Strategic Requirements for Next Stage Financial Sector Reform in Armenia

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The paper examines the issues and challenges facing financial sector development in Armenia. It notes that Armenian banks are small and are only able to serve small and medium-sized enterprises. The paper sets out general recommendations for financial sector reform, as well as more specific recommendations with regard to the banking and insurance sectors, securities markets, and pension reform. The paper also touches more general structural challenges faced by Armenia, including high poverty, a weak business environment, the need to strengthen corporate governance, and train the judiciary in commercial affairs.

I. Introduction

Significant work has been carried out in the field of financial sector development in Armenia in recent months. The International Monetary Fund (IMF) and the World Bank have updated the earlier Financial Sector Assessment Program, while USAID has financed a comprehensive financial sector assessment to review developments in banking, non-bank credit, insurance, pension reform, and securities markets. Throughout the process, the Central Bank of Armenia (CBA) has led the policy and reform effort in building stable structures for the financial sector and economy. The Ministry of Finance and Economy and other parts of the central government have likewise been engaged in activities that focus on insurance and pension reform, property registry development, and legal reform.

This paper looks at some of the issues and challenges for the next stages of financial sector development in Armenia. As with any other market, such issues cannot be evaluated in a vacuum and must account for the real sector, public sector performance, and general institutional issues of transparency, accountability, trust, and confidence. Poverty remains endemic. Corporate governance standards and facets of the business environment are often weak. Tax evasion and avoidance are high. Perceptions of political risk and the associated risk premium of investing in Armenia remain high. All of these and other factors have a major impact on investor, creditor and deposit confidence and, hence, financial sector development. Nonetheless, this short paper focuses strictly on the financial sector

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challenges and only references related areas of importance as they link to the financial sector theme.

II. BASIC CHALLENGES

A. A Snapshot of Banking Sector Challenges and Risks

The banking system is the main part of the formal financial system, accounting for about 90 percent of assets and most recorded income. This is not because the banking system is large. In fact, bank assets are small as a share of Gross Domestic Product (GDP), after-tax earnings were less than US$20 million for the entire system in 2004, and intermediation levels remain low as they are in most other Commonwealth of Independent States' (CIS) markets. Nonetheless, the banking system is the core of the formal financial system, and any future view of financial sector development must account for its primary role and its continued stability.

There have been many favorable trends in the banking system. After years of instability, the banking system has shown signs of greater stability in recent years, largely due to efforts of the CBA to instill discipline. The system's key prudential ratios are sound, and banks are broadly in compliance with CBA requirements concerning capital adequacy, asset quality, liquidity management, and market risk exposures. Meanwhile, financial intermediation is growing, albeit from a small base of about 15 percent in 2004. Much of this latter trend is tied to improving perceptions of stability, as households in particular have increased their deposits with the banks. This, in turn, helps banks identify new clients who are credit worthy, often salaried, employees, small business owners, or people and/or families benefiting from regular remittance flows from Russia or other markets.

Notwithstanding these favorable trends, funding remains a challenge for the banks. This is largely due to the unwillingness or inability of enterprises to place funds with the banks in a largely cash-oriented business environment. In late 2004, enterprise deposits with the banks were only about US$203 million-equivalent. This not only constrains funding, but also limits other income-generating opportunities for the banks. In effect, one of the key problems is enterprise disenfranchisement from the banking system (and larger formal system). Small as the enterprise sector may be in Armenia, its participation and involvement is a key foundation for future growth and modernization of financial services. In this regard, reforms in tax administration and protocols for account garnishing may be needed for enterprises to have greater confidence in their own account confidentiality at the banks. This is largely rooted in the issues surrounding tax administration and collection, which go beyond the scope of banking and finance.

Net of enterprise deposit weaknesses, there is limited non-deposit funding in the banking system. There is little access (if any) to the syndicated loan market. Subordinated debt and other mezzanine instruments have not been introduced in the securities markets. Private placements may occur, but these have not been reported as key liabilities for term funding for the banks. Likewise, capital levels are generally small, with only a few banks comfortably above Armenia's low minimum capital requirements. Thus, overall, funding sources are thin in Armenia, which limits the quantum of earning assets.

Beyond the funding challenge, most banks face asset management challenges for future earnings growth. On the positive side, loans have increased. This is the result of rising resource mobilization, as well as the shift in resource allocation to loans as earnings on government securities have declined. This is particularly favorable for two key reasons: (1) rising access to finance for households and small businesses and (2) credit allocation well within prudential concentration limits, reducing some of the risk to the portfolio and capital that might otherwise occur in the event of default on large exposures.

