CENTRAL BANK OF THE REPUBLIC OF ARMENIA

FINANCIAL STABILITY REPORT

2014
first half

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, 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 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 involves efforts for identifying 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.

The Central Bank has a task to maintain the stability and functionality of the financial system of Armenia. The Central Bank's statutory responsibility for the country's financial stability is directly related to its primary goal of price stability. Serious disruptions in the financial sector may create impediments to effective implementation of monetary policy. On the other hand, 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 development 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 are creditworthy enough,
- a stable and 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 those 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 percent of entire financial system assets. The banking sector as a principal pillar to the financial system today determines overall financial stability and development trends.

ABSTRACT

The set of risks threatening financial stability has not changed in relation to the previous year, although some risks go an upside track.

The main risks affecting financial stability of Armenia persisted during the first half of the year while uncertainties over the future developments added. Developed countries saw their economic growth recovering further at an unsteady pace though, while economic growth outlook in developing countries is mostly unfavorable. Decreased prices of base metals in international markets, a sluggish growth of the Armenian industry and bad weather conditions contributed to lower domestic economic growth. Geopolitical developments created additional obstacles to Russia's economic growth, which in turn can affect the inflow of private transfers to Armenia and export volumes to Russia.

The first half of 2014 was prominent with downside risks to the global economic growth.

Global economic recovery continued during the first half of the year, although suspended quantitative easing policy in the U.S.A. as well as geopolitical developments added to downside risks. Adverse climatic conditions in developed countries and the Ukrainian crisis-related events resulted in lower than expected economic growth. Developing countries saw an even more persistent trend of slowing economic growth, which in turn has contributed to dropped prices of some exchange traded commodities.

Monetary authorities kept on implementing expansionary policies for economic growth stimulation.

Monetary authorities of developing and developed countries continued pursuing an expansionary monetary policy to shore up economic growth. In the period under review, interest rates of monetary instruments remained at extraordinarily low levels, while the U.S. Federal Reserve kept on tapering the volumes of quantitative stimulus program as was announced.

Economic developments in trade partners cannot be described as positive, though their adverse impact on the domestic economy is still negligible.

Economic developments in Armenia's main trade partners – some countries of the European Union and Russia – have been unexpectedly unfavorable, although their impact on the domestic economy is still weak. In particular, in the period under review growth rates of both commodity

exports and private remittances have been slower (see details in section *Developments in the global economy*).

According to the first six months' data, economic growth in Armenia was 3.4% (3.5% in the first half of 2013). The slower growth rate was mainly due to the decline in industry and decreases reported in other sectors of the economy (see details in section *Developments in macroeconomic environment in Armenia*).

Armenia's economic growth stands below the projected growth indicators and those of the previous year.

During the first half of the year, capital adequacy reduced at somewhat a slower pace along with slowing growth rates in the credit portfolio. In the period under review, Armenian banking system had capital adequacy and liquidity ratios above the regulatory requirements, and manageable market risks.

Slowing growth rates in the banking credit is mostly due to wary credit policy commercial banks conduct.

Though in some cases on an upside track, risks in the financial system remain manageable in terms of financial stability (see details in sections *Stability of financial institutions of Armenia* and *Financial stability in market infrastructures of Armenia*).

1. DEVELOPMENTS IN THE GLOBAL ECONOMY [1]

1.1. MACROECONOMIC ENVIRONMENT

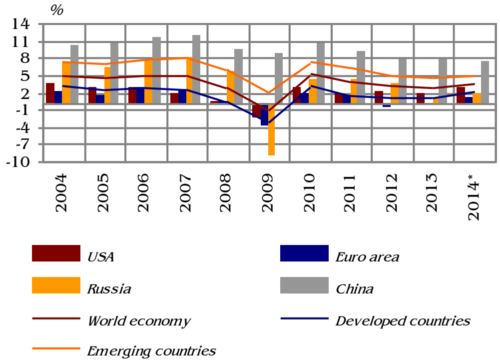
The first half of 2014 was marked with a number of unexpected developments which have negatively affected earlier optimistic expectations.

The first half of 2014 started with optimistic expectations, but a bunch of factors – including weak economic activity in developed countries and geopolitical risks in developing countries – have led to the global economic slowdown and more uncertainties.

However, international organizations' and markets' expectations and projections for the second half are more optimistic.

Global instability factors are persisting, and despite global economic risks have reduced, a set of risks is still on agenda.

Regional economic growth rates



*Indicators marked by asterisk in this chart and the ones following thereafter are the IMF estimates (July 2014).

Source: IMF.

World economy recovery continued, although principal risks remained alarming throughout the first half of the year.

Trends typical to the first half of 2014 included further rebounding economic activity in Euro-area (although at different rates across countries), economic slowdown in the United States and Russia, as well as domestic currency depreciation pressures in developing countries and insignificant variation of prices of the main exchange-traded commodities.

IMF Overview of the World Economic growth Projections, %

Indicator *(economic growth)*	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	2014 forecasts as of 30.04.14	2014 forecasts as of 30.07.14
World economy	3.5	3.3	3.1	3.0	3.7	3.7	3.4
Developed countries	1.4	1.3	1.2	1.3	2.2	2.2	1.8
USA	2.0	1.9	1.7	1.9	2.8	2.8	1.7
Euro area	-0.2	-0.4	-0.6	-0.4	1.0	1.1	1.1
Emerging countries	5.5	5.3	5.0	4.7	5.1	4.8	4.6
CIS	3.8	3.4	2.8	2.1	2.6	1.9	0.9
Russia	3.7	3.4	2.5	1.5	2.0	1.3	0.2
China	8.2	8.1	7.8	7.7	7.5	7.6	7.4

Notwithstanding weak activity reported in the first half of the year, some key countries will be expecting more rapid economic recovery during the second half. According to the IMF, world economic growth for 2014 is estimated 3.4% (in 2013, economic growth was 3.0%). Economic growth in

[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.*

developed countries is expected to be 1.8%, 0.5 percentage point higher compared to the previous year, whereas no significant change will be observed in developing countries, so economic growth will be around 4.6%[2].

In the U.S.A., economic growth slowed down during the first quarter of the year due to an unprecedented cold weather but growth rebounded afterward.

Lower-than-predicted economic growth in the U.S.A. hampered global economic growth in the first half of the year. The economic growth of 3.2% reported in the second half of 2013 was a pretty good prospect for 2014, but this winter's severe weather conditions disrupted the optimistic expectations. Moreover, large excess inventory, a 7.6% decline in exports and reduced output pushed the economic growth indicator down.

Eased monetary conditions of the U.S. Federal Reserve System, increased household income and facilitated terms of lending by the banking system may contribute to further economic growth in the United States. As the country posted an economic growth, the unemployment rate dropped to 6.3%, the lowest level in the past six years. In the meanwhile, no inflationary pressures from the labor market were observed. In the U.S.A., the number of persons seeking job for 6 months and farther remain high (3081 thousand[3]), which points to the fact that improvements in the labor market are not fundamental yet. According to the IMF estimates, economic growth in the U.S.A. will be 1.7% in 2014 and 3.0% in 2015.

Developments in Euro-area are positive, but low inflation and weak lending hamper the economic growth.

Increased volumes of net export, stabilized domestic demand and eased fiscal policy conditions in European countries have contributed to the economic recovery. Positive changes in debt management were observed in peripheral Europe, including Greece and Spain, which positively affected the yield on government bonds of these countries.

Despite positive developments mentioned above, a handful of factors hindering economic growth - low demand for credit, budgetary and debt problems, companies with heavy debt burden among others - are further leaving negative impact on macroeconomic stability. In Euro-area, economic growth is predicted 1.1% for 2014 and 1.5% for 2015.

While economic growth recovered, the countries of European Union faced with a weak inflationary environment. Continued slowing of economic growth could lead to deflationary expectations, which could adversely affect economic growth in the medium run. The European Commission's inflation forecast is 0.8% for 2014 instead of formerly projected 1.0%, and is 1.2% for 2015 compared to previous forecast of 1.5%.

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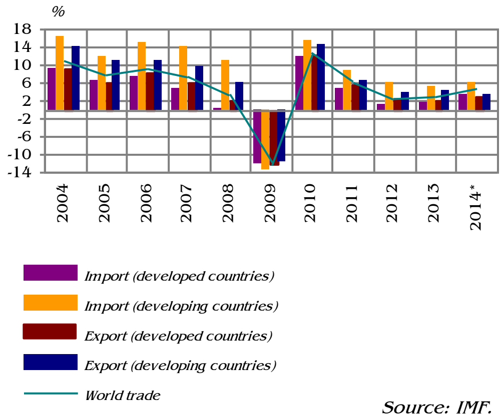
[2] *All forecasts and estimations by the IMF are based on the "World Economic Outlook Update, July 2014" report.*
[3] *http://www.bls.gov/bls/newsrels.htm*

Slowing of economic growth in developing countries continues.

Annual growth rate of world trade



Source: IMF.

Developing countries, which generate 2/3 of global economic growth, saw their economic growth slowing down during the first half of 2014. Economic situation in developing countries today is determined by export growth amidst currency depreciation patterns and economic activity trends in developed countries, on the one hand, and low investment and long-term funding difficulties, on the other. This prompted a number of developing countries to conduct tightened monetary policies which, however, resulted in the contraction of domestic demand. To some developing countries, an abrupt increase of credit to the economy is also an important concern in terms of maintaining the financial stability. Particularly, strong growth in lending in China in recent years may deepen the country's macroeconomic imbalances, which may in turn affect economic developments on a global scale. Given these developments, economic growth in developing countries is 4.6% for 2014 and 5.2% for 2015, according to the IMF estimates.

With the current level of economic activity in the world, there is a low inflation environment globally. Based on this circumstance, the IMF's estimate of the 2014 annual inflation is 1.5% for developed countries and 5.5% for developing countries. Moreover, inflationary pressures are not expected in the coming year.

Developments in commodity markets were largely in line with global economic growth tendencies.

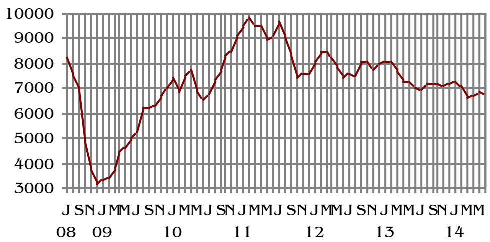
Brent oil prices
(USD per barrel)

As economic activity grew stronger in late 2013, the growth of world trade created favorable conditions for expecting further expanding of world trade volumes in the first half of 2014. The growth of world trade, however, diminished during the first quarter of the year due to the slowdown of growth in developing countries. According to the IMF data, the annual growth of world trade volumes will be 4.0% in 2014 and is forecast to reach 5.3% in 2015.

The first half of 2014 saw an increase of prices of basic commodities in international markets, which was determined by developments specific to some product markets.

Behavior of prices of base metals was determined largely by economic and political developments.

Copper prices
(USD per ton)



Source: Bloomberg Data Warehouse.

The oil price trended upward from the start of the year. Average semiannual price of Brent crude was USD 108.8 per barrel, representing a 0.9% increase in relation to the same reference period of the previous year.

Current geopolitical situation in the Middle East and Russia brings in a probability that energy prices would increase[4].

During the first two quarters of 2014, prices of base metals behaved differently, in response to economic and political developments. Average semiannual copper price

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[4] In the second quarter of 2014, the energy prices went down attributable to the shale gas mining by the USA and the unchanged volumes of gas mining in the light of economic growth slowdown.

was USD 6884 per ton, dropping by 9.1% in relation to the same reference period of the previous year, whereas average semiannual molybdenum price posted a 4.3% increase compared to the previous reference period's average.

In the short run, other conditions being equal, base metals prices will continue to be driven by development trends in emerging economies and will not post an abrupt rise.

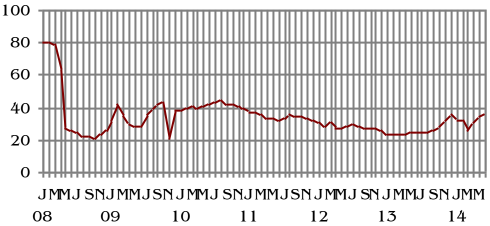
International wheat prices performed in variance during the first half of the year, hitting their peak, USD 9.4 per bushel, in April. In the first half of 2014, average wheat price was USD 8.4 per bushel, representing a 2.8% drop in relation to the same reference period of the previous year. In the short run, world wheat markets will have downside price expectations, but prices are expected to stabilize in the medium run.

In the first half of 2014, gold price was relatively stable, with slightly an upward trend. Yet, economic activity of developed countries, which is getting more impetus, has forced investors out of the gold market in order to invest in higher-earning assets.

Average semiannual gold price in 2014 was USD 1291 per troy ounce, which represents some 15.3% decrease in comparison with the same reference period of the previous year.

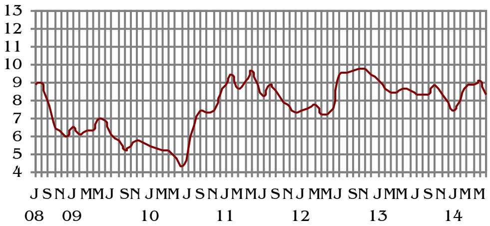
In the short-term perspective, in view of optimism for global economic recovery, sharp variation in gold prices is not anticipated.

Molybdenum prices
(1000 USD per ton)

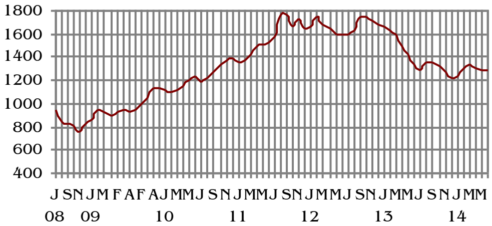


The wheat prices have decreased.

Wheat prices
(USD per bushel)



Gold prices
(USD per troy oz)



Source: Bloomberg Data Warehouse.

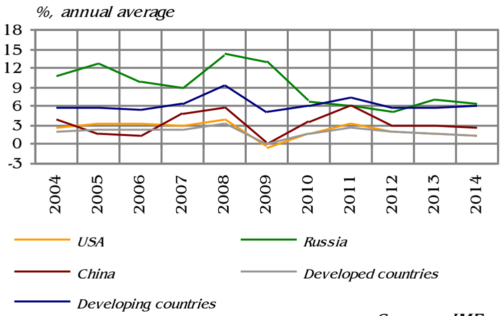
1.2. INTERNATIONAL FINANCIAL MARKETS

In the first half of 2014, relative to the previous semi-annum, the situation in international financial markets has somewhat improved. In particular, the U.S. economy has entered a new phase of recovery, but this depends on how financial markets will react to the decisive steps to terminate the quantitative easing program. Termination of the QE program will leave an influence on developing countries too, as they have not yet fully recovered from negative effects of the international financial crisis. The banking system's stability has not been on a satisfactory footing.

The trend observed last year persisted over the first half of 2014: amid fears of unsteady financial situation in European countries and slowing economic growth in developing countries, investors further preferred mostly German bonds

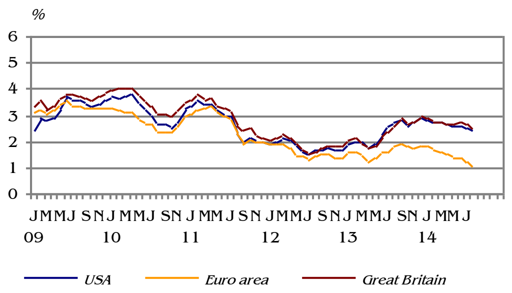
The spread of interest rates of government bonds of countries with debt problems and of German government bonds widened.

Inflation in selected countries



Source: IMF.

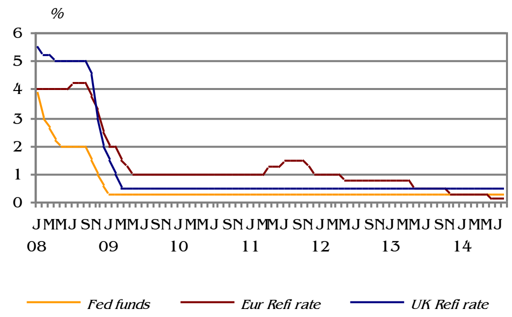
10-year government bond yield



Source: Bloomberg Data Warehouse.

The central banks of main developing countries and of all developed countries have carried out expansionary monetary policies.

Interest rate policies of central banks



Source: Bloomberg Data Warehouse.

Favorable macroeconomic developments encouraged the U.S. Fed to continue tapering the QE program.

and other highly liquid government bonds. However, low-yields prompted investors to look for high-income investment destinations. This resulted in narrowing spreads on corporate and government bond yields, which was most pronounced on the part of lower-rated bonds.

New enhancements of capital have contributed to better capital adequacy at global systemically important banks (G-SIB), and stress-tests conducted reported improved results. On the other hand, profitability of the banking system is still low; moreover some European countries unfortunately retain high proportion of non-performing assets in their loan portfolios[5]. The latter is partly attributable to the fact that the European Central Bank that implements new rules for measuring the quality of bank assets.

During the first half of the year too, key developed countries continued implementing a low interest rate policy amidst unstable global economic growth and major economic challenges.

In particular, in June the ECB did a 10-basis-point cut on both Refinancing and Deposit rates down to 0.15% and - 0.1%, respectively. Moreover, interest rate for banks' excess reserves with the ECB was also set to be negative, - 0.1%. This action pursued the goal to promote the growth of bank credits and combat the low inflation.

The Bank of England kept monetary policy rate at a low level, revision of which, the Bank had announced, would not only depend on the rate of unemployment but also on how a wider spectrum of economic indicators would perform further.

Though the U.S. Fed kept the policy rate at its lowest, it further attempted tapering the QE program. During the first half of the year, the Fed twice reduced the volumes of asset purchases each time by USD 10 billion to USD 35 billion. The QE program is intended to finally end after an October 2014 meeting of the Federal Open Market Committee, provided that the U.S. economy is prepared for it.

Termination of the QE program will definitely influence not only the U.S. economy, but it will also leave an impact on both international financial markets and developed and developing economies. Recently, some developing countries have seen substantial capital flights (due to the geopolitical situation in Russia and restrictive policy of Chinese government for short-term capital inflows), which resulted in a significant devaluation of currencies.

