing better protection to future retirees* – from both demographic and economic shocks as money is set aside for them each year.
- *Encouraging employees to have a stake in capital markets* – nationally, regionally and internationally, thereby developing a greater self-interest in the global capital markets and leading them to support the inevitable shift to a shareholder society.

One disadvantage of a fully funded system is that if contributions are invested, but not available at retirement – due to a poor investment policy, failure to permit diversification, failure to supervise the financial institutions, failure to properly license pension funds, etc. – the pensioner will receive no benefits.

By its very nature, a system of individual accounts must be funded in a consistent manner each year. Defined Contributions systems are almost always funded while Defined Benefit systems, although commonly funded can also be unfunded.

Partially Funded

Under a partially funded system, part of the system is unfunded while part is funded. It is also sometimes referred to a system of notional credits or notional accounts.

This has the advantages of:

- *Reducing the amount of pension debt* which must be financed in the change from Pay-As-You-Go to funding.
- *Providing most of the benefits of a funded system* and limiting some of the disadvantages of an unfunded system.
- *Allowing risk diversification*.

However, the unfunded portion of the system remains exposed to the problems of population ageing and future financing.

C. PARTICIPATION

Mandatory

Virtually all countries have decided that social insurance for retirement, disability, and survivorship is a responsibility of government. Several reasons are often put forth to justify mandatory participation in these social security systems:

Markets will not provide sufficient protection from the unfortunate contingencies of life. Market failure is caused by adverse selection. This means that the people who are most likely to collect benefits from a certain unfortunate event are the same people who will most demand insurance. As a result, insurance premiums must be higher than when everyone is equally at risk. Unless the provider of insurance can distinguish high-risk people from low-risk people, the low-risk people are priced out of the market. By mandating unilateral participation, the government increases the size of the risk pool to all employees in the country, thus decreasing the risk that adverse selection will occur and, in turn, reducing insurance premiums to economical levels.

A large, mandated system of social insurance is cost effective.

- *This is because insurance and annuity markets are complicated and are characterized by economies of scale, which means that average costs decline as more people participate in the system*. This

argument assumes that a public sector system is less expensive than private-sector alternatives and that a one-size-fits-all pension system is superior to one that allows more choice, but which is more expensive overall.

- *In many cases social insurance programs, in addition to providing protection against certain adverse contingencies, also redistribute income*. If the program were not compulsory, those who would not benefit from the system would opt out of it.
- M*ost people are insufficiently far-sighted to prepare for their own retirements*. Although this argument is often put forward, most economists do not accept it because it implies that people are irrational, or at least, less inclined to look after their own well-being than would a remote government bureaucrat. Moreover, even if the proposition were true – and there is little evidence to suggest it is – some argue that people should decide such issues for themselves, even if they sometimes make mistakes.

There are advantages and disadvantages that are associated with the two general systems of social pensions – defined benefit and defined contribution. If they are mandatory, both systems solve the problem of adverse selection and reap the advantages of economies of scale. Both avoid the spillover costs of people who do not save for their own retirement. However, the two systems have different implications for income redistribution and for macroeconomic efficiency.

Mandatory systems frequently have additional, often negative, impacts on the larger economy. This is because they affect the saving and labor decisions of employees. The specific mechanisms of program-induced incentives differ widely across countries, but the general nature of these problems is fairly common.

Economists assume that spending and savings decisions are based on lifetime considerations. Employees save a portion of their income during their working lifetimes. After retirement, they live from their savings and accumulated earnings until they die, and bequeath what remains to their heirs. The life cycle theory of consumption is that even though income will vary substantially over a lifetime, consumption is smoothed out at a relatively stable level.

Initially, when individuals first enter the workforce or are in school, their earnings are relatively low. At this stage, individuals consume at a higher level than their income, and thus are dis-savers. They do this by borrowing, or by using another agent's (their parent's) resources. As individuals grow older and earn more income, they will consume less than they earn in order to set aside resources for their retirement. So, during this stage, the individuals are savers. When individuals finally retire, their income falls dramatically, although their consumption will remain at its relatively steady level. During retirement, individuals dis-save the resources they earlier set aside.

There are four main ways that a mandatory pension system may influence an individual's and a nation's savings patterns:

- Employees may view their contributions towards government-provided retirement benefits as part of their own savings, and, consequently, tend to save less on their own when the government taxes them for social insurance.
- If the social pension system in place is a Pay-As-You-Go system, employees' contributions are used, in part, to fund the consumption of retired people, and are not used as investment in the nation's capital stock.
- In some systems, employees who wish to begin receiving system benefits must limit their participation in the labor force, by retiring earlier than they otherwise would have, or by limiting their amount of labor income. This may induce employees to save more during their shortened working lives in anticipation of their longer period of retirement.

- Similarly, a social insurance program can influence savings through its impact on bequests that people make to their heirs. If one reason for savings is to accumulate an inheritance, then people will take into account the impact of the public pension program on savings. If the public program redistributes income from young (employees) to old (retirees) then people would, presumably, save more so their bequests are not reduced by the public program.

Public pension programs also affect a country's macro-economy by influencing employees' decisions in the labor market, especially those regarding earlier partial or full retirement.

The tax treatment of retirement benefits also affects labor supply decisions, as do specific characteristics of the benefit formula and other parameters of the tax code.

B. Voluntary

By contrast, voluntary participation is usually restricted to additional, personal savings.

People with disposable income will always find things to do with it, but in developing countries those things are often related to disposal rather than saving, and hence contrary to government objectives.

For example, in many developing countries people with income send their savings abroad for investment as opportunities within their own country are perceived to be high risk, to lack diversification as they are tied exclusively to the domestic economy and to provide insufficient flexibility and liquidity.

A well-structured voluntary savings or pension program (the Individual Retirement Accounts – IRAs – in the United States are one example) that is designed to meet macroeconomic objectives will benefit both employees and the government by:

- Alleviating capital flight problems by allowing some international diversification. For example, by allowing an annuity savings fund to be invested up to10 percent in high quality foreign markets, the government could end up with even more being invested in domestic markets than if all funds left the country illegally.
- Acting as an incentive for people to save and provide for their own needs.
- Acting as an incentive for savings and reinforcing confidence in the financial sector infrastructure, which complements the government's economic goals.
- Protecting employees' savings by having clear definitions and regulations on what institutions or savings products can be used and the strength of the companies that provide such services, and by having strong oversight and supervision of the permitted voluntary pension programs.

ANNEX 10: SECURITIES MARKETS IN ARMENIA[143]

INTRODUCTION

The purpose of this report is to assess the current stage of development of the capital market in the Republic of Armenia and to provide recommendations as to the most effective, efficient and operationally practical developments to transition the Armenian capital market into a realistic financial growth engine.

This focus of this report is on the emerging markets aspects of the Armenian capital market. An emerging country/market is classified by the World Bank as having a low or middle-income economy, regardless of its particular stage of development. Low and middle-income economies are currently defined as those with a 2001 gross national income ("GNI") per capita below $9,206. While all countries that fit this economic profile are considered emerging, not all are considered investable. This analysis assesses the market's potential investability and where gaps and impediments exist, recommendations to increase the market's investability, and ability to attract and retain investment capital.

THE APPEAL OF EMERGING MARKETS

Economic growth has constituted the reason for investing in emerging markets, including superior relative expected returns and an expanding opportunity set for investment. In recent years, emerging markets have collectively out-performed their developed market counterparts globally. Over time, many emerging markets have also undertaken wide-ranging institutional reforms, which have increased their appeal to foreign investors. These have included: stock exchange modernization; establishment of central clearing and settlement corporations and central depositories; establishment and empowerment of securities regulatory agencies, decreases in commission rates and other transaction charges, stricter accounting, auditing and information disclosure requirements; and establishment of insider trading rules.

Progress towards political openness in many countries has created governments that are more receptive to free market policies and increased foreign investment. Government officials have come to realize that for the capital markets to develop, they must create an environment attractive to both domestic and foreign investors with safeguards in place to guarantee property rights and proficient settlement arrangements.

Emerging markets may provide an expanded opportunity set for investment and diversification. However, not all emerging markets present meaningful opportunities for institutional investors. In many emerging markets the potential for rapid growth is often offset by a high degree of risk associated with investing in developing countries.

Currently, the Armenian capital market is small and illiquid. The operational viability and financial sustainability of the market is constrained by: (i) a lack of listed issues; (ii) a lack of a variety of issues; (iii) a small number of market intermediaries; and (iv) a pervasive "buy and hold" investor strategy. Simply stated, left to purely internal domestic market forces, the Armenian capital market is too small with too few listed issues and too few market intermediaries to have a reasonable chance for economic sustainability and any realistic opportunities to grow. The recommendations proposed later in this report are specifically aimed at correcting immediate market growth impediments so that the growth engine may be "jump started" and commence to work. As stated in the recommendations section, the initial momentum to prime the growth engine will have to be applied primarily by sources external to the Armenian marketplace.

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MARKET DEVELOPMENT

Subsequent to independence, Armenia proceeded to construct the fundamentals of a capital market. In the intervening years, with technical assistance provided by the United States Agency for International Development (USAID), Armenia has constructed an institutional capital market framework.

The establishment of a capital market included the creation and implementation of:

- Securities Law
- Companies Law
- Contract Law
- Stock Exchange
- Central Securities Depository

STOCK EXCHANGE

In 1997, the Securities Market Members Association (SMMA) was formed and three years later, in August 2000, the 24 members of the SMMA, as legal entities, signed an agreement by which they agreed to:

- Participate in the establishment of the Stock Exchange as a Self-Regulatory Organization (SRO).
- Refrain from becoming a member of any other SRO that is organized for the purposes of the public trading of securities and the dissemination of securities quotation.
- Engage in the trading of securities exclusively on the Stock Exchange, and on the trading boards established and regulated by the Stock Exchange.
- Comply with rules, requirements and internal by-laws as approved by the members of the Stock Exchange.

In November 2000, the SMMA was officially renamed The Armenian Stock Exchange (Armex), and a revised charter adopted.

During the month of January 2001, technical assistance provided by USAID resulted in Armex acquiring an electronic, automated securities trading system. The first electronic trading session was conducted in February 2001.

DEVELOPMENT IMPEDIMENTS

Currently, the major impediments to developing a capital market in Armenia are: (i) a lack of basic securities products capable of attracting and retaining domestic and international investor capital, and (ii) a lack of a sufficient number of participants in the capital market willing to buy and sell security instruments in the marketplace.

