CENTRAL BANK OF THE REPUBLIC OF ARMENIA

FINANCIAL STABILITY REPORT

2013

2014

This Financial Stability Report presents an assessment of potential risks that could threaten the stability of financial system of the Republic of Armenia as well as the capacity of the financial system to absorb such risks.
More detailed information on Armenia's macroeconomic environment and financial system analyses is available in the Central Bank's periodicals, such as *Annual Report of the Central Bank, Status Report on Monetary Policy Implementation and Armenian Financial System: Development, Regulation, and Supervision.*

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Financial stability can be characterized as concurrence of financial and macroeconomic conditions when the financial system i.e. financial institutions, markets and market infrastructures are capable to withstand the probable shocks and instability, in this way minimizing the probability of interruption of intermediation function.

In defining the financial stability, what is taken into consideration is that financial instability can emerge as a result of interruption of internal functions of the financial system as well as unfavorable developments in domestic and world economies, credit risk issues connected with major borrowers and lenders, shifts in economic policies and infrastructures.

Maintaining the financial stability presumes the efforts for the identification of main risk sources, poor-managed financial risks, ineffective asset pricing and finally implementation of the policy as appropriate.

PREFACE

The Financial Stability Report of the Central Bank of the Republic of Armenia is prepared on a semiannual basis. It contains a broad assessment of risks that could threaten the stability of financial system as well as the capacity of financial system to withstand such risks. Through publishing of information concerning a variety of reviews on financial stability, the Central Bank seeks to bring interested parties' attention to those risks and events that could undermine financial stability of the Republic of Armenia as well as provide an opportunity to debate on how to minimize such risks.

One of the tasks of the Central Bank is to maintain the stability and functionality of the financial system of Armenia. The primary objective of the Central Bank is price stability in the country. Serious disruptions in the financial sector may create impediments to effective implementation of monetary policy. Contrariwise, the monetary and macroeconomic stability contributes to the minimization of risks threatening financial stability. The financial sector plays an important role in overall economic system, and the financial sector needs to maintain continuity and sustainability of processes thus contributing to the organic growth of the entire economy.

The Central Bank carries out an ongoing monitoring and analysis of financial stability for early disclosure of any changes and variations that could threaten financial stability. The report refers to the risks revealed in macro-environment and financial sector and their influence on the developments in all sectors of the economy and financial system.

Risks affecting financial stability of Armenia can emerge in the domestic economy, external economy and the financial sector itself. In this sense, the main preconditions for financial stability are:

- a domestic and external macroeconomic environment with sustainable development whereby households and companies would be creditworthy enough,
- an effective financial system with risks that are prudent and manageable,
- efficient financial infrastructures with operational continuity to the benefit of functioning of the financial system.

As presented in this report, risks that can potentially undermine financial stability of Armenia derive from:

- developments in world economy,
- developments in macroeconomic environment in Armenia,
- developments in financial market in Armenia,
- financial institutions of Armenia, and
- financial infrastructures of Armenia.

The report addresses the risks revealed in these areas and attempts to measure their possible impact on the developments in the economy on the whole and all parts of the financial sector. The report mainly focuses on the risks to the banking sector and development trends: the role the sector plays in overall financial system is vital as assets of commercial banks account for almost 90% of entire financial system assets. The banking sector as a principal pillar to the financial system of today determines overall financial stability and development trends.

ABSTRACT

A set of risks threatening financial stability has not changed notably compared to the previous year, though the key risks have increased

During 2013, the financial system of Armenia continued to expand, while maintaining its stability and robustness to cope with potential risks. Key risks deriving from the external sector and affecting the domestic economy and financial stability persisted in 2013. The low level of industrial commodity prices in international markets, low growth of industrial sector of Armenia and the drop in construction contributed negatively to the economic growth of Armenia. Simultaneously, the growth of export volumes had a positive impact on the creditworthiness of exporting enterprises. On the other front, the increase in net factor incomes and remittances fuelled the creditworthiness of households receiving remittances.

Although some strengthening of economic activity was recorded in the second half of 2013, however, steady recovery of the global economy is not yet secured

Recovery of the global economy gained momentum in the second half of the year, mainly due to positive macroeconomic developments in developed countries, especially the USA. In Eurozone countries, as opposed to negative developments of the first half of the year, some trend of overcoming the economic downturn was observed already at the end of the year.

In developing countries, the economic growth slowdown trend was maintained, contributing to a low level of stock commodity demand and prices.

Monetary authorities further implemented easy monetary policies

The economic growth elevation and strengthening were still considered as priority policies for the monetary authorities in developed and developing countries. Both the developed and emerging countries kept on implementing easy monetary policy, linking the probable changes with a certain target level of main macroeconomic indicators.

Economic developments in partner countries were adverse at times, though they had little influence on domestic economy

The economic growth in Russia and EU countries, Armenia’s main trade partners, were lower-than-expected; though it did not influence significantly the domestic economy of Armenia. (for details, please see the section “Developments in the Global Economy”)

Domestic economic developments were characterized by slowdown of economic growth rates and high inflationary environment

Economic growth of Armenia reached 3.5% in 2013, according to National Statistics Service data (7.2% economic growth in 2012). This slowdown was mainly due to low growth of industry sector and the decrease in construction.

Increased incomes in the economy ensured high creditworthiness of borrowers

Armenia posted better performance of indicators on private transfers, factor income and foreign trade turnover. This has positively contributed to the incomes of exporting companies and households, thus strengthening their financial stability (for details, please see the section "Macroeconomic Environment Developments in Armenia").

Credit market activity continued, though the growth fell from its previous year's pace

During 2013, a slowdown in capital adequacy decline was recorded as loan portfolio growth of banking sector decelerated. In parallel with the lending growth decrease, deposits posted accelerated growth resulting in the augmentation of banking system liquidity. During the year, the banking system of Armenia maintained its capital adequacy and liquidity ratios above the regulatory requirements, while keeping the market risks manageable. Net interest margin declined, thus causing a reduction of banking system profitability.

According to the results of stress tests, the banking system of Armenia is liquid and capitalized enough to absorb the impact of adverse shocks (for details, please see the sections "Stability of Financial Institutions of Armenia" and "Stability of Financial Market Infrastructures").

1. DEVELOPMENTS IN THE GLOBAL ECONOMY [1]

1.1. MACROECONOMIC ENVIRONMENT

Though the first half of 2013 was characterized by pessimistic expectations and negative trends, during the second half the economy came back to positive territory of developments and trends

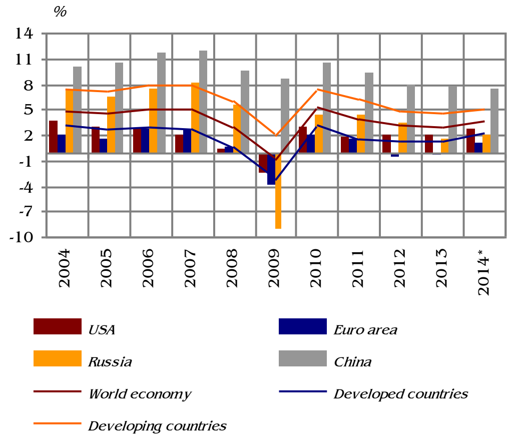
The main economic developments and trends were different in the first and second halves of 2013. Though the first half of the year was characterized by pessimistic expectations and negative trends, the second half saw more positive developments and optimistic expectations of the market.

Meanwhile, a number of global uncertainty factors remain, preventing from stating the overcoming of the global financial crisis even after 6 years from its beginning.

The global economic growth of 2013 declined as compared to the previous year

In 2013, the global economic growth was an estimated 3.0 percent, according to the IMF (3.1% in 2012). The economic growth in developed countries continued with a slow pace and was 1.3%. At the same time, that of developing countries had not exceeded the previous year's figure and remains around 4.7%.[2]

Economic growth indicators, by regions



* Hereafter all indicators marked with asterisk are IMF estimates (2014 January).

Source: IMF.

The main trends of the year were the economic activity recovery in advanced markets (though the pace of the recovery varied from country to country), the rooting of economic slowdown in emerging markets, the steady trend of the prices of main commodities, the depreciation pressures of national currencies in developing countries.

The recovery of global economy remained; however, the key risks were of great concern during the whole year

IMF Overview of the World Economic growth Projections

Indicator *(economic growth)*	2012 assessment as of 30.01.13	2013 forecasts as of 30.01.13	2013 forecasts as of 30.04.13	2013 forecasts as of 30.07.13	2013 assessment as of 30.01.14	2014 forecasts as of 30.01.14
World economy	3.1	3.5	3.3	3.1	3.0	3.7
Developed countries	1.3	1.4	1.3	1.2	1.3	2.2
USA	2.3	2.0	1.9	1.7	1.9	2.8
Euro area	-0.4	-0.2	-0.4	-0.6	-0.4	1.0
Emerging countries	5.1	5.5	5.3	5.0	4.7	5.1
CIS	3.6	3.8	3.4	2.8	2.1	2.6
Russia	3.6	3.7	3.4	2.5	1.5	2.0
China	7.7	8.2	8.1	7.8	7.7	7.5

[1] International developments and predictions were based on information taken from IMF, World Bank, Economist Intelligence unit, Financial times, Bloomberg, RBC, the Institute of International Finance and other sources.
[2] All the forecasts and assessments of IMF were taken from "World Economic Outlook Update, January 2014"

USA economic growth continued to gain momentum

The global economic growth benefited much from the USA, where a moderate economic growth was observed whole year long, at the same time the growth in the 4th quarter was the highest in the last years. The negative effect of fiscal consolidation was less than expected; conditions remained favorable in financial markets owing to low level of interest rates and quantitative easing. According to IMF estimates, US economy had a growth of 1.9 percent in 2013, and is expected to have 2.8% growth in 2014, stimulated by private consumption and fiscal policy easing.

The euro area developments allowed to record a beginning of economic recovery

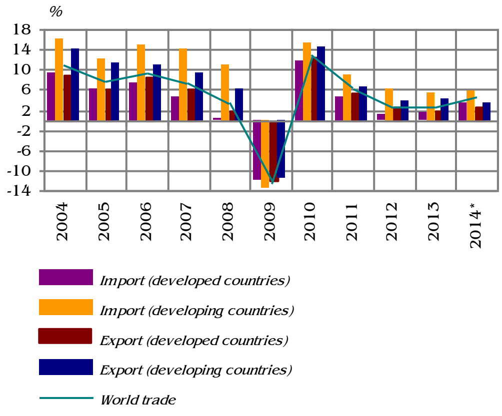
Though the economic condition in the advanced European countries was alarming at the beginning of the year, particularly situation in Cyprus and other countries with debt problems formed some expectations of recession rooting; however, more positive trends were marked during the second half of the year.

The euro area recorded a q-o-q 0.1% and 0.5% economic growth in the third and fourth quarters, thus stating the end of the recession. An economic recovery is projected in the short term for the euro area (1.0% in 2014, 1.4% in 2015), though the economic growth will be more moderate and unsteady in problematic countries. Overall, the high degree of debt both in private and public sectors will suppress the growth of private demand, though the possible speed-up of exports will affect positively the economic recovery.

The slow pace of emerging countries' economic growth will probably prolong

The European debt crisis and existing uncertainties of economic recovery in developed countries conditioned the economic growth slowdown of developing countries and the risks of further pace of those trends. Low external demand, low level of international prices for main commodities, high level of inflation, as well as the announcement and implementation of tightening the monetary conditions by Fed in 2013 made the challenges for emerging markets more realistic.

Annual growth rate of world trade



Source: IMF.

Given the IMF data, the economic growth was 4.7% in developing countries in the year 2013, and it is estimated that these countries will face a 5.1% economic growth in 2014.

Despite the downtrend of the world economy in the first half of the year, it entered a rising phase at the end of the year, partially conditioned by the recovery of export in developing countries and high levels of trade turnover in key European countries. According to the IMF data, the annual growth rate of world trade was 2.7% in 2013, surging to 4.5% forecast for 2014.

Developments in commodity markets were largely in line with the global economic trends

At the beginning of the year the prices of main commodities showed dynamic increase, due to progresses in certain commodity markets, as well as development trends of global economy. Nevertheless, in response to decrease in emerging markets demand and existing uncertainties worldwide, a fall in prices was recorded in almost all the markets starting from the second quarter and maintained this trend during the year.

Oil price displayed an upward trend starting from the beginning of the year. In February it hit a price of USD 119 a barrel, slipping back afterwards and keeping the same level during the year. Brent crude oil annual average price was USD 109 a barrel, edging down by 3.0%, compared to the same period of the previous year.

It is anticipated, that annual average energy prices will display a relatively horizontal trend in short-term. Meanwhile, geopolitical developments could pose upside risks to energy prices (though with lower probability than before).

Given the improvement in global expectations at the beginning of the year, base metal prices gained momentum, which, however, was neutralized in upcoming months, due to emerging countries' economic growth slowdown trend. The annual copper price averaged at around USD 7300 per ton, plunging by 8.6% year-on-year.

In the short-term the international prices of base metals are not expected to register notable increase, ceteris paribus, subject to economic trends of developing countries.

A declining dynamics of wheat international prices was apparent during the year, owing to harvest expectations in new marketing year.

In 2013 average wheat price reached USD 8.5 a bushel, declining by 2.0%, relative to the previous year.

In short term no wide fluctuations of prices are estimated in wheat international markets.

Gold has supported continuing downward trend throughout 2013. This decline was mainly due to US economic activity improvements, which led investors to leave the gold market in favor of more profitable assets.

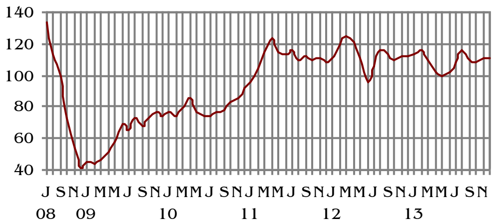
Average annual international gold price amounted to USD1400 per troy ounce in 2013, declining by 17.0% against the previous year.

No significant change in gold prices is assumed in short term, owing to optimistic expectations of world economy recovery.

Inflation pressures were limited in developed and emerging countries in 2013. The IMF assesses a 1.4% annual inflation rate in developed countries, and 6.1% in developing countries. Moreover, no inflationary pressures are expected to occur during the upcoming year.

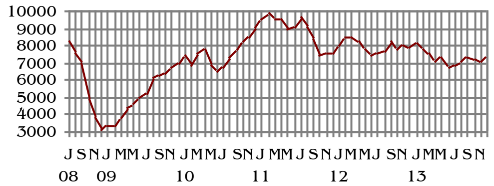
International oil prices are mainly sensitive to geopolitical developments

Brent oil prices
(USD per barrel)

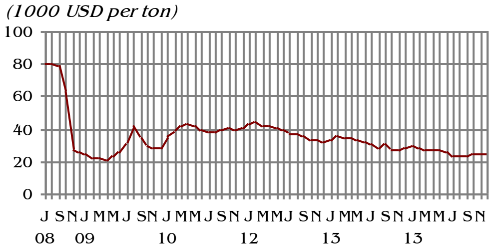


Copper price dynamics change according to the emerging countries' economic growth trends

Copper prices
(USD per ton)

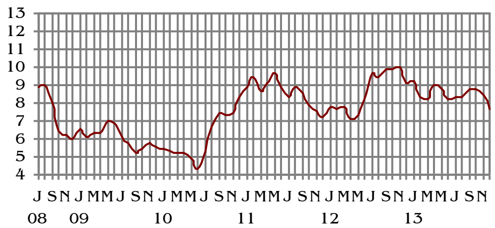


Molybdenum prices
(1000 USD per ton)



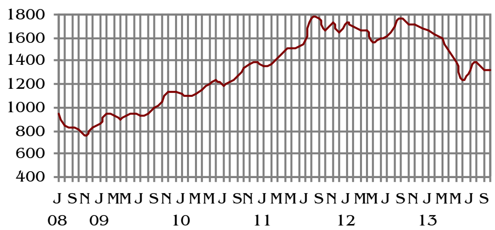
Wheat prices recorded a decline

Wheat prices
(USD per bushel)



Gold market became less attractive to investors thus triggering a fall in gold prices

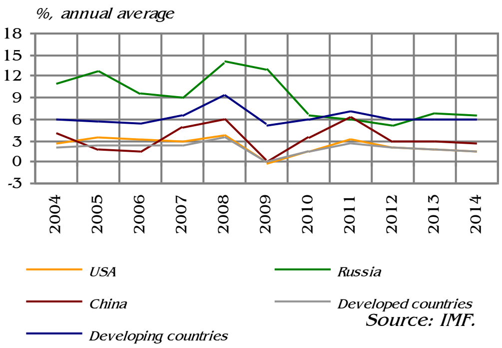
Gold prices
(USD per troy oz)



Source: Bloomberg Data Warehouse.

The monetary authorities of key developed countries carried on implementing low-rates policy and quantitative easing program in 2013, while some developing countries raised refinancing rates due to depreciation pressures of national currency.

Inflation in selected countries



Source: IMF.

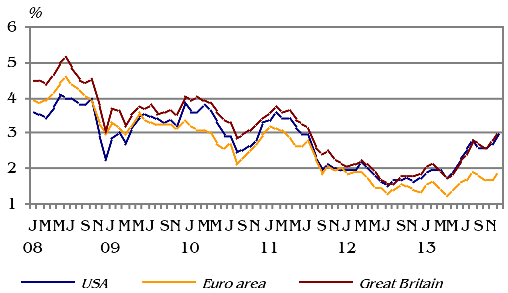
1.2. INTERNATIONAL FINANCIAL MARKETS

During 2013 no significant improvement in international financial markets was observed: both budget and debt problems remained unsolved in European countries, banking system stability was still vulnerable, the US government decision on tapering of quantitative easing program created further risks globally resulting in depreciations of other currencies and funding difficulties worldwide.

The spread between German government bonds and countries with debt problems widened

Taking into account the unstable condition of European countries and the concerns over economic slowdown of developing countries, investors still mostly prefer American, German and other highly liquid government bonds, which maintained a low yield during the year.

10-year government bond yield

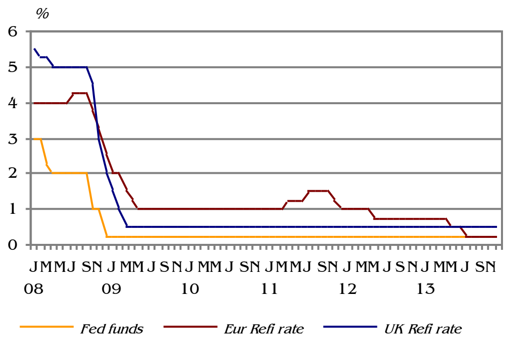


Source: Bloomberg Data Warehouse.

Given the main economic challenges and unstable growth of global economy during the year, the key developed countries carried on low interest rate policy, with the exception of the USA, which started a gradual tapering of quantitative easing program, whilst maintaining the fed funds rate on a minimum level.

Central banks of key developed and emerging countries implemented soft monetary policy

Interest rate policies of central banks



Source: Bloomberg Data Warehouse.

Taking into consideration the deterioration of macroeconomic prospects, weak business activity in industry and service sectors, tense state of labor market (the euro area unemployment rate peaked at 12.0% at the end of the year), the ECB had to announce a number of monetary policy tools to be put into practice for economy stimulation in the first half of the year. Later, in order to support fragile recovery of the economy, these interest rates were maintained at the same level.

Bank of England kept the monetary policy rate at low level of 0.5%, which has to be maintained at the same level in the future, according to the Bank announcements.

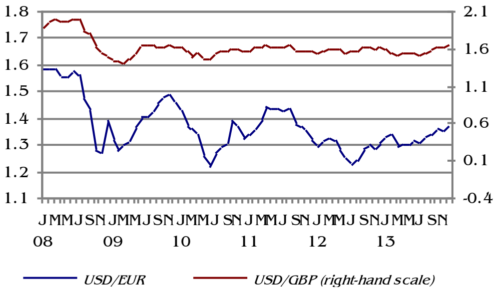
Favorable macroeconomic developments encouraged the FRS to taper

At the same time, during 2013 the Federal Reserve System (FRS) pursued expansionary policy in order to promote economic growth and reduce unemployment, yet, it decided and implemented gradual tapering of the quantitative easing program. Particularly, during a consecutive meeting on the 17-18 December it declared the volume cutback of assets purchase from USD 85 billion to

USD 75 billion, followed by the decision on the 29th of January to cut the purchase volumes by another USD 10 billion.

The main currencies displayed volatile trend

USD exchange rate versus EUR and GBP



Source: ECB.

Various developments of the euro area debt problems during the year, macroeconomic indexes of countries and implemented policies determined the volatile dynamics of major currencies.

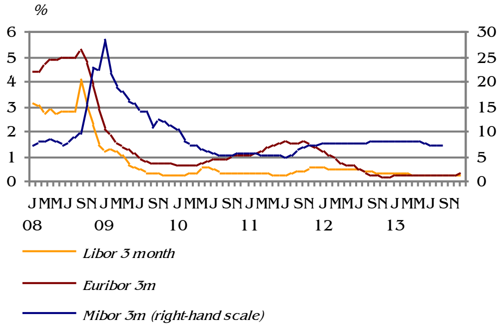
Conditioned by current developments in the USA and the euro area economies, US Dollar frequently depreciated and appreciated versus euro.

