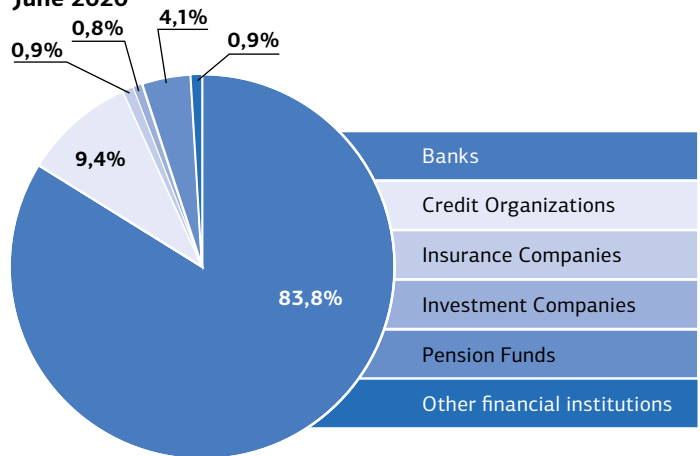


# Overview of the financial sector in Armenia



The financial sector in Armenia is dominated by banks with an 83.8% share in total financial sector assets. Other financial institutions such as credit organizations, pension funds, insurance companies, etc. are rather small and do not have a significant impact on the overall health of the financial system. Therefore, the following analysis will focus on commercial banks.

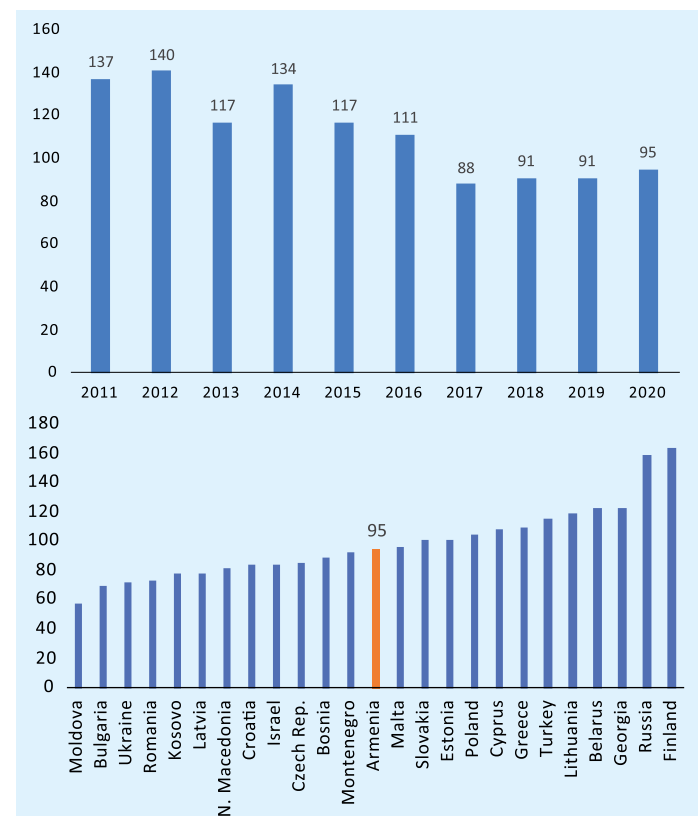
Figure 1. The structure of financial sector assets in Armenia, June 2020



Source: Financial stability report 2020-I, Central Bank of Armenia

The size of the banking sector in Armenia is large relative to the economy, as banks' total assets to GDP equals 108%, a level that is close to the average for BSTDB member countries. The banking system in Armenia comprises 17 commercial banks with strong market competition as the concentration of banks' assets is very low, with the 3 largest banks holding less than 50% of total banking sector assets and with individual shares of less than 20% each. According to the Central Bank of Armenia, the HHI index of market concentration is around 9% for assets, which is a relatively low number compared to peer countries<sup>1</sup>. Foreign participation in banks capital is around 60% as at the end of 2020.

