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Executive Memorandum

ARMENIA

Financial Crisis Assessment

APRIL 2009
This document was produced for review by the United States Agency for International Development. It was prepared by Chemonics International Inc. for the Financial Sector Knowledge Sharing Project, delivery order number EE-E-03-05-00006-00.

The author's views expressed in this publication do not necessarily reflect the views of USAID or of the United States Government.

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ACKNOWLEDGEMENT

A Financial Crisis Assessment of Armenia was conducted from April 13-24, 2009 by Roberto Toso, Project Manager of the Financial Sector Knowledge Sharing Project, managed by Chemonics International Inc. Mr. Toso would like to thank the representatives of financial institutions, corporations, International Finance Institutions (IFIs), and Government of Armenia authorities for providing information and discussing the current financial challenges facing the country. The consultant would also like to thank Hugh Haworth of the United States Agency for International Development for his leadership and expert orientation during the interviews, and USAID Armenia and in particular Haikanush Bagratunyan for support and assistance with logistics and interviews with financial and corporate sector leaders, IFIs, and government officials. The consultant would like to acknowledge the diligent participation of Karen Dallakyan in assembling and facilitating background documents and reports and for providing valuable insights about the financial sector of Armenia. The consultant also acknowledges Melissa Scudo for her review and contributions to this report and the *Guidelines for a Rapid Financial Crisis Assessment* included as an annex to this report.

INTRODUCTION

The United States Agency for International Development (USAID) Bureau for Economic Growth Agriculture and Trade (EGAT) created the Financial Sector Knowledge Sharing Project (FS Share) to collaborate with USAID missions to develop effective and efficient financial sector programs that increase access to financial services and develop well-functioning markets worldwide. USAID awarded Chemonics International the FS Share delivery order under the Financial Sector Blanket Purchase Agreement. FS Share has a three-year period of performance, July 2008 through July 2011.

Through the FS Share Task Order, USAID EGAT and Chemonics International proactively collaborate with missions to identify financial sector priorities and develop strategies and programs for growing the financial sector. FS Share also identifies financial sector best practices and aggregates those best practices through model scopes of work, technical briefs, diagnostic tools, best practice case analyses, and other tools. These technical deliverables are disseminated to USAID missions to integrate into financial sector programming. FS Share can assist with implementation and connect mission staff to external resources on best practices. In response to mission demand, FS Share delivers informative presentations and other knowledge-sharing initiatives.

The objectives of the Rapid Financial Crisis Assessment for Armenia are to identify strengths and vulnerabilities of financial sector participants, assess overall soundness and stability of the financial and corporate sectors, highlight linkages between the macro-economy and the financial sector, and ascertain economic policy implications.

METHODOLOGY

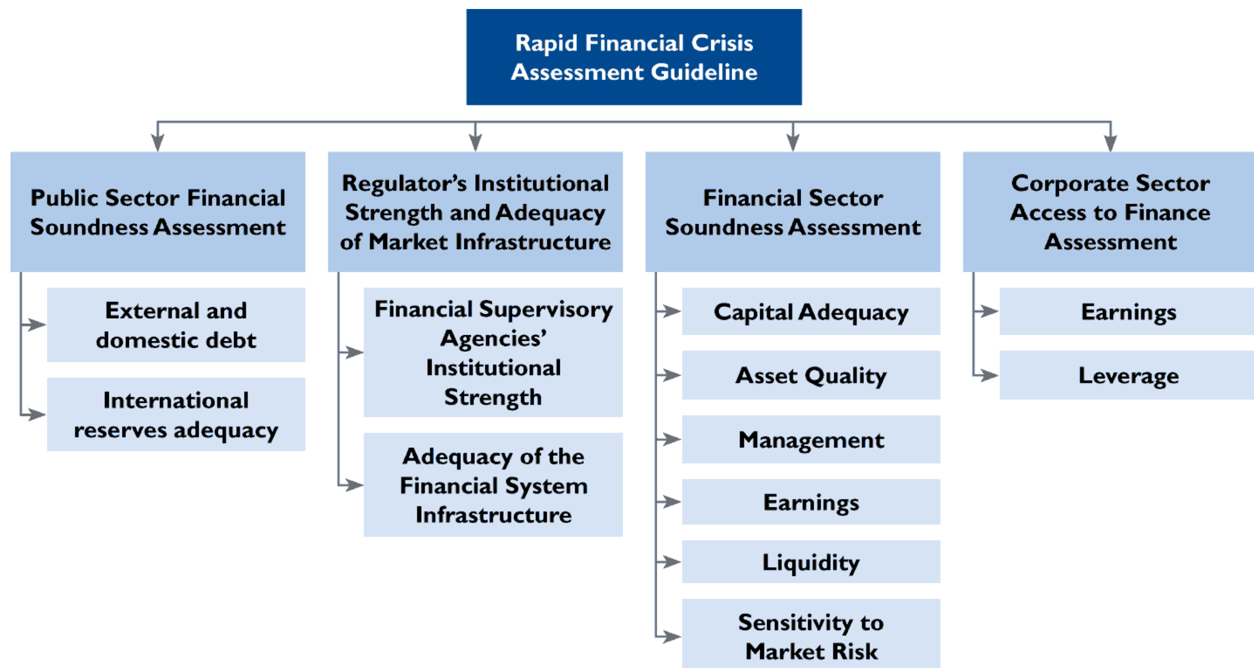
The RFCA process took place in Armenia between April 13-24, 2009. It was designed as an action-driven, swift and simple assessment of the most immediate and urgent vulnerabilities of the Armenian financial and corporate sectors impacted by the financial crisis. The RFCA is not meant to be a substitute of more systematic and comprehensive assessments such as “stress tests” and the Financial Sector Assessment Program (FSAP) conducted by The World Bank and the International Monetary Fund (IMF) that require specialized resources and significantly more time to execute.

The RFCA is divided into seven sections. The first four sections are analytical and provide an overview of the impact of the global financial crisis on the Armenian economy, the financial soundness of the public sector, the preparedness of the financial sector policy and regulatory institutions and the capacity of the country’s financial market infrastructure to withstand the financial crisis. This assessment is based on interviews and a review of secondary data, including economic reports and statistics, legislation and regulations. The other two sections of the RFCA assess the capacity and soundness of financial institutions (primarily commercial banks) and the

corporate sector and access to finance constraints. The last section presents the economic policy implications to be addressed by the authorities.

A critical decision regarding use of this assessment tool was the selection of persons and sources to be interviewed to obtain reliable answers. There was a significant degree of subjectivity and potential lack of completeness reflected in the responses when the persons providing them had an interest in the conclusions likely to be drawn from the responses. For example, the Central Bank may have been the most logical party to answer questions regarding the single financial regulator and its supervisory and enforcement capabilities, but regulators in general are reluctant to report that they are not doing the best possible job. Similarly, senior officials at the Central Bank, the Ministry of Finance, and the Ministry of Economy may be the appropriate persons to answer questions regarding macro- and microeconomics developments and financial sector shocks, but few senior officials admitted that they are not doing everything they could be doing to address the effects of the crisis. For these reasons, the consultants looked for independent verification of responses through direct interviews with financial and corporate sector participants. These participants were representatives of financial institutions and the corporate sector as well as representatives from international agencies such as USAID, The World Bank, KfW, the IFC and the IMF.

The *Guidelines for a Rapid Financial Crisis Assessment* was developed by Roberto Toso, FS Share Program Manager, with support from Melissa Scudo, FS Share Deputy Manager, and is attached to this report.



GLOBAL FINANCIAL CRISIS AND IMPACT ON ARMENIA

Armenia has been negatively and severely affected by the global economic and financial crisis after many years of strong economic performance. Armenia's financial sector is underdeveloped and its integration with the international financial markets is limited. Therefore, the global financial crisis did not transmit to the Armenian economy via the financial sector as it did in several countries in the region such as Russia, Ukraine, and Kazakhstan, but mainly through the real economy with a lag of about six months.

Moreover, as a result of its main trading partner, Russia, sliding into its first recession in 10 years, Armenia's total exports is falling and foreign direct investment (FDI) and remittances are dramatically slowing. Russian firms control strategic sectors of the Armenian economy such as energy, communications, banking, and railroads. It is estimated that 70 percent of FDI comes from Russia. International prices of Armenia's major exports such as copper and molybdenum during the first quarter of 2009 reached only about half of what they were a year ago. Net remittances, US$1.7 million per year or 20 percent of GDP, dropped about 40 percent during the first quarter of 2009 compared with the same period a year ago. 75 percent of total inward remittances come from Russia.