There are, however, numerous challenges facing banks (and others) regarding credit risk and asset management. These can be viewed broadly at the "macro" and "micro" levels. First, at the macro level, useful data and information on industries, sectors, and other segments of the market are in short supply and questionable veracity. This makes it difficult for banks to evaluate systematically market prospects and targets and to design financial products and services needed by potential clients. Second, banks have been unwilling to participate in the proposed credit bureau to improve their information on prospective borrowers. These macro weaknesses make it more difficult for banks to evaluate borrowers and transactions, whether loans should be approved, and what the risk premium, loan pricing and loan structure should be if approved.

At the micro level, credit risk-management capacity at the banks is considered insufficient. Part of this is due to the macro constraints associated with inadequate information; however, some of it is also considered to be due to internal weaknesses and systems that would still exist even if adequate market information was abundantly and systematically available. Second, without adequate market information and credit risk-management capacity, there is obviously weakness in terms of portfolio-management capacity. Thus, not only are underwriting standards questioned, but capacity to structure portfolios, measure for systematic risks (covariance), assign probabilities to potential default losses, adequately allocate contingency reserves for unexpected losses, and generally present credible risk-adjusted return on capital (RAROC) or equity (ROE) targets is not there. This raises doubts about banks' strategic plans, and whether their RAROC and/or ROE targets (if they exist) are sound. In general, the view is that banks often fail to capture opportunities due to weaknesses in risk measurement and management, reducing access for credit-worthy real sector borrowers while limiting earnings opportunities for banks.

Lending is also challenged by imperfections in the secured transactions framework, as well as the inability of many small borrowers to comply with bank underwriting requirements. Secured transactions are undermined by fragmented and incomplete property registries and traditional judicial protection of borrowers. Loan recovery through the court system has been difficult for banks. The inability to enforce judgments in many cases has been due to endless debtor appeals, flawed registration and title (without clear links to true owners), mobility and/or emigration and asset stripping, and allegations of corruption in the court system. Even with improvements, many businesses lack adequate assets to pledge for anything but low levels of working capital. The low level of reported assets reduces the collateral coverage of loans, thereby reducing loan amounts and maturities. In addition to low volumes of assets reported, there is limited variety of desirable collateral, usually apartments and vehicles. These problems constrain the willingness of banks to make loans and add to the overall risk premium when loans are approved.

Another legal weakness relates to loan restructuring. The insolvency framework for enterprise and debt restructuring is underdeveloped and, therefore, of limited use for debt resolution and contract enforcement issues. The judiciary is not experienced in this domain, and there has been little exposure and training. This will be important in the future if banks are to seek out medium- and large-scale enterprise sector loans (including via syndications). Until such weaknesses are resolved, banks will have little incentive to make loans, even if they can within house or regulatory concentration limitations.

Beyond that, banks show low levels of non-credit income. This partly reflects limited product and service development to date, as well as the low level of participation by medium- and large-scale enterprises in the banking system. In many functioning bank-oriented markets, banks provide a range of financial services for companies. These routinely include cash management, payroll services, custodial operations, foreign-exchange trading, trade-finance products, and other offerings. In Armenia, banks are only beginning to introduce some of these services, and most of these are geared to households and small businesses whose demand for such fee-based services may be constrained by size. Moreover, there is no active hedging or derivatives market in Armenia, and banks have not engaged in loan sales or active syndication. As long as these trends remain in effect, banks' opportunities to increase returns from non-credit activities will be limited, which will also raise their individual risk profiles due to the concentration of earnings from their loan portfolios.

On the other hand, there is a risk that banks will want to become "universal" because of the small market and limited opportunities for earnings. While not intrinsically good or bad, banks in Armenia have enough challenge mastering core fundamentals of banking. Adding other lines of business will raise their risk profile unless they can demonstrate management capacity and systems to ensure non-bank risk exposures do not undermine the underlying solvency of the bank. This is a particularly important concern with the imminent introduction of a deposit-guarantee scheme. This process can be facilitated with consolidation of the banking system, strategic investment from investment-grade institutions for skills and systems transfer, and/or the presence of foreign branches to induce more competition and increase product offerings and service levels.