A number of external and domestic shocks in developing countries led to depreciation pressures on their currencies. The depreciation trend accelerated when Federal Reserve System avowed their intention to cut asset purchases and accomplished it later.

Though the abovementioned decision by Fed was not a surprise for the market and did not cause significant fluctuations in the financial markets, it created essential risks for developing countries, especially triggering capital outflow and currency depreciation.

Dynamics of stock indices and interbank rates were in line with international developments

Interbank interest rates



Source: Bloomberg Data Warehouse.

The capital outflow from security markets of developing countries amounted to USD 11.6 billion only in December. According to World Bank analysis, the tapering by Fed will cause a further 10% cutback of capital inflows to emerging markets by 2016.

Overall, the recovery of capital inflows to developing countries will depend on economic developments in those countries and investors' feedback on the USA policy.

Stock indices of developed and emerging countries displayed a fluctuating course in line with economic developments, recording some growth at the end of the year.

Interbank low rates were due to low base rates and global economic instability.

Box

Economic developments in Russian Federation [1]

A continuous slowdown of economic growth rates was recorded in Russian Federation in 2013, simultaneously, the inflation rate was above the target and main economic risks remained on the agenda.

In 2013, a notable economic slowdown in Russia was caused by construction drop, growth weakening of industry, retail and wholesale trade, as well as investment cutbacks due to the end of a number of government and energy projects in 2012.

In 2013, construction posted a 1.5% decline (2.4% growth in 2012). Though the growth rate of retail trade came to be 3.8%, retail and wholesale trade reduced notably as compared to the previous year; 1,1% growth rate. Agriculture and financial sector displayed a rise, thus positively affecting the economic growth. In 2013, GDP growth was 1.3%, twice as low as in the previous year; 3.4%.

Given the data of the Central Bank of Russia, in 2013 annual export stood at USD 521.6 billion or 1.2% lower compared to the previous year. Imports summed up to USD 344.3 billion, thus 2.6% higher compared to the previous year. Moreover, exports to CIS countries edged down, while imports from CIS countries grew.

In December 2013, trade balance surplus decreased by 14.3% and constituted USD 14.1 billion. According to Russia Ministry of Finance figures, state budget deficit was USD 310.5 billion, 0.5% of GDP.

The consumer price index was 6.5% (6.6% in 2012). The unemployment was 5.5% of economically active population, declining by 0.1 pp. as compared to the previous year. Real disposable earnings grew by 3.3% over the year, though slower than in 2012; 4.6%. This figure is smaller than the real wage growth, which is attributable to the low profitability of businesses, as well as to the accelerated growth of mandatory payments: the ratio of debt payments to income amounted to 4.0% this year instead of 2.8% of the previous year.

The banking sector assets grew by 16.0% and amounted to 57 423.1 billion rubles in 2013, while the share of 5 biggest banks with the largest amount of assets turned out to be 52.7% instead of 50.3%. According to the Central Bank of Russia's financial stability report, there is a trend of continuous deterioration of the loan portfolio of banks, as well as a declining of the banking sector profitability.

International rating agency Fitch affirmed Russia's BBB level, with a "stable" outlook; the low level of public debt (10.4% of GDP) and high level of net foreign assets (24.0% of GDP) contributed to this ranking. However, after the recent geopolitical developments on March 21st, Fitch lowered the "stable" outlook to "negative" conditioned by possible deterioration in the business environment as a result of the international sanctions.

Sustainable growth of lending and wage in the following period will stimulate private consumption. Simultaneously, the prospect of international financial conditions tightening can cause national currency depreciation pressures, while the economy and public finances will continue to be sensitive to oil international price fluctuations.

According to statements of officials of the Ministry of Economy and the Central Bank of Russia[2], the Russian economy bears signs of crisis, as well as economic growth slowdown[3] in Russia and other BRICS[4] countries and high inflation are observed.

Economic growth slowdown, capital outflow, the unfavorable situation in currency markets (11.0% depreciation of the ruble against the USD since the beginning of the year), the base rate increase from 5.5 to 7.0% by the Bank of Russia on March 3rd can significantly change the direction of developments of the Russian economy, compared with the forecasts of the beginning of the year.

In this context, depending on developments in Russia, the directions of risks affecting the stability of the financial system of Armenia are uncertain for now.

[1] The data, estimates and projections on the economic developments in Russia are taken from the "Social and economic development of the Russian Federation in 2013" publication of the Ministry of Economic Development of Russia.
[2] http://www.bloomberg.com/news/2014-03-17/russia-sees-economy-tipping-into-crisis-as-western-sanctions-hit.html; http://www.gazeta.ru/comments/column/shelin/5859805.shtml.
[3] The Ministry of Economic Development of Russia declared a sharp deterioration of the official forecast of economic development on April 8th. The baseline scenario assumes a 1.1% GDP growth for 2014 as opposed to 2.5% forecast in December. The mild scenario assumes a 0.5% GDP growth for 2014. http://top.rbc.ru/economics/09/04/2014/916620.shtm/.
[4] Brazil, Russia, India, China and South Africa.

SUMMARY

Overall, the world economy entered a new phase of development. The economic growth recovery continued in 2013, though with a slow pace, while current risks have mainly a decelerating trend. The economic growth of developed countries gradually stabilized chiefly near the year-end, while an economic slowdown was observed in developing countries.

In the U.S. economy private consumption continued to fuel, while fiscal consolidation inhibited economic growth.

Euro area countries showed some signs of recovery in the last quarter, resulting not only from policy implementation, but also optimistic expectations. However, some restoration of confidence and steady growth of exports were not enough to neutralize the weak domestic demand. At the same time, both in the peripheral and core European countries the balance sheets of banks stay problematic, leaving the financial stability issue on the agenda.

To conclude, the foremost key risks being transmitted on a global scale for 2013-2014 are:

- In terms of positive macroeconomic developments in the USA, the negative impact of further tapering of quantitative easing program on European countries with debt problems, and especially on developing countries,
- The persistence of economic slowdown trend in emerging markets,
- Deferment of solving structural problems in developed countries, particularly in euro area.

2. MACROECONOMIC ENVIRONMENT DEVELOPMENTS IN ARMENIA

2.1. MACROECONOMIC DEVELOPMENTS [3]

In 2013 an economic growth slowdown was observed in the domestic economy of Armenia due to both internal and external developments. The events taking place in main economic partner countries of Armenia somehow influenced the development of domestic economy; however, the growth in foreign trade, factor income and remittances persisted.

According to National Statistics data, the economic growth of Armenia in 2013 amounted to 3.5%, (7.2% previous year).

The value added of industry reported a 4.9% growth in 2013. The growth rate was especially high in mining and processing industries.

Agriculture value added showed an 8.1% growth. Plant growing and animal production contributed to the growth in agriculture sector.

The value added of construction reported an 11.2% decline as compared to the previous year, mainly due to reduction of volumes of construction financed by companies. Meanwhile, the volume of households-funded construction has increased.

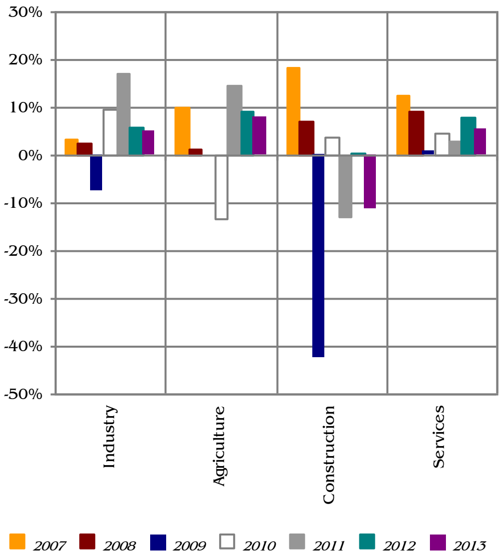
The growth of service sector value added has been 5.3% in 2013. The low pace of growth compared to the previous year was a consequence of private demand decrease.

The private consumption recorded a 1.8% increase, according to the National Statistics data, which was more than 5 times lower than in previous year. The lower pace of growth of private consumption was a consequence of high level of prices, a drop-off in lending growth volumes and a growth slowdown recorded in agriculture. Meanwhile, government expenditure posted a higher growth; 13.4%.

The investment climate weakened in 2013; both the public and private investments continued to decrease. According to National Statistics of Armenia, private investment fell by 4.2%, while public investments by 12.5%; the latter being a result of delays in the implementation of the "North-South" road corridor investment program, as well as the policy aimed at reducing the budget deficit.

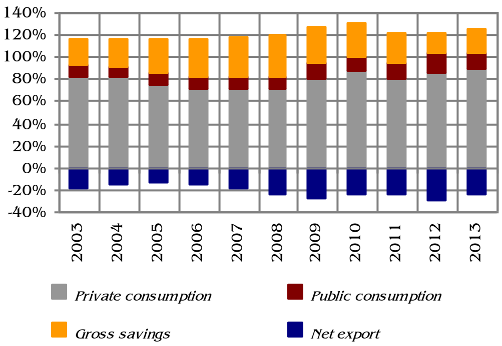
In the context of the lending growth reduction policy, credit market activity recorded an 11.2% increase. Credit

The anuual growth of main sectors of economy



Source: National Statistics Service of Armenia.

GDP expenditure components
(share in GDP)



Source: National Statistics Service of Armenia.

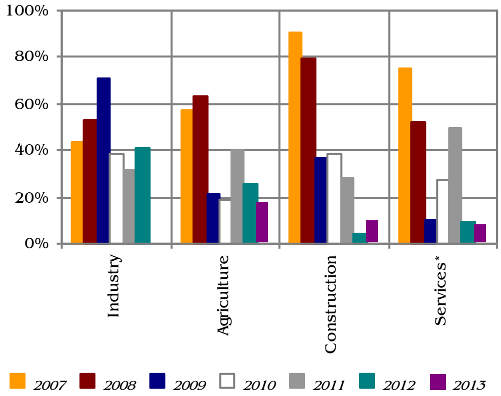
[3] *For details on the developments of macroeconomic environment in Armenia, see the quarterly publication "Inflation Report, Q1, 2014).*

growth was registered in all sectors of the economy, with trade and transport and communication sector lending volumes having reported the highest growth rates. Along with the growth of credit investments the share of non-performing loans in total loans increased by 0.8%, summing up to 4.7%. Relatively high non-performing loan ratio was recorded in construction; 8.3%.

According to surveys conducted by CBA, composite economic indices[4] had dissimilar development trends during the year. The index of business activity declined by 12.0 pp. in 2013 Q4 as compared to the same period of the previous year, though remaining in the range of stability. At the same time a 0.2pp. increase in business climate index indicates a stable attitude of businessmen toward the business climate.

2013 was highlighted by the introduction of a new instrument for financing the budget deficit, that is government bonds issued in foreign currency /Eurobonds/ with an amount of USD 700 million, 6.25% yield and a 7-year term. Meanwhile, a high demand in international capital market was in part due to upsurge of investors' interest towards government bonds of developing countries. As a result, an average reduction of 4.5 percentage points[5] was recorded in dram denominated government bonds yield. This action of the government creates opportunities for the private sector to attract more funds available with low interest rates from the global financial markets.

Growth of lending to main sectors of economy



In chart the sector of services includes trade and other service sectors' aggregate values.

Source: Central Bank of Armenia.

The first issue of government bonds in foreign currency took place in 2013

Qualitative public debt indicators of the Republic of Armenia

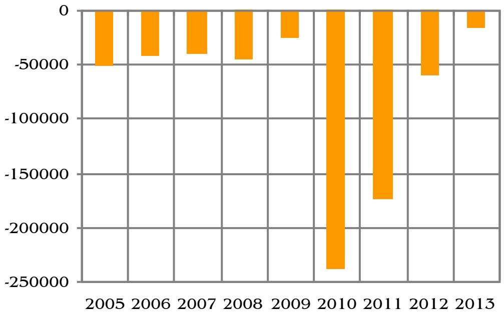
Indicator	2005	2006	2007	2008	2009	2010	2011	2012	2013
Debt/GDP (limit 50%)	22.3%	18.2%	14.0%	13.6%	35.7%	34.2%	36.4%	37.6%	37.5%
Debt/ Export	77.6% (less indebted)	79.8% (less indebted)	81.6% (less indebted)	89.8% (less indebted)	221.7% (moderately indebted)	170.31% (moderately indebted)	148.0% (less indebted)	150.0% (less indebted)	139.4%(less indebted)
Debt service/ Export	4.6% (less indebted)	4.2% (less indebted)	2.9% (less indebted)	3.1% (less indebted)	6.0% (less indebted)	5.0% (less indebted)	4.2% (less indebted)	9.9% (less indebted)	14.4[6]% (less indebted)
Interest/ Export	0.9% (less indebted)	0.7% (less indebted)	0.6% (less indebted)	0.7% (less indebted)	2.0% (less indebted)	2.4% (less indebted)	2.1% (less indebted)	2.3% (less indebted)	1.8% (less indebted)

[4] The economic activity and business climate composite indices were calculated based on quarterly surveys on economy sectors by the Central Bank of Armenia.
[5] Data according to Armenia's Ministry of Finance.
[6] Debt service / export figure does not include the Russian early loan repayment. In case of considering this repayment, the debt service / export ratio will be 30.7%.

External debt has increased, while Armenia is still considered a less indebted country

Armenia government budget deficit (-) / surplus (+)

(mln AMD)



Source: National Statistics Service of Armenia.

According to Armenia's Ministry of Finance data, public debt of Armenia has increased by 5.0% compared to the previous year and amounted to 44.0% of GDP. The major part of the public debt - the external debt - has increased by 4.4% and amounted to 37.5% of GDP. The share of loans with floating rate continued to show a downward trend of about 13.1% in comparison to the previous year and was 22.2% of the total volume of debt.

Though the qualitative indicators of the external debt have mainly increased during 2013, Armenia is still considered a less indebted country.

As a result of tax administration improvements in 2013, positive developments were recorded in the state budget of the Republic of Armenia.

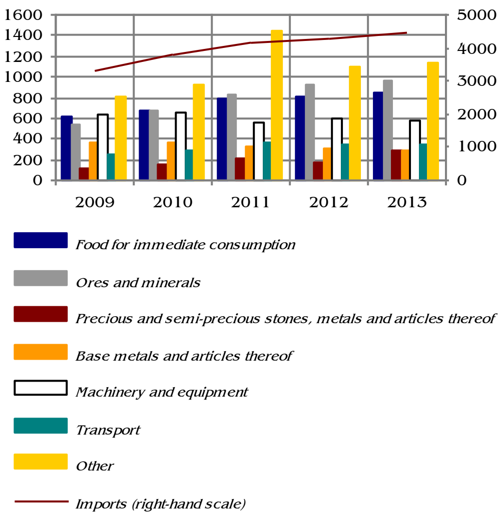
According to National Statistics Service data, a 13.5% growth was posted in government budget revenues in 2013. A similar growth trend is due to 14.0% growth in tax revenues, thus the income and value added tax being the determinant contributors to the upsurge.

The expenditures (including PIU funds) grew by 8.2%. In view of accelerated growth of revenues as compared to expenditures and government's contractionary fiscal policy, the budget deficit is reduced by 73.0% and the budget deficit to GDP ratio was 0.4% in 2013 instead of 1.5% in the previous year.

Taking into account the appreciation of food products and services, particularly energy prices increase from July, a high inflationary environment was shaped in 2013. The 12-month inflation rate was 5.6% in December, thus stepping aside the confidence band.

Armenia's imports by commodity groups

(mln USD)



Source: National Statistics Service of Armenia.

2.2. FOREIGN TRADE

On the back of global and domestic economic developments, the balance of payments current account deficit improved in 2013 compared to the previous year and amounted to 10.5% of GDP, according to CBA estimates. Reduction of the current account deficit is largely a result of growth in income and remittances over the previous year.

According to National Statistics figures, the trade turnover registered a growth of 4.6% in 2013 and amounted to USD 5 956.8 million.

The import amounted to USD 5 265.7 million in 2013, increasing by 7.3%, while the import expansion in real terms has been assessed 6.2%.

Imports increased especially in items "mining products", "food for immediate consumption", "precious and semi-precious stones, precious metals and articles thereof".

Export volumes grew by 9.6% to USD 2800.7 million, the increase in export in real terms was 12.5%.

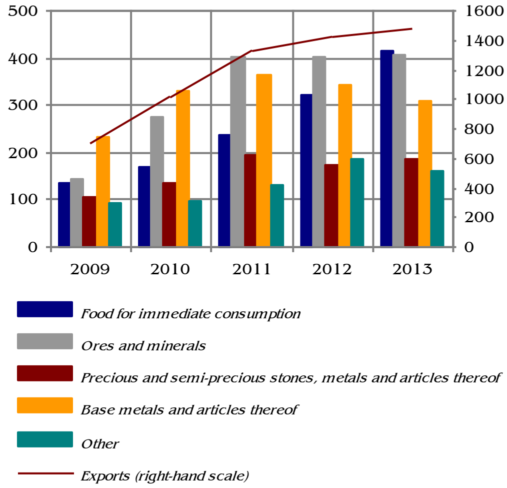
The main commodities that experienced a volume growth were "mining products", "food for immediate consumption", "precious and semi-precious stones, precious metals and articles thereof".

Despite the accelerated growth of exports compared to imports, the trade balance deficit increased by 4.7% as compared to the previous year, amounting to 23.7% of GDP.

The geographic distribution of Armenia's foreign trade can be described as highly concentrated in 2013. Main partner countries remain Russia and EEC member states. The share of CIS member states in export structure increased by 2.7 percentage points, while that of EEC countries decreased by 3.7 pp., according to the National Statistics Service records. The volume of exports to Russian Federation - a country with a leading share in the structure of foreign trade of Armenia - increased by 19.8% in 2013. A remarkable 17.7% upsurge was recorded in exports to Bulgaria, another country with a large share in the structure of exports.

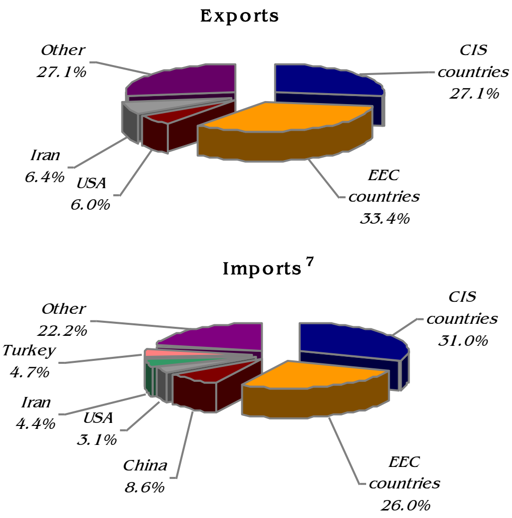
In the commodity structure of exports the following changes have occurred: the share of "food for immediate consumption" increased and the share of "non-precious metals and articles thereof" reduced. A high level of concentration persisted, which increased the vulnerability of mining and food industries to withstand the potential shocks from any partner country or world economy. The main partner countries in the structure of imports remained CIS and EEC member states, recording 0.3 pp. and 0.5 pp. decrease, respectively, in the structure of imports.

Armenia's exports by commodity groups
(mln USD)



Source: National Statistics Service of Armenia.

Armenia foreign trade, by country, as of 31.12.2013



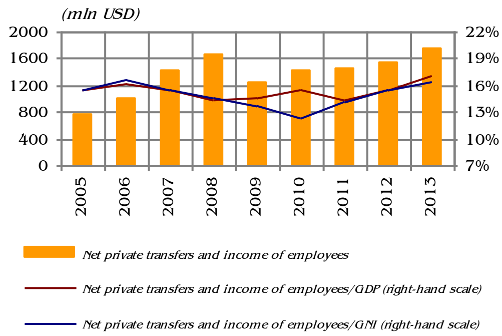
Source: National Statistics Service of Armenia.

2.3. NET FACTOR INCOMES AND TRANSFERS

Non-commercial remittances from abroad remain key component of disposable income of Armenian households. According to CBA surveys, about 16.0%[8] of surveyed households receive remittances. As a result, the abovementioned funds received from abroad are of a considerable importance from the households' living standards, creditworthiness, as well as financial stability of Armenia perspective.

Non-commercial remittances have increased during the year, positively affecting household income and wealth

Net private transfers and income of seasonal employees



Source: National Statistics Service of Armenia.

