

Financial Stability Report (2023 annual report)

2024-04-16

EXECUTIVE SUMMARY

Amid high levels of geopolitical and regional uncertainties, the financial system of Armenia maintained the normal process of financial mediation, fulfilling the demand for financial services from the population and business entities. Throughout the year, the steady growth dynamics of the banking system's credit portfolio and deposits were sustained. Loan growth was recorded across all main lending areas. Specifically, the expansion of the banking system's credit portfolio was driven equally by the growth of loans to households and businesses. The increase in loans to the economy was accompanied with the high economic growth of Armenia, leading to the absence of a significant rise in the economy's debt burden or the associated credit risk. An exception was the mortgage lending sector, where trends indicating potential overheating from previous years persisted.

Unlike the previous year, the growth of deposits in the banking system in 2023 was driven by the continuous high growth of deposits from residents exclusively.

In 2023, there was notable activity in the consumer lending, which still does not show signs of excessive or risky lending. Compared to previous years, a relatively high growth rate of consumer loans was recorded this year. The increase in demand for consumer loans was driven by the high growth of incomes in the economy and the increased demand for purchasing long-term household goods, amid the high activity observed in the real estate market in recent years.

However, given the moderate annual growth rates of consumer loans over the past three years and the almost unchanged consumer loans/GDP ratio amid relatively high income growth, any significant risk accumulation in this sector is not currently anticipated.

Risks of overheating in the mortgage lending and real estate markets have persisted. The Central Bank has repeatedly communicated about overheating trends and risky developments in the real estate market in its previous publications and press conferences. In 2023, the substantial growth of new mortgage loans continued, accompanied by a continuous increase in real estate prices. As a result, the risks of overheating in the mortgage and real estate markets persisted. Additionally, past and current developments in real estate demand and supply suggest that the market may be near the upper

inflection point of the cycle. Under these conditions, the possibility of decreased activity in the real estate market and potential price adjustments remains.

In the context of high geopolitical and regional uncertainties, the risks a decrease in the future economic activity and new inflationary pressures remain elevated. Under these conditions, there may be risks of increasing the debt burden and difficulties in servicing the debt. Throughout the year, expectations of a “soft landing” prevailed among global financial market participants, meaning that inflation rates would continue to fall while the world economy would avoid a deep and prolonged recession. However, with the further escalation of geopolitical tensions, the risks of new inflationary pressures and decreased global economic growth persist, which could as well impact the Armenian economy. In this scenario, the risks of an increased debt burden and the materialization of credit losses thereof are considered high, both in terms of the magnitude and speed of the impact.

The banking system exhibits robust capitalization and liquidity levels. The banking system has consistently maintained capital adequacy and liquidity reserves well above the minimum regulatory requirements, demonstrating a strong ability to withstand possible shocks. Despite a certain decrease, the banking system recorded sufficiently high profitability for the year. Unlike the previous year, profitability in 2023 was significantly boosted by an increase in net interest income, driven by the relatively high interest rates in global and domestic markets and structural changes in banks’ balance sheets. In the context of high economic growth and increased credit market activity, the quality of the credit portfolio has improved.

The results of the macro stress testing indicate that the Armenian banking system has sufficient risk absorption capabilities under a severe scenario. The stress testing assessments also considered the potential materialization of risks accumulated in the real estate market. Specifically, the assumed highly pessimistic macroeconomic scenario accounted for credit risks resulting from the deterioration of mortgage loan quality and the financial conditions of construction companies. The results demonstrate that the banking system possesses adequate capital to withstand the events outlined in the scenario.

However, given the persistent high level of uncertainties, the uncertainties regarding the pessimistic scenario, its duration, and the extent of its impact remain significant.

Consequently, the Central Bank underscores the importance of commercial banks adopting balanced and prudent approaches in risk management, capital management,

balance sheet management, and dividend distribution processes.

The Board of the Central Bank increased the countercyclical capital buffer. At the beginning of the year, the countercyclical capital buffer rate was raised by 0.5 percentage points, to be set at 1.5% from August 1, 2023. In its decisions on setting the countercyclical capital buffer (CCyB) rate, the Central Bank Board considered the cyclical developments in the credit market, as well as the assessments of the risks already accumulated in the banks' balance sheets. Throughout the year, the cyclical developments regarding the total credit portfolio were balanced .

From the perspective of credit risk already accumulated in the banks' balance sheets, the continuous high growth of the mortgage loan portfolio, which the CBA assesses as containing risks of overheating, was pivotal to the decisions regarding the CcyB.

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