There is also a risk of adverse selection in lending markets. As banks move away from government securities and towards real sector lending to increase earnings, there is a risk they will all do so at the same time. This may induce rate competition that squeezes margins, a flight to lower quality loans, and/or assumption of higher risk loans without adequate loan interest charges to compensate. At a minimum, it will be essential that banks have reasonable estimates of the probability of default and that their provisioning practices reflect this. It will also be important for the CBA to monitor efforts by banks to bid up deposit interest rates for longer-term funds at a time when loan rates may decline due to competition. As of late 2004, banks had not shown this kind of behavior; however, there is a risk of this occurring for banks to obtain funds for periods of longer than one year to more easily originate housing and/or commercial property loans and other term exposures.

An increase in term lending by the banks (as needed for investment in the small- and medium-sized enterprise (SME) sector) could introduce interest rate risk, as well as obvious maturity mismatches and potential foreign exchange risk. Banks have been increasing their consumer lending, with maturities often running for up to three years. Likewise, there has been some housing-sector lending for up to seven years. Both of these present possible risks relative to the predominance of the funding base, which is for nine months or less, but there were no serious maturity mismatches or interest rate risks currently reported, as most loans are short-term and the interest rate environment has been improving. Nonetheless, it is a potential risk, and banks will need to learn how to manage these mismatches and open positions over time.

The following Box captures some of the weaknesses and challenges facing the banks as of late 2004-early 2005.

Box 1: Snapshot Weaknesses and Challenges in the Armenian Banking Sector

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

Source: *Financial Sector Assessment of the Republic of Armenia*, *Emerging Markets Group under contract to USAID, 2005*

In the end, the banking system does not have the full capacity to handle increased financial inflows. There are few instruments available in Armenia for improved liquidity management (let alone long-term investment). Credit risk remains high due to limits on transparency and creditor protection. Capital markets are underdeveloped. Other markets like real estate and property development are primarily cash-based, notwithstanding recent increases in this area by the banks. In general, banks have little experience with portfolio and investment management, and are sufficiently challenged by fundamental credit management.

B. General Non-Bank Challenges

Insurance

The Armenian insurance sector is underdeveloped. Armenia is among the smallest of insurance markets in the world, with an estimated density per capita of less than US$2 and annual premium revenues per active company of about US$205,000.

While reforms are under way, a weak insurance framework translates into the absence of institutional investors. Insurance companies are needed as institutional investors for capital markets development, private placements, improved governance in financial institutions, and strengthened financial discipline in companies. For this to be achieved, adequate laws, regulation, and supervisory capacity will need to be in place. The Ministry of Finance and Economy regulates the insurance sector, though not very actively. Its budget in 2003 was reported to be US$12,000. Moreover, there is little useful information or reporting, making it difficult to conduct off-site surveillance. Staff training is needed for skills development.

As the country moves ahead with modernization, the insurance framework will need to be brought closer to global standards, including coordination on a cross-border basis. At the moment, underdevelopment of the insurance sector constrains business and financial sector development, though it presents no known systemic risk under current conditions.

Pension Reform

Armenia has an unsustainable pay-as-you-go pension system, although reforms are being discussed. Reform will eventually help with fiscal issues as well as with the gradual development of institutional investment in the economy; however, this is likely to be a long-term challenge as it takes time for capacity and systems to develop and assets to accumulate.

For pension reform to be effective, it will require institutional investors, management and custodial capacity, new and longer-term financial instruments, and improvements in the way Armenia’s securities market currently functions. Broad improvements in governance, management, transparency, accountability, and consumer protection will be needed.

There may not be much impact of pension reform in terms of lending and investment in the near term; however, if a sound legal and regulatory framework is introduced and regular contributions can be generated, privately managed pension funds should evolve over time. As of late 2004, the government had not yet agreed on the legal, regulatory or institutional requirements needed for a reformed pension system.

In the meantime, there are the continued risks and challenges of leakage and opportunity cost. In terms of risk, the current social insurance system is based on such small disbursements that few want to contribute in the first place. This contributes to tax evasion and contribution avoidance from employers and employees alike. Such a system also encourages informality and serves as a disincentive to formal employment. Reports of leakage add to the issue of accountability and public confidence in the system.

Beyond this, there is an issue of opportunity cost. Pension funds (second and third pillar) and insurance companies play a major role in driving product development and innovation in the securities markets, while also serving as a major source of term liquidity for banks. As an example, Chile's institutional investors (largely pension funds) provide about 20 percent of their assets to the banking system for housing loans. The result has been the only effective mortgage-backed securities market in Latin America. Thus, there is an opportunity cost to Armenia's economy and financial system in holding back pension reform. This is particularly relevant given Armenia's interest in developing primary and secondary housing finance markets.