It should be noted, however, that not all developing economies suffered, since financial markets' response in different countries depended largely on the economic policy

[5] *http://www.bankofengland.co.uk/publications/Pages/fsr/2014/fsr35.aspx*

conducted in that particular country. According to Moody's, an international rating agency, most sensitive to the tapering and to an approaching termination of the QE program are countries which consistently run current account deficit and are dependent on external funding. Overall, in the short-term perspective, developing countries will hardly anticipate capital inflow to rebound to its pre-crisis level. According to Moody's estimations, reduction of the inflow of capital will cost developing countries a cumulative loss of 2.8-3.1% of GDP growth in the period 2013-2016[6].

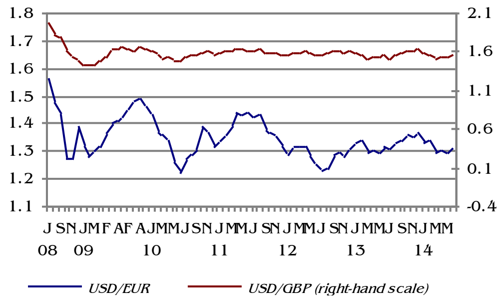
During the first half of the year, major currencies behaved in volatile patterns. The U.S. dollar has repeatedly depreciated and appreciated versus Euro, driven by economic policies the United States and European countries conducted as well as in response to the expectations. Currencies of developing countries demonstrated mostly depreciation patterns, attributable to both the Fed's policy and domestic developments across countries. As a result, in financial sectors of developing countries the foreign currency risk derived from external funds has grown significantly.

In developed and developing countries, economic developments and expectations are uncertain while stock indices remained volatile.

Low base rates and global economic imbalances determined a down-sloping behavior of interbank interest rates, with the exception of Russia's MIBOR 3m rate, which rose by almost 2.0 percentage points during the semester.

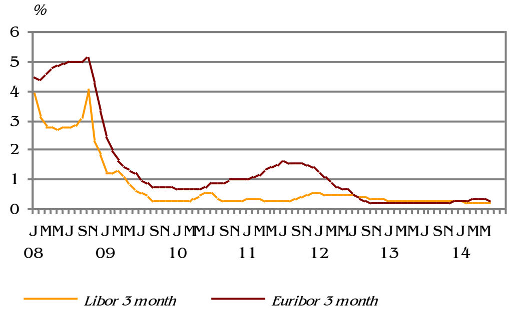
Major currencies have been volatile.

USD exchange rate versus EUR and GBP



Source: ECB.

Interbank interest rates



Source: Bloomberg Data Warehouse.

Box

Economic developments in main trade partner country

In the first half of 2014, the Russian economy continued to grow at a slow pace, which reflects the negative effects of geopolitical tensions associated with Ukraine, on the one hand, and previous structural problems, on the other. The Russian economy is still highly reliant on the energy sector, so economic growth in this country greatly depends on how international oil prices will develop. A non-competitive business environment and low level of infrastructure development remain major impediments to Russia's economic growth.

According to the Federal State Statistics Service of Russia, despite negative growth in the first quarter of 2014, the Russian economy bounced back to a positive growth territory in the second quarter, thus avoiding a technical recession. Overall, based on the first half 2014 results, the GDP growth was 0.8%. However, such indicators as construction growth, investment growth, as well as electricity, gas and water production and distribution sector growth are still negative.

By semiannual results, capital investment plunge by 2.8% and construction fell by 2.6%[1]. Both the trade and service sectors kept on declining during the first quarter and could only track a little positive growth in the second quarter, lagging behind the data of the same reference period last year.

[6] *http://openmarkets.cmegroup.com/7847/qes-lingering-effect-on-emerging-markets*

According to semiannual data provided from the Federal State Statistics Service of Russia, exports amounted to USD 255.6 billion, representing a 1.3% increase in relation to January-June of 2013. Imports are an estimated USD 152.8 billion, which is a 5.1% y/y reduction. Thus, the positive trade balance amounted to USD 102.8 billion[2].

In June 2014, relative to December, inflation in Russia was 4.8% against a 3.5% figure reported last year. According to preliminary data provided from the Russian Ministry of Economic Development, the unemployment rate remains historically low, which, ignoring the seasonal factor, is an estimated 4.9%.

In January-March of 2014, in the face of rising geopolitical tensions and growing demand for foreign currency, the Russian currency weakened against other currencies. To ease the situation, the Central Bank of Russia intervened with the foreign exchange market from time to time, as well as used a variety of other tools. Although the Russian ruble started strengthening from mid-March, this did not neutralize the currency depreciation effect observed at the beginning of the year. Based on the first half data, the official U.S. dollar exchange rate has appreciated versus the Russian ruble by 3.6% to RUB 33.84, and the euro exchange rate appreciated by 2.5% to RUB 46.18.

In January-June of 2014, the Russian banking sector assets have grown by 6.9% to RUB 61385.2 billion, with the weight of 5 largest banks, which hold the biggest amount of assets, having increased from 52.7% to 53.8% in total.

Credit rating of Russia remains BBB, with a "negative" perspective[3]. A strong external balance Russia runs today is an important support for its rating to remain unchanged: international reserves reach USD 477 billion and net foreign assets amount to 23.0% of the GDP.

As for geopolitical tensions associated with Ukraine, starting from March 2014, the United States and the European Union launched a series of trading and economic sanctions against Russia. This has negatively affected the capital outflow, foreign investment and domestic economic growth on the whole.

The announced sanctions apply to the financial, energy and military industry sectors. In particular, restrictions were imposed on ammunition, some articles of dual-use purpose, as well as on export of a number of oil industry equipment and technology to Russia. Any financial assistance that would be for trading of items included in the list of restrictions has been prohibited. Furthermore, restrictions were imposed on individual companies and organizations active in financial, defense and fuel/energy sectors, with the main stipulation that transactions with financial instruments with 30-day and more maturity issued after September 12, 2014 is prohibited.

[1] *Information on the Russian economic development, as well as estimates and projections is from the periodical "Мониторинг об итогах социально-экономического развития Российской Федерации в первом полугодии 2014 года" (Monitoring of the Results of Socio-Economic Development of the Russian Federation in the First Half of 2014) issued by the Russian Ministry of Economic Development.*

[2] *http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/ftrade/*

[3] *http://www.fitchratings.ru/rws/press-release.html?report_id=841761*

SUMMARY

In the first half of 2014, the global economy continued recovering, but it was slower than expected. With unstable world economic growth, Armenia posted an increased trade balance deficit due to a low growth rate in exports of goods.

In developed countries, issues like economic growth slowdown, low inflationary environment remain on the agenda. Under such conditions, developed countries kept on implementing a low interest rate policy. Developing countries encountered capital flight, which led to domestic currency depreciation pressures. Apart economic risks hampering growth in developing countries, risks associated with the crisis in Ukraine got a particular emphasis. Russia's economic growth slowdown somewhat decelerated the inflow of non-commercial remittances from this country; this may later on affect the domestic household income and Armenia's overall financial stability.

2. MACROECONOMIC ENVIRONMENT DEVELOPMENTS IN ARMENIA

2.1. MACROECONOMIC DEVELOPMENTS [7]

Weak investment climate, adverse weather conditions and trends demonstrating economic activity slowdown in the main partner countries all left their negative impact on the economy of Armenia. It is noteworthy that adverse developments of sanctions the West has imposed on Russian Federation could lead to further deceleration of economic growth rates in Armenia.

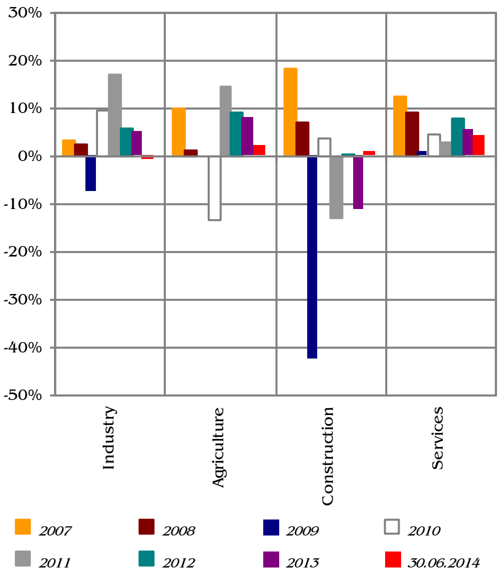
Implementation of moderate expansionary fiscal and expansionary monetary policies has mitigated the negative impact of these risks considerably.

Economic growth in Armenia in the first half of 2014 was 2.6% y/y, according to the National Statistical Service of Armenia. The main contribution to the economic growth came mainly from services, whereas decline in industry had a negative impact on overall economic growth.

According to the NSSA, in the first half of 2014 industry reported a 0.8% y/y decrease in value added as a result of contraction of value added in mining sector and reduced electricity production. The decline in mining industry is driven by the fall in international prices of non-ferrous metals in global markets. In the meantime, processing industry output and water production volumes have increased.

The growth of value added in agriculture was 1.9%. This is 1.0 percentage point lower from the figure reported for the same period last year, which is due mainly to unfavorable weather conditions that resulted in damaged apricot and other such crops.

The anuual growth of main sectors of economy

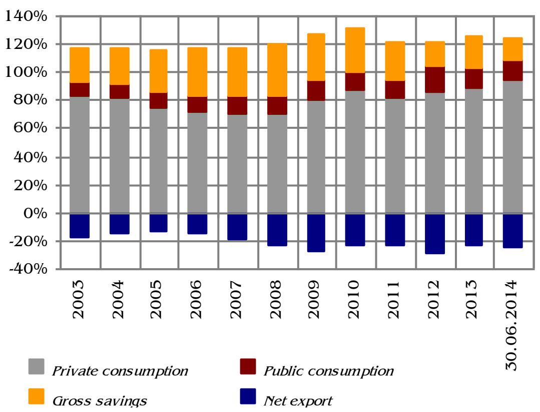


Source: National Statistics Service of Armenia.

In the period under review, construction sector reported a 0.7% increase in value added, driven mainly by increased volumes of construction funded by companies, international loans, the central budget and local budgets. At the same time, the volumes of construction funded by households and resources of humanitarian aid have contracted.

The growth of value added in services sector was 4.1% y/y, which is fuelled by services rendered as well as increased trade turnover, particularly in retail and wholesale trade.

GDP expenditure components (share in GDP)



Source: Central Bank of Armenia.

By GDP expenditures, private consumption grew by 1.4% in the first half of 2014. The slow rate of growth is attributable to weaker growth rates in transfers from Russia as well as lower-than-expected domestic economic activity and lesser public spending. The growth of public consumption was 2.0% for the first half of the year.

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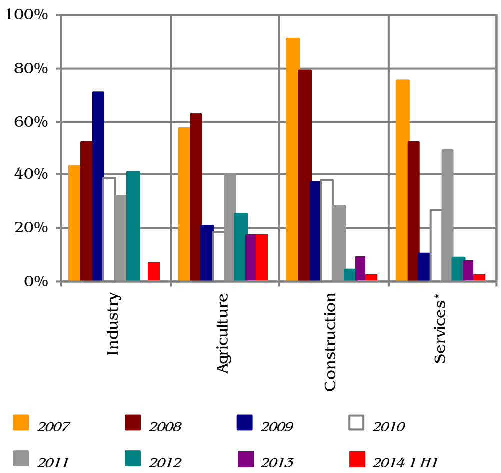
[7] *For details on the developments of macroeconomic environment in Armenia, see the quarterly publication "Inflation Report, Q2, 2014).*

Investment activity in the economy was weak – in line with expectations – due to persistently low output volumes in construction sector and in the business activity on the whole. In the period under review, the growth of private investment was 2.2% y/y. Public investment reported a 15.6% y/y decline.

In the first half of 2014, relative to the yearend, loans to the economy have grown by 4.5%. Growth of the loan portfolio was recorded in almost all sectors of the economy, with the fastest growth rates of lending in public catering and other services and agriculture, by 15.4% and 11.4%, respectively. As loan portfolio grew, the share of non-performing loans in total loans has risen by 1.3 percentage point to 5.6%. Non-performing loans were relatively more in construction, public catering and industry sectors, making up 10.4%, 7.9% and 5.8%, respectively.

In the first half of 2014, the volumes of credit to agricultural and ore mining sectors grew.

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.

According to surveys conducted by the Central Bank, in the second quarter of 2014 Business Climate Indicator[8] rose by 1.9 percentage point to 57.1, which is above the stability range and points to the optimism of businesses for the business environment.

According to the Republic of Armenia Ministry of Finance data, foreign debt of the Republic of Armenia was USD 3,850.5 million, as of June 30, 2014. Compared to the yearend, foreign debt has reduced by 0.8% to 36.2% of GDP. Armenia's foreign public credit included funds disbursed from international organizations (81.9%), foreign government loans (17.6%), and loans provided from commercial banks (0.5%). Moreover, the share of loans with a floating rate kept on shrinking to 20.0% of total credit at the end of the semester.

Qualitative public debt indicators of the Republic of Armenia

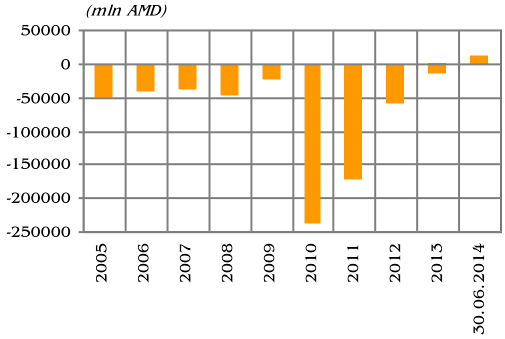
Indicator	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 H1
Debt/GDP (limit 50%)	22.3%	18.2%	14.0%	13.6%	35.7%	34.2%	36.4%	37.6%	37.5%	36.2%
Debt/ Export	77.6% (less indebted)	79.8% (less indebted)	81.6% (less indebted)	89.8% (less indebted)	221.7% (moderately indebted)	170.31% (moderately indebted)	148.0% (less indebted)	150.0% (less indebted)	139.4% (less indebted)	128.7% (less indebted)
Debt service/ Export	4.6% (less indebted)	4.2% (less indebted)	2.9% (less indebted)	3.1% (less indebted)	6% (less indebted)	5.0% (less indebted)	4.2% (less indebted)	9.9% (less indebted)	14.4[9]% (less indebted)	11.1% (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)	2.4% (less indebted)

[8] A composite economic index of business climate which the Central Bank builds based on quarterly survey data obtained from different sectors of the economy.
[9] The above Debt Service/Export indicator does not include an advance repayment of Russia Loan. When inclusion of the repayment is considered, the Debt Service/Export indicator will reach 30.7%.

Almost all qualitative indicators of public debt of the Republic of Armenia have improved, so Armenia remained a country with a less debt burden

The first half of 2014 marked an improvement in main qualitative indicators of public debt of the Republic of Armenia, which means Armenia remains a country with a less debt burden.

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



Source: National Statistics Service of Armenia.

Over the first six-month period, the actual figures of the Republic of Armenia state budget were less expansionary than planned.

According to the NSSA, in the first half of 2014 budget revenues posted a 5.4% y/y growth[10], which implies a performance almost entirely in line with quarterly plans. The growth was attributable to *value added tax* and *income tax,* two sub-items holding a large share in total tax revenues, which have increased by 7.2% and 24.0%, respectively. Though an increase in expenditures is more remarkable, 8.97%, expenditures made were fallen short of the expenditures plan.

Thus, an underperformed public spending encouraged the state budget to generate AMD 10.9 billion of surplus in the first half of 2014 in lieu of AMD 52.5 billion of deficit as had been envisaged under the adjusted plan. The Surplus/GDP ratio in the first half of 2014 was 0.64%.

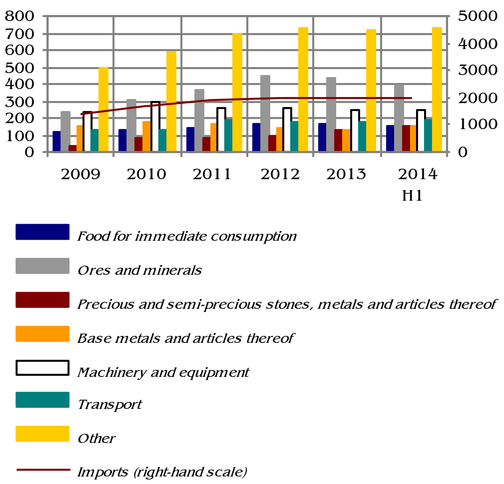
In June of 2014, the 12-month inflation rate was 1.8%, stepping below the lower bound of the confidence band.

Given a notable falling of prices of some food products during the semester, as well as a phase-out of the effect of energy price increases in July of 2013, the inflation environment in the first half of 2014 was low, with the 12-month inflation rate reaching 1.8% in June, hitting the lower bound of the inflation target.

2.2. FOREIGN TRADE

According to the Central Bank data, current account deficit of the Republic of Armenia deteriorated during the first half of 2014 by 16.6% y/y to USD 646.7 million. The deterioration was driven largely by broadened deficit of trade balance and reduced net incomes. In the period under review, the Current Account Deficit/GDP ratio has risen by 0.5 percentage point y/y in relation to the same reference period last year to 6.1%[11].

Armenia's imports by commodity groups (mln USD)



Source: National Statistics Service of Armenia.

In the period under review, the volume of foreign commodity turnover has increased by 1.2% y/y to USD 2,723.0 million, according to the NSSA data.

Import of goods has grown by 1.2% y/y to USD 1,706.52 million, and import of services has grown by 39.7% y/y to USD 727.1 million, according to the Central Bank data. Such

[10] This includes working funds of project implementation units.
[11] In the calculation, the GDP is annualized.

increase of services is due to the revised methodology of calculation of item "Travelling" in the BOP.

By structure of imports, increases were reported in the following items: "precious and semi-precious stones, precious metals and articles made thereof", "transport means" and "machinery and equipment".

The dollar value of exports of goods has decreased by 0.3 % y/y to USD 760.7 million. Meantime, the export of services has increased by 60.8% to USD 689.4 million due to the revised methodology mentioned above.

