



CENTRAL BANK OF THE REPUBLIC OF ARMENIA

2014

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*Financial Stability
Report*

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**FINANCIAL
STABILITY
REPORT**

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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 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, poorly-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:

- favorable developments in global economy and international financial markets,
- sound domestic macroeconomic environment whereby households and companies are creditworthy enough,
- effective financial system with risks that are prudent and manageable,
- financial infrastructures with operational continuity to the benefit of the financial system functioning.

Based on the abovementioned facts, risks that can potentially undermine financial stability of Armenia are presented in this report as follows:

- risks derived from developments in global economy,
- risks derived from developments in macroeconomic environment in Armenia,

- risks derived from developments in financial market in Armenia,
- risks derived from financial institutions of Armenia,
- risks derived from financial infrastructures of Armenia.

The report addresses the risks revealed in those areas and measures their possible impact on the developments in the economy overall and all parts of the financial sector. The report mainly focuses on the risks to the banking sector and development trends: assets of commercial banks account for almost 90 percent of entire financial system assets. Therefore, the banking sector stance mainly determines overall financial stability and development trends.

ABSTRACT

The set of risks threatening the financial stability has not changed in relation to the previous year, though the financial stability became more vulnerable to some risks.

The main risks affecting financial stability of Armenia persisted during 2014, meanwhile the impact of a set of risks to financial stability of Armenia expanded. The unsteady pace of economic growth recovery of developed countries and continuous slowdown of developing countries' economic growth of the first half of the year were maintained further. Decreased prices of base metals in international markets, the reduced demand for main products exported from Armenia and absence of growth of the Armenian industry contributed to lower domestic economic growth. Geopolitical developments created additional obstacles to Russia's economic growth, which in turn affected negatively the inflow of private transfers to Armenia and export volumes to Russia, highlighted in November-December 2014.

The year was prominent with materialization of downside risks to the global economic growth.

The global economic recovery was slower during the second half of the year, which resulted in a 0.3 percentage point lower global economic growth assessment as compared to the beginning of the year. Although the USA recorded high economic growth, the Euro area countries experienced lower-than-expected economic growth, mainly due to geopolitical developments. In developing countries the trend of economic growth slowing was maintained, which in turn has contributed to world trade cut and dropped prices of some exchange-traded commodities.

Monetary authorities kept on implementing accommodative policies to stimulate economic growth.

Monetary authorities of developing and developed countries continued pursuing an expansionary monetary policy to support economic growth. These accommodative monetary policies become more difficult in developing countries parallel with countervailing measures to domestic currency depreciations. During the year, interest rates of monetary instruments remained at low levels, while the termination of quantitative easing program by the U.S. Federal Reserve has created expectations of an increase in interest rates not sooner than in the third quarter of 2015.

Economic developments in Armenia's main trade partners- some countries of the European Union and Russia (for details, please see box "Economic developments in Russian Federation") – have been unexpectedly unfavorable, and their impact on the domestic economy manifested in the second half of the year (for details, please see section "Developments in the global economy").

In 2014, economic growth in Armenia was 3.4% (3.5% in 2013). The slower growth rate was mainly due to growth absence in industry, a decline in construction indicators and decreased growth rates reported in other sectors of the economy (for details, please see section "Macroeconomic environment Developments in Armenia").

The growth rate of lending by banking sector reduced as compared to the previous years due to low economic growth and fall in private remittances. Parallel a slowdown of decreasing trend of capital adequacy was recorded. Armenian banking system had capital adequacy and liquidity ratios above the regulatory requirements, and manageable market risks.

The banking lending is mostly due to cautious credit policy of commercial banks and uncertain economic developments.

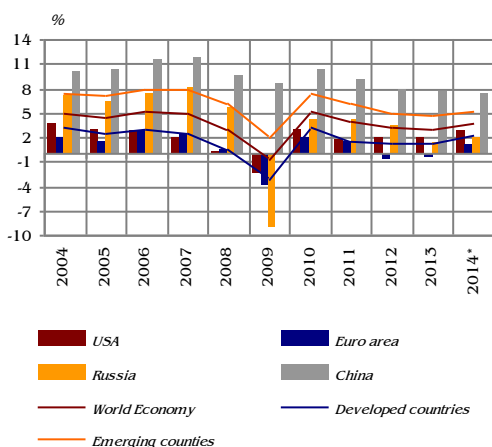
Though in some cases on an upside track, risks in the financial system remain manageable in terms of financial stability (for details please see sections "Stability of financial institutions of Armenia" and "Financial market infrastructures stability").

1. DEVELOPMENTS IN THE GLOBAL ECONOMY ¹

1.1. MACROECONOMIC ENVIRONMENT

In 2014, the positive trends and expectations inherent to the previous year were not maintained.

Regional economic growth rates



*Indicators marked by asterisk in this chart and the ones following thereafter are the IMF estimates (April 2015).

Source: IMF.

The year 2014 started with optimistic expectations, which, did not sustain until the end of the year. Overall, different economists and well-known organizations characterized 2014 as a year of new important economic and political challenges. The reversed trends of economic developments during the year created grounds for negative expectations for the future.

The economic activity was generally low in developed countries, except the USA. The geopolitical developments in developed countries and the risks emerged thereof resulted in a slower growth rate of global economy and a further rise of uncertainties.

The expectations of international organizations and market participants on the economic growth in 2015 are mainly edging down, though a slight stimulus of economic growth is possible due to low oil prices. The reason for slowdown expectations of economic growth rate is actually the high volatility in financial markets. This is more specific for emerging oil-exporter countries, where the decline in oil prices lead to aggravated trade balance deficit.

The factors of worldwide uncertainty still exist together with additional challenges connected to geopolitical developments. This broadens the set of risks threatening the global economy.

The main trends of the year are the boost of US economic growth, the slowing down of economic growth recovery in the Euro area, the decline of economic growth in developing countries, which occurred in the context of growth of investment risks and depreciations of national currencies, as well as the ongoing decline in prices of main stock commodities.

The pace of global economic recovery slowed down, while the main risks remained alarming during the whole year.

In 2014, the global economic growth was an estimated 3.4 percent, according to the IMF (3.4% in 2013). The economic growth in developed countries is expected to gain momentum by 0.4 pp. to 1.8%. A slowdown in economic growth was estimated in developing countries, 4.6% against 5.0% of the previous year². The potential economic growth in both developed and developing countries has declined and stands at a lower than the pre-crisis levels, due to demographic and economic factors. In this context, the

¹ International developments and predictions were based on information taken from IMF, World Bank, Economist Intelligence unit, Financial times, Bloomberg, RBC, the Institute of International Finance and other sources.

² All the forecasts and assessments of IMF were taken from "World Economic Outlook Update, April 2015"

priority of economic policymakers should be potential economic growth increase through economic reforms as the low potential economic growth will hamper the decrease in debt burden, the implementation of effective monetary and fiscal policies in the medium term.

IMF Overview of the World Economic Growth Projections, 2014-2015, in percent

Indicator (economic growth)	2014 forecasts as of 30.01.14	2014 forecasts as of 30.04.14	2014 forecasts as of 30.07.14	2014 forecasts as of 31.10.14	2014 assessment as of 31.01.15	2015 forecasts as of 31.01.15	2014 assessment as of 15.04.15	2015 forecasts as of 15.04.15
World economy	3.7	3.7	3.4	3.3	3.3	3.5	3.4	3.5
Developed countries	2.2	2.2	1.8	1.8	1.8	2.4	1.8	2.4
USA	2.8	2.8	1.7	2.2	2.4	3.6	2.4	3.1
Euro area	1.0	1.1	1.1	0.8	0.8	1.2	0.9	1.5
Developing countries	5.1	4.8	4.6	4.4	4.4	4.3	4.6	4.3
CIS	2.6	1.9	0.9	0.8	0.9	-1.4	1.0	-2.6
Russia	2.0	1.3	0.2	0.2	0.6	-3.0	0.6	-3.8
China	7.5	7.6	7.4	7.4	7.4	6.8	7.4	6.8

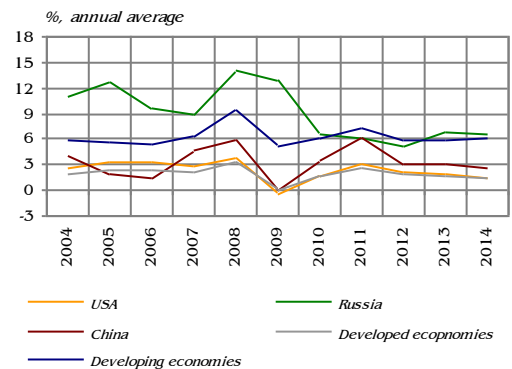
In the context of the current economic activity a low inflationary environment was formed. Consequently, the IMF has estimated the inflation to be 1.4% in developed countries and 5.1% in developing countries. Moreover, no inflationary pressures are expected to occur in the following year.

Despite the bad weather conditions of the first quarter of 2014, the year ended up with a high economic growth rate in the USA.

The capital inflow from the developing countries driven by the expectations of further rising of rates by the Federal Reserve System (FRS) helped the US economy to gain momentum. The Fed's quantitative easing program, the easy loans provided by the banking system and relatively moderate fiscal adjustments may contribute to further economic growth in the USA. According to the IMF assessments, a 2.4% economic growth was recorded in the US in 2014, while the forecast for 2015 is 3.1%. Parallel to the economic growth, the unemployment rate declined to 5.6% this year, the lowest for the last 6 years. The 31.5% of unemployed remain long-term unemployed (actively looking for a job for more than 6 months³), whose number has shrunk during the last 12 months, thus, stating positive economic changes.

³ <http://www.tradingeconomics.com/united-states/unemployment-rate>

Inflation in selected countries



Source: IMF.

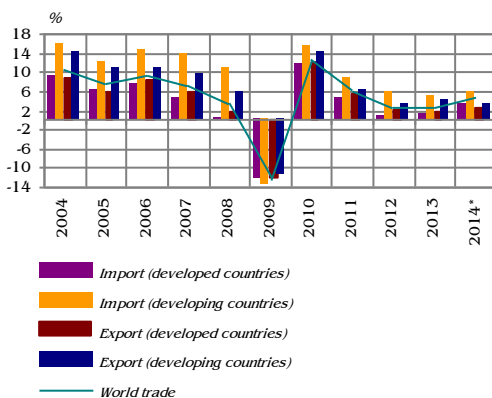
The annual economic growth in the US was higher than expected, thus, contributing to economic growth in developed countries.

The developments in the Euro area were positive, though the weak investment environment hindered the economic growth.

The growth of net export, the stabilization of domestic demand and the fiscal policy easing played a restorative role for the economy of the European countries. However, some economic difficulties still existed in the Euro area at the end of 2014, causing a lower-than-expected economic growth. In particular, the investment environment was unfavorable and the export growth was low due to geopolitical factors. The industry was vulnerable, being concentrated in such sectors of industry that are sensitive to export. The stabilization of domestic demand has restored the economic activity in service sector, while the income growth of the population, due to low oil prices, will be a contributing factor further in 2015. Therefore, the ongoing fall in oil prices, further accommodative monetary policy stance, a somehow neutral fiscal policy stance and the expected depreciation of euro are considered to promote further economic activity in the Euro area. However, these positive factors may be offset by weak investment prospects, partly reflecting the impact of weaker growth in emerging market economies - main partner countries of the Euro area. The economic growth in the Euro area is assessed 0.9% in 2014 and a 1.5% forecast for 2015. Along with the economic recovery, the Euro union experienced a weak inflationary environment. The ongoing decline of economic growth rate may lead to deflationary expectations, which may negatively affect the economic growth in the medium term. The Eurostat has announced annual inflation down to -0.2% for 2014, contrasting 1.4% in 2013⁴, while the forecast for 2015 is 0.5%.

The decline of economic growth rates continued in developing countries.

Annual growth rate of world trade



Source: IMF.

In 2014, the emerging market economies, being the main contributor to the global economic growth, underwent economic growth weakening. Currently, the economic stance of developing countries is characterized by a positive impact of export on one hand, which is due to depreciation of national currencies and economic activity growth trends in developed countries, and low investment and difficulties in long-term financing on the other hand. This year China experienced the lowest growth rate since the financial crisis. The traditional drivers of growth seem to have lost momentum. The economic slowdown is more structural, rather than cyclical⁵. The registered drop in investment may continue referring to a number of factors. Monetary and other policymakers should be more cautious on the possible financial instability due to skyrocketed lending and should somehow restrain the measures aimed to stimulate the economic growth. Slower growth in China will also have important regional effects. The IMF assessed 4.6% economic growth in developing countries in 2014 and forecasted 4.3% growth in 2015.

A continual drop in prices was recorded in commodity markets, principally in the second half of the year.

The growth of world trade at the end of 2013 created grounds for further trade expansion expectations, which did

⁴ <http://ec.europa.eu/eurostat/documents/2995521/6483802/2-16012015-APEN.pdf/b69dcfc9-4b9e-495a-b25b-84d93356b61a>

⁵ BNP Paribas, « Global outlook , November 2014 »

not realize in 2014. Both lower-than-expected global growth and sanctions against Russia, as well as its response to them (for details, please see box “Economic developments in Russian Federation”), conditioned the slow pace recovery of world trade. Given the IMF data, the annual growth rate of world trade is 3.4% in 2014 and will be 3.7% in 2015.

During the first half of 2014, the international prices of main commodities showed dynamic increase, due to specific progresses in certain commodity markets. Nevertheless, a sharp and continuing fall in oil prices was recorded in the second half of the year.

Brent crude oil annual average price was USD 96.9 a barrel, edging down by 11.0%, compared to the previous year.

Further pace of oil prices will be mainly sensitive to geopolitical situation; developments in Middle East, as well as relations between Russia and West⁶.

Parallel to economic and political developments, base metal prices displayed a fluctuating course in 2014. The annual copper price averaged at USD 6778 per ton, plunging by 7.1% year-on-year. Annual molybdenum average price rose by 10.3% as compared to the previous year.

International prices of base metals will not change dramatically in short-term, ceteris paribus, subject to development trends of emerging market economies.

Wheat international prices have performed a volatile trend during the year. The highest price was recorded in April, USD 9.7 per bushel, continuously declining afterwards. In 2014, average wheat price reached USD 7.7 a bushel, falling by 9.0%, relative to the previous year. In the short term, expectations for international wheat prices are on a downward trend, though a stabilization of prices is expected in the medium term.

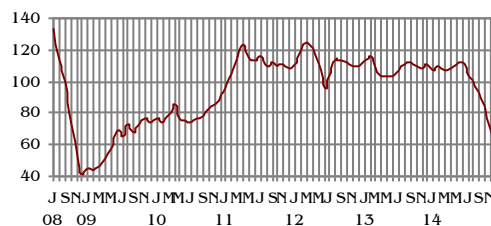
Gold has supported continuing downward trend throughout 2014. Economic activity improvements in developed countries led investors to leave the gold market in favor of more profitable assets.

Average annual international gold price amounted to USD 1252 per troy ounce in 2014, declining by 10.4% against the previous year.

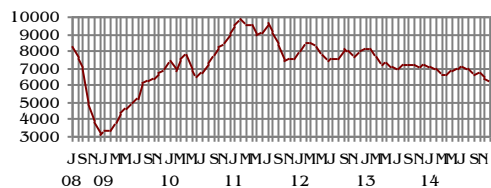
No significant change in gold prices is assumed in the short term, owing to optimistic expectations of recovery of the global economy.

Prices of base metals were largely in line with economic and political developments.

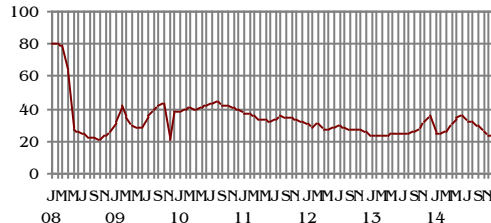
Brent oil prices
(USD per barrel)



Copper prices
(USD per ton)

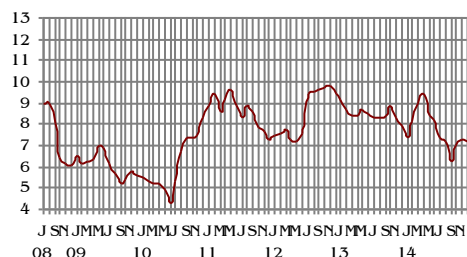


Molybdenum prices
(1000 USD per ton)

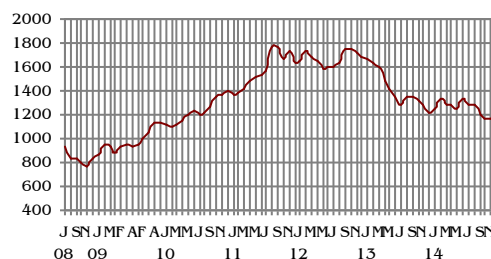


Wheat prices recorded a decline as compared to the beginning of the year.

Wheat prices
(USD per bushel)



Gold prices
(USD per troy oz)



Source: Bloomberg Data Warehouse.

⁶ The energy prices declined sharply in the third quarter of 2014, due to shale gas extraction by the USA, as well as preserving the same level of oil production amidst low economic growth.

Economic developments in Russian Federation

The economic growth rates in Russia continued to decline during 2014, which reflects the negative effects of geopolitical tensions associated with Ukraine, on the one hand, and previous structural problems, on the other. Though private consumption rates dropped and investment environment was unfavorable, the net export recorded a slight increase thanks to notable cut of net imports. A drop in internal demand, sanctions against Russia, inflation and more than 30% depreciation of Russian ruble conditioned the latter. 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, a 0.6% growth in economy was recorded in 2014 compared to the previous year. However, such indicators as construction growth, investment, as well as real disposable income growth are still negative.

Capital investment plunge by 2.5% annually and construction fell by 4.5%¹. The tension of geopolitical factors and the expansion of economic sanctions enlarged the uncertainty level towards the business environment. The limited access of Russian companies to international financial resources, as well as tightening of monetary policy resulted in increase in borrowing prices. This had a negative effect on investment demand and consumption, leading to capital outflows and inflation. The fall in oil prices and worsening of external economic situation aggravated the existing problems.

According to Federal State Statistics Service of Russia, the annual exports amounted to USD 493.6 billion, representing a 5.7% decrease in relation to 2013. Imports are an estimated USD 308.0 billion, which is a 9.8% year-on-year reduction. Thus, the trade balance surplus amounted to USD 185.6 billion².

In December 2014, 12-month inflation was 11.4%, 4.9 pp. more than reported last year. According to preliminary data provided by the Russian Ministry of Economic Development, the unemployment rate remains low, which, ignoring the seasonal factor, is an estimated 5.2%.