During 2013, both net private transfers and net income of seasonal workers grew, amounting to around USD 1.8

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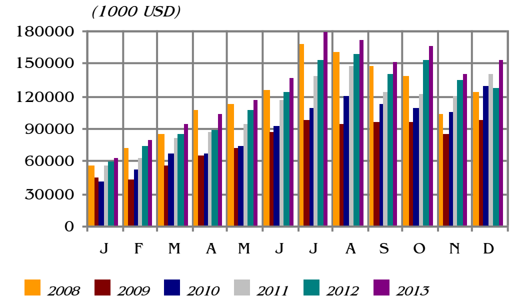
[7] The structure of imports is represented according to the countries of origin.
[8] Source: statistical research conducted by the Central Bank on "Consumer Confidence Index in the 4th quarter of 2013"

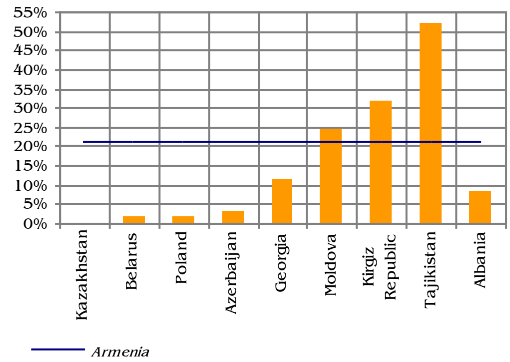
Net non-commercial remittances of individuals by banking system



Source: Central bank of Armenia.

Most of non-commercial remittances are received from Russia, which aggravates the dependence of Armenian economy from the developments in Russia.

Commercial transfers to GDP, as of 2012



Source: Central bank of Armenia.

billion[9], exceeding the pre-crisis level for the first time. In terms of progressive increase of remittances as to GDP, non-commercial remittances to GDP ratio also grew to 17.0%, a sufficiently high level compared to other countries. Simultaneously, net inflow of non-commercial remittances of individuals via banking system also grew by 10.8%.

Overall, the positive effects of increased transfers diminished the risks deriving from the households. The bulk of non-commercial remittances inflow continues to flow from Russian Federation; 85.9%, which augments the vulnerability of financial stability of Armenia over possible negative economic developments in Russia. Particularly, the majority of Armenian citizens leaving for Russia are engaged in construction, where a 1.5% drop was recorded during the year (for details, please see Box "Economic developments in Russian Federation").

As for Russia's migration policy, the amendments in Federal Law "On the Procedures of Entry to and Departure from Russia" and "On Legal Status of Foreign Citizens in Russia" came into force on January 1, 2014[10]. Under these amendments, from January 1 onwards, the Armenian citizens who do not have work permits may stay in Russia for 90 days every 180 days[11].

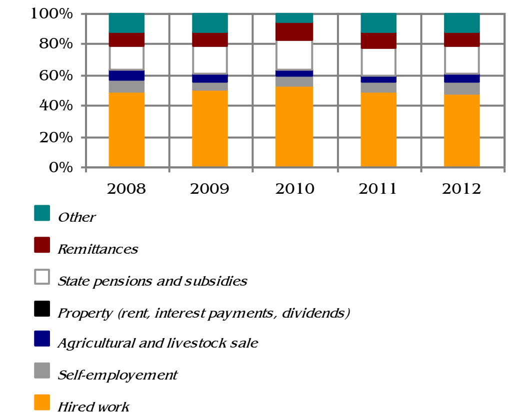
Given Russia's economy assessments carried out by international organizations and the abovementioned amendments, the Central Bank of Armenia set the growth forecasts of non-commercial remittances in the range of 7-9% for 2014[12].

2.4. HOUSEHOLD INCOME AND DEBT BURDEN

The annual nominal wages and household savings in banking system grew at a slower pace

The household income level is of great importance in terms of financial stability, as it directly affects the proper performance of the obligations on credit by households. Nominal wages increased by 6.0% in 2013, having the biggest share in the income of Armenian population. Moreover, nominal wages rose both in private and public sectors. As a result, the real wage growth of just 0.2% was recorded on the back of consumer price index amounting to 5.8%. During the year, a positive impact on living standards of households made non-commercial remittances inflow from abroad, contributing to the reduction of financial stability risks arising from the household sector.

Household average monthly income structure per capita



Source: National Statistics Service of Armenia.

[9] https://www.cba.am/en/SitePages/statexternalsector.aspx
[10] http://www.smsmta.am/?show_news&news_id=265
[11] At present negotiations are held to ease the procedures
[12] https://www.cba.am/en/SitePages/pperiodicals.aspx

The unemployment rate moderated in 2013 and amounted to 16.2% at the end of the year. The unemployment reduced with a slower pace due to economic growth slowdown. Over 1 year unemployment of 35-45 years old job seekers continues to be a concern, which can afterwards limit their chances of finding a job. Overall, both employment and nominal wages are still at lower than average levels in some regions, which affects the population living standards in those regions as well as financial inclusion levels.

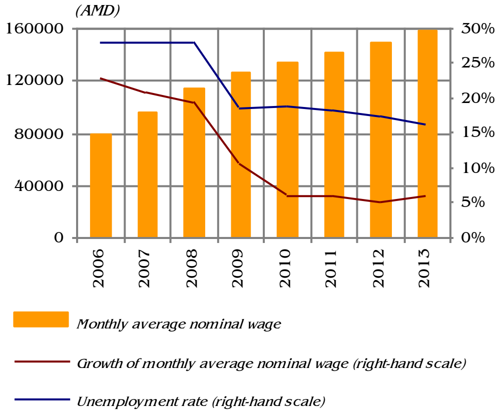
According to the Central Bank's estimates, an average nominal wage growth of around 13.0% is expected in 2014 due to the increase of minimum wage threshold, as well as a significant increase in the wages of public sector employees[13]. The average unemployment rate, according to estimates, will amount to 14.9%.

Parallel to increase in nominal income and remittances of households, bank deposits grew as well by 23.8%. As a result, the share of household deposits in total deposits of residents increased by 1.6 pp. to 68.8%. Foreign currency deposits continue to maintain a large share in bank deposits (66.9%), which can limit the possibilities of placing financial resources in dram-denominated assets. A further deposit growth can be promoted owing to household income growth and increase of confidence in financial system.

Household liabilities to financial institutions augmented by 17.8% parallel to income growth, making up a dominant share in household debt burden[14]. As household debt increased faster than the GDP, the debt/GDP ratio grew reasonably and amounted to 18.1%, still standing behind indices of many other European countries. Therefore, we can assume that further moderate growth of debt burden, which will be accompanied by household income growth, cannot pose significant threats to financial stability.

During the year both mortgage and consumer credit posted slower growth compared to the previous two years; 12.8% and 25.4%, respectively. Growth was registered in all types of consumer loans. The share of consumer credit card lending increased by 3.0 pp. and amounted to 33.7%, contributing greatly to the overall increase of lending. The results of CBA survey[15] show that consumer credit continues to maintain its position of a desirable product with high competition level. Consequently, the easing of lending

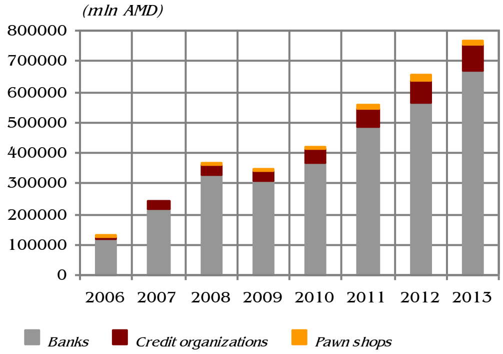
Nominal average wage and unemployment



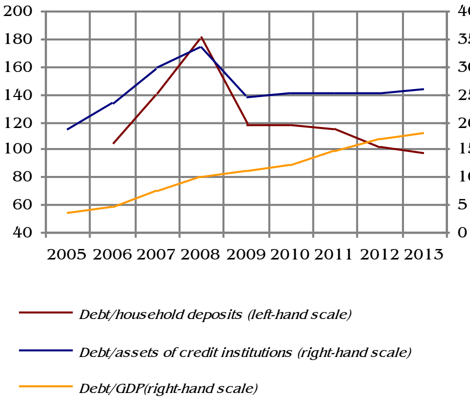
Source: Central bank of Armenia.

A moderate growth was registered in the debt burden of Armenian households

The structure of household liabilities to financial institutions



Housholds' debt and income indicators, %



Source: Central bank of Armenia and National Statistics.

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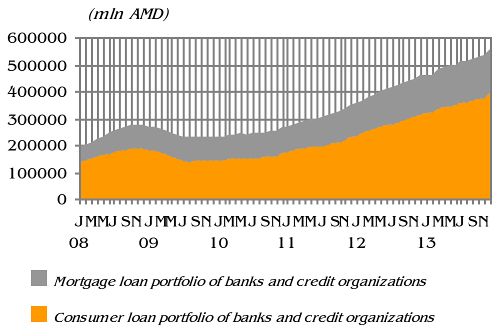
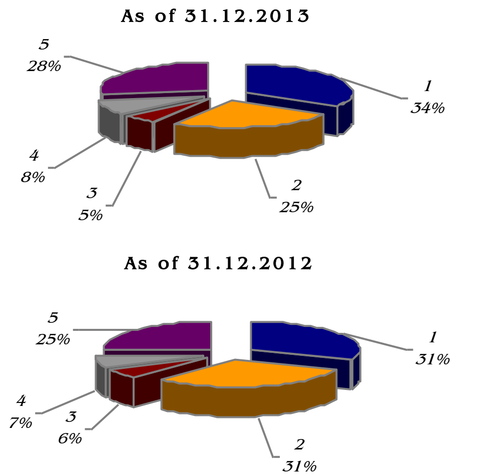
[13] *https://www.cba.am/en/SitePages/pperiodicals.aspx*
[14] *Source: summaries of annual survey conducted by the Central Bank of Armenia on foreign exchange reserves in cash and debt indicators of households'.*
[15] *Source: results of the quarterly survey of the CBA Terms of Lending by Banks and Credit Organizations in Armenia, 2013.*

Consumer and mortgage loan portfolio of banks and credit organizations



Consumer loan portfolio structure of banks and credit organizations of Armenia

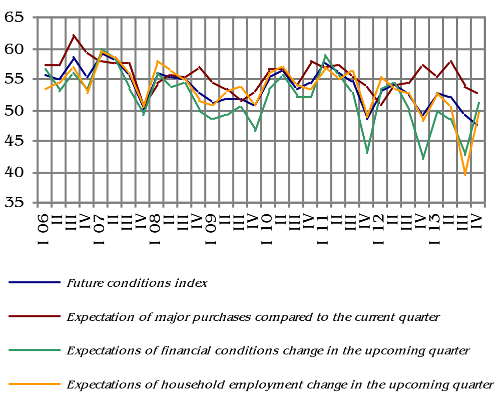


1. Card loans 2. Gold-backed loans 3. Car loans 4. Home appliance loans 5. Other consumer loans

Source: Central bank of Armenia.

Household credit portfolio quality risks remain at a manageable level

Future conditions index and its components



Source: Central bank of Armenia.

procedures, the improvement of proposed conditions of lending continued.

The growth of mortgage lending was driven mainly by mortgage loans for the purchase of real estate. More than 50.0% of these mortgage loans are foreign currency loans, which can increase the credit risk conditioned by foreign currency risk among borrowers who have dram-denominated income. Expanded maturities of loans for real estate acquisition have a positive role from financial stability point of view, as it contributes to decreasing of debt service and increasing the repayment rate on mortgage loans.

Activities of the National Mortgage Company and the program "Affordable Housing for Youth" bolster the development of domestic mortgage market. The central institutional goal is to increase access to home purchase loans by refinancing mortgage loans. During 2013, the volume of refinanced loans by the above-mentioned companies was about 28.0% of the total mortgage loan portfolio of credit institutions. As to the interest rates, both consumer and mortgage lending rates had a downward trend up to 1.0 pp.

The share of non-performing loans in the total consumer and mortgage loans provided to households by credit institutions increased to some extent. The share of non-performing loans in dram-denominated mortgages grew, while those in foreign currency diminished. As a result, the share of NPLs in mortgage loans increased by only 0.3 pp. The consumer credit NPLs grew by 2.5 pp., due to increase in credit card and other consumer NPLs. Overall, the credit risk of household lending portfolio was at governable level, due to sufficiently strict approaches of banks in assessment of borrowers' creditworthiness.

The components of the consumer confidence index – current and future conditions sub-indices – are a source for indirect valuation of expectations of financial standing and incomes of households[16]. Since the second quarter of 2013, the current conditions sub-index remained unchanged (34.5). However, the future conditions sub-index continuously decreased during the year and was 47.2 in the fourth quarter. Among indices characterizing future conditions, the index of financial conditions expectations decreased, yet, along with other indicators characterizing future conditions remained in the stability range.

[16] *Source: statistical research conducted by the Central Bank of Armenia on "Consumer Confidence Index for the 4th quarter of 2013".*

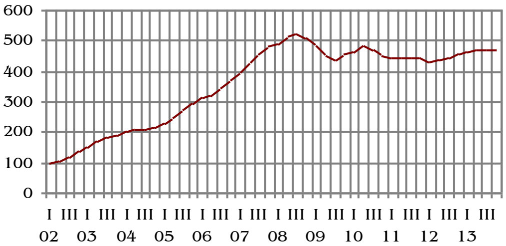
2.5. REAL ESTATE PRICES

From the financial stability perspective, developments in real estate market have a significant importance, as they directly or indirectly affect the regular functioning of financial system. This can be explained by the fact that real estate is an alternative financial investment on one hand, and the majority of loans are secured by real estate, on the other.

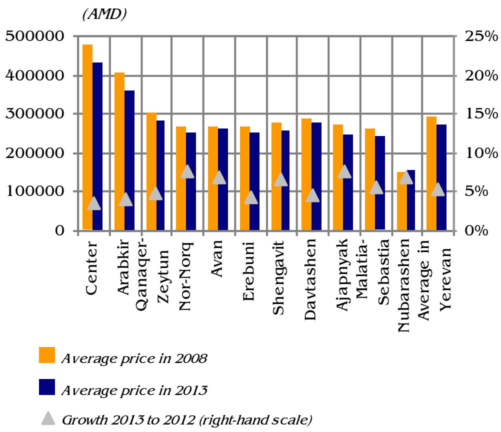
In 2013 the increase in apartment prices affected positively the risk deterrence of real estate prices' possible negative fluctuations

Both the first and second halves of 2013 saw price inflation of apartments in multi-apartment homes[17] which positively affected risk deterrence of real estate prices' possible negative fluctuations. Price increase was observed in all districts of Yerevan (5.5%), especially in Nor Nork, and Ajapnyak administrative districts, where apartment prices were comparatively low. Nevertheless, real estate prices are still lower from their pre-crisis levels. This is obvious especially in Arabkir, Center and Ajapnyak districts. Apartment prices rose also in other cities of Armenia regions by 4.3%. Real estate prices persisted at their high also elsewhere in Armenia: in Tsaghkadzor, Vagharshapat and Abovyan towns.

Average apartment price index in Yerevan (sq m)



Apartments prices by communities in Yerevan (sqm)



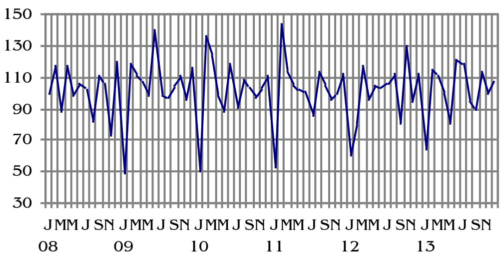
Source: State Committee of Real Estate Cadaster at the Government of Armenia.

At the same time, commercial banks were continuously applying a conservative approach by preserving 60 to 80% loan-to-value ratio, referring to their risk management needs. In this respect, risks deriving from real estate price fluctuations were not significant (for details, please see "Commercial banks market risk" section).

In terms of real estate sale and purchase transactions, a stirring was observed in the market activity, though risks connected to the sale of collateral were displayed

Parallel to inflation, apartment sale and purchase transactions both in Yerevan and other regions shrunk, due to positive changes of the second half of 2013. With regard to CBA survey results[18], transaction volumes were relatively significant in real estate secondary market, while the market activity for new-built apartments was rather low. Notwithstanding some stirring in real estate market in 2013, as to CBA surveys, the risk connected with collateral liquidity remains relatively high, which is caused by legal difficulties impeding rapid and effective implementation of such transactions.

Real estate sale and purchase transactions index



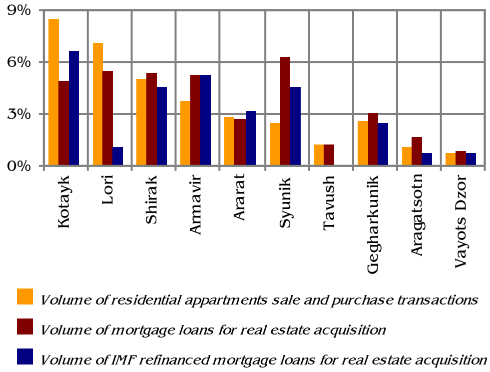
Source: State Committee of Real Estate Cadaster at the Government of Armenia.

Overall, the slowdown in real estate market activity growth is due to both exploited residential apartments reducing supply and low solvent demand. In particular, low level of solvent demand is the main limiting factor of real estate market activity, conditioned by the low level of income of the population. In this respect, real estate acquisition loans granted by financial institutions are of an essential

[17] As there is no single index of Armenia's real estate average price, the criterion for real estate price developments is considered the average price index of apartments in Yerevan.
[18] Source: results of the quarterly survey of the Central Bank Terms of Lending by Banks and Credit Organizations in Armenia, 2013.

The low solvent demand of real estate limits further activity of real estate market

The share of appartment transactions and real estate acquisition mortgage loans, by regions

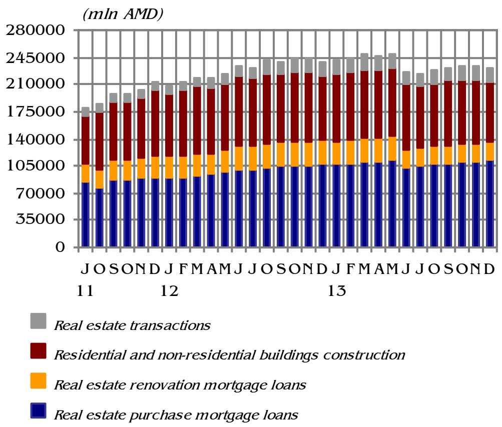


Source: Central Bank of Armenia, National Mortgage Company

Though the volume of exploited residential buildings diminished, the construction volumes of real estate augmented

Credit risk growth was observed in residential and non-residential buildings construction loans in 2013

Volume of loans to real estate market



Source: Central Bank of Armenia.

importance, which make up to 6.1% of the total loan portfolio (for details, please see "Household income and debt burden"). Mortgage loan term growth recorded since 2008 has a positive significance in terms of demand liveliness, as it contributes to the relative reduction of the debt repayment of borrowers, which in turn has a positive impact on the availability of mortgage loans. It should be noted, however, that high concentration by regions has its negative impact on real estate subsequent stimulation, because it limits the further expansion of mortgage lending.

As for real estate supply, a decrease of 4.3 percent was observed in 2013 in the total volume of exploited residential buildings, due to volume cuts in resources of corporate sector and state budget. The volumes of household-funded apartment operation continued to trend up, thus decelerating the pace of decline in the total volume of exploited residential buildings.

Residential buildings completion by sources of financing

Sources of financing	2013 exploited residential buildings (sq. m)	Share in total	Percentage change as to 2012
Total, of which:	223440	100%	-4.3%
State budget	9212	4.1%	-73.7%
Corporations' funds	47430	21.2%	-22.7%
Household funds	166798	74.7%	25.2%

Source: the National Statistics service of Armenia.

A 4.0 percent increase in the volume of real estate construction was observed during the period under review, which could further contribute to increasing the supply of real estate.

Accompanied by a decrease in the volume of construction by companies, banks have reduced loans for residential and non-residential building construction by 5.5%. At the same time, NPL ratio of these loans has increased by 8.7 percentage points and amounted to 11.1%. However, taking into account the small share of loans for construction of residential and non-residential buildings in credit institutions total loan portfolio (4.8%), it can be concluded that the risks arising from these activities do not have any significant impact on the financial stability.

SUMMARY

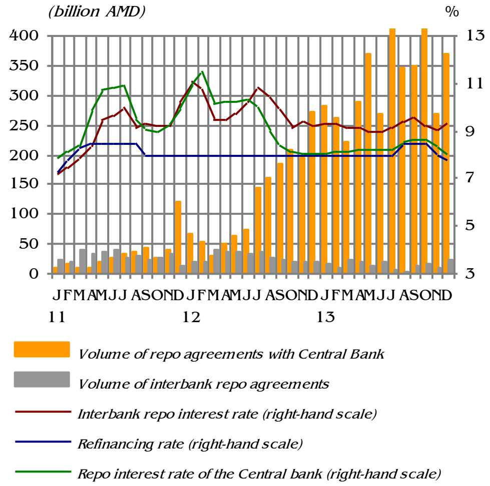
Economic activity sustained during 2013, however, with a slower pace, mainly due to low growth of world economy and investment decline in domestic economy. Simultaneously, the price upsurge of food products and services, including energy prices increase in the second half of the year created a high inflationary environment. The abovementioned developments have had their impact on creditworthiness of households and businesses, as well as on opportunities for financial services. Nevertheless, surge of non-commercial remittances, export volumes and real estate prices to some extent contributed to income and wealth growth of households and businesses. Thus, risks to financial stability arising from these sectors remain manageable.

