

Armenia Benchmarking Report 2004

Vahe Dalyan (MEDI), Matt Graham (MIX), February 2006

Background¹

Armenia has faced several shocks in recent decades. A 1988 earthquake devastated one third of the country, leaving hundreds of thousands homeless. Disintegration of the Soviet Union led to the collapse of its industrial base and markets. A war with Azerbaijan over Nagorno Karabakh resulted in an influx of Armenian refugees and emigration of Armenians seeking better economic opportunities elsewhere, as well as an on-going economic blockade imposed by Azerbaijan and Turkey. Nevertheless over the past three years, the Armenian economy's growth has outpaced that of every other Newly Independent State (NIS), with an average real GDP growth of over 10 percent. At the same time, inflation, which peaked at 10,000 percent in 1993, has been reduced to an average of roughly three percent per annum over the past five years.

This drop in inflation is the result of a declining budget deficit, an improvement in the balance of payments, and the high real interest rate policy of the Central Bank of Armenia (CBA). Consequently, as the inflation rate has fallen, the CBA has engineered a decline in the overall interest rate environment, whereby the current prime lending rate is 16 percent and the interest rate paid by banks on savings account ranges from zero to eight percent.

With the government committed to a poverty reduction agenda, the enabling environment for the small and medium enterprise (SME) and microfinance sectors looks promising. Nonetheless, Armenia faces serious external threats in relation to the disputed region of Nagorno-Karabakh (NK). Resumption of this conflict would undoubtedly have a deleterious effect on the economy. In the absence of such an external event, and providing the global economy continues to expand, the outlook for the Armenian economy should be positive. In such an environment, the microfinance sector should continue to do well.

Microfinance in Armenia

Similar to many other parts of the world, microfinance in Armenia has evolved as a means of reducing poverty, improving living standards, and creating jobs through improving access to affordable financial services. In the mid 1990's, a number of charitable organizations opened microfinance facilities in Armenia. These organizations began to extend loans to micro businesses that had little or no access to affordable business finance. These microfinance institutions (MFIs) have managed to develop a notable clientele base and sizeable portfolios in a



¹ **ACKNOWLEDGMENTS:** Vahe Dalyan is Microfinance Institutions Development Specialist at MEDI, and Matt Graham is Regional Manager Eastern Europe & Central Asia at MIX. **DISCLAIMER:** The authors' views expressed in this publication do not necessarily reflect the views of the United States Agency for International Development or the United States Government.

MEDI is a United States Agency for International Development funded project implemented by Chemonics International Inc. Proshian Street, 1st lane # 32, Yerevan 375019, Armenia
Tel.: +374 (10) 545 121, Fax: +374 (10) 588 011
www.medi.am

While developing this report MEDI used data and tools provided by Microfinance Information Exchange (MIX). In particular, MEDI collected data from Armenian MFIs utilizing MIX data collection tool. The Microfinance Center (MFC) verified the information submitted against audited financial statements where available. Then, in order to generate benchmarks for Armenian MFIs, these data were imported into the MIX's benchmarking database, the MIX Monitor. Finally MIX provided MEDI with benchmarks for Eastern Europe and Central Asia (ECA) and Caucasus groups of MFIs, the format for this report and editing support.



USAID
FROM THE AMERICAN PEOPLE

**MICRO ENTERPRISE
DEVELOPMENT INITIATIVE**

miX
Microfinance Information Exchange

MICROFINANCE CENTRE
for Central and Eastern Europe and the New Independent States

relatively short period of time, in spite of largely relying on the willingness of donors to allocate resources for lending particular loan products to specific groups of people in specified regions rather than on market principles. Nevertheless, the microfinance landscape is changing rapidly and MFIs will have to adapt if they are to remain relevant players over the long term. For instance, encouraged by a high growth rate in the SME sector, banks have begun to aggressively enter this market, as evidenced by introduction of express loans from USD \$500 to USD \$3,000 by a number of commercial banks, including ACBA and Converse. Additionally, changes in the Law on Credit Organizations, enacted in 2002, have led to additional credit organizations entering the market, creating more intense competition.