In 2014, in the face of rising geopolitical tensions and growing demand over supply for foreign currency, the Russian currency continuously weakened against other currencies. The devaluation of national currency, high inflation and pessimistic expectations created severe problems to financial stability. To ease the situation, the Central Bank of Russia raised the refinancing rate for 6 times, to a 17.0% rate lastly, as well as intervened with the foreign exchange market from time to time. A number of other monetary tools were also used, particularly foreign currency injections through swap instrument. Based on annual data, the official Russian ruble versus U.S. dollar exchange rate has depreciated by 55.5%. It is noteworthy, that because of interventions aimed to improve the economic situation during the year, Russia's international reserves decreased by 24.4%.

In 2014, loans to economy by the banking system of Russia grew by 25.9% (12.9% currency revaluation of foreign currency loans are excluded), to over 57.0% of GDP. Simultaneously, the share of overdue liabilities rose by 1.5 pp. to 5.9%.

The Moody's rating company downgrades Russia's sovereign rating to Ba1 from Baa3 with a "negative" perspective³. The grounds for the downgrade are:

- The conflict with Ukraine and low oil prices, that may further constrain Russia's economic growth in medium term,
- The state financial stability may deteriorate sharply, due to increase of state intervention and tax reduction, as well as decline of international reserves conditioned by capital outflows and limited access to international financial resources.

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 flows, foreign investment and domestic economic growth overall.

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 developments, as well as estimates and projections are taken from the periodical "Мониторинг об итогах социально-экономического развития Российской Федерации в 2014 году" (Monitoring of the Results of Socio-Economic Development of the Russian Federation in 2014) issued by the Russian Ministry of Economic Development.

² http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/trade/

³ https://www.moody.com/research/Moodys-downgrades-Russias-sovereign-rating-to-Ba1-from-Baa3-outlook-PR_318857

1.2. INTERNATIONAL FINANCIAL MARKETS

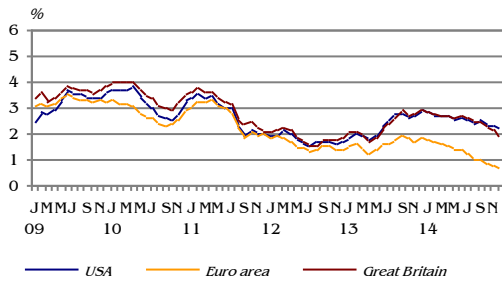
During 2014, no significant fluctuations in international financial markets were observed: though the main risks remain on the agenda. A number of countries continued to implement accommodative monetary policy in order to stimulate global economic growth. The latter, unfortunately, brought to financial risks upsurge, including growth of portfolios with high risk⁷ and boost in the share of loanable funds in balance sheets.

In 2014, taking into account the unstable condition of European countries and the concerns over economic slowdown of developing countries, investors still mostly

⁷ IMF, *Global Financial Stability Report. Navigating Monetary Policy Challenges and Managing Risks*, April 2015.

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

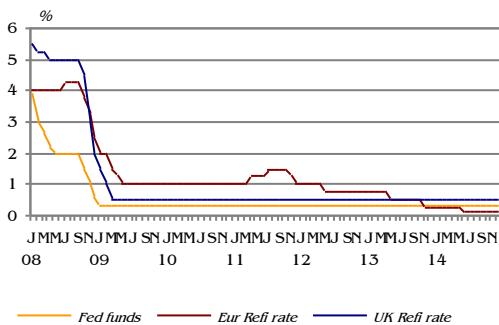
10-year government bond yield



Source: Bloomberg Data Warehouse.

Central banks of key developed and emerging market countries implemented accommodative monetary policy.

Interest rate policies of central banks



Source: Bloomberg Data Warehouse.

Favorable macroeconomic developments encouraged the FRS to terminate the quantitative easing program.

prefer German and other highly liquid government bonds, maintaining the trend of the previous year. Meanwhile, investors started to look for more profitable investment paths conditioned by low profitability. In this context, the spread between corporate and government bonds narrowed, which was more apparent in bonds with low rating.

In 2014, taking into account the unstable condition of European countries and the concerns over economic slowdown of developing countries, investors still mostly prefer German and other highly liquid government bonds, maintaining the trend of the previous year. Meanwhile, investors started to look for more profitable investment paths conditioned by low profitability. In this context, the spread between corporate and government bonds narrowed, which was more apparent in bonds with low rating.

Given the main economic challenges and instable growth of global economy during the year, the key developed countries carried on low interest rate policy.

The ECB continuously lowered the rates of main refinancing operations and deposit facility to 0.05% and -0.2%, 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, the revision of which would not only depend on the rate of unemployment but also on how indicators of economic activity would perform further, as the Bank had announced.

The U.S. Fed kept the policy rate at its lowest. The rise of the rate will occur in case of further improvements in labor market and inflation trends. Gradually reducing the volumes of asset purchases, the FRS finally ended the QE in October 2014. The improvements in market conditions, in particular low inflation and steadily falling unemployment, lead to termination of the third round of QE program. USD 4.48 trillion has been spent since November 2008 within the program,. The termination of the QE program definitely influenced not only the U.S. economy, but left an impact on both international financial markets and on developed and developing economies. some developing countries have seen substantial capital outflows (due to the geopolitical situation in Russia and restrictive policy of Chinese government for short-term capital inflows), which resulted in a significant depreciation of their national currencies.

It should be noted, however, that financial markets' response in different countries depended largely on the economic policy conducted in that particular country. According to Moody's, an international rating agency, most sensitive to the tapering and to termination of the QE

program were countries that 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 capital inflow will cost developing countries a cumulative loss of 2.8-3.1% of GDP growth in the period 2013-2016⁸.

During the reporting year, major currencies assumed volatile trends. The U.S. dollar has mainly appreciated versus Euro, driven by economic policies conducted by the United States and European countries 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, the foreign currency risk derived from external funds has grown significantly in financial systems of developing countries.

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

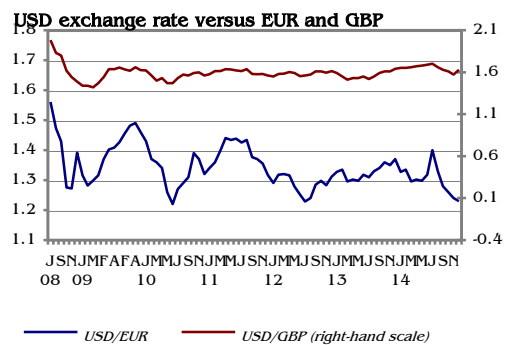
Low base rates and global economic imbalances determined a down-sloping behavior of interbank interest rates.

SUMMARY

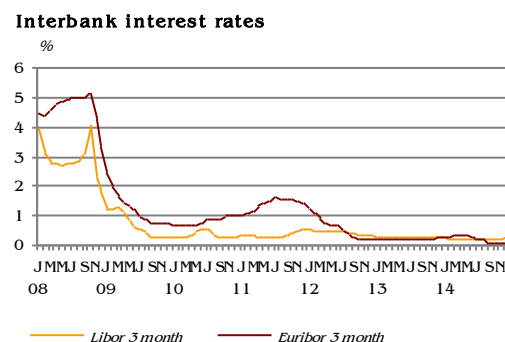
In 2014, the global economy continued recovering, but it was slower than expected because of new downward risks. Unstable world economic growth, changed direction of US monetary policy and current economic challenges in Russia affected negatively Armenia's investment environment, economic growth, export and private transfers' growth. The abovementioned developments may have a negative effect of financial stability of Armenia.

In developed countries, except the USA, 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 outflows, which led to domestic currency depreciation pressures. Apart the economic risks hampering growth in developing countries, geopolitical risks associated with the crisis in Ukraine, as well as relations between Russia and West got a particular emphasis.

Russia's economic growth slowdown, the depreciation of Russian ruble and the decline in private consumption somewhat decelerated the inflow of non-commercial remittances from this country and growth rates of export to Russia.



Source: ECB.



Source: Bloomberg Data Warehouse.

⁸ <http://openmarkets.cmegroup.com/7847/qes-lingering-effect-on-emerging-markets>

2. MACROECONOMIC ENVIRONMENT DEVELOPMENTS IN ARMENIA

2.1. MACROECONOMIC DEVELOPMENTS ⁹

Weak investment climate starting from the beginning of the year, decline of foreign and domestic demand in Russia derived from negative economic trends and the decrease of private remittances left their negative impact on the economic activity of Armenia.

The implementation of expansionary fiscal and monetary policies has somehow mitigated the negative impact of these risks.

In 2014, the economic growth in Armenia was 3.4% y/y, according to the National Statistical Service of Armenia. The contribution to the economic growth came mainly from the growth in agriculture and services production volumes, whereas decline in industry and construction had a negative impact on economic growth, overall.

The declining trend of value added in industry of the first half of the year was maintained. In 2014, industry reported a 0.7% y/y decrease because of contraction of value added in mining sector and reduced electricity production. The decline in mining industry is driven by the fall in export volumes of mining products.

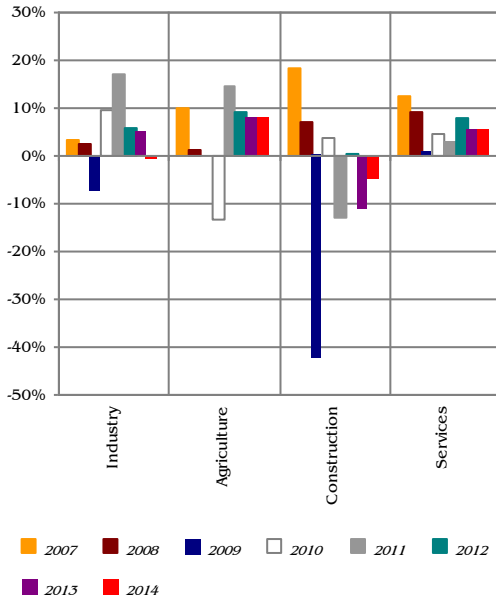
The growth of value added in agriculture was 7.8% y/y. Moreover, a growth was registered in all sectors. Plant propagation, animal production and fishing levels increased by 6.9%, 7.8% and 24.6%, respectively.

In 2014, construction sector reported a 5.0% decrease in value added, driven mainly by shortened volumes of construction funded by households and government budget. At the same time, the volumes of construction funded by companies, communities and international loans have increased. The communities-funded construction volumes reported the most considerable increase.

The growth of value added in services sector was 5.6%, which has been fuelled by 5.9% increase in services rendered. Retail trade has fallen due to private demand shortage.

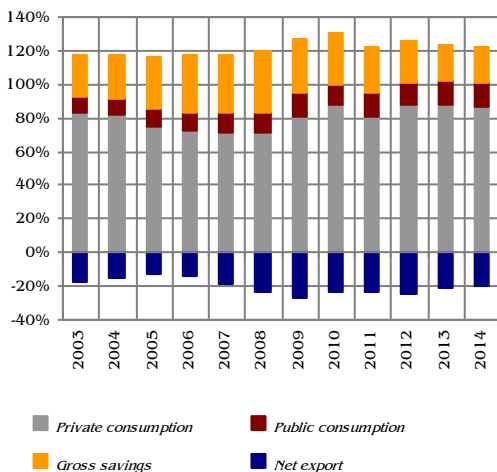
According to the NSSA data, by GDP expenditures, private consumption has not changed dramatically as compared to the previous year (a mere 0.6%). The slow rate of growth of private consumption is attributable to significant decrease in non-commercial transfers from Russia, 8.1%, as well as lower-than-expected domestic economic activity. The public consumption recorded a notable increase, 5.3%.

The annual growth of main sectors of economy



Source: National Statistics Service of Armenia.

GDP expenditure components (share in GDP)



Source: National Statistics Service of Armenia.

⁹ For details on the developments of macroeconomic environment in Armenia, see the quarterly publication "Inflation Report 2015, 1st quarter".

The low business activity and continual low output volumes in construction were in line with rising uncertainty of business entities, which became more apparent because of the year-end uncertainty in the financial market, currency depreciation and inflationary expectations. The inflationary expectations at the end of the year created an additional demand that led to a decrease in financial working capital in the structure of investments. Thus, in 2014, private investment plunged by 4.4% as compared to the previous year. Though public investment reported a decline in the first half of the year, overall, it grew by 9.7% at the end of the year.

In 2014, relative to the previous year, loans to the economy have grown by 19.4%. Growth of the loan portfolio was recorded in almost all sectors of the economy, except transport and communication sector. The fastest growth rates were recorded in lending to public catering and other services, agriculture and industry, by 45.7%, 19.1%¹⁰ and 17.6%, respectively. As loan portfolio grew, the share of non-performing loans in total loans has risen by 2.2 percentage points to 6.4%. Non-performing loans were relatively high in construction, public catering and trade sectors, making up 17.2%, 9.5% and 6.6%, respectively.

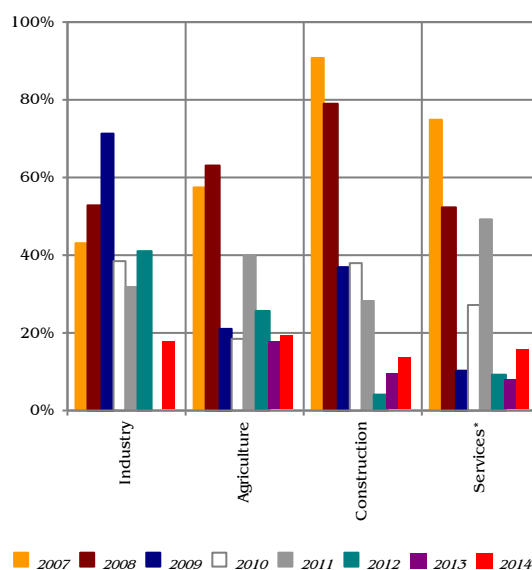
Loan procedures to companies, price policies and creditworthiness assessment criteria of banks were tightened in midst of economic adverse environment, prospect of aggravation of financial situation of customers and price increases of attracted resources. At the same time, banks did a huge work in order to help the customers with financial consulting and support businesses to overcome the crisis of the year-end.

According to surveys conducted by the Central Bank of Armenia, Business Climate Indicator¹¹ rose by 0.8% in the fourth quarter of 2014, which is within the stability range and points to the optimism of businesses for the business environment.

According to the Republic of Armenia Ministry of Finance data, external public debt of the Republic of Armenia was USD 3,785.3 million, in 2014, which is 85.2% of total public debt. Compared to the previous year, external public debt has reduced by 2.9% and amounted 34.8% of GDP. Armenia's foreign public credit included funds disbursed from international organizations, which rose to 84.2% this year. Foreign government loans were 17.6% and loans provided from commercial banks stood at 0.5%. Moreover, the share of loans with a floating rate in the structure of loans was low, 20.9% at the year-end.

In 2014 loans to public catering and other services, agriculture increased.

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.

¹⁰ Loans to forestry and fishing are not included in the agriculture sector.

¹¹ A composite economic index of business climate that the Central Bank builds based on quarterly survey data obtained from different sectors of the economy.

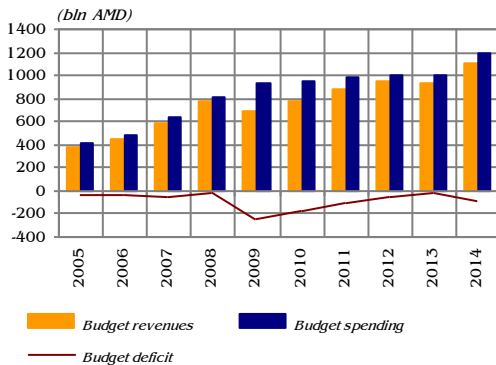
Qualitative external public debt indicators of the Republic of Armenia

Indicator	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Debt/GDP (limit 50%)	22.3%	18.2%	14.0%	13.6%	35.7%	34.2%	36.4%	37.6%	37.5%	34.8%
Debt/ Export	77.6% (less indebted)	79.8% (less indebted)	81.6% (less indebted)	89.8% (less indebted)	221.7% (moderately indebted)	170.51% (moderately indebted)	148.0% (less indebted)	150.0% (less indebted)	139.4% (less indebted)	114.9% (less indebted)
Debt service/ Export	4.6% (less indebted)	4.2% (less indebted)	2.9% (less indebted)	3.1% (less indebted)	6.0% (less indebted)	5.0% (less indebted)	4.2% (less indebted)	9.9% (less indebted)	14.1 ² % (less indebted)	6.8% (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)	1.0% (less indebted)

All the qualitative indicators of Armenia's external public debt improved, and Armenia remains a less indebted country.

From the financial stability viewpoint, an improvement in main qualitative indicators of external public debt of the Republic of Armenia was marked in 2014, which means Armenia remains a country with a less debt burden.

Government budget main indicators



Source: National Statistics Service of Armenia.

Though lower figures of the Republic of Armenia state budget were reported against expected performance values in 2014, the fiscal policy had an expansionary effect on the economy, conditioned by neutral income and expansionary spending policies.

According to the NSSA data, budget revenues¹³ posted a 6.6% y/y growth in 2014. The growth was attributable to 9.6% growth of value added tax, a sub-item holding a large share in total tax revenues. Public spending¹⁴ grew by 14.1% compared to the previous year. Moreover, all expenditure figures grew, except non-financial asset expenditures.

As a result, the state budget deficit was 2.1% of GDP, passing the previous year's indicator by 0.4 pp. The state budget deficit remained within the limits of public debt stability.

In 2014, the 12-month inflation was 4.6%, which remains within the acceptable fluctuation limits of target inflation.

Given the increase of prices of some food products by 6.3%, which had a 3.4 pp. contribution to the total inflation, the 12-month inflation rate reached 4.6% in December 2014, remaining within the acceptable fluctuation limits of target inflation.

¹² Debt service / export figure does not include the Russian early loan repayment. In case of considering this repayment, the debt service / export ratio will be 30.7%.

¹³ This includes extra-budgetary funds

¹⁴ This includes working funds of project implementation units.

2.2. FOREIGN TRADE

In 2014, current account deficit of the Republic of Armenia grew by USD 24.1 million as compared to the previous year to USD 863.3 million. The deterioration was driven largely by decrease in secondary income (net current transfers) and net inflow of workers' compensation. The reduction of import growth rates also contributed to current account deficit deepening. In 2014, the Current Account Deficit/GDP ratio remained nearly unchanged at the level of 7.9% y/y due to accelerated growth of gross domestic product compared to current account.

According to the NSSA data, the volume of foreign commodity turnover has increased by 0.7% y/y to USD 5399.0 million. The low rate of foreign commodity turnover is caused by slow pace of import growth.

Import of goods has grown by 0.2% y/y to USD 3734.0 million, and import of services has grown by 43.3% to USD 1733.1 million¹⁵.