CAPITAL MARKET AS A GROWTH ENGINE

The development of a capital market inherently has the effect on a national economy of a growth engine. The difficulty in most newer, smaller markets is in priming the engine so as to set the growth engine in motion. The primary functions of a capital market engine include, but are not limited to:

- Efficient and Cost-Effective Use of Capital
- Capital Availability in a Securities Marketplace

- Provide a Viable Alternative to Bank Financing
- Support for Pension and Retirement Schemes
- Attract and Retain Domestic and Foreign Capital
- Fuel National Economic Growth

SYSTEMIC GAPS & GROWTH IMPEDIMENTS

Trading activity in the Armenian capital markets is practically non-existent. Securities trading, to the extent it exists, is comprised of Republic of Armenia Government Securities. The Government Securities market is an institutional, inter-bank market where trades are executed on an “off-market” basis and subsequently reported to the Stock Exchange for market data dissemination.

An analysis of the 199 companies currently listed on the Exchange evidences the fact that the possibilities of IPO-type issuances and/or new share issuances are slim to non-existent. A recap summarizing average company capital and shares outstanding is provided below.

TABLE 10.1: PROFILE OF LISTED COMPANIES

Armex Listed Companies – Average Capital per Company		
Total Companies Listed	actual	199
Total Capital for all Listed Companies	AMD	42,734,688,295
Average Capital per Listed Company (AMD)	AMD	214,747,177
Average Capital per Listed Company (USD)	USD	$390,449

As the simple table shows, the average listed company’s capital is equal to approximately $390,000. The possibilities of bringing such small companies to market with expectations of offering large share blocs for sale and thus raising considerable amounts of new capital are remote.

In discussions with various market participants, the findings above were borne out by the general perception that at present Armenian enterprises are too small to be attractive in the IPO market.

TABLE 10.2: ARMEX LISTED COMPANIES – AVERAGE SHARES ISSUED PER COMPANY

Total Companies Listed	Actual	199
Total Shares for all Listed Company	Total Shares	49,894,933
Average Shares per Listed Company	Average Shares	250,728

The constraint on Public Float is obvious from the basic data above. The average company listed on Armex has issued slightly more than 250,000 shares. Subsequent to an enterprise’s founding principals retaining shares to protect their ownership, there are not many shares left in general circulation to support a liquid market.

RECOMMENDATIONS

STANDARDIZED LISTINGS

To standardize the quality of listings on the Armex and to insure that only truly public companies are available for trading, it is recommended that non-public, privately held companies be de-listed from the Exchange.

BOX 10.1: STANDARDIZED LISTINGS

Time Frame	Recommendation
Immediate Term	Review each Armex Listing to determine Listing's status as a Public Company or a Private Company In conjunction with the Exchange' Listing Rules and in consultation with the Securities & Exchange Commission, de-list Issues that do not conform with a Public Shareholding Company
Medium Term	Prepare a Business Case for the implementation and operation of a Private Placement Board on the Exchange. Present the Private Placement Board proposal to the Securities & Exchange Commission for review & approval
Long Term	Enhance current trading system's capabilities so as to accommodate an Electronic Private Placement Market.

GOVERNMENT SECURITIES TRADING ON ARMEX

There has been considerable discussion in the marketplace related to moving the trading of Government Securities onto Armex. It is strongly recommended that the trading of Government Securities be transitioned onto Armex as soon as possible.

The transitioning of Government Securities trading onto Armex will provide the Exchange with a significant vote of confidence from the Central Government as to the trust and confidence the Government maintains in Armex. This "vote of confidence" would also be valuable in attracting and retaining foreign capital to the Armenian marketplace.

Additionally, the trading of Government Securities directly on the Exchange would provide transaction-generated revenue for the Exchange.

BOX 10.2: GOVERNMENT SECURITIES TRADING ON ARMEX

Time Frame	Recommendation
Immediate Term	Review business, operational and technical requirements to transition the trading of Government Securities onto the Exchange Obtain ISIN numbers for outstanding Government Debt issues Create new trading symbols (issue symbology) for each Government Debt Issue Establish a distribution network to support the diaspora's accessibility to securities instruments

PRODUCT DEVELOPMENT

To establish the capital market in Armenia as a practical growth engine, it is strongly recommended that the number, variety and volumes of tradable products be increased.

BOX 10.3: PRODUCT DEVELOPMENT

Time Frame	Recommendation
Immediate Term	Establish a Product Development Department within the Stock Exchange
Medium Term	Train Stock Exchange personnel in research and Product Development Conduct a Listing Review to purge non-public companies from active listing on the Exchange
Long Term	Conduct a focused campaign to develop new tradable instruments and increase Exchange listings

Over the years, for the sake of simplicity, the creation and operation of capital markets have been compared to the creation and operation of a commercial shop or a similar enterprise. To attract business into a commercial shop, there must be a wide variety of products that meet the needs of the widest variety of potential buyers. In the absence of a variety of suitable products, potential investors will not be interested in "shopping" in the store. In the simplest of terms, potential investors must find the marketplace attractive, especially in the availability of a variety of investment products that meet their needs.

Specific additional products recommended for development by the Stock Exchange are listed below:

Gilt Fund(s) or Government Securities Funds

Most small transition markets have developed Gilt Funds or Government Securities Funds as a point of entry for individual investors and to "prime" the capital markets for growth. It is a commonly accepted adage that the majority of individual investors and potential investors are risk averse. The option for an individual investor to spread risk by investment in a portfolio that contains a number of Government Securities where the Government is guaranteeing interest and principal payments is a very attractive

proposition. Therefore, it is recommended that one or more Gilt Funds be established, on a Closed-End basis, containing Armenian Government securities.

Due to the unique composition of the Armenian diaspora, it is also recommended that one or more specific instruments be designed specifically for members of the Armenian diaspora, and one or more General Closed-End Funds.

It is also recommended that assistance be considered to approved members of the diaspora to enable them to sponsor or operate Gilt Funds or Government Securities Funds.

BOX 10.4: GILT FUND(S) OR GOVERNMENT SECURITIES FUNDS

Time Frame	Recommendation
Immediate Term	Determine the legality of Funds
Medium Term	Train Armex personnel in basics of Fund Administration Train Securities & Exchange Commission personnel in the basics of Fund Administration and Funds Oversight Create issuance environment that will support the issuance of Gilt Funds and Government Securities Funds
Long Term	Train Armex personnel to market the sponsorship of Gilt Funds and Government Securities Funds

Municipal Bonds

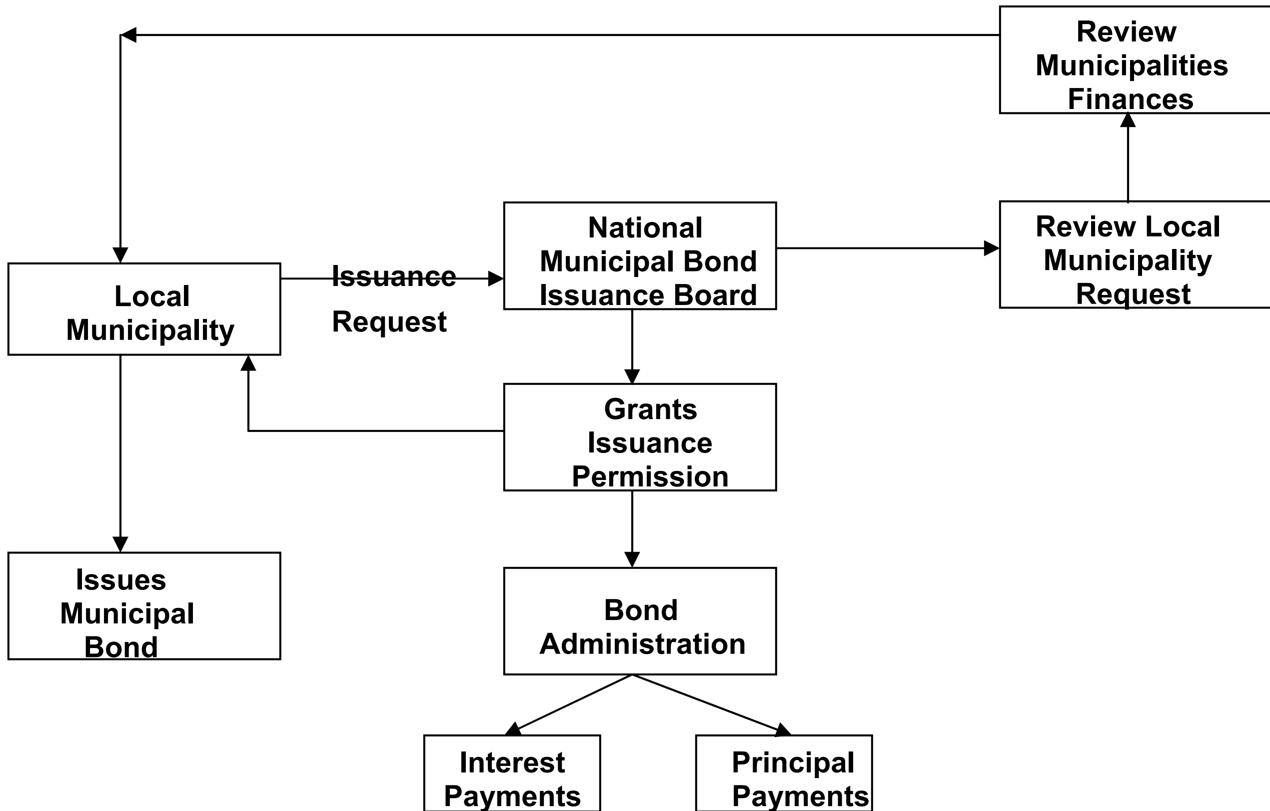
It is recommended that the issuance of Municipal Bonds be undertaken in Armenia. Although the issuance of Municipal Bonds is usually associated with more sophisticated markets, the issuance of such instruments may, in actuality, be very suitable for use in Armenia.

The practicality of issuing Municipal Bond in Armenia will be governed mainly by:

- Legal & financial empowerment of local municipalities
- Ability of Central Government to supervise and control Municipal Bond issuance
- The ability to issue Municipal Bonds that are attractive to the Armenian Diaspora
- The willingness of the Government of Armenia to grant tax concessions to the purchasers of Armenian Municipal Bonds

Discussions held with various groups in Armenia strongly indicate the ability of local municipalities to issue and manage a Municipal Bond issue is severely limited. In light of this reality, it is recommended that a Municipal Bond issuance structure, similar to below, be developed.