Armenia has seen GDP growth slow to about 10 percent in 2008 from 13.7 percent the year before, and it could drop as low as –9 percent by the end of 2009. Compared with the same period a year ago, preliminary estimates suggest that during the first quarter of 2009 exports dropped by 45 percent, total imports contracted by 22 percent, and consumer spending and real estate sales — largely financed by remittances — dropped by 50 percent and 30 percent respectively.

Due to the worsening terms of trade and slowing capital inflows, the Central Bank's board made a decision to limit currency interventions to sustain the value of the dram and return to a free float policy in March 2009. As a result, the dram depreciated by approximately 25 percent against the United States dollar (USD). According to a working paper published in March 2009, the IMF concluded that the dram was indeed overvalued by about 20 percent to 30 percent prior to the devaluation. The Central Bank also raised the refinancing rate by 100 basis points to 7.75 percent.

To ease the effects of the financial crisis in Armenia, the IMF recently announced a stand-by loan of US$540 million, of which US$239 million will be drawn immediately. The IMF had already approved a US$13.6 million loan program in November 2008. In February 2009, Armenia agreed to a US$500 million stabilization loan from Russia and a SME program with The World Bank and KfW for US$250 million, of which US$50 million will be disbursed in 2009. This loan plus additional funding being negotiated with the Asian Development Bank, The European Bank for Reconstruction and Development (EBRD), and the Black Sea Trade Development Bank will bring a total of $525 million to support Armenian business sectors.

The Government of Armenia is also implementing a fiscal stimulus package in the form of various programs, among them a special liquidity facility to allow construction companies to complete their residential construction projects and an investment fund to support projects and

enterprises with equity investments in areas and sectors considered innovative and entrepreneurial.

Inflation is likely to be contained at 4 percent to 6 percent in 2009. The drop in international commodity prices such as petrol and wheat — of which Armenia is a net importer — may contribute to easing inflationary pressures. An additional factor is the structural characteristic of the Armenian economy and its low responsiveness of imported goods' prices to exchange rate movements (IMF, 2009). According to the IMF (2009), this characteristic of the Armenian economy results in an incomplete exchange rate pass-through in the short run, implying also that changes in world prices of imported goods have only a gradual effect on the domestic economy.

PUBLIC SECTOR SOUNDNESS AND CHALLENGES

Armenia is facing the eruption of the global financial crisis with a low level of public debt distress. At the end of 2008, the main indicators of external and internal debt and of international reserves adequacy were at comfortable levels.

According to an IMF report (February 2009) all external debt indicators were well below the relevant country-specific debt-burden thresholds until the end of 2008. According to the same IMF report, Armenia's external debt stock as of end-2008 is estimated at US$2.1 billion (18 percent of GDP), mostly representing public and publicly guaranteed debt owed to multilateral international organizations. The outstanding debts of the government with The World Bank and the IMF account for 55 percent and 8 percent of total external debt stock, respectively. Armenia's estimated private sector external debt outstanding accounts for about 15 percent of total external debt. The share of domestic debt in the stock of public and publicly guaranteed debt is small, reflecting the limited development of the domestic debt markets. In 2008, the publicly guaranteed debt owed to domestic creditors accounted for 2.3 percent of GDP.

Until the end of 2008, the fiscal position remained sustainable. The IMF report states that the net present value of public sector debt was 9.8 percent of GDP in 2008. The net present value of debt-to-revenue ratio was 49 percent in 2008, and the debt service-to-revenue ratio was below 10 percent in 2008.

At the same time, gross international reserves as of February 2009 were at a comfortable level of US$1.14 million. With no significant debt maturities during 2009 and the concessionary nature of Armenia's foreign debt, international reserves remain at an adequate level.

As a result of the deteriorating economic conditions in 2009 reflected in the sharp drop in GDP growth, net remittances, FDI, exports, and government revenues, debt distress is likely to spike in 2009. Moreover, with a notable increase in anticipated concessional financing over the short and medium term, the net present value of external debt is expected to significantly increase from its current 7 percent of GDP in 2008, resulting in a steep increase in the external debt service ratio or external debt service as a percent of exports. The net present value of public external debt as a percent of exports will likely rise rapidly from the current level of 50 percent in 2008, due to the current and expected weaker export performance. A mitigating factor of debt distress is the predominately concessionary debt burden of the country.

A major challenge facing the government is the dramatic drop in government revenues and a significant worsening of the fiscal deficit as a percentage of GDP. During the first quarter of 2009, revenues were estimated to be 35 percent below the 2009 budget, forcing the government to postpone planned expenditures to the last quarter of the year. It is still uncertain what the fiscal deficit may be during 2009, but preliminary estimates put that figure at -5 percent of GDP for the year.

Armenia also has one of the lowest tax ratios to GDP in the world (19 percent), and tax and customs administration is notoriously arbitrary, inefficient, and plagued by corruption. Tax and customs enforcement and collections, despite recent improvements, remains one of the weakest aspect of Armenia's public administration. This is not likely to change in the short term, as authorities tend to be more lenient during economic crisis. Nevertheless, the government will have to address tax and customs administration structural reform sooner rather than later.

It is expected that during 2009, Armenia will be able to adequately manage its debt burden and the level and composition of international reserves. Therefore, public sector soundness will not be so dramatically affected by the crisis as to become a major systemic risk factor.

FINANCIAL SECTOR STRUCTURE, SOUNDNESS, AND CHALLENGES

As of March 2009, commercial bank assets represented 95 percent the total assets of Armenia's financial system. The remaining 5 percent of the assets are distributed among 25 credit organizations (with 48 branch offices), 10 insurance companies, 3 insurance brokerage firms, 67 pawnshops, 289 exchange offices (including branches), 2 currency dealers, 11 money transfer companies, 7 companies specialized with processing and clearing payment instruments, 10 investment companies, NASDAQ OMX Armenia, and the Armenia Central Depository.

COMMERCIAL BANKS

Notwithstanding the rapid growth of the banking system during the past five years, the level of financial intermediation remains low in Armenia and lags behind the level observed in the CIS countries. The ratio of banking system assets to GDP is about 20 percent, while bank lending to GDP ratio is approximately 15 percent.

In recent years, foreign investors have been increasingly interested in Armenia's banking system. German (ProCredit Bank), Lebanese (Byblos Bank), and Russian (Troyka-Dialog Bank and GasProm Bank) investors, among others, have entered the Armenian banking sector. At present, 14 banks include some proportion of foreign capital in their total capital, representing 60 percent of the total assets of the banking system.

Concentration in the Armenian banking system is moderate, reflecting an acceptable systemic risk. By the end of 2008, the five largest banks (22 banks in the system) represented 54 percent of total assets, lower than Estonia (98 percent), Lithuania (81 percent), Kazakhstan (76%), and Latvia (67 percent), but higher than Russia (44 percent) and Germany (22 percent). To evaluate concentration in the banking system, the Central Bank applied the Herfindahl-Hirschman Index

of Concentration for the period 2005-2007 to measure concentration of banking assets, liabilities, and capital, and concluded that concentration has not changed significantly over time and remains at a moderate level (Central Bank of Armenia, 2008). The Central Bank also conducted a competitiveness assessment of the banking system using the Panzer-Rosse Model and measured cost factors such as wages, fixed assets, and costs on interest income, and concluded that the Armenian banking system is characterized by “oligopolistic competition.”

Market structure as well as lack of economies of scale and persistent high credit risks due to imperfections in the financial market infrastructure help explain why Armenia’s interest rate spreads remain significantly higher than in most Central and Eastern European countries. Interest rate spreads are currently at about 12 percent, down from 14 percent in 2004, but remain significantly higher than spreads (below 10 percent) prevailing in Georgia, Azerbaijan, Russia, West CIS countries, and the Baltic countries.

Capital

Largely encouraged by the Central Bank, the capital adequacy ratio of the Armenian banking system is approximately 27 percent, with only HSBC having a capital adequacy ratio of 14 percent. This relatively high capital adequacy ratio is a positive indicator and compares favorably with the level of the indicators of Eastern European and CIS countries. Due to the crisis, systemic risks are growing and a higher capital base will allow banks to confront potential large losses by using their own resources.

However, in the current crisis environment, the level of capital may quickly devolve from satisfactory to deficient and not fully support the banks’ increasing risk profile. There is need for further strengthening, even if the banks’ current capital level exceeds minimum regulatory and statutory requirements.

