Armenia

Industry Research – Banks

7 May 2018

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Armenian Banking Sector Metrics

	2015	2016	2017
Assets, AMD th.	3,6	4,1	4,4
Loans, AMD th.	2,3	2,6	2,9
ROA, %	0,6	0,5	0,9
ROE, %	3,6	3,2	5,6
CAR, % (min 12%)	25,1	38,8	33,2
NPL, % to loan portfolio	12,0	9,5	9,02
CBA FX rate - AMD/$1	483,75	483,94	484,10

Source: AmRating based on data from CBA and Armenian banks

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1. INTRODUCTION

In 2017 the Armenian banking sector dynamics were characterized by a high level of excess liquidity due to finalization of the consolidation process, connected with the need to comply with the new normative standard of total capital. The sector was also characterized by the slowing loan and deposit portfolios' growth rates, insignificant reduction in the level of capital adequacy, improvement in the asset quality and profitability figures.

Macroeconomic factors associated with the favorable export conditions and restoration of the traditional transfer economy[1] of Armenia contributed significantly to domestic demand and increased overall market liquidity. This circumstance significantly influenced the activity of retail bank lending, but so far could not support the declined levels of corporate lending. At the same time, the rather high level of competition in the banking sector, unprecedentedly low level of interest rates and, as a result, a significant decrease in interest margin created a long-term trend of banking sector consolidation.

However, the main indicators are unevenly distributed throughout the whole sector, the five leaders of which are characterized by a more healthy and diversified portfolio.

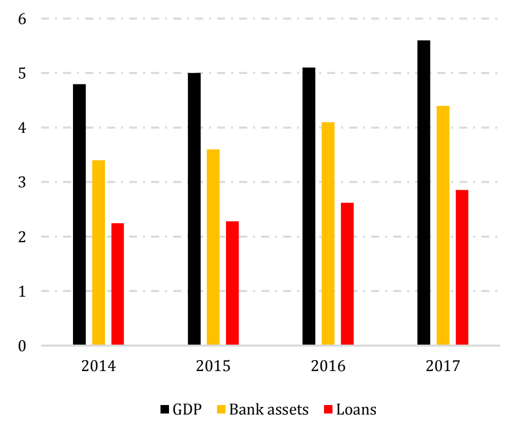
Against the backdrop of the favorable macroeconomic conditions and banking sector consolidation (see graph 1), in order to support the sector and increase availability of loans, the Central Bank of Armenia (CBA) started the process of monetary policy easing by systematically lowering the refinancing rate, which decreased by 4.5p.p. down to 6% between 2015-2017. This has pushed banks to revise rates on loans and deposits downwards, evidenced by dropping credit and deposit rates from 14,7% to 10,7% and from 9,7% to 5,3% in 2016-2017 respectively (see graph 2). Since 2015, as part of the program to support the debt securities market, the regulator has effectively nullified the obligatory reserve ratio for banks when raising funds by issuing bonds in national and foreign

[1] The Armenian economy is characterized by a high ratio of transfers from abroad to GDP: 13% in 2016 according to the World Bank. In addition, according to the CBA data for 2017, the volume of transfers to Armenia increased by almost 15%.

currencies. This has significantly helped to increase the issuance activity of banks. Simultaneously, the CBA expanded the list of international financial organizations, funds attracted from which are subject to mandatory reservation under a reduced normative standard.

2. INDUSTRY STRUCTURE AND PERFORMANCE

Graph 1: GDP, bank assets and loans, AMD tn.