By structure of imports, increases were mainly reported in the following items: "machinery and equipment", "non-precious metals and articles thereof" and "precious and semi-precious stones, precious metals and articles thereof", which grew by 3.2%, 10.7% and 2.6%, respectively.

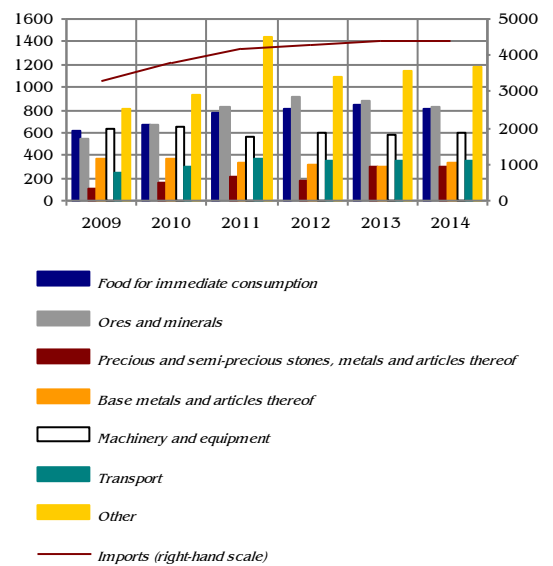
The dollar value of exports of goods has increased by 1.8 % y/y to USD 1665.1 million. Meantime, the export of services has increased by 48.5% to USD 1630.3 million¹⁵.

By structure of exports, the main increases were in "food for immediate consumption", "precious and semi-precious stones, precious metals and articles thereof" and "textile products" for 8.9%, 22.5% and 29.0%, respectively.

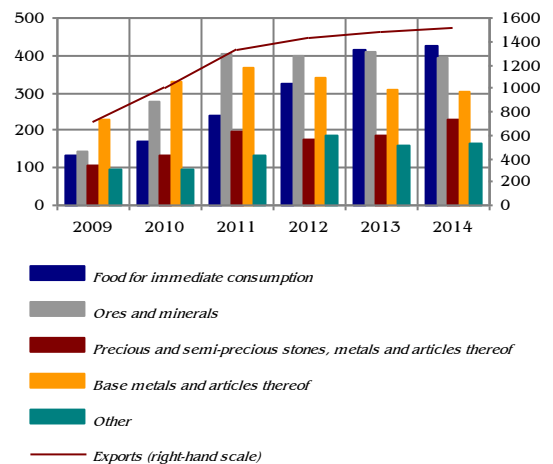
Due to accelerated growth of exports compared to imports and improvement of trading conditions¹⁶, the trade balance deficit decreased by 1.1% as compared to the previous year, amounting to 19.0% of GDP.

In 2014, foreign trade of the Republic of Armenia again run with major concentrations by country, which is a threat to financial stability. Main trade partners included Russia and the EU countries, though their share in foreign trade diminished during the year. The share of exports to Russia and the EU countries has decreased, respectively, by 7.7% and 11.5% amid low external demand. At the same time, the

Armenia's imports by commodity groups (mln USD)



Armenia's exports by commodity groups (mln USD)

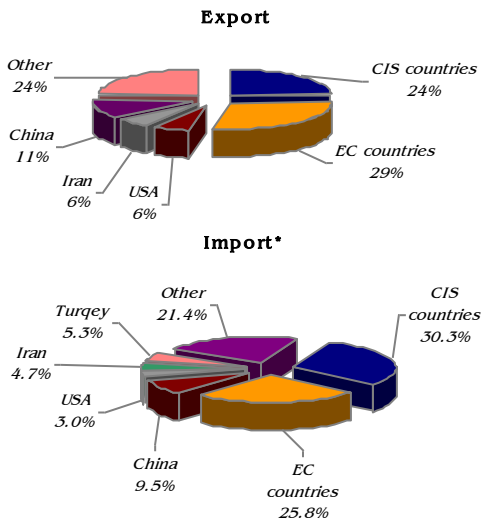


Source: National Statistics Service of Armenia.

¹⁵ Such increase of services in 2014 compared to 2013 is due to the revised methodology of calculation of item "Travelling" in the BOP, which has not yet been revised for previous years.

¹⁶ The decrease of y/y dollar value of the import was more than the decrease of y/y dollar value of exports.

Armenia foreign trade, by country, as of 31.12.2014



* The structure of imports is represented according to the countries of origin.

Source: National Statistics Service of Armenia.

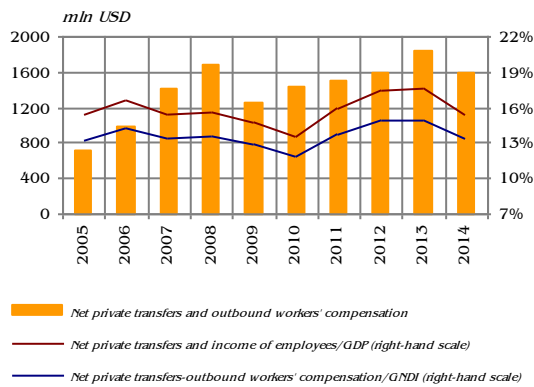
share of China and Iraq grew in the structure of export of goods. As for imports, the structure is almost unchanged. The main partner countries are Russia, China, Germany and Turkey. The volume of imports from these countries grew by 6.7%, 8.2%, 1.2% and 10.3%, respectively.

The trend of the first half of the year maintained throughout 2014: increases were reported in such items as “food for immediate consumption” and “precious and semi-precious stones, precious metals and articles made thereof” in the structure of export goods, but the shares of items “ores and minerals” and “non-precious metals and articles made thereof” posted decreases. According to the Herfindahl-Hirschman index, which is 0.183, Armenia’s export is moderately concentrated. Such value of the index is mainly due to great share of mining and food sectors, which makes export more vulnerable to the developments in these sectors.

2.3. NET PRIMARY (FACTOR) IN COMES AND PRIVATE TRANSFERS

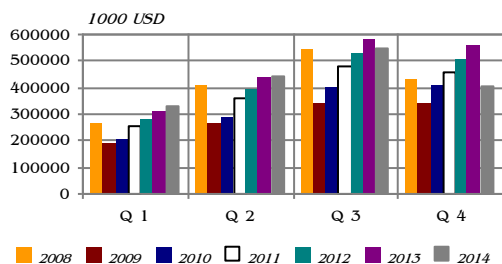
In 2014, non-commercial remittances decreased because of Russian ruble depreciation and slowdown of Russia’s economic growth.

Net private transfers and outbound workers' compensation



In the period under review, a decrease in transfers of 8.1% was registered for the first time after 2009, caused by adverse economic developments abroad,. This was due to fall in both outbound workers’ compensation and private transfers by 7.2% and 9.3%¹⁷, respectively. As this indicator decreased and GDP grew, the ratio private transfers and workers’ compensation/GDP declined to 15.5% against 17.6% in the previous year. Meanwhile, this ratio is still high enough to enlarge Armenian economy’s vulnerability to foreign uncertainty. The inflow of net non-commercial transfers via the banking system has also shrunk by 7.6% during the year.

Net non-commercial remittances of individuals by banking system



Source: Central Bank of Armenia.

The decrease of remittances is primarily attributable to a decline of remittances from Russia, especially in the fourth quarter of the year, which is mainly a result of the Russian ruble's depreciation versus the U.S. dollar (for details, please see the box “Economic Developments in Russian Federation”). This decrease was also driven by the fall in construction and low growth of trade in Russia, which limits the possibilities of Armenia’s outbound workers to find jobs. Nevertheless, according to the CBA surveys, the share of town households receiving non-commercial remittances from abroad remains unchanged as compared to the previous year at the level of 15.0%¹⁸. During the year, no significant amendments were made in management of workforce inflow

¹⁷ Transfers in Russian rubles, the main part in total non-commercial remittances, have increased by 10.3% during the year.

¹⁸ Source: “Consumer confidence Index” survey by the CBA, fourth quarter 2014

to Russia by migration authorities. An agreement regarding “The status of Armenian citizens in Russian Federation and Russian citizens in the Republic of Armenia” was ratified in March 2015. 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.

As a result of decrease in non-commercial remittances through banking system, the share of inflows from Russia narrowed by 3.0 pp. to 83.0%, in total remittances. Remittances from the USA and Germany grew to some extent, thus their share in total remittances increased by 6.0% and 1.1%, respectively. Overall, the share of inflows from Russia remains rather high in total remittances, which increases Armenia's economic vulnerability to negative economic and geopolitical developments in Russia.

The decrease in transfers from Russia had its negative impact on current consumption¹⁹, current account, which then affected the quality of loan portfolio of banks. Then again, the reduction in transfers affected directly the commissions of separate banks from money transfers²⁰.

The forecasts for inflow outbound workers’ compensation and private transfers for 2015 are subject to developments in Russian economy. Given the expected downturn in Russian economy, a downside forecast of about 30.0% of value of non-commercial remittances in US dollars²¹ is expected, which may affect the financial stability.

2.4. HOUSEHOLD INCOME AND DEBT BURDEN

In 2014, the foreign and domestic adverse developments affected the labor market of Armenia, causing the unemployment rate to increase to 17.6%. Parallel to unemployment rate increase the nominal wages grew by 8.3%, quite a high upsurge as compared to the previous years. This increase is due to raising the minimum wage threshold, as well as rise in wages in public sector (9.0%) and private sector (7.3%). However, the decrease in net factor income and private remittances, which make up a certain part of household income of Armenia, and the growth of unemployment rate had a negative effect living standards of the population. These developments have had their impact on the components of Consumer confidence index²²

¹⁹ Report on “Household survey for migration in Armenia, 2014” NSSA, Migration International Company.

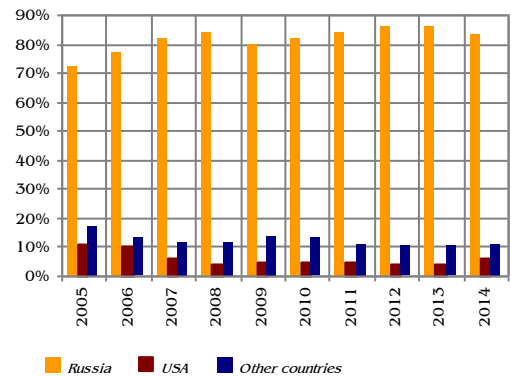
²⁰ “Banks in Commonwealth of Independent States Feel Pinch as Russian Workers’ Remittances Decline” February 2015, by Moody’s

²¹ Source: “Inflation Report, 1st quarter, 2015” by the CBA.

²² Source: “Consumer confidence Index” survey by the CBA, fourth quarter 2014.

The prevailing part of non-commercial remittances is from Russia which increases Armenia's economic vulnerability to economic developments in Russia.

Remittances by countries of origin

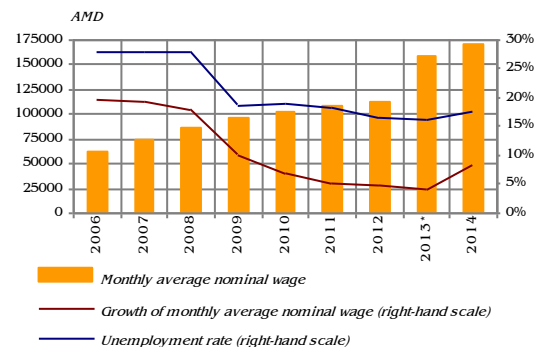


Source: Central Bank of Armenia.

The decline in private remittances had somehow affected the loan portfolio quality.

Nominal wages grew, whereas employment rate declined during the year.

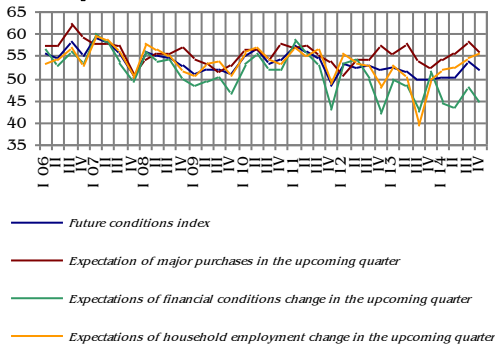
Nominal average wage and unemployment



* 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.

National Statistics Service of Armenia.

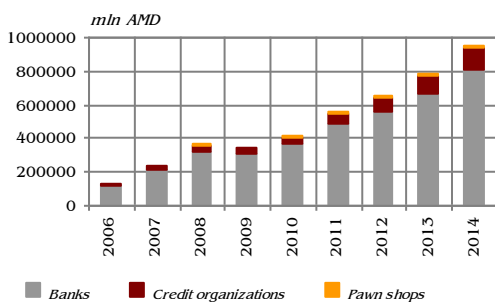
Future conditions index and its components



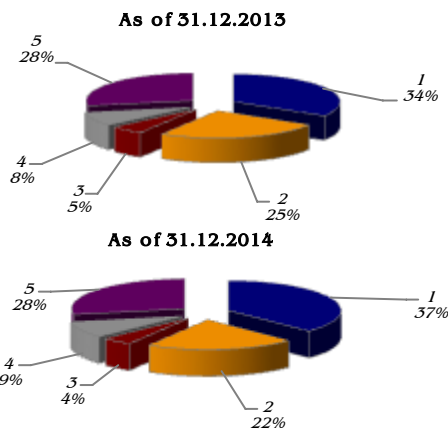
Source: Central Bank of Armenia.

Notably, the consumer credit volumes of households were high.

The structure of household liabilities to financial institutions



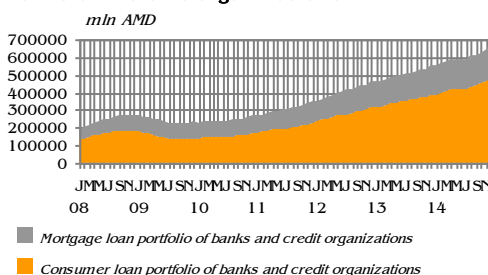
Consumer loan portfolio structure of banks and credit organizations of Armenia



1. Card loans 2. Gold-backed loans 3. Car loans 4. Home appliance loans 5. Other consumer loans
Source: Central Bank of Armenia.

Risks deriving from the household loan portfolio quality remain manageable.

Consumer and mortgage loan portfolio of banks and credit organizations



Source: Central Bank of Armenia.

leading to both current conditions sub-index and future conditions sub-index decrease. The instability in both domestic and foreign economies will further negatively affect the labor market. In particular, it is anticipated that the average salary will have a slower growth pace (6.2%) in 2015, while the unemployment rate may grow to 18.5%, conditioned by the anticipated slowdown of economic growth²⁵.

Households' liabilities to financial institutions have grown by 20.7% during the year, due to greater volume of lending by both banks and credit organizations. Credit card loans were the main contributor to consumer loan growth, thus, the share of credit card loans in total consumer loans increased by 3.6 pp. to 37.3%. Mortgage loans for the purchase of real estate contributed to the growth of mortgage lending overall, which grew by 17.3%. Foreign currency loans constitute more than 58.0% of mortgage loans, which makes the households receiving income in Armenian drams more vulnerable to foreign currency risk. 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. Their refinanced mortgage loans grew during the year and constituted nearly 36.0% of total mortgage lending portfolio. The National Mortgage Company intend to issue mortgage-backed bonds. This will improve both the mortgage and security markets, enlarging the mortgage lending accessibility. A model for the issue is being developed now, based on international best practice and specific characteristics and limitations of Armenian market. The model will be selected during the current year, and then the issue will follow. In order to encourage the activity of real estate and mortgage market, amendments to the law on "Income tax" of the Republic of Armenia entered into force in January 2015. Thus, people buying apartments straight from the builder are privileged (for details, please see section "Real estate prices").

In the midst of adverse economic developments and accelerated growth of credit portfolio for recent years, the credit risk losses of commercial banks grew in 2014. This has not affected the banks' solvency, but may constrain the household lending. The share of non-performing loans in consumer loans has grown in both FX and AMD, and NPLs of mortgage loans provided to households have grown in FX only. This is an evidence that credit risk derived by foreign exchange risk is rather important for credit institutions.

²⁵ Source: "Inflation Report, 1st quarter, 2015" by the CBA.

Under current conditions of economic instability, the banks provided their customers with financial consulting for proper management of credit risk, as well as loan repayment schedules and lending conditions were revised. Adjustments were made in lending conditions, collateral claims and creditworthiness assessment criteria²⁴. The abovementioned actions by banks have contributed to reducing the likelihood of risks to financial stability.

In 2014, due to accelerated increase of resident household lending as compared to GDP, the share of household loans in the GDP has increased to 20.0% of GDP. Though the latter stands at a lower level than in many European countries, it may bring to credit risk from the financial stability viewpoint.

Parallel to lending to resident households, household deposits grew as well, to 19.7% of GDP. A growth in FX deposits was more apparent and their share in total deposits made up 71.2%. From the commercial banks' perspective, this limits their possibility of financial assets relocation in Armenian dram assets, including AMD lending to households.

2.5. REAL ESTATE PRICES

In 2014, the prices of apartments in multi-apartment homes²⁵ both in Yerevan and in other towns of Armenia remained approximately at the same level as in the previous year. In this perspective, risks to real estate price fluctuations were insignificant (for details, please see sub-section "Market risk of commercial banks"). Responding to their risk management needs, commercial banks were further conservative as they continued keeping the loan-to-value ratio mostly in the 60-80% range. Moreover, concerning the mortgage loans, this ratio decreased as compared to the previous year and did not surpass 50% level. The real estate market activity was higher than in previous years, though remained below the pre-crisis level. Real estate transactions in Yerevan increased by 13.3% to 16000 transactions, in 2014 as compared to the previous year. Trades were relatively more in the secondary market of real estate, while the market of new-built apartments was estimated to be quite low²⁶. In the period under review, risks associated with the sale of collateral are persisting.

