

STABILITY AND DEVELOPMENT OF THE BANKING SYSTEM OF THE REPUBLIC OF ARMENIA IN THE POST-COVID PERIOD

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Abstract

Risks associated with the financial stability of the banking system of Armenia arise mainly from three sources: the external economy, the domestic economy, and the financial system itself. The latter is usually considered separately since the financial system is a special component of the economy.

In recent years, the banking sector of Armenia has been subject to some shocks and the accumulation of systemic risk, which has led to a higher level of dollarization and thereby limited the ability of the Central Bank to influence the economic environment through traditional monetary policy instruments.

However, a comprehensive analysis of early warning indicators of credit market trends, especially over the past two years, allows us to conclude that the credit market is in a phase of moderate growth, and cyclical systemic risks are generally balanced, except mortgage lending, where there is a risk of overheating.

Keywords and phrases: banking system, commercial banks, financial stability, systemic risk, capital adequacy.

СТАБИЛЬНОСТЬ И РАЗВИТИЕ БАНКОВСКОЙ СИСТЕМЫ РЕСПУБЛИКИ АРМЕНИЯ В ПОСТКОВИДНЫЙ ПЕРИОД

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Аннотация

Риски, связанные с финансовой стабильностью банковской системы Армении, возникают в основном из трех источников: внешней экономики,

внутренней экономики и самой финансовой системы. Последнее обычно рассматривают отдельно, поскольку финансовая система является особой составляющей экономики.

В последние годы банковский сектор Армении подвергся ряду потрясений и накоплению системного риска, что привело к более высокому уровню долларизации и тем самым ограничило возможности Центрального банка влиять на экономическую среду с помощью традиционных инструментов денежно-кредитной политики.

Однако комплексный анализ индикаторов раннего предупреждения тенденций кредитного рынка, особенно за последние два года, позволяет сделать вывод, что кредитный рынок находится в фазе умеренного роста, а циклические системные риски в целом сбалансированы, за исключением ипотечного кредитования, где есть риск перегрева.

Ключевые слова и словосочетания: банковская система, коммерческие банки, финансовая устойчивость, системный риск, достаточность капитала.

ՀՀ ԲԱՆԿԱՅԻՆ ՀԱՄԱԿԱՐԳԻ ԿԱՅՈՒՆՈՒԹՅՈՒՆԸ ԵՎ ԱՌԿԱ ԶԱՐԳԱՅՈՒՄՆԵՐԸ ՀԵՏԲՈՎԻԴՅԱՆ ՇՐՋԱՆՈՒՄ

ՌԱՖԻԿ ՀԱՐՈՒԹՅՈՒՆՅԱՆ

ՀՀ գիտությունների ազգային ակադեմիայի
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Համառոտագիր

Հայաստանում բանկային համակարգի ֆինանսական կայունության տեսանկյունից ծագող ռիսկերն առաջանում են հիմնականում երեք աղբյուրներից՝ արտաքին տնտեսությունից, ներքին տնտեսությունից և բուն ֆինանսական համակարգից: Վերջինը սովորաբար դիտարկվում է առանձին, որովհետև ֆինանսական համակարգը տնտեսության առանձնահատուկ բաղադրատարրն է:

Վերջին տարիների ընթացքում Հայաստանի բանկային ոլորտը ենթարկվել է մի շարք շոկերի և համակարգային ռիսկի կուտակման՝ հանգեցնելով դոլարայնացման ավելի բարձր մակարդակի, այդպիսով սահմանափակելով Կենտրոնական բանկի՝ դրամավարկային քաղաքականության ավանդական գործիքների միջոցով տնտեսական միջավայրի վրա ազդելու հնարավորությունը:

Սակայն, հատկապես վերջին երկու տարիներին վարկային շուկայի միտումները ներկայացնող վաղ ահազանգման ցուցանիշների համապարփակ վերլուծությունը թույլ է տալիս եզրահանգել, որ վարկային

շուկան գտնվում է չափավոր աճի փուլում, իսկ ցիկլային համակարգային ռիսկերը, ընդհանուր առմամբ, հավասարակշռված են, բացառությամբ հիփոթեքային վարկավորման, որտեղ առկա են գերտաքացման ռիսկեր:

Բանալի բառեր և բառակապակցություններ. բանկային համակարգ, առևտրային բանկեր, ֆինանսական կայունություն, համակարգային ռիսկ, կապիտալի համարժեքություն:

Introduction

The banking system is the most important component of any country's financial infrastructure, which directly impacts the economy. The assessment of the banking system's stability has a rather wide spectrum, as it requires careful analysis not only in the financial sector but in general, taking into account the main trends prevailing in the economy and the influences of the world. From this point of view, the banking system, the economic relations of the outside world, and the indicators characterizing the general state of the economy act as the main evaluation indicators [1, page 16].

The risks arising from the financial stability of the banking system in Armenia arise mainly from three sources: the external economy, the domestic economy, and the financial system itself. The latter is usually considered separately because the financial system is a special component of the economy.