3. FINANCIAL MARKET STABILITY OF ARMENIA

3.1. MONEY AND CAPITAL MARKET

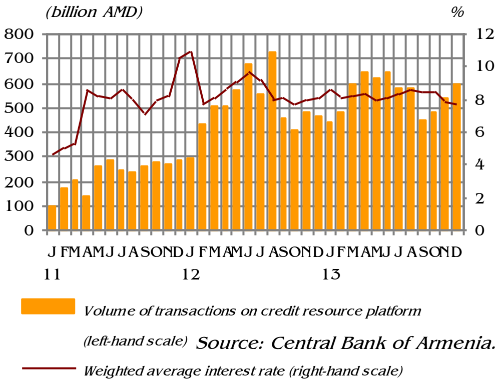
Interest rates displayed a downward trend

Monthly volume of repo transactions and repo interest rates



Source: Central Bank of Armenia.

Volume of transactions on credit resource platform and weighted average interest rate



Source: Central Bank of Armenia.

In June 2013 the reserve requirement for banks' dram-denominated obligations was cut to 4%

Government bonds' yield displayed a reduction along the curve

The Central Bank of Armenia responded to the developments of 2013 by maintaining the monetary policy instrument unchanged at 8% rate from the beginning of the year until August. In August, the Central Bank raised the refinancing rate by 0.5pp. to 8.5%, in response to the continued expansion of inflationary environment and exacerbating of inflationary expectations in short-term. Later, taking into account more than expected mitigation of inflation, elimination of inflationary impact of energy tariffs on domestic prices in short-term, as well as mid-term non-inflationary expectations in external and domestic economies, the CBA gradually eased monetary conditions by reducing the refinancing rate by 0.75 pp. to 7.75% until the end of the year.

The change of refinancing rate was more obviously manifested in the short-term financial market.

In order to stimulate the dram-denominated loan supply by commercial banks, the CBA Board lowered the reserve requirement for banks' dram-denominated obligations in June 2013, by setting it on a 4% level. This contributed to the growth of government bonds' demand. The reserve requirement for obligations in foreign exchange was set at 12%, which aims to reduce the level of dollarization.

Since July 2013 the Central Bank applies a new approach[19] of yield curve construction.

The curve study shows that bonds yield fell along the curve from July to December in the secondary market. The spread[20] of yields to maturity of short-term and long-term bonds declined by 3.6 percentage points during the half of the year and amounted to 2.5% at the end of the year. In this respect, bonds with 6-month maturity were perceived as short-term bonds and 10-year maturity bonds as long-term bonds. The spread narrowing was due to the decrease of 10-year maturity bond yield.

Reducing interest rate of government bonds was mainly conditioned by the Ministry of Finance's debt management policy, which had a more significant impact on long-term bonds.

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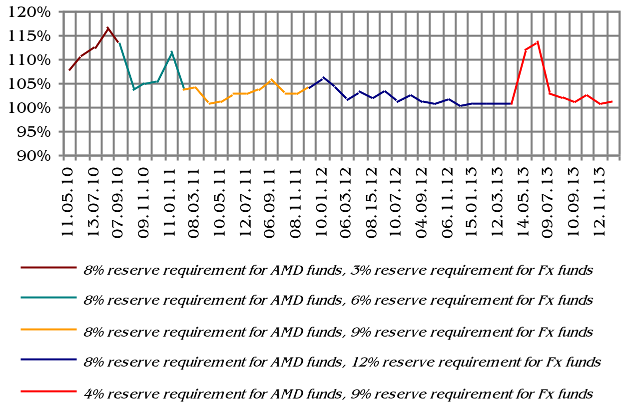
[19] Government bond yield curve is the dependence between interest rate of bonds and yield to maturity. The new yield curve is constructed by Nelson and Siegel model and is a parametric statistical model, which is an approximation of the yield curve for all periods through one function.
[20] The difference between deposit and credit interest rates.

Excess funds in AMD (reserve funds in AMD/ actual reserve funds)



For the purpose of summarizing government securities market trends, the CBA builds indices of government coupon bonds[21] data on which is presented in the Table.

Indices of government coupon bonds in circulation, by maturity as of 31.12.2013

Index	G03	G05	G5I	GMI
Modified duration (year)	1.27	1.88	6.21	3.17
Risk weighted yield	9.06	9.59	10.83	10.39
Average maturity (year)	1.43	2.29	12.91	5.36
Average weighted coupon (%)	11.48	11.24	12.03	11.47
Market Price of government bonds (mln AMD)	119859	183770	79271	263042
Price change in case of +/-1% yield change (mln AMD)	1522	3455	4923	8338

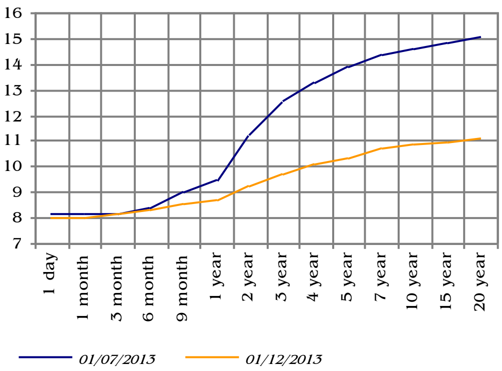
As of end 2013, the modified duration of government coupon bonds outstanding was 3.17 years, while average maturity was 5.36 years.

In case of 1% change in government bonds yield, the possible loss/income of investors may amount to AMD 8.3 billion. Moreover, the significant part of the change is expected in long-term bonds because of their high sensitivity towards interest rate change.

During 2013, total operations in securities market by investment service providers[22] (including repo and reverse repo transactions except for operations with CBA) increased by 0.9% compared to the previous year and made AMD 2 trillion 456 billion. Securities trade operations were 28.2% of the aforementioned total turnover.

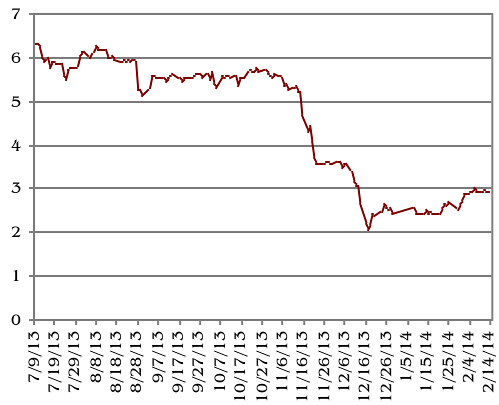
[21] Four indices are calculated for the government coupon bonds: G03, G05, G5I, which cover bonds with maturities, respectively, from 0 to 3 years, 0 to 5 years and 5 years and more; and GMI, which is a coupon bond index. Indices include the bonds issued in AMD by the Ministry of Finance, with semi-annual fixed coupons and 1 billion and more turnover. For details please see the CBA website.
[22] As of 31.12.2013, investment service providers included 21 commercial banks, 8 investment companies and 3 investment fund managers.

Yield curve change

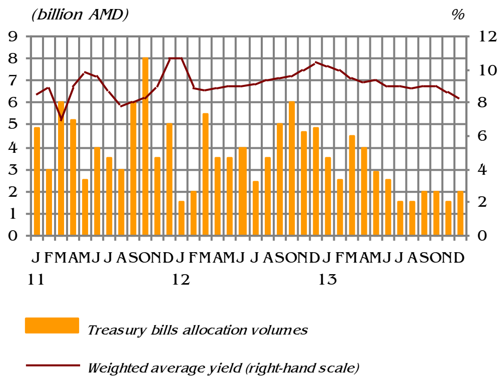


Source: Central Bank of Armenia.

Spread of 6-month and 10-year bonds

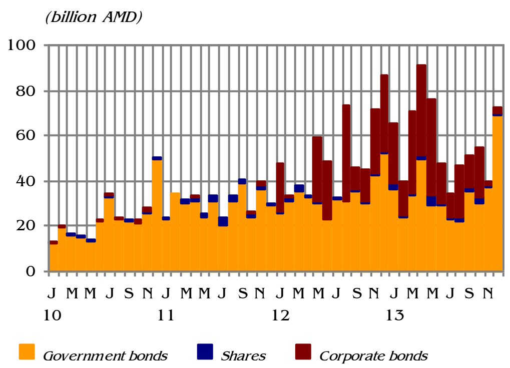


Treasury bills allocation volumes and weighted average yield



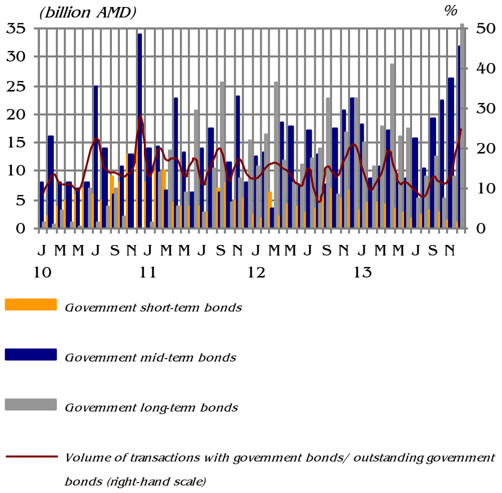
Source: Central Bank of Armenia.

Security trades by investment service providers



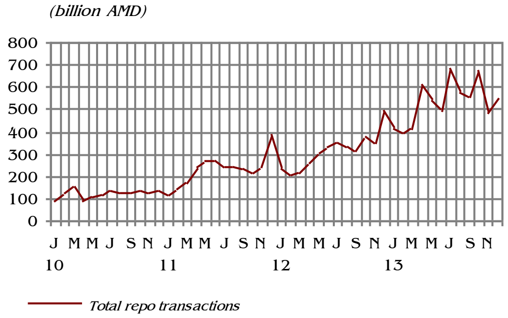
Source: Central Bank of Armenia.

Volume of transactions with government securities and volume of transactions with government securities/outstanding government securities ratio



Source: Central Bank of Armenia.

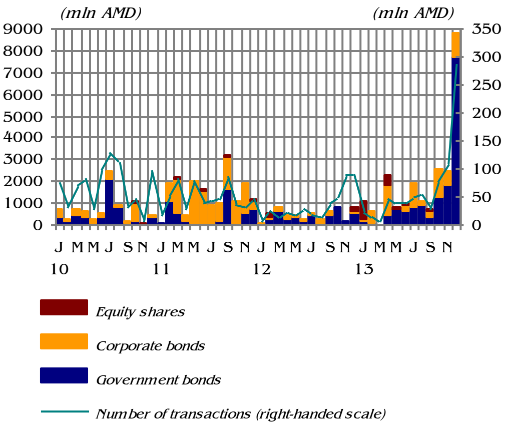
Repo transactions by investment service providers



Source: Central Bank of Armenia.

Transactions with government bonds increased notably in regulated market operations.

Securities trades and repo transactions at regulated market of securities



Source: Central Bank of Armenia.

In 2013, market liquidity (according to indices describing the liquidity)[23] of Armenia's government bonds displayed a more fluctuating path against the previous year. This was mainly due to the sharp rise in government bond trading operations in April and December. The market liquidity ratio of government securities was more than average annual liquidity by 2.46, as compared to the same ratio of the previous year; 2.25.

The shares of sale and purchase transactions in mid-term and long-term government bonds were respectively 47.7% and 43.7% of total transactions; short-term government securities transactions had an 8.5% share.

The volume of repo and reverse repo transactions carried out by investment service providers (excluding operations with CBA) during the year declined by 2.8% and made AMD 1 trillion 765 billion. It is notable that the vast majority of transactions were made in government bonds. Repo transactions in corporate securities were 0.5% of total transactions performed.

The total turnover of security trades and repo transactions in regulated market made up AMD 23.5 billion in 2013, of which 92.5% were sale and purchase transactions.

Transactions with government bonds outweighed the sale and purchase deals and repo transaction in the regulated market, amounting to 69.5% of total stock turnover. Trading operations with corporate bonds and equity securities constituted 23.6% and 6.9%, respectively.

The share of transactions on security trades in the regulated market in total transactions by investment service providers was 3.1 percent.

In 2013, the stock market capitalization/GDP ratio stood at 1.4%, increasing by 0.1 pp. compared to the previous year. The gross turnover of the stock market/GDP ratio rose by 0.8 percentage points and reached 16.2% by the end of the year.

As of 31.12.2013, the concentration of largest reporting issuers out of 14 reporting issuers admitted to trading on a regulated market by capitalization had a slight upward trend.

The 3 and 5 largest share issuers' concentration by capitalization, 2010 – 2013 (%)

Period	Capitalization of the 3 largest companies (%)	Capitalization of the 5 largest companies (%)
31.12.2010	80.1	94.7
31.12.2011	83.8	96.6
31.12.2012	78.8	96.2
31.12.2013	79.8	96.7

[23] *The liquidity of government securities market is calculated as ratio between an amount of monthly trade transactions executed by investment service providers in the secondary market of government bonds and an amount of government bonds outstanding.*

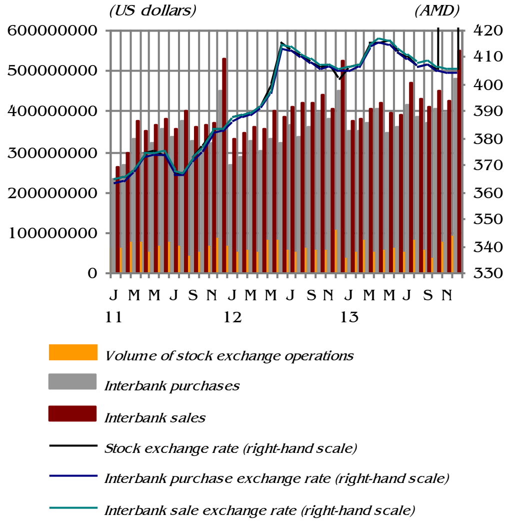
3.2. FOREIGN EXCHANGE MARKET

The national currency did not show significant fluctuations in foreign exchange market during 2013. The average market exchange rate of AMD to USD was 409.6, depreciating by 1.9 percent against the previous year. The average market exchange rate of AMD to EUR depreciated by 5.1% and made 544.1; the exchange rate of AMD to RUB was 12.9, appreciating by 0.5 percent.

In 2013 the average nominal effective AMD exchange rate has depreciated by 0.5 percent, while real effective exchange rate has appreciated by 1.6 percent, relative to the previous year[24].

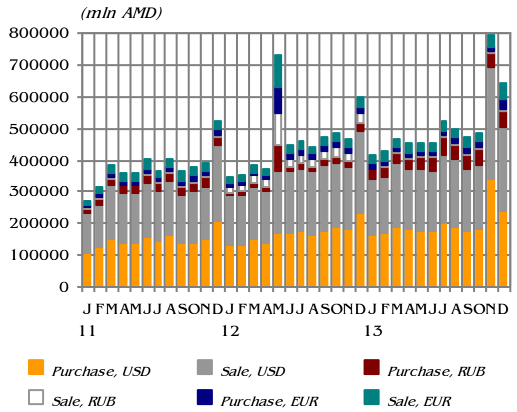
The gain of the banking sector from foreign exchange transactions during the year amounted to AMD 14.8 billion.

Volume of operations in exchange market of Armenia and the exchange rates



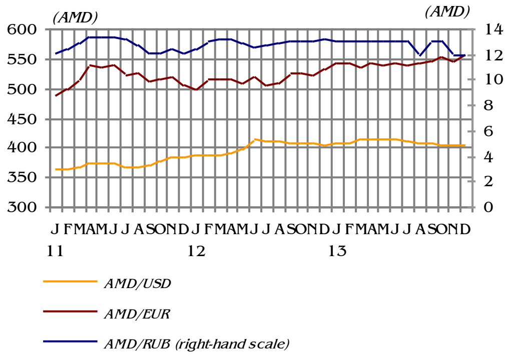
Source: Central Bank of Armenia.

Transactions in exchange market of Armenia by currencies



Source: Central Bank of Armenia.

Exchange rates in exchange market of Armenia



Source: Central Bank of Armenia.

SUMMARY

The beginning of the year was characterized by low and steady inflationary environment and high economic activity, meanwhile the increase in energy prices significantly changed the macroeconomic policy environment. The Central Bank estimated shock effects on price stability and responded in a flexible manner by dint of interest rates in order to mitigate the possible secondary effects and to neutralize the expectations. Later, when the inflationary environment was mitigated and inflation projections approached the target, the CBA Board gradually eased monetary conditions so as to stipulate economic activity.

Interest rates of government bonds displayed a slight descending pattern at the end of the year, which had no negative effect on financial market stability.

In the secondary market of securities trades with securities by investment service providers remained essentially unchanged, while repo transactions grew.

Foreign exchange market developments were mainly on a depreciation trail.

To conclude, the developments in the financial markets in 2013 did not have an essential impact on the financial stability.

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[24] *When examining the dram exchange rate behavior as well as Armenia's competitiveness in external sector, the nominal effective exchange rate and real effective exchange rate are also considered. The latters are calculated using the weights of the main 12 trade partners of Armenia (the Euro area, Russia, Ukraine, South Korea, Bulgaria, Switzerland, Iran, the USA, Turkey, Georgia, Japan and China) in foreign trade turnover.*

4. STABILITY OF FINANCIAL INSTITUTIONS OF ARMENIA

The expanding path of financial intermediation persisted in 2013

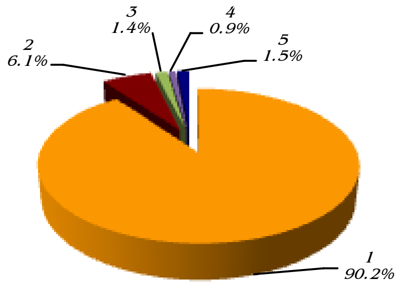
The financial system assets to GDP ratio has increased by 8.5 pp. to reach 77.1 percent in 2013. The banking system holds 89.5 percent of the financial system assets. In this context, the identification and evaluation of risks stemming from the banking system activities is rather important in the financial stability assessment framework.

The share of insurance companies, credit organizations, securities market participants and other financial organizations is still small enough in comparison with the banking system, so their potential impact on the financial stability of the Armenian financial system is estimated to be minor.

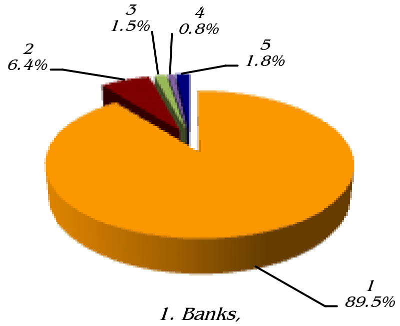
In 2013, compared to the previous year, banks showed relatively low activity in the credit market. As a result, the banking system's loan portfolio growth rates have decreased, which is assessed to be positive from the credit risk mitigation perspective.

The structure of financial system assets, by financial institutions

31.12.2012



31.12.2013



1. Banks,
2. Credit organizations,
3. Insurance companies,
4. Investment companies,
5. Other financial institutions

Source: Central Bank of Armenia.

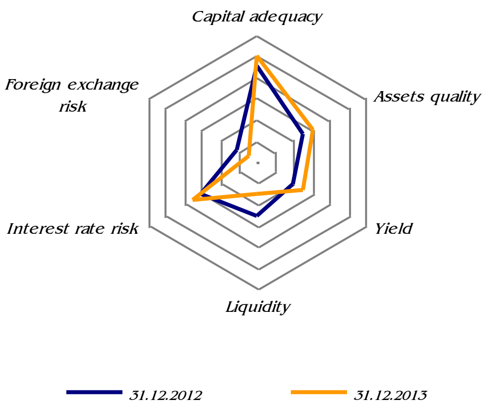
4.1. COMMERCIAL BANKS

Banking system stability map

The banking system stability map illustrates the stability of banking system and reflects the change of banking risk indicators relative to the previous period.

The banking system stability map components[25] showed some changes in the fourth quarter of 2013 compared to the same period of the previous year. Some positive developments were recorded in exchange rate and liquidity ratios' behavior. The interest rate, asset quality and yield indicators underwent minor changes towards risk increasing direction (for details, please see Credit risk, Liquidity risk, Market risk, Capital adequacy and Earnings subsections).