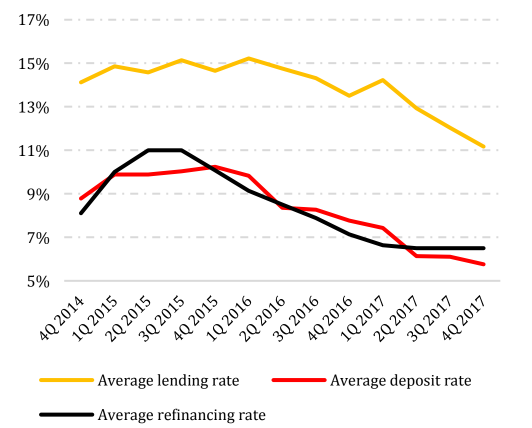
Source: AmRating calculations based on data from banks of Armenia and the SCRA

The concentration level of the Armenian banking sector increased after the additional capitalization process' completion: by the end of 2017 the share of assets of the five largest banks was 55,2% (see graph 3). Against the backdrop of the restrained optimism about the further pace of economic recovery, the sector consolidation is expected to continue due to the high current level of competition, low level of ROE, scarceness of the client base, and possible growth in the non-performing assets caused by the retail segment's risk appetite increase.

During the sector consolidation process in 2014-2017 the share of foreign capital in the authorized capital of the Armenian commercial banks decreased from 74,6% to 61,8%. Four banks left the market, three of which were direct subsidiaries of foreign banks: German international banking group ProCredit Bank, Russia's Gazprombank and Kazakhstan's BTA[2]. According to the market's analysts, these events, among other things, led to some reputational losses of the banking sector as a whole.

Nevertheless, the number of foreign holders of Armenian banks' capital continued to be high. Foreign capital was registered in 16 out of 17 functioning banks, which include subsidiaries of foreign banks - HSBC Bank Armenia (HSBC, the UK), VTB Bank (Armenia) (VTB Group, Russia), Byblos Bank Armenia (Byblos Bank S.A.L., Lebanon), Mellat Bank (Mellat, Iran) and ACBA - Credit Agricole Bank (Credit Agricole, France).

Graph 2: Lending, deposit and refinancing rates, %



Source: AmRating calculations based on data from the CBA and banks of Armenia

The international donor financial institutions, including the European Bank for Reconstruction and Development (EBRD), the Asian Development Bank (ADB), the member of the banking group KfW - Deutsche Investitions-und Entwicklungsgesellschaft mbH (DEG), the International Finance Corporation (IFC), Rural Impulse Fund II (structure of the Belgian Incofin Investment Management - Incofin IM), are represented in the capital of four Armenian banks.

Foreign private capital is widely represented by individuals, mainly members of the Armenian foreign diaspora of Russia, Ukraine, Argentina and Switzerland. Presence of some of these individuals' capital in the Armenian banking sector is structured through offshore companies.

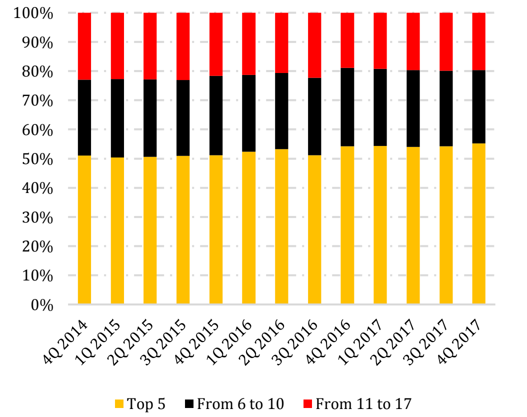
The capital adequacy ratio (minimum level of the normative standard is at 12%) remains solid, despite the slight decrease of 5,6p.p. y-o-y down to 33.23% in 2017 (see graph 4). The ratio's decline was observed from 2017 onwards quarter to quarter after the completion of the capitalization

[2] Also at the end of 2016, the Armenian Development Bank left the market, having been acquired by the Araratbank.

process of 2015-2016. This was mainly due to the increase of the minimum size of the total bank's capital to AMD 30 bn from the previous value of AMD 5 bn. We do not expect any significant reduction in capital adequacy until the end of the year, as the accumulated bad loans write-off process was factually completed.