Assets

During the last 8 years, the expansion of credit reached 650% on a cumulative basis and credit risk remained relatively low due to moderate ratios of nonperforming loans and low loan concentration ratios by client and by economic sector. However, in recent years, bank lending for construction, consumption, mortgages, and trade activities increased dramatically because of the following factors:

- Double-digit economic growth;
- Increased demand for loans due to continuous rise in household incomes fueled by growth in remittances;
- Development of a mortgage lending market;
- Inflow of inexpensive financial resources to the banking system from abroad; and
- Development of new financial products and technologies.

In January 2009, banks started to reduce dram lending to ease the impact of the largely anticipated devaluation of the dram. The actual 25 percent devaluation of the dram in March 2009 led to a massive shift of dram-denominated deposits into USD-denominated deposits, and

banks virtually stopped lending in drams. This development plus the dramatic drop in economic activity — particularly in consumer spending, construction activities, and mortgages — has dramatically increased the underlying credit risk of bank assets. Recent estimates indicate that nonperforming loans in the banking system may have now peaked at 6 percent and are significantly higher for consumer loans and mortgages.

Moreover, the large share of mortgage loans in total loan portfolios has made banks increasingly vulnerable. The quality of such loans largely depends on stable real estate prices to ensure high mortgage loan recovery rates and to safeguard the banking system from loan losses. Most Armenian banks have originated mortgage loans with a loan to value (LTV) ratio not exceeding 70 percent. It is estimated that the LTV ratios have dropped due to declines in real estate prices.

Given the current crisis environment, asset quality and credit administration practices may become less than satisfactory or deficient, and in some cases may present an imminent threat to banks' viability — especially for those banks heavily exposed in consumer loans, construction, and mortgages. Trends indicate deterioration in asset quality and an increase of risk exposures. The level and severity of certain classified assets, other weaknesses, and risks require an elevated level of supervisory concern. Banks' credit monitoring, administration, and risk management practices should be strengthened.

Management

Among the banks with foreign capital participation and also among the largest 10 banks, management performance appears to be satisfactory — indicating adequate risk management practices relative to the bank's size, complexity, and risk profiles. Significant risks are rising, and so far management seems to be able to measure, monitor, and adequately control such risks.

Quality of management among smaller banks ranges from less than satisfactory to critically deficient. The capabilities of management are becoming insufficient for the new risk conditions that are unfolding. There is a high level of concern that growing problem loans and growing risks are inadequately identified, measured, monitored, and controlled by a number of smaller, weaker banks.

Earnings

In recent years and until October 2008, the return on assets and return to equity ratios were stable, reaching approximately 3 percent and 14 percent respectively. However, for the entire year 2008, profitability indicators declined since both capital and assets of the banking system have grown more than net profit. The most recent figures indicate that in March 2009 the majority of banks showed losses due to exchange rate disruptions and a steep decline in interest rate revenues.

Aggregate earnings for the banking system are declining and losses are increasing. Therefore, earnings may reach deficient to critically deficient levels in the months to come. If the declining trend in earnings is maintained, earnings will be insufficient to support operations in some of the

weakest banks, and maintaining appropriate capital and allowance levels may become an insurmountable challenge.

Liquidity

Over the last three years and until October 2008, the growth rate of loans outpaced that of total assets by nearly double and, therefore, the growth rate of highly liquid assets lagged behind the growth rate of total assets. Until October 2008, the liquidity in the Armenian banking system remained considerably high, and banks did not face any serious problems with liquidity that could have undermined their financial stability. In the recent years until October 2008, liquidity fluctuations in the banking system were low and outperformed the required standards. According to a Central Bank report (2008), the liquidity ratios applied in Armenia have been more restrictive than liquidity ratios in other countries.

In recent years, the volumes of assets in all maturity groups have outgrown those of liabilities, and it is reasonable to expect the banking system in 2009 will face increasing liquidity risks. However, increased banking system capitalization ratios may contribute to mitigate a possible liquidity crunch.

A major challenge facing the banks today is the mismatch between currency denominations of assets and liabilities. Before the devaluation of the dram, foreign currency–denominated deposits were 20 percent of total deposits. After the devaluation, this figure became 80 percent. On the other hand, assets remain largely denominated in drams. This situation represents an excess liquidity in foreign currency that banks are not able to lend, as there is limited demand for foreign currency–denominated loans.

As a result of the crisis, dram liquidity in the banking system may devolve from reasonable to deficient levels. This situation may threaten the viability of certain institutions, which may require external financial assistance from the Central Bank to meet liquidity needs.

Sensitivity to Market Risks

Following devaluation of the dram in March 2009, losses associated with foreign currency risk in the banking system reflect increasing vulnerability of financial stability. Until now, the level of interest rate risk in the banking system remained manageable. The average maturity of assets and liabilities is short (about one year), which enables banks to respond rapidly to changes in market interest rates and to adjust them. Price risk in the banking system is growing significantly. The banking system may be incurring losses in 2009 on price risk from devaluation of commercially available and ready-for-sale financial assets and devaluation of fixed assets.

As a result of the current crisis, market risk sensitivity is high and growing, and there is a possibility that the capital position of banks may be adversely affected. Risk management practices in certain banks may become increasingly deficient.

INSURANCE COMPANIES

The insurance industry is extremely small and undeveloped in Armenia. Total insurance premiums in 2008 reached US$17 million, which is less than 1 percent of GDP. There are 10 insurance companies and 3 brokers. The 3 largest companies represent 60 percent of total premiums.

It is worth mentioning, however, that risks to insurance companies are closely related to risks in the banking sector. About 50 percent of premiums are tied with insurance policies required by banks in their commercial activities. Therefore, a contraction in banks' earnings will impact insurance companies' earnings. However, the Armenian insurance system for the moment is not likely to have an influence on financial system stability, since the scope of activities of insurance companies is still small and the current activities of this industry can hardly be considered risky.

CHALLENGES AND PREPAREDNESS OF THE FINANCIAL SECTOR POLICY AND REGULATORY INSTITUTIONS

The Central Bank is one of the strongest and most professional government institutions in the country, and its technical staff is considered highly qualified. It adopted inflation targeting in 2006, guided by an analytical framework established around a small open economy quarterly projections model. The model captures aggregated and simplified relations in the Armenian economy to explain fluctuations in output, inflation, the exchange rate, and the interest rate. While the model has supported monetary policy decisions according to known guidelines, the Central Bank also promotes monetary and financial policy transparency by publishing comprehensive analytical economic information and statistical data.

A single financial regulator under the Central Bank allows integration and coordination of the roles of "lender of last resort" and financial sector regulatory decisions. This institutional organization has become an advantage to monitor and deal with the effects of the crisis. It is a general opinion among financial institutions that the Central Bank places a high priority to quality of management, governance, risk management, and internal controls of the supervised institutions. Banks and other financial entities are required to comply with strict corporate governance principles and information disclosure based on internationally accepted accounting principles. The Central Bank is also perceived to be independent and with adequate enforcement legal powers and capacity, but not always willing to use these powers.

The Central Bank has been vigilant in monitoring the crisis and is progressively realizing the extent of the growing financial instability, where a number of commercial banks may become insolvent and fail, and that significant disruptions are developing in the provision of key financial services such as deposits and loans, liquidity and payment services, monitoring of the users of funds, and scrutiny of foreign exchange and interest rate risks of borrowers and counterparts.

Realizing the priority of maintaining credit flow, the Central Bank has been proactive in implementing a World Bank-KfW SME program of US$250 million, of which US$50 million will be disbursed this year. This facility is provided by the lenders to the Central Bank in USD and made available to qualified commercial banks in drams plus a hedging premium. According to The World

Bank, there is sufficient systemic absorptive capacity to place the totality of the first tranche of this loan by the end of summer 2009.

The Central Bank could consider freeing up significant additional funding by applying a foreign exchange hedging mechanism to funds held by commercial banks in the form of USD-denominated deposits if they are lent in drams. By establishing appropriate limits and requirements, money supply and inflationary concerns can be kept under control. It is a fact that there is USD excess liquidity in the banking system and no demand for USD-denominated loans. A Central Bank–supported hedging mechanism can leverage the resources already made available by The World Bank-KfW facility and significantly increase the amount of dram-denominated loanable funds in the economy while lowering interest rates.