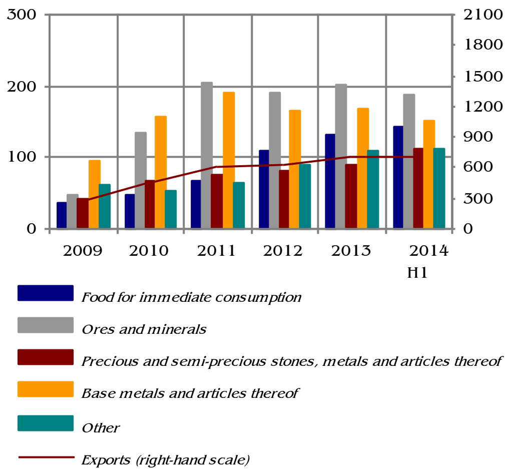
By structure of exports, the main increases were in the following items: "products of prepared food", "precious and semi-precious stones, precious metals and articles made thereof" and "transport means".

Despite reported small growths in import and export, in the period under review the balance of trade deficit has broadened by 2.5% to 8.9% of GDP in relation to the same reference period last year.

As in previous years, foreign trade of the Republic of Armenia in the first half of 2014 was again run with major concentrations by country. Main trade partners included Russia and the EU countries. The NSSA data suggest that the share of exports to the CIS and EU countries has decreased, respectively, by 2.4 and 2.8 percentage points, as economic growth slowed down in these countries, whereas the share of exports to other countries has grown by 5.1 percentage points. Specifically, in the foreign trade structure China's share grew by 5.8 percentage points; in terms of volume, export of goods in the first half of 2014 reported almost a 2.5 times increase. Germany also remains a very important destination for export: in the period under review, relative to the same reference period last year, the growth of export of goods to Germany has been impressive, 99.6%, which gave this country a leading 2nd place in the foreign trade structure.

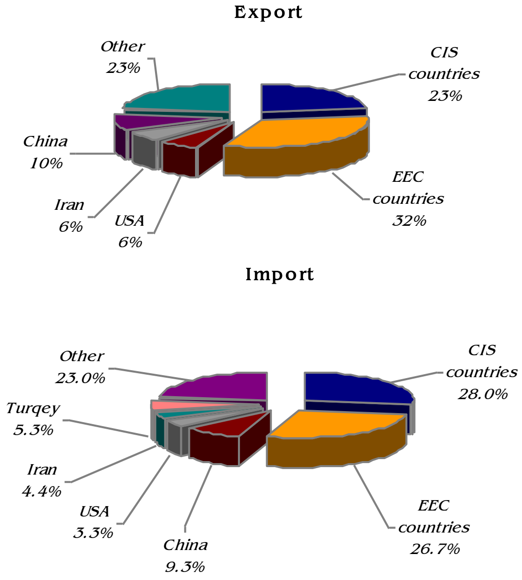
There have been changes in the export structure of commodity groups: increases were reported in such items as "products of prepared food" and "precious and semi-precious stones, precious metals and articles made thereof", but the shares of items "ores and minerals" and "non-precious metals and articles made thereof" posted decreases. Concentration persisting at high levels further leaves the Armenian mining and food sectors vulnerable to possible shocks in any trade partner or the global economy on the whole. By the import structure, main trade partners included Russia, China, Germany and Turkey. The share of imports from the CIS and EU countries has decreased, respectively, by 1.2 and 0.3 percentage points while the share of other countries, China and Turkey in particular, has increased by 1.5 percentage points.

Armenia's exports by commodity groups (mln USD)



Source: National Statistics Service of Armenia.

Armenia foreign trade, by country, as of 30.06.2014



Source: National Statistics Service of Armenia.

2.3. NET FACTOR INCOMES AND TRANSFERS

The remittances were of great importance in terms of financial stability.

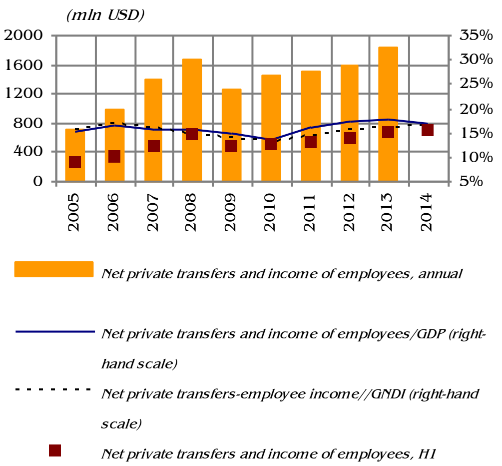
Non-commercial remittances from abroad are crucial for maintaining the financial stability of the Republic of Armenia. This explains the fact that these funds have a direct impact on individual household's standard of living, spending, credit-worthiness, hence macroeconomic and financial stability.

From the year 2008 onward, the share of private remittances has been increasing in the structure of monthly monetary income of both urban and rural households and it now amounts to about 9% per household member[12]. According to the Central Bank surveys, around 16% of respondents from urban households receive remittances from abroad[13].

During the first half of 2014, non-commercial remittances of individuals grew, at a slower pace though.

In the period under review, relative to the same reference period last year, the Remittances/GDP ratio has risen by 0.4 percentage point to 16.8%, reflecting a slow growth rate in remittances. Outbound workers' compensation and private current transfers have increased by 7.4% y/y compared to a 14.8% y/y growth reported last year[14]. The inflow of net non-commercial transfers of individuals via the banking system has grown slowly, either: in the first half of 2014 it grew merely by 3.1% y/y compared to a 10.5% y/y growth reported for the same reference period last year.

Net private transfers and income of seasonal employees



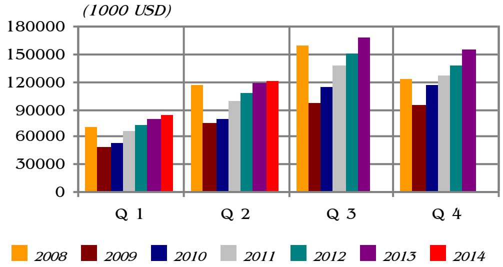
Source: Central Bank of Armenia.

The slowing in growth rates of the abovementioned indicators is primarily attributable a decelerated rate of growth of remittances from Russia, which is mainly a result of a 2.6% y/y decline in construction[15] and Russian ruble's 11.3% y/y depreciation versus the U.S. dollar in the first half of 2014. Although narrowed to some extent, the share of inflows from Russia remains rather high, 81.2%, in total remittances, which increases Armenia's economic vulnerability to such non-commercial transfers.

The bulk of non-commercial remittances of individuals comes from Russia, and this amplifies the country's economic dependence on the developments in Russian economy.

The migration policy of the Russian Federation has provided for some easing for Armenia citizens regarding their stay in the country. In July of 2014, an arrangement was concluded regarding the status of Russian citizens in the territory of the Republic of Armenia and Armenian citizens in the Russian Federation. It discharges citizens of the Republic of Armenia, including outbound workers from Armenia, of the obligation to register with relevant authorities within 30 days in the territory of the Russian Federation.

Net non-commercial remittances of individuals by banking system



Source: Central Bank of Armenia.

Given Russia's economic assessments by international organizations, the Central Bank made a downside forecast of the 2014 growth rates of non-commercial remittances to be within a 1.0-3.0% range[16].

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[12] *Source: Social Snapshot and Poverty in Armenia, 2013, the NSSA.*
[13] *Source: Consumer Confidence Index in Q1 and Q2, 2014, Central Bank of Armenia, https://www.cba.am/am/SitePages/statsscci.aspx*
[14] *https://www.cba.am/am/SitePages/statexternalsector.aspx*
[15] *http://www.economy.gov.ru/wps/wcm/connect/economylib4/mer/activity/sections/macro/ index*
[16] *Source: Inflation Report, Q3, 2014, the Central Bank of Armenia.*

Though, in the financial stability point of view, the growth in non-commercial remittances contributed to the reduction of risks arising from the household sector in the period under review, persisting sluggishness in the growth rate of transfers may later increase those risks.

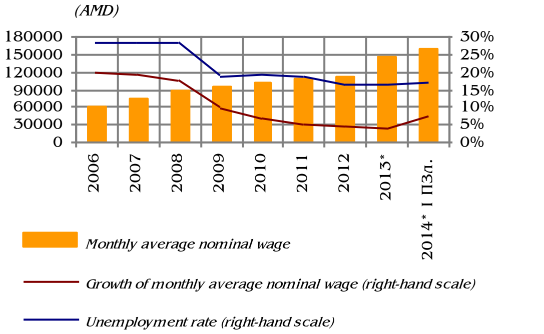
2.4. HOUSEHOLD INCOME AND DEBT BURDEN

The first half of 2014 saw a rise in both nominal wages and household savings with the banking sector.

The level of household income is an important aspect in maintaining financial stability as not only it can directly affect how properly households perform their credit obligations but also is a primary source of bank savings.

According to the Central Bank estimates, in the period under review the unemployment rate has increased by 0.8 percentage point to 17.0%, as economic growth rate slowed down. The employment of people aged 31-50 who seek job more than 1 year remains a major problem in the labor market. Long-term unemployment may drive this age group out of the opportunity to find a relevant job, which will possibly be associated with a loss of professional skills and other expertise.

Nominal average wage and unemployment

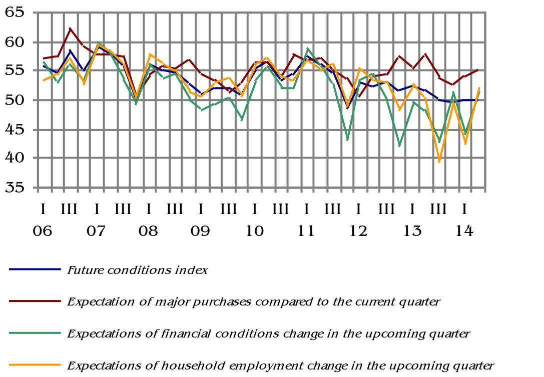


** The indicator is calculated according to the Republic of Armenia Law on Income Tax, effective from 01.01.2013, which stipulates that mandatory social charges payable by the employer have been also included in salaries and salary equivalents since January 1, 2013.*

Source: National Statistics Service of Armenia.

The nominal wage, which makes up a prevailing part of nominal per capita household monetary income, has grown by 7.1% y/y in both public sector (5.4% y/y) and private sector (8.8% y/y). In the period under review, the level of real wage has increased in relation to the previous reference period. This, coupled with increased inflow of non-commercial remittances from abroad, has positively affected households' living conditions and creditworthiness. However, the level of both employment and nominal wages in some regions remains low, which leaves an impact on living standards of the people hence on the financial inclusion in the regions.

Future conditions index and itscomponents

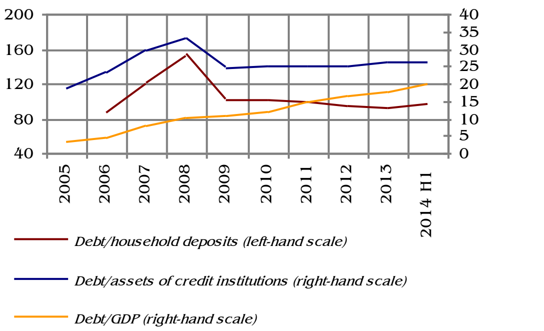


Source: Central Bank of Armenia.

According to the Central Bank estimates, in 2014 nominal wages will grow by 11.6% in line with expected acceleration in the growth rate of nominal wages during the second half of the year. This, combined with generally a low inflationary environment, will lead to increases of real income. In 2014, the unemployment rate is expected to rise by 0.3 percentage point in anticipation of relatively an humble economic growth. The unemployment rate, however, will decrease gradually with the acceleration of economic growth in the period 2015-2017[17].

Debt burden of the Republic of Armenia households demonstrated a moderate growth.

Households' debt and income indicators, %



Source: Central Bank of Armenia.

Current conditions sub-index and future conditions sub-index as two components of Consumer Confidence Index[18] are used to denote households' economic conditions and income. In the second quarter of 2014, the *future conditions*

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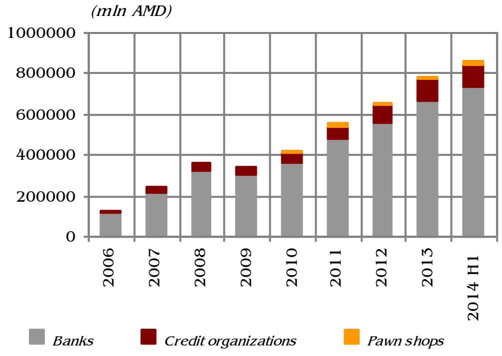
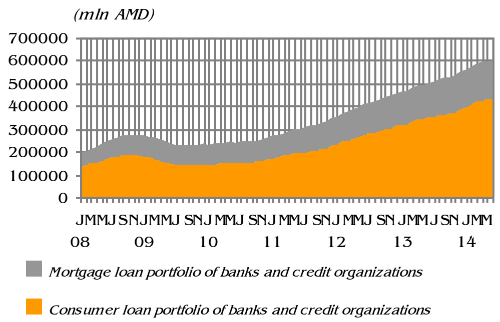
[17] Source: Inflation Report, Q3, 2014, the Central Bank of Armenia.
[18] Source: the Central Bank Quarterly Survey of Households, Q2, 2014.

The structure of household liabilities to financial institutions



Source: Central Bank of Armenia.

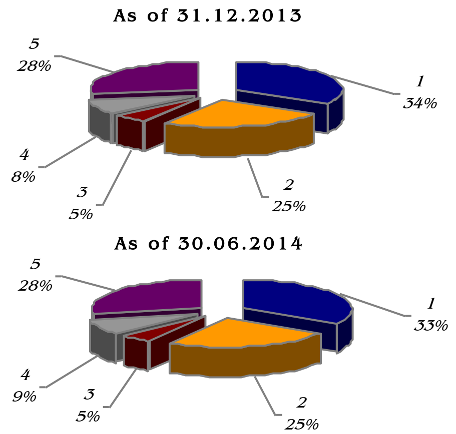
Consumer and mortgage loan portfolio of banks and credit organizations



Source: Central Bank of Armenia.

There has been an increase in household consumer credit volumes.

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.

sub-index dropped to 49.9. Mainly the *sub-index of financial situation change expectations on the next quarter* fell, but the increase of the other indicators that denote future conditions helped the *future conditions sub-index* stay within a stability range.

With a rise in nominal income and inflow of remittances, there has been 19.7% y/y increase in households' bank deposits (the share of these deposits in total resident deposits amounted to 68.6%). Foreign currency deposits remained holding the biggest share, 66.9%, in the total deposits portfolio, which limits the ability of commercial banks to allocate financial resources in dram-denominated assets.

Households' liabilities to financial institutions have grown by 19.3% y/y. A larger increase of household debt in relation to the GDP growth has led to the rise in the Debt/GDP ratio to 19.9%, which is still quite low compared to European countries.

In the period under review, compared to the previous two years, both mortgage and consumer credit volumes have grown more slowly. Growth in consumer loans has been posted for all types of loan products, and the structure of consumer credit remained virtually unchanged. The Central Bank surveys showed that consumer credit remained a preferred area for financial institutions and this made the competition stronger[19].

Improvement in lending procedures and terms and conditions continued along with growing maturity of credits. The year is expected to see a growth in consumer credit owing to anticipated increases of demand and supply, which, however, may add to the households' debt burden and result in deteriorated quality of loan portfolio of banks and credit organizations in the event real income is not high enough.

Mortgage loans for the purchase of real estate contributed to the growth of mortgage lending on the whole. Foreign currency loans constitute more than 50% of such lending, which may increase foreign currency risk among borrowers who receive dram incomes. Longer maturities of real estate loans play a positive role in terms of financial stability, since this contributes to the reduction of servicing debt burden of mortgage loans and to higher loan repayment rates. Undertakings such as Housing for Youth and the National Mortgage Company also contribute to the development of mortgage market by refinancing mortgage loans and making them more accessible.

In the first half of 2014, the loans these companies refinanced constituted nearly 20% of the total mortgage portfolio. Notwithstanding an increase in demand for

[19] *Source: the Central Bank Quarterly Survey of Terms and Conditions of Bank and Credit Organization Loans, 2014.*

mortgage loans, there has been some slowing in the easing of lending procedures[20]. The banks' unfavorable expectations of real estate market somewhat hamper further activation of the mortgage market.

The shares of "non-performing" loans in consumer loans and mortgage loans provided to households have grown to some extent. The shares of NPL in both FX and AMD have increased in consumer loans. The share of NPL has grown in FX real estate purchase mortgage loans.

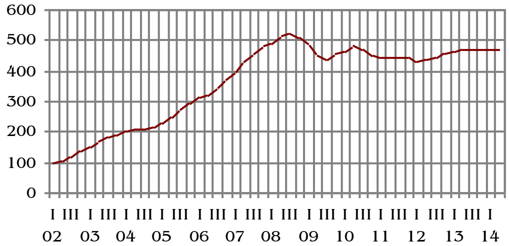
Risks deriving from the household loan portfolio quality remain manageable.

2.5. REAL ESTATE PRICES

Developments in the real estate market are crucial for financial stability and can substantially affect the households' wealth and soundness of financial institutions. This explains the fact that real property is an alternative to financial investment, on the one hand, and serves a security for credit, on the other.

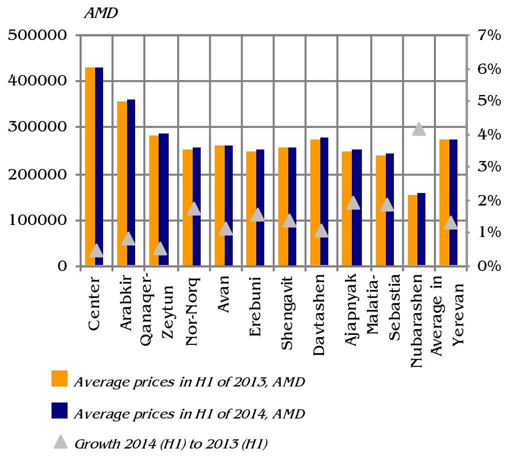
In the first half of 2014, apartment prices were almost the same.

Average apartment price index in Yerevan (sq m)



In the first half of 2014, relative to the previous six months and to the same reference period last year, prices[21] of multi-apartment homes in Yerevan have grown by 0.3% and 1.3%, respectively, primarily attributable reported price increases in Noubarashen, Ajapnyak and Erebouni communities of capital Yerevan. Prices of apartments in regions of Armenia remained almost unchanged.

Apartments prices by communities in Yerevan (sqm)



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

Responding to their risk management needs, commercial banks were further conservative as they continued keeping the Loan/Value ratio mostly in the 60-80% range. This is why risks to real estate price fluctuations are not significant in the financial stability point of view (see more in the subsection *market risk of commercial banks*).

There has been certain activity of real estate transactions in the property market, yet risks associated with the sale of collateral persisted.