In 2017 the bank's assets increased by 6,7%, but the volume of lending to the economy declined by 0,4% (see graph 5). The key components of the upward dynamics of assets were investments in securities (mainly government bonds), loans to individuals and consumer loans. In that year investments in government bonds increased by 18%, while the total loan portfolio grew by 8,8%. In 2017 the volume of retail lending grew by 15,4%, in particular, mortgage loans increased by 14,4% and consumer loans by 17,8% albeit the significant decline in car loans of 24,7%. The increase in mortgages, as well as the decline in the overall level of interest rates, are mainly due to the strengthening of special state support programs as part of measures to refinance mortgage loans from the state-owned National Mortgage Company and implementation of the "Affordable Housing for Youth" project. An even greater rally of the retail lending market is expected to be influenced by the further remittances recovery and, as a result, the aggregate demand increase.

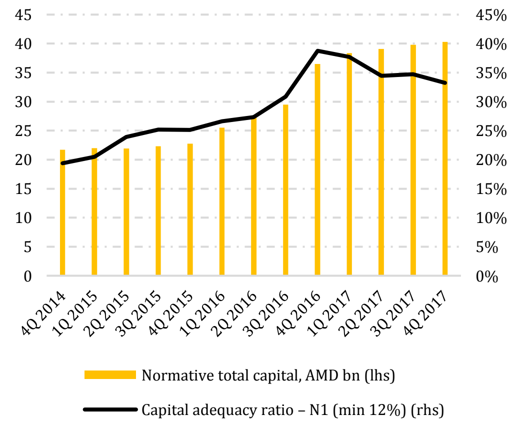
Graph 3: Assets' concentration by groups of banks, %



Source: AmRating calculations based on data from banks of Armenia

The decline in the growth rate of loans to legal entities was due to the limited capacity of the market, and high over-crediting of its participants. In our opinion, the situation in the corporate lending segment is ambiguous and difficult to explain, against the backdrop of the accelerated economic growth from 0,2% in 2016 to 7,5% in 2017 and the decline in the overall level of lending rates. Nevertheless, we forecast some activation of SMEs lending, the growth rate of which will depend on the success of the economical structural reforms continuation and the real sector cost reduction.

Graph 4: Capital adequacy metrics



Source: AmRating calculations based on data from banks of Armenia

The quality of bank's assets remains stable, whereas the share of overdue loans of legal entities and individuals decreased by 1,7p.p. and 0,3p.p. y-o-y down to 5,2% and 2,2%[3] in 2017 respectively (see graph 6). The share of overdue loans in the banks' loan portfolio as a whole decreased by 0,5 p.p. y-o-y down to 9%[4] in 2017. The share of the low quality loans (categories "doubtful" and "bad" - IV and V in accordance with the classification of the CBA) also slightly decreased by 0,9 p.p. y-o-y down to 6,5% in 2017 (see graph 7). We expect that the switch of banks' positioning to the retail credit can worsen the quality of assets by 2019, and thereby affect the overall market performance.

Sector's profitability improved in 2017, with ROA and ROE reaching 0,9% and 5,6%, respectively, which are the highest figures since 4Q 2014 (the

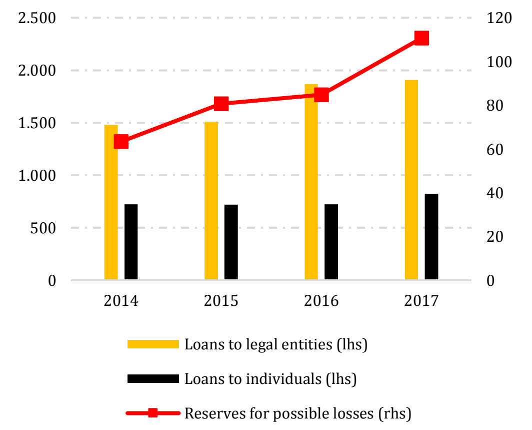
[3] The share of overdue loans of legal entities and individuals in the loan portfolio was calculated based on data from 14 out of 17 functioning Armenian banks, as 3 other banks publish classification of their loan portfolio by risk groups without a separate breakdown for loans from legal entities and individuals.
[4] The total share of overdue loans in the total loan portfolio is calculated based on data from 17 functioning Armenian banks.