To address the increasing fragility of commercial banks, the Central Bank is promoting bank consolidations and capitalizations. Encouraged by the Central Bank, the aggregate capital adequacy ratio of the banking system is now at 27 percent. The Central Bank will also provide a liquidity facility equal to the amount of the capital increase for commercial banks that are willing to increase their capital either via new capital injections or consolidations. There are commercial banks that already started considering mergers and acquisitions with other banks. To support consolidations, the Central Bank should consider engaging specialized technical assistance to guide the highly complex and contentious consolidation process and learn from international experience and best practices.

Finally, the Central Bank is willing to relax loan classification regulations on an individual bank basis. If an individual bank presents a comprehensive strategic plan to address loan restructuring or refinancing needs of their clients and this plan is approved by the Central Bank, transitory short-term relaxation of loan classification requirements will be permitted. This measure will allow banks to address clients' short-term liquidity issues without compromising their solvency, and as a result negatively affect the quality of the loan portfolio of the bank.

CHALLENGES AND PREPAREDNESS OF THE REGULATORY AND PHYSICAL INFRASTRUCTURE OF THE FINANCIAL SECTOR

The legal infrastructure for finance, including the insolvency regime and creditor's rights, is extremely weak in Armenia. This is one of the major obstacles for banking to recover assets and execute foreclosures and repossessions. The legal system is based on the Civil Code and the practice of courts is biased in favor of borrowers, who can hold a foreclosure process hostage by constantly appealing to the courts. There are no specialized courts to handle commercial disputes, and judges in general are not adequately trained in commercial and financial matters. As a result, credit risk is high because banks are, in practice, severely limited to exercise their creditors' rights in an effective manner. Moreover, property title registration procedures are flawed and plagued by corruption.

The Association of Banks of Armenia is considering a proposal to establish a government-sponsored collection agency to service all the banks. Aside from underscoring the collection problem, it is doubtful that a new government-sponsored agency will correct the inefficiencies of the legal system. Moreover, during the current crisis it is doubtful that the agency will proactively enforce collection activities. Therefore, it is advisable to reform the current legal system of debt collection and title property registration, and select and train judges to address

commercial and financial bank foreclosures. Technical assistance to courts to streamline the legal process and strengthen their institutional capacity will result in a reduction in overall credit risk and improved lending.

Since January 2003, a credit registry has been functioning within the Central Bank. The Credit Registry is designed to collect data on the credit history of borrowers, process such information, and provide it to commercial banks, credit organizations, and borrowers. The Credit Registry must enter into its records loans in excess of 1.5 million drams and loans in the amount less than 15 million drams that were overdue and were classified.

Each quarter, the Credit Registry publishes the names of non-diligent borrowers in the press and on the Central Bank Web site. The assessment of credibility of a customer by using credit history reduces time spent on lending and enables curtailing credit risk and thus avoiding dealing with non-diligent borrowers.

The ACRA Credit Reporting Company, established in January 2004, is the first private credit bureau in Armenia. ACRA is a databank where information from financial and nonfinancial institutions pertaining to natural person and legal entity exposures is collected. All financial or nonfinancial institutions that originate loans or carry out transactions with overdue payments can enter into cooperation with ACRA. In order to cooperate, ACRA and the given institution enter into a contract on provision of services, whereby the institution undertakes to supply information about its customers in exchange for receiving information, shortly after an appropriate need arises, concerning credit history of its potential borrower. ACRA has already concluded many service contracts with commercial banks and credit organizations operating in Armenia.

Every citizen or legal entity can obtain information about its own credit history from the credit bureau. To receive information about its customer and/or counterparty, a legal entity enters into a contract with the credit bureau on provision of services and seeks consent in writing from the subject of the credit history. ACRA began delivering loan reports in April 2007.

A multilayer coding system, supported by special firewall hardware, has been developed to store information owned by ACRA and to prevent unauthorized access by outsiders. The system traces all actions, and an ongoing monitoring of the system is in place to prevent suspicious and unauthorized action.

Both the Central Bank and the ACRA credit bureaus are considered effective in delivering comprehensive and updated information on borrowers.

Following the adoption of the Republic of Armenia Law on Combating Legalization of Proceeds from Crime and Terrorism Financing in 2004, the Financial Monitoring Center (FMC) of the Central Bank has been making active efforts in that direction. The FMC and the Central Bank continuously work on making adjustments in the Armenian legislation and other legal acts in the combat of ML/FT, screening of internal legal acts of reporting entities, and development of cooperation with domestic and foreign bodies and institutions. A new reporting form was

adopted relating to procedures of reporting by regional units of State Committee of Cadastre of Real Estate.

After the FMC joined the Egmont Group of Foreign Financial Intelligence Units, the process of information sharing with other financial intelligence units considerably intensified and became very effective. In 2007, the FMC also joined Egmont Secure Web, making it possible for the FMC to have a safe and facilitated exchange of information with financial intelligence units of foreign countries, using state-of-the-art information technologies. In the meantime, the Central Bank continued effectively cooperating with the Interagency Committee of the Fight Against Forgery and Fraud in the Field of Plastic Cards.

The existing deposit insurance scheme provides the basis for a financial safety net. However, in the current crisis where banks are becoming more vulnerable to deposit withdrawals, a reasonable increase in the minimum amount of deposits insured may be a stabilizing and precautionary measure. However, to avoid a “moral hazard” problem, the increase in the minimum insured must be accompanied by more stringent loan underwriting rules, loan performance monitoring, and prudential regulations.

Reasonable transparency, governance, and information and payment infrastructure, including interbank payments and the accounting and auditing disclosure regime and market monitoring arrangements for financial firms, are all in place in Armenia and are considered adequate.

CORPORATE SECTOR SOUNDNESS AND ACCESS TO FINANCE

The global financial crisis and its initial impact on Armenia’s real sector have been widespread for the corporate sector. There is virtually no company size in any economic sector that has not been severely and negatively affected in its sales and earnings. Access to finance is becoming more difficult as banks are requiring more stringent lending conditions and credit in drams is virtually unavailable.

Of particular concern is the small and medium enterprise (SME) sector sales that represents 40 percent of Armenia’s GDP. Therefore, it is of critical importance to promote SME growth and enhance competitiveness through the provision of credit and equity to dynamic firms and the regulatory and institutional setting associated with effective access to credit and investments. Improvements in the functioning of the formal financial sector can reduce financing constraints for SMEs and others who have difficulty in self-financing or in finding private or informal sources of funding. Currently, lack of SME financing results from lack of adequate collateral, which is exacerbated in provinces where the value of real estate is lower than in Yerevan and where collateral liquidation is more difficult. Lack of collateral has been addressed by government guarantees, but with limited results. ACBA-Credit Agricole has achieved some success by implementing a system of community-based cross-guarantees. A second reason is the lack of adequate accounting and recordkeeping, which makes credit analysis on the part of banks extremely difficult. Finally, the infrastructure of business service providers (BSPs) is not well-developed in Armenia. The development of BSPs is fundamental to help SMEs achieve “bankable” projects.

As in most emerging economies, smaller firms in Armenia are often dynamic and innovative. If Armenia inhibits the SME growth potential by imposing or not removing financial constraints, they will not only lose the growth opportunity of these enterprises but also risk missing the chance to diversify into new areas with comparative advantages. Financial inclusion also enables incumbent firms to reach a larger equilibrium size by enabling them to exploit growth and investment opportunities. Furthermore, greater financial inclusion allows firms the choice of more efficient asset portfolios as well as more efficient organizational forms, such as incorporation. If a strong financial system can promote entry of new firms, enterprise growth, innovation, larger equilibrium size, and risk reduction, then it is almost certain that a more developed financial system, particularly long-term capital markets (including private equity and venture capital funds), will improve aggregate economic performance.

At any given level of financial development, smaller firms have more difficulty accessing finance than do larger companies. But with greater availability of finance, firms that were formerly excluded are given new opportunities. International research shows that small firms benefit the most from financial development, both in terms of being able to enter the marketplace and of seeing their growth constraints reduced. Therefore, inclusive financial sectors also have consequences for the composition of and competition in the enterprise sector.

The availability of financing depends not only on a firm's own situation, but also on the wider policy and institutional environment supporting the enforceability and liquidity of the contracts that are involved in financing firms. It also depends on the existence and effectiveness of a variety of intermediaries and ancillary financial and business services that help bring providers and users of funds together in the market.

Commercial bank finance is a traditional source of finance for larger firms in Armenia, but modern trends in transactional lending suggest that improvements in information availability (for example, through coverage expansion of credit registries) and technological advances in analysis of this improved data (for example, through the use of automated credit appraisal) are likely to improve financing of SMEs.