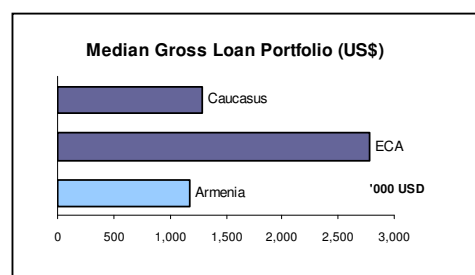
This report however, focuses mainly on non-profit MFIs that serve over 82 percent of the known borrowers currently being reached in the Armenian microfinance market.² Some MFIs have a much stronger position in the market than others. For example, the consolidated outstanding portfolio of the three largest MFIs surveyed accounts for 72 percent of the total portfolio outstanding of the seven MFIs surveyed, while in terms of active clients the portion of these three MFIs is as high as 84 percent. Even though the median age of these MFIs is 5.5 years, they have a limited range of products, and many still offer only modifications of a single loan product. The majority of surveyed MFIs focuses on serving urban clients engaged mainly in small trade or services that require short-term working capital loans. The portfolio is not evenly distributed throughout Armenia, almost one-third of it is allocated to the city of Yerevan alone. However, there are also institutions which focus on rural lending. Nevertheless, the outstanding portfolio of all surveyed MFIs is not well diversified, with roughly half invested in trade (mainly open market trade), 36 percent in agriculture, 10 percent in production and services and 2 percent in social loans.

Although five out of seven MFIs have achieved financial self-sufficiency, in some cases this is done by charging high interest rates that mask inefficient operations, or by operating with low levels of investment in infrastructure, solid systems, and staff development, which may have negative long-term consequences. For example, failing to develop professional skill sets for staff in the areas of market research, product development, and risk management, could limit the institution's capacity to identify and respond to changes in the market and limit its future growth. It should be noted though that some MFIs have developed five-year strategic plans, where they outline the measures and timeframe for addressing many of those issues. A recent Micro Credit Demand Survey conducted by MEDI³ showed that Armenian financial institutions are meeting less than half of the existing micro-credit demand, which suggests there is a good opportunity for MFIs to increase their scale and outreach.

Performance Analysis of Non-bank MFIs ⁴

Institutional Size

Armenian MFIs conduct relatively smaller operations than their Eastern Europe and Central Asia (ECA) peers, as defined by Microfinance Information eXchange. Despite the fact that the median age of Armenian MFIs is 5 years old, just one year shy of the regional median, Armenian MFIs differ significantly in terms of their individual scales. For example, in terms of portfolio size, 0.9 million USD is the portfolio of the smallest Armenian MFI, which is two-thirds smaller than the ECA median, while the largest Armenian MFI has a total gross loan portfolio of over 5,5 million USD, which is 50 percent greater than the ECA median. The loan portfolios of the other five MFIs range from 1 to 3.6 million USD. While, in general, limited access to external funding has hindered the portfolio growth of the Armenian microfinance industry, a lack of market research and strategic marketing skills by the MFIs remains one of the main reasons for their relatively small scale. Although the median number of offices at Armenian MFIs is equal to the ECA median, some Armenian MFIs are still a long way off from becoming national financial institutions. The only current exception is the largest MFI which has an extended network of branches covering most of the country, while other MFIs are recently beginning to expand.



While, in general, limited access to external funding has hindered the portfolio growth of the Armenian microfinance industry, a lack of market research and strategic marketing skills by the MFIs remains one of the main reasons for their relatively small scale. Although the median number of offices at Armenian MFIs is equal to the ECA median, some Armenian MFIs are still a long way off from becoming national financial institutions. The only current exception is the largest MFI which has an extended network of branches covering most of the country, while other MFIs are recently beginning to expand.