FIGURE 10.1: MUNICIPAL BOND ISSUE DESIGN FOR ARMENIA



NOTE: In recent years, Municipal Bonds have been used to establish and operate Special Enterprise Zones whose aim is to create employment in exchange for manufacturing facilities and tax concessions.

Project Mentoring & Monitoring

To maximize any technical assistance provided, it is recommended that Mentoring and Monitoring mechanisms be in place. The Monitoring mechanism would consist of a capital markets participant group comprised of key players in the Armenian capital market who would collectively be willing to take responsibility for the success of project work. The existence of such a group and the group's willingness to accept project responsibility and ownership would be key to success. Multi-part projects that cut across institutional lines must be held together preferably by a group of participants who have a strong vested interest in the project's outcome. The Mentoring mechanism would be the responsibility of the services provider, and would consist of the services provider "partnering" with capital market participants in a way that guarantees a reasonably smooth transition and operational hand-off.

Securities Borrowing and Lending

In 1989, the Central Banks of the Group of 10 Countries proposed standards for securities markets. One of the recommendations was the creation of a well-managed system for the borrowing and lending of securities.

The ability of participants in a market to borrow securities to cover a short position is considered to be a significant advantage in:

- increasing liquidity
- minimizing the effects of institutional "Buy & Hold" strategy

It is recommended that a basic program to support securities borrowing and lending be implemented in Armenia to stimulate activity in the marketplace.

ANNEX 11: LEGAL FRAMEWORK FOR FINANCIAL SERVICES IN ARMENIA[144]

INTRODUCTION

The following is an assessment of the legal framework of the financial sector in Armenia. The assessment is based on a review of available English translations of the relevant laws and interviews with participants and supervisors in the financial sector conducted during a mission to Armenia from October 28 to November 11, 2004.

Changes to the original draft report have been made following discussions with CBA and other supervisory officials, taking into account as well recent legislation regarding anti-money laundering as well as differing interpretations from regulatory officials with regard to certain provisions in the legislation. Most differences in interpretation are from the CBA, with the main points highlighted as Comments.

The analysis described in this report shows that the framework for the legal sector contains most of the laws needed for the financial sector to work properly. Certain laws are missing, such as an Investment Fund Law and an Insurance Bankruptcy Law. These laws are now being drafted and will complete the set of relevant financial sector laws.

BACKGROUND

1. GENERAL PRINCIPLES: THE LEGAL AND SUPERVISORY FRAMEWORK

Efforts to strengthen the financial sector in any country ultimately rest on three factors:

- A clear, practical and consistent legal framework
- Effective supervision
- Favorable business conditions

This analysis centers on the first factor—assessing the clarity and consistency of the legal text, and evaluating its practicality in addressing the specific needs of the financial sector. The legal framework should support establishment of institutions and protect business transactions by ensuring that the rights and obligations of transactions are fully honored and enforced, and that institutions are financially sound, operate in a transparent manner, and are not involved in market manipulation or fraud.

2. REGULAR LAWS

The financial sector is regulated by a number of specialized laws, including the Law on Insurance, the Securities Market Regulation Law, and the Law on Banks and Banking. More general laws serve a supporting role, such as the Joint Stock Company Law and the Law on Bankruptcy.

Some of Armenia's laws are organized in the Civil Code, which includes, among others, laws on obligations, contracts, leasing, insurance, pledges and mortgages.

[144] Primary author: Erik Huitfeldt. (Deletions of original text and insertions of *Comments* from Armenian stakeholders based on comments from stakeholders at workshops and in meetings to discuss the draft report prior to finalization: by Michael Borish).

3. Civil Code

The concept of the Civil Code dates back to the "Code Civil" initiated by Napoleon in France, and has given the name to the legal system practiced in continental Europe and many former European colonies.

The Code Civil is treated differently in the various Civil law countries. For example, Norway blends the laws of the Code Civil among the rest of its laws, and they are not considered laws of higher rank. In other countries, such as Romania and Albania, the laws of the Code Civil have been contained as an entity and considered lex superior, overriding regular laws if a conflict presents between the two. Countries that have kept the Code Civil intact and are now transforming their legal systems have benefited from that approach. This is because the law's historic principles are usually correct and remain unchanged, even during periods of communist legislation.

In Armenia, the laws of the Civil Code are changed frequently, typically resulting in laws that are less clear than the original text or organization of legal material that seems arbitrary. One example is the inclusion of the articles on bank deposits (Article 902 to 911) and bank accounts (Article 912 to 928) in the Civil Code, which would better be included in the Law on Banks and Banking.

This practice and the resulting scattered organization of the legal provisions makes it much more complicated to actually apply the law. In some cases, the Civil Code and the regular laws are inconsistent and may even offer contradictory provisions. For example, the definition of the term "Bank deposit" in Article 902 in the Civil Code and Article 5 in the Law on Bank and Banking offer differing definitions of the same term. (Comment) At the same time, neither CBA nor bankers complained of any misunderstanding or problems associated with these differing definitions.

Interviews with seasoned lawyers confirmed that confusion exists about conflict of law principles and whether the Civil Code is lex superior to regular laws in Armenia.

Part I – Banking Laws

The relevant laws in the banking sector at the time of the review were:

- The Civil Code
- The Central Bank Law
- The Law on Bank and Banking
- The Law on Bankruptcy of Banks and Credit Institutions
- The Law on Bank Secrecy
- The Law on Credit Institutions

Comment: Subsequent to the review, it was reported that a new law on anti-money laundering and combating the financing of terrorism was drafted, effectively reversing some of the original concerns expressed about nominee accounts (as they affect banking, securities markets and other financial services).

1. The Legal Structure of Banks

Banks can be organized as a joint stock company, a limited liability company or a cooperative bank in accordance with Article 12 of the Law on Banks and Banking.

2. BANKS ORGANIZED AS A JOINT–STOCK COMPANY

a. No Limited Liability

The beneficial characteristic of a joint-stock company is ordinarily the limited liability it provides its owners and the free trade in its ownership shares.

The Armenian Joint-Stock Company Law does not fully recognize the principle of limited liability, holding the owners responsible beyond their investments:

> If the reason for Company insolvency (bankruptcy) is the activities (inaction) of shareholders or other persons that have either the right to give compelling instructions to the Company or an opportunity to determine the activities of the Company in advance, then these shareholders or other persons may be exposed to additional/subsidiary liability for the Company's obligations in an amount that cannot be covered sufficiently by the Company's property. (Article 3, Paragraph 4 in the Joint-Stock Company Law)

A joint-stock company may be liable for its subsidiary company:

> A principal company (affiliation) that has the right to deliver compelling instructions to the daughter company shall share with the daughter company the liability for transactions carried out at its instruction (Article 7, Paragraph 4 in the Joint-Stock Company Law)

Recommendation: The joint-stock company's liability should be absolute. The present uncertainty will hamper investments in joint-stock companies, such as banks.

Comment: In response to the draft assessment, CBA noted that there are strict fiduciary requirements imposed on the banks, and that these are devised to prevent joint stock companies from potentially abusing shareholders by engaging in practices that would violate observance of key shareholder obligations. Until consolidation principles are in place, this will continue as an issue.

b. Share Capital and Equity Capital

The share capital of a joint stock company is the nominal value of its share multiplied by the number of outstanding shares. The share capital does not reflect the financial situation of the company other than on its day of creation, when it has no other assets or liabilities. This is because the capital infused into a company by issuing and selling shares is just one of several items on the balance sheet and the balance sheet must be viewed in its totality to understand the company's financial situation. Shares are regularly sold at a price that differs from the shares' nominal value. Therefore, share capital is useful for calculating ownership, but not for assessing a company's financial soundness.

Equity capital does offer a good measure of a company's financial situation – it provides information about the remaining balance after deducting the company's assets from its liabilities.

The concepts of share capital and equity capital are confused in the Joint-Stock Company Law:

1. Company equity is made up of the nominal value of shares acquired by shareholders.
2. Company equity determines the minimum amount of Company property guaranteeing the interests of its creditors.
3. The minimum size of Company equity shall not be less than the 1000-fold of the wage minimum at the time of Company's state registration for open companies, and no less than the 100-fold of the wage minimum for closed companies. (Article 30 in the Joint-Stock Company Law).

The capital adequacy requirements in the financial sector laws depend on a correct understanding of the term “equity capital.” In this case, the law’s confusion of share capital and equity capital make the capital adequacy requirements ineffective.

This misunderstanding also results in illogical adjustments of a company’s share capital, such as described in Article 43, Paragraph 3 of the Joint-Stock Company Law:

> The value of Company net assets is estimated using data from a Company balance sheet or audit inspection, in the manner stipulated by laws and other legal acts. If it turns out at the end of the second and each of the following financial years that the net assets of the Company are smaller than the equity, the Company shall announce reduction of its equity and register it in the established manner.

In extension of this, Article 35 in the Joint-Stock Company Law provides an example of how a company’s equity can easily be inflated:

A Company may increase its equity by means of increasing the nominal value of shares or allocating additional shares.

c. The Bank’s Total Capital and Statutory Capital

The share capital is called “statutory capital” in the Law on Banks and Banking (see Article 17), and equity capital is called the “total capital.” The misunderstanding described in relation to share capital and equity capital in the Joint-Stock Company Law is replicated in the Law on Banks and Banking, such as in Article 45, Paragraph 2 that defines total capital.

<u>Article 45. Total capital of the Bank</u>

1. The sum of the core (primary) and additional (secondary) capital of the bank shall constitute the total capital of the bank.
2. The core (primary) capital shall consist of the statutory capital, retained earnings and other components established by the Central Bank.
3. The components of the additional (secondary) capital shall be established by the Central Bank. For the purpose of calculation of the prudential standards, the Central Bank may limit the participation of the additional capital in the calculation of the total capital.

d. Capital Adequacy of Banks

Section V of the Law on Banks and Banking regulates the prudential standards for banking activities. The statutory capital is used as a key term in this section when defining the capital adequacy for banks. Because the term is mistakenly thought to provide indication of the bank’s financial soundness, the law’s capital adequacy requirement for banks is flawed.