Provided that the relevant laws and institutional and market infrastructure capacity are in place, asset-based lending such as Purchase Order Financing (POF), factoring, inventory financing, and leasing are examples of financial products that can release sizable financing flows in Armenia, even for small firms. However, relationship lending (which relies on personal interaction between borrower and lender and is based on an understanding of the borrower's business and not just on collateral or mechanical credit scoring systems) remains important in Armenia for larger firms with established relationships with commercial banks and for microenterprises that are closely linked to microfinance institutions. Because relationship lending is costly for the lender, it requires either high spreads or large volumes to be viable. If the customer's creditworthiness is hard to evaluate, then there may be no alternative to relationship lending. Indeed, limited access to credit in Armenia may be attributable to the reluctance of existing intermediaries to do relationship lending on a small scale. Therefore, the development of value chain financing mechanisms, where SMEs and commercial banks can meet and know each other, is an initiative that should be promoted. Despite recent improvements, SMEs in Armenia still have difficulties accessing financing, and banks and other financial institutions have yet to fully

capitalize on new market opportunities, especially outside of Yerevan. At present, ACBA-Credit Agricole , FINCA and AREGAK are the main players in provinces in the microenterprise and SME market space.

ECONOMIC POLICY IMPLICATIONS

Managing a systemic financial crisis requires that policy decisions be made in different stages of the crisis — the immediate containment stage as well as the longer-term resolution and structural reforms that follow — which often entail difficult tradeoffs between reestablishing confidence in the short term and containing moral hazard in long term.

According to a recent World Bank Policy Research Working Paper (World Bank, January 2009), some of the fundamental questions authorities need to address as soon as possible are:

• Are blanket guarantees inevitable to prevent a systemic crisis from deepening?
• Should the Central Bank bailout and take ownership of financial institutions that become insolvent?
• Should the Central Bank regulate and restructure the financial sector more aggressively?
• Should monetary policy target asset prices as well as inflation?

Crises repeat in part because policymakers forget the lessons from the previous ones. While every crisis is different, past crises in Armenia and elsewhere provide important lessons that need to be learned to prevent policymakers from reinventing the wheel.

In addition to the general policy implications mentioned before, there are other specific ones that Armenian authorities will need to address :

1. Need to maintain the availability of credit in the economy

The Central Bank should avoid a “drying-up” of credit in the economy. Despite the slowing down in demand for credit, businesses still need to access financing for working capital, basic investments and financing to restructure or refinance existing debts in favorable terms to weather the crisis. Because of prevailing devaluation expectations and the dollarization of the Armenia economy, there is excess liquidity in the banking system held in the form of foreign currency. However, banks are resistant to lend and borrowers refrain from borrowing in foreign currency. As a result, there is no dram credit available. In these circumstances, the Central Bank should consider a role of “hedger of last resort,” and provide devaluation coverage to banks willing to lend part of their foreign currency–denominated deposits in drams. These hedging mechanisms may contribute to freeing liquidity in domestic currency. A measure like this should be considered only temporary until expectations stabilize.

2. An opportunity to further strengthen the banking system

The current crisis offers an opportunity for further strengthening the banks’ capital base. The Central Bank is actively promoting capital increases through new capital injection provided by shareholders and bank consolidations. This should also be an opportunity to “right-size” the

number of banks and gain economies of scale promoting lower lending costs. Moreover, by "skimming-out" weaker banks, systemic risks in the system will also be reduced. Ancillary to bank consolidation, a revision of current bank regulations and its adequacy to anticipate, prevent, and address a systemic crisis should be part of crisis policy actions to be adopted by the Central Bank.

3. Encourage and stimulate more access to finance for SMEs

SMEs' sales represent 40 percent of Armenia's GDP. Access to finance to SMEs should be encouraged and expanded. The Central Bank and the IFIs should consider expanding the number of eligible banks for IFI-sponsored SME programs. Better geographic distribution and competition about SME funding will result in broader access. Additionally, reviews in the current legislation and market infrastructure should be encouraged to make SMEs more "bankable."

4. Develop long-term capital markets and institutional investors

There are virtually no capital markets in Armenia. The Central Bank should place a high priority on the development of long-termed capital markets and of institutional investors such as insurance companies and pension funds. An acceleration of the legislation reforming pensions should be encouraged. Long-term capital availability is fundamental to finance investment projects and improve Armenia's competitiveness.

With regard to the development of pension funds, the challenges are significant. The government has stated that starting January 2010, workers in Armenia will see part of their pay go into private pension plans according to a governmental decision adopted on November 13, 2008. The reform is understood to be a way for the government to stimulate the development of capital markets.

The intention of the government's pension reform is to increase pension benefits and to link benefits to the amount that a worker has contributed over the years. Under the current PAYGO system, benefits are based on the number of years a person was employed and does not consider the wages earned during those years.

The IMF and The World Bank, in the Joint Staff Advisory Note on the Second Poverty Reduction Strategy Paper for the Republic of Armenia, argue that Armenia should not privatize the management of its pension system. The Note suggests that Armenia is not ready to adopt a mandatory private pension system because the new system would require a long-term domestic bond market, which is not yet developed in Armenia. It also requires the administrative capacity to record, manage, regulate, and supervise the private pension accounts, a capacity Armenia has not developed yet.

INTERVIEWS

ACBA-Credit Agricole. Stepan Gishyan, General Manager.

ACP-Armenian Copper Programme. Tigran Khachatryan, Chief Financial Officer.

Ameria Bank. Artak Hanesyan, General Director and Chairman of the Management Board. Levon Arevshatyan, Director Corporate Banking. Andrei Shikevich, CFA, Director of Investment Banking and Management Board Member.

American Chamber of Commerce in Armenia. AMCHAM. David Atanessian, President.

Anelik Bank CJSC. Bagrat A. Tshzmachyan, Deputy Chairman of the Board.

Aregak Universal Credit Organization. Armine Aghajanyan, Finance Director.

Capital Asset Management. Tigran Karapetyan, General Director and Partner.

Cascade Investments. Haik Papyan, CFS, Executive Director.

Central Bank of Armenia. Dr.Vache Gabrielyan, Deputy Chairman.

Converse Bank. Ararat Ghukasyan, Chairman of the Management Board and Executive Director.

Financial Sector Deepening Project (FSDP). USAID. Martin Dinning, COP. Richard Webb, Resident Insurance Advisor. John Fitzgerald, Resident Banking Adviser. Edgar Karapetyan, Acting Team Leader.

First Mortgage. David Atanessian, Managing Partner & CEO.

HSBC. Tim Slater, Chief Executive Officer.

Inecobank. Avetis Baloyan, Chief Executive Officer. Anatoli Tirosyan, Department Head, Branch Network Coordination.

International Finance Corporation (IFC). Nerses Karamanukyan, Head Office Yerevan.

International Monetary Fund. Nienke Oomes, Resident Representative in Armenia. Ara Stepanyan, Economist.

KfW. Dr. Karapet A. Gevorgyan, Representative in Armenia.

London-Yerevan Co Insurance Company. Aram Piruzyan, Managing Director.

Ministry of Economy. Nerses Yeritsyan, Minister of Economy.

Ministry of Finance. Vardan Aramyan, Deputy Minister of Finance.

NASDAQ OMX. Armen Melikyan, CEO. Rouzanna Sarkissian, Head of Marketing and Communications.

Pro Credit Bank. Ashot Abrahamyan, Deputy Executive Director.

SME Association of Armenia. Syran Avagyan, President, Special Advisor to the President of Armenia on SMEs.

SPI Albania. Ramona Vali Bratu, Albania General Manager.

The World Bank. Aristomene Varoudakis, Country Manager Armenia Office.

Unifish-Noy Fish LTD. Armen Mkrtchyan, Founder and President.

Union of Banks of Armenia. Emil Soghomonyan, Chairman. Seyran Sagsyan, Executive Director.

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GUIDELINES FOR A RAPID FINANCIAL CRISIS ASSESSMENT (RFCA)

(APRIL 2009)

INTRODUCTION

The United States Agency for International Development (USAID) Bureau for Economic Growth Agriculture and Trade (EGAT) created the Financial Sector Knowledge Sharing Project (FS Share) to collaborate with USAID missions to develop effective and efficient financial sector programs that increase access to financial services and develop well-functioning markets worldwide. USAID awarded Chemonics International the FS Share delivery order under the Financial Sector Blanket Purchase Agreement. FS Share has a three-year period of performance, July 2008 through July 2011.