In the period under review, there were more real estate transactions in Yerevan than compared to the same reference period last year. Relative to the first half of 2013, the number of such transactions has increased by 23.3% but decreased by 5.2% compared to the second half of 2013. There were similar developments in regions: the number of transactions has increased by 9.5% compared to the first half of the previous year but decreased by 13.7% relative to the second half of that year. According to the Central Bank

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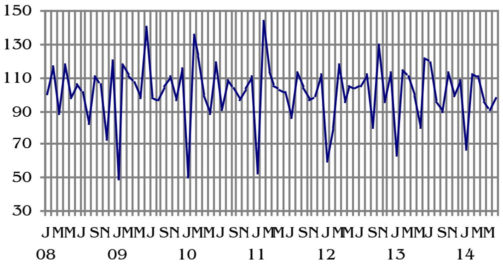
[20] Source: the Central Bank Quarterly Survey of Terms and Conditions of Bank and Credit Organization Loans, 2014.
[21] In Armenia, an average composite real estate price index is lacking, therefore the average price index of homes in Yerevan has been accepted as a criterion for real estate price developments.

Real estate sale and purchase transactions index



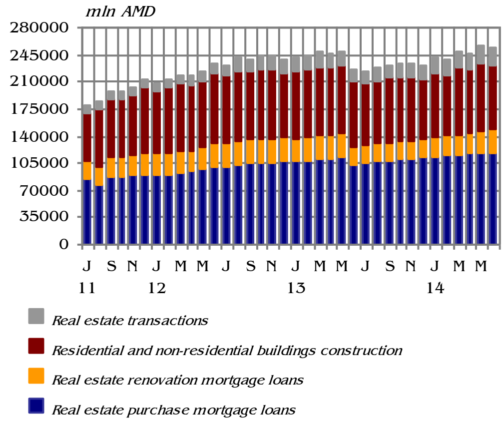
Source: State Committee of Real Estate Cadaster at the Government of Armenia.

Low solvent demand for real estate restricts further activation of the property market.

The volumes of residential houses commissioned to operate have reduced.

In the first half of 2014, the share of non-performing loans for construction of residential and non-residential building shrank.

Volume of loans to real estate market



Source: Central Bank of Armenia.

survey[22], trades were relatively active in the secondary market of real estate, while the market of new-built apartments is estimated to be quite low. According to respondent organizations, risks associated with the sale of collateral are persisting.

In general, a slowing growth rate in real estate market activity is mostly due to a low solvent demand attributable to relatively a low level of household income growth. In this context, real estate mortgage loans originated by financial institutions were a major contribution (see more in subsection *household income and debt burden*). Increased maturities of mortgage loans, which has been the case since 2008, make a positive impact for stimulating demand. This facilitates low income borrowers' access to mortgage loans.

In the first half of 2014, the volumes of residential houses commissioned to operate contracted by 10.7% y/y due to reduced volumes of construction financed by organizations. On the other hand, the volumes of household-funded apartment operation have continuously increased in recent years, and the share of the latter has grown to 88.6% in total residential buildings operation.

Residential buildings completion by sources of financing

Sources of financing	2014 H1 completed residential buildings (sq. m)	Share in total	Percentage change in H1 2014, y/y
Total, of which:	59782	100%	-10.7%
State budget	0	0	0
Corporations' funds	6802	11.4%	-53.5%
Household funds	52980	88.6%	1.3%

Source: National Statistics service of Armenia.

In the period under review, credit provided by banks and credit organizations for construction of residential and non-residential buildings has grown by 13.0%. In the meantime, the share of non-performing loans in these loans has dropped by 2.2 percentage points to 8.7% in total loan portfolio. Given relatively a small share of credit for construction of residential and non-residential buildings in total loan portfolio, one may conclude that the risks associated with these activities cannot leave a significant impact on the financial stability of the Republic of Armenia.

[22] *Source: the Central Bank Quarterly Survey of Terms and Conditions of Bank and Credit Organization Loans, 2014.*

SUMMARY

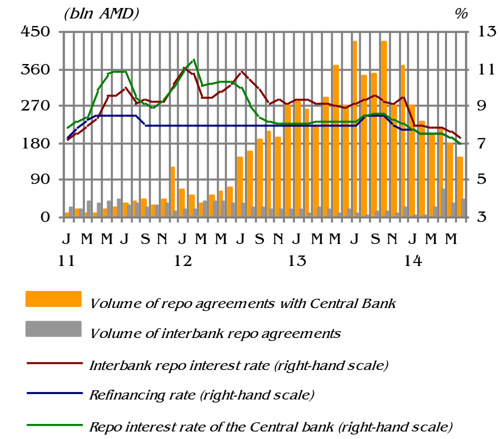
There was economic growth reported in the first half of 2014, with the growth rate slowed down due to sluggish economic activity in trade partners' countries as well as weak investment climate and bad weather domestically. Economic growth was fuelled mainly by the services sector while growth rate in other sectors has been relatively low. The first half of 2014 saw a low inflationary environment as prices of some food products plunged considerably and the effect of energy price increase in July 2013 phased out. The growth of non-commercial transfers which further had a significant impact on living standards of households, was however modest in comparison with previous years. Overall, there are risks to economic growth slowdown in 2014 amidst external and domestic developments, which may have a negative impact on financial stability.

3. FINANCIAL MARKET STABILITY OF ARMENIA

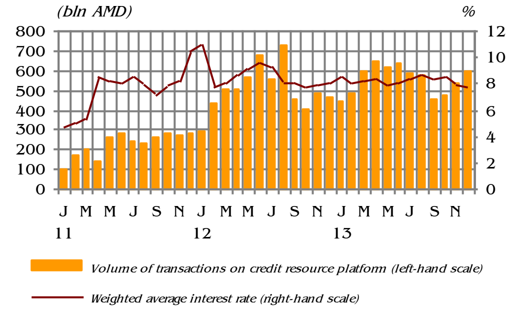
3.1. MONEY AND CAPITAL MARKET

Interest rates in the financial market further trended down.

Monthly volume of repo transactions and repo interest rates

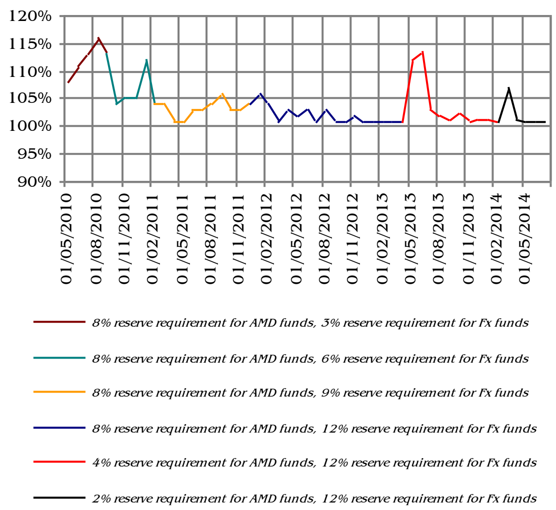


Volume of transactions on credit resource platform and weighted average interest rate



Source: Central Bank of Armenia.

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



In the first half of 2014, inflation continued reducing at a faster pace than expected, which was determined by a slow arte of economic growth and seasonal decline in prices of some food products. Under such circumstances, during the first half of 2014 the Central Bank gradually lowered the refinancing rate by a total of 0.75 percentage point to 7.0% in late June. Reducing the dram reserve requirement ratio from 4% to 2% in March 2014 was another action aimed at easing the monetary conditions.

Interest rate of the Central Bank's main policy instrument reduced along with dropping of the refinancing rate and the aforementioned reserve requirement ratio, whilst short-term interest rates continued trending down in the financial market.

The yield curve[23] shows that at the end of the first half of the year, relative to the yearend, yields of short-term treasury bills narrowed but yields of long-term treasury notes grew in the secondary market.

The narrowing of short-term interest rates was driven by the effect of both the Central Bank's policy and public debt management policy of the Ministry of Finance. The rising of interest rates in long-term segment of the yield curve is explained by the upside adjustment of previous year's interest rates. As a result, the spread[24] of short-term and long-term interest rates grew during the semester by 1.0 percentage point to 3.5% at the end of the year.

For summarized illustration of what are the current trends in the government securities market, the Central Bank calculates indices of government bonds, which are presented in the table below[25]:

[23] The yield curve involves dependence between the yields and maturities of government bonds. Starting from July 2013, the Central Bank is using a new approach to building the yield curve by applying the Nelson and Siegel Model; this is a parametric statistical model and it approximates the yield curve of all periods as a function.
[24] Short-term treasury bills are considered to be 6-month bills and long-term treasury notes, 10-year notes.
[25] There are 5 indices calculated for government bonds_4 for coupon bonds and 1 for discount bonds. The coupon bond indices are 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 AMD 1 billion and higher turnover. Discount government bonds TBI include bonds with maturity of one week and more, with AMD 400 million and higher turnover. For more details, please see the CBA website.

Indices of government coupon bonds in circulation, by maturity as of 30.06.2014

Index	TBI	G03	G05	G5I	GMI
Modified duration	0.37	1.32	1.71	5.94	3.08
Risk weighted yield	7.7	8.86	9.29	11.45	10.64
Average maturity (year)	0.39	1.52	2.04	12.54	5.39
Average weighted coupon (%)	-	11.23	11.08	11.97	11.36
Market Price of government bonds (million AMD)	10200	138791	182237	87400	269637
Market price change of index in case of +/-1% yield change (million AMD)	37	1842	3113	5192	8305
Market price change of index in case of yield change within the standard deviation (million AMD)[26]	7	301	774	1657	2038

Indices of government securities portfolio of comercial banks as of 30.06.2014

Index	TBI	G03	G05	G5I	GMI
Available for sale and held for government bonds (million AMD)	5819	63631	89471	30280	119791
Share in total portfolio (%)	4.9	53.1	74.7	25.3	100
MD	0.33	1.58	2.00	5.53	2.89
Price change +/- (million AMD)	19.2	1004.5	1788.5	1675.4	3463.8
Portfolio change in case of yield change within the standard deviation (million AMD)	4.2	186.6	481.8	505.9	788.9

As of the end of the first half of 2014, modified duration of government coupon bonds outstanding was 3.08 years, with an average maturity of 5.39 years. These indicators for discount bonds were 0.37 and 0.39, respectively.

In case of a 1% change in the yield of government securities, investors' likely loss / gain could be about AMD 8.3 billion or 3.0% of the market value of government bonds. Moreover, a notable portion of the change might come from long-term bonds, as they have greater sensitivity to the interest rate change.

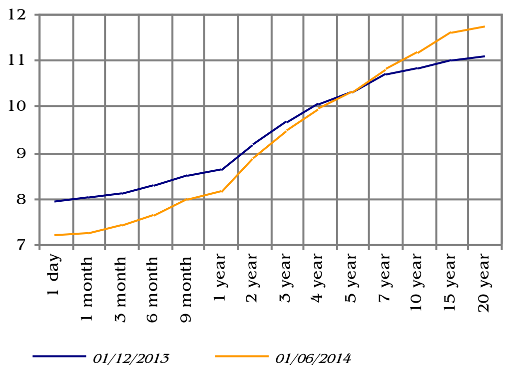
Operations in securities markets (including repo and reverse repo transactions but excluding operations with the Central Bank) carried out by investment service providers[27] during the first half of 2014 grew by 26.8% compared to the same reference period last year and amounted to AMD 1 trillion 529 billion. Transactions involving securities trades constituted 21.0% percent of the operations mentioned above.

In the first half of 2014, the government securities market liquidity[28] was less volatile (according to the indicator describing the level of liquidity) compared to the previous

[26] Standard deviation of risk weighted yield within 01/12/2013 - 30/06/2014.
[27] As of 30.06.2014, investment service providers included 21 commercial banks, 8 investment companies and 3 investment fund managers.
[28] The liquidity of government securities market is calculated as a 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.

Dynamic analysis of the yield curve shows that yields of treasury bills in short-term segment have reduced.

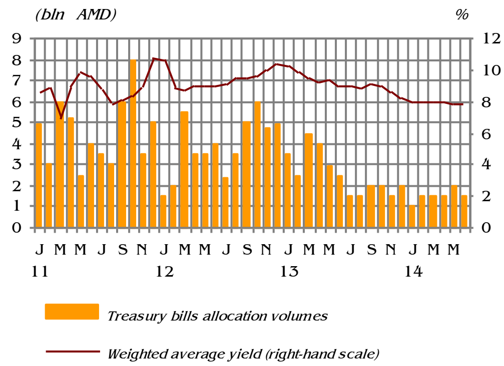
Yield curve change



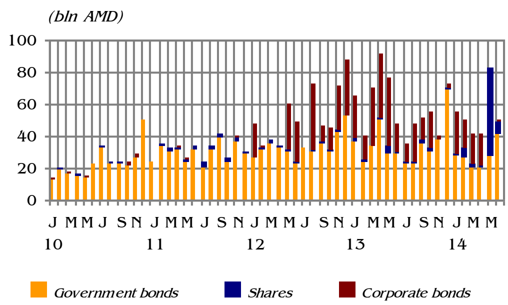
Spread of 6-month and 10-year bonds

Source: Central Bank of Armenia.

Treasury bills allocation volumes and weighted average yield

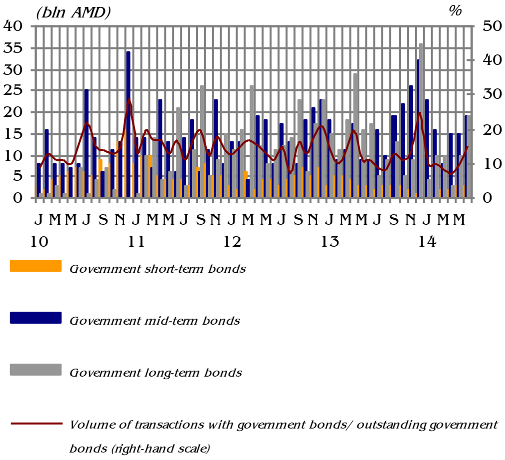


Security trades by investment service providers



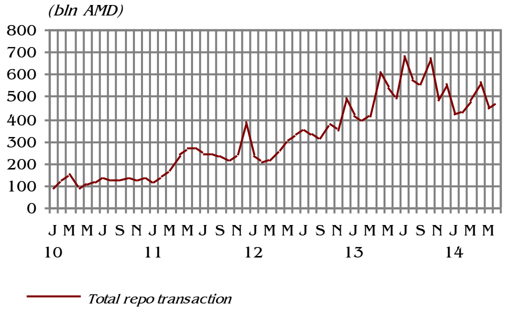
Source: Central Bank of Armenia.

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



Source: Central Bank of Armenia.

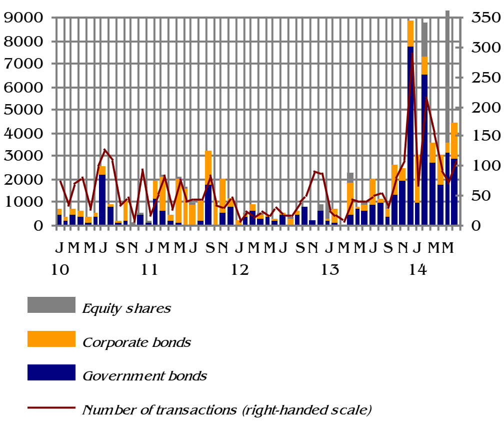
Repo transactions by investment service providers



Source: Central Bank of Armenia.

The regulated market saw an increase in transactions.

Securities trades and repo transactions at regulated market of securities (mln AMD)



Source: Central Bank of Armenia.

reference period. As of June, 2014, the average liquidity has been 1.8 points higher than the average semester liquidity level.

The share of trades with medium-term and long-term securities amounted to 59.2% and 34.6%, respectively, of total transactions involving government securities trades. The share of short-term securities reached 6.2%.

In the first half of 2014, relative to the same reference period last year, the volume of repo and reverse repo transactions (excluding operations with the Central Bank) carried out by investment service providers has increased by 8.9% and amounted to AMD 1 trillion 208 billion. Again, almost all repo transactions involved government securities. Repo transactions with corporate bonds constituted a mere 0.1% in total.

In the first half of 2014, the total volume of securities trades and repo operations in regulated market amounted to AMD 54.1 billion, with securities trades constituting 98% in total.

In the regulated market, transactions with shares were the prevailing part, 52.3%, in the structure of securities trades and repo transactions, which was attributable to a replaced shareholder of a reporting issuer. The trades with government and corporate securities constituted, respectively, 33.4% and 14.3% in total.

The share of regulated market in the structure of securities trades by investment service providers has been 16.5% since the beginning of the year.

In the first half of 2014, the Securities Market Capitalization/GDP ratio was 2.2%, up by 0.7 percentage point against the end of the previous year. The increased capitalization again was attributable to a replaced shareholder of a reporting issuer. The Securities Market Gross Turnover/GDP ratio stood at 7.32%.

3.2. FOREIGN EXCHANGE MARKET

During the first half of 2014, the Armenian dram / U.S. dollar exchange rate did not see major fluctuations. However, in light of monetary policies implemented by governments as well as geopolitical developments, the dram's exchange rate against other currencies (particularly, Euro, Russian ruble, Turkish lira, the Ukrainian hryvnia) was somewhat volatile. The average semiannual exchange rate versus the U.S. dollar reached AMD 411.94, appreciating by 0.1% against the same reference period last year. The average semiannual exchange rate depreciated versus Euro but appreciated versus the Russian ruble by 4.1% and 12.9%, making up AMD 564.47 and AMD 11.77, respectively.

In 2014, compared to the same reference period last year, the average semiannual nominal effective exchange rate and the average semiannual real effective exchange rate of the Armenian dram appreciated, respectively, by 8.4% and 8.1%[29].

During the semester, gain from foreign currency trades by the banking system amounted to AMD 6.5 billion.

SUMMARY

The Central Bank reacted to a rapid decline in inflation rates and persistently low economic activity in early 2014 by easing the monetary conditions: the Central Bank cut the refinancing rate by a total of 0.75 percentage point to 7.0%.