last quarter before sharp devaluation of the national currency) (see graph 8). These positive dynamics were mainly caused by the less conservative reserve policy and the increase in the share of commission income (see graph 9). At the same time, a significant portion of the sector's profits is still generated by the two largest banks - Ameriabank and Inecobank (38,4% of the total profit of the banking sector in 2017, compared to 58,4% in 2014). Only two banks were unprofitable - VTB Bank (Armenia) and HSBC Bank Armenia. Reduction of disproportionality of profits' distribution leads to contraction of the banking sector stability risks.

The sector's liquidity position remains satisfactory, despite the decline in key ratios in 2017, as compared to 2016 (see graph 10). Just as in the case of profitability indicators, we observed a high disproportionality in the distribution of liquidity.

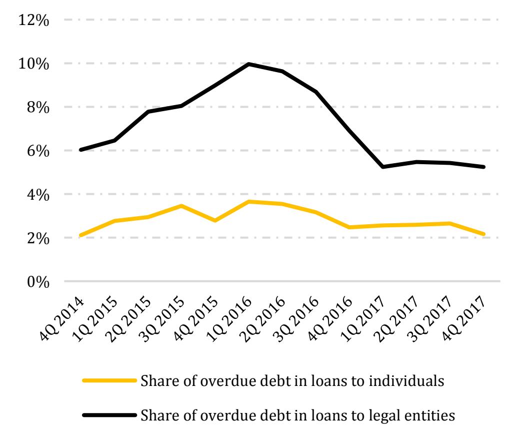
The funding base was characterized by a gradual increase in the share of individuals' funds by 6,7p.p. up to 42,6% from 2014 until 2017, as well as a decrease in the average level of interest rates by 3,1p.p. down to 6,65% over the same period. In general, the volume of individuals' funds increased by 20,6% in 2017, while deposits and current accounts of legal entities grew only by 3,2% in the same period.

Graph 5: Loans and reserves for possible losses, AMD bn



Source: AmRating calculations based on data from banks of Armenia

Graph 6: Share of overdue loans, %



Source: AmRating calculations based on data from banks of Armenia

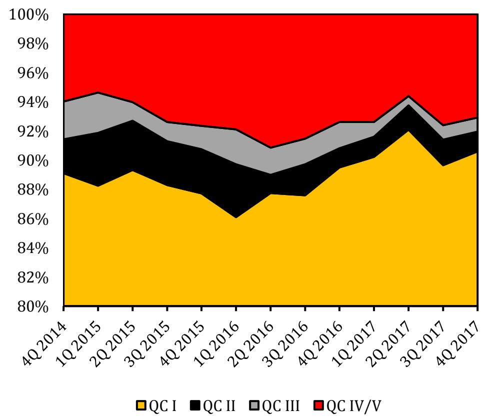
3. BANK REGULATION

The CBA continued pursuing a loose monetary policy, reducing refinancing rate down to 6% in February 2017, which so far has been kept the same. Based on the internal and external economic dynamics the CBA, in the context of its monetary policy, considers to keep the rates unchanged. However, in the medium term, the CBA plans to gradually neutralize the stimulating monetary conditions to keep inflation at the target level of 4%, with the possible deviation range of 1,5p.p. up or down.