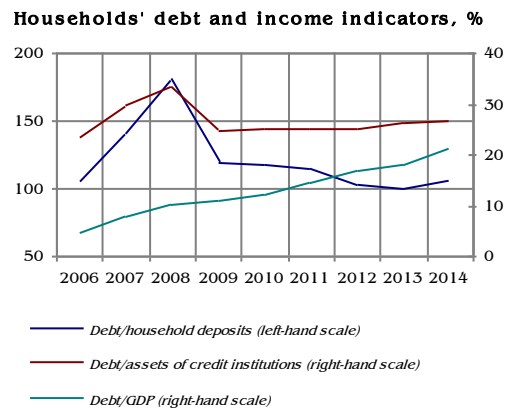
In general, the growth rate in real estate market activity is hampered because of a low solvent demand attributable to

²⁴ Source: the Central Bank Quarterly Surveys of Conditions of Bank and Credit Organization Loans, 2014

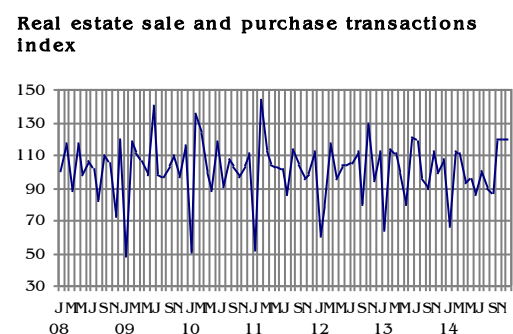
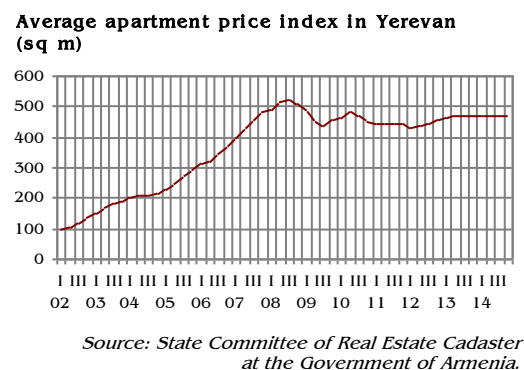
²⁵ As there is no single index of Armenia's real estate average price, the criterion for real estate price developments is considered the average price index of apartments in Yerevan

²⁶ Source: the Central Bank Quarterly Surveys of Conditions of Bank and Credit Organization Loans, 2014

The debt burden of Armenian households grew, though an adequate income growth did not occur.



In 2014, the apartment prices in Armenian dram remained unchanged.



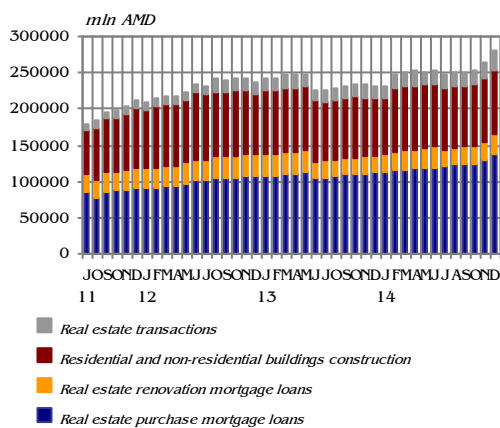
The low solvent demand for real estate limits further activity of real estate market.

relatively low level of household income. Real estate mortgage loans originated by financial institutions were a certain contribution to real estate demand (for details, please see sub-section “Household income and debt burden”). In this context, the mortgage lending revisions parallel to uncertain directions of economic development and cut in foreign financing volumes may decrease the real estate market activity. In order to encourage the demand of real estate, amendments to the law on “Income tax” of the Republic of Armenia entered into force in January 2015. Thus, people buying apartments straight from the builder are privileged. In particular, the borrower’s service interests will be paid on behalf of the income tax, in such a way easing the financial burden of borrowers. The abovementioned privileges are for new-built apartments and new-built homes only, which may contribute to the activity in primary market of real estate, according to quarterly surveys of commercial banks²⁷.

In 2014, lending to both residential and non-residential buildings increased.

During the year, the volume of residential houses commissioned to operate increased by 15.1% due to augmented volumes of construction financed by organizations. On the other hand, the volume of household-funded apartment operations has decreased as opposed to the previous years, and the share of the latter has consequently fallen to 58.8% in total residential buildings operation volumes.

Volume of loans to real estate market



Source: Central Bank of Armenia.

Residential buildings completion by sources of financing

Sources of financing	2014 exploited residential buildings (sq. m)	Share in total	Percentage change as to 2013
Total, of which :	257272	100%	15.1%
State budget	0	0	0
Corporations' funds	106078	41.2%	2.2 times
Household funds	151194	58.8%	-9.4%

Source: the National Statistics service of Armenia.

In 2014, credit provided to companies for construction of residential buildings has grown by 19.4%. In the meantime, the share of non-performing loans in these loans has increased by 10.0 percentage points to 21.0% in total loan portfolio. The share of loans for residential and non-residential buildings in total loan portfolio is still low at 4.0% level, so the risks associated with these activities cannot leave a significant impact on the financial stability of the Republic of Armenia.

²⁷ Source: the Central Bank Quarterly Survey of Conditions of Bank and Credit Organization Loans, 2014, fourth quarter

SUMMARY

The adverse economic developments of global economy, especially in partner countries of RA had their slowing impact on economic growth of Armenia and foreign trade. The economic growth was lower-than-expected due to economic activity slowdown in main partner countries and low domestic investment setting. The service and agriculture sectors were main contributors to economic growth.

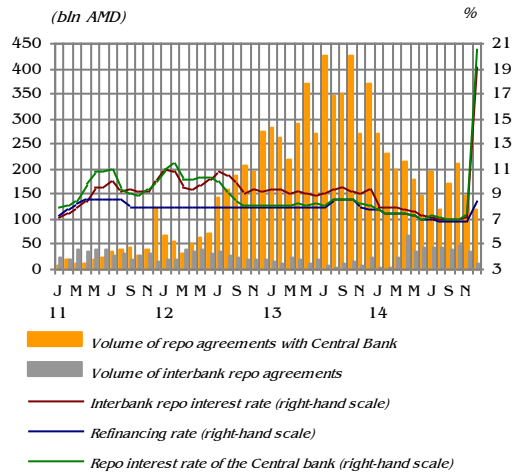
The current account deficit remained due to decrease in export growth and decrease in remittances from abroad. The growth of household income was somewhat hampered by shrinkage of private remittances and outbound workers' compensation, which in turn affected the domestic consumption. Overall, in the context of domestic and foreign developments, some risks of economic growth decrease can occur in the upcoming years, which may increase risks to financial stability.

3. FINANCIAL MARKET STABILITY OF ARMENIA

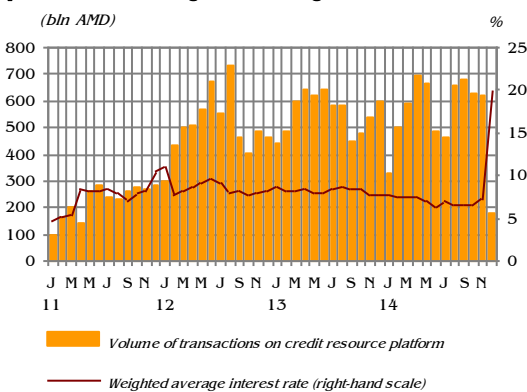
3.1. MONEY AND CAPITAL MARKET

The CBA responded to the late 2014 stance with drastic actions, which had their impact on short-term market rates.

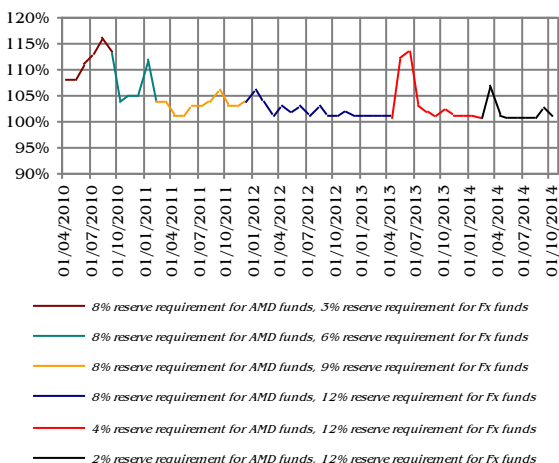
Monthly volume of repo transactions and repo interest rates



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



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



Source: Central Bank of Armenia.

From the beginning of 2014, inflation continued reducing at a faster pace than expected, which was determined by a slow rate of economic growth, seasonal decline in prices of some food products and non-inflationary expectations from both foreign and domestic economies. Under such circumstances, during the first 9 months of 2014 the Central Bank gradually lowered the refinancing rate by a total of 1.0 percentage point to 6.75% in late September.

Another action aimed at easing the monetary conditions was the reducing dram reserve requirement ratio from 4.0% to 2.0% starting from February 2014 .

In the fourth quarter of 2014, the worldwide deepening of geopolitical conflict, particularly in our region influenced foreign exchange market of Armenia, where dram depreciation was observed due to reduction in foreign currency transfers from abroad, especially from Armenia’s main partner countries. The CBA responded to the situation with drastic actions, raising the Lombard repo rate to 21.0%. Later, for liquidity regulation reasons the CBA council implemented reserve requirement mechanism as monetary policy tool for the first time during the recent years doubling the reserve requirement in foreign currency from 12.0% to 24.0%. The short-term market rates grew sharply in response to financial market conditions tightening by the CBA, temporarily approaching the Lombard repo rate of the CBA. Under the conditions of stabilization in foreign exchange market, the CBA gradually lowered reserve requirements in foreign currency from 24.0% to 20.0%, and the Lombard repo rate from 21.0% to 12.0% at the end of the first quarter of 2015. Simultaneously, in order to anchor inflation expectations caused by dram depreciation around the target, the CBA council raised the refinancing rate by 3.75 pp. to 10.5%, thus reflecting the growth trends of investments risks and interest rates in developing countries in the long term.

The shift of yield curve²⁸ shows that at the end of the year, relative to the previous year, yields of short-term treasury bills²⁹ did not change dramatically but yields of long-term treasury notes grew by 3.0 pp. As a result, the spread of

²⁸ 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 in 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.

²⁹ Short - term treasury bills are considered to be 6-month bills and long - term treasury notes, 10 - year notes.

short-term and long-term interest rates widened during the year by 3.5 percentage points to 6.0% at the end of the year. Under such conditions of money market rates, the Ministry of Finance of Armenia did not place any short-term bonds in December.

For summarized illustration of what are the current trends in the government securities market, the Central Bank calculates indices of government bonds³⁰, which are presented in the table below.

Indices of government bonds, as of 31.12.2014

INDEX	TBI	G03	G05	G5I	GMI
Modified duration	0.37	1.15	1.61	5.40	2.90
Risk weighted yield	8.23	9.72	10.72	13.86	12.71
Average maturity (year)	0.39	1.31	1.96	12.37	5.66
Average weighted coupon %	-	10.83	10.58	11.95	11.07
Market Price of government bonds (bln AMD)	12.11	125.55	177.57	91.18	268.75
Price change in case of +/-1% yield change (mln AMD)	-/+45	-/+1438	-/+2857	-/+4923	-/+7782
Price change in case of yield change within the standard deviation ³¹ (mln AMD)	3	144	326	683	906

Indices of government securities portfolio of commercial banks, as of 31.12.2014

INDEX	TBI	G03	G05	G5I	GMI
Government bonds held and available for sale (billion AMD)	9.51	112.6	164.91	91.37	246.29
Share in total portfolio (%)	3.9	45.8	67.0	33.0	100
Modified duration (MD)	0.38	1.20	1.70	5.47	2.94
Price change in case of +/-1% yield change (mln AMD)	-/+36.2	-/+1353.6	-/+2796.3	-/+4447.5	-/+7243.9
Portfolio change in case of yield change within the standard deviation (mln AMD)	2.7	135.2	319.0	617.1	843.5

As of the end of 2014, modified duration of government coupon bonds outstanding was 2.90, with an average

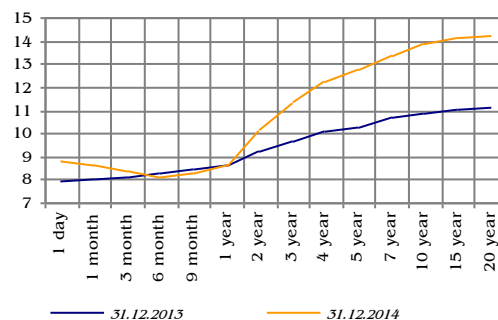
³⁰ There are 5 indices calculated for government bonds, of which 4 for coupon bonds and 1 for discount bonds. The coupon bond indices are G03, G05, G5I, which cover bonds with maturities, respectively, from 0 to 3 years, 0 to 5 years and 5 years and more; and GMI, which is a coupon bond index. Indices 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 details, please see the CBA website: www.cba.am

³¹ Standard deviation of Risk weighted yield, 01/12/2013-30/06/2014

The analysis of yield curve shows that yields of long-term treasury notes grew.

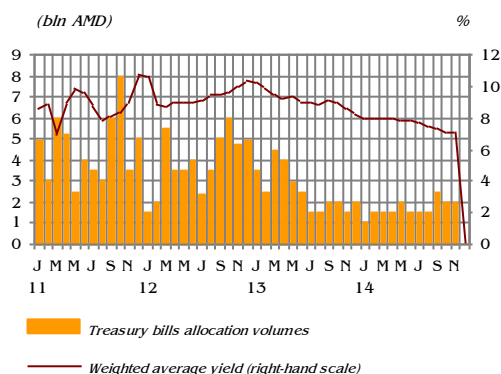
Yield curves of government bonds



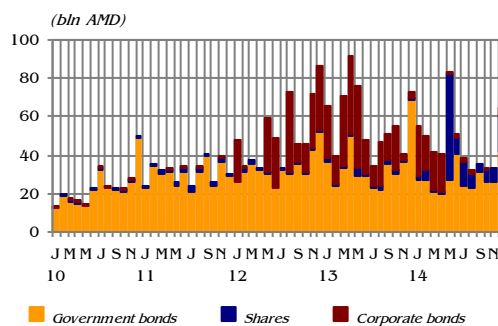
Spread of 6-month and 10-year bonds



Treasury bills allocation volumes and weighted average yield

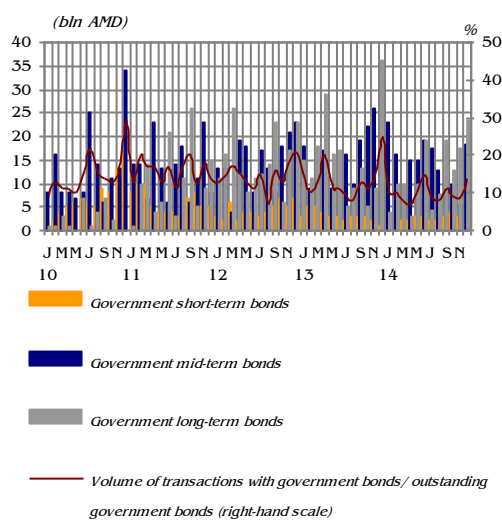


Security trades by investment service providers

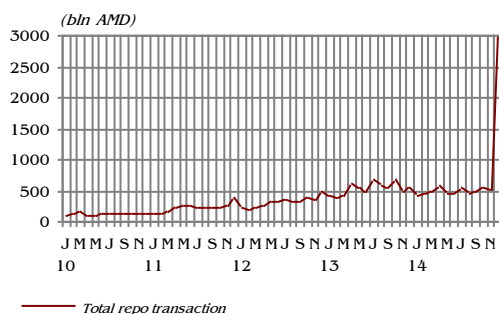


Source: Central Bank of Armenia.

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

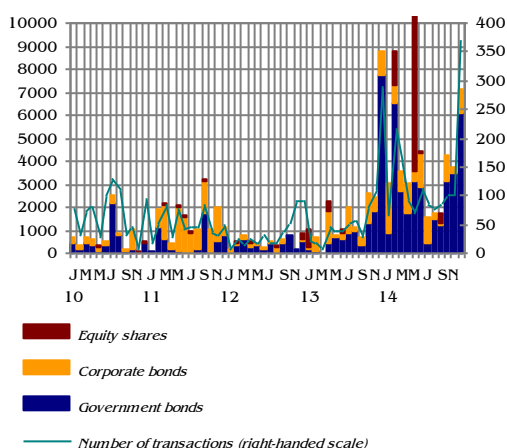


Repo transactions by investment service providers (including repo transactions with the Central Bank)



The operations in the regulated market increased.

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



Source: Central Bank of Armenia.

maturity of 5.66 years. These indicators for discount bonds were 0.37 and 0.39, respectively.

In case of a 1% change (increase/decrease) in the yield of government securities, investors' likely loss / gain could be about AMD 7.8 billion or 2.9% 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 without operations with the Central Bank) carried out by investment service providers³² grew by 36.4% compared to the last year and amounted to AMD 3 trillion 350 billion in 2014. Transactions involving securities trades constituted 16.7% of the operations mentioned above.

The government securities market liquidity³³ was less volatile (according to the indicator describing the level of liquidity) compared to the previous year. A relatively high liquidity was recorded in June and December of 2014, when the average liquidity has been respectively 2.0 and 1.8 points higher than the average yearly liquidity level.

The share of trades with medium-term and long-term securities amounted to 50.8% and 42.3%, respectively, of total transactions involving government securities trades. The share of short-term securities reached 6.9%.

In 2014, relative to the previous year, the volume of repo and reverse repo transactions (excluding operations with the Central Bank) carried out by investment service providers increased by 58.2% and amounted to AMD 2 trillion 791 billion. Again, almost all repo transactions involved government securities. Repo transactions with corporate bonds constituted a mere 0.1% in total.

In 2014, the total volume of securities trades and repo operations in regulated market amounted to AMD 75.5 billion, with securities trades constituting 97.0% in total.

In the regulated market, transactions with shares comprised the prevailing part, 45.0%, in the structure of securities trades and repo transactions. The trades with government and corporate securities constituted, respectively, 38.4% and 16.9% in total.

The share of regulated market in the structure of securities trades by investment service providers has been 13.1% since the beginning of the year.

³² As of 31.12.2014, investment service providers included 21 commercial banks, 8 investment companies and 4 investment fund managers.

³³ 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.

At the end of 2014, the Securities Market Capitalization/GDP ratio was 1.6%, up by 0.2 percentage point against the end of the previous year. The Securities Market Gross Turnover/GDP ratio stood at 12.2%.

The share of 3 and 5 largest issuers by capitalization, 2010 – 2014 (%)

Period	Capitalization of the 3 largest companies (%)	Capitalization of the 5 largest companies (%)
31.12.2010	80.1	94.7
31.12.2011	83.8	96.6
31.12.2012	78.8	96.2
31.12.2013	79.8	96.7
31.12.2014	86.5	97.2

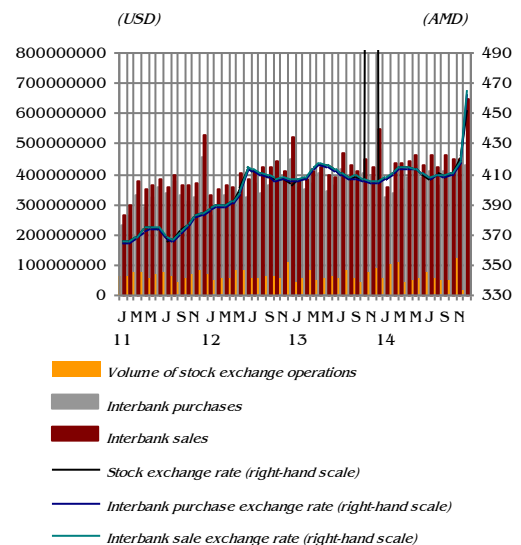
3.2. FOREIGN EXCHANGE MARKET

During the first three quarters of 2014, the Armenian dram/ U.S. dollar exchange rate did not see major fluctuations. However, in the fourth quarter, in light of sharp fall in money transfers from abroad, especially from main partner countries of Armenia, the Armenian dram devaluated sharply against the US dollar. As a result, the average quarterly AMD exchange rate versus the U.S. dollar depreciated by 5.9% against the same reference period last year. The average quarterly AMD exchange rate appreciated versus Euro by 2.6% and versus the Russian ruble by 36.7%.