When conducting any analysis on financial stability, primary attention is always paid to the external environment, which regularly exhibits severe fluctuations, which is noticeable especially in the recent period. Accordingly, certain negative impulses from abroad are transferred occasionally to Armenia through various channels, particularly, through the transfer of exports and private remittances.

It should be noted that in recent years, the RA financial system faced some risks that were transferred from the foreign economy, which had a certain impact on both the stability of the financial system and the rate of growth of the banking system indicators.

In 2021, despite outbreaks in various countries of the pandemic, the recovery of the global economy was recorded, although still with the disruption of production chains and the factors of supply constraints still in place to some extent.

After the 2020 economic recession, in 2021, the RA economy entered the stage of recovery of economic growth. In the conditions of relatively favorable external and internal developments in 2021 the economic growth of RA was 5.7% [5], to which the growth of the services sector had the biggest positive contribution due to the relaxation of anti-epidemic conditions, the cancellation of restrictions on the movement of citizens and the tourism sector growth.

In 2022 at the beginning of the year, the economic consequences of the

pandemic were still present in the world economy, and already in March, the deterioration of economic conditions deepened as a result of the escalation of the Russian-Ukrainian conflict and the harsh sanctions imposed on Russia by the West. As a result, there were some disruptions in the supply of raw materials and food products and a sharp decrease in supply, which caused a large wave of inflation at the world level.

Since the beginning of the year, central banks of many countries have gradually tightened financial conditions to counter rising inflationary pressures. In particular, the US Federal Reserve refinancing rate in 2022 gradually increased by 4 percentage points bringing it to 4.5% at the end of the year [9]. The European Central Bank also tightened monetary policy, raising the interest rate from 0, by a total, of 2.5 percentage points starting in the middle of the year [8].

Referring to Armenia, it should be stated that during 2022 economy of our country was mostly characterized by positive development trends. During the year, economic activity remained at a fairly high level – 12.6% [6], due to the sharp increase in external demand, which in turn was stimulated by international visitors, remittances, inflow of labor, and an increase in export volumes.

A high inflationary environment was maintained during the year in the conditions of high demand in the economy. The 12-month inflation was 8.3%, which had negative consequences on the real income of the economy. To curb inflation in 2022, the Central Bank of Armenia raised the refinancing rate by a total of 3 percentage points, setting it at 10.75% [7].

In 2022 due to the high demand of international visitors for domestic services and the significant inflow of financial funds, certain fluctuations were recorded in the currency market of Armenia. In December 2022 compared to December last year, the Armenian dram appreciated by 22% against the US dollar, 29% against the Euro, and 15% against the Russian ruble.

Results

In 2022, favorable conditions were formed for the banking system of Armenia. In the conditions of high economic activity, lending grew at a fairly high rate – 15.5%, which was mainly contributed by the sharp increase in the volume of mortgage loans – 34.2%. The concentration of the loan portfolio also decreased, in particular, the share of loans granted to large borrowers decreased by 4.1 percentage points [2].

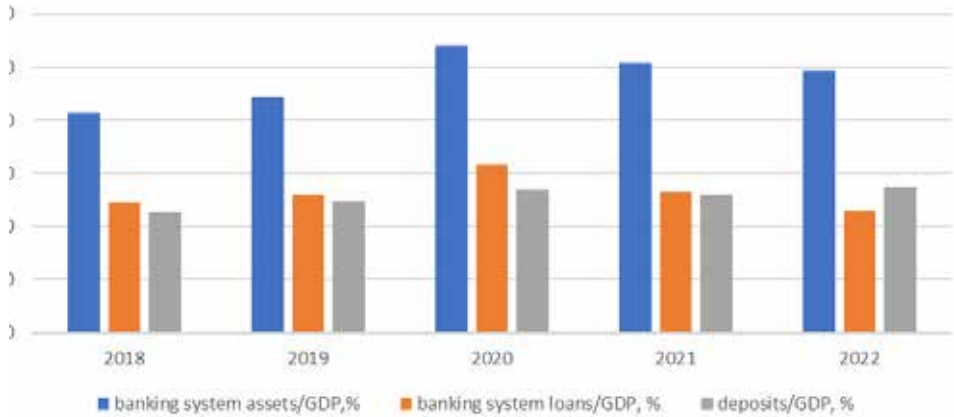
It should be noted that, as in previous years, in 2022 the dollarization of loans has continuously decreased. During the year, the Central Bank implemented another change in the structure of mandatory reserves: the share of foreign currency reserves against foreign currency funds was increased by another 2 percentage points at the expense of the share of AMD.

Deposits of legal and natural persons also recorded a dynamic growth. The latter increased by around 43% at a fixed exchange rate (in monetary terms, the increase was 28.8%), while deposits of residents increased by 29.4%, and deposits

of non-residents by 96.3% [2].

The banking system continued to occupy a dominant position in the RA financial system, the share of which in 2022 was 85% [2]. Observing the main indicators characterizing the banking system in recent years, we see that they have had certain fluctuating dynamics (Diagram 1).