Banking system stability map



[25] *The banking system stability map contains indicators denoting capital adequacy, assets quality, liquidity, yield, interest rate risk and foreign exchange risk. Before usage, these indicators were scaled from 1 to 10 and calculated in accordance with the IMF methodology. The map should be interpreted in this way: the values away from the center show higher risk and close to the center show low risk level. One should not interpret the map as point reflection of the financial stability level, instead it provides a picture of whether the level of risks has increased or decreased.*

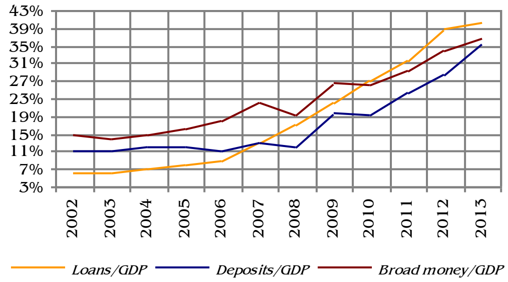
4.1.1. Financial intermediation and concentration

During 2013, parallel to nominal GDP growth, an accelerating growth in banking system balance sheet indicators was recorded, resulting in significant increase in the banking system intermediation indicators. The banking system assets to GDP ratio has increased by 6.8 pp., constituting 69.0%, as compared to the previous year. The ratio of loans to economy to GDP was 40.1%, pushing the ratio up by 1.5 pp. The deposits to GDP ratio has also increased by 7.3 pp., and reached 35.7 percent.

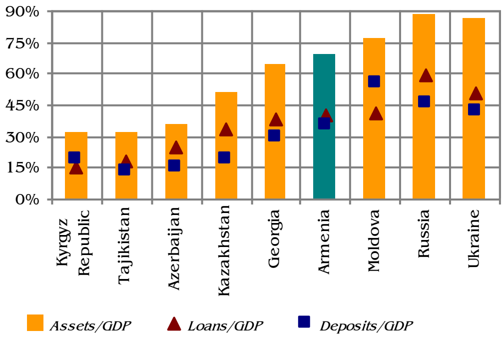
The broad money to GDP ratio has grown by 2.6 pp. and made up 36.5% during the reporting year.

Total capital of the banking sector has grown by 13.8% (AMD 55.3 billion); and total assets by 18.8% (AMD 465.9 billion). As a result, the leverage ratio (capital to assets ratio) has dropped by 0.7 pp. to 15.5 percent. The capital increased due to AMD 38.2 billion net profit and replenishment of AMD 11.4 billion statutory capital. 4 banks replenished statutory capital completely by foreign sources. Consequently, compared to the end of the previous year, the share of non-resident investors' participation in the statutory capital of the banking sector has increased by 1.3 pp. to 74.6% at the end of the year.

Financial intermediation

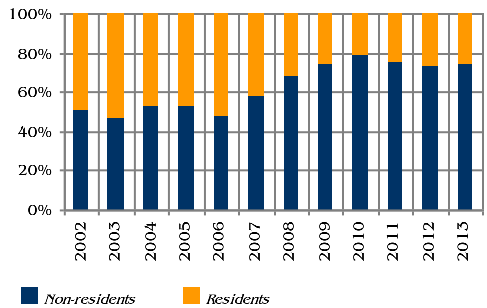


Financial intermediation in 2013, by countries



Source: National (Central) Banks

Foreign investors' participation in banking system capital of Armenia



The Herfindahl-Hirschman Concentration Index

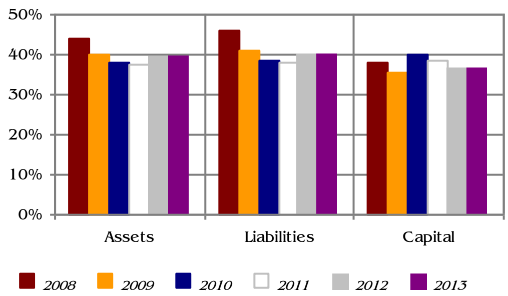
Indicators	31.12.10	31.12.11	31.12.12	31.12.13
Total assets	0.0670	0.0775	0.0787	0.0699
Total liabilities	0.0787	0.0792	0.0705	0.0727
Total capital	0.0646	0.0644	0.0637	0.0613

Source: Central bank of Armenia.

Herfindahl-Hirschman coefficient calculated for the main banking indicators[26] (assets, liabilities, capital, loans, and deposits) shows that the banking system has a low level of concentration. Thus, the probability of concentration risk adverse impact on financial stability is limited.

The share of assets, liabilities and capital of 4 largest banks out of 22 in Armenia decreased by 0.1, 0.1 and 0.2 pp., respectively and reached 39.3%, 39.8% and 36.5%.

Share of 4 largest banks` assets, liabilities and capital in total banking system



Source: Central Bank of Armenia.

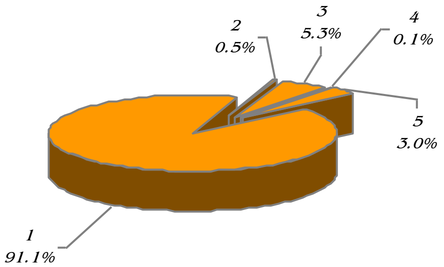
4.1.2. Credit risk

The loan portfolio growth slowed down

The most significant risk of the Armenian banking system remains credit risk. The share of credit risk in commercial banks' risk weighted assets is 91.1% (92.4% as of

[26] *The Herfindahl-Hirschman index varies between 0 and 1, characterizing the level of concentration (values near 0 denote lower concentration).*

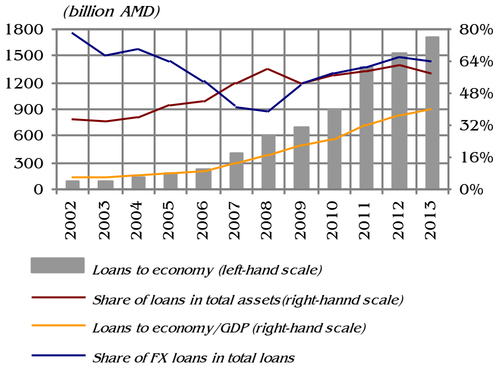
The structure of risk weighted assets calculated in banking system capital adequacy index, as of 31.12.2013



1. Credit risk, 2. Interest rate risk, 3. Operational risk, 4. Foreign exchenge risk, 5. Price risk of capital instuments

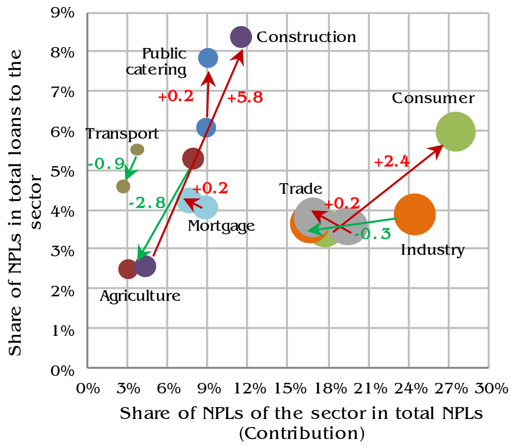
Source: Central Bank of Armenia.

Loans to economy



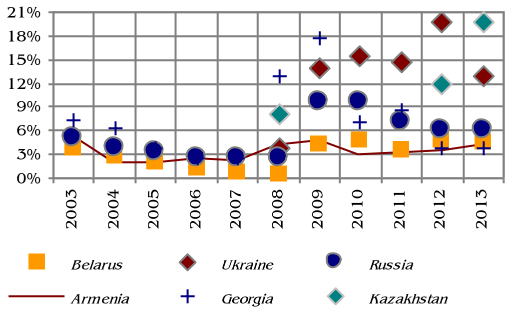
Source: Central Bank of Armenia.

The change of the share of NPLs in the loans to different sectors of economy
(The end of the arrow shows data as of 31.12.2013, the beginning - as of 31.12.2012)



Source: Central Bank of Armenia.

Share of non-performing loans in total loan portfolio



Source: IMF.

31.12.2012). In this context, its proper management is extremely important from the banking system stability viewpoint.

In 2013, loans provided to the economy grew by 11.2%. Loan portfolio increases were recorded in almost all sectors of economy, except in industry[27] sector, where 4.7% fall was reported. The growth rates of consumer credits (23.7%), transport and communication (14.6%) and mortgage loans (12.4%) were significant. Industry, trade and consumer credits have the largest shares in total loan portfolio; 20.7%, 20.7% and 20.0%, respectively.

In terms of credit quality, the share of non-performing loans and receivables (classified as "watched", "substandard", and "doubtful") has grown by 0.8 pp. and constituted 4.3% of total loan portfolio. The growth of the share of non-performing loans and receivables occurred due to the increase of the share of loans classified as "watched". The latter was significantly contributed by the high growth of the loan portfolio in the last 3 years (30% average annual growth). In this context, the slowdown of loan portfolio growth is evaluated as positive for credit risk mitigation.

Regarding the sectorial distribution of loans, the share of non-performing loans was relatively high among loans provided to construction and consumer loans, growing by 5.8 and 2.4 pp. and constituting 8.3% and 6.0%, respectively. Consequently, the contribution of construction and consumer non-performing loans increased in the overall banking system's non-performing loans formation. The non-performing loans of these sectors amounted to 11.5% and 27.5%, respectively, in the total non-performing loans at the end of the year (as of 31.12.2012, 4.3% and 17.7%, respectively).

The share of non-performing loans and receivables in total loans and receivables, calculated according to international methodology[28], has grown by 1.1 pp. and amounted to 7.3 percent at the end of the year. Relative to the previous year, the ratio of net asset loss provisions to total assets has increased by 0.3 pp. to 1.2%.

The Herfindahl-Hirschman concentration index for sectoral distribution of loans has grown by 0.01 pp. to 0.12, which points to the moderate concentration of loans in the banking system. The average concentration by banks remains

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[27] As a result of change in accounting records of one commercial bank, where standard loans were charged off from the balance sheet (though the loans remained in the economy) and have been registered in the parent bank's balance sheet. Where this change was excluded, the growth rate of industry credits would amount to 13.6%, and their share in total loan portfolio would be 23.3%.

[28] According to international methodology, the share of non-performing loans and receivables in total loan portfolio and accounts receivable is calculated as the ratio of loans classified as "substandard", "doubtful" and "loss" to total loans and receivables.

unchanged, 0.17. The high indicator of banks' average, compared to sectoral concentration index of banking system as a whole, is an evidence of high sectoral concentration of lending in some banks. The share of loans made to large borrowers[29] in total loan portfolio, has grown by 0.1 pp. compared to the end of the previous year and amounted to 25.2% at the end of this year.

Credit risk stress scenarios [30]

31.12.2013	Stress scenarios		
	25 % of watched, substandard and doubtful loans classified into losses	75 % of doubtful loans classified into losses	30 % of standard loans classified into watching loans
Loss of the banking system	AMD 15.0 billion or 3.5% of regulatory capital of the banking system	AMD 6.1 billion or 1.4 % of regulatory capital of the banking system	AMD 51.9 billion or 12.1% of regulatory capital of the banking system
Total capital adequacy of the banking system in case of stress scenario	16.2%	16.5%	15.0%

The results of credit risk stress-scenarios conducted at the end of the year mainly deteriorated, compared to those conducted at the end of the previous one. This was due to certain increase in the share of non-performing loans in loan portfolio. In case of the worst stress scenario violation of the capital adequacy ratio was reported with some banks. Nevertheless, the probability of insolvency issues, because of possible losses deriving from the credit risk, was assessed as too small.

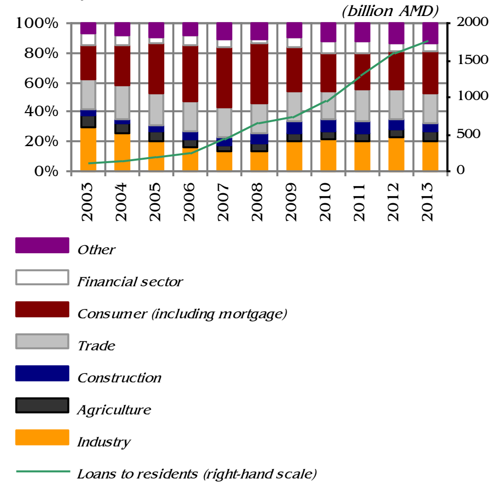
Stress scenario of credit risk derived from off-balance sheet contingent liabilities

31.12.2013	Stress scenarios
	When 50% of off-balance sheet contingent liabilities performed
Banking system capital adequacy ratio before stress scenario	16.7%
Banking system capital adequacy ratio in case of stress scenario	16.5%

The results of stress scenario of credit risk derived from off-balance sheet contingent liabilities[31] showed that no bank would be in breach of the capital adequacy requirement and the decrease of capital adequacy would not exceed 1 percentage point in any bank. Thus, the credit risk deriving from of off-balance sheet contingent liabilities was estimated to have a negligible impact on financial stability.

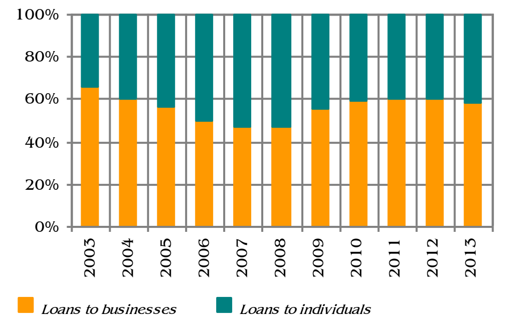
[29] The bank risk of large borrowers exceeds 5% of average monthly regulatory capital, given the interconnectedness.
[30] This and further stress scenarios are not forecasting emergence of any risks, but rather are aimed to reveal the weaknesses of the financial system, as well as to assess its ability to absorb such risks.
[31] Off-balance sheet contingent liabilities include unused part of lines of credit, credit cards, overdrafts, L/Cs, guaranties and sureties.

Structure of bank loans to residents, by economy sectors



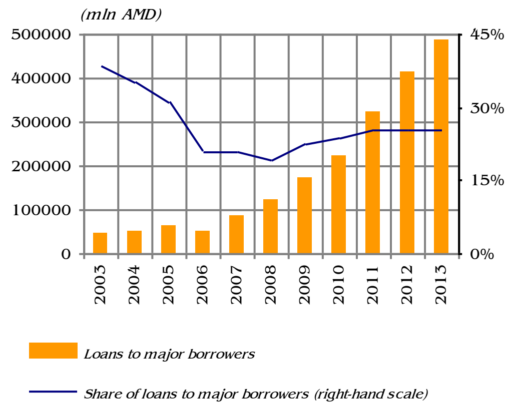
Source: Central Bank of Armenia.

Share of loans to the businesses and individuals in total loan portfolio

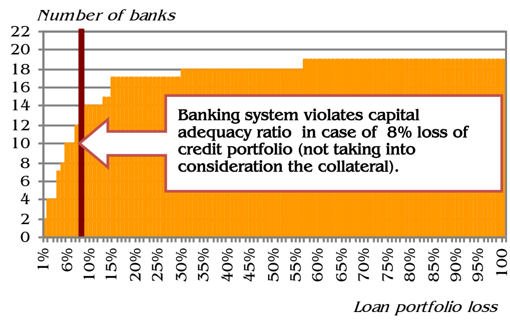


Source: Central Bank of Armenia.

Loans to major borrowers/total loans



The number of banks violating capital adequacy regulatory ratio under dynamic growth of loan losses



Source: Central Bank of Armenia.

4.1.3. Liquidity risk

In 2013, the liquidity of commercial banks slightly increased in line with slowdown of lending growth rates. Relative to the end of 2012, the total liquidity and current liquidity ratios of commercial banks have increased by 3.5 and 16.3 pp. and amounted to 29.1% and 142.3%, respectively, at the end of the year. (The minimum prudential thresholds are 15% and 60%, respectively). During the reporting year, the commercial banks' foreign currency liquidity significantly improved. As compared to the end of the previous year, total and current liquidity ratios for the first group of foreign currencies increased respectively by 4.9 and 24.9 percentage points and amounted to 22.0% and 114.9%, respectively. (The minimum prudential thresholds are 4% and 10%, respectively). Regarding each bank individually, liquidity prudential ratios were at adequate levels. No regulatory requirement violation was recorded in any bank.

In terms of asset and liability duration gaps, the assets to liabilities[32] ratio with up to 30 days (including demand liabilities and assets), up to 3 months and up to one year maturities are 108.6%, 101.6% and 88.7%, respectively. As of 31.12.2012 the ratios were, 101.0%, 99.5% and 89.0%, respectively. A negative gap was observed only in the maturity basket of up to 1 year. This change is a consequence of increase in loan terms along with the deepening of financial intermediation.

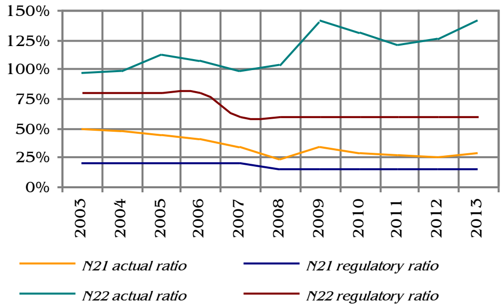
The assets to liabilities ratio with up to 30 days (including demand liabilities and assets) maturity is rather important from the point of view of banks' current liquidity. The latter, historically ranging from 90-100%, displayed a growing trend. The observed pattern is positively assessed in the context of improvements in liquidity management.

In terms of liabilities concentration, the share of major liabilities in total liabilities remained unchanged, 26.2%.

Foreign borrowings of commercial banks have remained fairly unchanched compared to the previous year (a mere 0.2% growth was recorded). Funds attracted from international financial institutions have increased by 8.7 percent and accounted for 40.3% of total foreign borrowings. The main creditor countries are Russia (20.3%), Luxembourg (10.2%), Netherlands (6.3%), and Great Britain (5.3%). The share of long-term liabilities was 88.6%, which almost rules out the likelihood of risks associated with the refinancing of these liabilities.

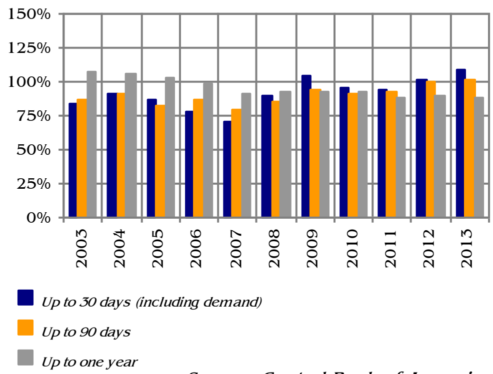
Commercial banks liquidity levels have increased on the positive side

Actual and regulatory liquidity ratios of the banking system



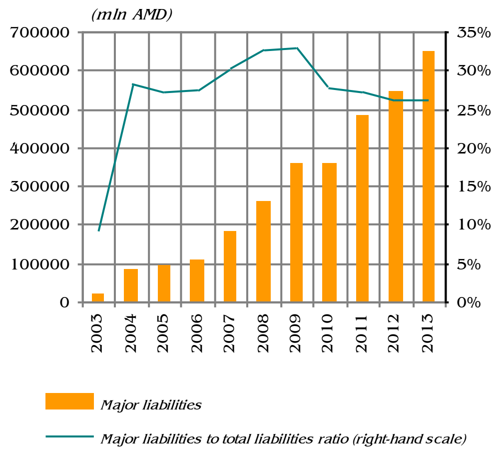
Source: Central Bank of Armenia.

The ratio of banking system assets to liabilities by terms to maturity



Source: Central Bank of Armenia.

The ratio of banking system major liabilities to total liabilities



Source: Central Bank of Armenia.

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[32] *In the calculation of assets to liabilities ratio for maturity baskets the off-balance sheet contingent liabilities have been assigned a 20% weight.*

In terms of credit financing sustainability a significant decrease in risk was recorded in the reporting year. Loans to deposits[33] ratio decreased by 23.3 percentage points to 112.3% compared to the previous year. It is noteworthy that the improvement of loans to deposits ratio (LTD) was maintained due to high growth rate of deposits from individuals as compared to loans.

Liquidity risk stress scenarios

31.12.2013	Stress scenarios		
	Withdrawal of 25% of individuals' time deposits	Withdrawal of 25% of demand liabilities	Withdrawal of 25% of demand liabilities and of 25% of individuals' time deposits
Total liquidity ratio of banking system	23.6%	25.3%	19.2%
Current liquidity ratio of banking system	107.0%	156.0%	109.3%

The outcomes of stress scenarios carried out in the end of the year have improved compared to the previous year, given the liquidity levels growth amid loan portfolio growth slowdown.

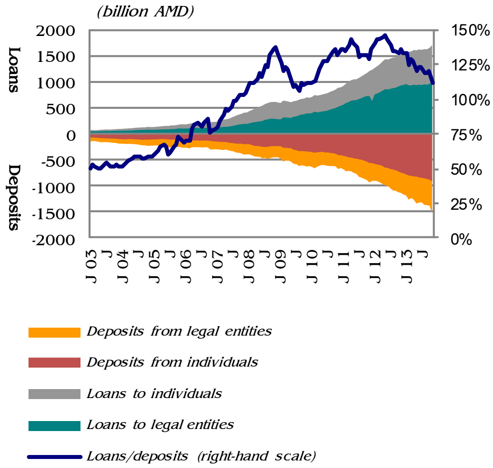
In the worst case stress scenario (simultaneous withdrawal of 25% of demand deposits and 25% of time deposits of individuals), violations of total and current liquidity regulatory requirements were recorded in some banks. However, high liquid assets of such banks are well sufficient to cover outflow of liabilities.