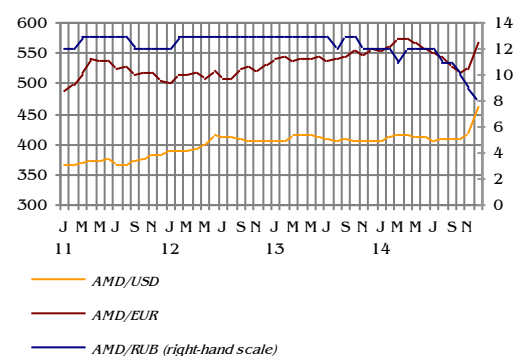
The real effective exchange rate of Armenian dram appreciated, due to foreign currency inflow reductions and main partner countries' currency depreciation against the US dollar. In the fourth quarter of 2014, compared to the same reference period of the last year, the real effective exchange rate appreciated by 9.3%. This was mainly caused by quick pace of partner countries' nominal effective average exchange rate depreciation, especially of Russian ruble. In the fourth quarter, the average nominal effective exchange rate of Armenian dram appreciated by 11.7% compared to the same period of the previous year³⁴.

³⁴ 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).

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



Exchange rates in exchange market of Armenia (AMD)



Source: Central Bank of Armenia.

SUMMARY

During the first nine months of 2014, the CBA continuously lowered the refinancing rate. At the end of 2014, in the foreign currency market an exchange rate adjustment was implemented resultant from Armenia's economy fundamentals in dram depreciation direction. In the fourth quarter, for price and financial stability, the CBA implemented tight monetary policy, affecting short-term market rates.

Under these circumstances, the bond yields arose in the long term, along with growing instability in financial markets in the long term. This had its negative impact on incomes of commercial banks from securities portfolio.

Nevertheless, along with return of the economy to normal situation and after the neutralization of unprecedented monetary actions implemented in the end of the year, the short-term market rates are expected fall further³⁵, approaching the refinancing rate and thus contributing to the stability in the financial market.

³⁵ On March 24 2015, the CBA council decided to lower the Lombard rate to 12.0%, thus establishing it at its usual 1.5pp. difference from the refinancing rate.

4. STABILITY OF FINANCIAL INSTITUTIONS OF ARMENIA

In 2014, the financial sector credit-to-GDP ratio has increased by 6.3 percentage point to 49.1% while the assets-to-GDP ratio by 6.7 percentage points to 83.8%. Armenia's banking sector accounts for 90% 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 shares of insurance and securities market participants and other players of the financial market remain small enough in comparison with the banking sector, so their impact on the financial stability is negligible.

4.1. COMMERCIAL BANKS

Banking system stability map

The banking system stability map provides a general understanding of the behavior of the banking system stability, reflecting the change of indicators of banking risks relative to the previous period.

In the fourth quarter of 2014, relative to the fourth quarter of 2013, the elements of the stability map³⁶ incurred some changes, mainly due to negative changes of some indicators of the banking system in the fourth quarter of 2014 (for details, please see subsections "Credit risk", "Liquidity risk", "Market risk", "Capital adequacy and Profitability").

4.1.1. Financial intermediation and concentration

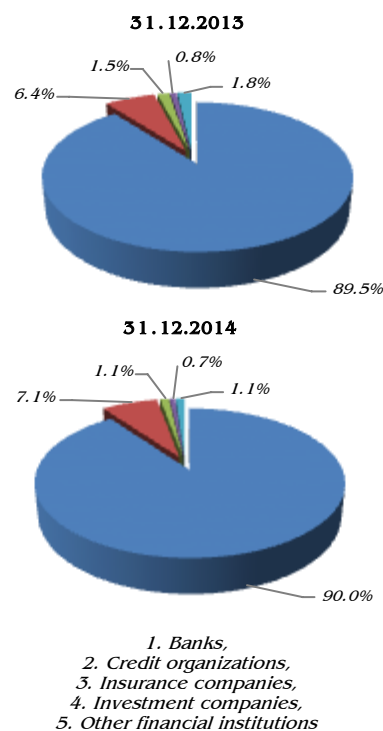
In 2014, growth rates of main indicators of the banking sector surpassed nominal GDP growth rate. As a result, main indicators of banking intermediation have increased, except for the Deposits-to-GDP ratio. Compared to the previous year, ratios such as Banking sector assets-to-GDP, Credits-to-GDP and Broad money-to-GDP have improved by 6.4, 5.7 and 0.9 percentage points to 75.4%, 45.8% and 37.4%, respectively. The deposits-to-GDP ratio has dropped by 0.2 pp. to 35.5%.

In the period under review, total capital of the banking sector grew by 2.9% (AMD 13.1 billion) while total assets by 15.9% (AMD 467.2 billion). As a result, the total capital to

³⁶ 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.

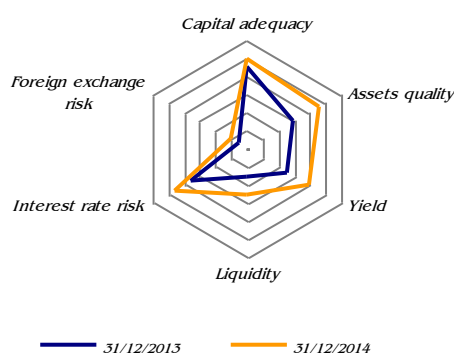
The financial system is still bank-dominated

The structure of financial system assets, by financial institutions



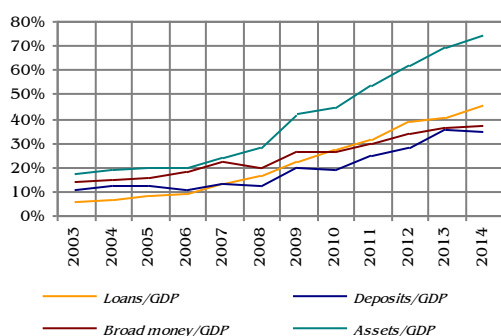
Source: Central Bank of Armenia.

Banking system stability map

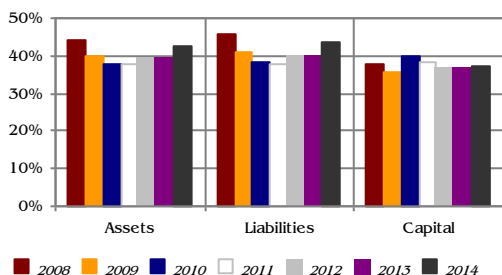


Source: Central Bank of Armenia.

Financial intermediation

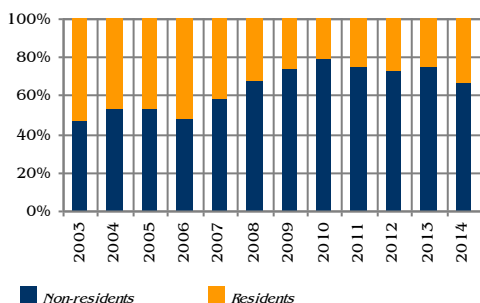


Share of 4 largest banks' assets, liabilities and capital in total banking system



Source: Central Bank of Armenia.

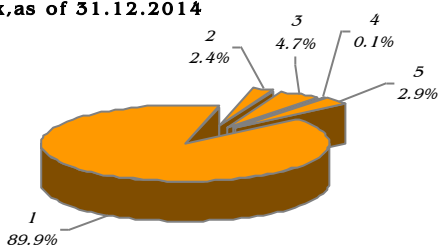
Foreign investors' participation in banking system capital of Armenia



Source: Central Bank of Armenia.

Credit risk is considered as the most important risk to the financial stability.

The structure of risk weighted assets calculated in banking system capital adequacy index, as of 31.12.2014



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

Source: Central Bank of Armenia.

assets ratio (the leverage ratio) has decreased by 1.7 percentage point to 13.8%. The growth of total capital was largely due to net profit of AMD 21.2 billion. During the year, 8 banks replenished the statutory capital by a total of AMD 27.1 billion to, AMD 10.1 billion of which was replenished from external sources. Non-resident participation in the statutory capital of the banking sector has reduced by 8.1 percentage points to 66.5% due to changed residency status resulting from a shift in a center of economic interest of a bank shareholder.

The Herfindahl-Hirschman Concentration Index

Indicators	31.12.11	31.12.12	31.12.13	31.12.14
Total assets	0.0775	0.0787	0.0699	0.0728
Total liabilities	0.0792	0.0705	0.0727	0.0751
Total capital	0.0644	0.0637	0.0613	0.0627

Source: Central bank of Armenia.

The Herfindahl-Hirschman Index of Concentration³⁷ for main balance sheet items (assets, liabilities, total capital) 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 year, the share of assets, liabilities and total capital of 4 largest banks out of 22 banks³⁸ in Armenia has increased by 3.4, 4.0 and 0.6 percentage points to 42.7%, 43.8% and 37.1%, respectively.

4.1.2. Credit risk

Credit risk remains the most important risk to the financial stability of Armenia's banking sector. The share of credit risk in risk-weighted assets of commercial banks accounts for 89.9% (as of 31.12.2013, it was at 91.2%). In this context, credit risk prudent management is extremely important.

During 2014, loans to economy granted by the banking system grew by 21.3%. Growth of credit was reported for almost all sectors of the economy, except for transport and communication, where loans contracted by 2.5%. At the end of the year, the shares of consumer loans, industry and trade credits were large in total loan portfolio, making up 21.2%, 20.3% and 18.2%, respectively.

Relative to the previous year, the share of non-performing loans and receivables (classified as "watched", "substandard", and "doubtful") has grown by 2.2 percentage

³⁷ The Herfindahl - Hirschman Concentration Index varies between 0 and 1, characterizing the level of concentration (values near 0 denote lower concentration).

³⁸ There are 21 commercial banks and one development bank (Pan Armenian Bank JSC) functioning in the Republic of Armenia.

points to 6.4% of total loans and receivables. 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 increase in the share of non-performing loans and receivables.

During the year, the shares of non-performing loans were somehow larger in loans to construction, agriculture and trade sector, which grew by 8.9, 3.0 and 2.8 percentage points to 17.2%, 5.5% and 6.6%, respectively. As a result, the share of non-performing loans of these sectors added to the growth of total non-performing loans in the banking system. Compared to the previous year, the shares of non-performing loans in construction, agriculture and trade sector in total non-performing loans grew by 3.2, 1.3 and 0.6 pp. and stood at 14.7%, 4.4% and 17.5%, respectively.

As calculated according to the international standards³⁹, the share of non-performing loans and receivables in total loan and receivables portfolio has grown by 2.7 percentage points relative to the previous year and amounted to 10.0%. Relative to the previous year, the net loan loss provisions-to-assets ratio has increased by 1.0 percentage point to 2.2%.

The Herfindahl-Hirschman sectorial concentration index for banking lending to economy has decreased by 0.01 point to 0.11, which points to some concentration of loans in the banking system. The same indicator calculated using the banks' average was 0.18, increasing by 0.1 pp. The indicator of banks' average is higher in comparison with the banking system lending sectorial concentration index and this is an indication of relatively high sectorial concentration of loan portfolios in some banks. The share of loans made to large borrowers has increased by 0.7 percentage point to 25.9% of total loan portfolio at the end of the year relative to the same period of the previous year⁴⁰.

Credit risk stress scenarios⁴¹

31.12.2014	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 28.0 billion or 0.2% of regulatory capital of the banking system	AMD 10.4 billion or 2.3 % of regulatory capital of the banking system	AMD 62.8 billion or 12.2% of regulatory capital of the banking system
Total capital adequacy of the banking system in case of stress scenario	13.7%	14.2%	12.7%

Source: Central Bank of Armenia.

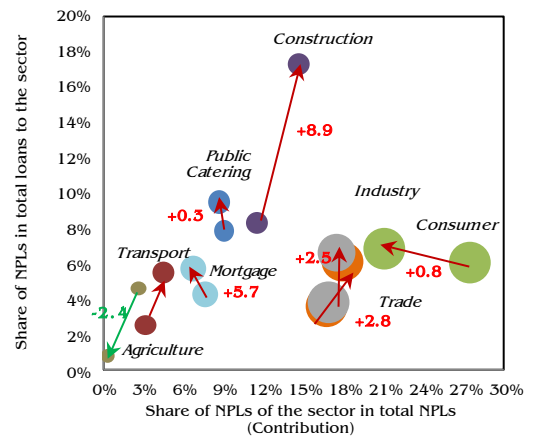
³⁹ According to the international methodology, the share of non-performing loans and receivables in total loan and receivables portfolio is calculated as the ratio of loans and receivables classified "substandard", "doubtful" and "loss" to total loans and receivables.

⁴⁰ The bank's risk on large borrowers exceeds 5% of average monthly regulatory total capital, considering the interdependence.

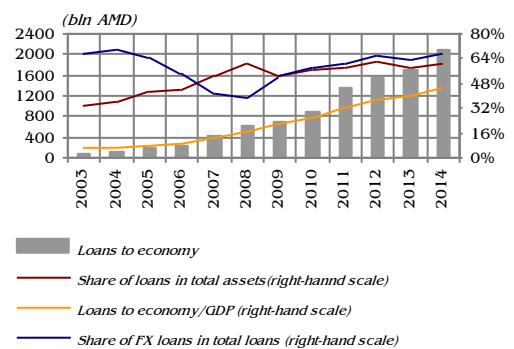
⁴¹ This and further stress scenarios are not forecasting emergence of any risks, but rather are aimed to reveal the weaknesses of the financial system, as well as to assess its ability to absorb such risks.

The change of the share of NPLs in the loans to different sectors of economy

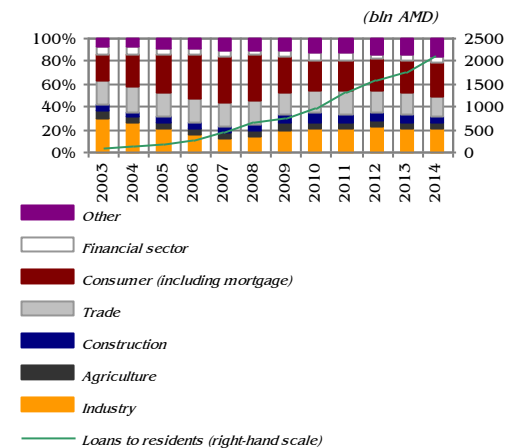
(The end of the arrow shows data as of 31.12.2014 the beginning - as of 31.12.2013)



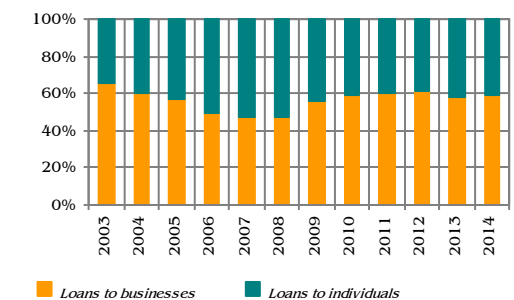
Loans to economy



Structure of bank loans to residents, by economy sectors

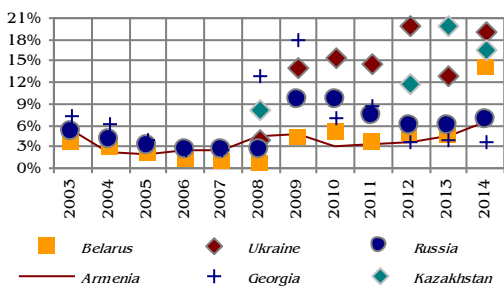


Share of loans to the businesses and individuals in total loan portfolio



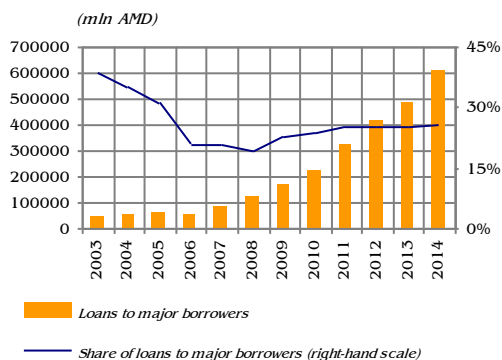
Source: Central Bank of Armenia.

Share of non-performing loans in total loan portfolio



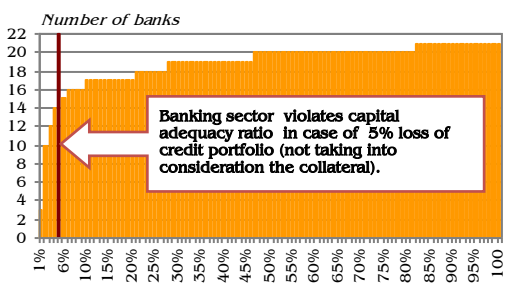
Source: IMF.

Loans to major borrowers/total loans



Source: Central Bank of Armenia.

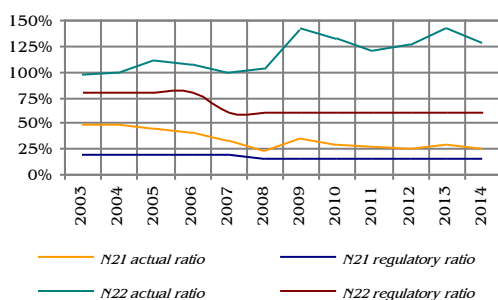
The number of banks violating capital adequacy regulatory ratio under dynamic growth of loan losses



Source: Central Bank of Armenia.

The liquidity of commercial banks diminished.

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



Source: Central Bank of Armenia.

There has been some worsening in the results of credit risk stress test compared to the previous year, which was attributable to the loan portfolio impairment, as compared to the stress tests conducted at the end of 2013. 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 12.0%, 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

31.12.2014	Stress scenarios
	When 50% of off-balance sheet contingent liabilities performed
Banking system capital adequacy ratio before stress scenario	14.5%
Banking system capital adequacy ratio in case of stress scenario	14.3%

Source: Central Bank of Armenia.

The results of stress scenario of credit risk derived from off-balance sheet contingent liabilities⁴² 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 arising from off-balance sheet contingent liabilities on financial stability is estimated to be insignificant.