Securities Markets

Armenia's capital markets are underdeveloped. Market turnover was estimated to be about US$700,000 in 2003, equivalent to less than US$3,000 per trading day. Domestic investment in securities is generally limited to T-bills and notes, with new annual issuance of less than US$80 million in 2003-04. There are no corporate bonds, municipal bonds, mortgage bonds, or active equities trading. Only a handful of companies are in a position to issue corporate bonds, and these companies can borrow from foreign banks more cheaply than the costs and disclosure associated with bond issues.
Moving forward, commercial banks are expected to be among those that will be able to list and issue bonds to obtain long-term funding for mortgage finance, leasing, and other credit activities that exceed one year terms; however, this will require higher levels of transparency and disclosure to meet market standards. This is particularly important if Armenian firms (financial or otherwise) want to benefit from cross-listings on other exchanges. As of early 2005, this has not been possible.

In general, there is no real capital markets culture in Armenia. The corporate sector's financing needs have traditionally been met by bank loans or from other channels, reducing the demand for financing from capital markets. There has been no active tradition of listing on securities exchanges or meeting meaningful disclosure requirements to trigger corporate debt or equity activity. All of this will need to change for securities market development to occur and for Armenian firms to be able to use this mechanism to raise capital.

Non-Bank Credit Institutions

The non-bank credit market is small. There is significant investment in housing and construction in Armenia, yet very little of it is run through the formal financial system. Banks accounted for less than ten percent of lending and/or investment in the housing market as of late 2004. Leasing is nascent, with about US$1.5 million in reported contracts. Micro-finance groups had made about US$13-$14 million in loans, about five percent of the banks' low totals. While some of the Multilateral Financial Institutions (MFIs) have good management and are run commercially, others focus on humanitarian relief and poverty reduction, not commercial viability. This complicates the task of supporting commercial MFIs without diluting or undermining legitimate efforts of relief to improve the lot of the most impoverished in society.

Non-bank credit should grow in the future, though given the small size of the market, it is uncertain to what degree. In some cases, banks can be expected to develop these areas for their own portfolios, because credit is core to their earnings. At the same time, specialized finance companies such as mortgage, leasing and commercial finance companies can be useful clients for banks. This may include loan sales (to and/or from mortgage companies), receivables financing and factoring (commercial finance and leasing companies), cash management and transfers, foreign currency trading, and trade finance (*e.g.*, stand-by letters of credit, performance guarantees).

C. Accounting and Financial Information

Markets broadly trade on information. Likewise, maintenance of sound governance standards and management systems depend on completeness, accuracy and timeliness of information flows. Beyond this, capacity is needed for ongoing monitoring and analysis; however, if the data are flawed or the culture is fundamentally closed, systems and analytical skills will not be sufficient for building viable financial markets.

In Armenia, these weaknesses exist. Accounting and audit standards need further development, capacity needs further development, professional standards and ongoing certification need to be implemented, and hiring practices need to show greater focus on merit than personal relationships.

Specific to the banking sector, banks are required to present their financial statements according to International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS). While banks claim to do so, there are gaps between local accounting standards and revised IAS and IFRS. Altogether, there were reported to be inconsistencies in 31 RAAS principles of the 41 IAS principles. Likewise, RAAS had not yet been updated to reconcile with the five IFRS principles.

As elsewhere, Armenian banks often focus on accounting and audit as reporting formalities more than strategic management tools. Over time, banks will need to develop more comprehensive accounting systems and treat external audits as part of a strategic exercise to improve governance, operations, systems, procedures, controls, etc.

Part of the problem in building professional standards is that the effort to make domestic accounting standards consistent with IFRS (then IAS) has experienced a time lag. Rather than a legalistic and interventionist approach by government, it is advisable that Armenia pursue a more common standards-based approach (as followed in market-based economies) in which professional associations are responsible for standards, certification, continuing education, ethics and compliance. This will not solve all problems, as evidenced by accounting and corporate governance scandals in advanced markets generally known for having high levels of accounting and audit capacity. Nonetheless, a strengthened mandate for the local association to become the institutional mechanism for professional standards and member certification will help bridge the accounting and audit gap. This, in turn, will help with other issues related to transparency, disclosure, governance, and enterprise credit worthiness.