Stress scenario of liquidity risk derived from off-balance sheet contingent liabilities

31.12.2013	Stress scenarios
	When 50% of off-balance sheet contingent liabilities performed
Banking system total liquidity ratio	25.5%
Banking system current liquidity ratio	124.4%

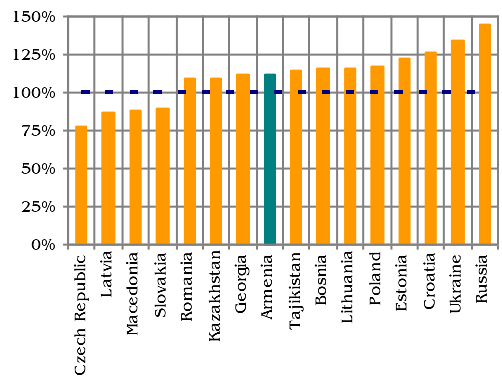
According to the results of stress tests aimed to assess the risk of liquidity derived from performance of off-balance sheet contingent liabilities, some banks report violation of total and current liquidity ratios. However, the ratios are close to the minimum prudential threshold. Lastly, the liquidity risk derived from performance of off-balance sheet contingent liabilities does not have a significant impact on financial stability.

The structure of funds financing loans of banking system of Armenia



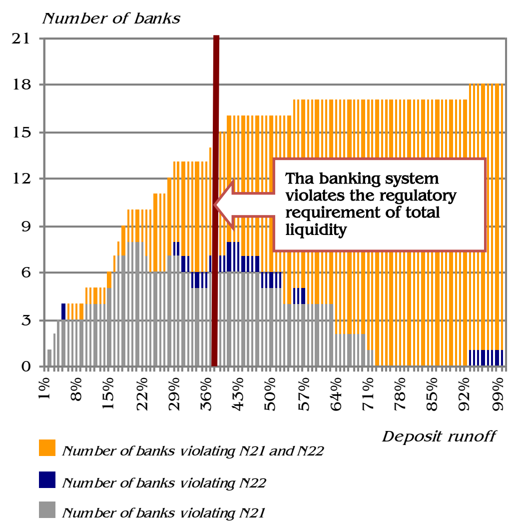
Source: Central Bank of Armenia.

Loans to deposits in banking system of Eastern Europe and CIS countries



Source: IMF.

The number of commercial banks violating liquidity regulatory ratios in case of individuals' call and time deposits runoff



[33] *While calculating the ratio of loans to deposits, loans include loans to the real sector of the economy (including leasing and factoring), while deposits include funds involved from natural and legal persons.*

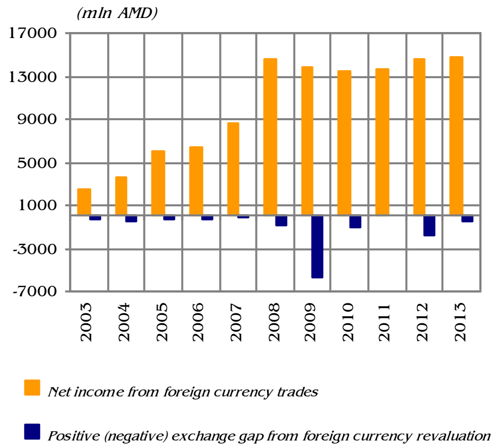
4.1.4. Market risk

The possible impact of market risk on financial stability is rather weak

Foreign exchange risk

In 2013, the dram fluctuations against other currencies led to AMD 447 million loss (or 0.1% of regulatory capital) as a result of the banking system foreign currency revaluation. Accordingly, 15 banks incurred losses and 7 banks reported profit. The banking system generated net revenue of AMD 14.8 billion from foreign exchange transactions.

Net income of the banking system from foreign currency trades and revaluation



Relative to the end of the previous year, the share of foreign currency loans in total loans decreased by 2.0 pp. and was 63.7%. The share of foreign currency deposits in total deposits have grown by 0.7 percentage points and have constituted 71.0%.

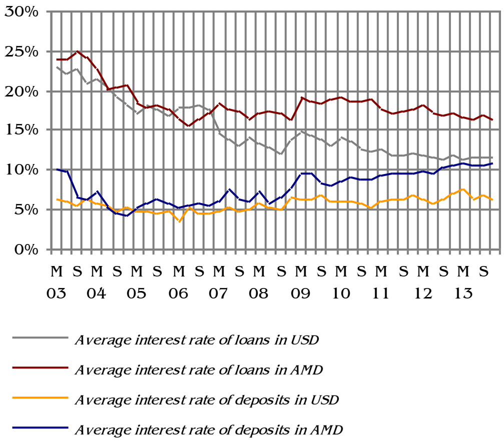
As of end of the year, commercial banks' net short position of foreign currencies (inclusive of derivative instruments) was AMD 370 million or 0.1% of total regulatory capital. (As of 31.12.2012, net long position was AMD 5.9 billion or 1.6 percent of total regulatory capital)[34].

Foreign exchange risk stress scenarios

31.12.2013	Stress scenarios		
	Profit (loss) in case of 5% depreciation (appreciation) of AMD/USD	Profit (loss) in case of 5% depreciation (appreciation) of AMD/EUR	Possible maximum 10-days loss estimated through VaR Model
Banking system's profit (loss) from foreign currency revaluation	AMD 189.9 million or 0.04% of regulatory capital (AMD –189.9 million)	AMD 56.0 million or 0.01% of regulatory capital (AMD -56.0 million)	AMD 92.7 million or 0.07% of regulatory capital

In the worst case stress scenario[35], bank losses incurred as a result of foreign exchange open position are insignificant, so the impact of such losses on the financial stability is weak.

Average interest rates of bank deposits and loans



Source: Central Bank of Armenia.

Interest rate risk

During 2013, the trend of loan interest rates decline and deposit interest rates growth continued. Particularly, dram-denominated deposit interest rates showed more obvious growth and loan interest rates more obvious decline resulting in a significant spread narrowing of dram-denominated loan and deposit rates. In the reporting year the weighted average

[34] Derivative instruments include the derivative contracts signed for long-term deposits with foreign governments, central (national) banks, financial organizations and international prestigious institutions that are rated A + (A1) or higher than A+ (A1) by Standard & Poor's or Fitch (Moody's).
[35] The calculation of losses estimated through stress-scenarios and the VaR Model (the VaR Model is not considered as a stress-scenario since the calculation of the model is based on historical exchange rate series of currencies) is based on FX positions of commercial banks as of 31.12.2013.

nominal interest rates of dram-denominated and foreign currency loans decreased by 0.7 and 0.2 pp., respectively. The weighted average nominal interest rates of dram-denominated and foreign currency deposits grew by 0.7 pp. and 0.4pp. As a result, AMD and USD loan and deposit spreads narrowed by 1.4 and 0.6 percentage points.

The decrease of loan interest rates and the increase of deposit interest rates are mainly driven by an increased competition in the banking system.

The duration gap of assets and liabilities is small, varying within 3 months. This means that possible fluctuations in market rates will not entail major losses in the banking system.

Interest rate risk stress scenarios

31.12.2013	Impact of 2 pp. decrease (increase) of market interest rates on the economic value of capital, estimated through the "Duration Method"	Deviation of net interest income from expected income of the three months ahead in case of 2 pp. decrease (increase) of market interests, estimated through the "Interest rate-sensitive assets and liabilities Gap Method"
Banking system's profit (loss)	AMD 3.5 billion or 0.8% of banking system capital (AMD -3.5 billion or 0.8% of banking system capital)	AMD 383.6 million or 0.1% of banking system capital (AMD -383.6 million or 0.1% of banking system capital)

In case of the worst possible stress scenario of interest rate risk, probable losses of banks from market interest rate fluctuations are averaged in the region of 2.1 percent of capital. In this context, banking system losses, as a result of market interest rate fluctuations, will neither be significant nor will cause vulnerabilities to financial stability.

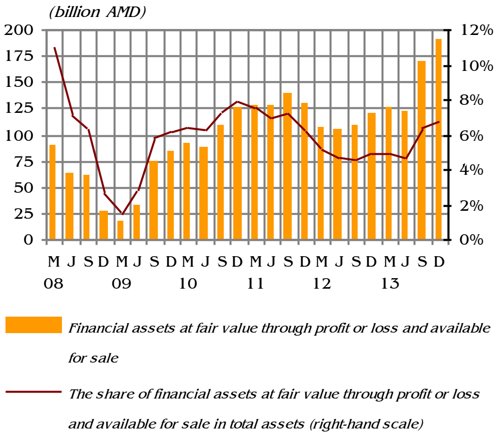
Price risk

During 2013, as a result of expanding of government bond portfolio holded by banking system the share of financial assets available-for-sale and held at fair value through profit or loss in total assets increased. Relative to the end of the previous year, the share of those financial assets augmented by 1.9 pp. and amounted to 6.8%. However, the price risk of the banking system continues to be assessed as quite low.

As a result of market interest rate fluctuations in the reporting year the banking system net income was AMD 2.4 billion due to revaluation of financial assets held at fair value through profit or loss and available-for-sale. All banks reported profit from the revaluation.

Risks associated with real estate price fluctuations remained manageable. The commercial banks of Armenia

The share of financial assets at fair value through profit or loss and available for sale financial assets in total assets



Source: Central Bank of Armenia.

further provided mortgages with loan-to-value ratio between 60-80 percent, while taking quite a strict approach in evaluating borrower creditworthiness. Such restrictions significantly lower the possibilities of losses from real estate price volatilities.

Real estate price change stress scenarios

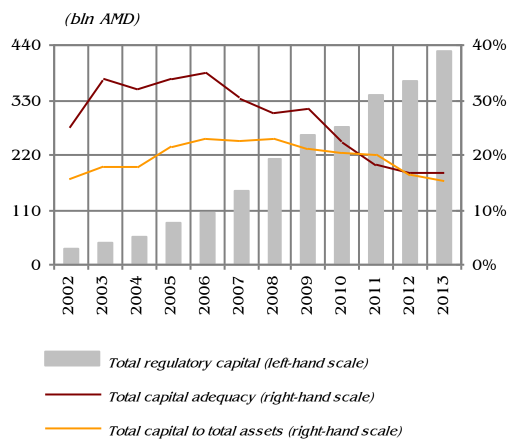
30% depreciation of real estate	31.12.2013
The banking system's loss due to revaluation of own real estate property *(price risk)*	AMD 12.9 billion (or 3.0% of banking system capital)
The banking system's loss due to a 30% loss of vulnerable credit portfolio[36] (taking into consideration that the collateral involved has been sold at a depreciated cost), if a stress-scenario occurs *(credit risk)*	AMD 6.1 billion (or 1.4% of banking system capital)
The banking system's loss due to a 100% loss of vulnerable credit portfolio (taking into consideration that the collateral involved has been sold at a depreciated cost), if a stress-scenario occurs (credit risk)	AMD 20.3 billion (or 4.7% of banking system capital)

If the stress scenario of 30% devaluation of real estate price occurs, maximum potential losses of commercial banks (from the price risk and derived indirect credit risks perspective) will trend upward, which will be mainly attributable to mortgage lending rate, exceeding those of the regulatory capital and loan-to-value ratio growth in line with the deepening of competition. However, real estate price fluctuations are not high (taking into account the last 2-3 years' developments) and the impact of credit and price risks to financial stability is assessed non-vulnerable.

4.1.5. Capital adequacy and profitability

The capital adequacy of commercial banks remains at a reasonable level

Banking system capital adequacy



The capital adequacy ratio remained fairly unchainged due to slower pace of lending growth and amounted to 16.7% (16.8% as of 31.12.2012). All the banks maintained capital adequacy ratio within the required prudential threshold, and no cases of violation of regulatory capital adequacy ratios were recorded during the year.

Compared to the end of the previous year the total regulatory capital of the banking sector has grown by 16.2 percent and reached AMD 428.5 billion at the end of the year. In terms of total regulatory capital quality structure, the share of regulatory Tier 1 capital in total regulatory capital is still high, constituting 86.6%. (As of 31.12.2012 the ratio was 90.7%). This points to the high level of risk-absorption of regulatory capital of commercial banks.

[36] *Vulnerable loan portfolio represents the sum of loans outstanding, the residual values of which exceed the 30% devaluated values of the real estate used as collateral.*

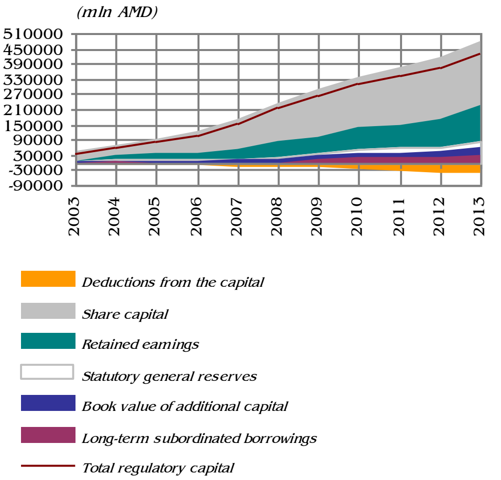
The net profit of the banking system, calculated in accordance with the Central Bank supervisory reports[37], amounted to AMD 38.2 billion. During the year, 16 banks operated at a profit and 6 banks at a loss. Compared with the previous year, return on assets (RoA) and return on equity (RoE) of the banking system have decreased by 0.5 pp. and 2.2 pp. and amounted to 1.4% and 9.2%, respectively. The decrease in banking system profitability is mainly conditioned by the growth of net loss provisions to assets ratio owing to loan portfolio quality deterioration and a decline of net interest margin[38] owing to interest rate spread narrowing.

As compared to the previous year, net asset loss provisions to assets ratio increased by 0.3 percentage points to 1.2%. Net interest margin decreased by 0.6 percentage points to 4.5%.

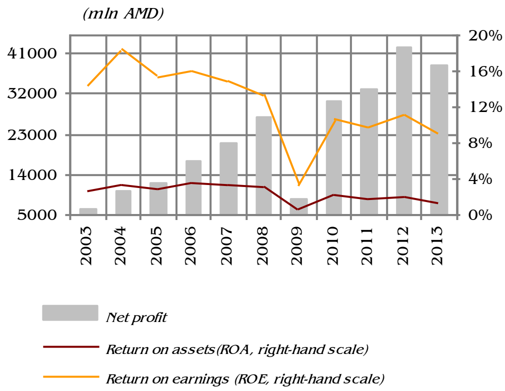
In 2013, gross revenues of the banking system have grown by 24.7 percent and reached AMD 514.2 billion. Gross expenditures have grown by 30.0%, amounting to AMD 464.9 billion. The shares of assets loss provisions and recoveries in the structure of revenues and expenditures grew. In the structure of banks' revenues the share of interest income declined, meanwhile in the expenditure structure non-interest expenditures decreased. These structural changes are mainly due to relative high fluctuation of NPLs in total loan portfolio during 2013.

The banking system net profit, calculated in accordance with International Financial Reporting Standards (IFRS), amounted to AMD 48.1 billion, while the return on assets (RoA) was 1.6 percent and return on equity (RoE) 10.0 percent.

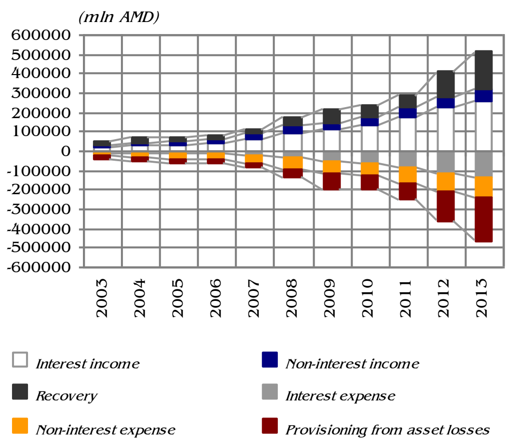
The structure of total regulatory capital



Profitability ratios of the banking system



Income and expense of banking system



Source: Central Bank of Armenia.

4.2. CREDIT ORGANIZATIONS

Credit organizations are the second largest sector of Armenia's financial system. The assets of credit organizations constituted 6.4 percent of the entire financial system assets. In the period under review, credit organizations generated significant increases in assets, liabilities and capital.

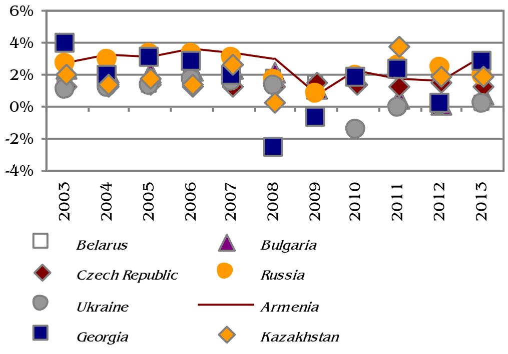
Assets, liabilities, capital and profit of credit organizations

(thousand AMD)

Indicator	31.12.2012	31.12.2013	Growth (%)
Assets	168,530,773	209,841,599	24.5
Liabilities	105,653,830	132,243,167	25.2
Capital	62,877,084	77,598,432	23.4
Net profit	4,847,791	5,852,591	20.7

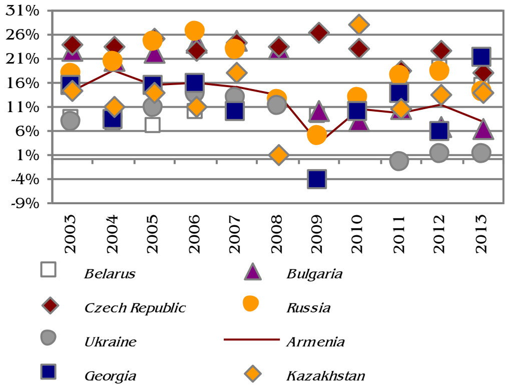
[37] *This differs from IFRS mainly on the part of loan loss provisioning for standard assets.*
[38] *Net interest margin is calculated as ratio of net interest revenues to assets.*

Banking system ROA in selected East European and CIS countries



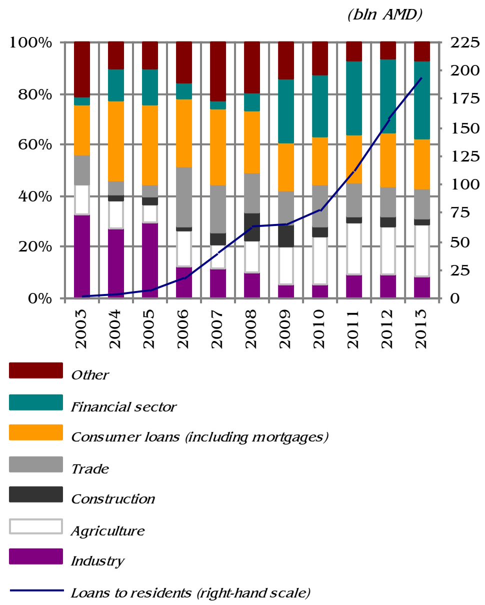
Source: IMF.

Banking system ROE in selected East European and CIS countries



Souce: IMF.

Balance of loans to residents by credit organizations, by sectors



Souce: Central Bank of Armenia.

During 2013, total assets growth of credit organizations exceeded the growth rate of total capital by 1.1 pp. As a result, the leverage ratio (total capital to total assets ratio) of credit organizations has displayed a 0.3 pp. decrease to 37.0 percent.

In 2013, net profit of credit organizations, calculated according to supervisory requirements of the Central Bank, amounted to AMD 5.9 billion, thus, 30 credit organizations posted profit and 3 posted loss. Return on assets (RoA) and return on equity (RoE) of credit organizations, relative to the previous year, augmented by 0.8 and 2.4 pp. and amounted to 3.1 and 8.1 percent, respectively.

Profit of credit organizations, calculated in accordance with IFRS, has amounted to AMD 6.2 billion; in this case return on assets was 3.2 percent and return on equity, 8.6 percent.

The share of non-performing loans and receivables in total loans and receivables remained unchanged, amounting 3.8% at the end of the year. The share of non-performing loans is relatively high in public catering and other service sectors, consumer loans and construction; 14.5%, 8.0% and 7.7%, respectively.

The share of non-performing loans and receivables (classified as “substandard”, “doubtful” and “loss”), calculated by international methodology, remained unchaged at the level of 4.9% at the end of the year.

Relative to the previous year, the ratio of assets loss provisions to total assets has fallen by 0.1 pp. and amounted to 1.5 percent in 2013.

In all maturity baskets of assets and liabilities (up to 180-day (including demand), from 180 days to one year, more than one year), the volumes of assets surpassed the volumes of liabilities, pointing out, ceteris paribus, to the low liquidity risk of credit organizations.

Credit risk assessment scenarios[39]

31.12.2013	Stress scenarios		
	25 % of loans in watched, substandard and doubtful categories classified into loss loans	**75 % of loans in doubtful category classified into loss loans**	**30 % of loans in standard category classified into watched loans**
Total loss of credit organizations	AMD 1.3 billion or 1.7% of regulatory capital	AMD 447.1 million or 0.6% of regulatory capital	AMD 4.5 billion or 6.0% of regulatory capital

Source: Central Bank of Armenia.