4.1.5. Liquidity risk

In 2014, the level of liquidity of commercial banks somewhat diminished. Relative to the end of the previous year, prudential ratios of total liquidity and current liquidity have decreased by 3.9 and 12.9 percentage points to 25.1% and 129.4% (with minimum thresholds of 15.0% and 60.0%), respectively. Prudential ratios of total liquidity and current liquidity for Group 1 foreign currencies have reduced by 4.2 and 17.6 percentage points to 17.8% and 97.3% (with minimum thresholds of 4.0% and 10.0%), respectively. Regarding each bank individually, total liquidity and current liquidity prudential ratios were in line with regulatory requirements, so no infringement of such liquidity indicators by any bank has been reported.

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 were 92.3%, 89.3% and 81.5% (as of 31.12.2013, these were 108.6%, 101.6% and 88.7%),

⁴² Off - balance sheet contingent liabilities include unused part of credit lines, credit cards, overdrafts, L/Cs, guaranties and sureties.

respectively⁴³. Considerable negative liquidity gap persists only in the up to 1-year cumulative time horizon, which is due to increased maturity of loans along with deepening of 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 of 90% to 110%, pointing to the banks' ability to provide current liquidity all the time.

In 2014, risks to debt concentration of commercial banks have reduced: the share of large liabilities in total liabilities has contracted by 1.7 pp. to 24.5%.

Relative to the previous year, foreign borrowings of commercial banks have increased by 31.2%. Funds attracted from international financial institutions have reduced by 1.2% to 30.4% of total foreign borrowings. The main lender countries included Russia (19.1%), Netherlands (11.7%) and Luxemburg (9.5%). The share of long-term loans amounted to 80.5%, which almost excludes risks related to refinancing of such liabilities in a short-term horizon.

From the loans' financing sources stability perspective, relative to the previous year, the loans to deposits ratio has increased by 16.9 percentage points to 129.2% at the end of the year⁴⁴.

Liquidity risk stress scenarios

31.12.2014	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	19.5%	21.3%	15.0%
Current liquidity ratio of banking system	93.0%	138.7%	90.7%

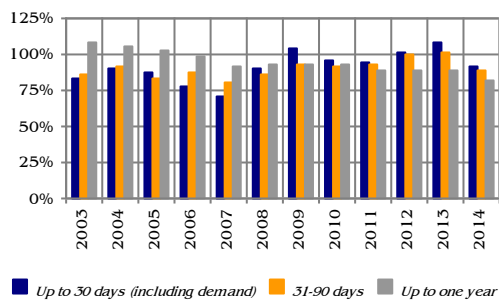
Source: Central Bank of Armenia.

Relative to the results of liquidity risk stress tests conducted at the end of the previous year, there has been some worsening in the results of stress tests, which was attributable to the decrease in the general level of liquidity in commercial banks. 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 the simulated outflow of liabilities. In this context, the emergence of liquidity problems undermining financial stability is estimated to be negligible.

⁴³ The calculation of ratios of assets and liabilities includes off-balance sheet contingent liabilities by a 20% weight.

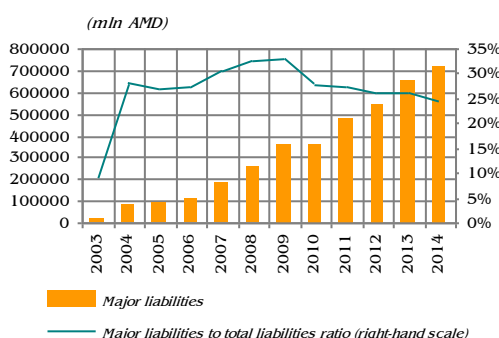
⁴⁴ In the calculation of this ratio, loans include loans (lease and factor operations inclusive) to real sector, while deposits include funds attracted from individuals and companies.

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

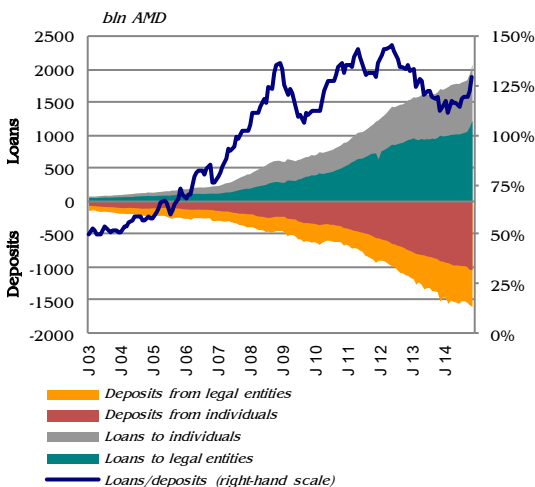


Source: Central Bank of Armenia.

The ratio of banking system major liabilities to total liabilities

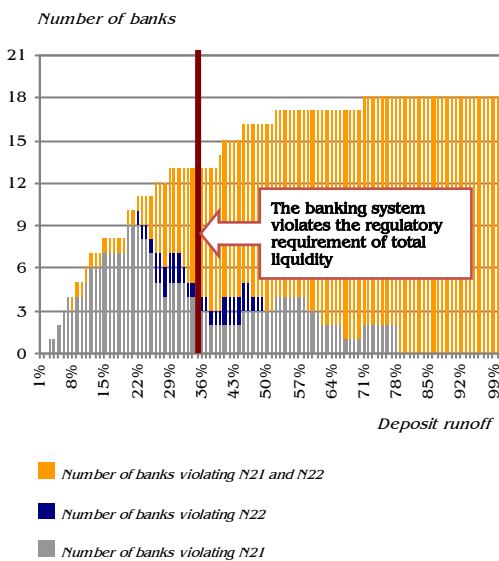


The structure of funds financing loans of banking system of Armenia



Source: Central Bank of Armenia.

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

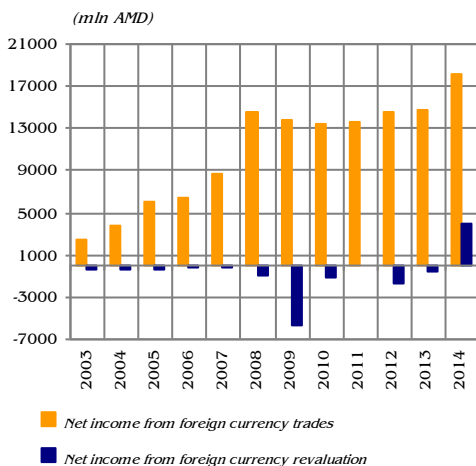
31.12.2014	Stress scenarios
	When 50% of off-balance sheet contingent liabilities performed
Banking system total liquidity ratio	21.6%
Banking system current liquidity ratio	111.1%

Source: Central Bank of Armenia.

According to the results of stress tests 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.

The probable influence of market risk on the financial stability is estimated to be low.

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



Source: Central Bank of Armenia.

4.1.4. Market risk

Foreign exchange risk

In 2014, the Armenian dram exchange rate fluctuations against other currencies drove the domestic banking system to revaluation gains reaching AMD 3.9 billion or 0.9% of total regulatory capital. Because of foreign currency revaluation, 13 banks incurred losses and 9 banks reported profit. The banking system generated net revenue of AMD 18.2 billion from foreign exchange transactions.

During the year, the share of foreign currency loans has grown by 3.7 percentage point to 67.4% of total loan portfolio. The share of foreign currency deposits has increased by 1.7 percentage points to 72.6% of total deposit portfolio. The banking sector's foreign currency net short position (including derivatives) amounted to AMD 25.8 billion or 5.7% 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)⁴⁵.

If worst possible stress scenarios reviewed in the above stress test⁴⁶ 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.

⁴⁵ Derivative instruments include the derivative contracts signed for long-term deposits with foreign governments, central (national) banks, financial organizations and international prestigious institutions that are rated A + (A1) or higher than A+ (A1) by Standard & Poor's or Fitch (Moody's).

⁴⁶ 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 31.12.2014.

Foreign exchange risk stress scenarios

31.12.2014	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 1.4 billion or 0.3% of regulatory capital (AMD – 1.4 billion)	AMD -49.6 million or 0.01% of regulatory capital (AMD 49.6 million)	AMD 730.5 million or 0.2% of regulatory capital

Source: Central Bank of Armenia.

Interest rate risk

In 2014, a trend of rise in interest rates of deposits and slight fall in loan interest rates was marked. By currency structure, average weighted interest rate of loans in Armenian dram increased by 0.3 pp. whereas average weighted interest rate of loans in U.S. dollar declined by 0.5 pp. The average weighted interest rate of deposits in Armenian dram increased by 0.2 pp. whereas average weighted interest rate of loans in U.S. dollar remained unchanged. Overall, the spread of interest rates of deposits and loans in AMD have increased by 0.1 pp. while the spread of interest rates of deposits and loans in USD decreased by 0.5 percentage point.

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

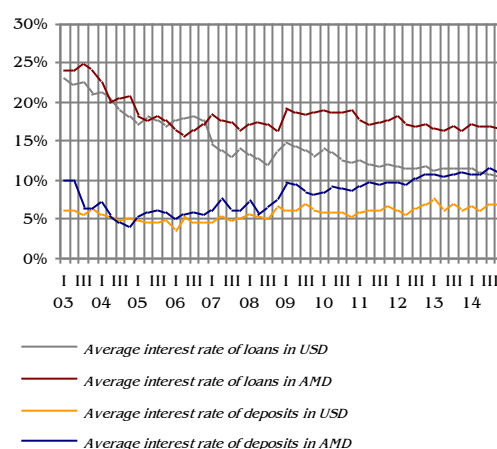
Interest rate risk stress scenarios

31.12.2014	Impact of 2 pp. 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 interest, estimated through the "Interest rate-sensitive assets and liabilities Gap Method"
Banking system's profit/loss	AMD -11.6 billion or 2.6% of banking system capital (AMD 11.6 billion or 2.6% of banking system capital)	AMD -1.2 billion or 0.2% of banking system capital (AMD 1.2 billion or 0.2% of banking system capital)

Source: Central Bank of Armenia.

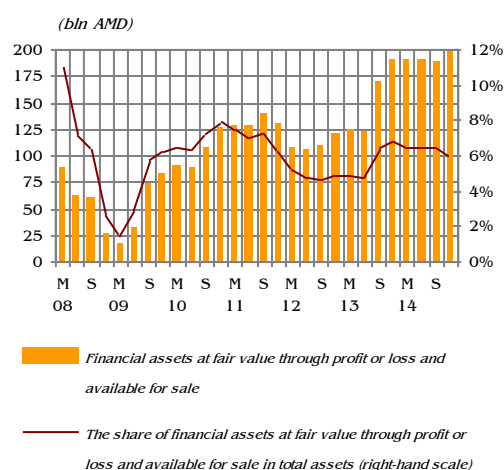
In case of worst possible stress scenarios, possible losses of banks resulting from interest rate fluctuations are in the region of 4.2% of capital. This implies that losses of the banking system resulting from interest rate fluctuations neither will be significant nor will cause vulnerabilities to financial stability.

Average interest rates of bank deposits and loans



Source: Central Bank of Armenia.

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



Source: Central Bank of Armenia.

Price risk

In 2014, 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 0.8 percentage point to 6.0% of total assets.

Given the 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 during the year was AMD 704.0 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 borrowers' creditworthiness. Such restrictions significantly lower the possibilities of loan losses from real estate price volatilities.

If the stress scenario of 30% depreciation of real estate price unfolds, maximum potential losses of commercial banks associated with price and credit risks tend to increase, which is mainly attributable to the real estate secured lending growth rate increasing faster than the total regulatory capital and to increase in the loan-to-value ratio.

Real estate price change stress scenarios

30% depreciation of real estate	31.12.2014
The banking system's loss due to revaluation of own real estate property (<i>price risk</i>)	AMD 13.3 billion (or 3.0% of banking system capital)
The banking system's loss due to a 30% loss of vulnerable credit portfolio ⁴⁷ (taking into consideration that the collateral involved has been sold at a depreciated cost), if a stress-scenario occurs (<i>credit risk</i>)	AMD 11.6 billion (or 2.6% 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 (<i>credit risk</i>)	AMD 38.6 billion (or 8.5% of banking system capital)

Source: Central Bank of Armenia.

However, real estate price fluctuations are not high (taking into account the last 2-3 years' developments) and the impact of credit and price risks to financial stability is assessed non-vulnerable.

⁴⁷ *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.*

4.1.5. Capital adequacy and profitability

In 2014, commercial banks' total capital adequacy ratio fell by 2.2 percentage points to 14.5%, which was driven by the loan portfolio's fast growing rate and loan portfolio impairment. In the period under review, individual banks kept their total capital adequacy prudential indicators in compliance with established requirements, so no bank reported breaches of capital adequacy standards.

Total regulatory capital of commercial banks has grown by 5.6% to AMD 452.4 billion relative to the previous year. The share of tier 1 capital has increased by 0.9 percentage point to 87.5% of total regulatory capital. This ratio points to a strong risk absorption capacity of regulatory capital in commercial banks.

In 2014, net profit of the banking system, calculated in accordance with the Central Bank supervisory reports⁴⁸, amounted to AMD 21.1 billion, with 16 banks reporting profit and 6 banks incurring losses. Compared with the last year, return on assets (ROA) and return on equity (ROE) ratios of the banking system have fallen by 0.7 and 4.6 percentage points to 0.7% and 4.5%, respectively. The decrease in banking system ROE was driven largely by the decrease of ROA, while the leverage ratio did not affect ROE.

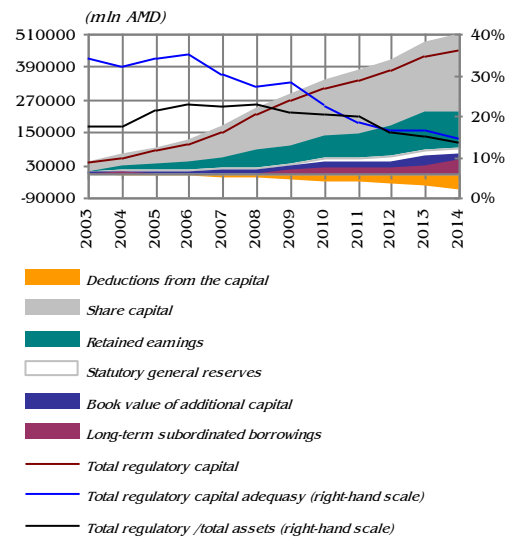
The return on assets decreased mainly due to 1.0 pp. growth of net provisioning to assets as a result of fall in loan portfolio quality, as well as 0.2 pp. decrease of net interest margin as a result of income spread narrowing. The 0.2 pp. increase of non-interest income/assets ratio and 0.2 pp. decrease of non-interest expense/assets influenced positively the return on assets.

The shares of interest income, interest expense and non-interest expense decreased in the banking system income and expenditure structure, while the shares of non-interest income, assets loss provisions and recoveries increased. These structural changes are mainly due to increase of net provisioning occurred because of fall in loan portfolio quality, as well as relatively high volatility of non-performing loans ratio.

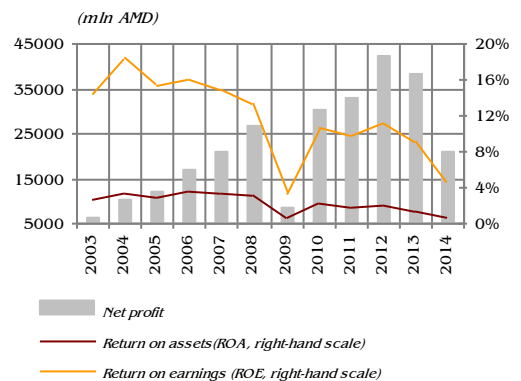
The banking system net profit, calculated in accordance with International Financial Reporting Standards (IFRS), amounted to AMD 25.8 billion, while the return on assets (ROA) was 0.8 percent and return on equity (ROE) 5.2 percent.

The capital adequacy of commercial banks is sufficient.

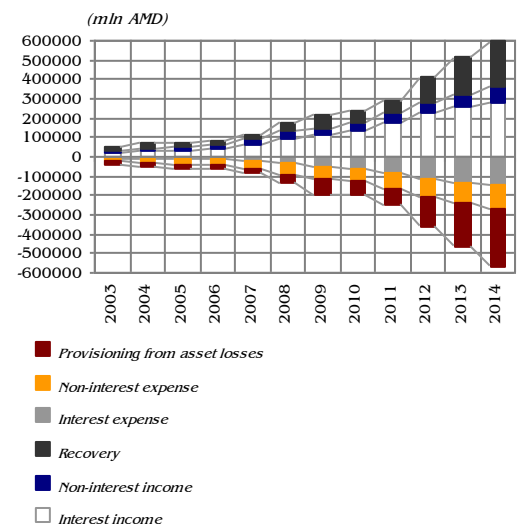
The structure of total regulatory capital



Profitability ratios of the banking system



Incomes and expense of banking system



Source: Central Bank of Armenia.

⁴⁸ This differs from IFRS mainly on the part of loan loss provisioning for standard assets.

4.2. CREDIT ORGANIZATIONS

Credit organizations represent the second largest sector of Armenia's financial system, with their assets making up 7.1% of entire financial system. During the year, 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	209,841,599	269,156,880	28.3%
Liabilities	132,243,167	159,508,741	20.6%
Capital	77,598,432	109,648,139	41.3%
Net profit	5,852,591	9,861,000	68.5%

Source: Central Bank of Armenia.

In 2014, total capital of credit organizations demonstrated growth rate outpacing that of total assets by 13.0 percentage points. As a result, the total capital-to-assets ratio (leverage ratio) has increased by 3.8 percentage points to 40.7%.

Net profit of credit organizations, calculated in accordance with the Central Bank supervisory reports, amounted to AMD 9.9 billion. During the year, 29 credit organizations posted profit, 3 reported losses. The return on assets (ROA) and return on equity (ROE) of credit organizations have increased by 1.0 and 2.2 percentage points relative to the previous year to 4.1% and 10.3%, respectively.

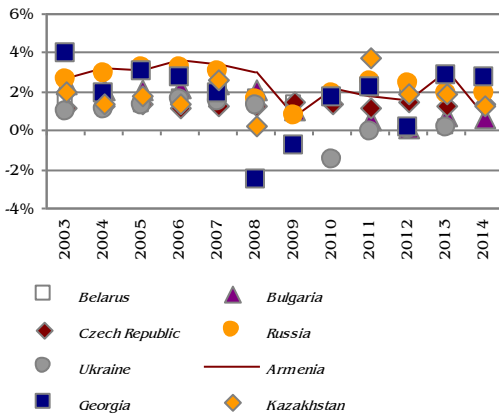
Profit of credit organizations, calculated in accordance with International Financial Reporting Standards (IFRS), totaled AMD 7.9 billion, with return on assets (ROA) and return on equity (ROE) having reached 3.1% and 7.6%, respectively.