Through the FS Share Task Order, USAID EGAT and Chemonics International proactively collaborate with missions to identify financial sector priorities and develop strategies and programs for growing the financial sector. FS Share identifies financial sector best practices and aggregates those best practices through model scopes of work, technical briefs, diagnostic tools, best practice case analyses, and other tools. These technical deliverables are disseminated to USAID missions to integrate into financial sector programming. FS Share can assist with implementation and connect mission staff to external resources on best practices. In response to mission demand, FS Share delivers informative presentations and other knowledge-sharing initiatives.

OBJECTIVE OF THE RAPID FINANCIAL CRISIS ASSESSMENT

The objective of the *Guidelines for a Rapid Financial Crisis Assessment (RFCA)* is to identify strengths and vulnerabilities of financial sector participants, assess overall soundness and stability of the financial sector, highlight linkage s between the macro-economy and the financial sector, and ascertain technical assistance needs and policy recommendations.

The Guidelines for a Rapid Financial Crisis Assessment was developed by Roberto Toso, FS Share Program Manager, with support from USAID EGAT.

FS SHARE RAPID RESPONSE HOTLINE

For assistance identifying resources and addressing questions about financial sector assessments, contact FS Share Project Manager Roberto Toso at 202-955-7488 or rtoso@chemonics.com or Melissa Scudo at 202-775-6976 or mscudo@chemonics.com.

To access the FS Share task order and EGAT assistance on any mission financial sector program, scope of work, or procurement questions, contact:

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Contracting Officer: Kenneth Stein	kstein@usaid.gov	(202) 712-1041

PURPOSE OF THE RAPID FINANCIAL CRISIS ASSESSMENT

The objectives of the Rapid Financial Crisis Assessment (RFCA) are to identify strengths and vulnerabilities of financial sector participants, assess overall soundness and stability of the financial sector, highlight linkages between the macro-economy and the financial sector, and ascertain technical assistance needs and policy recommendations.

METHODOLOGY

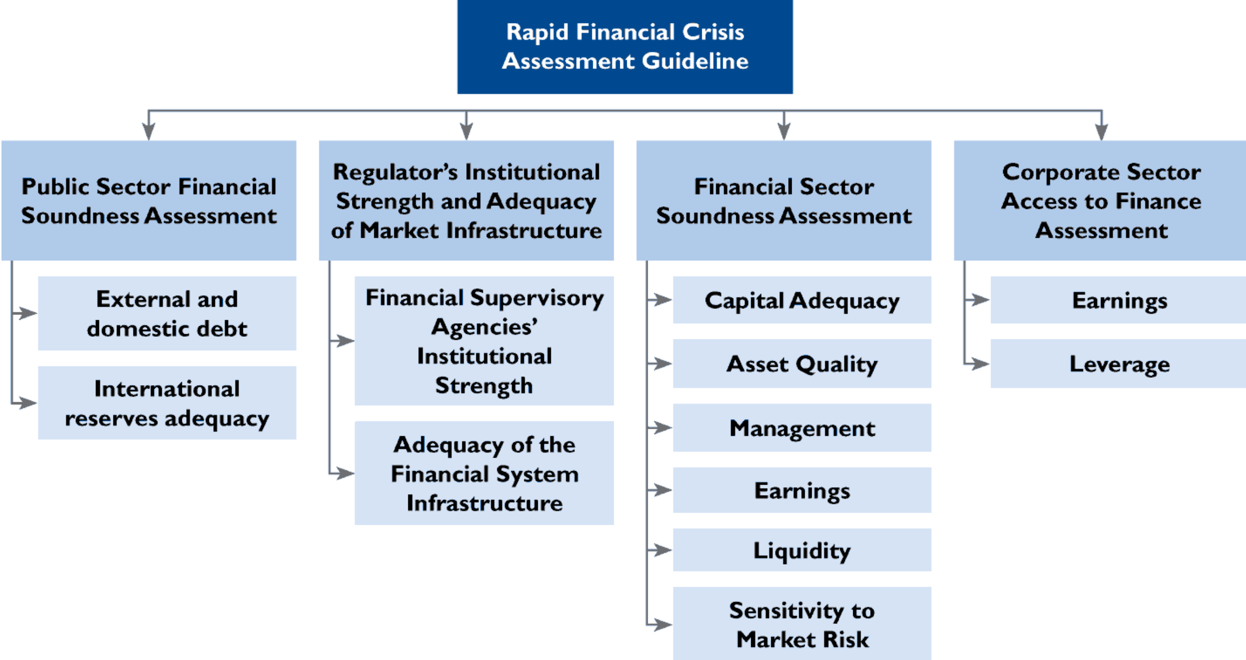
The RFCA is designed to address the most immediate and urgent vulnerabilities of the financial sector impacted by the financial crisis. The process takes two to four weeks, depending on the size and complexity of the financial system under analysis, and is completed by a team of two assessors. The main characteristics of this process are *speed*, *simplicity* and *action-driven*. RFCA is not a substitute for more systematic and comprehensive assessments, such as "stress tests" and the Financial Sector Assessment Program (FSAP) conducted by The World Bank and the International Monetary Fund (IMF), which require specialized resources and more time to execute.

The RFCA is divided into four sections. The first two sections are analytical, and provide an overview of the financial soundness of the public sector and the capacity of a country's regulatory system and market infrastructure to withstand a financial crisis. This assessment is based on a review of secondary data, including economic reports and statistics, legislation, and regulations. Copies of such data should be recorded to support the assessment. Sections 3 and 4 provide a framework to assess the capacity and soundness of financial institutions and the corporate sector in the market under consideration.

A critical decision regarding use of this assessment tool is the selection of persons and sources to be interviewed to obtain reliable answers. There is a significant degree of subjectivity and potential lack of completeness that may be reflected in responses when the persons providing them have an interest in the conclusions. For example, a financial regulator may be the most logical party to answer questions regarding the law, regulations, and enforcement capability, but regulators may be reluctant to report that they are doing an inadequate job. Similarly, senior officials at the Central Bank and Ministry of Finance may be the appropriate persons to answer questions regarding market developments and financial sector shocks, but few senior officials are likely to admit that they are not doing everything they could be doing to address the effects of the crisis. For these reasons, assessors should seek independent verification of responses through direct interviews with financial market participants. These participants representing financial institutions and the corporate sector are country-specific, but will include within the sample local independent economists and consultants and representatives from international agencies such as The World Bank, the IMF and USAID.

The guidelines presented here are general and should be modified on a per-country basis.

FRAMEWORK FOR THE RAPID FINANCIAL CRISIS ASSESSMENT



COMPLETING THE RAPID FINANCIAL CRISIS ASSESSMENT

Section 1: Public Sector Financial Soundness Assessment

The objective of this assessment is to obtain qualitative and quantitative indicators.

A. Review indicators of external and domestic debt.

   Illustrative indicators are:

   1. Debt maturity profiles and amortization schedule.
   2. Interest rate structure and currency composition.
   3. Ratios of external debt to exports and to GDP (these are useful indicators of trends in debt and repayment capacity).
   4. Where public sector borrowing is significant, the ratio of debt to tax revenue is particularly important to assess the country's repayment capacity.
   5. Sovereign Country Risk Ratings (international rating agencies).

B. Review indicators of reserves adequacy.

   Illustrative indicators are:

   1. International reserves adequacy to assess a country's ability to avert liquidity crises.
   2. The ratio of reserves to short-term debt as a proxy to assess the vulnerability of countries with significant but uncertain access to voluntary international capital markets lending.

Assessors should conduct interviews with and obtain reports from senior officials in the Ministry of Finance, the Central Bank, and representatives of USAID and international financial institutions (IFIs), including The World Bank and the IMF.

Section 2: Financial Regulator's Institutional Strength and Adequacy of the Market Infrastructure

The objective of this assessment is to obtain qualitative and tabulated quantitative information (current and compared with one year ago) on

A. Financial Supervisory Agencies' Institutional Strength:

   1. Is there adequate or excessive focus on formal compliance (check-box approach)? Insufficient or sufficient attention to quality of management, governance, risk management and internal controls?
   2. Are there adequate enforcement powers and capacity, and willingness to utilize them?
   3. Is the regulator effectively independent?
   4. Is regulatory forbearance a common or unusual practice?

