

Financial System of Armenia. Development, Regulation, Supervision 2005

2006-05-25

Preface

The recent trends of stable development in the macroeconomic environment, which have positively affected the developments in the banking system as well, continued in 2005. In the reporting year, financial intermediation of the banking system has risen, and the measures carried out in that direction in the last couple of years have contributed to such an advance. Those undertakings have ensured an inflow of financial resources into the banking sector, while established mechanisms of lending and economic activity have considerably enlarged the volumes of loans. Performing on a competitive field, the banking sector has attracted broader circles of customers in the reporting year. Rising financial intermediation provides evidence that the banking system has enough potential for expansion and magnification under a sustainable economic development.

Under faster growth rates of assets of the banking system (21.2 percent) and loans to the economy (39.1 percent), in relation to the nominal GDP growth of 17.5 percent, the ratios of banking system assets/GDP and banking system loans/GDP have risen by 0.6 pp. and 1.3 pp. to 19.8 percent and 8.3 percent, respectively. However, the level of financial intermediation in Armenia is still too low.

As an indicator of the level of financial intermediation, a relatively higher interest rates spread in Armenia is witnessing an insufficient financial intermediation of the country's financial system. In 2005, the interest rates spread of the Armenian banks remained high, ranging between 13-16 percent, which is high enough in relation to the 5 percent spread in Baltic and Central European countries.

High spread is mostly a result of a limited supply of loans under large demand. The demand for long-term loans is currently growing but long savings in the economy are not observable, and the mismatches in attraction and allocation of financial resources generate a need for additional coverage against losses expected from other risks (liquidity, interest rate). To this effect in 2006, the Central Bank will embark on implementing supervision of other market participants (insurance market, securities market) and take several actions to develop these sectors, as strong presence of insurance and securities markets is a vital precondition for creation of long-term funds in

the economy.

Implementing a policy of sustained development and minimization of risks in the banking system, the Central Bank highlighted the importance of introducing core principles of corporate governance in 2005. To this end, both the legislative amendments and supervision have mainly pursued the above-said policy. In 2005, RA Law on Changes and Addenda to the Law on Banks and Banking was adopted establishing legal status of banks' management bodies, particularly general meeting of participants, board, executive body and chief accountant of the bank, determining organizational criteria, and other provisions for corporate governance. Target inspections in banks in 2005 were carried out to identify weaknesses in internal control mechanisms at banks. The main purpose of these inspections was the study of the Observance of minimum internal control implementation requirements and risk management system in banks.

As a result of consistent policies exercised by banks and the Central Bank, the current risks in the Armenian banking system are in a manageable band. The banking sector in 2005 showed certain encouraging developments:

Currency structure of banking system assets and liabilities changed notably; dram denominated assets and liabilities increased by 49 percent and 44 percent and foreign currency denominated assets and liabilities increased by 4 percent and 5 percent, respectively, which resulted in an impressive enlargement of the share of dram assets and liabilities;

Currency structure of deposits changed considerably, too, as deposits grew entirely owing to the growth of dram denominated deposits, resulting in a broader share of dram deposits;

Statutory fund of the banking system had an incredible growth of 50 percent;

Volumes of lending increased sharply, by 39 percent, pushing the share of loans in total loans to grow by 5.4 percent to make up 41.8 percent at yearend.

Loans grew in number by 35 percent and amounted to 222.4 thousand. Having grown both in value and number, any drop of quality in loan investments has not been observed. It is worthwhile to mention that the seasonality in lending to the economy, shown in the previous year, was maintained. Lending by the banking sector in 2005 and in recent years grew mainly due to consumer loans (including mortgage loans) and commercial loans. Growth of net disposable household income has contributed to AMD 22.6 bln growth of

consumer loans (in 2005, private sector's disposable income grew by 16 percent).

In 2005, Industry, Construction and Services were the main contributors to the nominal GDP growth. Contribution to the growth of construction came not from the increased lending by the banking sector but rather owing to enlarged volumes of construction, as funded by the private sector. However, the nominal growth of output in Construction was 59 percent while lending to this sector by the banking system rose by 49 percent. A 34 percent increase was recorded in Services sector, with the banking sector's lending grown by 65 percent.

In 2005, loans to Industry grew by 10 percent while the nominal growth of industrial output was 22 percent. High nominal growth output, compared to the previous years, was recorded in processing industry, 26 percent. In line with fast growing loan investments, the quality of banking system loans even slightly improved. The share of non-performing loans at year-end was a mere 1.6 percent a large part of which represents the category of watched assets. During the year, the share of net provisioning in total assets was just 0.3 percent, denoting a low level of credit risk.

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