During the year, the share of non-performing loans and receivables has grown by 1.3 percentage point to 5.1% of total loans and receivables. The share of non-performing loans and receivables is relatively high in consumer loans, mortgage loans and loans to public catering and other service sectors, amounting to 14.2%, 12.5% and 8.4%, respectively.

The share of non-performing loans and receivables, classified as "substandard", "doubtful" and "loss" and calculated by international methodology, increased by 0.5 percentage point and reached 5.4%. Relative to the previous year, the ratio of net provisions to total assets has reduced by 0.9 pp. to 0.6%.

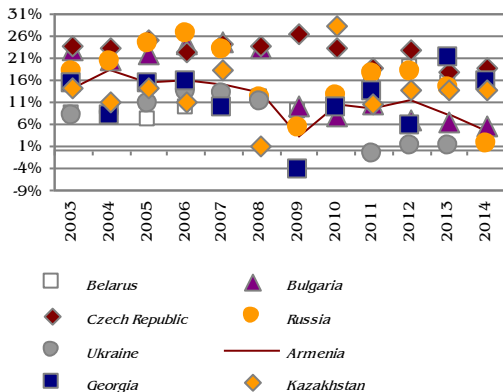
In all maturity time bands of assets and liabilities (up to 180-days (including demand instruments), from 180-days to 1-year, more than 1-year), the amount of assets was in excess of the amount of liabilities. This is a clear indication, ceteris paribus, that the level of liquidity risk of credit organizations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

Banking system ROA in selected East European and CIS countries



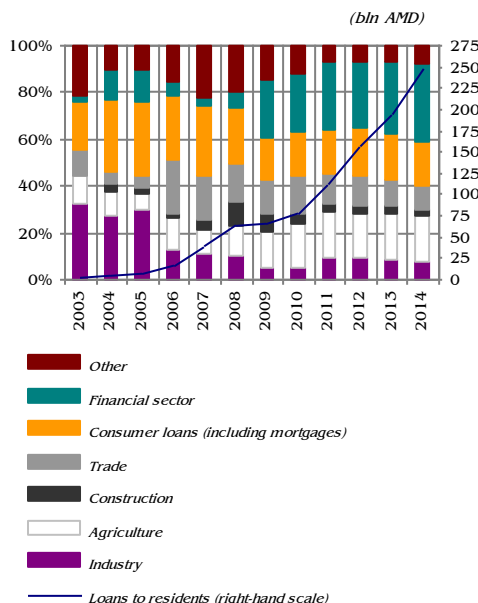
Source: IMF.

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.

Credit risk assessment scenarios⁴⁹

31.12.2014	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 2.5 billion or 2.3% of regulatory capital	AMD 534.9 million or 0.5% of regulatory capital	AMD 4.9 billion or 4.6% of regulatory capital

Source: Central Bank of Armenia.

Capitalization of credit organizations is stronger than that of banking sector, and according to various stress scenarios, credit organizations are fully capable to absorb potential risks.

4.3. INSURANCE COMPANIES

At the end of 2014, there were eight insurance companies licensed to perform insurance business in the Republic of Armenia⁵⁰.

In 2014, the amount of assets of insurance companies has reduced by 13.2% to AMD 43.4 billion and the amount of liabilities decreased by 18.7% to AMD 27.7 billion. Total capital has reduced by 1.3% to AMD 15.8 billion. During the year, relative to the same reference period last year, the amount of accrued premiums, the main indicator of insurance activity, has plunged by 15.8% to AMD 30.1 billion (the growth of this indicator in the previous year was 1.0%).

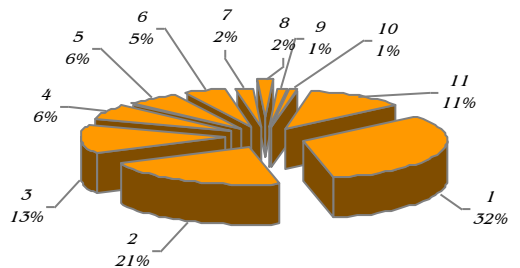
The premiums to GDP ratio, another key indicator of insurance companies, was 0.67% at the end of the year, which had fallen by 0.16 percentage point in relation to 2013⁵¹. In December 2014, the premium per capita ratio was AMD 9,982 versus AMD 11,850 reported in December 2013. The decrease in key indicators of insurance companies' activity is explained by the fact that they no longer insure government employees in 2014. Instead, this year the Ministry of Finance of Armenia has transferred the health insurance contributions to the Ministry of Healthcare of Armenia, which provides for the state employees since 2014.

⁴⁹ Stress scenarios are built on an assumption that the amounts of loans of credit organizations are unchanged and the secured property is ignored (which means when loans are classified as loss, a possible sale of the collateral is not considered).

⁵⁰ As of 31.12.2014, this section collates indicators of 8 insurance companies active and reportable, since one company, although duly licensed, does not carry out insurance activities.

⁵¹ 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 market countries (source: Swiss Re, Sigma No 3/2014, May 2014).

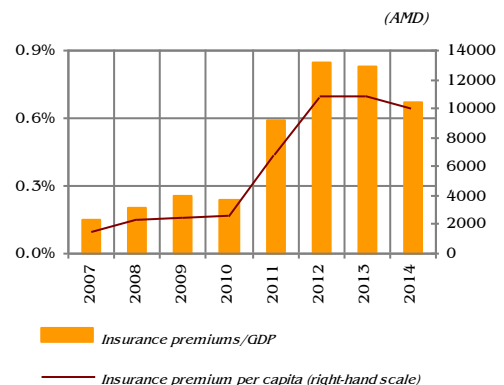
Insurance sector assets, as of 31.12.2014



1. Deposits with banks, 2. Government and non-government securities (including securities sold under repo agreements), 3. Sums receivable on direct insurance, 4. Reinsurers' share in insurance reserves, 5. Fixed assets, 6. Costs for future periods and prepayments on insurance, 7. Cash and Bank accounts, 8. Subrogation claims, 9. Borrowings, 10. Claims on compensation, 11. Other assets

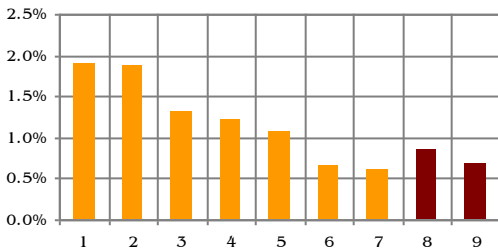
Source: Central Bank of Armenia.

Main ratios of insurance sector of Armenia



Source: Central Bank of Armenia.

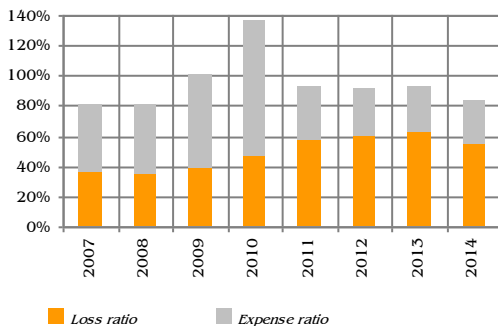
Insurance premium/ GDP in EEC and CIS (2013)



1. Georgia, 2. Ukraine, 3. Turkey, 4. Russia, 5. Romania, 6. Azerbaijan, 7. Kazakhstan, 8. Armenia -2013, 9. Armenia - 2014

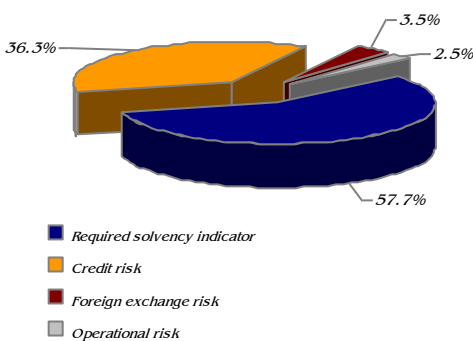
Source: Central Bank of Armenia, Swiss Re, Sigma No 3/2013.

Loss and expense ratios of Insurance sector



Source: Central Bank of Armenia.

The share of risk weighted assets and required solvency in insurance sector capital adequacy ratio, as of 31.12.2014



Source: Central Bank of Armenia.

In 2014, the loss ratio of insurance companies has reduced by 8.5 percentage points to 53.7%⁵². The reduction came along with insurance companies' expense ratio⁵³ having dropped by 0.9 percentage point in relation to the previous year to 29.4%. This may well point to an increased operational effectiveness of insurance companies.

The shares of risk-weighted assets and required solvency in the insurance sector's capital adequacy ratio were 42.3 percent and 57.7 percent, respectively. The regulatory capital adequacy ratio of the insurance sector was 195.8% as of 31.12.2014 (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

31.12.2014	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 0.6 billion or 3.6 % of regulatory capital of the sector
Total capital adequacy ratio of the insurance sector, if the stress scenario occurs	186.4%

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.

Credit risk assessment stress scenarios

31.12.2014	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 4.3% of regulatory capital	AMD 1.4 billion or 7.9% of regulatory capital	AMD 0.4 billion or 2.2% of regulatory capital
The total capital adequacy ratio of the insurance sector, if the stress scenario occurs	186.8%	181.2%	189.1%

Source: Central Bank of Armenia.

⁵² 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).
⁵³ The expense ratio was calculated using the following formula: non-interest expense / (earned insurance premiums - sums refunded on the contracts terminated).

The results of the stress tests of credit risk assessment 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.

*Foreign exchange risk assessment stress scenarios*⁵⁴

31.12.2014	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 26.3 million or 0.1% of regulatory capital (AMD -26.3 million)	AMD 0.7 million or 0.004% of regulatory capital (AMD -0.7 million)	AMD 168.1 million or 0.7% 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.

Liquidity risk assessment stress scenario

31.12.2014	Stress scenarios
	Sharp increase of outstanding claims reserves, 25%
Required growth of outstanding claims reserves when the stress scenario occurs	AMD 0.4 billion or 2.2% of regulatory capital
Liquidity of insurance companies when the stress scenario occurs	361.4%

Source: Central Bank of Armenia.

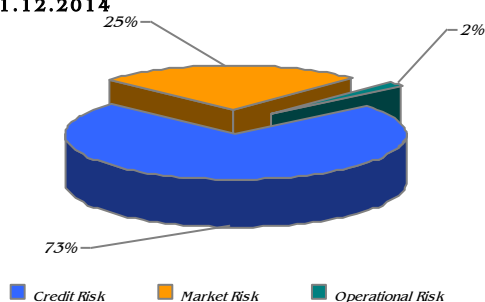
Overall, the share of insurance sector in the financial system remains small. Risks to insurance companies are controllable and non-vulnerable in the financial stability point of view.

4.4. SECURITIES MARKET PARTICIPANTS

As of December 2014, there were 21 banks providing investment services and 8 investment companies in the securities market of Armenia. Also 4 investment fund managers are registered in the financial market of Armenia, two of which are entitled to run a mandatory fund and two a voluntary pension fund.

⁵⁴ 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.

The structure of assets in the capital adequacy ratio of investment companies as of 31.12.2014



Source: Central Bank of Armenia.

In 2014, relative to previous year, total assets of investment companies have decreased by 6.0% and amounted to AMD 25.4 billion, and total capital has reduced by 4.6% to AMD 4.9 billion. Total profit of investment companies has been AMD 1.1 billion. During the year, six companies posted profit and two incurred losses.

As of 31.12.2014, credit risk of investment companies accounted for 73.0% of risk-weighted assets, market risk constituted 25.3% and operational risk, 1.7%. Remarkably, interest rate risk had the largest share in market risk of investment companies (76.4%), while foreign exchange and share price risks constituted, respectively, 20.4% and 3.2%. The capital adequacy of investment companies is much higher than the required minimum level, so the abovementioned risks are manageable.

24 classes of securities of 15 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 34.0% of total issuance of securities, while the share of bonds issued by four financial institutions was 54.0% of total issuance of bonds. Total amount of shares was AMD 38.9 billion and total amount of bonds, AMD 14.6 billion. Six of these bonds were in foreign currency with their share making up 42.0%.

As of 31.12.2014, there were 2190 registries of nominal security holders and 105222 nominal security owners running registries at the Central Depository of Armenia.

SUMMARY

In 2014, the financial risks remained manageable in the banking sector. However, the dram depreciation occurred in the fourth quarter of 2014 somehow added to the risks to financial stability. In the background of high dollarization of loan portfolio, this sharp depreciation of Armenian dram endangers the loan repayment due to growth of loan burden of business entities and households that receive dram-income. In this context, the banking sector profitability has reduced, due to higher loan loss reserve allocations.

Non-bank financial institutions also underwent business expansion, and the regulatory indicators remained within the required limits.

5. STABILITY OF FINANCIAL MARKET INFRASTRUCTURES

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

In Armenia, over 99 percent of interbank settlements are made via the Central Bank systems⁵⁵.

5.1. INTERBANK PAYMENTS VIA ELECTRONIC PAYMENT SYSTEM OF CENTRAL BANK

In 2014, there were about 3.5 million payments, totaling AMD 11133.4 billion, executed via the Electronic Payment System 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 and remained on a stable low level compared to the previous years. The reduction in the number of payments is due to the sharp decrease in the number of EPS payments starting from October 2013. The target analysis (based on general and target sectors message type (MT) study, budgetary and interbank segments, in particular) has shown that the decrease in the number of payments is due to message type optimization used in the system. In particular, big number of payments are attached to one slip MT message type in budgetary as well as other payments.

After the abovementioned decrease, the number of payments have stabilized during 2014, displaying a rise at the end of the year conditioned by seasonality and economic factors.

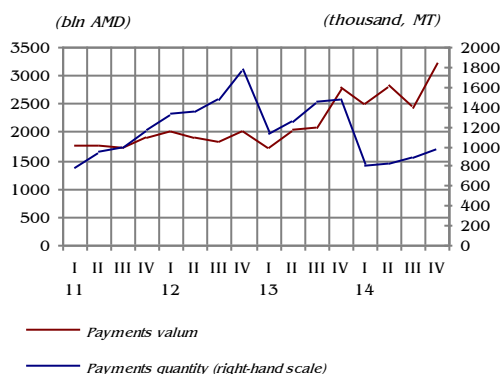
In this context, the reduction in the number of payments results from optimizing the message types used in the system and active use of slip and bulk message types, which somehow replaced single message types applicable in different markets. This contributes to easing of the workload of the system while increasing its efficiency.

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

⁵⁵ Payments via the Central Bank systems involve EPS payments without stock exchange trades, also transactions concerning the CBA indirect monetary instruments, the Central Bank's internal payments, as well as final settlements of ArCa cards system and the cash leg of the transactions of the Government Securities Accounting and Settlement System (GSASS). For details, please see the paper "Payments and Securities Settlement Systems in the Republic of Armenia", 2010.

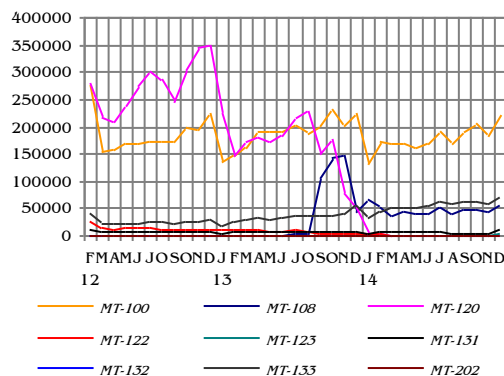
The results of monitoring of the EPS functioning suggest that the system is safe and reliable and does not create problems in terms of stability.

Payments by Electronic Payment System (without exchange market transactions)



Source: Central Bank of Armenia.

The dynamics of payments number by MT



Source: Central Bank of Armenia.

There is no credit risk identified in the EPS.

Credit risk

Credit risk to the settlement bank (i.e. the Central Bank of Armenia) in the system is non-existent since the participant will, in case of insufficient funds with its correspondent account, be able to use an intraday repo instrument, which is secured by government bonds of the Republic of Armenia, securities of the Central Bank of Armenia, and/or high-rated corporate bonds. The size of the attracted fund is calculated using the percentage subtracted from the market value of the bond (haircut). Nor is there credit risk to the recipient as it receives the notice of the payment only after the payment is made final and irrevocable⁵⁶.

Liquidity risk

In 2014 the daily average indicator of own liquidity used for assessment of liquidity risk⁵⁷ have assumed a volatile trend; it declined in the first half of the year but then started to climb. The volatility was due to change in the value of payments⁵⁸. A steady growth was recorded at the beginning of the year, followed by a marked decline in June and a relatively horizontal trend displayed afterwards. The liquidity at the beginning of the day remained stable until the end of the year.

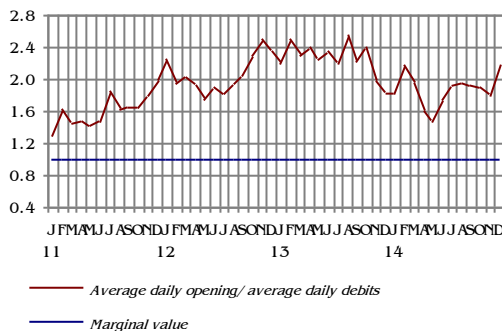
The amendments made in regulatory reserves requirements in December lead to a notable increase of liquidity in AMD correspondent accounts of banks within the Central bank. The value of payments recorded a remarkable increase in the same month, though its growth rate was lower than the increase in the opening liquidity of the day. The aforementioned resulted in a significant increase of the own liquidity indicator's value, having a positive impact on the controlling of liquidity risk in the system.

Regardless of the volatility of the indicator, average opening liquidity of the day continues to exceed the average daily payments, staying markedly above the marginal value of 1.

In assessing the liquidity risk, 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

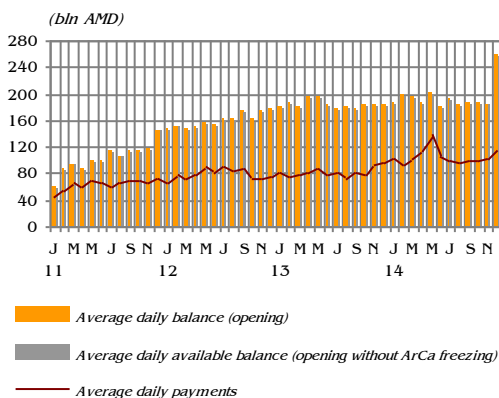
The likelihood of emergence of liquidity risk and systemic problems in the EPS is very low.

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



Source: Central Bank of Armenia.

⁵⁶ For details, please see the "Financial Stability Report", 2007, and the paper "Payments and Securities Clearance and Settlement Systems in the Republic of Armenia", 2010.