5. Is there effective or poor information exchange with domestic and foreign supervisors?
6. What is the capacity to identify vulnerabilities of specific financial entities and the willingness and political ability to enforce corrective actions?
7. What is the capacity and political willingness to identify systemic vulnerabilities and effectively act on them?
8. What specific actions should be adopted by the authorities to confront the current crisis?

B. Adequacy of the Financial System Infrastructure:

1. Legal infrastructure for finance, including insolvency regime, creditor's rights, and financial safety nets.
2. Systemic liquidity infrastructure, including monetary and exchange operations payments and securities settlement systems.
3. Transparency, governance, and information infrastructure, including monetary and financial policy transparency, corporate governance, accounting and auditing framework, disclosure regime, and market monitoring arrangements for financial and nonfinancial firms and credit reporting systems.

Assessors should conduct interviews with and obtain update reports from senior officials in the Ministry of Finance, the Central Bank, and the Financial Supervisor as well as with representatives of USAID and IFIs, including The World Bank and IMF.

Section 3: Financial Sector Soundness Assessment

The objective is to assess a representative sample (depending on the specific country) of commercial banks' and other selected financial institutions' (insurance companies and microfinance institutions) strengths and weaknesses to confront the current crisis. This assessment provides insight about a country's financial system vulnerabilities to institutional and regulatory weaknesses and market risks, including changes in international and domestic funding sources, interest rates, and exchange rates.

The assessment is conducted through interviews with senior managers and/or major shareholders using a simplified Federal Deposit Insurance Corporation (FDIC) CAMELS framework and classification system.[1] Once the interview process is completed, financial institutions are classified according to the following categories:

Category A: The financial institution is fundamentally sound. Any weaknesses are minor and can be handled adequately by the board of directors and management. The institution is stable and capable of withstanding the current business fluctuations. The institution is in substantial compliance with laws and regulations. Overall risk management practices are satisfactory

[1] The acronym "CAMEL" stands for Capital, Assets, Management, Earnings, and Liquidity, five components of a bank's financial operation that are examined by the regulators. In the late 1990s a sixth component was added to the CAMEL rating system, recognizing bank and thrift Sensitivity to interest-rate or market risk (CAMELS).

relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited. Depending on the size of the financial institution, systemic implications may or may not exist.

Category B: The financial institution exhibits some degree of weakness in one or more of the component areas. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. The institution is less capable of withstanding business fluctuations and is more vulnerable to outside influences. Additionally, the institution may be in noncompliance with certain laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. The institution requires more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely given the overall strength and financial capacity. Depending on the size of the institution, systemic implications may or may not exist.

Category C: The financial institution exhibits unsafe to extremely unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. The institution is not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the institution's size, complexity, and risk profile. Close and ongoing supervisory attention is required — which means, in most cases, formal enforcement action is necessary to address the problems. The institution poses a significant risk to the deposit insurance fund, and failure is highly probable. Depending on the size of the institution, systemic implications may or may not exist.

CAMELS Assessment Components

A simplified FDIC CAMELS framework assesses an institution's financial vulnerabilities. The key components assessed are capital adequacy, asset quality, management capability, earnings quantity and quality, liquidity adequacy, and sensitivity to market risk.

CAPITAL

A financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution's activities will determine the extent to which it may be necessary to maintain capital at levels above required regulatory minimums to properly reflect the potentially adverse consequences that these risks may have on the institution's capital.

Illustrative questions:

Compared with one year ago —

- How do you assess the level and quality of capital and the overall financial condition of the institution?
- What is the state of implementation of Basel II?
- Do you apply specific risk-weighted coefficients in the calculation of capital adequacy? If so, what are these weights?
- How do you rate the ability of management and board members to address emerging needs for additional capital?
- What are the nature, trend, and volume of problem assets, and the adequacy of allowances for loan losses?
- Is there any tax or other impediment to constitute adequate loan loss or off-balance sheets provisions?
- What is the current balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities?
- What is the risk exposure represented by off-balance sheet activities?
- What are your prospects and plans for growth? Your past experience in managing growth?
- What actions are being taken to deal with the current financial crisis?

Ratings for Capital Adequacy:

1. A rating of 1 indicates a strong to satisfactory capital level relative to the institution's risk profile.
2. A rating of 2 indicates a less than satisfactory to deficient level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements.
3. A rating of 3 indicates a critically deficient level of capital such that the institution's viability is threatened. Immediate financial assistance from shareholders or other external sources is required.

ASSETS

The asset quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, and other assets, as well as off-balance sheet transactions. The ability of management to identify, measure, monitor, and control credit risk also is reflected here.

Illustrative questions:

Compared with one year ago —

- How do you rate the adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices?
- How do you rate the level, distribution, severity, and trend of problem, restructured, delinquent, and nonperforming assets for both on- and off-balance sheet transactions?
- What are the credit risks arising from off-balance sheet transactions (such as unfunded commitments, guarantees, commercial and stand-by letters of credit, and lines of credit)?
- How is the diversification and quality of your loan and investment portfolios?
- What is the extent of securities underwriting activities and exposure to counter-parties in trading activities?
- Where are your assets concentrated?
- What are your loan and investment policies, procedures, and practices?
- Is staff able to properly administer its assets, including timely identification and collection of problem assets?
- How do you rate the adequacy of internal controls and management information systems?

Ratings for Asset Quality:

1. A rating of 1 indicates strong to satisfactory asset quality and credit administration practices. Identified weaknesses in risk exposure are modest in relation to capital protection and management's abilities. Asset quality in such institutions is of minimal supervisory concern.
2. A rating of 2 is assigned when asset quality or credit administration practices are less than satisfactory or are deficient. Trends may be stable, or may indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. Credit administration and risk management practices need to be improved.
3. A rating of 3 represents critically deficient asset quality or credit administration practices that present an imminent threat to the institution's viability.

MANAGEMENT

The management rating reflects the capability of the board of directors, management, and staff, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities and to ensure safe, sound, and efficient operation in compliance with applicable laws and regulations.

Illustrative questions:

Compared with one year ago —

- What is the level and quality of oversight and support of all institutional activities by the board of directors and management?
- What formal corporate governance rules are in place?
- Is the board of directors and management, in their respective roles, able to plan for and respond to risks that may arise from changing business conditions or the initiation of new activities or products?
- How appropriate are the internal policies and controls addressing the operations and risks of significant activities?
- Are the accuracy, timeliness, and effectiveness of management information and risk monitoring systems appropriate for the institution's size, complexity, and risk profile?
- Do audits and internal controls promote effective operations and reliable financial and regulatory reporting?
- Is management responsive to recommendations from auditors and supervisory authorities?

Ratings for Management:

1. A rating of 1 indicates strong to satisfactory performance by management and the board of directors and strong risk management practices relative to the institution's size, complexity, and risk profile. Significant risks are identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to address existing and potential problems and risks.
2. A rating of 2 indicates risk management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors is insufficient for the type, size, or condition of the institution. Problems and significant risks are inadequately identified, measured, monitored, or controlled.
3. A rating of 3 indicates deficient to critically deficient management and board performance, or risk management practices that are inadequate considering the nature of the institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution.

EARNINGS

The earnings rating reflects not only the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings.

Illustrative questions:

Compared with one year ago —

- What is the level of earnings, including trends and stability?
- How are the quality and sources of earnings?
- How is the level of expenses in relation to operations?
- How adequate are the budgeting systems, forecasting processes, and management information systems in general?
- How adequate are the provisions to maintain the allowance for loan losses and other valuation allowance accounts?
- How exposed are earnings to market risks such as interest rate, foreign exchange, and price risks?

Ratings for Earnings:

1. A rating of 1 indicates earnings that are stable and sufficient to support operations and maintain adequate capital after considering asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.
2. A rating of 2 indicates earnings need to be improved. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.
3. A rating of 3 indicates earnings that are deficient to critically deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. Institutions so rated may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantial drop in earnings from previous years.

LIQUIDITY

In evaluating the adequacy of a financial institution's liquidity position, consideration should be given to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds management practices relative to the institution's size, complexity, and risk profile. In general, funds management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in

market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds management practices should ensure that liquidity is not maintained at a high cost, or through excessive reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Illustrative questions:

Compared with one year ago —

- How adequate are the liquidity sources in relation to present and future needs? Is the institution able to meet liquidity needs without adversely affecting its operations or condition?
- What is the availability of assets readily convertible to cash without undue loss?
- What is your access to money markets and other sources of funding?
- What is the level of diversification of funding sources, both on- and off-balance sheet?
- What is the degree of reliance on short-term, volatile sources of funds — including borrowings and brokered deposits — to fund longer-term assets?
- What is the trend and stability of deposits?
- Is management able to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds management strategies, liquidity policies, management information systems, and contingency funding plans?

