

Armenian International Policy Research Group Seminar Series

Armenian Banking Sector

Issues Note

What makes a financial sector important for the overall economy?

- Financial sector development promotes growth (see, for instance, King and Levine (1993) and Levine (1997)), therefore contributing to the reduction of poverty (Dollar and Kraay (2001)).
- Not only the financial sector helps to create employment in other sectors of the economy, but it also creates a safe haven for household deposits, remunerating them against loss of value caused by inflation.

Where does Armenia stand in terms of its financial sector development? How important a role the financial sector plays in development of Armenian economy?

- Armenia's banking system is by far the largest and most important component of the financial system (hence the focus of the note). In spite of this, the banking sector remains very small compared to the size of the overall economy: total loans comprised 10 percent and total deposits comprised approximately 13 percent of GDP in 2001. Contractual savings (i.e., insurance companies and pension funds) and capital market related financial institutions are underdeveloped. The network of micro-finance and rural credit institutions is not extensive enough to satisfy the demand for credit generated by the SME's and farms in rural areas.
- The population in general have little contact with the banking system either by means of depositing their savings or by means of borrowing. With virtually no cash-flow-based lending taking place, loans are heavily collateralized. Margins of lending remain significant, suggesting high administrative costs and inefficiencies. Gradual reduction of the volume of T-bills offered on the market, led to reduction of (risk-free) interest earnings. New services are developing extremely slowly: a system of credit cards – ArCa - was introduced only recently. In recent years, some banks have successfully tapped the market of private transfers from abroad, which became a significant source of revenues.

What are the problems facing the banking system in Armenia?

- Despite the fact that the reported aggregate data points to a relatively healthy system, severe weaknesses and vulnerabilities remain. In particular, they relate to (1) a generally weak credit culture, including inadequate credit evaluation methodology, (2) lack of rigorous monitoring and management practices, and, in the presence of a highly dollarized economy, (3) sizable foreign currency exposure to borrowers engaged in production of non-tradable goods and services and those without access to foreign markets (i.e., without foreign currency earnings).

Macro

- In general, the banking sector enjoys the fruits of macroeconomic stability – issues related to exchange rate and price stability are considered as less worrisome. However, macroeconomic stability itself is not sufficient to generate a well functioning financial system (i.e., is only a necessary condition).

Legal and Regulatory

- The key laws governing the system are the Law on the Central Bank and the Law on Banks and Banking activities. Other laws relevant for the sector are Law on Bankruptcy of Banks and the Law on Secrecy.
- Judging by the level of technical advancement and ability to lead the banking system, the CBA is relatively advanced. The Banking Supervision Department has received substantial Technical Assistance, including through foreign resident advisors based in Yerevan. Supervisors generally receive training in terms of short courses abroad. However, as the compensation level of supervisors lags somewhat behind that of private bankers – a proxy for supervisory quality – potential problems in the incentive structure remain.

State Control

- Although state ownership of banks is not an issue in Armenia (because until its privatization recently only the Savings Bank was majority state-owned), interventions by government officials in credit allocation in the past had had impact on the quality of (the stock of) outstanding loans (e.g., energy sector).

Problems related to the asset side of the balance sheet

- The small size of most banks preclude them from attaining economies of scale. This also prevents the banks from incurring (large) fixed costs of technological modernization, etc.
- Perceived systemic risks (measured by country and currency risk premiums) preclude interest rates from dropping, leaving the level of real interest rates prohibitively high for investments. The current interest rate structure is likely to attract either projects with very high rates of return, or crooks! All others in between will be unable to borrow.
- Issues related with transfer of ownership (i.e., repossession and realization) of collateral contribute to conservatism in lending decisions by banks. In addition, absence (or weakness) of secondary markets for some assets predominantly used by enterprises as collateral (such as buildings, productive assets, etc.) make banks accept these types of collateral at a heavy discount, further reducing enterprises' ability to borrow.
- The credit culture is under-developed. The long term implications of non-payment of bank loans are negligible, which encourages imprudent behavior from borrowers' side.

- Connected lending seem to be a major issue. The monetary authorities have managed to achieve only partial success in curbing insider borrowing. Most of it is being done through related party lending and proves difficult to track down.
- Anecdotal evidence suggests that bank officers require kick-backs in return to issuing loans to borrowers. This effectively raises the costs to borrowers and may discourage them from financing otherwise viable projects through bank lending. Especially worrisome is the situation with low interest rate loans from international donors (which are being channeled through local commercial banks): lower interest rates that these loans typically carry leaves more room for kick-backs to be demanded from the borrowers.