Recommendation: Capital adequacy is the most important requirement for banks. The law’s definition of capital adequacy must be corrected to ensure a useful tool exists for controlling a bank’s solidity.

Comment: In general, CBA’s view of capital and other provisions in the legislation are that they are in compliance with international standards. Broadly, CBA has worked closely with the IMF and World Bank on all adopted legislation. This applies as well to regulations, which CBA claims are also consistent with recommended standards and practices of BIS. Thus, CBA rejects the claim that capital and CAR provisions are flawed or inconsistent with international standards.

e. Difference in Prudential Standards

Article 44 in the Law on Banks and Banking gives the Central Bank the power to:

> Establish stricter major prudential standards for some of the banks in comparison to other banks if the aggregated rating of the bank is below the threshold.

Stricter capital adequacy should not be imposed on weaker banks, because it increases the chances that a bank meeting the regular capital adequacy standard is pushed into failure, imposing a loss on deposit holders and owners. The capital adequacy standards should be set so that compliance with the standards is satisfactory to conduct prudent banking.

Recommendation: Stricter capital adequacy requirements could be considered if a bank undertakes activities that expose it to more risk, but should not be required solely on the basis that the bank is likely or close to breaching the regular capital adequacy requirements.

Comment: CBA claims there is no differentiation in standards and treatment, apart from banks vs. non-bank credit organizations.

3. Banks as a Limited Liability Company

A Limited Liability Company Law has been passed in Armenia. The need for this law is uncertain. Some jurisdictions, such as certain states in the United States, have promulgated limited liability company laws to allow for the creation of partnerships with limited liability. This form has been popular with professionals in companies, such as law firms, where the owners work in the company and do not want ownership to be freely traded.

The Armenian Limited Liability Law is not drafted to allow for a limited liability alternative for partnership, but instead is drafted with the small joint-stock companies in mind. Indeed many of the articles in the Limited Liability Law have been taken from the Joint-Stock Company Law.

Having two laws regulating the same type of company with almost identical content increases the general confusion in the company law area in Armenia.

Recommendation: The Limited Liability Company Law should be amended to mirror the Partnership Law in the Civil Code instead of the Joint-Stock Company Law.

4. Banks as a Cooperative

Banks can be organized as a cooperative under Article 12 of the Law on Banks and Banking. The regulation of cooperatives is provided in the Civil Code. Paragraph 1 of Article 117 in the Civil Code explains that:

> A cooperative is a voluntary amalgamation of citizens and legal persons on the basis of membership with the purpose of satisfying the financial and other needs of the participants, an amalgamation realized by the combining of property participatory share contributions by its members.

A cooperative does not provide limited liability to the owners. Paragraph 4 of Article 118 in the Civil Code states that:

> Members of a cooperative are obliged within two months after approval of the annual balance sheet to cover losses that have occurred by additional contributions.
>
> The members of a cooperative jointly and severally bear liability for its obligations within the limits of the uncontributed part of the supplementary contribution of each member of the cooperative.

The cooperative structure where the borrowers are also the owners fits well for micro finance or a credit cooperative organized around a group of people with a common interest, such as a church community or a workplace. It is therefore appropriate that Article 3 in the Law on Credit allows for credit institutions to be organized as a cooperative.

The cooperative structure does not fit well for a bank where the borrowers typically do not have a stake in running the banking business. It is of particular concern that borrowers will also be liable for the bank's potential losses if a bank is organized as a cooperative.

Recommendation: Banks should not be permitted to organize as a cooperative. That organizational structure will impose liability for the bank's debt on the bank's borrowers.

5. The Branch of a Joint-Stock Company

A branch is internationally understood to be an office located at an address different from the main company, but part of the same legal entity as the main company, operating on the same balance sheet and legally in the same position as the main company.

The Joint-Stock Company Law provides a description of a branch that is inconsistent with this understanding:

> Company branches and representative offices are not legal entities; they act on the basis of charters approved by the Company.
>
> The property of branches and representative offices is made available by the establishing Company. The property of branches and representative offices is accounted both in their separate balance sheets and in the Company balance sheet.

Branch and representative office managers are appointed by the Company. Branches and representative offices act on behalf of the founding Company. The founding Company shall bear liability for the activities of branches and representative offices. (Article 5, Paragraphs 3 and 5 in the Joint-Stock Company Law)

While it is not always necessary to use traditional legal term definitions, such consistent usage does make it easier to operate in the international financial market.

The non-traditional Armenian definition of a "branch" precludes the branch from conducting any form of business. Under the law, only legal entities are permitted to enter into contracts, but by definition, an Armenian branch is not a legal entity.

Comment: CBA claims branches are legal entities and can conduct business consistent with banking legislation.

6. Bank Branches

The definition of a branch in the Joint-Stock Company Law is repeated in Article 14 of the Law on Banks and Banking:

> A branch of a bank is a separated department that has no legal entity of a bank and is located away from the premises of the bank that functions within authorities given to it by the bank and implements banking functions on its behalf and/or implements financial functions provided for by this Law.

Recommendation: The definition of a bank branch should be amended by stating that a branch is not a separate legal entity, but shares legal entity with the main bank and can enter into contracts as the bank itself.

Comment: CBA and market players claim branches are part of the legal entity that is the specific bank and can conduct business consistent with banking legislation. Bank branches are not defined as a separate legal entity.

7. Foreign Branches

The Law on Banks and Banking allows the establishment of branches of foreign banks in Armenia. It is important that the bank supervisor obtains proper oversight of the foreign bank's balance sheet, because the branch operates on this balance sheet.

Recommendation: The bank supervisor can establish such oversight by requiring direct oversight as a condition when licensing the branch and should also cooperate with the bank supervisor in the home country of the foreign bank to gain proper oversight regarding bank activities and financial soundness.

Comment: CBA claims it has licensing guidelines in legislation and regulations, and that an amendment would be needed to the Law on Central Bank and the more general Law on Licensing. CBA claims the main restriction is on foreign branches collecting deposits.

8. Registration in the State Register

A company must be registered in the state registry for enterprises to become a legal person able to obtain and undertake legally enforceable rights and obligations. It is the registration of the company in the State Registry of Enterprises that marks the establishment of a company's status as a legal person. (Paragraph 3, Article 56 in the Civil Code).

Article 27 in the Law on Banks and Banking contradicts Article 56 in the Civil Code. It states that a bank receives the status of legal entity from the moment it is registered by the Central Bank.

Recommendation: Article 27 in the Law on Banks and Banking should be amended to state that a bank gains its legal status when it is registered in the State Register of Enterprises.

9. Steps to Obtain a Bank License

Banks are required to follow a three step licensing procedure to be licensed under Article 24 of the Law on Banks and Banking. The steps are:

- Preliminary agreement to issue the license,
- Registration of the bank or the branch of the foreign bank, and
- Issuing the license.

The application for a preliminary agreement to issue a license is submitted to the Central Bank. The Central Bank can deny the application if it believes the bank would be unable to implement normal banking activities, or if its economic program is not realistic.

No right to appeal the administrative decision exists in the event an application for a preliminary agreement is rejected. This inability to appeal is counter to accepted administrative law principles.

Recommendation: Article 26 in the Law on Banks and Banking should be amended to authorize that rejections of a preliminary agreement can be appealed to the court.

10. Registration of Banks with the Central Bank

The bank can move to the stage of registration with the Central Bank once it has received the preliminary agreement from the Central Bank to issue a license. In accordance with Article 27 in the Law on Banks

and Banking, a bank shall be registered in the State Register of Enterprises once it has been registered by the Central Bank. This provision contradicts Article 12 in the Law on State Register of Enterprises, which requires the bank to be licensed by the Central Bank before it can be registered in the State Register of Enterprises.

Recommendation: The Law on State Register of Enterprises should be amended so that a bank company can be registered without having first obtained the banking license from the Central Bank.

11. Registration of a Branch

Article 28 in the Law on Banks and Banking requires registration of bank branches. Branches are the same legal entity as the bank and cannot correctly be registered separately.

Recommendation: Article 28 of the Law on Banks and Banking should be amended so that it does not require separate registration of a bank branch.

12. Licensing of a Bank

Licensing requirements to banks are included in the Law on Licensing in addition to the requirements in the Law on Banks and Banking. Article 10 in the Law on Licensing provides that the Central Bank shall decide the licensing procedures for banks and make use of the "complex procedure." The Law on Licensing explains the complex procedure, but this procedure does not apply to banks. The Law on Licensing exempts institutions that are subject to licensing requirements in other laws, such as the Law on Banks and Banking.

Recommendation: The Law on Licensing should be amended by deleting its references to the Central Bank and exempt banks from its provisions. This would clarify the licensing requirements for banks.

13. Bank Representative Agents

Article 15 in the Law on Banks and Banking explains that banks may establish their representative agencies in the territory of the Republic of Armenia and abroad. The Article defines a representative agency of a bank as:

> A separated department that has no legal entity of a bank and is located away from the premises of the bank, represents the bank, studies the financial market, signs contracts on behalf of the bank, and implements other similar activities. The representative agency shall not implement banking and financial functions provided for by this law.

Article 28 of the Law on Banks and Banking requires registration of representative agencies.

A representative office is internationally understood to be a marketing office of the bank that solicits but does not sell the bank's products.

An agent is normally interpreted as a legal entity that can act in the name of the bank and legally bind the bank, but does not itself become a party to the contact with the third person.

It is unclear what the Law on Banks and Banking means by the term "representative agent." It states that it does not have legal entity but enters into contracts on behalf of a bank.

Recommendation: The Law on Banks and Banking should be amended to include a clear definition of the term "representative agent."

14. Restrictions on Significant Ownership

The Law on Banks and Banking restricts significant ownership in a bank without approval from the Central Bank. Article 18 states that:

> A person or interrelated persons may acquire significant participation in the bank's statutory capital through one or a number of transactions only with preliminary agreement of the Central Bank.

This is a useful article in supervising ownership of banks and imposing proper corporate governance, but its effectiveness is undercut by the provision in the Securities Market Regulation Law that allows the use of nominee accounts.

The purpose of a nominee account is to hide the true identity of the shareowner. The cover provided by the nominee accounts will make it impossible for the Central Bank to supervise the ownership structure of a bank.

Recommendation: The provision in the Securities Market Regulation Law that allows the use of nominee accounts should be deleted. Use of nominee accounts should be prohibited.