Ratings for Liquidity:

1. A rating of 1 indicates satisfactory liquidity levels and funds management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds management practices.
2. A rating of 2 indicates liquidity levels or funds management practices in need of improvement. Institutions rated 2 may lack ready access to funds on reasonable terms or may show evidence of significant weaknesses in funds management practices.
3. A rating of 3 indicates deficient to severely deficient liquidity levels or inadequate funds management practices. Institutions rated 3 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs, and the continued viability of the institution may be threatened. Institutions rated 3 may require immediate external financial assistance to meet maturing obligations or other liquidity needs.

SENSITIVITY TO MARKET RISK

This reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or capital. When

evaluating this component, consideration should be given to management's ability to identify, measure, monitor, and control market risk; the institution's size; the nature and complexity of its activities; and the adequacy of its capital and earnings in relation to its level of market risk exposure.

Illustrative questions:

Compared with one year ago —

- What is the sensitivity of the financial institution's earnings to adverse changes in interest rates, foreign exchange rates, commodity prices, or equity prices?
- Is management able to identify, measure, monitor, and control exposure to market risk given the institution's size, complexity, and risk profile?
- What is the concentration of the institution's earnings with specific clients?
- What is the concentration of the institution's earnings in specific economic sectors?
- What is the weight of the financial institution's deposits, loans, and capital in the overall financial subsector (banks, insurance industry, microfinance institutions, etc.)?

Ratings for Market Risk Sensitivities:

1. A rating of 1 indicates that market risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk management practices are satisfactory for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of market risk taken by the institution.
2. A rating of 2 indicates that control of market risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk management practices need to be improved given the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital may not adequately support the degree of market risk taken by the institution.
3. A rating of 3 indicates that control of market risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk management practices are deficient for the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of market risk taken by the institution.

Section 4: Corporate Sector Access to Finance Assessment

The objective is to assess two key indicators of corporate sector access to financial services: *earnings* and *leverage*. The foreign exchange and interest rate exposure of companies are two

other indicators to assess the potential impact of exchange rate and interest rate changes on corporate sector balance sheets.

EARNINGS

This rating reflects not only the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings.

Illustrative questions:

Compared with one year ago —

- What is the level of earnings, including trends and stability?
- How are the quality and sources of earnings?
- How is the level of expenses in relation to operations?
- How adequate are the budgeting systems, forecasting processes, and management information systems in general?
- How exposed are earnings to market risks such as interest rate, foreign exchange, and price risks?

Ratings for Earnings:

1. A rating of 1 indicates earnings that are stable and sufficient to support operations and maintain adequate capital after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.
2. A rating of 2 indicates earnings need to be improved. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.
3. A rating of 3 indicates earnings that are deficient to critically deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. Institutions so rated may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantial drop in earnings from previous years.

LEVERAGE

This reflects the ability of the company to access finance. This refers to refinancing of existing loans, access to equity if needed, access to working capital at reasonable interest rates and conditions, and adequate internal sources of working capital.

Illustrative questions:

Compared with one year ago —

- Are the funding sources adequate to meet present and future needs? Is the company able to meet liquidity needs without adversely affecting its operations or condition?
- How do you rate the ability of management and board members to address emerging needs for additional capital?
- What is the level of diversification of funding sources (both equity and debt)?
- What is the degree of reliance on short-term, volatile sources of funds, including short-term borrowings to fund longer-term needs?
- Is management able to properly identify, measure, monitor, and control the company's financing needs?
- How do you rate your current access to finance and financial services from banks and other traditional financial institutions?

Ratings for Leverage:

1. A rating of 1 indicates satisfactory access to funding and financial services. The company has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs.
2. A rating of 2 indicates liquidity levels or funding management practices need improvement. Companies rated 2 may lack ready access to funds on reasonable terms or may show evidence of significant weaknesses in funding management practices.
3. A rating of 3 indicates deficient to severely deficient liquidity levels or inadequate funding management practices. Companies rated 3 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs, and the continued viability of the company may be threatened.

REFERENCES

Federal Deposit Insurance Corporation CAMELS Rating System

World Bank and International Monetary Fund Financial Sector Assessment Program (FSAP)

Rapid Financial Crisis Assessment Guideline	
Section 1. Public Sector Financial Soundness Assessment	**Collected**
Indicators of external and domestic debt: 1. Debt maturity profiles and amortization schedule.	
2. Interest rate structure and currency composition.	
3. Ratios of external debt to exports and to GDP.	
4. Ratio of debt to tax revenue (repayment capacity).	
Indicators of international reserves adequacy:	
1. International reserves adequacy.	
2. Ratio of reserves to short-term debt.	
Section 2: Financial Regulator's Institutional Strength & Adequacy of the Market Infrastructure	**Collected**
Financial Supervisory Agencies' Institutional Strength 1. Is there adequate or excessive focus on formal compliance, insufficient or sufficient attention to quality of management, governance, risk management and internal controls?	
2. Are there adequate enforcement legal powers and capacity and willingness to use these powers?	
3. Is the regulator effectively independent?	
4. Is regulatory forbearance a common or unusual practice?	
5. Is there effective or poor information exchange with domestic and foreign supervisors?	
6. What is the capacity to identify vulnerabilities of specific financial entities and willingness and political ability enforce corrective actions?	
7. What is the capacity and political willingness to identify systemic vulnerabilities and effectively act upon them?	
8. What specific actions adopted by the authorities to confront the current crisis?	
Adequacy of the Financial System Infrastructure: 1. Legal infrastructure for finance, including insolvency regime, creditor's rights, and financial safety nets.	
2. Systemic liquidity infrastructure, including monetary and exchange operations payments and securities settlement systems.	
3. Transparency, governance, and information infrastructure, including monetary and financial policy transparency, corporate governance, accounting and auditing, framework, disclosure regime and market monitoring arrangements for financial and non-financial firms and credit reporting systems.	

Rapid Financial Crisis Assessment Guideline			
Section 3. Financial Sector Soundness Assessment	**Rating 1 - 3**	**Section 3. Financial Sector Soundness Assessment**	**Rating 1 - 3**
Institution:		**Institution:**	
1. Capital Adequacy Rating		1. Capital Adequacy Rating	
2. Asset Quality Rating		2. Asset Quality Rating	
3. Management Rating		3. Management Rating	
4. Earnings Rating		4. Earnings Rating	
5. Liquidity Rating		5. Liquidity Rating	
6. Sensitivity to Market Risk Rating		6. Sensitivity to Market Risk Rating	
Classification (Category A, B, C)		Classification (Category A, B, C)	
Institution:	**Rating 1 - 3**	**Institution:**	**Rating 1 - 3**
1. Capital Adequacy Rating		1. Capital Adequacy Rating	
2. Asset Quality Rating		2. Asset Quality Rating	
3. Management Rating		3. Management Rating	
4. Earnings Rating		4. Earnings Rating	
5. Liquidity Rating		5. Liquidity Rating	
6. Sensitivity to Market Risk Rating		6. Sensitivity to Market Risk Rating	
Classification (Category A, B, C)		Classification (Category A, B, C)	

Rapid Financial Crisis Assessment Guideline	
Section 4. Corporate Sector Access to Finance Assessment	**Collected**
Corporation:	
Earnings *("Compared with one year ago…") :*	
1. What is the level of earnings, including trends and stability?	
2. How is the quality and sources of earnings? Interest rate structure and currency composition.	
3. How is the level of expenses in relation to operations?	
4. How adequate are the budgeting systems, forecasting processes, and management information systems in general?	
5. How exposed are earnings to market risks such as interest rate, foreign exchange, and price risks?	
Earnings Rating (1 - 3):	
Leverage *("Compared with one year ago…"):*	**Collected**
1. How adequate are the funding sources compared to present and future needs and the ability of the company to meet liquidity needs without adversely affecting its operations or condition?	
2. How do you rate the ability of management and board members to address emerging needs for additional capital?	
3. What is the level of diversification of funding sources, both equity and debt?	
4. What is the degree of reliance on short-term, volatile sources of funds, including short term borrowings to fund longer term needs?	
5. What is the capability of management to properly identify, measure, monitor, and control the company's financing needs?	
6. How do you rate your current access to finance and financial services from banks and other traditional financial institutions?	
Leverage Rating (1 - 3):	