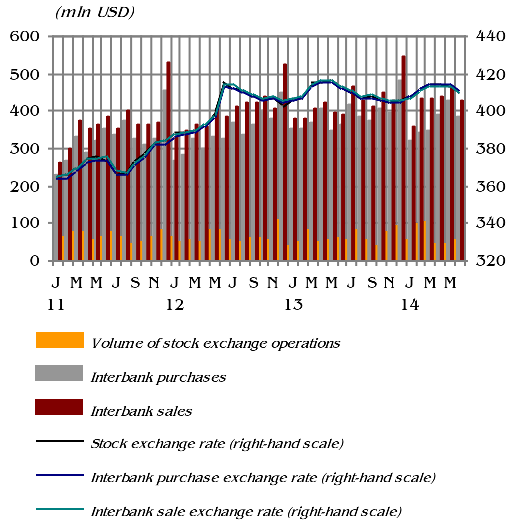
Amid measures to ease the monetary conditions, the financial market further saw a downward trend in short-term interest rates. Interest rates of short-term government bonds also reacted to the Central Bank's policy of interest rate change.

In the secondary market of securities, the volumes of securities trades and repo transactions by investment service providers have increased.

Developments in the currency market demonstrated primarily appreciation patterns.

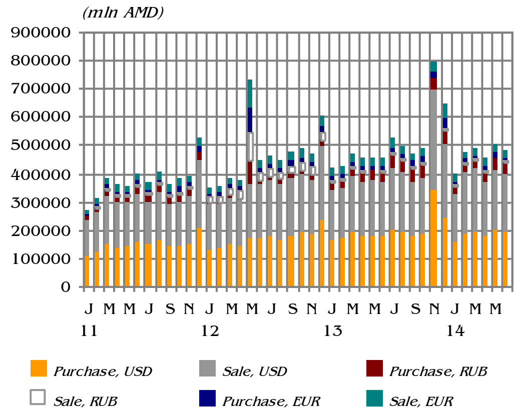
In the first half of 2014, developments in the financial markets largely contributed to the maintaining of financial stability, without creating new risks for financial stability.

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



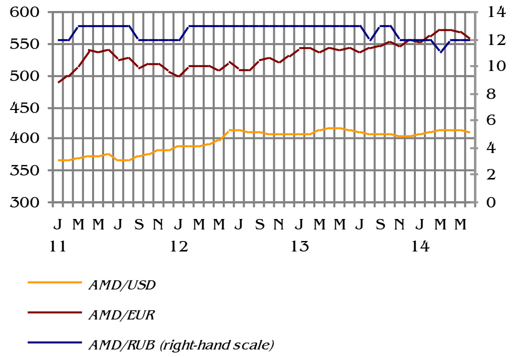
Source: Central Bank of Armenia.

Transactions in exchange market of Armenia by currencies



Source: Central Bank of Armenia.

Exchange rates in exchange market of Armenia (AMD)



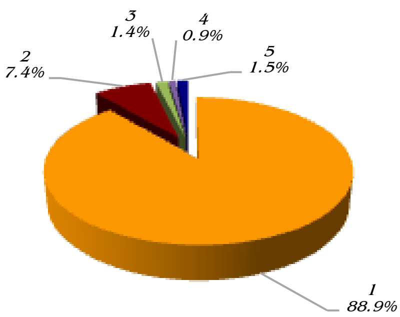
Source: Central Bank of Armenia.

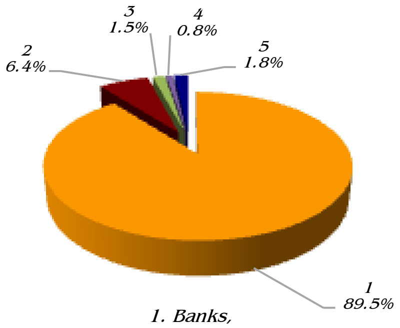
[29] *To study the Armenian dram's exchange rate behavior as well as external competitiveness of the Republic of Armenia, both nominal and real effective exchange rates are considered. These exchange rates are calculated on a basis of country weight in proportion of the main twelve trade partner countries (Euro-Area, Russia, Ukraine, South Korea, Bulgaria, Switzerland, Iran, U.S.A., Turkey, Georgia, Japan, and China).*

4. STABILITY OF FINANCIAL INSTITUTIONS OF ARMENIA

Banks continue to act as a major participant in the financial system.

The structure of financial system assets, by financial institutions

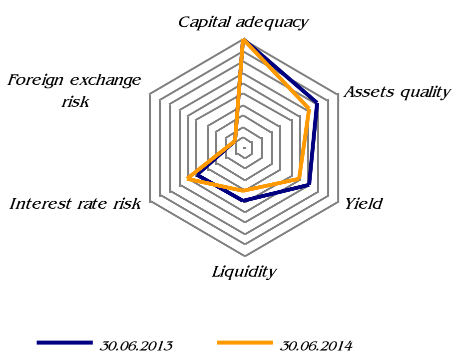




1. Banks,
2. Credit organizations,
3. Insurance companies,
4. Investment companies,
5. Other financial institutions

Source: Central Bank of Armenia.

Banking system stability map



In the first half of 2014, relative to 2013, the financial sector credit to GDP ratio has increased by 0.8 percentage point to 43.6% while the assets to GDP ratio dropped by 2.3 percentage points to 74.8%. Armenia's banking sector accounts for 88.9% of the financial system assets, and in this context identifying and evaluating banking system risks is vital for assessment of the domestic financial stability. The share of insurance and securities market participants and other players of the financial market remains small enough in comparison with the banking sector, so their impact on the stability of the financial sector is negligible.

Relative to the previous year, the growth rate of banks' loan portfolio has reduced: this is a positive development for financial sustainability in terms of credit risk mitigation.

4.1. COMMERCIAL BANKS

Banking system stability map

A banking system stability map provides a general understanding of the behavior of the banking system stability. It denotes how values in the set of indicators of banking risks changed relative to two previous periods.

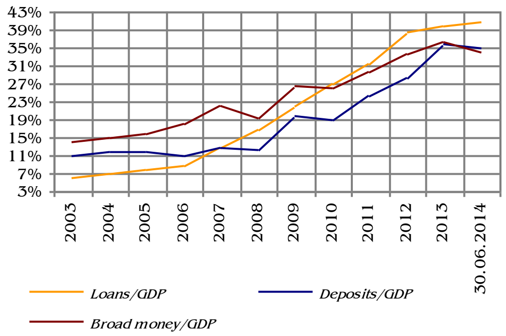
In the 2nd quarter of 2014, relative to the 2nd quarter of 2013, the elements of the stability map[30] incurred some changes: there was a positive shift in asset quality, profitability and liquidity indicators while the interest rate risk indicator reduced somewhat. The capital adequacy and foreign currency risk indicators remained unchanged (see details in subsections *Credit risk*, *Liquidity risk*, *Market risk*, *Capital adequacy* and *Earnings*).

[30] The banking system stability map contains indicators denoting capital adequacy, assets quality, liquidity, profitability, interest rate risk and foreign exchange risk. These indicators were firstly measured on a 1 to 10 scale basis and then calculated in accordance with the IMF methodology. Note that the nearer the value to the center of the map, the lower the level of risks associated with the indicator, and vice versa. The banking sector stability map shall not be interpreted as an indication of the level of financial stability, rather it provides a picture whether the level of risks involved has increased or decreased.

4.1.1. Financial intermediation and concentration

During the first half of 2014, growth rates of indicators of the banking sector lagged behind nominal GDP growth rate. As a result, main prudentials of banking sector intermediation have diminished, except for the Credit/GDP ratio. Compared to the end of the year, such ratios as banking sector assets/GDP, deposits/GDP and broad money/GDP have dropped by 2.5, 0.7 and 2.5 percentage points to 66.5%, 35.0% and 34.0%, respectively. The credit to economy/GDP ratio has increased by 0.5 percentage point to 40.6%.

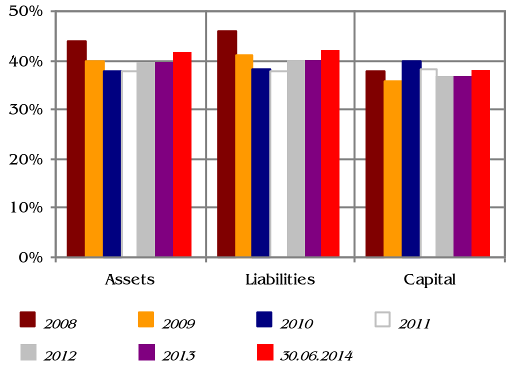
Financial intermediation



Source: Central Bank of Armenia.

In the period under review, total capital of the banking sector grew by 3.8% (AMD 17.1 billion) while total assets reduced by 0.7% (AMD 20.6 billion). As a result, the total assets to capital ratio (the leverage ratio) has increased by 0.7 percentage point to 16.2%. The growth of total capital was largely due to net profit of AMD 18.3 billion. During the semester, 4 banks added a total of AMD 19.8 billion to the statutory capital, of which AMD 7 billion replenished from external sources. Non-resident participation in the statutory capital of the banking sector has reduced by 7.4 percentage points to 67.2% due to changed residency resulting from a shift in a center of economic interest of a bank shareholder.

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



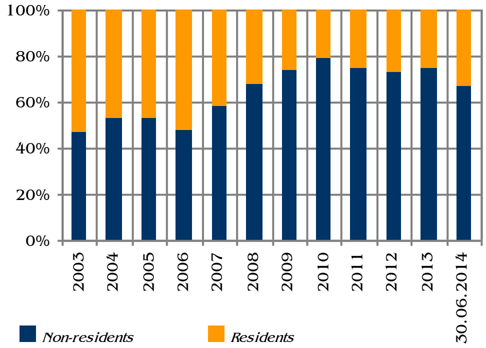
Source: Central Bank of Armenia.

The Herfindahl-Hirschman Concentration Index

Indicators	31.12.11	31.12.12	31.12.13	30.06.14
Total assets	0.0775	0.0787	0.0699	0.0710
Total liabilities	0.0792	0.0705	0.0727	0.0734
Total capital	0.0644	0.0637	0.0613	0.0628

Source: Central bank of Armenia.

Foreign investors' participation in banking system capital of Armenia



Source: Central Bank of Armenia.

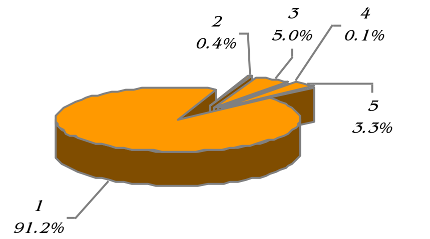
The Herfindahl-Hirschman Index of Concentration[31] for some balance sheet items (assets, liabilities, capital, loans, and deposits) denotes that concentration of the banking system remained low, and this limits the likelihood of the impact of concentration risk on the financial stability.

Relative to the previous end-year, the share of assets, liabilities and total capital of 4 largest banks out of 22[32] in Armenia has increased by 2.0, 2.2 and 1.2 percentage points to 41.3%, 42.0% and 37.7%, respectively, at the end of the reporting period.

[31] The Herfindahl-Hirschman Concentration Index varies between 0 and 1, characterizing the level of concentration (values near to 0 denote lower concentration).
[32] There are 21 commercial banks and one development bank (Pan-Armenian Bank JSC) functioning in the Republic of Armenia.

The loan portfolio growth rate slowed down.

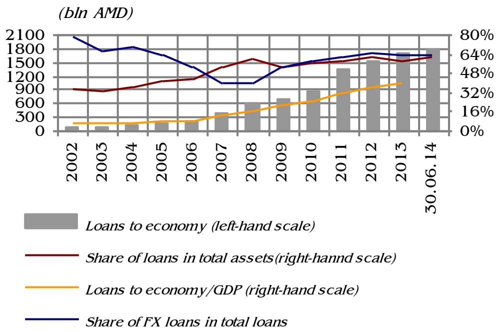
The structure of risk weighted assets calculated in banking system capital adequacy index,as of 30.06.2014



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

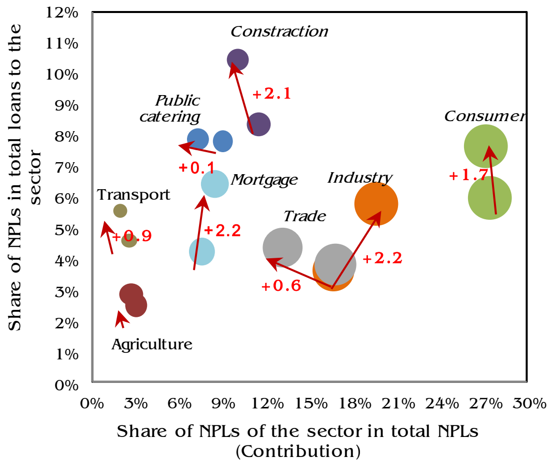
Source: Central Bank of Armenia.

Loans to economy



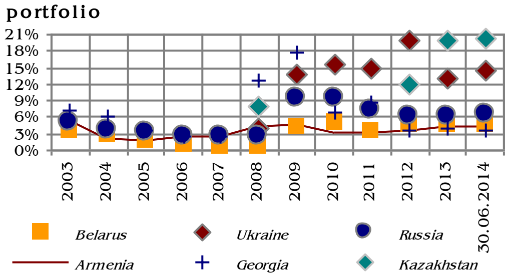
Source: Central Bank of Armenia.

The change of the share of NPLs in the loans to different sectors of economy
(The end of the arrow shows data as of 30.06.2014 the beginning - as of 31.12.2013)



Source: Central Bank of Armenia.

Share of non-performing loans in total loan portfolio



Source: IMF.

4.1.2. Credit risk

Credit risk remains an important risk to the financial stability of Armenia's banking sector. The share of credit risk in risk-weighted assets of commercial banks accounted for 91.2%, which was almost the same compared to year-end (as of 31.12.2013, it was at 91.1%). In the context, prudent credit risk management is extremely important.

In the first half of 2014, loans to economy by the banking system grew by 4.5%.Growth of credit was reported for almost all sectors of the economy, except for *transport and communication* and *trade* sectors, as loans there contracted by 10.9% and 2.5%, respectively. The highest growth rate in loans was reported for *public catering and related services*, *agriculture* and *consumer loans*, by 15.4%, 11.4% and 10.2%, respectively. At the end of the semester, the shares of consumer loans, industry and trade credits were large in total loan portfolio, making up 21.6%, 20.7% and 18.4%, respectively.

Relative to the end-year, the share of non-performing loans and receivables (classified as "watched", "substandard", and "doubtful") has grown by 1.3 percentage points to 5.6% of total loan and receivables portfolio. A loan portfolio with a fast growing rate in the past 3 years (as high as 30% annual growth on average) has considerably contributed to the increasing of the share of non-performing loans and receivables. In this context, a trend of slowing growth rate is good for mitigation of credit risk.

In the period under review, the shares of non-performing loans were somehow larger in credit to industry as well as mortgage and construction loans: these shares grew by 2.2, 2.2 and 2.1 percentage points to 5.8%, 6.4% and 10.4%, respectively. As of the end of the first half of 2014, the shares of non-performing mortgage, construction and industry loans in total non-performing loan portfolio stood at 8.5%, 10.1% and 19.6% (as of 31.12.2013, these were 7.6%, 11.5% and 16.7%), respectively. Persistently stable shares of industry and mortgage loans made it possible for these loans to contribute greatly to non-performing loans in total loan portfolio. Whereas the contribution of construction loans to the formation of non-performing loans in loan portfolio has reduced because of the decreased share of these loans in loan portfolio.

As calculated by international methodology[33], the share of non-performing loans and receivables in total loan and receivables portfolio has grown by 1.0 percentage point relative to the end-year and amounted to 8.3%. Relative to the first half of the previous year, the net loan loss provisions/assets ratio has reduced by 0.1 percentage point to 0.7%.

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

The Herfindahl-Hirschman Concentration Index of loans for economy sectors remained the same, 0.12, which points to some concentration of loans in the banking system. The same indicator calculated using the banks' average was 0.17, again at the same level. The indicator of banks' average is higher in comparison with the banking system loan sectoral concentration index and this is an indication of relatively high sectoral concentration of loans provided by some banks. At the end of the semester, relative to the end-year, the share of loans made to large borrowers has reduced by 0.7 percentage point to 24.5% of total loan portfolio[34].

Credit risk stress scenarios [35]

30.06.2014	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 22.0 billion or 5.0% of regulatory capital of the banking system	AMD 5.9 billion or 1.4% of regulatory capital of the banking system	AMD 53.5 billion or 12.2% of regulatory capital of the banking system
Total capital adequacy of the banking system in case of stress scenario	15.5%	16.0%	15.0%

In the period under review, relative to the end-year, there has been some worsening in the results of stress test on credit risk, which was attributable to an increased share of non-performing loans in the loan portfolio. The worst scenario considered revealed cases of infringement of the total capital adequacy requirement at some banks. However, even with a possible loss arising from credit risk, capital adequacy of the banking system remains above the established threshold of 12%, and the probability of emergence of insolvency problems is estimated to be low.

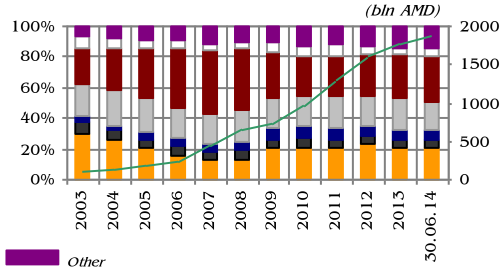
Stress scenario of credit risk derived from off-balance sheet contingent liabilities

30.06.2014	Stress scenarios
	When 50% of off-balance sheet contingent liabilities performed
Banking system capital adequacy ratio before stress scenario	16.2%
Banking system capital adequacy ratio in case of stress scenario	16.0%

The results of stress scenario[36] of credit risk derived from off-balance sheet contingent liabilities denote that the capital adequacy ratio at individual banks is not plunging more than 0.5 percentage point, so no infringement of the ratio by any bank is reported. In this context, the impact of credit risk

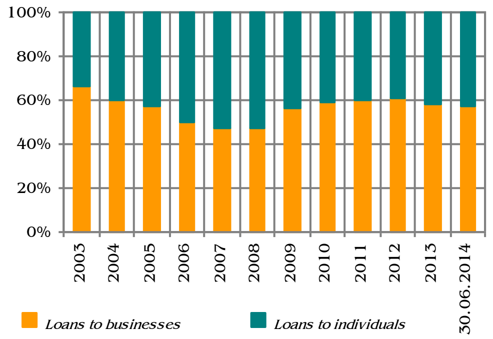
[34] *The bank's risk on large borrowers exceeds 5% of average monthly regulatory total capital, taking the interdependence into account.*
[35] *This stress-scenario and the other ones following are not prepared to forecast emergence of any risks, but rather aim to reveal the weaknesses of the financial system, as well as assess its ability to absorb such risks.*
[36] *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



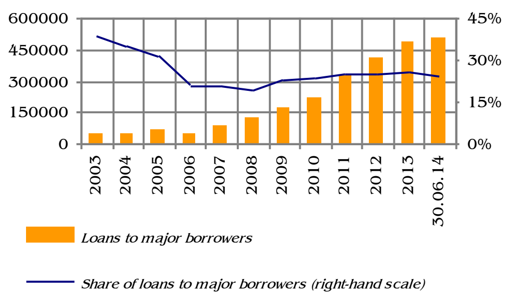
Source: Central Bank of Armenia.