⁵⁷ The daily average indicator of own liquidity is 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 banks' payments rejections if additional liquidity is not available within a day, namely to which extent would banks fulfil their payments using only opening balances of their own funds. The calculation does not include cash enhancements through the accounts of commercial banks. The indicator is calculated for a system level (aggregate for all banks), so indicators may vary across commercial banks.

⁵⁸ debits through the accounts including EPS payments and r flow of funds by paperbased orders

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 are important measures for the assessment of the liquidity risk.

The number of rejections due to insufficient liquidity as well as its share in the EPS payments remain negligible – a maximum of 0.4% by value and 0.003% by number.

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 recorded in patterns of intraday distribution of payments.

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

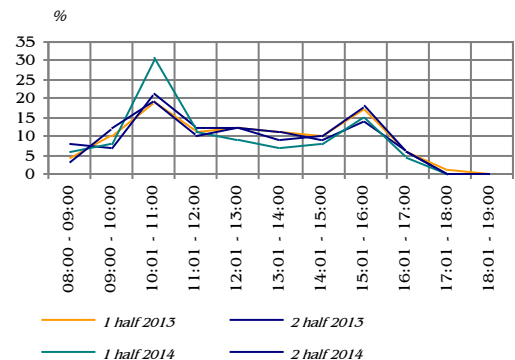
The peak for payments by value remained the same (from 10:00 a.m. to 11:00 a.m.), yet the share has significantly increased during the first half of the year by 10 percentage points to an average 31% of intraday payments. Since no changes in the share at the closing of the day were observed, and the share of payments in the remaining hours contracted instead during H1 2014, the increase of the share in the peak hour contributed to even more unequal intraday distribution of payments by value. During the second half of the year, the hourly distribution of peak hour intervals leveled off, returning to the same level of the previous period, 20.0% of the value of payments.

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 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. The changes of intraday distribution of payments by number was mainly due to the change in the behavior of participants in respect of changes in the message types in the system. Payment concentrations at the closing of the day

The rejections due to insufficient liquidity are negligible, as well.

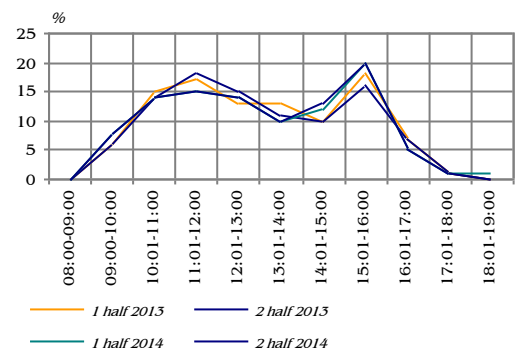
The concentrations during some hours of the day did not cause problems.

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



Source: Central Bank of Armenia.

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



Source: Central Bank of Armenia.

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 the very small share of rejections in total payments (for details, please see the previous subsections), an uneven distribution and concentration of payments during certain hours of the day did not lead to problems in 2014. The likelihood of emergence of risk to the system is generally low.

System capacity

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

The maximum hourly rate was 4917 payments per hour against 5997 payments/hour recorded in 2013. The maximum daily rate of payments has reduced notably to 26349 compared to the peak of 41809 payments/day ratio reported in 2013. The peak hour was recorded in September, from 03:00 p.m. to 04:00 p.m., making up 34% of the number and 27% of the value of the day's payments. It is noteworthy, that the peak hour was during the second half of the day because of technical problems in the system, which, fortunately, was quickly solved. Thus, due to sufficient liquidity of the system the operational day was not prolonged (for details, please see the subsection "Operational availability of the system").

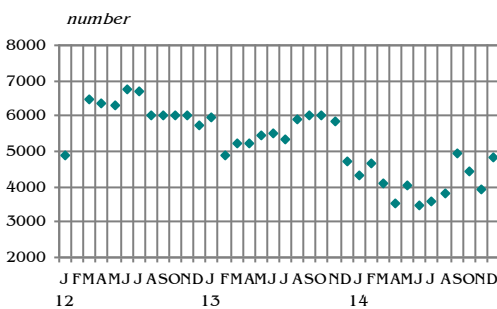
The maximum hourly rates by month have reduced considerably. Though a slight upsurge was recorded in the second half of the year, the overall rate remained at a lower level than in 2013.

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 per hour rate has become very rare. The 2500 payments/hour ratio also decreased. The volatility of the latter during the year is conditioned by the change in the number of EPS payments.

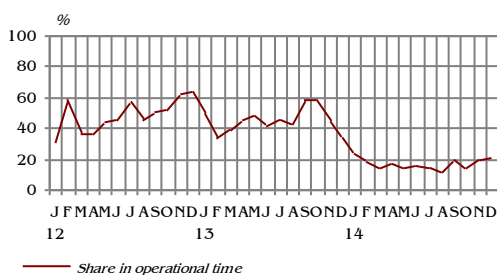
The matching with total payments via EPS shows that an abrupt fall in the marginal indicators was due to the reduced number of total EPS payment messages, which in turn is

During the reported period, the payments per hour decreased. The probability of generating risks to the system capacity is low, overall.

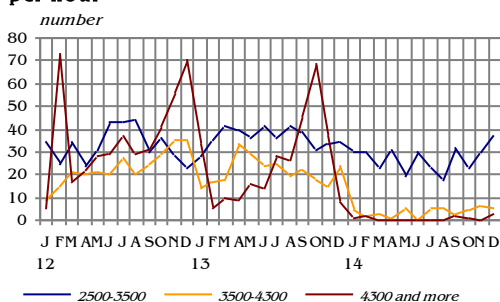
Maximum number of payments per hour, by month



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 payments per hour



Source: Central Bank of Armenia.

driven by optimization of message types applicable in the system. This has a positive impact on the ease of system overload and decreases the emergence of capacity-related risks.

The above system capacity indicators and the results of the target study denote that the hourly peaks were mainly 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 probability of emergence of capacity-related risks is estimated to be low.

Operational availability of the system

The operational availability of the EPS has been 99.7% for the period under review.

The operational availability of the EPS is 99.7%.

In 2014, 4 in some extent significant (with duration of more than 1 hour) incidents affecting the operational availability of the EPS were reported. Two incidents were reported in connection with problems in the electronic message delivery system, as a result settlements were not executed via the EPS during an hour. One of the incidents affected the bid submission of one of the participants in the auction of primary placement of government bonds, though the auction took place within the required timing. In addition, due to the same incident some stock deponation transactions of a number of banks were executed with retardation.

The third incident was related to the failure of EPS messages processing module in "Operational day" system. Because of the failure, no final settlements were done for nearly two and a half hours and stock deponation transactions of four banks were retarded.

The fourth incident, which lasted for 50 minutes, was due to problems occurred in the internal network of the Central Bank. Fortunately, this incident had no negative outcome on other payments.

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

Overall, these cases did not have an important impact on the system thanks to sufficient system capacity. No need to extend the operational day for final settlements arose. The retardations of stock deponation transactions were short and without any impact on the stock transactions.

5.2. SECURITIES ACCOUNTING SYSTEMS

In Armenia, the settlement of securities is done through two frameworks: the corporate securities and state-issued Eurobonds are settled through the Securities Accounting and United Settlement System of the Central Depository of Armenia (hereinafter SAUSS), while the Government and the Central Bank securities are settled through the Government Securities Accounting and Settlement System (hereinafter GSASS).

In 2014, secondary market transactions totaling more than AMD 5689.0 billion were carried out through GSASS (AMD 3894.1 billion in 2013), which represented 1.5 times increase in relation to the previous year. The transactions executed through GSASS accounted for about 97.6 percent of secondary market transactions executed totally via securities settlement systems (98.0% in 2013). In the financial stability point of view, GSASS remains a systemically important system.

Transfers of securities through the Government Securities Accounting and Settlement System of the Central Bank pertaining to the operations with securities in the secondary market⁵⁹

	2013	2014
OTC operations (trades, repo and reverse repo) related transactions in nominal value, AMD million	3879351.8	5656738.4
Stock operations (trades) related transactions in nominal value, AMD million	14780.7	32239.5
Total	3894132.4	5688977.9

Transfers of securities through the Securities Accounting and United Settlement System of the Central Depository of Armenia pertaining to the operations with securities in the secondary market⁶⁰

	2013	2014
OTC operations (trades and repo) related transactions in nominal value, AMD million	66780.0	132541.2
Stock operations (trades and repo) related transactions in nominal value, AMD million	4996.9	7013
Total	71776.9	139554.2

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

⁵⁹ The statistical information provided includes the GSASS-executed payments and excludes internal transfers made by sub-custodians for their clients.

⁶⁰ The statistical information provided includes the SAUSS-executed payments both with corporate bonds and Eurobonds issued by the RA and excludes government bonds transfers made by the CDA as sub-custodian for its clients.

In 2014 there were no significant (with duration of more than 1 hour) incidents which influenced the uninterrupted functioning of GSASS. The primary and the secondary market infrastructure operational availability of GSASS were both 100%.

Given the abovementioned, the GSASS is assessed as reliable and safe.

5.3. GUARANTY OF DEPOSITS

The Deposit Guarantee Fund (hereinafter Fund) was established by the Central bank of the Republic of Armenia in 2005. This establishment acts in accordance with the Republic of Armenia Law “On Guaranteeing Reimbursement of Bank Deposits of Individuals” (hereinafter Law).

The goal of the Law is to help strengthen the soundness of the banking system of Armenia, enhance public confidence in the banking system and protect depositor interests in the country.

In 2014, the growth of individual depositors and bank deposits of individuals continued to trend upward.

The total amount of deposits of individuals (non-guaranteed deposits defined in the third sub point of the second article of the Law included) amounted to AMD 1,062.0 billion, a 14.4% increase as compared to the previous year.

As of the end of 2014, the amount of guaranteed deposits was 26.7 percent of the total deposits, recording a 3.4% decrease as compared to the previous year. This was due to rise of foreign currency deposits in total deposits.

Continuing the trend of the previous years, the number of individuals holding guaranteed deposits has grown by 7.6% to 1,703,155 persons (excluding former USSR Savings Bank depositors) in 2014 as compared to 2013.

In the banking system of Armenia, the prevailing part of depositors holds deposits only in dram, thus reaching 84.3 percent. The share of depositors holding only foreign currency deposits reaches 6.6%.

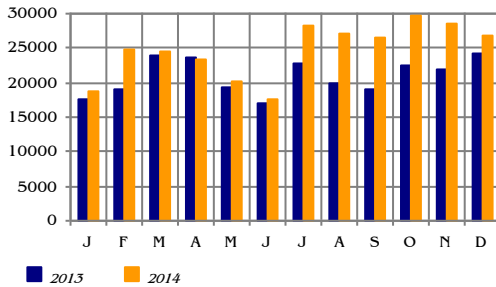
5.4. CREDIT REGISTRY AND ACRA CREDIT BUREAU

The Credit Registry

The Credit Registry has been functioning within the structure of the statistical department of the Central Bank of the Republic of Armenia since January 1, 2003. The Credit Registry is designed to collect reliable data for effective monitoring 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 that were overdue and were classified. At the end of 2014, the number of loans recorded in the Credit Registry was 2,014,640 loans to individuals and 138,400 loans to legal persons, totaling 2,153,040 loans.

As compared to the previous year, the total number of loans registered in the Credit Registry augmented by 450,187 loans. Based on the end-year 2014 data, the Credit Registry possessed information on 524,445 loans outstanding and 1,628,595 loans repaid.

The number of loans provided during 2013-2014



Source: Central Bank of Armenia.

The number of loans registered in the Credit Registry as of end 2014

Number of loans	Outstanding	Repaid	Total
Loans to individuals	506942	1507698	2014640
Loans to legal persons	17503	120897	138400
Total	524445	1628595	2153040

The number of loans granted during the year 2014 was 296,006, which has increased by 18.0% as compared to the previous year. The growth of granted loans affirm the continuous growth of credit activity.

A number of methodical and software updates were completed during the year. In particular, the Credit Registry has discontinued providing data to banks and crediting organizations on the creditworthiness of the customers for their ongoing monitoring since January 1, 2014. Both natural and legal persons may obtain data from the Credit Registry about their credit history once a year, for free.

The new software input processes are close to completion, which will help banks and credit organizations to provide information to ARCA Credit Bureau and Credit Registry in one united report. These amendments aim to reduce the volume of work of banks and credit organizations, to improve both quantity and quality of the information on borrowers, which may lead to a more efficient use of information for monitoring and analysis by other departments of the Central Bank.

The ACRA Credit Bureau

In 2014, the number of borrowers registered with the ACRA Credit Bureau has increased by 6.7%, relative to 2013, and amounted to 1,449,636 borrowers as of December 31.

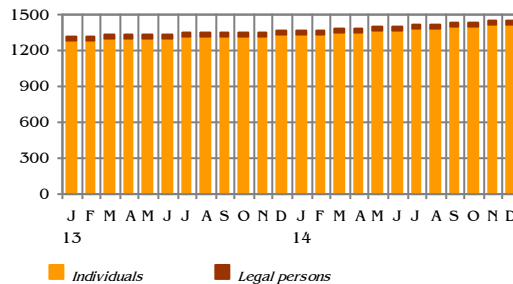
Of this number, 98.0 percent are individuals. The number of loans available in the database has grown by 19.7% and reached 9,964,747, as of December 31.

Any individual or legal person is entitled to receive information from the Credit Bureau concerning their personal credit history. For the legal persons to obtain credit history of its client or counterparty, it should enter into a cooperation agreement with the Bureau and receive the written consent from the borrower. The Credit Bureau has started providing credit reports since April 2007. The number of credit reports provided in 2014 has grown by 101.0 percent compared to the previous year.

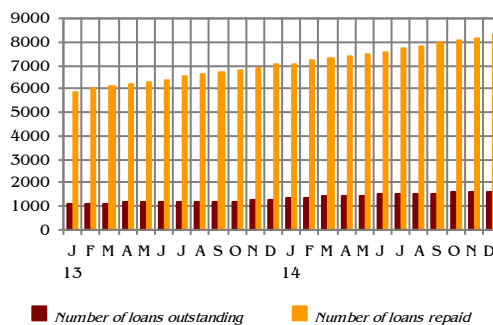
Starting from 2014, the Credit Bureau has been receiving information from "Express Credit" UCO CJSC and "Orange Armenia" CJSC, a telecommunications company. The database ACRA compiles information about payments fallen overdue from "Orange Armenia" CJSC. Talks are being held with "ArmenTel" CJSC, another telecommunications service provider, in the field of organizing information circulation. The Credit Bureau receives information from such public databases as the Ministry of Labor and Social Affairs and the Traffic Police Service of the Republic of Armenia Police on unpaid fines within 60 days (calculated from the next day after the last date specified to pay the penalty as prescribed by the legislation of Armenia). Negotiations between the Credit Bureau and the RA Ministry of Finance concerning obtaining information on tax liabilities non-performed in a duly established timeframe are underway.

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

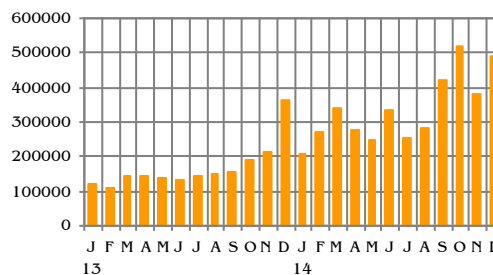
The number of borrowers registered in ACRA database (in thousands)



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



The number of reports provided by ACRA credit registry



Source: ACRA Credit Bureau.

SUMMARY

The results of monitoring assure that credit and liquidity risks are minimized in the EPS. The system capacity is sufficient and ensures the continuity of payments during the day. No operational risks were recorded in the system; the operational availability of the system was maintained on an internationally accepted level.

Overall, the EPS and GSASS functioning are assessed satisfactory enough; the developments in the payment and settlement system are manageable in terms of financial stability and no risks exposed to the system arise.

During 2014, an increase of loans registered with the Credit Registry of the Central bank of Armenia and ARCA Credit Bureau was noted, along with development of united reporting form and increased efficiency of general performance.

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GLOSSARY OF TERMS

<i>Economic growth</i>	The growth of volume of goods and services produced in the economy during a certain period of time.
<i>Inflation</i>	An increase in the general level of prices of goods and services.
<i>Consumer price index</i>	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.
<i>Balance of payments</i>	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).
<i>Foreign trade</i>	This involves an exchange of capital, goods, and services across international borders or territories, in the form of exports and imports.
<i>Gross external debt</i>	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.
<i>Credit risk</i>	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.
<i>Liquidity risk</i>	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).
<i>Foreign currency risk</i>	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.
<i>Interest rate risk</i>	Interest rate risk is the risk that interest rate volatilities in the market will adversely affect profits and/or capital of the financial institution.
<i>Price risk</i>	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.
<i>Standard asset</i>	An asset which is serviced under a contract, and is not problematic.
<i>Watched asset</i>	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.
<i>Substandard asset</i>	An asset the contractual obligations towards which are not performed due to the borrower's fragile financial standing or inability to repay the debt.
<i>Doubtful asset</i>	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.
<i>Loss asset</i>	An asset non-collectable and fully impaired uncollectible, so that its recording on the balance sheet is no longer reasonable.
<i>Major liability</i>	A liability that amounts to 5 percent and more of total liabilities of the financial institution, without regard to affiliation.
<i>Return on assets (RoA)</i>	A ratio of net annual profit to average annual total assets.

<i>Return on equity (RoE)</i>	A ratio of net annual profit to average annual total capital.
<i>Total liquidity</i>	A ratio of high liquid assets to total assets.
<i>Current liquidity</i>	A ratio of high liquid assets to demand liabilities.
<i>Regulatory total capital</i>	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".
<i>Capital adequacy</i>	A ratio of regulatory total capital to risk weighted assets.
<i>Leverage</i>	A ratio of total assets to total capital.
<i>Off-balance sheet contingent asset</i>	Off-balance sheet contingent assets include outstanding credit lines, credit cards and overdrafts as well as letters of credit, guarantees and warranties provided.
<i>Net provisioning</i>	The difference between provisions to and recoveries from assets loss reserve fund.
<i>Net foreign currency position</i>	The difference between assets and liabilities in FX assets and local currency assets containing FX risk.
<i>Gross foreign currency position</i>	This position measures the sum of absolute values of positions of various currencies.
<i>The Herfindahl-Hirschman index</i>	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).
<i>Economic cost of capital</i>	The difference of the present value of total assets and present value of total liabilities.
<i>Spread</i>	The difference between deposit and credit interest rates.
<i>Nonperforming asset</i>	An asset which has been classified by the bank as watched or substandard or doubtful or bad.
<i>Major borrower</i>	A party the risk on which exceeds 5 percent of total capital of the bank.

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 Depository of Armenia
TB	Treasury Bills
EPS	Electronic Payments System
GSASS	Government Securities Accounting and Settlement System