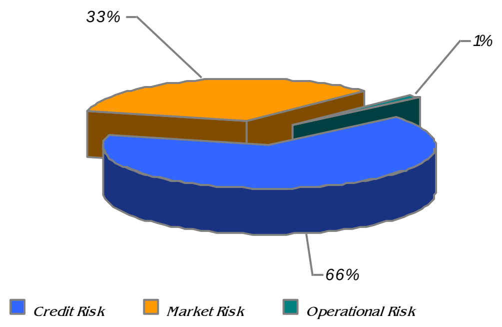
[39] *Stress scenarios are built on an assumption that the amounts of loans of credit organizations are unchanged and the secured property is ignored (which means when loans are classified as loss, a possible sale of the collateral is not considered).*

Compared to the banking system, capitalization of credit organizations is stronger, and according to various stress scenarios, they are fully capable to absorb possible risks.

4.3. SECURITIES MARKET PARTICIPANTS

As of December 31, 2013, there were 21 banks providing investment services and 8 investment companies operating in the Armenian securities market. Also 3 investment fund managers are registered in the financial market of Armenia, two of which are entitled to run a mandatory (both licenses received during the reporting year), and one a voluntary pension fund.

The structure of assets in the capital adequacy ratio of investment companies as of 31.12.2013



In 2013, relative to the previous year-end, total assets of investment companies have grown by 14.5 percent and amounted to AMD 27.0 billion, and total capital has increased by 36.1% to AMD 5.2 billion. Profit of investment companies has totaled to AMD 874 million; 6 companies reported profit and 2 reported loss.

The credit risk of investment companies accounted for 65.3% of risk weighted assets; market risk accounted for 33.3%; and operational risk, 1.4 percent. Remarkably, interest rate risk had the largest share in the market risk (84.0 percent), while foreign exchange and equity bonds price risks of investment companies constituted 14.7 and 1.3 percent, respectively.

At the end of the year, a total of 21 classes of securities of 14 reporting issuers were admitted to trading in the regulated market. Two issuers are accountable on both shares and bonds. The share of equity securities issued by three commercial banks is 25.0% of total issued securities while the share of bonds issued by one commercial bank and one credit organization is 21.0% of total issued bonds. The total amount of shares was AMD 53.4 billion and the total amount of bonds, AMD 10.5 billion. Moreover, the share of foreign currency bonds is almost 74.0%.

As of 31.12.2013, there were 2046 registries of nominal security holders and 107001 nominal security owners running the register at the Central Depository of Armenia.

4.4. INSURANCE COMPANIES

Though the compulsory MTPL insurance and health insurance have boosted up the insurance market, the total weight of the insurance market in the financial system remains small. In the meantime, however, insurance *company risks are controllable and pose no threat to financial stability.*

As of 31.12.2013, there were 9 insurance companies licensed to conduct insurance activities in Armenia[40].

During 2013, the assets of insurance companies have increased by 30.3% to AMD 50.0 billion; liabilities have surged by 38.1% to AMD 34.0 billion, whereas total capital has grown by 16.3% and amounted to AMD 16.0 billion. The share of total assets of insurance companies in the financial sector has grown by 0.1 pp. and reached 1.5% of the financial sector assets. The accrued premiums, the main indicator describing the activity of insurance companies, have risen by 1.0%, relative to the same period of the previous year; amounting to AMD 35.8 billion (the growth of this indicator in the previous year was 58.8%).

The premiums to GDP ratio amounted to 0.83% at the end of 2013, which has decreased by 0.1 pp. relative to the previous year[41]. The premium per capita ratio was AMD 10,894 in 2013 versus AMD 10,824 reported in 2012.

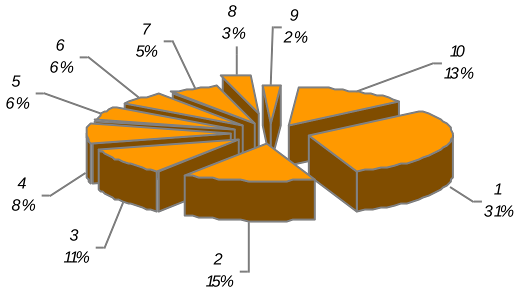
In 2013, relative to the previous year, the loss ratio of insurance companies has increased by 3.0 pp. to 62.2%[42]. This increase came in parallel with insurance companies' expense ratio[43] dropping by 2.0 pp. relative to the previous year and reaching 30.3% at the end of the year. This is pointing to an increased operational effectiveness of insurance companies.

The shares of risk-weighted assets and required solvency in the insurance sector capital adequacy ratio amounted to 38.4 percent and 61.6 percent, respectively. The regulatory capital adequacy ratio of the insurance sector was 139.4%, exceeding the required minimum value by 39.4 pp. (marginal value of regulatory capital adequacy is 100%).

Solvency risk

The change in solvency levels of insurance companies was assessed in the event the following stress scenarios unfold (10% growth of reimbursement frequency rates and 5% insurance payments increase). Results suggest that the level of solvency will not incur notable changes, so the likelihood of risk emergence to the financial stability from the insurance sector is very low.

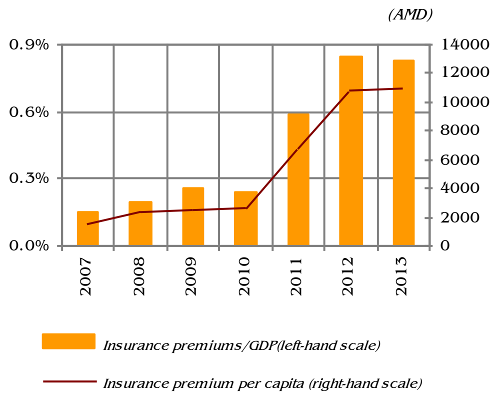
Insurance sector assets, as of 31.12.2013



1. Deposits with banks, 2. Sums receivable on direct insurance, 3. Securities sold under repo agreements 4. Government and non-government securities, 5. Fixed assets, 6. Costs for future periods and prepayments on insurance, 7. Reinsurers' share in insurance reserves, 8. Borrowings, 9. Bank accounts, 10. Other assets

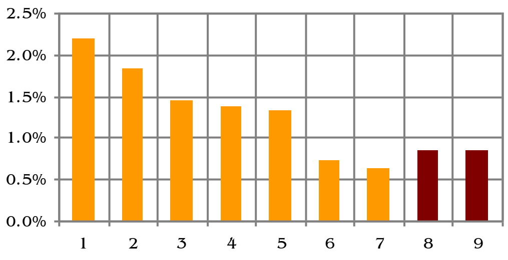
Source: Central Bank of Armenia.

Main ratios of insurance sector of Armenia



Source: Central Bank of Armenia.

Insurance premium/ GDP in EEC and CIS (2012)



1. Georgia, 2. Ukraine, 3. Romania, 4. Turkey, 5. Russia, 6. Kazakhstan, 7. Azerbaijan, 8. Armenia 2012, 9. Armenia 2013

Source: Central Bank of Armenia, Swiss Re, Sigma No 3/2013.

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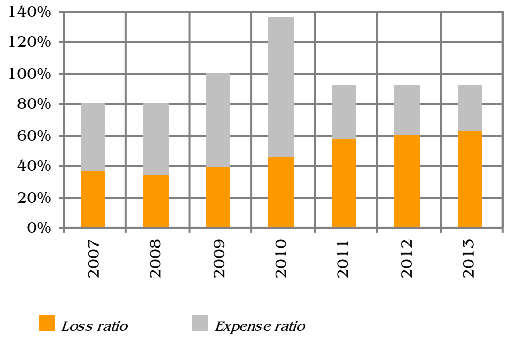
[40]Indicators of 8 insurance companies active and reportable have been summarized as of 31.12.2013, as 1 insurance company does not exercise insurance activities, though having a license.
[41] Based on the 2012 data, the premiums to GDP ratio on non-life insurance was 3.61 % on average in developed industrial countries and 1.26% in emerging countries (source: Swiss Re, Sigma No 3/2013, May 2013).
[42] The loss ratio was calculated using the following formula: (net accrued indemnity + net provisions to technical reserves (except for unearned insurance premium reserves, UIPR) + other transaction costs on insurance) / (earned insurance premiums - sums refunded on the contracts terminated).
[43] The expense ratio was calculated using the following formula: non-interest expense / (earned insurance premiums - sums refunded on the contracts terminated).

Solvency assessment stress scenarios

31.12.2013	Stress scenarios
	Growth of reimbursement rates, 10%, and insurance payments increase, 5 %
Required growth of UIPR of the insurance sector, if the stress scenario occurs	AMD 1.0 billion or 6.1 % of regulatory capital of the sector
Total capital adequacy ratio of the insurance sector, if the stress scenario occurs	130.9%

Source: Central Bank of Armenia.

Loss and expense ratios of Insurance sector

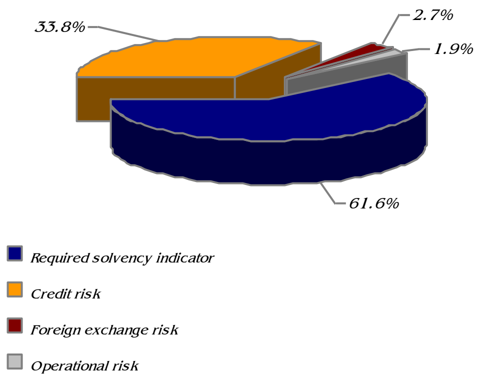


Source: Central Bank of Armenia.

Credit risk

Allocating funds of the insurance sector in low-risk assets allows keeping investment risk at a low level. Assets equivalent to technical reserves are invested primarily in time and demand deposits with commercial banks as well as government and non-government bonds.

The share of risk weighted assets and required solvency in insurance sector capital adequacy ratio, as of 31.12.2013



Credit risk assessment stress scenarios

31.12.2013	Stress scenarios		
	Classifying 30% of "standard" assets into "watched" category	Classifying 5% of "standard" assets into "loss" category	Sharp increase of outstanding claims reserves, 25%
Loss of the insurance sector	AMD 0.8 billion or 5.3% of regulatory capital	AMD 1.6 billion or 9.6% of regulatory capital	AMD 0.6 billion or 3.6% of regulatory capital
The total capital adequacy ratio of the insurance sector, if the stress scenario occurs	133.2%	128.0%	134.4%

Source: Central Bank of Armenia.

The results of credit risk assessment stress tests show that potential loss of the insurance sector is low.

Foreign exchange risk

Given the outcomes of foreign exchange stress scenario, the loss of insurance companies incurred from foreign exchange risk is estimated to be insignificant.

Foreign exchange risk assessment stress scenarios[44]

31.12.2013	Stress scenarios		
	Gain (loss) in case of 1% AMD depreciation (appreciation) versus USD	Gain (loss) in case of 1% AMD depreciation (appreciation) versus EUR	Maximum potential 10-day loss valued through a VaR method
Insurance sector's gain (loss) in case of foreign exchange revaluation	AMD 23.2 million or 0.1% of regulatory capital (AMD -23.2 million)	AMD 0.9 million or 0.01% of regulatory capital (AMD -0.9 million)	AMD 26.1 million or 0.2% of regulatory capital

Source: Central Bank of Armenia.

[44] *The calculation of losses estimated through stress-scenarios and the VaR Model (the VaR Model is not considered as a stress-scenario since the calculation of the model takes historical exchange rate series of currencies) makes an assumption that FX position of insurance companies would not change in a 10-day timespan.*

Liquidity risk

The liquidity risk in the insurance sector is controllable, which can be seen by the results of the following stress scenario.

Liquidity risk assessment stress scenario

31.12.2013	Stress scenario
	Sharp increase of outstanding claims reserves, 25%
Required growth of outstanding claims reserves when the stress scenario occurs	AMD 0.6 billion or 3.6% of regulatory capital
Liquidity of insurance companies when the stress scenario occurs	310.0%

Source: Central Bank of Armenia.

SUMMARY

During 2013, an accelerated growth of the balance sheet indicators of major financial institutions compared to nominal GDP was recorded, resulting in significant deepening of financial intermediation. The financial risks of the banking system, which represents the prevailing part of the financial system in terms of financial stability, are kept manageable.

During the year, some quality deterioration in credit portfolio was recorded, primarily due to accelerated growth of the loan portfolio in the last 3 years. In this context, the loan portfolio growth slowdown is assessed to be positive in terms of credit risk mitigation in the upcoming years. Parallel to loan portfolio growth slowdown, dram-denominated and foreign exchange liquidity levels slightly increased.

Non-bank financial institutions also recorded business expansion, and the regulatory indicators were maintained within the required limits.

5. STABILITY OF FINANCIAL MARKET INFRASTRUCTURES

Given the importance and the impact of payment and settlement system on the monetary policy and financial stability of Armenia[45], the Central Bank further pays due attention to the country's systemically important payment and securities settlement systems and the telecommunication network supporting their activities.

In Armenia, most interbank settlements are made via the Central Bank systems[46]; the largest value (over 99 percent) of interbank payments is made via the Central Bank systems.

5.1. INTERBANK PAYMENTS VIA ELECTRONIC PAYMENT SYSTEM OF CENTRAL BANK

The results of monitoring of the EPS functioning suggest that the system is safe and reliable and does not create problems in terms of stability

In 2013, there were about 5.3 million payments, totaling AMD 8617.2 billion, executed via the Electronic Payment System of the Central Bank of Armenia (10.3% value increase and 10.5% number decrease compared to the previous year). The decrease in the number of EPS payments was due to a more frequent use by participants of bulk messaging formats[47].

The risks in the system are reviewed separately for each area described below.

Credit risk

There is no credit risk identified in the EPS

Credit risk to the settlement bank (i.e. the Central Bank) in the system is non-existent since the participant will, in case of insufficient funds with their correspondent account, be able to use an intraday repo instrument, which is secured by government bonds of the Republic of Armenia, securities of the Central Bank of Armenia, and/or high-rated corporate bonds. The size of the attracted fund is calculated using the percentage subtracted from the market value of the bond (haircut). Nor is there credit risk to the recipient as it receives the notice of the payment only after the payment is made final and irrevocable[48].

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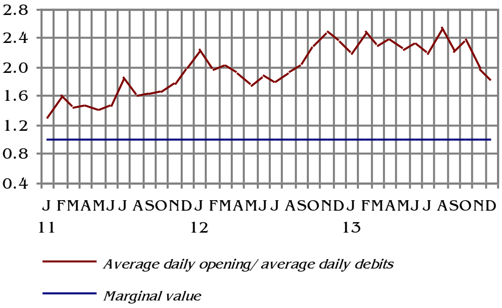
[45] For details please see "Financial Stability Report", 2007 and "Payments and Securities Clearance and Settlement Systems in the Republic of Armenia", 2010 publications.
[46] Payments via the Central Bank systems involve EPS payments without stock exchange trades, also transactions concerning the CBA indirect monetary instruments, the Central Bank's internal payments, as well as final settlements of ArCa cards system and the Government Securities Accounting and Settlement System (cash leg of transactions). For details, see the paper "Payments and Securities Settlement Systems in the Republic of Armenia", 2010.
[47] Bulk messaging formats (MT 202, MT 203) allow to attach and submit in one message multiple payments initiated by one payer to one beneficiary participant, which can result in a decrease in overall payment flows.
[48] For details, please see the "Financial Stability Report", 2007, and the paper "Payments and Securities Clearance and Settlement Systems in the Republic of Armenia", 2010.

Liquidity risk

The likelihood of emergence of liquidity risk and systemic problems in the EPS is very low

In the reporting period the daily average indicator of own liquidity used for assessment of liquidity risk[49] further trended to improve steadily (2.25 in 2013, 2.05 in 2012, 1.62 in 2011).

The dynamics of average daily payments on own expense



Source: Central Bank of Armenia.

The system had on average more opening liquidity than they needed for making payments within a day. Moreover, the liquidity at the beginning of the day has grown (15.0%) in relation to the previous year, whereas average daily flows on the correspondent account remained almost the same (4.0% growth).

The Liquidity ratios are positive in terms of individual banks

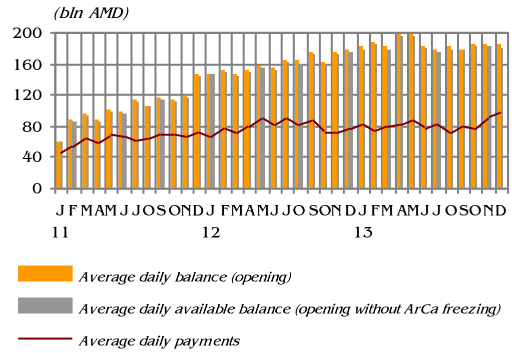
A target analysis was also carried out in 2013 considering the abovementioned indicators also by each individual bank. The evaluation results indicate that the banks had significantly more opening liquidity than they needed for making payments within the day during the reporting period.

In assessing liquidity risk in terms of the above indicators one should take into account that the calculation of the indicator does not include incoming payments (crediting of the account) and/or funds from other sources to increase liquidity.

The amount of rejections because of insufficient liquidity is negligible as well

Both the number and value of rejections and their share in total payments made through the system is an important measure for the assessment of the liquidity risk.

Average daily payments, average daily opening balances, average daily opening available liquidity comparative analyses



Source: Central Bank of Armenia.

The number and value of rejections due to insufficient liquidity in the EPS transfers are still insignificant – an average annual 0.5% by value and 0.01% by number.

These rejections are merely due to individual cases and may be an outcome of improper management of liquidity (payment flows) by the participants, which can not affect the liquidity of the system.

Intraday distribution of payments

No specific change was observed in regard to intraday distribution of payments

The opening and closing hours of the day were recorded as peak hours for execution of payments by both value and number.

During the peak hours of the reporting period 20 percent of the value (from 10:00 to 11:00) and 18 percent of the number (11:00 - 12:00) of the payments were settled.

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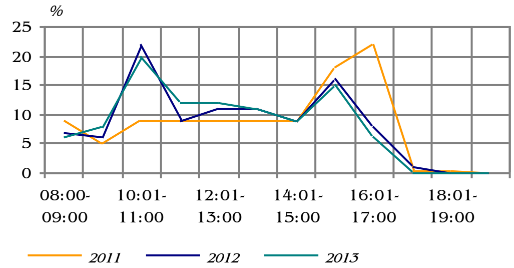
[49] *The daily average indicator of own liquidity was calculated on the basis of a ratio of opening liquidity on dram correspondent accounts of commercial banks to debits (payments) through the account. Incoming payments are not included in the indicator so that a stress-scenario can assess the likelihood of bank rejections if additional liquidity is not available within a day, namely to which extent would banks generate their payments using only opening balances of their own funds. The calculation does not include cash enhancements through their own accounts of commercial banks. The indicator is calculated for a system level (aggregate for all banks), so indicators may vary across commercial banks.*

During the reporting period, the share of end of day payments (executed after 3:00 p.m.) remains significant (21.0% in value and 25.0% in number). Yet, some decrease both in value (4.0pp.) and number (1.0pp.) of payments has been observed in 2013, which is a positive trend.

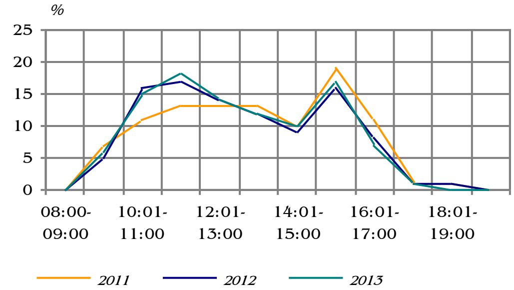
The analysis for assessing the possible negative impact of uneven distribution of payments and concentrations during peak hours[50] has shown that no problem occurred in the system due to sufficient liquidity and the lack of operational problems. Given the positive results of liquidity indicators and availability of the system, as well as insignificant share of rejections in total payments (for details, please see the previous sections), an uneven distribution and concentration of payments during certain hours of the day did not bring problems in 2013. On the whole, the likelihood of the risk to the system is estimated to be low.

Concentrations at certain hours of the day have not caused any problems

Intraday distribution of the value of payments on an average semiannual basis



Intraday distribution of the number of payments on an average semiannual basis

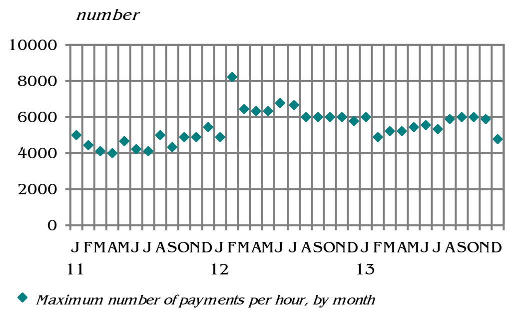


System capacity

In 2013 the payments per hour maximum ratio was 5997, which was lower than a year before (8181 payments per hour in 2012). Two cases were registered in the reporting year; at 11:00-12:00 (12.0% in value and 21.0% in number of the given day), and at 15:00-16:00 (9.0% in value and 19.0% in number of the given day). The latter was registered on overloaded days, but there were no problems and the operating day of the system was closed on time.