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

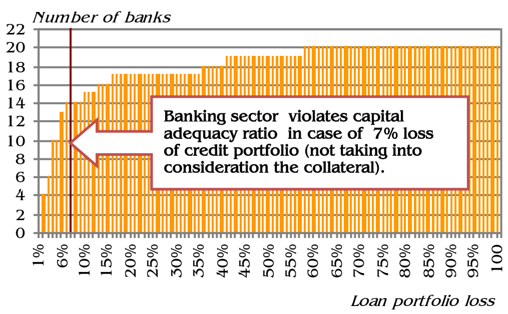


Source: Central Bank of Armenia.

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.

arising from off-balance sheet contingent liabilities on financial stability is estimated to be insignificant.

The level of liquidity of commercial banks has decreased .

4.1.3. Liquidity risk

In the first half of 2014, the level of liquidity of commercial banks somewhat diminished. Relative to the end of the year, prudential ratios of total liquidity and current liquidity have decreased by 1.6 and 7.2 percentage points to 27.5% and 135.1% (with minimum thresholds of 15% and 60%), respectively. Prudential ratios of total liquidity and current liquidity for Group 1 foreign currencies have reduced by 1.7 and 10.1 percentage points to 20.3% and 104.8% (with minimum thresholds of 4% and 10%), respectively. At individual banks, total liquidity and current liquidity prudentials were in line with regulatory requirements, so no infringement of such liquidity indicators by any bank has been reported.

At the end of the first half of 2014, assets and liabilities by maturity were structured as follows: for up to 30-day (including demand deposits), up to 3-month and up to 1-year maturity baskets the assets to liabilities ratios[37] were 100.5%, 94.5% and 84.0% (as of 31.12.2013, these were 108.6%, 101.6% and 88.7%), respectively. Considerable negative liquidity gap persists only in the up to 1-year segment, which is due to increased maturity of loans along with deepening financial intermediation.

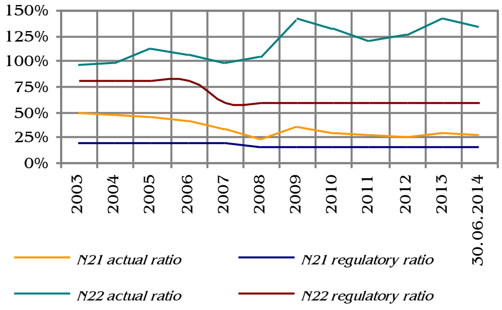
The assets to liabilities ratio for up to 30-day (including demand instruments) maturity baskets is particularly important for commercial banks in maintaining their current liquidity. In the last 5 years, the ratio has always been in the range 90%-110%, pointing to the banks' ability to provide current liquidity all the time.

In the period under review, risks to debt concentration of commercial banks have reduced: the share of large liabilities in total liabilities has contracted by 4.2 percentage points to 22.0%.

Relative to the end-year, foreign borrowings of commercial banks have decreased by 6.9%. Funds attracted from international financial institutions have reduced by 7.6% to 40.0% of total foreign borrowings. The main lender countries included Russia (20.3%), Luxemburg (11.7%), and Netherlands (6.1%). The share of long-term loans amounted to 87.7%, which almost excludes risks that such liabilities might be refinanced in a short-term horizon.

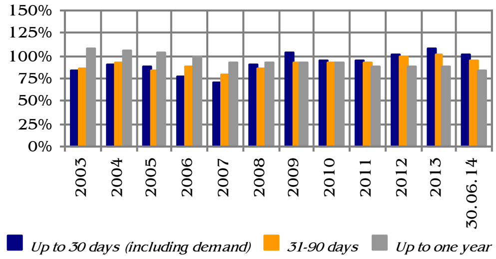
Relative to the end-year, the loans to deposits ratio[38] has increased by 3.7 percentage points to 116.0% at the end of the semester.

The dynamics of actual and regulatory liquidity ratios of the banking system



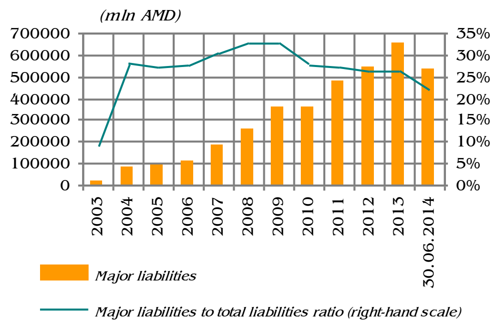
Source: Central Bank of Armenia.

The ratio of banking sysem assets to libilities by terms to maturity



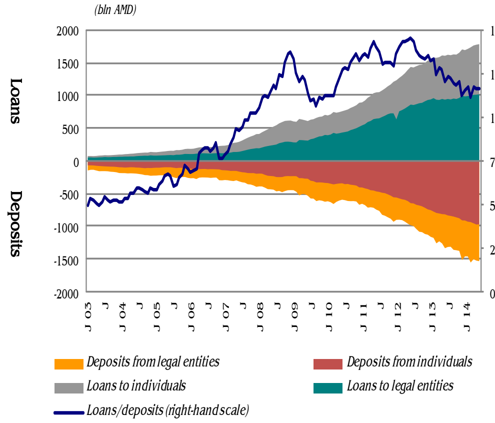
Source: Central Bank of Armenia.

The ratio of banking system major liabilities to total liabilities



Source: Central Bank of Armenia.

The structure of funds financing loans of banking system of Armenia



Source: Central Bank of Armenia.

[37] *The calculation of ratios of assets and liabilities includes off-balance sheet contingent liabilities by a 20% weight.*

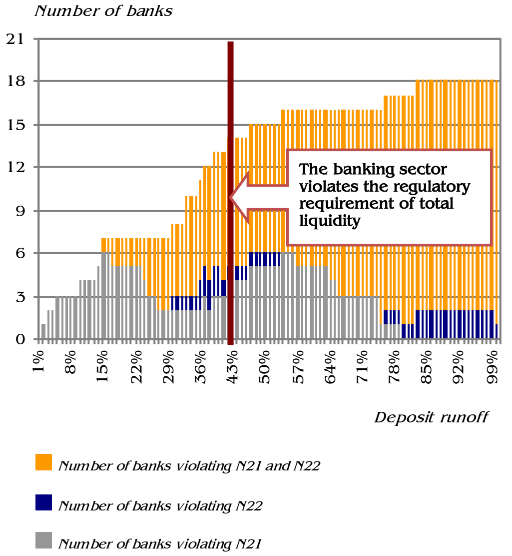
[38] *In the calculation of this ratio, credit includes loans (lease and factor operations inclusive) to real sector, while deposits include funds attracted from individuals and companies.*

Liquidity risk stress scenarios

30.06.2014	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	21.9%	23.6%	17.4%
Current liquidity ratio of banking system	100.0%	146.6%	100.0%

Relative to the results of liquidity risk stress tests conducted at the end of the year, the first half of 2014 results suggest that liquidity indicators have reduced to some extent as the level of liquidity of commercial banks declined. As stress scenarios show, some banks reported breaches of total and current liquidity requirements. However, high liquid assets in these banks are sufficient to cover an outflow of liabilities. In this context, the emergence of liquidity problems undermining financial stability is estimated to be negligible.

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



Source: Central Bank of Armenia.

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

30.06.2014	Stress scenarios
	When 50% of off-balance sheet contingent liabilities performed
Banking system total liquidity ratio	23.8%
Banking system current liquidity ratio	117.0%

According to the results of stress-test to assess liquidity risk arising from off-balance sheet contingent liabilities, some banks will report infringement of regulatory total and current liquidity standards. However, high liquid assets in these banks are enough to cover contingent liabilities. In this context, the liquidity risk arising from off-balance sheet contingent liabilities is estimated insignificant in terms of leaving an impact on financial stability.

4.1.4. Market risk

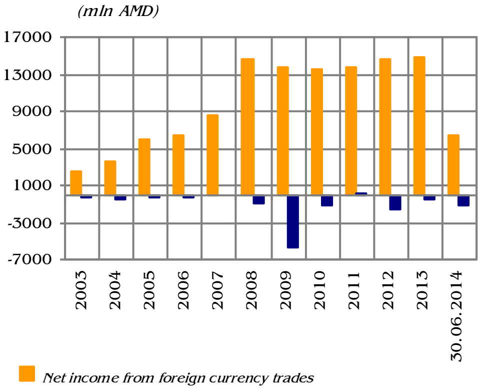
Foreign exchange risk

Potential impact of market risk on the financial stability is estimated to be very weak.

In the first half of 2014, the Armenian dram exchange rate fluctuating against other currencies drove the domestic banking system to revaluation losses reaching AMD 1.2 billion or 0.3% of total regulatory capital. As a result of foreign currency revaluation, 15 banks incurred losses and 7 banks reported profit. The banking system generated net revenue of AMD 6.5 billion from foreign exchange transactions.

In the period under review, the share of foreign currency loans has grown by 0.3 percentage point to 64.0% of total

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



Source: Central Bank of Armenia.

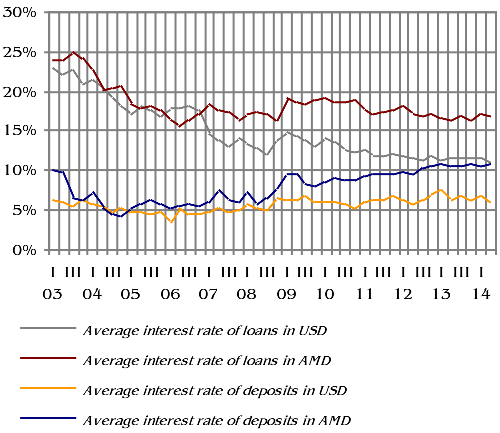
loan portfolio whereas the share of foreign currency deposits has decreased by 0.7 percentage point to 70.3% of total deposit portfolio. The banking sector's foreign currency positions are virtually closed, with net long position (including derivatives) amounting to AMD 4.3 billion or 1.0% of total regulatory capital (as of 31.12.2013, it has been a negative value of AMD 370 million or 0.1% of total regulatory capital)[39].

Foreign exchange risk stress scenarios

30.06.2014	Stress scenarios		
	Profit (loss) in case of 5% appreciation (depreciation) of AMD/USD	**Profit (loss) in case of 5% appreciation (depreciation) of AMD/EUR**	**Possible maximum 10-days loss estimated through VaR Model**
Banking system's profit (loss) from foreign currency revaluation	AMD -60.2 million or 0.014% of regulatory capital (AMD 60.2 million)	AMD -23.8 million or 0.005% of regulatory capital (AMD 23.8 million)	AMD 27.2 million or 0.01% of regulatory capital

If worst possible stress scenarios reviewed in the above stress-test[40] unfold, bank losses resulting from an open FX position will be insignificant and the impact of such losses on the financial stability will be weak.

Average interest rates of bank deposits and loans



Source: Central Bank of Armenia.

Interest rate risk

The first half of the year marked a trend of slight rise in interest rates of loans and deposits. By currency structure, interest rates of loans and deposits in Armenian dram tended to increase whereas interest rates of loans and deposits in U.S. dollar to decline. The weighted average interest rate of dram loans rose 0.5 percentage point, but that of interest rate of U.S. dollar loans fell 0.2 percentage point. The average interest rate of deposits in dram grew 0.1 percentage point, while the weighted average interest rate of U.S. dollar deposits dropped 0.3 percentage point. Overall, spreads of interest rates of AMD and USD loans and deposits have increased by 0.4 and 0.1 percentage points, respectively.

The average weighted duration gap of present value of assets and liabilities of the banking sector is almost closed and varies in the region of a half year. This means that possible fluctuations in market rates will not lead to major losses in the banking system.

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[39] Derivative instruments include derivative contracts signed with foreign governments, central (national) banks, financial organizations and reputable international institutions for long-term deposits that are rated A + (A1) or higher than A+ (A1) by Standard & Poor's or Fitch (Moody's).
[40] 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 considers historical exchange rate series of currencies) is based on FX positions of commercial banks as of 31.12.2013.

Interest rate risk stress scenarios

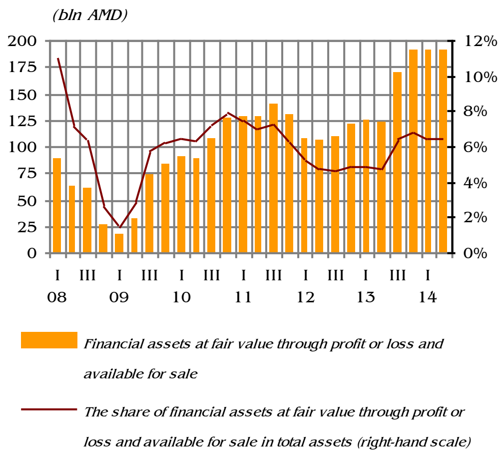
30.06.2014	Impact of 2 pp. increase increase (decrease) of market interest rates on the economic value of capital, estimated through the "Duration Method"	Deviation of net interest income from expected income of the three months ahead in case of 2 pp. increase (decrease) of market interests, estimated through the "Interest rate-sensitive assets and liabilities Gap Method"
Banking system's profit (loss)	AMD -5.6 billion or 1.3% of banking system capital (AMD 5.6 billion or 1.3% of banking system capital)	AMD -234.6 billion or 0.1% of banking system capital (AMD 234.6 billion or 0.1% of banking system capital)

In case of worst possible stress scenarios, possible losses of banks resulting from interest rate fluctuations are in the region of 3.0% percent of capital. This implies that losses of the banking system resulting from interest rate fluctuations will neither be significant nor will cause vulnerabilities to financial stability.

Price risk

In the first six months under review, the price risk of the banking system remains very low. The share of financial assets available-for-sale and held at fair value through profit or loss has contracted by 0.3 percentage point to 6.5% of total assets.

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.

In the period under review, as a result of interest rate fluctuations, net income generated by the banking sector from revaluation of financial assets available-for-sale and held at fair value through profit or loss was AMD 657 million.

Risks associated with real estate price fluctuations remained manageable. Domestic commercial banks further provided mortgages with loan-to-value ratio mostly between 60-80%, while taking quite a strict approach in evaluating borrower creditworthiness. Such restrictions significantly lower the possibilities of loan losses from real estate price volatilities.

Real estate price change stress scenarios

30% depreciation of real estate	30.06.2014
The banking system's loss due to revaluation of own real estate property *(price risk)*	AMD 14.7 billion (or 3.3% of banking system capital)
The banking system's loss due to a 30% loss of vulnerable credit portfolio[41] (taking into consideration that the collateral involved has been sold at a depreciated cost), if a stress-scenario occurs *(credit risk)*	AMD 7.4 billion (or 1.7% 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 25. billion (or 5.7% of banking system capital)

[41] 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.

If the stress scenario of 30% devaluation of real estate price unfolds, maximum potential losses of commercial banks associated with price and credit risks will increase in 2-3 years, which is mainly attributable to the real estate-secured lending rate growing faster than the regulatory capital and to the loan-to-value ratio increasing amidst stronger competition.

However, real estate price volatility is not high (taking into account the last 2-3 years' developments), so the impact of credit and price risks remains non-susceptible to financial stability.

4.1.5. Capital adequacy and profitability

The capital adequacy of commercial banks remains at a reasonable level.

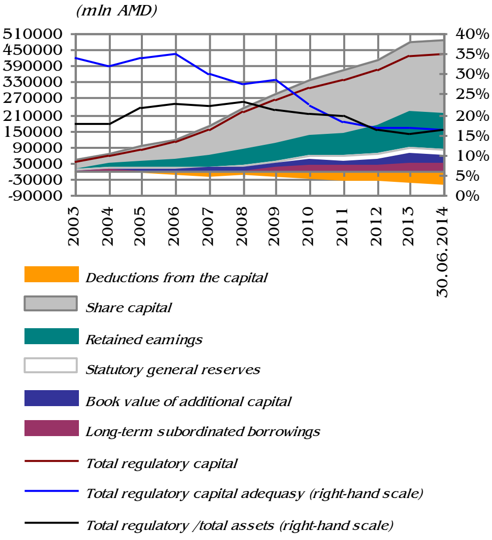
In the first half of 2014, commercial banks' total capital adequacy ratio fell by 0.5 percentage point to 16.2%, which was driven by the loan portfolio with its faster growth rate over that of total regulatory capital. In the period under review, individual banks kept their total capital adequacy prudentials in compliance with established requirements, so no bank reported breaches of capital adequacy standards.

As of the end of the first half of 2014, relative to the end-year, total regulatory capital of commercial banks has grown by 2.8% to AMD 440.3 billion. The share of tier 1 capital has increased by 2.2 percentage points to 88.8% of total regulatory capital. This ratio points to a strong ability of commercial banks risk to absorb risks to their capital.

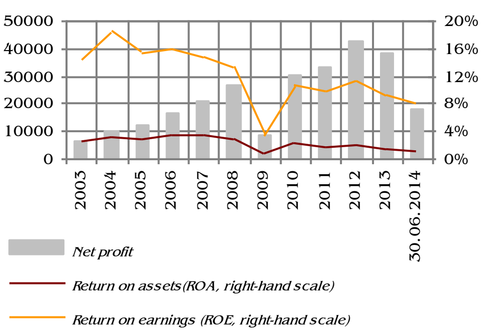
In the first half of 2014, net profit of the banking system, calculated in accordance with the Central Bank supervisory reports,[42] amounted to AMD 18.3 billion, with 16 banks reporting profit and 6 banks incurring losses. Compared with the same reference period last year, annualized *return on assets* and annualized *return on equity* ratios of the banking system have grown by 0.3 and 2.0 percentage points to 1.3% and 8.0%, respectively. The increase in banking system profitability figures was driven largely by the ratios *net loan loss provisions to assets* and *non-interest expense to assets* having dropped by 0.3 and 0.4 percentage points, respectively. Net interest margin[43] having reduced by 0.5 percentage point considerably affected the profitability of commercial banks.