Figure 2. Total Loans to Customer Deposits (%)



Source: Financial Soundness Indicators, IMF database

<sup>1</sup> Website of the Central Bank of Armenia: <https://www.cba.am/en/SitePages/fscintroduction.aspx>

The loan book accounts for around 60% of total banking sector assets. The share of liquid assets in total assets has declined from 32% in 2017 down to 26% in 2020. However, liquidity buffers are still more than enough to cover short term liabilities as the ratio of liquid assets to short term liabilities stands at 109%. Banks' funding mostly consists of deposits, as they account for around 60% of total liabilities and around half of these are retail deposits. Borrowings from other financial institutions are also an important source of funding as they accounted for more than 20% of total liabilities as of end 2020. The loan to deposit ratio dropped from 134% in 2014 down to 88% in 2017 as deposits grew much faster than loans. However, since 2017 the loan to deposit ratio has increased and it further accelerated in 2020, reaching 95%, a figure which is close to the average of peer countries in the region.

The banking system in Armenia has solid capital buffers as the ratio of regulatory capital to risk weighted assets has stayed well above the required minimum of 12% over the last decade. In 2020, capital adequacy declined slightly to 17%. The strong capital position of the banking system highlights a capacity to absorb potential losses in case a negative scenario materializes.

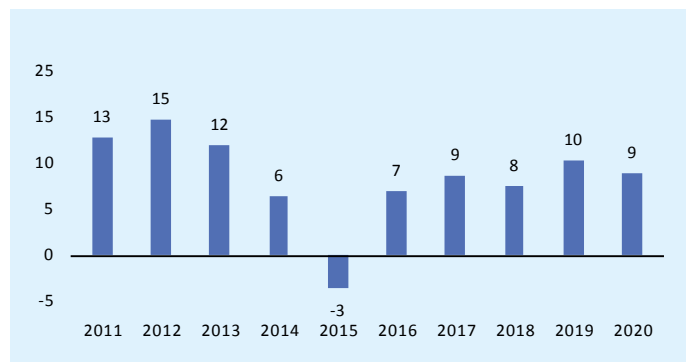
Figure 3. Regulatory Capital to Risk-Weighted Assets (%)



Source: Financial Soundness Indicators, IMF database

Prior to shocks in 2014-2015, the banking sector in Armenia reported strong profitability as the ROE ratio averaged 13% per year. In 2014-2015, as economic growth slowed and the local currency depreciated, banks' profits declined, and in 2015 profits went into negative territory. Since then the profitability of the banking sector has recovered somewhat but not to pre-2014 levels. In 2020 the ROE for the banking system was 9%, which is equivalent to the average profitability for the period since 2015. At these levels, the profitability of the banking sector in Armenia is relatively low compared to peer countries with similar creditworthiness.

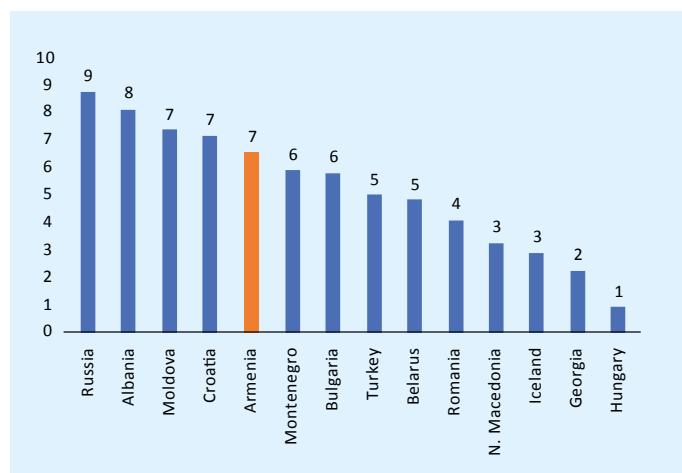
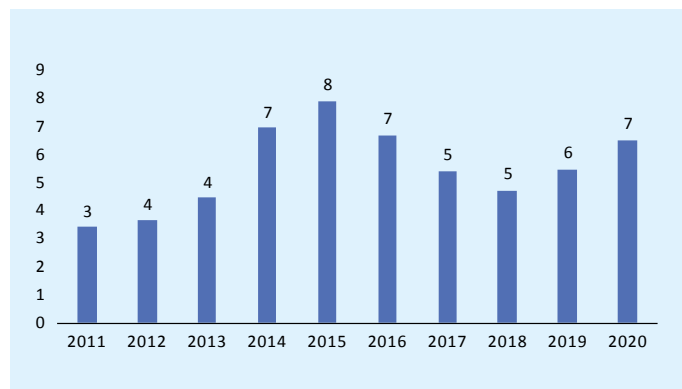
Figure 4. Return on Equity (%)