In the reporting period the monthly peak payments per hour ratio has reduced, which has a positive impact on the workload of the system

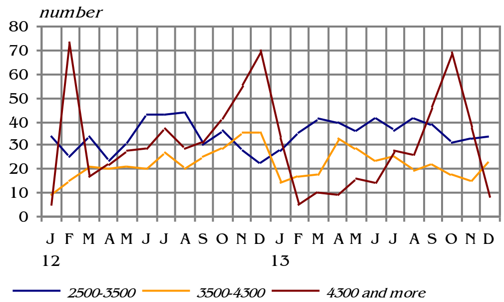
Maximum number of payments per hour, by month



In the reporting period, the maximum monthly payment per hour ratio was 5200 and more (in 2012 predominantly 6000 payments per hour). The share of peak-hour payments in the number of payments of the given day was averaged at 20-25%, not exceeding 20.0% by value; yet varying from month to month (in February peak-hour payments by value reached 32.0% of the day's payments).

Some variations of the number of payments per hour have also been observed. However, the likelihood of emergence of capacity-related risks is estimated to be low

The dynamics of payments exceeding the threshold of 2500, 3500 and 4300 payments per hour



In the reporting period, a considerable decrease in hourly payments indicators was observed, (especially on the 4300 and more payments per hour indicator: 15.9% in the first half of 2012, 22.7% in the second half of 2012, 8.4% in the first half of 2013 and 18.3% in the second half of 2013). Since the second quarter, some augmentation of payments per hour has been observed, which was mainly due to increase in total number of payments via EPS. Starting from the second half of the year, the 4300 and more payments per hour indicator have registered a noticeable growth,

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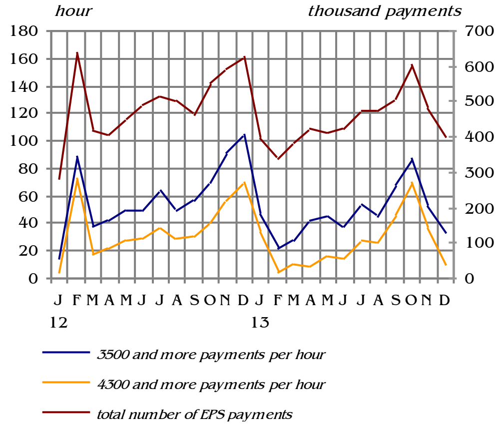
[50] The purpose of the analysis was to identify the extent of the impact of concentrations on the timely performance of time critical payments (particularly on stock exchange deponation), and to assess the extent of the current system capacity to manage the risks associated with the concentrations. The analysis was performed based on the data for March of 2013 and the peak day of that month: the results showed that exchange deponations were performed in a timely manner. The system capacity indicators significantly improved compared to the 2012 analysis, which could be conditioned by the less overloading of the system.

The dynamics of total number of EPS payments and marginal values



creating some overload in the system. A considerable pick was registered in October: a 34.5% of the operational hours during the month. In the fourth quarter a sharp decrease was observed for the abovementioned indicator, driven by the reduced number of total payments via the EPS. The latter has been conditioned by more frequent use of bulk messaging formats by the participants. The use of such formats contributes to the ease of the system's workload and more efficient use of the system capacity.

As such cases are still insignificant by share in total payments (13.4% of operational hours of the year) and no factual incidents have occurred during that period of time, the likelihood of emergence of capacity-related risks is estimated to be low.

The operational availability of the EPS was 99.7%

Operational availability of the system

During 2013, 4 in some extent significant (with duration of more than 1 hour) incidents affecting the operational availability of the EPS were reported.

Two incidents were reported in connection with slowing of the "BankMail", an electronic message delivery system. In one case, settlements were not executed via the EPS during an hour. In the other case, the additional orders of 3 banks for depositing transactions in "NASDAQ OMX Armenia" stock exchange were not executed within a required timing. These cases did not have a negative impact on the other payments and no need to extend the operational day for final settlements arose.

Another incident was associated with the failure of CBANET interbank network for 5.5 hours. This resulted in a two-hour extension of operational day in order to insure the final settlements of that day. Back-up facilities were launched, which gave the opportunity to settle 70.0% of accumulated payments before the elimination of the problem, also ensuring the final settlements of the stock exchange transactions on the given hour. The remaining 30.0% were conducted after the full recovery of the network.

The other incident, which lasted for 1 hour 40 minutes, was due to problems occurred in the internal network of the Central Bank. As the failure occurred during non-peak hour and the system had sufficient capacity, no need to extend the operational day arose.

Appropriate measures in connection with these incidents were taken to prevent them in future and to reduce negative impact.

Nevertheless, the abovementioned incidents did not significantly affect the system. In the period under review the operational availability has reached 99.7%[51] for the EPS and 99.9% for "Operational Day" software settlement system[52].

5.2. SECURITIES ACCOUNTING SYSTEMS

In Armenia, the settlement of securities is done through two frameworks: the Central Depositary of Armenia (hereinafter CDA) provides for the settlement of corporate securities while the Central Bank and government securities are settled through the Government Securities Accounting and Settlement System (hereinafter GSASS).

In 2013, secondary market transactions totaling more than AMD 3894132 million were carried out through GSASS (AMD 3357318 million in 2012), which represented 16.0% increase in relation to the previous year. The transactions executed through GSASS accounted for about 98.0 percent of secondary market transactions (96.0% in 2012). In the financial stability point of view, GSASS remains a systemically important facility.

Transfers of securities through the GSASS of the Central Bank pertaining to the transactions with securities in the secondary market [53]

Operations	2011	2012	2013
OTC operations (trades and repo) in nominal value, *AMD million*	2870958.0	3353038.9	3879351.8
Stock Exchange operations (trades) in nominal value, *AMD million*	5673.8	4279.5	14780.7
Total	2876631.7	3357318.4	3894132.4

In GSASS, the settlement of OTC transactions is subject to the principle "delivery versus payment" (DVP) while stock exchange transactions are executed through a procedure of pre-depositing of securities and cash, thereby reducing counterparty risk. The usage of gross settlement and irrevocability principles in the system rules out the emergence of credit risk.

In 2013 there were 2 in some extent significant (with duration of more than 1 hour) reported incidents which influenced the uninterrupted functioning of GSASS. One

[51] The operational availability of payment module of European Union's TARGET 2 system was 99.89%, which was considered a good indicator. The operational availability of TARGET was 99.65% in 2008. Moreover, while calculating this indicators, the operating day extensions because of operational problems are included, which mitigates the penetration level. In case of calculating using this methodology, the availability of EPS for 2013 would amount to 99.9% (instead of 99.7%).
[52] Accounting related to final settlements are conducted within the "Operating Day" software system. The system also serves as the CBA's "General Ledger".
[53] The statistical information provided includes the GSASS-executed payments and excludes internal transfers made by sub-custodians for their clients.

incident was due to problems occurred in the internal network of the Central bank. The other incident was connected with the failure of CBANET interbank network (the abovementioned incidences influenced the uninterrupted functioning of EPS as well, for details, please see the previous section). In case of the first incident, the operational hours of the system were extended, yet the final settlement of stock market transactions was conducted timely. The second incident was insignificant and no need to extend the operational day occurred.

The primary market infrastructure operational availability of GSASS was 99.8%, while that of the secondary market infrastructure, 99.7%.

Given the small number of incidents, as well as measures aimed at eliminating the incidents and the operational availability indicators of the system, the GSASS can be assessed as reliable and safe.

5.3. GUARANTY OF DEPOSITS

The Deposit Guarantee Fund (hereinafter Fund) was established by the Central bank of the Republic of Armenia in 2005, completing infrastructures for ensuring financial stability. This is an establishment which acts in accordance with the Republic of Armenia Law "On Guaranteeing Reimbursement of Bank Deposits of Individuals". The Fund helps strengthen the soundness of the banking system, enhance public confidence in the banking system and protect depositor interests in the country.

In 2013 the growth of bank deposits and guaranteed deposits of individuals trended upward.

As of the end of 2013, the amount of deposits of individuals has increased by around 22.9% and the amount of guaranteed deposits, by 19.3 percent, relative to the end of 2012. The number of individuals holding guaranteed deposit has grown by 15.8% to 1,582,431 persons (excluding former USSR Savings Bank depositors, who are registered in VTB Armenia Bank CJSC).

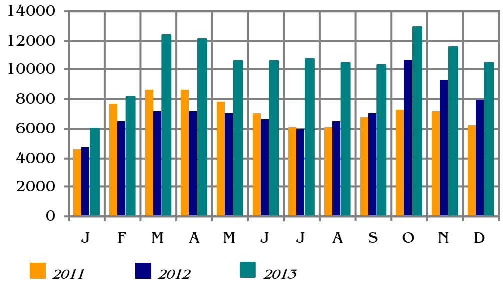
In the banking system of Armenia, the prevailing part of depositors holds deposits only in dram. The share of depositors who hold deposits only in dram made up 84.6 percent in total as to the end of 2013. The share of depositors holding only foreign currency deposits reached 6.4%. Relative to the end of 2012, the share of dram deposits has grown to 30.6 percent in total.

5.4. CREDIT REGISTRY AND ACRA CREDIT BUREAU

The Central Bank Credit Registry

The Credit Registry has been functioning within the structure of the Central Bank of the Republic of Armenia since January 1, 2003. The Credit Registry is designed to collect data on credit history of borrowers, to process such information and provide it to commercial banks, credit organizations, as well as to borrowers. The Credit Registry keeps records of loans in excess of AMD 1.5 million and loans in the amount less than AMD 1.5 million that were overdue and were classified. At the end of 2013 the number of loans recorded in the Credit Registry was 1,702,853 from which 1,580,505 were loans to natural persons and 122,348 were loans to legal persons. As compared to the previous year, the total number of loans augmented by 356,649.

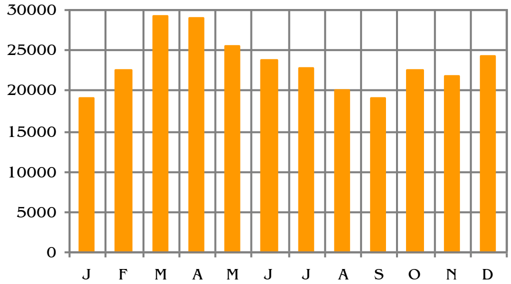
The number of requests received during 2011- 2013



Source: Central Bank of Armenia.

Based on the year-end 2013 data, the Credit Registry possessed information on 362,660 loans outstanding and 1,340,193 loans repaid.

Number of loans registered in credit registry in 2013, by months



Source: Central Bank of Armenia.

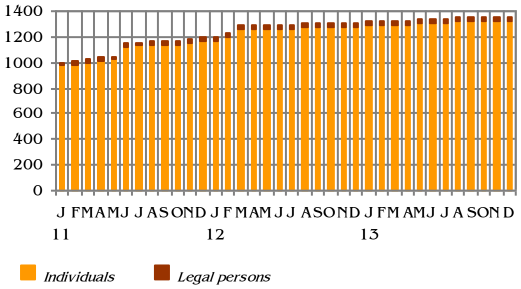
The number of registered loans has increased 1.26 times in relation to the previous year, pointing to a livelier activity in the credit market. Parallel to the changes of loans outstanding, the volumes of entry information also altered. In the period under review the average entry rate of information has grown dramatically (84.0 percent), which now makes up an average 16,600 registrations.

An automatic data input program has been introduced, which excludes the involvement of human factor. The increase of information volume and effective input has made it possible to possess more complete information used for assessing and monitoring the creditworthiness of borrowers, enabling a more efficient assessment of lenders' credit risk by avoiding non-diligent borrowers.

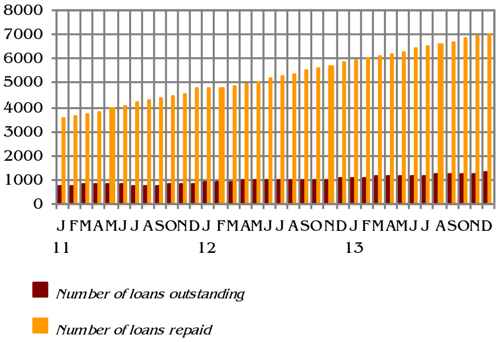
Most commercial banks and credit organizations have an automated delivery of data to the credit registery now, resulting in greater system efficiency. A software update for Credit Registry made it possible for the credit history to be provided to banks and credit organizations within at best one day after the request has been received. Likewise, the share of errors of Credit Registry data has been minimized.

According to the chart, the number of requests increased especially in the second half of 2013. The number of requests grew by 1.47 in 2013 as compared to the previous year, which was due to the increase of the number of credits granted. The assessment of creditworthiness of the customer by the use of credit history reduces the time spent on lending and allows reducing credit risk by avoiding non-diligent borrowers. Most commercial banks and credit organizations are attaching even greater importance to the credit history, especially in case of lending to new customers.

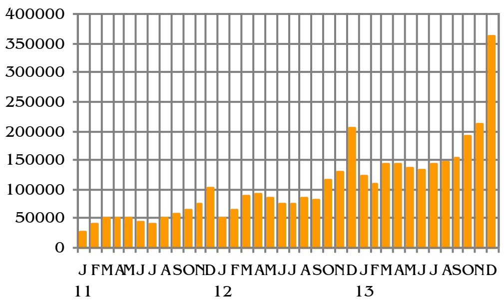
The number of borrowers registered in ACRA database *(in thousands)*



The number of loans registered in ACRA database *(in thousands)*



The number of reports provided by ACRA credit registry



Source: ACRA Credit Bureau.

The number of both loans granted and requests received has risen during 2013.

The volume of information entered with the Credit Registry, as well as the rate of usage of such information reported in 2013 will most likely continue to grow throughout 2014. The work done by commercial banks and credit organizations suggests that all lenders which provide information to the Credit Registry will get the delivery of such information automated.

More methodological changes will continue to occur aimed to reduce the number of errors and strengthen the capacity.

The ACRA Credit Bureau

In 2013, the number of borrowers registered with the ACRA Credit Bureau has increased by 3.4%, relative to 2012, and amounted to 1,358,523 borrowers. Of this number, 98.0 percent were individuals.

In 2013, relative to December 2012, the number of loans available in the database has grown by 21.1% and reached 8,325,837, as of the 31st of December.

Any individual or legal person is entitled to receive information from the Bureau concerning his personal credit history. For the legal persons to obtain credit history of its client or counterparty, it should enter into a service contract with the Bureau and receive the written consent from the borrower.

The Bureau started providing credit reports since April 2007. The number of credit reports provided in 2013 has grown by 74.0 percent compared to the number of reports provided in the same period of 2012.

Starting from 2013, the Credit Bureau has been receiving information from "Credo Finance" CJSC and "K-Telecom" CJSC, a telecommunications company. The database ACRA compiles information about payments fallen overdue from "K-Telecom" CJSC. A contract has been signed with "Orange Armenia", a telecommunications company, as well as talks are being held with "ArmenTel", another telecommunications service provider, in the field of organizing information circulation. The Credit Bureau receives information from such public databases as the Ministry of Labor and Social Issues and the Traffic Police Service of the Republic of Armenia Police on unpaid fines within 60 days (calculated from the next day after the last date specified to pay the penalty as prescribed by the legislation of Armenia). Negotiations between the Credit Bureau and the State Revenue Committee concerning obtaining information on tax liabilities non-performed in a duly established timeframe are underway.

In 2013, ACRA Credit Bureau has introduced an ACRA SMS-scoring service, which helps obtain a digitized assessment of the borrower's credit risk via SMS. Credit scoring is based solely on statistical methods and is set to escape, as much as possible, the use of expert judgment. Since 2013, this SMS-service has been provided by the "K-Telecom" service provider.

A multi-level coding system has been developed to protect information owned by the Bureau and to prevent its illegal usage by the third parties whatever. The system traces all actions, as well as an ongoing monitoring of the system is in place to prevent suspicious and unauthorized action.

SUMMARY

The results of monitoring indicate that credit and liquidity risks to the Electronic Payment System are minimized, the system capacity is satisfactory and the intraday payments are executed uninterruptedly. No significant operational risks has been identified in the system, so the system's availability is at an internationally accepted level.

Overall, the EPS and GSASS operation is satisfactory. In the financial stability point of view, the developments in the payment and settlement system remain manageable, while risks leave no room for vulnerability.

An increase in the number of loans registered with both the Central Bank's Credit Registry and the ACRA Credit Bureau was recorded during 2013. Moreover, a series of activities were carried out aimed at reducing the number of errors disclosed and increasing the operational efficiency.

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GLOSSARY OF TERMS

Economic growth	The growth of volume of goods and services produced in the economy during a certain period of time.
Inflation	An increase in the general level of prices of goods and services.
Consumer price index	An index of the variation in prices paid by typical consumers for retail goods and other items. The consumer price index measures the changes in the price of a market basket of consumer goods and services purchased by households.
Balance of payments	A system of recording of all economic transactions of Armenia (residents and non-residents) with the rest of the world over a reporting period (a quarter, a year).
Foreign trade	This involves an exchange of capital, goods, and services across international borders or territories, in the form of exports and imports.
Gross external debt	Gross external debt, at any given time, is the outstanding amount of those actual current, and not contingent, liabilities that require payment(s) of principal and/or interest by the debtor at some point(s) in the future and that are owed to nonresidents by residents of an economy.
Credit risk	Credit risk refers to the risk that a borrower will default on any type of debt by failing to make payments which it is obligated to do. The risk is primarily that of the lender and includes the lost principal and interest, disruption to cash flows and increased collection costs.
Liquidity risk	Liquidity risk is the risk that a given security or asset cannot be traded by the financial institution quickly enough in the market to prevent a loss (or make the required profit).
Foreign currency risk	Foreign currency risk is the risk that a change in exchange rate in the market will adversely affect profits and/or capital of the financial institution.
Interest rate risk	Interest rate risk is the risk that interest rate volatilities in the market will adversely affect profits and/or capital of the financial institution.
Price risk	Price risk is the risk that a change in price of securities in the market or price of similar financial instruments on balance sheets will adversely affect profits and/or capital of the financial institution.
Standard asset	An asset which is serviced under a contract, and is not problematic.
Watched asset	An asset which is serviced under an original contract yet certain circumstances have emerged that may undermine the borrower’s ability to serve that asset.
Substandard asset	An asset the contractual obligations towards which are not performed due to the borrower’s fragile financial standing or inability to repay the debt.
Doubtful asset	An asset the contractual obligations towards which are not performed; it is more problematic, making its collection at the given time very difficult or impossible.
Loss asset	An asset non-collectable and fully impaired uncollectible, so that its recording on the balance sheet is no longer reasonable.
Nonperforming asset	An asset which has been classified by the bank as watched or substandard or doubtful or bad.
Major borrower	A party the risk on which exceeds 5 percent of total capital of the bank.

Major liability	A liability that amounts to 5 percent and more of total liabilities of the financial institution, without regard to affiliation.
Return on assets (RoA)	A ratio of net annual profit to average annual total assets.
Return on equity (RoE)	A ratio of net annual profit to average annual total capital.
Total liquidity	A ratio of high liquid assets to total assets.
Current liquidity	A ratio of high liquid assets to demand liabilities.
Regulatory total capital	The difference between total capital as shown in statement on financial standing and deductions as specified in Central Bank "Regulation 2 on Banks and Banking".
Capital adequacy	A ratio of regulatory total capital to risk weighted assets.
Leverage	A ratio of total assets to total capital.
Off-balance sheet contingent asset	Off-balance sheet contingent assets include outstanding credit lines, credit cards and overdrafts as well as letters of credit, guarantees and warranties provided.
Net provisioning	The difference between provisions to and recoveries from assets loss reserve fund.
Net foreign currency position	The difference between assets and liabilities in FX assets and local currency assets containing FX risk.
Gross foreign currency position	This position measures the sum of absolute values of positions of various currencies.
The Herfindahl-Hirschman index	This index is defined as the sum of the squares of the market shares. It varies between 0 and 1, characterizing the level of concentration (values near to 0 denote lower concentration.
Economic cost of capital	The difference of the present value of total assets and present value of total liabilities.
Spread	The difference between deposit and credit interest rates

ABBREVIATIONS

CBA	Central Bank of the Republic of Armenia
GDP	Gross Domestic Product
GNDI	Gross National Disposable Income
NSS	National Statistics Service
IMF	International Monetary Fund
UNO	United Nations Organization
CIS	Commonwealth of Independent States
ECB	European Central Bank
USA	United States of America
FRS	Federal Reserve System
NMC	National Mortgage Company
FDI	Foreign Direct Investment
RF	Russian Federation
IFRS	International Financial Reporting Standards
MTPL	Motor third party liability insurance
CDA	Central Depositary of Armenia
TB	Treasury Bills
EPS	Electronic Payments System
GSASS	Government Securities Accounting and Settlement System