Levels of the key prudential standards have remained unchanged in recent years, except for the requirement for a minimum amount of total capital, which was tightened on the 1st of January 2017 up to AMD 30 bn from previous AMD 5 bn. Having made this decision in December 2014, in order to mitigate the risk of the sector's destabilization, the regulator gave banks a two-year notice for additional capitalization. In order to support the banking sector the CBA softened the mandatory reserve ratio for attracted foreign exchange funds from 20% to 18% and extended the period for transferring the reserved amounts to 28-30 days from the previous two weeks in September 2016. The revision of the standard took place after two years since the last policy tightening on the 17th of December 2014 from 12% to 24%, followed by a forced reduction by 4p.p. on the 23rd of December of the same year, which was then due to the sharp devaluation of the national currency.

In addition to these changes, the CBA has taken steps to reactivate the capital market, having lowered the compulsory reserve requirement for the funds attracted through bonds in national and foreign currencies to 0% since 2015. Simultaneously, the regulator expanded the list of international financial organizations, funds raised from which are subject to a reduced normative for mandatory reservation. The reduction of the compulsory reserve requirement created favorable conditions for banks when attracting long-term resources. This enhanced crediting opportunities and allowed bond issuance with listing on international exchanges. As a result, as of the 3rd of April 2018, Nasdaq OMX Armenia had already issued ten bank bonds (as opposed to two in 2015 and four in 2016). The number of currently listed tranches is already 44 (against six in 2015 and ten in 2016), the dominant part of which are USD denominated. In 2015-2017, the active entry of banks into the corporate bond market increased the volume of deals made on the exchange by 5,2 times up to AMD 11 bn, with three banks (Ardshinbank, Ameriabank, Evokabank) placing their debt securities on international markets. Additionally, in mid-December 2017 there was a debut in the Armenian capital market – the first ever securitization of mortgage loans. This was structured through the two separate USD and AMD tranches issued by the First Mortgage, underwriter and market maker of which was the Araratbank.

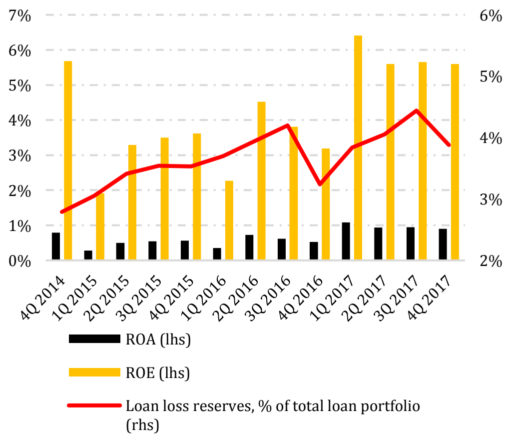
Graph 7: Loans by Quality Category (QC), %



Source: AmRating calculations based on data from banks of Armenia

In the end of 2016, the Armenian parliament adopted amendments to the securities market law submitted by the CBA, which took into account the requirements and standards of the International Swaps and Derivatives Association (ISDA), thus ensuring the implementation of the organization's standards in the country's legal framework. The first REPO deal was concluded in early April 2018 between EBRD and Armswissbank.

Graph 8: Profitability metrics VS loan loss reserves, %



Source: AmRating calculations based on data from banks of Armenia

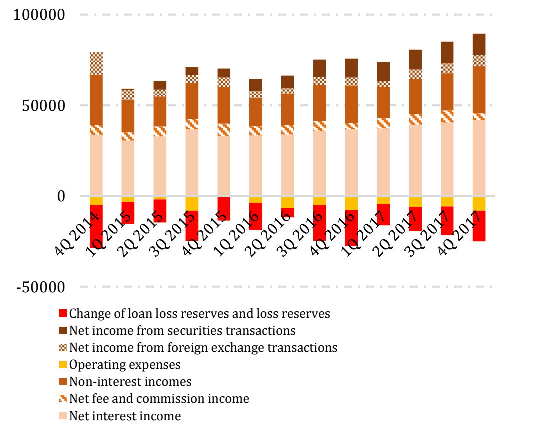
In September 2017, the Armenian parliament approved the draft amendments and additions to the banking law submitted by the CBA aimed at ensuring at least 93% compliance of financial organizations with international standards. As part of the amendment to the law, along with the current minimum capital requirement the CBA proposed to set requirements for additional capital in order to form an additional buffer, so that in case of external shocks banks could cover the resulting risks at the expense of equity rather than at the expense of customers. To limit the burden of lending, the CBA proposed to set a ratio of income to liabilities as well as collateral requirements. Another amendment concerned the introduction of the concept of a systemically important bank, over which a more stringent control is to be established. In addition, the CBA considered it to be economically rational, to raise the bar of the maximum loan size per borrower from the current 20% to 30% of capital.