Source: Financial Soundness Indicators, IMF database

One of the challenges of the banking sector in Armenia is a relatively high level of NPLs. The quality of the credit portfolio started to deteriorate during the regional shock of 2014-2015 when NPLs increased to 8% of gross loans. In later years NPLs declined somewhat but from 2019 onwards they started to increase again. The COVID pandemic and an economic contraction related to it, together with military conflict in Nagorno Karabakh<sup>2</sup>, will probably feed NPLs further, as the full impact of these events is not yet reflected in the asset quality. The level of NPLs is on the high side compared with regional peers and the coverage of NPLs with loan loss provisions remains modest at around 60%.

Figure 5. Evolution of NPLs in Armenia and regional comparison (% of total gross loans)

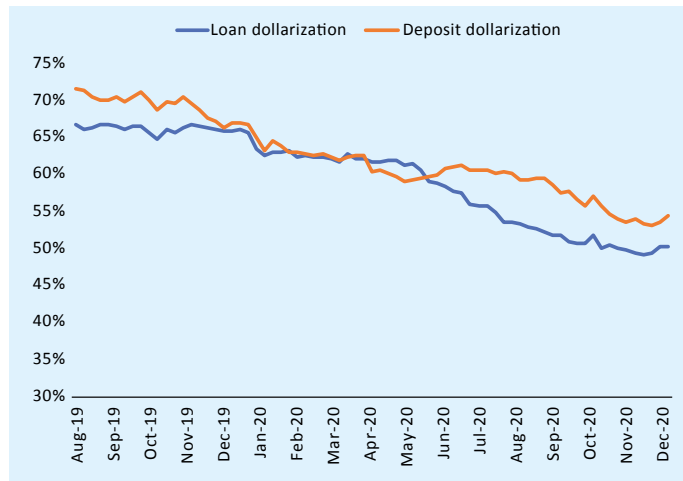


Source: Financial Soundness Indicators, IMF database

<sup>2</sup> "Loans by banks operating in the Republic of Armenia to the NK are estimated at about 3 percent of Armenia's GDP (3.3 percent of total Armenia's banking sector assets) as at end-2019." – Staff Report, December 2020, IMF

Another important challenge for the banking system in Armenia is a relatively high level of dollarization both for loans and deposits. Over the past five years, dollarization in Armenia has declined and, despite the pandemic, it continued to decline in 2020. Overall, for the period from 2015 to 2020, dollarization declined by 16-17 percentage points and was 50% and 54% for loans and deposits respectively, at the end of 2020. Still, dollarization remains at a high level, exposing the banking system to exchange rate fluctuations. It should be noted though that for loans to households (including mortgages), that are more vulnerable to exchange rate risk, dollarization is much lower at 23% at the end of 2020.

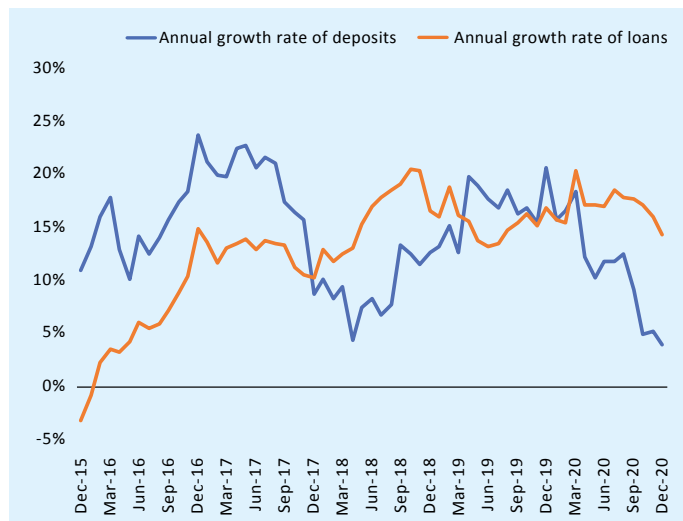
Figure 6. Evolution of dollarization for loans and deposits in the banking sector of Armenia