Comment: New anti-money laundering legislation eliminates nominee accounts.

15. Definition of a Bank Deposit

Article 5 in the Law on Banks and Banking provides the following definition of a bank deposit:

> Banking deposit is the monetary sum provided to a person under established conditions for banking deposit agreement prescribed by the Civil Code of the Republic of Armenia, and which is not provided for guaranteeing undertaking the risk by the depositor, or for leaving a property or rights for the property, compensation for provision of work or services or as means of liability guarantee.

The Civil Code also provides a definition of a bank deposit in Article 902:

> Under the contract of bank deposit, one party (the bank) that has accepted a monetary sum (the deposit) coming from the other party (the contributor) or coming from the contributor, undertakes the duty to return to the depositor the sum of the deposit and pay interest on it on the conditions and by the procedure provided by the contract.

Recommendation: The legal framework should not include differing definitions of the same term. The definition of a bank deposit in the Civil Code is the better version of the two. The Law on Banks and Banking should be amended to delete its different definition of bank deposit.

Comment: CBA disagreed with the assessment and claims there is no confusion regarding deposits.

16. Credit Organization

Credit organizations are financial institutions similar to banks but are not allowed to accept deposits. They are regulated under the Law on Credit Organizations. This law shares many of the same weaknesses as described in the Law on Banks and Banking:

- The contradiction between the Law on State Registration of Enterprises and Paragraphs 3 and 4 in Article 5 of the Law on Credit Organizations regarding when the status of legal entity is obtained;
- The inconsistent definition of a branch in Paragraph 3, Article 5 in the Law on Credit Organization;
- The restriction on significant ownership in Paragraph 1, Article 10 in the Law on Credit Organizations that is undercut by the right to establish nominee accounts in the Securities Market

Regulation Law; and

- The flawed definition of prudential standards in Paragraph 1, Article 12 in the Law on Credit Organizations that mistakenly uses the statutory capital in defining capital adequacy.

Recommendation: Amendments should be made to the Law on Credit Organizations to correct the mistakes and inconsistencies carried over from the Law on Banks and Banking.

Comment: CBA disagreed with draft findings, as per the bank issues reflected above. Specific to non-banks as well, CBA noted that credit unions and savings unions are permitted to mobilize deposits.

17. Micro-Finance

The Law on Credit Organizations has prohibited micro-finance institutions from establishing themselves as foundations. Paragraph 4 in Article 3 of the Law on Credit Organizations requires a micro finance institution to be organized as a limited liability company, joint-stock company, or commercial or non-commercial cooperative enterprise.

The prohibition on organizing as a foundation will likely have an adverse effect on micro finance institutions, bringing them under less favorable tax treatment.

Recommendation: The tax treatment of micro-finance institutions should be considered in light of the social impact of these institutions and the small amounts and operational margins in this line of business. Micro-finance institutions should not be permitted to organize in legal structures that are less suited for their activity. A cooperative structure is probably the most suitable legal structure for a micro-finance institution, at least when the institution requires payment, such as interest, from its borrowers.

18. Bankruptcy of Banks and Credit Institutions

The Law on Bankruptcy of Banks and Credit Institutions (the "Law on Bank Bankruptcy") regulates events when a bank or credit institution is under financial duress and heading toward liquidation.

Paragraph 2 in Article 2 of the Law on Bank Bankruptcy does not allow appeal to courts for review of any decision by the Central Bank that a bank is insolvent.

Recommendation: Accepted rule of law principles dictate that the Central Bank's decision regarding a bank's insolvency should be review able through court appeal. The Law on Bank Bankruptcy should be amended accordingly.

Article 15 in the Law on Bank Bankruptcy allows an Administrator of a bank to terminate contracts that are obviously unfavorable.

Recommendation: Article 16 of the Law on Bank Bankruptcy should not limit the Administrator's right to terminate a contract to situations where the contract is "obviously unfavorable." The Administrator's right to terminate contracts should be amended in accordance with the international bankruptcy principle to provide a broader right to terminate contracts.

Article 16 in the Law on Bank Bankruptcy provides the court with a right to invalidate transactions performed by the bank in certain time periods prior to the appointment of the Administrator.

Recommendation: A right to invalidate transactions conducted in bad faith, regardless of timeframe, should be included in Article 16 to make the rules consistent with international bankruptcy practice in the area of fraudulent conveyances.

19. Bank Supervision

It is important that banking laws set forth the objectives of the bank supervisor. Everything the supervisor does flows from the definition of objectives, and the regulatory framework is interpreted in light of the objectives of the supervisor. This is highlighted in Principle 1 of the Basle Committee on Banking Supervision's Core Principles for Effective Banking Supervision:

> An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organizations.

The banking laws do not provide clear responsibilities and objectives for the Central Bank. The Central Bank Law simply states that its objective is to "provide solvency," without explaining whether that refers to the Central Bank's role as "bank of last resort", the objective to supervise capital adequacy, or both.

Recommendation: The legal framework should be amended to include a clear description of the bank supervisor's (the Central Bank) responsibilities and objectives.

Comment: In general, CBA's view was that regulations and supervisory practices are in compliance with international standards, having worked closely with the IMF and World Bank on all adopted prudential norms. This is particularly true after the FSAP in 2001, which included an assessment of Core Principles and led to new regulations and norms. CBA also claims these are generally consistent with recommended standards and practices of BIS.

20. Exchange of Information

The banking legislation provides very limited access to exchange information with other domestic and foreign supervisors. Article 57 in the Law on Central Bank provides that the Central Bank can:

On the basis of an international agreement signed between the Central Bank and the body in possession of exclusive rights for supervision over the banking activities in a foreign country, the Central Bank may forward to the body in possession of exclusive rights for supervision over the banking activities in a foreign country (national bank or another body) the information it has obtained in the result of on-sight examinations in a bank if that information may be necessary to the latter to implement supervision over the territorial branch of a bank operating in the territory of the Republic of Armenia established in its territory, or to grant the agreement to establish the territorial branch in its territory. The Central Bank may forward the information outlined in this paragraph supra even if it comprises banking or other type of secrecy.

It is important that all domestic and foreign financial supervisors cooperate seamlessly, constantly exchanging information to keep each other abreast of recent developments. The free flow of information between domestic and foreign financial supervisors is of particular importance because banks are allowed to conduct not just banking but also securities business.

Recommendation: The banking legislation should be amended with provisions that allow the bank supervisors to work closely together and exchange information with other domestic and foreign financial supervisors.

Part II – Insurance and Pension Funds

1. The Relevant Laws

The relevant laws regulating the insurance sector are:

- The Civil Code

- The Law on Insurance
- The Law on Licensing

A Law on Bankruptcy of Insurance Companies is presently being prepared but the draft is not available in English translation. Legislation regarding third party car insurance is being discussed, but a draft text for a law has not yet been prepared.

The Insurance Law came into effect on August 1, 2004, and the regulations for this law are being prepared. Regulations for the previous Insurance Law from 1996 are still being used to the extent they apply to the new law.

The legal framework for the insurance sector is limited by several shortcomings:

- The flawed definition of prudential standards in Paragraph 1, Article 20 of the Law on Insurance that incorrectly uses statutory capital in defining capital adequacy;
- The legally inconsistent definition of a branch in Paragraph 10, Article 11 in the Law on Insurance (Comment: this may not be completely accurate according to CBA, as per the banking sector comments above; MoFE did not comment);
- The Law on Insurance does not contain an article that clearly specifies the insurance supervisor's responsibilities and objectives;
- The Law on Insurance does not provide the insurance supervisor with the right to work closely and exchange information with other domestic and foreign financial supervisors.

2. INSURANCE AGENT

An insurance agent is defined in the Law on Insurance as:

> A natural person having entered into employment relationships with the insurers and, on behalf and on the instruction of the insurer, carrying out works connected with conclusion of insurance contracts or certificates with the insurants through explanatory works or other actions not prohibited by the legislation.

The Law on Insurance also provides that:

> Intermediary activity implemented by legal entities or natural persons in connection with concluding insurance contracts with or selling insurance certificates to the insurants on the instruction and on behalf of the insurers shall be prohibited on the territory of the Republic of Armenia. (Paragraph 5 in Article 9)

In most countries, insurance companies pay their agents on the basis of earned sales commissions instead of taking the risk of having to pay salaries to a large number of sales representatives under an employment contract. In Armenia, however, marketing and selling of insurance products through independent agents is prohibited. Instead, the insurance company must employ its sales force. This approach will greatly reduce the use of insurance products in Armenia because insurance companies are not likely to employ the required workforce. Insurance products need to be actively sold by a strong sales force that can create demand for insurance products—they do not sell themselves in the same way a bank's loan products sell. Permitting insurance sales through independent agents will boost use of insurance products and also has the potential to decrease unemployment.

Recommendation: Amend the definition of agent in the Law of Insurance so that it does not require employment by the insurer. Sale of insurance products through independent sales agents should be permitted.

3. Foreign Insurers

Foreign insurers have limited access to the domestic market. Paragraph 6, Article 8 in the Law on Insurance states that:

> The insurance organizations with 49 and more percent of foreign investment shares in their statutory capital cannot implement life insurance, mandatory insurance, mandatory state insurance, as well as insurance of property interests of state and local organizations in the Republic of Armenia.

Selling foreign insurance through a local insurer, agent or intermediary is also prohibited under Paragraph 4, Article 9:

> Concluding insurance contracts or selling insurance certificates on behalf and on the instruction of foreign insurance organizations shall be prohibited on the territory of the Republic of Armenia.

Recommendation: The insurance legislation should be amended to allow for foreign insurance to be sold in Armenia. This would provide consumers with a broader selection of insurers to choose among, increase the price competition, and bring the insurance legislation in compliance with trade regulation such as potential bilateral agreements and WTO standards. The law should at least allow for foreign insurance products to be sold if there is not a similar product in the domestic market.

Recommendation: 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) proper cooperation with the foreign branch's home country insurance supervisor.

Paragraph 2, Article 9 of the Law on Insurance allows intermediaries to sell foreign reinsurance. This provision expresses the right principle, but stands in conflict with the restricted rule in Paragraph 4:

> The insurance broker shall be also entitled to re-insure the insurance risks of the insurers with the foreign insurance organizations. (Article 9, Paragraph 2)

4. Life and General Insurance in one Entity

The Law of Insurance allows an insurance company to sell both life and general insurance. This follows from Paragraph 1, Article 21 that states:

> For the insurers implementing life and non-life insurance, the maximum requirement of the norm defined in the Sub-Item (a) of this Item shall apply.