In the period under review, gross revenues of the banking system grew by 1.2% to AMD 282.0 billion but gross expenditures reduced by 1.7% to AMD 258.1 billion. The shares of interest income, non-interest income and interest expense have increased while the share of return to/from assets loss provisioning contracted.

The structure of total regulatory capital



Profitability ratios of the banking system

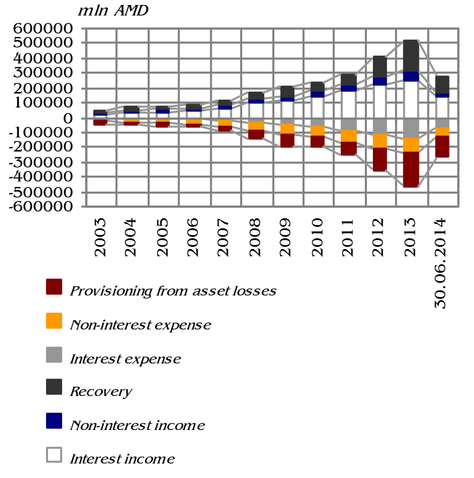


Source: Central Bank of Armenia.

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

Net profit of the banking system, calculated in accordance with International Financial Reporting Standards, amounted to AMD 17.9 billion, with annualized ratios of *return on assets* and *return on equity* having reached 1.2% and 7.4%, respectively.

Incomes and expense of banking system



Source: Central Bank of Armenia.

4.2. CREDIT ORGANIZATIONS

Credit organizations represent the second largest sector of Armenia's financial system, with their assets making up 7.4% of entire financial system. In the period under review, credit organizations reported significant increases in assets, liabilities and capital.

Assets, liabilities, capital and profit of credit organizations

(thousand AMD)

Indicator	31.12.2013	31.12.2014	Growth (%)
Assets	209841599	242183153	15.4
Liabilities	132243167	145819185	10.3
Capital	77598432	96364328	24.2
Net profit	5852591	3872024	x

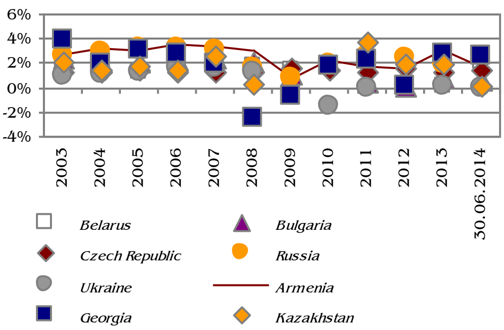
During the first half of 2014, total capital of credit organizations demonstrated growth rate outpacing that of total assets by 8.8 percentage points. As a result, the total capital to total assets ratio (leverage ratio) has increased by 2.8 percentage points to 39.8%.

Net profit of credit organizations, calculated in accordance with the Central Bank supervisory reports, amounted to AMD 3.8 billion. During the semester, 28 credit organizations posted profit, 5 reported losses. In the period under review, relative to the same reference period last year, the annualized ratios *return on assets* and *return on equity* of credit organizations have decreased by 0.2 and 0.4 percentage points to 3.4% and 8.9%, respectively.

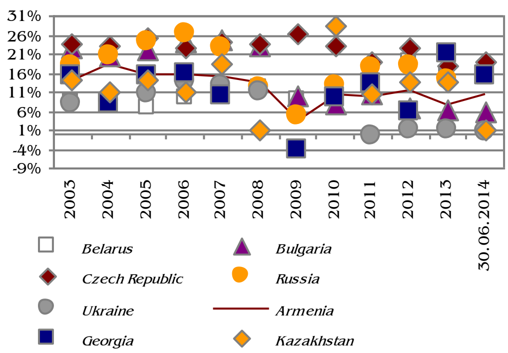
Profit of credit organizations, calculated in accordance with International Financial Reporting Standards, totaled AMD 3.5 billion, with the annualized ratios *return on assets* and *return on equity* having reached 3.1% and 7.7%, respectively.

During the semester, the share of non-performing loans and receivables has grown by 0.5 percentage point to 4.3 % of total loan and receivables portfolio. The share of non-performing loans and receivables is the relatively high in public catering and other service sectors, mortgage and consumer loan segments, amounting to 14.9%, 10.1% and 9.0%, respectively.

Banking system ROA in selected East European and CIS countries

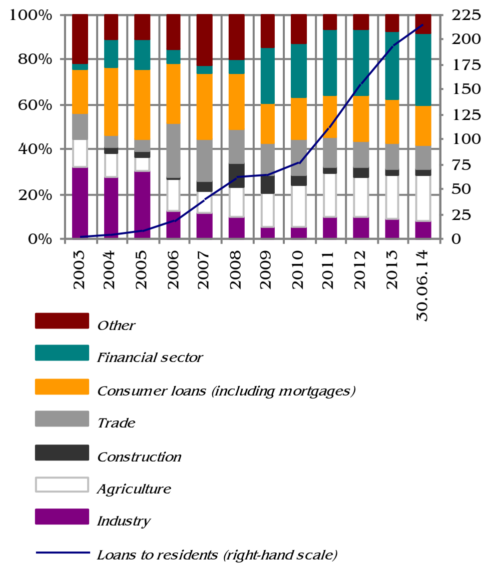


Banking system ROE in selected East European and CIS countries



Source: IMF.

Balance of loans to residents by credit organizations, by sectors



Source: Central Bank of Armenia.

The share of non-performing loans and receivables, classified as "substandard", "doubtful" and "loss" and calculated by international methodology, increased by 0.3 percentage point and reached 5.2%. In the period under review, relative to the same reference period last year, the ratio of net provisions to total assets has been the same, 0.6%.

In all maturity time bands of assets and liabilities (up to 180-day (including demand instruments), from 180- day to 1-year, more than 1-year), the amount of assets was in excess of the amount of liabilities. This is a clear indication, ceteris paribus, that the level of liquidity risk of credit organizations is low.

Credit risk assessment scenarios[44]

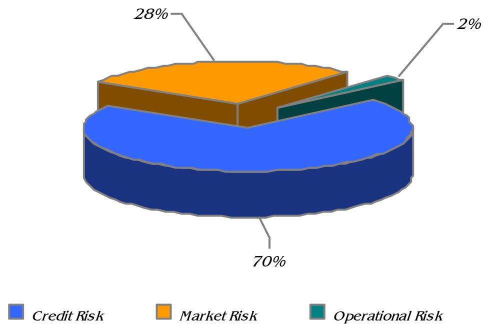
30.06.2014	Stress scenarios		
	25 % of loans in watched, substandard and doubtful categories classified into loss loans	**75 % of loans in doubtful category classified into loss loans**	**30 % of loans in standard category classified into watched loans**
Total loss of credit organizations	AMD 1.8 billion or 2.0% of regulatory capital	AMD 549.9 billion or 0.6% of regulatory capital	AMD 4.9 billion or 5.4% of regulatory capital

Source: Central Bank of Armenia.

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

4.3. SECURITIES MARKET PARTICIPANTS

The structure of assets in the capital adequacy ratio of investment companies as of 30.06.2014.



Source: Central Bank of Armenia.

As of June 30, 2014, there were 21 banks providing investment services and 8 investment companies in the securities market of Armenia. Also 3 investment fund managers are registered in the financial market of Armenia, two of which are entitled to run a mandatory fund and one a voluntary pension fund.

In the first half of 2014, relative to the end-year, total assets of investment companies have grown by 6.5% and amounted to AMD 28.8 billion, but total capital has reduced by 0.4% to AMD 5.2 billion. As of June 30, 2014, total profit of investment companies has been AMD 734 million. During the semester, seven companies posted profit and one incurred losses.

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[44] 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 that where loans are classified as loss, a possible sale of the collateral is not considered).

As of June 30, 2014, credit risk of investment companies accounted for 69.9% of risk weighted assets; market risk constituted 27.9% and operational risk, 2.2%. Remarkably, interest rate risk had the largest share in market risk of investment companies (82.8%), while foreign exchange and share price risks constituted, respectively, 16.6% and 0.6%.

As of the end of the first half of the year, a total of 24 classes of securities of 16 reporting issuers were admitted to trading in the regulated market. Two issuers were accountable on both shares and bonds. The share of equity securities issued by three commercial banks was 25% of total issuance of securities, while the share of bonds issued by four financial institutions was 55% of total issuance of bonds. Total amount of shares was AMD 53.4 billion and total amount of bonds, AMD 15.4 billion. Six of these bonds were in foreign currency with their share making up 53%.

As of June 30, 2014, there were 2083 registries of nominal security holders and 105585 nominal security owners running registries at the Central Depository of Armenia.

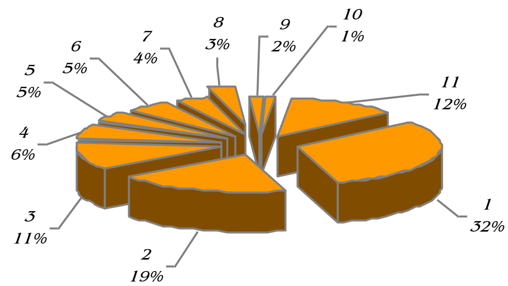
4.4. INSURANCE COMPANIES

As of June 30, 2014, there were 9 insurance companies[45] licensed to perform insurance business in the Republic of Armenia.

In the period under review, the amount of assets of insurance companies has reduced by 7.6% to AMD 46.2 billion and the amount of liabilities decreased by 14.1% to AMD 29.2 billion. However, total capital has grown by 6.3% to AMD 17.0 billion. During the semester, the share of insurance companies in the domestic financial sector contracted by 0.1 percentage point to 1.4% of the financial sector assets. In the period under review, relative to the same reference period last year, the amount of accrued premiums, the main indicator of insurance activity, has plunged by 30.8% to AMD 15.7 billion (the drop of this indicator in the previous reference period was 4.7%).

The annualized premiums to GDP ratio, another key indicator of insurance companies, was 0.65%, which had fallen by 0.18percentage point in relation to 2013[46]. In June 2014, the premium per capita ratio was AMD 9,546 versus AMD 11,850 reported as of December 2013.

Insurance sector assets, as of 30.06.2014



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

Source: Central Bank of Armenia.

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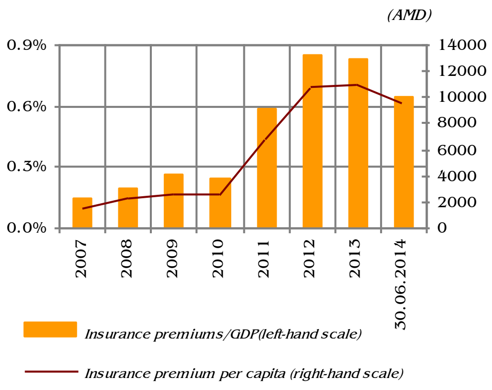
[45] *This section actually collates indicators of 8 insurance companies active and reportable, since one company, although duly licensed, does not carry out insurance activities.*

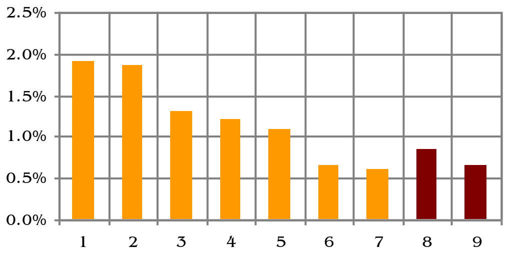
[46] *Based on the 2013 data, the premiums to GDP ratio on non-life insurance was 3.53 % on average in developed industrial countries and 1.31% in emerging countries (source: Swiss Re, Sigma No 3/2014, May 2014).*

Main ratios of insurance sector of Armenia



Source: Central Bank of Armenia.

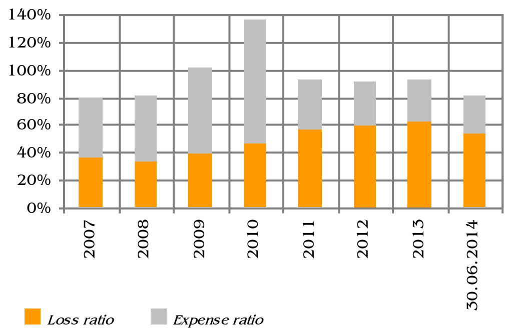
Insurance premium/ GDP in EEC and CIS (2013)



1. Georgia, 2. Ukraine, 3. Romania, 4. Turkey, 5. Russia, 6. Kazakhstan, 7. Azerbaijan, 8. Armenia -2013, 9. Armenia - 30.06.2014

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

Loss and expense ratios of Insurance sector



Source: Central Bank of Armenia.

In the period under review, relative to the same reference period last year, the loss ratio of insurance companies has reduced by 8.5 percentage points to 53.7%[47]. The reduction came along with insurance companies' expense ratio[48] having dropped by 3.6 percentage points in relation to the previous year to 26.7%. This may well point to an increased operational effectiveness of insurance companies. Relative to the same reference period of previous year, net profit of insurance sector was positive, amounting to AMD 1.7 billion, based on calculation in accordance with the Central Bank supervisory reports. The annualized *return on assets* and annualized *return on equity* ratios have risen to 7.1% and 20.8%, respectively. The aforementioned ratios calculated in accordance with IFRS amounted to 7.1% and 19.8%, respectively.

The shares of risk-weighted assets and required solvency in the insurance sector capital adequacy ratio were 40.0 percent and 60.0 percent, respectively. The regulatory capital adequacy ratio of the insurance sector was 165.1% (marginal value of regulatory capital adequacy is 100%).

Solvency risk

As stress-scenarios shown below unfold (a 10% rise in the indemnification rate and a 5% growth of insurance payments), the change in solvency levels of insurance companies was assessed. Results suggest that the level of solvency will not incur notable changes, so the likelihood of risks undermining financial stability in the insurance sector is very low.

Solvency assessment stress scenarios

30.06.2014	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 5.9% of regulatory capital of the sector
Total capital adequacy ratio of the insurance sector, if the stress scenario occurs	155.3%

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.

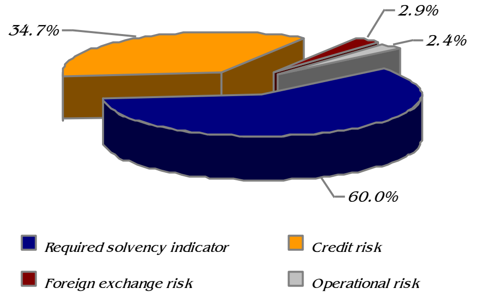
[47] *The loss ratio was calculated using the following formula: (net accrued indemnity + net provisions to technical reserves (except for unearned insurance premium reserves, UIPR) + other transaction costs on insurance) / (earned insurance premiums – sums refunded on the contracts terminated).*
[48] *The expense ratio was calculated using the following formula: non-interest expense / (earned insurance premiums – sums refunded on the contracts terminated).*

Credit risk assessment stress scenarios

30.06.2014	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 4.6% of regulatory capital	AMD 1.4 billion or 8.4% of regulatory capital	AMD 0.5 billion or 3.1% of regulatory capital
The total capital adequacy ratio of the insurance sector, if the stress scenario occurs	159.0%	153.8%	160.0%

Source: Central Bank of Armenia.

The share of risk weighted assets and required solvency in insurance sector capital adequacy ratio, as of 30.06.2014



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

The results of foreign exchange stress scenario suggest that the loss of insurance companies resulting from foreign exchange risk is not considerable: it merely exceeds 0.5% of the value of regulatory capital.

Foreign exchange risk assessment stress scenarios[49]

30.06.2014	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 20.0 million or 0.1% of regulatory capital (AMD -20.0 million)	AMD 3.5 million or 0.05% of regulatory capital (AMD -3.5 million)	AMD 14.0 million or 0.1% of regulatory capital

Source: Central Bank of Armenia.

Liquidity risk

The level of liquidity risk in the insurance sector is low, which can be seen through the results of the stress-scenario. The level of liquidity amounted to 333.2%, while the minimum threshold is defined 100%.

Liquidity risk assessment stress scenario

30.06.2014	Stress scenario
	Sharp increase of outstanding claims reserves, 25%
Required growth of outstanding claims reserves when the stress scenario occurs	AMD 0.5 billion or 3.1% of regulatory capital
Liquidity of insurance companies when the stress scenario occurs	333.2%

Source: Central Bank of Armenia.

The share of insurance market in the financial sector remains small. Risks to insurance companies are controllable and non-vulnerable in the financial stability point of view.

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[49] *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 considers historical exchange rate series of currencies) makes an assumption that FX position of insurance companies would not change in a 10-day time-span.*

SUMMARY

In the period under review, the financial risks were further manageable in the banking sector which is the largest part of the financial system. The growth rate of loans has decreased which is positive for credit risk mitigation in the upcoming time horizon in terms of financial stability. Some quality deterioration in credit portfolio was recorded due primarily to accelerated growth of the loan portfolio in the past 3 years. However, with a possible loss arising from credit risk, capital adequacy of the banking system remains above the established minimum threshold. The probability of emergence of liquidity and market risks to threaten financial stability is estimated to be low. Non-bank financial institutions also saw their business operations, and the regulatory indicators were further maintained within the required limits.

5. STABILITY OF FINANCIAL MARKET INFRASTRUCTURES

Highlighting the importance of the payment and settlement system of the Republic of Armenia and how it affects the domestic monetary policy and financial stability, 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.

Most interbank settlements in the territory of the Republic of Armenia are made via the Central Bank systems[50]. More than 99% of the value of interbank payments in Armenia is made via the Central Bank systems.

5.1. INTERBANK PAYMENTS VIA ELECTRONIC PAYMENT SYSTEM OF CENTRAL BANK

The results of the EPS monitoring indicate that the system is safe and reliable and trouble-free from the system stability point of view.

In the first half of 2014, there were about 1.6 million of payments, with a total value of AMD 5351.4 billion, executed via the Electronic Payment System (EPS) of the Central Bank of Armenia.

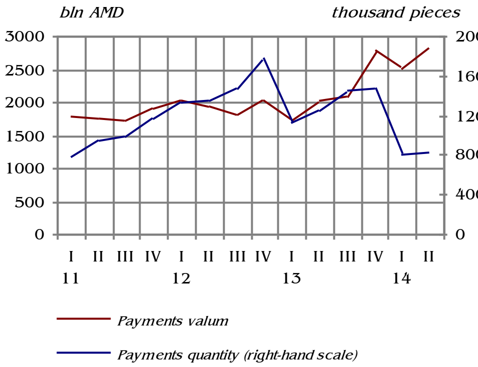
In the period under review, the value of payments kept on growing while the number of payment messages has plunged sharply compared to the level reported in previous years.