INSTITUTIONAL INDICATORS		Armenian MFIs	MBB ECA FSS	MBB All ECA	MBB Caucasus
Number of MFIs	Sample Size of Group	7	45	60	15
Age	Years Functioning as an MFI	5	6	6	6
Gross Loan Portfolio	Gross Loan Portfolio, adjusted for standardized write-offs	1,176,731	3,137,182	2,780,486	1,280,770
Offices	Number, including head office	7	8	7	6
Personnel	Total number of employees	34	47	42	41

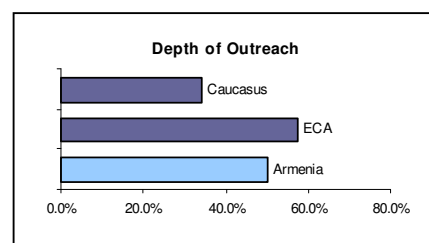
² 7 out of total 7 Armenian MFIs were analyzed in this report.

³ Analysis of Micro Credit Demand in Armenia, June 2005 www.medi.am

⁴ The analysis is based on the information provided by seven non-bank MFIs that participated in MicroBanking Bulletin: AREGAK, FINCA Armenia, MDF-Kamurj, SEF – ARM International, ANIV Fund, ECLOF - ARM and Horizon Fund.

Outreach

Although the median number of active borrowers of Armenian MFIs is below the ECA median of roughly 3,000 and Caucasus median of over 4,000, two MFIs have more than 6,000 and a third has more than 17,000 active clients. These three MFIs together have 84 percent of all surveyed active clients. Of the remaining MFIs, one has 2,700 clients and the other three have less than 2,000 clients each. Given the current unmet demand for micro credits, Armenian MFIs have good prospects in terms of increasing their outreach if they succeed in developing internal skills related to market research and product development. Additionally, with the exception of one MFI, SEF - ARM, which is already registered as a Universal Credit Organization, all other MFIs will have to register by March 1, 2006 with the CBA in order to comply with legislation and regulation governing lending activities. It should be noted that MEDI was nominated by the CBA to organize an MFI working group to provide feedback on key regulations governing credit organizations. As a result, significant progress has been made toward clarifying the legal and regulatory environment for microfinance and to do so based on guiding principles established by the Consultative Group to Assist the Poor (CGAP). However, once this is completed, registered MFIs will become eligible to attract commercial debt and equity, which is becoming increasingly needed to finance their future growth.



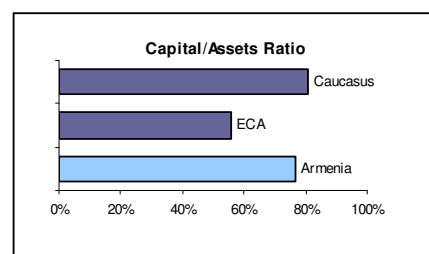
In terms of depth of outreach, Armenian MFIs are rather diversified. Partially as a result of their methodology, the larger MFIs who offer predominantly group loans reach the poorest clients, while the smaller MFIs serve better-off entrepreneurs with individual loans. For example, the depth of outreach ratio, as measured by average loan size over gross national income per capita, of the largest MFI is around 30 percent. The same ratio of the smallest MFI is around 660 percent. The smallest loans are given predominantly to unregistered businesses, often run by women involved in market trade. Most Armenian MFIs focus primarily on densely populated areas with the largest concentration of micro businesses and farms, which enables them to maximize the number of clients without large investments in office infrastructure. This leaves entire regions with little or no access to microfinance services.

OUTREACH INDICATORS		Armenian MFIs	MBB ECA FSS	MBB All ECA	MBB Caucasus
Number of Active Borrowers	Number of borrower with loans outstanding, adjusted for standardized write-offs	2,720	4,127	2,884	4,127
Percent of Women Borrowers	Number of active women borrowers/Adjusted Number of Active Borrowers	31.4%	60.8%	60.8%	51.0%
Average Loan Balance per Borrower	Adjusted Gross Loan Portfolio/Adjusted Number of Active Borrowers	560	1022	1023	345
Average Loan Balance per Borrower/GNP per Capita	Adjusted Average Loan Balance per Borrower/GNP per Capita	50.0%	50.0%	53.4%	34.0%

Financial Structure

Armenian MFIs are primarily donor-funded and the debt funds which they have on their balance sheets typically represent loans from founders, associated networks, or socially responsible investors. As evidenced by their lack of leverage, which is over 60 percent lower than the ECA median, Armenian MFIs do not mobilize savings and have yet to attract funds from commercial sources for reasons explained above. Taking into account the fact that sometimes MFI founders prefer to structure their MFI investments as zero interest rate or subordinated debt rather than equity, the real debt-to-equity ratio may be even lower⁵.