Recommendation: The Law on Insurance should be amended to require that life and general insurance is provided by separate legal entities. It is necessary to keep separate these two forms of insurance business to ensure that their solvency standards correctly reflect the different risks posed by the two forms of insurance.

Paragraph 2 in Article 21 offers the right approach, requiring that:

> The thresholds of the basic economic norms and the procedure of calculation shall be defined separately for the insurers carrying out life and non-life insurance.

This provision correctly implies that life and general insurance must be organized in two separate legal entities to satisfy the requirement of preparing and maintaining two separate balance sheets.

5. PENSION FUNDS AND PENSION SCHEMES

The Ministry of Finance is preparing a Law on Non-State Pension Security (the "Law on Pension Security") and was planning to deliver this draft law to the first reading in the Parliament in December 2004. (For this analysis, the October 23, 2003 draft law has been reviewed.) The Ministry of Finance explained in our meetings that the text of the draft Law on Pension Security is being revised prior to its introduction. That review should be used to strengthen the October 23, 2003 draft law.

Chapter 6 in the draft Law on Pension Security includes provisions allowing the employer to make contributions to the pension fund. The draft law does not contain any provisions regarding the terms and conditions between the employer and the pension fund (commonly called the pension scheme).

Recommendation: The Law on Pension Security should include provisions regulating the relationship between the employer and the pension fund, such as to ensure the vesting requirements to benefit from the pension fund are clear, participation is open to all employees but is not a condition of employment, etc.

Article 2 authorizes insurance companies, banks and pension funds to offer pension products, but it does not regulate the pension business conducted by either banks or insurance companies. The regulations address only pension funds offering pension products.

Recommendation: The Law on Pension Security should include regulations covering banks and insurance companies that are licensed to market and sell pension products. These regulations should address the entity's solvency (e.g., its ability to meet pension obligations when due, disclosure requirements to inform participants about the pension product and financial status, etc.).

Under Article 9 in the Law on Pension Securities, pension benefits shall be calculated and paid on the basis of a formula prescribed by the bank supervisor, the insurance supervisor, or the securities supervisor.

The law authorizes the pension fund to invest in government securities, securities listed on a stock exchange registered by the Securities Commission, and securities "circulating outside the Republic of Armenia" (Article 42), but it does not include any requirement to ensure the capital adequacy of pension funds.

Recommendation: The Law on Pension Security should be amended to include requirements to ensure the pension fund's financial soundness so that it can meet the future pension obligations as stipulated by the formula described in Article 9.

A Council elected by the members of the pension fund manages the pension fund (Article 25). The Council decides the investment strategy for the pension fund. The Council also elects an Administrator for the pension fund (Paragraph 4 Article 31) and the Administrator is responsible for the daily running of the pension fund. The Administrator can be a person or a company (Article 75).

The law assumes that the pension fund retains an Asset Management Company and states that the Asset Management Company shall implement investment and management functions for the Pension Fund (Article 78). In practice, the Asset Management Company will be much less involved in running the pension fund than is customary practice in other countries, because it is left to the Council to decide on the investment strategy for the pension fund, while the Administrator oversees actual management of the pension fund.

These provisions will cause difficulty for investors who wish to prospectively assess the pension fund's chances for success. Not only do the provisions allow for Council members to change frequently, but also the investment strategy itself may continually be subject to change at the whim of the Council.

Recommendation: Investors need knowledge about the pension fund managers (who they are) and the investment strategy the managers will follow to make informed investment decisions. The Law on Pension Security should include provisions that make permanent the management and investment strategy

of the pension fund. Participants can change their investments to another pension fund at any time to remedy mismanagement and lackluster performance of the fund.

The Law on Pension Security does not contain any tax provisions.

Recommendation: The Law on Pension Security should include provisions that give favorable tax treatment to savings invested in pension funds. Absent this incentive, it would be very difficult to promote pension funds in competition with ordinary investment funds, which allow investors to redeem their investments at any time they choose.

The Law on Pension Securities includes a contradiction in Paragraph 7, Article 40, stipulating a minimum wage based maximum for pension contributions and also stating that pension contributions cannot be confined.

Recommendation: The provision should be clarified to eliminate the contradiction.

PART III – SECURITIES LAW

1. RELEVANT LAWS

The relevant laws for the securities sector are:

- The Civil Code
- Securities Market Regulation Law
- Law on Joint-Stock Company

A Draft Investment Fund Law is also being prepared.

2. THE DEFINITIONS IN THE SECURITIES MARKET REGULATION LAW

Overall, the Securities Market Regulation Law is well drafted and contains all provisions one would expect in a securities law. As described below, some of the definitions should be revised.

a. Definition of Prospectus

Under Article 4, a prospectus is defined as:

> any communication, that is announcement, notice, note, publication, circular, advertisement or message (written, oral, by radio or TV, or other means of communication), which offers to sell security or contains an offer to purchase a security.

This definition contradicts the requirements in Article 10 that specify the information to be included in a prospectus.

Recommendation: The definition of prospectus should be amended to clarify that it is a specific document that must satisfy information requirements provided by the law. A company must publish a detailed prospectus when it is conducting a public offering by issuing and selling securities.

b. Requirement to Publish a Prospectus

Article 6 of the Securities Market Regulation Law exempts several issuers of securities from having to publish a prospectus, such as banks, insurance companies, religious, educational, benevolent, and other non-commercial organizations. Short-term bonds issues are also exempted from the prospectus requirements.

Recommendation: The exemptions from the prospectus requirements do not comply with internationally accepted principles. Article 6 should be amended to delete these exemptions. In addition, short-term bond issuers should be required to publish a prospectus.

c. Beneficial Owner

The definition of beneficial owner in Article 4 incorrectly refers to 10 percent ownership. Article 37 offers a better approach, using the term beneficial owner to describe the real owner of the security.

Recommendation: The definition of the term "beneficial owner" in Article 4 should be amended to make clear that it refers to the person who controls and obtains the benefits from owning the security.

3. Requirements for Broker-Dealer Companies

Article 76 in the Securities Market Regulation Law provides the requirements that apply to broker-dealers. Paragraph 1 states that a broker-dealer should be organized as a partnership or a company.

Recommendation: Article 76 should be amended to provide capital adequacy requirements for broker-dealers because a broker-dealer is allowed to trade securities on its own account under Paragraph 2 of Article 74. 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.

4. Issuers of Securities

a. The Right to Redeem a Share

A put option normally means a contract entered into by a shareowner that gives him the right to sell his share to the seller of the put option at a determined share price at a certain time or within a stipulated period. Article 57 in the Joint-Stock Company Law uses the term to describe a shareholder's right to redeem his share(s) in the company:

The owner of a voting share may put his/her shares back to the Company, demanding that the latter buy back all or a part thereof, if:

- a decision was adopted on Company reorganization, suspension of the right of first refusal, or conclusion of a large transaction in accordance with Paragraph 2 of Article 61 hereof, and if the shareholder in question voted against such decision or did not participate in the vote; or
- the Charter was amended or expanded, or a new edition of the Charter was approved, which limited the rights of the shareholder in question, and if the latter voted against or did not participate in the vote.

Providing a shareholder with the right to redeem his shares runs counter to the concept of shareholding, makes it more difficult for the company to survive through difficult times, and will limit the company's access to loans and credit.

Recommendation: The Joint-Stock Company Law provision in Article 57 giving the shareholders the right to redeem their shares in the company should be deleted.

5. Corporate Governance

a. Payment in kind

Article 42 in the Joint-Stock Company Law allows for payment of shares in kind:

> Company shares can be paid for by means of property, including money, securities and property rights, and intellectual property.

The option to pay in kind is regularly misused by majority shareholders to defraud the company and its minority shareholders because it is difficult to accurately price the value of the asset that is used to pay for the shares.

Recommendation: The option to pay in kind in Article 42 of the Joint-Stock Company Law should be amended so that payment in kind is prohibited. This will help prevent majority shareholder abuse by selling ownership in the company for assets with highly inflated value.

b. Preventing Asset Stripping

The Joint-Stock Company Law includes several articles aimed at protecting minority shareholders by requiring heightened scrutiny in connection with large transactions conducted by the company. The law seeks to prevent fraudulent transactions such as purchasing assets with overstated values or selling assets at understated values.

Company management typically conducts such "asset striping" or "tunneling" practices. Article 59 and the succeeding Articles under the Joint-Stock Company Law require that the board of managers establish the price when the company is buying property. Only when the company is buying property for a value that is equal to 50 percent or more of the book value of the company shall the shareholder's meeting make the decision regarding the purchase.

Since it typically is the management that is conducting the asset stripping of the company, this provision will not effectively prevent fraud. Shareholders must be involved in the decision to ensure that transactions are properly monitored.

Recommendation: Article 59 and its succeeding Articles should be amended to prevent asset stripping by involving the shareholders in purchases or sales from the company. Shareholders' involvement can be either as stipulated by the law through approval in the shareholder meeting, or by giving the shareholders a right to be informed about the transaction and a right to challenge the pricing.

c. Conflict of Interest

Article 64 and its succeeding Articles in the Joint-Stock Company Law regulate several conflict of interest situations. These provisions are useful, but would be more effective if the law were to define "conflict of interest."

Recommendation: The Joint Stock Company Law should be amended to add a definition of the term "conflict of interest" that would effectively protect shareholders.

d. Preferred Share

The Joint-Stock Company Law includes provisions, such as Article 38, regarding preferred shares that are intended to regulate bonds and other types of debt securities:

> If designated by its Charter, a Company may allocate preferred shares with fixed or floating dividends, as well as cumulative, convertible, and other types of preferred shares. The holders of preferred shares do not have a voting right in the Meeting, unless otherwise stipulated by this Law and the Charter for certain classes of preferred shares.

This confusion between preferred shares and debt securities is accentuated in Paragraph 7, Article 38:

> Non-payment of dividends to the holders of preferred shares for a consecutive three-year period may serve as a basis for liquidating the Company in court.

Recommendation: The definition of preferred share in Article 38 of the Joint-Stock Company should be amended to clarify whether it addresses an equity or a debt security. Paragraph 7 should be deleted because three years of not paying dividends on an equity security should not in itself lead to liquidation. In addition, there should not be a requirement to default on payment on a debt security for three years before bankruptcy proceedings can be commenced.