Source: Central Bank of Armenia

After the regional shock of 2014-2015, credits and deposits grew rapidly at an average annual rate of 13-14% and this trend continued in the first half of 2020. Deposit and credit growth were supported by accommodative monetary policy as the Central Bank of Armenia cut the policy rate gradually from 10.5% down to 4.25% in this period. It was accompanied by strong economic growth as real GDP growth from 2016 to 2019 averaged 5% per year. However, as depreciation of the local currency fed inflation, monetary authorities started tightening policies in the second half of 2020, which together with contraction in economic activity translated into a slowdown of growth rates of both credits and deposits. By the end of 2020 annual growth of loans was 14% while the growth of deposits was up only 4%. In 2021 the CBA continued tightening of monetary policy, something which will put further downward pressure on credit growth.

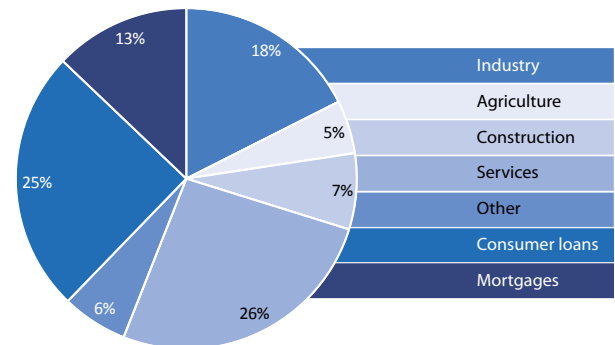
Figure 7. Annual growth of loans and deposits for 2015-2020



Source: Central Bank of Armenia

Corporate borrowers accounted for 62% of the total credit portfolio in Armenia in 2020, with the services sector having the largest share in the corporate loan book. Services were followed by industry and construction with a 13% and 7% share in the total credit portfolio respectively. Consumer loans accounted for 25% of the total loans in 2020, while the share of mortgages was 13%. Loans to households, both consumer loans and mortgages, are mostly denominated in the local currency with dollarization standing at 15% and 31% respectively. Households with foreign exchange debt are more exposed to exchange rate risk, together with the borrowers operating in the agriculture sector where dollarization is also relatively low at 36%. Other corporate loans, excluding loans to agriculture, are mostly granted in FX with dollarization exceeding 70%.

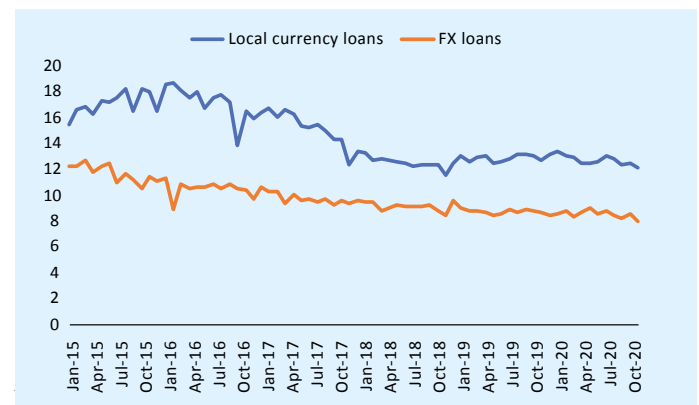
Figure 8. The structure of the credit portfolio as of end 2020



Source: Central Bank of Armenia

As expected, monetary policy easing in 2015-2019 resulted in lower lending rates for domestic currency loans. Interest rates for US\$ denominated loans declined also, mainly due to relaxed financial conditions globally. As the central bank started tightening the policy in the late 2020 its effect on lending rates is not yet seen and as a result the declining trend for interest rates continued further in 2020 both for local and FX denominated loans.

Figure 9. Interest rates for loans with maturity of more than 1 year (%)



Source: Central Bank of Armenia

The financial sector in Armenia is dominated by commercial banks. Banks have solid capital and liquidity buffers that highlight the strong shock absorbing capacity of the system. At the same time, the banking sector is quite competitive as market concentration is very low with the 3 largest banks holding less than 50% of the total banking sector's assets. The main challenges of the banking sector are (i) a relatively high level of NPLs, that may potentially increase, as the full impact of the pandemic related crisis is not yet reflected in the asset quality, and (ii) a high level of dollarization that, although on a declining trend, remains elevated.

