

Financial System of Armenia. Development, Regulation, Supervision 2006

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Introduction

On January 1, 2006, the Republic of Armenia Central Bank undertook to regulate and supervise the financial sector of Armenia. Worldwide, financial system developments have entailed convergence of banking, insurance, and securities trading. Supervision of common financial market risks was the main reason for creating a unified supervisory body. It had become necessary to perform complex supervision of financial market development trends, to assess risks typical of different segments of the financial market, and to evaluate the impact on general financial system developments of risks emerging in specific financial markets, institutions, and infrastructures.

Presently, bank assets account for about 93% of total financial system assets. However, it is essential to create prerequisites for non-bank financial institutions (mainly, insurance and securities markets) to develop hand in hand with the banking system. In terms of future prospects of regulation and supervision, the Central Bank focused in 2006 mainly on redefining the policies to develop the insurance and securities markets. Concept papers on the development of insurance and securities markets in Armenia were developed and reflected in amendments to the Law on Insurance and the Law on Securities Market Regulation. Sub-legislation needed to regulate and supervise insurance and securities markets, too, has been developed on the basis of these concept papers.

Considering that commercial banks are presently the most important players in the Armenian financial market, this paper mostly focuses on the banking system. On the whole, positive macroeconomic developments continued in 2006, positively influencing the banking system. Though the ratio of banking system assets to GDP remained unchanged at 19.8% in 2006, the lending to GDP ratio grew by 0.3 percentage points to 8.6% due to a strong increase in bank lending volumes. In view of sustainable economic growth, Armenia's financial system has sufficient potential to expand; however, the level of financial intermediation in Armenia is still extremely low.

The interest rate spread as an indicator of the level of financial intermediation remains rather high in Armenia, pointing at the inadequacy of financial intermediation in Armenia's financial system. During 2006, the interest rate spread fluctuated around 13 percentage

points, which is rather high in comparison with spreads of 4-6 percentage points in Baltic and Central European states.

The high spread is mainly due to limited supply of credit against high demand for loans. The ability to meet demand for long-term credit is another important consideration. In view of the continuing lack of long-term savings in the system, longterm lending may create problems posed by liquidity and interest rate risks arising out of a failure to match assets and liabilities. To this end, the Central Bank has been active to create preconditions for the development of insurance and securities markets, as well as the pension system, because these institutions need to develop for long-term money to become available in the economy. Furthermore, the Central Bank has continued implementing a number of measures aimed at developing mortgage lending (most of these measures are implemented in cooperation with the German KfW Development Bank).

A key development of the banking system in 2006 was the change in the currency structure of assets and liabilities, as follows:

The share of dram assets grew by 9.5 percentage points to reach 56.9% of total assets (dram assets grew by 42.9%, while foreign currency assets shrunk by 2.5%); and

The share of dram liabilities grew by 10.8 percentage points to reach 44.0% of total liabilities (dram liabilities grew by 54.8%, while foreign currency liabilities shrunk by 2.0%).

Bank lending to the economy grew by 25% during 2006 to reach AMD 230 billion at yearend. Lending grew in virtually all the sectors of the economy. Seasonal trends of lending to various sectors, which had been observed in 2005, persisted in 2006. Mortgage lending grew faster (114%) than other types of lending. As in previous years, consumer lending grew the fastest in terms of volume, facilitated by a 19% increase in net disposable household income in 2006.

Nominal GDP growth in 2006 was driven mainly by construction and services. Although construction growth was mainly due to higher volumes of privately-financed construction, rather than bank lending, the real growth of construction output amounted to 37%, while bank lending to construction grew by 47%.

The share of non-performing assets at yearend was 2.4% of total. 66% of such assets were

in the 'Watch' category. In 2006, net provisioning accounted for only 0.4% of total assets, which is indicative of low credit risk in Armenia's banking system.

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