6. SUPERVISION

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

Recommendation: The Securities Market Regulation Law should be strengthened to state that one of the objectives of the securities supervisor is to monitor the financial soundness of broker-dealers and trust managers. Including provisions that provide the securities supervisors with clear legal basis to cooperate and exchange information with other domestic and foreign financial supervisors should also be added to the law.

PART IV – OTHER RELEVANT FINANCIAL LAWS

1. MORTGAGES/COLLATERAL

a. Registration of Mortgage

The relevant laws are:

- The Civil Code
- The Law on State Registration of Rights to the Property

Significant work has been put into building a proper land register. The territory of Armenia has been measured and divided into lots that are registered in the State Register for Real Property. The registration in the State Register is ongoing and it is estimated to be about 60 percent completed. Land titles and mortgages are also registered in the State Register. The law includes provisions addressing conflicts over priority between mortgages and sale of the property to more than one buyer.

A certificate from the State Registry is required to obtain title to a property. Such a certificate is valid for 15 days and only one certificate for that particular property can be issued during each 15-day period. Article 28 of the Law on State Registration of Rights to the Property requires the mortgage holder to agree to a second priority mortgage. This provision is intended to prevent priority conflicts between mortgage holders:

> While registering the right of mortgage, no contradicting documents should be registered without the consent of the mortgagee.

Recommendation: The effectiveness of the State Register on Real Property can be improved by giving legal effect to registration of title and mortgages. The law should state that a person who purchases from the registered owner 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 his registration. Mortgages that are not registered prior to his registration will take lower priority.

b. Foreclosure

Article 249 in 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. 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.

Recommendation: Article 249 should not allow creditors to force a public foreclosure auction. That level of authority runs counter to the principle that land and mortgage registries have legal effect. Legal title can only be bought from the registered titleholder. The judicial system should instead be strengthened so it can process foreclosure actions in an appropriate manner.

2. Movable Property and Leasing

The relevant laws are:

- The Civil Code
- The Law on administration of movable property cadastre, registration of right to movable property and right to lease in leasing contracts
- The Law on administration of movable property cadastre, registration of right to movable property and right to lease in leasing contracts was passed in May this year to allow for providing collateral in movable property. The law has not taken effect because a registry for movable property is not yet established.

The Civil Code provides regulation of leasing and these rules are in harmony with international practice.

Part V – Conclusion

1. Short-term recommendation

Several shortcomings exist in the text of the financial sector laws. Some are more serious and in need of immediate correction, such as the incorrect definition of capital adequacy. The existing laws requiring review and correction are highlighted in this report.

2. Medium-term recommendation

After the corrections to existing financial sector laws are made, the legal framework should be revised to bring it in compliance with the EU directives. This will make the Armenian financial sector more accessible for investors and financial institutions from the EU member countries. This harmonization should be undertaken in several steps, starting with the banking sector.

3. Long-term recommendations

After the banking laws are harmonized with EU directives, the legal framework for the insurance sector and the securities sector should similarly be brought into EU compliance.

ANNEX 12: OVERVIEW OF TAX POLICY IN ARMENIA

The authors of the assessment wish to thank KPMG-Armenia for their help in clarifying existing tax rates and the conditions under which the rates apply.

BOX 12.1: TAX RATES ON FINANCIAL INSTRUMENTS IN ARMENIA

	Personal[145]	Corporate[146]
Interest from bank deposits	Interest earnings from bank deposits are taxed at 10 percent for both Armenian and foreign citizens	Interest earnings combined with other income and taxed at corporate profits tax rate of 20 percent. (Non-resident company pays 10 percent tax.)
Interest expense from bank loans	Individuals can not expense their interest payments.	Companies can expense their interest payments. However, the interest rate should not exceed the double size of the interest rate established by Central Bank of Armenia. If a higher rate is applied the exceeding part will not be allowed.
Interest from government securities	Holders of government securities pay zero percent tax on interest/yields received.	Companies pay 20 percent tax on interest/yields received.
Capital gains when selling government securities	Holders of government securities pay zero percent tax on capital gains received	Company holders of government securities pay 20 percent tax on capital gains received. (The capital gain is not calculated separately. The sales revenue and the cost are combined with other types of income and expenses and the difference is the taxable profit/loss).
Losses when selling government securities	Holders of government securities cannot offset income with losses from sales of securities.	Company holders of government securities can offset income with losses from sales of securities. (The loss is not calculated separately. The sales revenue and the cost are combined with other types of income and expenses, so the loss may be set off against other types of income).
Dividends from equity holdings	Holders of equities pay zero percent tax on dividends received.	Companies pay 20 percent tax on dividends received. (Non-resident companies pay 10 percent.)
Dividends paid by equity issuer	Not applicable.	Issuer dividend payment is treated as cash flow item, therefore after-tax payout.

[145] The rules applied to individuals who are not sole entrepreneurs are listed. The source for all the rules listed in this column is the RA Law "On Income Tax".
[146] The source for all the rules listed in this column is the RA Law "On Profits Tax".

	Personal[145]	Corporate[146]
Capital gains when selling shares	Holders of equities pay 10 percent tax on gross income received from the sale of shares to legal entities. However, if the shares are sold to individuals, zero percent applies.	Holders of equities pay 20 percent tax on capital gains received. (The capital gain is not calculated separately. The sales revenue and the cost are combined with other types of income and expenses and the difference is the taxable profit/loss.)
Losses when selling shares	Holders of equities cannot offset income with losses from sales of shares.	Holders of equities can offset income with losses from sales of shares. (The loss is not calculated separately. The sales revenue and the cost are combined with other types of income and expenses, so the loss may be set off against other types of income.)
Dividends from Open End Funds[147]	Holders of shares pay zero percent tax on dividends received. (There is no law on open end funds.)	Companies pay 20 percent tax on dividends received. (Non-resident companies pay 10 percent.)
Dividends paid by Open End Funds	Not applicable.	Fund payment of dividends considered cash flow item, therefore after-tax.
Capital gains when selling shares in Open End Funds[148]	Holders of Fund shares pay 10 percent tax on gross income received from the sale of shares to legal entities. However, if the shares are sold to individuals, zero percent applies.	Holders of Fund shares pay 20 percent tax on capital gains received. (The capital gain is not calculated separately. The sales revenue and the cost are combined with other types of income and expenses and the difference is the taxable profit/loss.)
Losses when selling shares in Open End Funds[149]	Holders of Fund shares cannot offset income with losses from sales of shares.	Holders of Fund shares can offset income with losses from sales of shares. (The loss is not calculated separately. The sales revenue and the cost are combined with other types of income and expenses, so the loss may be set off against other types of income.)
Dividends from Closed End Funds (see footnote re dividends on Open End Funds)	Holders of Fund shares pay zero percent tax on dividends received.	Companies pay 20 percent tax on dividends received. Non-resident companies pay 10 percent.
Dividends paid by Closed End Funds	Not applicable.	Fund payment of dividends treated as cash flow item, therefore after-tax.

[147] Irrespective of the payers, all the "types" of dividends are treated under the same rules.
[148] Capital gains arising on the sale of any "types" of shares are treated under the same rules.
[149] Losses arising on the sale of any "types" of shares are treated under the same rules.

	Personal[145]	Corporate[146]
Capital gains when selling shares in Closed End Funds (see footnote re capital gains on Open End Funds)	Holders of Fund shares pay 10 percent tax on gross income received from the sale of shares to legal entities. However, if the shares are sold to individuals, zero percent applies.	Holders of Fund shares pay 20 percent tax on capital gains received. (The capital gain is not calculated separately. The sales revenue and the cost are combined with other types of income and expenses and the difference is the taxable profit/loss.)
Losses when selling shares in Closed End Funds (see footnote re losses on Open End Funds)	Holders of Fund shares cannot offset income with losses from sales of shares.	Holders of Fund shares can offset income with losses from sales of shares. (The loss is not calculated separately. The sales revenue and the cost are combined with other types of income and expenses, so the loss may be set off against other types of income.)
Interest/yields on corporate bonds	Holders of corporate bonds pay 10 percent tax on interest/yields received.	Companies pay 20 percent tax on interest/yields received.
Interest/yields paid by issuer of corporate bonds	Not applicable.	Issuer of corporate bond expenses interest as part of operations.
Gains made on sale of corporate bonds	Holders of corporate bonds pay 10 percent tax on the gross income received from the sale of bonds to legal entities. However, if the shares are sold to individuals, zero percent applies.	Holders of corporate bonds pay 20 percent tax on capital gains received. (The capital gain is not calculated separately. The sales revenue and the cost are combined with other types of income and expenses and the difference is the taxable profit/loss.).
Losses from sale of corporate bonds	Holders of corporate bonds cannot offset income with losses from sales of bonds.	Holders of corporate bonds can offset income with losses from sales of shares. (The loss is not calculated separately. The sales revenue and the cost are combined with other types of income and expenses, so the loss may be set off against other types of income.)
Interest/yields on municipal bonds	Holders of municipal bonds pay zero percent tax on interest/yields received	Companies pay 20 percent tax on interest/yields received.
Interest/yields paid on municipal bonds	Not applicable	Not applicable[150]
Gains made on sale of municipal bonds	Holders of municipal bonds pay zero percent tax on capital gains received.	Company holders of municipal bonds pay 20 percent tax on capital gains received. (The capital gain is not calculated separately. The sales revenue and the cost are combined with other types of income and expenses and the difference is the taxable profit/loss.)

[150] Municipal bonds are issued only by Local Self-governing Authorities (municipalities)

	Personal[145]	Corporate[146]
Losses from sale of municipal bonds	Holders of municipal bonds cannot offset income with losses from sales of bonds.	Company holders of municipal bonds can offset income with losses from sales of bonds. (The loss is not calculated separately. The sales revenue and the cost are combined with other types of income and expenses, so the loss may be set off against other types of income.)
Non-life insurance expense	Not applicable.	Companies can expense insurance as normal part of operations.
Life insurance expense	No tax benefit for individuals to purchase life insurance.	No tax incentive for companies to purchase life insurance for employees.
Payroll deduction	Employees pay 3 percent of gross salary to PAYG pension/social insurance fund.	Companies pay variable percent of employee salaries/payroll to PAYG based on level of payroll.
Interest income on Financial Lease[151] received by Lessor	Not applicable.	Income taxed at normal corporate rate (20 percent).
Interest expense on Financial Lease paid by Lessee	Not applicable.	Installment payment is deductible.
Provisions for Losses on Financial Lease for Lessor	Not applicable.	Cannot expense provisions.
Losses on Lease Contract for Lessor	Not applicable.	Can be treated as expense.
Provisions for Losses on Financial Lease for Lessee	Not applicable.	Cannot expense provisions.
Discount of Factoring Package when sold	Not applicable.	Discount expensed as part of normal operations.
Earnings from Factoring Package when brought to maturity	Not applicable.	Earnings taxed at normal corporate tax rate of 20 percent.