Problems related to the liability side of the balance sheet

- Low level of private savings and, as a result, weak supply of deposits.
- Low confidence in the macroeconomic and financial sector stability, perceived currency risks and high dollarization (see Table 1).
- Lack of banking culture and experience in dealing with banks.
- Perception of mismanagement and corruption in the banking sector.

Performance in 2001

- Despite continuing accumulation of deposits (17 percent in nominal terms in 2001), the system is said to have incurred losses in the tune of 21.5 billion Dram (\$38 million). Total 13 banks reported profits, which 17 bans registered a loss.

What are the underlying causes of recent bank runs in Armenia? Were these developments expected?

- The issues related to quality of bank portfolio – which have been masked for a number of years by weak supervisory control and fraudulent practices of bankers – are coming to haunt the banking system. The most notorious of these is the commonly used practice of rolling over non-performing loans, which enables banks to inflate the balance sheet and overstate performance. Since some of these loans are not going to be paid off, these problems would eventually wipe off bank's capital, once the loan quality is taken into account.
- This run on weak and problem banks could result in a financial contagion, i.e., run on banks that are otherwise in good shape.
- At present, 11 banks are under temporary administration appointed by the CBA. In two of these cases the CBA withdrew banks' licenses. Another seven banks are showing signs of problem banks.
- Following the recent events, inter-bank credit market is virtually non-operational. For their liquidity management needs, the banks are dealing primarily with the CBA (and rationally so) to avoid excessive risks.

Are recent developments in Armenian banking sector likely to have a large impact on economic growth?

- To the extent that the size of the banking system - measured by the amount of credit it channels to productive activities – is relatively small, large scale bank runs are unlikely to create a sharp decline in real activities (i.e., production of goods and services). However, to the extent that this will shatter the confidence of general public in the ability of authorities to prevent loss of their deposits, this may result in loss of confidence in the overall financial system and may lead to social unrest, if not handled properly.
- Is there a political constraint for the authorities in their attempt to disclose the true extent of problems in the banking sector prior to presidential elections in 2003?

What are the potential ways out of this?

In the short run

- Could confidence boosting measures (to be undertaken to educate the general public about the state of affair in the banking system) prevent runs on otherwise healthy banks?
- Sanctions against certain managers and members of boards of directors should be taken, a measure that is likely to improve the confidence in the system.
- Any interventions by the state officials (either acting in private or official capacity) to direct credit should be brought to light to prevent such acts in the future. Individuals responsible for recent fraudulent activities should be brought to justice.

In the long run

- Once the short-run measures are undertaken, the CBA should take measures to improve accountability of bank management and owners. Tightening prudential control itself may not be effective unless bank owners and managers are called to justice for embezzlements and made personally liable for their actions. Reason: as long as $Assets > Equity$, the owners have incentives to tamper with assets of the bank and be liable only to the extent of their equity.
- Yet, at present, all measures taken by the CBA in this direction are likely – as it happened in the past - to be overturned in commercial courts. Therefore, authorities should strengthen the role of the CBA by strengthening its ability to revoke licenses, initiate legal proceedings against faulty managers and owners.
- Swift measures should be taken to consolidate the banking system – the current minimum capital requirement of \$1.65 million for existing banks is still too low. Recent empirical studies clearly show that consolidation is beneficial for the health of banks and banking sector in general.
- The CBA should continue its efforts to attract best practitioners to join its Banking Supervision Department.

Table 1**Armenia: Indicators of Financial Sector Development and Dollarization, 1997-2001**

	1997	1998	1999	2000	2001
	(in millions of Drams)				
Foreign exchange (FX) deposits	23,567	37,975	52,257	108,489	125,044
Dram deposits	9,084	16,167	13,678	19,513	24,673
Total deposits	32,651	54,142	65,935	128,002	149,717
Reserve money (RM)	50,550	53,839	53,853	72,390	80,369
Broad money (BM)	70,247	95,512	108,545	150,599	171,046
<i>Indicators of Confidence and Financial Sector Development</i>					
Money multiplier (=BM/RM)	1.39	1.77	2.02	2.08	2.13
Total deposits/Broad money	0.46	0.57	0.61	0.85	0.88
<i>Indicators of Dollarization</i>					
FX deposits/Total deposits	0.72	0.70	0.79	0.85	0.84
FX deposits/Broad money	0.34	0.40	0.48	0.72	0.73
<i>Interest Rates 1/</i>					
Dollar deposits (6 months)	27.4	23.6	22.0	18.0	11.0
Dollar loans (6 months)	51.7	39.4	30.4	32.7	...
T-Bill yield (21-30 week maturity)	48.9	46.2	49.0	24.8	17.0

Source: Central Bank of Armenia; and own calculations.

1/ End of period annualized rates. Numbers for 2001 are preliminary.