Generally, three main factors contribute to the low leverage level in Armenian MFI industry. First, over the course of the last six to seven years, international donors and MFI-founding organizations provided considerable funds for maintaining operations and loan capital of MFIs. Second, under Armenian law, savings collection by nonbank financial institutions is not permitted. Lastly, due to the unclear legal status of microfinance institutions described above, international investors are reluctant to enter the Armenian market and many local commercial financial institutions are hesitant to lend to MFIs as well. Exceptions to this include a few isolated instances where Armenian commercial banks have provided short-term overdraft facilities to MFIs during peak lending seasons. However, impending CBA regulation of Armenian MFIs will require MFIs to formally register with the CBA as credit organizations by March 1, 2006. This will, in theory, remove a major barrier to investment and thereby increase MFI access to commercial funding. Nevertheless in order to manage their assets effectively prior to attracting debts from commercial sources, Armenian MFIs have to develop relevant institutional capacities, such as risk and assets and liability management functions and enhance their financial management skills. It should be noted that many Armenian MFIs have recently engaged in serious



⁵ In accordance to Armenian Law on Foundations, Foundations do not have ownership and in case of liquidation equity is transferred to State Budget.

business planning exercises. As a result, they are in the process of implementing these plans and addressing many of these issues. Otherwise with a current ratio of consolidated gross loan portfolio to total assets of surveyed MFIs of around 83 percent, Armenian MFIs could manage their assets more efficiently by allocating a higher portion of their resources to their loan portfolios. Presently, Armenian MFIs divert 17 percent of their assets away from their loan portfolios. This has two negative implications: they reach fewer clients, and generate less revenue. However, expect the asset allocation to fall as these institutions transform into regulated institutions and their asset liability management systems evolve in order to account for the varying maturities of liabilities they will be accessing.

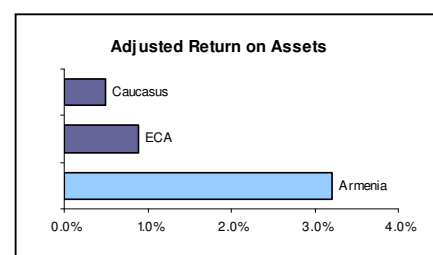
FINANCING STRUCTURE		Armenian MFIs	MBB ECA FSS	MBB All ECA	MBB Caucasus
Capital/ Asset Ratio	Adjusted Total Equity/ Adjusted Total Assets	76.7%	39.1%	56.0%	81.0%
Commercial Funding Liabilities Ratio	All liabilities with "market" price/ Adjusted Gross Loan Portfolio	0.0%	22.8%	14.6%	0.0%
Debt/ Equity Ratio	Adjusted Total Liabilities/ Adjusted Total Equity	30.3%	155.6%	78.6%	23.4%
Gross Loan Portfolio/ Total Assets	Adjusted Gross Loan Portfolio/ Adjusted Total Assets	83.4%	88.0%	87.4%	83.4%

Financial Performance

Several Armenian MFIs are among the most profitable MFIs in the region, and even though the majority of Armenian MFIs have reached operational and financial self-sufficiency, the key driver for reaching sustainability remains high yield on portfolio. This is evidenced by fact that Armenian MFIs with yields below 40 percent are not profitable. Given the intense competition and upcoming regulation by the CBA that will enforce a Civil Code loan interest cap requirement⁶, MFIs will be forced to charge lower interest rates, which will reduce their yields. Therefore, to remain profitable, Armenian MFIs will need to focus on cutting costs and improving efficiency.