Beyond basic accounting and audit issues, there is also an issue of business culture. Weak disclosure practices limit the volume, quality and timeliness of information needed for additional market development. This stifles risk-taking by banks as it undermines trust and fails to meet banks' underwriting standards for loan origination. This will also be a major challenge with regard to securities market development and the ability to attract capital. Likewise, in the event of major reform in contractual savings, insurance companies and pension funds will require levels of disclosure as a function of their fiduciary responsibilities before investing in instruments for their portfolios. Likewise, if Armenia hopes to attract capital from abroad via markets (as opposed to cash-based transactions in properties, companies, etc.), it will need to elevate disclosure standards and practices. This is particularly true if it wants to expand its potential market to reach others via cross-listings on other markets. Thus, closely held information will simply stifle market development.

An example of this can be applied to activation of an effective credit information bureau. If there is a shortfall in information flows, banks will only find it more difficult to evaluate and price credit risk. This, in turn, will reduce loan size, increase interest rates charged and add to the operating cost burden banks have in conducting the risk assessment. This, in turn, detracts from returns and makes it difficult to achieve return on equity or RAROC targets. Such information constraints will preclude open market investment via securities markets, again reducing prospects for corporate bonds or other instruments needed for market development.

Enterprises and households are not entirely to blame for restricting information flows, however. Tax administration and perceptions of arbitrary and subjective treatment serve as a disincentive for businesses and some individuals to disclose sales, incomes, assets, and other basics of financial reporting. Thus, movement to improved functioning of public administration in this regard is essential for the confidence needed to induce more open disclosure.

III. BUILDING BLOCKS FOR FUTURE DEVELOPMENT

A. General

Strategic: There is a need for strategic coordination. Cross-cutting areas such as legal reform, regulatory coordination, consolidated accounting and supervision, corporate governance, and institutional support systems (*e.g.*, property and pledge registries) should have customized strategies for each financial sub-sector (*e.g.*, banking, pension reform, insurance sector development, securities market development, mortgage finance, leasing, factoring), while also having working committees to identify areas of convergence and needed coordination. As an example, accounting and audit reform should have a specialized working committee focused on needed reforms and institutional development to effectively implement consolidated accounting and supervision, while providing a clear framework for investors and market players to pursue market development in a manner that is consistent with international standards of accounting, auditing, and financial reporting.

International standards: In general, reforms in Armenia should adhere to international norms, and institutions should seek to become members of international organizations. Coordination with IAIS in insurance and pension reform and the International Organization of Securities Commissions (IOSCO) for capital markets development will help to provide meaningful guidance as these Non-Bank Financial Institutions (NBFI) activities evolve. Harmonizing legislation and financial market practices with European Union (EU) Directives can also provide Armenia with minimum requirements and benchmarks for international standards. This is true in individual sectors (with customization and adaptation of non-EU practices as desired), as well as in broader informational requirements needed for market development. As an example, adoption of the EU's Eighth Directive on accounting would help provide Armenia with a framework for modernizing the accounting and audit profession.

Regulatory capacity: Regulatory and supervisory structures will need to evolve for adequate surveillance and supervision of market players as more risk (including transfer risk) is assumed. To date, only the CBA has demonstrated capacity. Over time, irrespective of organizational structure, responsibility, mandate or authority, regulatory structures will need to be monitoring for risk based on standard pools of information that reconcile on a consolidated basis.

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

Consolidated accounting: Consolidated legal concepts and accounting principles will need to be introduced, particularly if companies to which the banks lend have subsidiaries and affiliates. A tightening of legislation dealing with the role of consolidation (*e.g.*, parent companies, holding companies) will also be needed for such practices to be consistent with the broader legal framework.

Corporate governance: Building blocks for improved corporate governance should include protection of minority shareholder investment and stricter qualifications for board members. This will also need to be accompanied by changes in disclosure practices to be effective, as well as strengthening of internal audit functions.

B. Banking

Credit risk and portfolio management capacity: Armenian banks currently are challenged by credit risk, let alone portfolio management. Improved access to better, more accurate, more complete, and more timely information will be essential to boosting capacity. In addition, better systems and improved underwriting and portfolio modeling techniques will be needed. The CBA has an interest in spurring on banks to move in this direction. Ultimately, banks' initiatives will be required, rather than regulatory pressures, in building a modern system. This should and will be driven by asset quality, earnings and capital considerations.