[151] No real financial lease or factoring market, so tax policy not really in effect.

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www.imf.org

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www.armstat.am/

Organization of Economic Cooperation and Development

www.oecd.org

Transparency International

www.transparencyinternational.org

Universal Postal Union

www.upu.int

USAID Armenia Social Transition Program PADCO
www.padco.am/

World Bank

www.worldbank.org

ANNEX 14: LIST OF MEETINGS

Group 1: GOAM, Armenian Private Sector	Group 2: USAID, US Mission	Group 3: ILA, Donor Community
Government of Armenia: Mr. David Avetissian (Deputy Minister of Finance, Republic of Armenia Ministry of Finance and Economy) 1 Melik-Adamyan, Yerevan, Armenia Tel: 595-277 avetissian@mfe.am Mr. Tigran Khachatrian, Deputy Minister of Finance, Republic of Armenia Ministry of Finance and Economy) 1 Melik-Adamyan, Yerevan, Armenia Tel 595-223 khachatrian@mfe.am Mr. Ashot Gomtsyan (Head of Insurance Department, Republic of Armenia Ministry of Finance and Economy) 1 Melik-Adamyan, Yerevan, Armenia Tel 595-341 ash_gomtsyan@mfe.am Mr. Gordon Dowsley (Advisor to Deputy Minister of Ministry of Finance and Economy) 1 Melik-Adamyan, Yerevan, Armenia Mr. Karen Tamazyan (Director, Department of Financial Market Development and Currency Regulation, Republic of Armenia Ministry of Finance and Economy) 1 Melik-Adamyan, Yerevan, Armenia Mr. Arshalujs Margaryan (Head of Public Debt Department, Ministry of Finance and Economy) 1 Melik-Adamyan, Yerevan, Armenia Tel: 595-235 Mr. Vache Gabrielyan	Robin Phillips, USAID Mission Director Karl Fickenscher, USAID Deputy Mission Director Mr. Thomas Morris (Director, USAID Office of Economic Restructuring and Energy) 18 Baghramyam ave., Yerevan,. Armenia Tel: 529-975, 569-656 tmorris@usaid.gov Dr. Michael Blackman (Deputy Director, USAID Office of Economic Restructuring and Energy) 18 Baghramyam ave., Yerevan,. Armenia Tel: 529-975, 569-656 mblackman@usaid.gov Mrs. Haikanush Bagratunyan (USAID Program Management Specialist) 18 Baghramyam ave., Yerevan. Armenia Tel: 529-975, 569-656 hbagratunyan@usaid.gov Mr. John Caracciolo, (USAID MSME Advisor) 18 Baghramyam ave., Yerevan,. Armenia Tel: 529-975, 569-656 ccaracciolo@usaid.gov Mr. Karoly Okalicsanyi (USAID Economic Advisor) 18 Baghramyam ave., Yerevan,. Armenia Tel: 529-975, 569-656 kokalicsanyi@usaid.gov Mrs. Diana Avetyan (USAID Program Management Specialist)	Mr. Nerses Karamanukyan (IFC Resident Representative) 9 V. Sargssyan street, Yerevan, Armenia Tel: 54-52-43 Mr. James McHugh (Resident Representative, Republic of Armenia, International Monetary Fund) 1 Melik-Adamyan, Yerevan, Armenia Tel: 52-89-60 jmchugh@imf.org Mr. Karapet Gevorgyan (Local Representative/ Economist, KfW) 39/12 Mashtots ave., Yerevan, Armenia Tel 56-32-88, (09) 40-54-74, k.gevorgyan@netsys.am Mr. Roger Robinson Resident Representative World Bank Office Ms. Lia AghamyanMr. Karen Grigorian (Economist, PREM, Europe and Central Asia, The World Bank) 9 V. Sargssyan street, Yerevan, Armenia Tel: 523-992, 520-992 kgrigorian@worldbank.org Mr. John Vartanian (Chief of Party, USAID Capital Markets Project, Bank World Inc.) BankWorld, Tel: 409-187 Mr. Fred Van Antwerp (Chief of Party, USAID Local Government Program, The Urban Institute) 13 Khandjyan street, Yerevan,

(Board Member, Central Bank of the Republic of Armenia) 6 V. Sargsyan street Tel: 589-611 vache@cba.am Mrs. Gayane Matevosyan (Head of Financial Market Open Operations Department, Central Bank of the Republic of Armenia) 6 V. Sargsyan street Tel: 545-088 Mr. Armen Sargsyan (Head of Payment and Information Systems Development Department, Central Bank of the Republic of Armenia) 6 V. Sargsyan street Tel: 561-121 sarmen@cba.am Mr. Nerses Yeritsyan (Advisor to the Chairman of the Central Bank of the Republic of Armenia) 6 V. Sargsyan street Tel: 545-088 Mr. Artem Asatryan (Head of Department of Social Insurance and Pension Security, Republic of Armenia Ministry of Labor and Social Insurance) Repiblic Square, Government House 3, Tel: 520-448 asatryan@mss.am Mr. Frunzik V. Mousheghyan (President, State Social Insurance Fund Republic of Armenia) 13 Nalbandyan street, Tel: 52-48-14, (09) 40-30-11 Mr. Haroutyunyan Ara (Deputy Chairman, State Social Insurance Fund Republic of Armenia) 13 Nalbandyan street, Tel: 52-45-74 Mr. Edward Mouradyan	18 Baghramyam ave., Yerevan,. Armenia Tel: 529-975, 569-656 davetyan@usaid.gov Mrs. Rene Esler (USAID Social Sector Specialist) 18 Baghramyam ave., Yerevan,. Armenia Tel: 529-975, 569-656 resler@usaid.gov David Brown Contracting Officer Edward La Farge Senior Water and Energy Adviser Vardanyan, Marina Program Management Specialist Manukyan Anna General Support McDonald, Kathleen DSRO Office Director Koldys, Gregory Senior Democracy Advisor Nollan, Nancy Senior Social and Health Advisor Bruno, Nicholas Health Advisor Markarian, Bella Project Management Specialist	Armenia Mr. Arthur Drampian (Senior Resident Advisor, USAID Local Government Program, The Urban Institute) Mr. Craig Hart (Director, US Peace Corps Armenia) Mrs. Meredith Dalton (Administrative Officer, US Peace Corps Armenia) Mr. Arshak Hovhannisyan (Business Education Community Development Manager, US Peace Corps Armenia) Mr. Vladimir Kazanchev First Secretary, or Councellor Embassy of Russian Federation Ms. Elaine M. Conkievich Deputy Head OSCE Office Mr. Klaus Teufel Junior Expert GTZ (58-93-37) Mr. Avetik Nersisyan Assistant Representative FAO (52-54-53) Ms. Lise Grande Resident Representative UNDP Office Mr. Muzaffar Chouldhery WFP Office Mr. Alexis Loeber Delegation of the European Commission (57-71-97) Mr. Ara Hovsepyan

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Armenian Private Sector:		
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ANNEX 15: ACRONYMS

AAAA	Association of Accountants and Auditors of Armenia
ABA	Armenian Bankers' Association
ACCA	Association of Chartered Certified Accountants
ACRA	Armenia Credit Rating Agency
ALM	Asset-Liability Management
AML	Anti-Money Laundering
ATM	Automated Teller Machine
BIS	Bank for International Settlements
CALE	Capital, Asset quality, Earnings, Liquidity
CAMELS	Capital, Asset quality, Management, Earnings, Liquidity, Sensitivity to market risk
CAR	Capital Adequacy Ratio
CBA	Central Bank of Armenia
CFT	Combating the Financing of Terrorism
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
DCA	Development Credit Authority (USAID)
EBRD	European Bank for Reconstruction and Development
EU	European Union
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FIU	Financial Intelligence Unit
GAAP	Generally Accepted Accounting Principles
GAF	German-Armenian Fund (KfW)
GDP	Gross Domestic Product
GNI	Gross National Income
GoA	Government of Armenia
GTZ	Gesellschaft fur Technische Zusammenarbeit
HSBC	Hong Kong Shanghai Bank Corporation
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IBRD	International Bank for Reconstruction and Development
IFAC	International Federation of Accountants
IFC	International Finance Corporation (IBRD)
IFIs	International Financial Institutions
IFRS	International Financial Reporting Standards
IFS	International Financial Statistics
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISA	International Standards of Auditing

IT	Information Technologies
KfW	Kreditanstalt fur Weideraufbau
MEBO	Management Employee Buyout
MFIs	Microfinance Institutions
MIGA	Multilateral Investment Guarantee Agency (IBRD)
MIS	Management Information Systems
MoFE	Ministry of Finance and Economy
NARA	National Association of Realtors and Appraisers
NBCOs	Non-Bank Credit Organizations
NBFIs	Non-Bank Financial Institutions
NGOs	Non-Governmental Organizations
NPLs	Non-performing Loans
NSS	National Statistical Service
OECD	Organization for Economic Cooperation and Development
OPIC	Overseas Protection Insurance Corporation (USG)
OSCE	Organization for Security and Cooperation in Europe
PAYG	Pay-As-You-Go
POS	Point of Sale
PPP	Purchasing Power Parity
RAAS	Republic of Armenia Accounting Standards
RoAA	Return on Average Assets
RoAE	Return on Average Equity
RTGS	Real Time Gross Settlement
SMEs	Small and Medium-sized Enterprises
SOEs	State-owned Enterprises
SRO	Self-Regulatory Organization
SSIF	State Social Insurance Fund
SWIFT	Society for Worldwide Inter-bank Financial Telecommunication
UBPR	Uniform Bank Performance Report
UNDP	United Nations Development Program
USAID	United States Agency for International Development
USDA	United States Department of Agriculture
VAT	Value Added Tax