Revenues

Despite their higher portfolio yields, Armenian MFIs lag behind their ECA peers in terms of financial revenue generation. This is partially due to their devoting a lower percentage of their resources to their loan portfolios. It is likely that this tendency will continue as the upcoming CBA regulation and market forces will continue to put downward pressure on interest rates which will lead to lower yields in the near term.



Expenses

Armenian MFIs' expense levels are comparable with those of their ECA peers, although the expense levels of individual MFIs differ considerably. For example, Armenian MFIs spend from 16 to 40 cents to manage each dollar of their assets. This variation is mainly attributed to differences in lending methodologies, personnel expense levels and the overall development level of the institutions. MFIs with a larger portion of individual loans in their portfolios have higher expense levels, than those that focus on group lending. Likewise, the MFIs which pay the social security taxes of their employees have higher personnel costs than those which are tax exempt.⁷ Additionally some MFIs have higher salary levels which enable them to attract more experienced staff. Finally, some MFIs have poor systems in place, which allows them to keep the costs down in the short run, but will likely impede the growth of their organizations over the long term.

OVERALL FINANCIAL PERFORMANCE		Armenian MFIs	MBB ECA FSS	MBB All ECA	MBB Caucasus
Return on Assets	Adjusted Net Operating Income, net of taxes/ Adjusted Average Total Assets	3.2%	3.8%	0.9%	0.5%
Return on Equity	Adjusted Net Operating Income, net of taxes/ Adjusted Average Total Equity	12.1%	6.6%	3.2%	0.7%
Operational Self-Sufficiency	Financial Revenue/ (Financial Expense + Net Loan Loss Provision Expense + Operating Expense)	142.3%	135.0%	128.1%	121.9%
Financial Self-Sufficiency	Adjusted Financial Revenue/ Adjusted (Financial Expense + Net Loan Loss Provision Expense + Operating Expense)	123.7%	116.1%	108.5%	104.6%
REVENUES					
Financial Revenue Ratio	Adjusted Financial Revenue/ Adjusted Average Total Assets	27.3%	33.2%	31.2%	36.9%

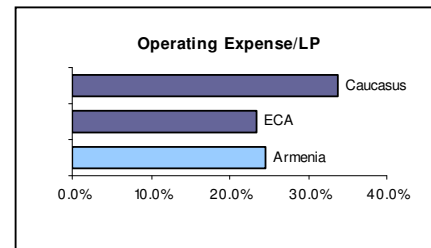
⁶ The new Civil Code loan interest rate cap will not allow financial institutions to charge interest rates that exceed twice the banking rate set forth by the Central bank of Armenia. Financial Institutions will still be able to increase the effective interest rate by charging additional fees, such as service or application fees, etc., but in those cases the fees would be subject to VAT.

⁷ In accordance to bilateral agreements between Armenia and USA, organizations created by US funding do not pay social security taxes on employee wages.

Profit Margin	Adjusted Net Operating Income/ Adjusted Financial Revenue	19.2%	13.9%	7.8%	4.4%
Yield on Gross Portfolio (nominal)	Adjusted Financial Revenue from Loan Portfolio/ Adjusted Average Gross Loan Portfolio	40.9%	38.4%	36.9%	45.1%
Yield on Gross Portfolio (real)	(Adjusted Yield on Gross Portfolio (nominal) – Inflation Rate)/ (1 + Inflation Rate)	31.8%	30.3%	28.4%	37.1%
EXPENSES					
Total Expense Ratio	Adjusted (Financial Expense + Net Loan Loss Provision Expense + Operating Expense) / Adjusted Average Total Assets	29.9%	28.6%	30.5%	38.5%
Financial Expense Ratio	Adjusted Financial Expense/ Adjusted Average Total Assets	5.4%	5.7%	7.3%	5.8%
Loan Loss Provision Expense Ratio	Adjusted Net Loan Loss Provision Expense/ Adjusted Average Total Assets	1.0%	1.0%	1.1%	1.5%
Operating Expense Ratio	Adjusted Operating Expense/ Adjusted Average Total Assets	18.2%	16.8%	18.5%	31.8%
Personnel Expense Ratio	Adjusted Personnel Expense/ Adjusted Average Total Assets	12.4%	10.8%	12.0%	15.6%
Administrative Expense Ratio	Adjusted Administrative Expense/ Adjusted Average Total Assets	4.9%	6.3%	7.5%	11.4%
Adjustment Expense Ratio	(Adjusted Net Operating Income - Unadjusted Net Operating Income)/ Adjusted Average Total Assets	5.3%	2.1%	3.8%	4.8%