The CBA initiated amendments to the mortgage law, as well as to a package of concomitant laws. The objectives of these amendments are to stimulate the growth of mortgage lending through the disclosure of all information on transaction and to liberalize collateral regulation and other measures made to protect the interests of consumer borrowers. In

December 2017, the Armenian parliament amended the Civil Code, thus adopting “anti-Lombard” measures, according to which the commercial banks and credit organizations of Armenia will be limited in their rights to charge penalties and pennies.

Additionally, the CBA continues its policy to strengthen the routine supervision practices and to apply stricter penalties due to fraud in the banking business.

Graph 9: Structure of financial result, AMD mln



Source: AmRating calculations based on data from banks of Armenia

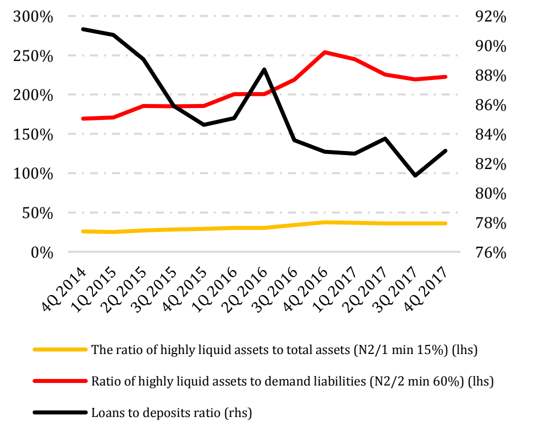
4. OUTLOOK

The credit growth is expected to be more rapid than in 2018 as compared to 2017 and will constitute around 20% for retail loans and over 10% for corporate loans in y-o-y terms. Moreover, loans to the economy will go to an upward trend due to the active involvement of banks in state programs of subsidized mortgages, agro-credits and leasing operations against the backdrop of the projected acceleration of economic growth.

We expect the profitability indicators to improve to some extent by the end-2018, while the level of capital adequacy will continue to decline slowly, and the quality of assets will somewhat increase, especially with regard to the retail loans.

We do not exclude the continuation of the consolidation process of the banking sector of Armenia in 2018, which will contribute to the further growth of sector concentration.

Graph 10: Liquidity ratios, %



Source: AmRating calculations based on data from banks of Armenia

Finally, we believe that the further growth of the Armenian banking sector will continue to depend on the level of transfers entering the country, over 60% of which come from remittances from Russia. In this regard, further strengthening of the sanction pressure on Russia may lead to a restriction of the remittances inflow. However, at the same time, this can increase the export opportunities of the local producers in the context of Russia’s policy on import substitution, as since 2013 Armenia is a full member-state of the common customs area of the EAEU. A lot will depend on realization of still modest expectations of the positive outcome of the new government's systemic reforms, as well as on the domestic political stabilization after the country's transition to a new parliamentary form of government.

The internal political situation in Armenia in the end of April 2018 can seriously affect not only the relative position of political power in the country, but also the business climate characterized by the presence of concentrated oligarchic capital and large monopolies directly bound with the country's political elite. In this regard, we anticipate some deterioration of the economic stance. However, the extent of the negative economic trend and its timeframe will depend on the depth of the political crisis.