With a stably growing value of payments, the decrement in the number of payment messages necessitated an in-depth study of the reason of the decline by examining the message types according to general and target sectors (budgetary and interbank segments, in particular).

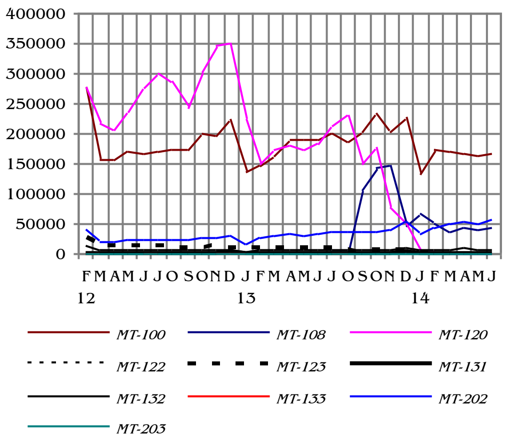
The analysis showed that the reduction in the number of payments is mainly due to the decrease in the number of budgetary payments, which was influenced by a sharp increase in the use of MT 202 bulk message types.

As a conclusion, it should be mentioned that the reduction in the number of payments is not for economic reason but results from optimizing the message types used in the system and active use of bulk message types which somehow replaced single message types applicable in different markets. This contributes to easing of the workload of the system while increasing its efficiency.

Payments by Electronic Payment System (without exchange market transactions)



The dynamics of payments number by MT



Source: Central Bank of Armenia.

[50] *Payments via the Central Bank systems involve the payments made through Electronic Payments System, EPS (excluding stock exchange trades), payments related to transactions with indirect monetary instruments of the Central Bank, payments executed within the Central Bank as well as final settlements of ArCa cards system and the Government Securities Accounting and Settlement System, GSASS (cash leg of transactions). For details, see the paper "Payments and Securities Clearance and Settlement Systems in the Republic of Armenia", 2010.*

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 gets the notice of the payment only after the payment is made final and irrevocable[51].

Liquidity risk

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

In the period under review, the daily average indicator of own liquidity used for assessment of liquidity risk[52] has plunged considerably, yet staying above the marginal value of 1.

The dropping of the indicator is conditioned by a significant increase in the value of payments[53] and sustainable level of opening liquidity of the day.

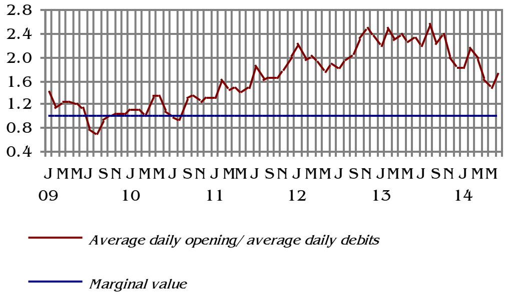
Notwithstanding the tumbled indicator, average opening liquidity of the day continues to exceeding the average daily payments.

In assessing the liquidity risk in terms of the above indicators, it should be noted 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 above indicator was monitored across individual banks as well, and the results of the monitoring suggest that the likelihood of liquidity risk is estimated to be minimal.

Reported rejections in the system and their share in total payments made through the system is an important measure for the assessment of the liquidity risk. The number of rejections due to insufficient liquidity as well as its share in

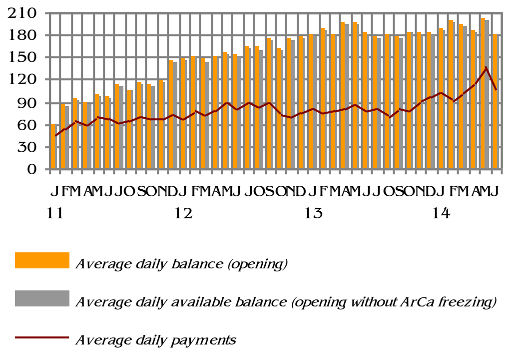
The dynamics of average daily payments on own expense



Source: Central Bank of Armenia.

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

(bln AMD)



Source: Central Bank of Armenia.

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[51] For details, please see the publications "Financial Stability Report", and the "Payments and Securities Clearance and Settlement Systems in the Republic of Armenia", 2007.
[52] 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.
[53] The debits side of the account, including the EPS payments on other debit flows on the account.

the EPS payments remain negligible – a maximum of 0.8% by value and 0.002% by number throughout the two quarters.

These rejections are merely due to individual cases and may be a result of improper management of liquidity (payment flows) by the participants, so this could not affect the liquidity of the system.

Intraday distribution of payments

There were two peak hours (in terms of value and number) during an operational day for executing payments – at the opening and closing of the day.

Some changes were observed in patterns of intraday distribution of payments.

The peak for payments by number has moved to the closing of the day, increasing the end-of-day share of payments (the semiannual figure is 20%, from 3:00 p.m. to 4:00 p.m., which is 4-5 percentage points higher from the indicator reported in the previous year).

The peak for payments by value remained the same (from 10:00 a.m. to 11:00 a.m.), yet the share has increased during the reporting period by 10 percentage points to an average 31% of intraday payments. Because no changes in the share at the closing of the day were observed, and the share of payments in the remaining hours contracted instead, the increase of the share in the peak hour contributed to even more unequal intraday distribution of payments by value.

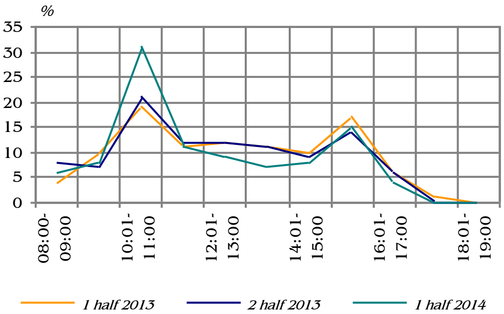
Despite the changes in the hourly distribution of payments, the system remained free of troubles while the risk was estimated to be minor. The peak of payments by value was recorded at the opening of the day and, fortunately, was not followed by the peak of payments by number. As a result, the risk to liquidity and capacity of the system is estimated to be minor. Intraday distribution of payments by number was mainly due to the change in the behavior of participants in respect of message types in the system. Payment concentrations at the closing of the day did not cause problems thanks to an adequate level of system capacity as well as optimization of message types in use (which resulted in a considerable reduction of total payment flows).

Given the positive performance of liquidity and operational availability indicators of the system, as well as a very small share of rejections in total payments (for details, please see the relevant subsections), an uneven distribution and concentration of payments during certain hours of the day did not lead to problems in the first half of 2014. The likelihood of emergence of risk to the system is generally low.

Rejections due to insufficient liquidity are insignificant.

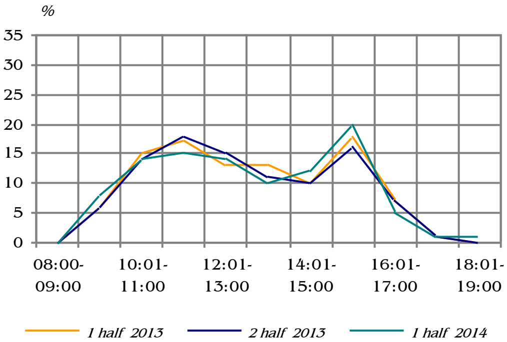
Some changes were observed in regard to intraday distribution of payments.

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



Concentrations during certain hours of the day did not cause problems.

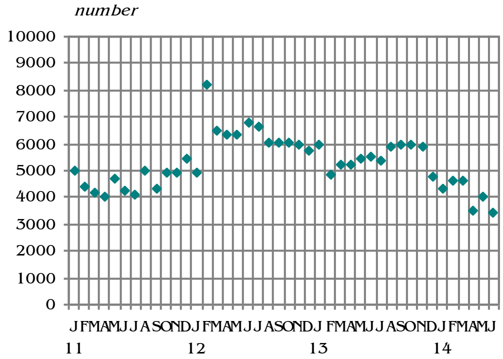
Intraday distribution of the number of payments on an average semiannual basis



Source: Central Bank of Armenia.

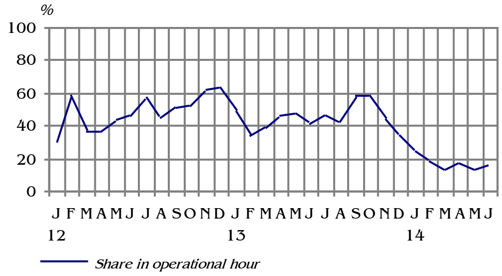
In the period under review, the payments per hour ratio has dropped, and the probability of risks associated with the system capacity is estimated to be minor on the whole.

Maximum number of payments per hour, by month

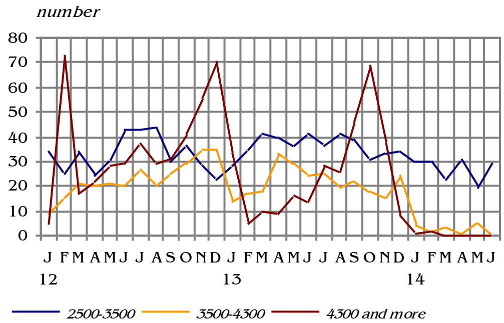


Source: Central Bank of Armenia.

Dynamics of the indicator exceeding 2500 payments per hour and its share in the total operational hours of current month



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



Operational availability of the EPS is 100%.

System capacity

In the first half of 2014, the number of payments per hour in the system plummeted dramatically, which was determined by dynamic use of bulk message types, on the one hand, and reduced number of single message types, on the other.

In the period under review, the maximum hourly rate was 4652 payments per hour against 5997 payments/hour recorded in 2013. The maximum daily rate of payments has reduced notably to 26028 compared to the peak of 41809 payments/day ratio reported in 2013. The peak hour was recorded in February, from 11:00 a.m. to noon, making up 27% of the number and 16% of the value of the day's payments. The maximum hourly rates by month have reduced considerably.

The shares of all marginal indicators (including the payments per hour) have shrunk. Moreover, starting from October 2013, the 4300 and more payments per hour ratio was no longer observable whilst the 3500 and more payments / hour rate has become very rare.

The matching with total payments via EPS shows that an abrupt fall in the marginal indicators was due to the reduced number of total EPS payment messages, which in turn is driven by optimization of message types applicable in the system.

The above system capacity indicators and the results of a special study[54] denote that the hourly peaks were determined by increased activity of a few commercial banks in certain days. Given the optimization of message types used in the system as well as the lack of actual incidents in the meantime, the likelihood of emergence of capacity-related risks is estimated to be low.

Operational availability of the system

No incident affecting the operational availability of Electronic Payment Systems of the Central Bank during the first half of 2014 was reported. In the period under review, the operational availability was 100% for the EPS and 100% for the system "Operational Day"[55].

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[54] *The study was made to determine the nature of utmost payments per hour (on a monthly basis) and to identify the payer behavior.*
[55] *The 2008 Financial Stability Report of the National Bank of Denmark states that operational availability for systemically important RTGS system, which is compliant to ESCB system requirements, should be very high, e.g. operational availability of TARGET was 99.65 percent, which is considered a good indicator.*

5.2. GUARANTY OF DEPOSITS

In 2005, the Central Bank of Armenia established the Deposit Guaranty Fund. The Fund acts in accordance with the Republic of Armenia Law on Guaranteeing Reimbursement of Bank Deposits of Individuals. An important pillar for financial stability, the Fund contributes to strengthening the soundness of the banking system, enhancing public confidence in the banking system and protecting depositor interests in the country.

In the first half of 2014, the banking sector of Armenia saw a sustainable growth of bank deposits of individuals and the number of depositors.

As of the end of the first half of 2014, relative to the last year, the amount of deposits of individuals has grown by around 6.70%, with the amount of guaranteed deposits grown by 3.14%, to AMD 268,045,018 thousand. Relative to the end-year 2013, the number of individuals holding guaranteed deposit has increased by 1.72% to 1,609,636 persons (excluding former USSR Savings Bank depositors who have been registered with VTB Armenia Bank CJSC).

In the banking system of Armenia, the biggest community of depositors only holds deposits in local currency. As of the end of the period under review, the share of depositors who only hold deposits in dram was 84.56% in total. The share of depositors who only hold foreign currency deposits was 6.50% in total. The above figures did not change much in comparison with the previous reporting period.

At the end of the first half of 2014, the share of local currency deposits in the banking sector of Armenia has grown by 0.14% to 30.74% in relation to the end-year 2013.

5.3. CREDIT REGISTRY AND ACRA CREDIT BUREAU

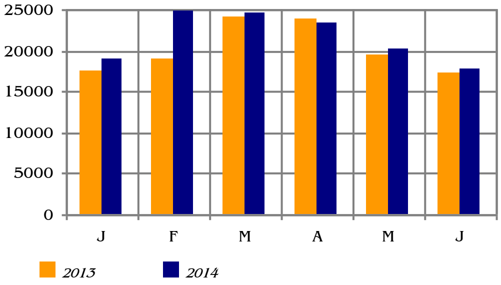
The Central Bank Credit Registry

The Credit Registry has been functioning within the structure of Statistics Department of the Central Bank of Armenia since January 1, 2003. Core function of the Credit Registry is to collect reliable information for effective surveillance and analysis. The Credit Registry keeps record of loans in excess of AMD 1.5 million and loans in the amount less than AMD 1.5 million which were fallen overdue and classified. At the end of the first half of 2014, the number of loans in the database of the Credit Registry was 1,922,918 from which 1,790,675 were loans provided to individuals and 132,243 loans provided to companies.

The number of loans registered in ACRA database

	Outstanding	Repaid	Total
Individuals	433682	1356993	1790675
Legal persons	19688	112555	132243
Total	453370	1469548	1922918

The number of requests received during first half of 2013-2014



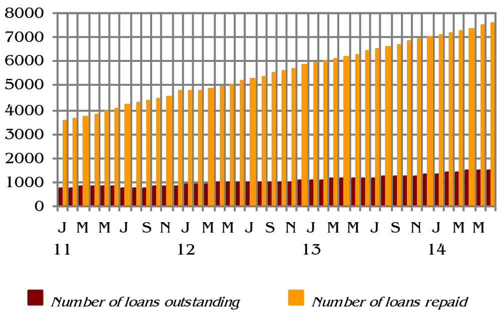
Source: Central Bank of Armenia.

The total number of loans registered with the Credit Registry has increased by 405,688 in relation to the first half of the previous year. At the end of the period under review, the Credit Registry possessed information on 453,370 loans outstanding and 1,469,548 loans repaid. According to the Credit Registry data, in the first half of 2013 lending institutions originated 120,725 loans in number compared to 129,170 loans provided during the first half this year.

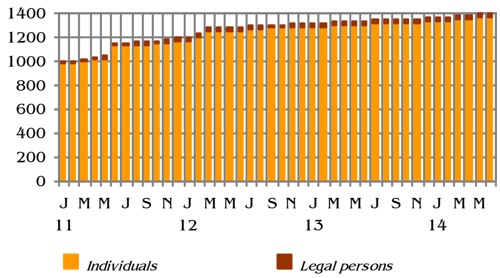
Changes to the methodology and software package for the operations of the Credit Registry are underway. Specifically, starting from January 1, 2014, the Credit Registry halted the practice of providing information to queries made by commercial banks and credit organizations in order to assess borrower creditworthiness and monitor current loans.

Work is carried out to design a similar database and uniform reporting formats so that commercial banks and credit organizations could furnish information to the Credit Registry and ACRA Credit Bureau in an improved manner. This will contribute to an increased effectiveness of activities of financial institutions and better quality of information collected on borrowers. Further efforts are spent to increase the effectiveness in using the Credit Registry data for supervisory and analytical purposes.

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



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



Source: ACRA Credit Bureau.

The ACRA Credit Bureau

In the period under review, relative to December 2013, the number of clients registered with the ACRA Credit Bureau has increased by 3.2% to 1,402,334 as of June 30, 2014. Note that 98% of these clients are individuals. In the meantime, the number of loans in the database has increased by 9.2% to 9,089,145 loans as of June 30, 2014.

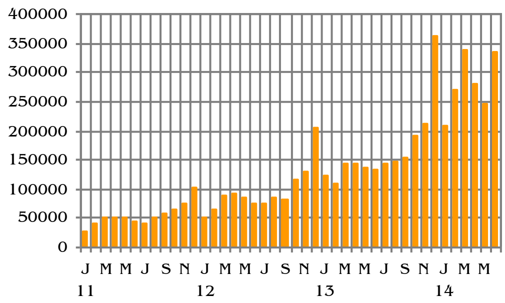
Any individual or company can obtain information from the Credit Bureau about their credit history. For credit history of the client and/or partner, companies have to sign a service contract with the Credit Bureau and get a written consent from the subject of credit history.

The Credit Bureau began providing credit reports from April 2007. In the first half of 2014, relative to the same reference period last year, the number of credit reports has risen dramatically, by 112%.

Starting from 2014, the Credit Bureau cooperates with *Express Credit UCO*, a universal credit organization and *Orange Armenia CJSC*, a telecommunications services provider. The cooperation with Orange Armenia CJSC involves the Credit Bureau getting information on overdue payments and entering it with its database. Currently, the Credit Bureau negotiates with *ArmenTel CJSC*, another provider of telecommunications services, for further cooperation. Moreover, the Credit Bureau has an access to public databases of the Armenian Ministry of Labor and Social Affairs and is authorized to obtain information from the Armenian Traffic Police Service about penalties 60 days fallen overdue (it counts from the next day of the established deadline for payment of penalties), in accordance with the Republic of Armenia legislation. Negotiations with the Armenian Ministry of Finance over getting information on outstanding tax liabilities are also underway.

A multi-level coding system has been developed to protect the information possessed by the Credit Bureau and prevent its unauthorized use by third parties. The system tracks all actions, and an ongoing monitoring of the system is in place to prevent suspicious and illicit action.

The number of reports provided by ACRA credit registry



Source: ACRA Credit Bureau.

SUMMARY

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

In general, the EPS operation is satisfactory. The developments in the payment and settlement system remained manageable, without such risks that could undermine the financial stability.

CHARTS

TABLES

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