Efficiency

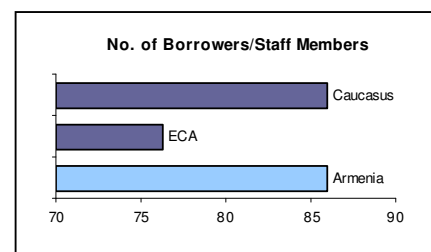
Generally, Armenian MFIs are comparable with their ECA peers in terms of efficiency. Even though their median total operating expenses represent slightly less than a quarter of the value of their loan portfolios, the operating expense to loan portfolio ratio ranges from 10 to 40 percent, depending on the institution. Armenian MFIs offer mostly group loans, which enables them to serve a relatively high number of borrowers. So, despite their relatively high operating expense ratio, Armenian MFIs reach more clients at a lower cost as it is reflected in their low cost per borrower ratio, as compared to ECA peers.



EFFICIENCY		Armenian MFIs	MBB ECA FSS	MBB All ECA	MBB Caucasus
Operating Expense/ Loan Portfolio	Adjusted Operating Expense/ Adjusted Average Gross Loan Portfolio	24.6%	20.1%	23.5%	33.8%
Personnel Expense/ Loan Portfolio	Adjusted Personnel Expense/ Adjusted Average Gross Loan Portfolio	13.3%	12.8%	13.9%	18.6%
Average Salary/ GNP per Capita	Adjusted Average Personnel Expense/ GNP per capita	472.1%	472.1%	492.5%	546.7%
Cost per Borrower	Adjusted Operating Expense/ Adjusted Average Number of Active Borrowers	143	180	197	130

Productivity

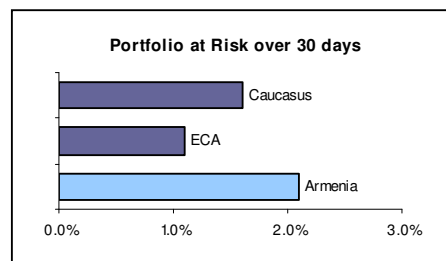
Even though the loan officer productivity in Armenia is higher than that of the median for ECA group it should be noted that loan officer productivity levels differ significantly from MFI to MFI and even within different branches of the same MFI. The main reason behind this is that some MFIs offer only group or individual loans, while others offer both products in selected regions. Armenian MFIs also have a low personnel allocation ratio as compared to their ECA peers. Less than half of all employees at Armenian MFIs are directly involved with the clients, which is below the median for the region. Underdeveloped communications and information systems at Armenian MFIs are one of the main causes for that.



PRODUCTIVITY		Armenian MFIs	MBB ECA FSS	MBB All ECA	MBB Caucasus
Borrowers per Staff Member	Adjusted Number of Active Borrowers/ Number of Personnel	86	86	76	86
Borrowers per Loan Officer	Adjusted Number of Active Borrowers/ Number of Loan Officers	165	169	147	159
Personnel Allocation Ratio	Number of Loan Officers/ Number of Personnel	47.5%	54.5%	53.0%	47.8%

Risk and Liquidity

Even though the majority of Armenian MFIs have developed strict repayment policies and incentive schemes for clients with good credit history, Armenian MFIs have higher delinquency rates than their regional peers. This can be explained by institutional as well as market factors. At the institutional level, the majority of MFIs did not manage to create strong delinquency management policies and systems, and they continue to rely heavily on loan officers in collecting bad loans. At the market level, one of the characteristics of the Armenian Micro Loan market is an over-indebtedness of clients because of market concentration. It is estimated that from 20 to 40 percent of MFI clients have parallel loans from different MFIs. High delinquency rates suggest that some of them cannot afford repaying on aggregate larger loans. Participation of all MFIs in the recently established ACRA private Credit Bureau will help MFIs track such clients and, thus minimize delinquency risks⁸. Although loan loss reserve levels are sufficient to cover the delinquency risk, the Armenian risk coverage ratio is much lower than for ECA peers. One explanation for this is that some MFIs are registered as foundations and do not have loan loss reserve accounts and expense delinquent loans only if they write them off. It should be noted that as soon as the sector is regulated by CBA, all MFIs will have to follow CBA loan provisioning standards and in that case the risk coverage ratio should become more uniform⁹.



RISK AND LIQUIDITY		Armenian MFIs	MBB ECA FSS	MBB All ECA	MBB Caucasus
Portfolio at Risk > 30 Days	Outstanding balance, loans overdue > 30 Days/ Adjusted Gross Loan Portfolio	2.1%	1.0%	1.1%	1.6%
Portfolio at Risk > 90 Days	Outstanding balance, loans overdue > 90 Days/ Adjusted Gross Loan Portfolio	0.8%	0.3%	0.3%	0.8%
Write-off Ratio	Adjusted Value of loans written-off/ Adjusted Average Gross Loan Portfolio	1.7%	0.8%	0.8%	1.1%
Loan Loss Rate	Adjusted Write-offs, net of recoveries/ Adjusted Average Gross Loan Portfolio	0.6%	0.6%	0.6%	0.9%
Risk Coverage	Adjusted Loan Loss Reserve/ PAR > 30 Days	82.7%	166.2%	133.8%	133.8%
Non-earning Liquid Assets as a % of Total Assets	Adjusted Cash and banks/ Adjusted Total Assets	5.5%	4.0%	4.1%	6.0%
Current Ratio	Short Term Assets/ Short Term Liabilities	862.0%	658.4%	695.9%	1196.5%

Conclusion

The majority of Armenian MFIs have achieved operational and financial self-sufficiency levels, however, as a general rule, this is achieved by charging high interest rates and sourcing cheap funds. Armenian MFIs are highly concentrated in urban areas and remain relatively small with a few notable exceptions. Forthcoming CBA regulation as well as market competition from banks will force MFIs to considerably reduce their interest rates, which will put pressure on their current profitability levels unless they significantly reduce their costs and improve efficiency of their operations.

Currently Armenian microfinance is at critical juncture. The era when MFIs were competing with each other to attract more clients and receive donor funding is over. Now they have to be prepared to work under CBA regulation and supervision in a highly competitive micro credit market, where not only MFIs, but also commercial banks and credit organizations are entering the market in search of new growth opportunities. To do so, they will have to enhance their overall institutional capacities, for example in areas such as market research, financial analysis and product development. Several key MFIs have engaged in business planning exercises with the support of MEDI and are taking steps to strengthen areas of institutional weakness. This will enable them to introduce more sophisticated financial products and better meet the needs of their clients.

Armenian MFIs need to become attractive to commercial debt and equity Investors, as in medium-term the donor funding in this region is drying up. As a result, MFIs will increasingly need to look to external sources of debt and equity in order to finance their future growth.

⁸ Armenian Credit Rating Agency (ACRA) was established by Credential Inc., a US based company in 2004. The Dun&Bradstreet Company owns 5%, and SCHUFA credit bureau (Germany) -2% of ACRA's shares. For more information about ACRA visit their web page www.acra.am

⁹ In accordance to CBA loan loss provisioning standards, financial institutions should have 1% reserve for performing loans, for 1<PAR<90 days - 10%; for 91<PAR<180 days - 20%; for 181<PAR<270 days -50%; and for PAR over 270 days -100%