Diagram 1. The ratio of assets, loans, and deposits of the RA banking system to GDP 2018-2022



As we can see from the diagram, in 2022 a decline in the banking system's credit/GDP ratio was recorded, although lending continued at a normal growth rate. The growth of loans granted by banks and credit organizations to the real sector (at a fixed exchange rate) was 13%. As a result of dram appreciation, the dram equivalent of loans increased by only 3.4% at the actual exchange rate, and was about 18 percentage points less than the nominal GDP growth. The banking system's assets/GDP and loans/GDP indicators decreased by 2.8 and 7.1 percentage points, respectively, and made 98.7% and 45.9%. Due to the high growth of deposits, the ratio of deposits/GDP increased by 3.0 percentage points to 54.8%. The share of cash deposits in total deposits almost did not change and made about 50% at the end of the year [2].

Referring to lending to households, it should be noted that in 2022 the total credit portfolio of this sector increased by around 18%. In 2022 the share of dram mortgage and consumer loans in total household loans made 87.4% increasing by 5.4 percentage points compared to the previous year.

Compared to the previous year, the growth of loans granted to individuals was higher-17.9%, it was mainly determined by the high growth of mortgage loans-27.6%, which was about 11% of GDP [2]. In 2022 in case of recovery of economic growth and increase in crediting, the household credit/GDP ratio

decreased and amounted to around 27% (2021–28%, 2020–30.2%). This indicator remains high compared to the median of the countries of the region, being inferior only to Georgia's level of 38% [2].

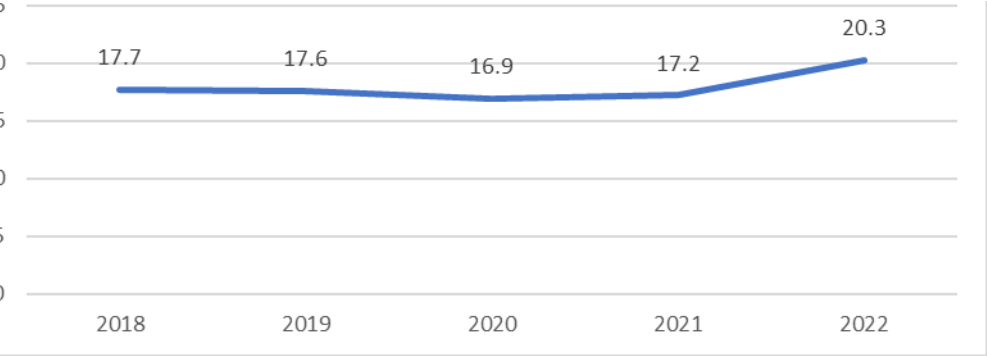
As in previous years, the high growth rates of mortgage lending continued to be maintained. The annual flow of mortgage loans also increased significantly – by the results of the 2022 year, it amounted to about 304 billion drams instead of 263 billion drams in 2021, registering a 17% increase. It should also be noted that such developments in the mortgage market were accompanied by a significant increase in real estate prices. Thus, the average monthly price of representative real estate in 2022 exceeded the same indicator level in 2021 by about 10%. In 2022 as of the fourth quarter, the amount of overvaluation of real estate prices, that is, the deviation of actual prices from the fundamental price, was estimated by the Central Bank at 16–22% [2].

To effectively manage systemic risks since April of 2022 the Central Bank of Armenia has launched the macroprudential instrument of the maximum limit of the ratio of claim/collateral value (loan-to-value). Moreover, in the case of AMD loans, the maximum normative limit was set at 90%, and in the case of foreign currency loans, it was set at 70%. At the same time, banks were allowed to issue loans that did not meet the requirements of the established norms, for dram and foreign currency loans, in the amount of 10% and 5%, respectively, in the amount of 10% and 5% of the average of the sums of the contractual principal amounts of loans in AMD secured by real estate provided by the bank during the two quarters preceding the reporting quarter. The rates of this instrument are subject to change in the event of further changes in the mortgage market.

It should be noted that the high rate of growth of mortgage loans in recent years was mainly due to the state program for the return of interest payments in the amount of income tax and its phase-out, as well as the sharp increase in real estate prices and rents, especially as a result of the large influx of foreigners during 2022.

Referring to the capital adequacy of commercial banks, it should be noted that the banking system has always maintained a level of capital adequacy exceeding the required minimum limit, which is an important prerequisite for absorbing possible losses and ensuring the continuity of operations. Diagram 2 below shows the dynamics of the capital adequacy ratio of commercial banks over the last 5 years.

Diagram 2. Dynamics of the capital adequacy ratio of commercial banks over the last 5 years



At the end of the year 2021, the total capital adequacy of the banking system was 17.2%, increasing by 0.3 percentage points compared to December last year. The change in capital adequacy was influenced positively by the growth of capital, the decrease in dram equivalent of risk-weighted assets (loans) as a result of dram appreciation as well as the decrease in dollarization of loans. Regulatory capital increased by 4.3% due to almost equal increases in authorized capital and retained earnings (including allocation to general reserve). The balance sheet capital/assets ratio decreased by 0.1 percentage point and made 13.0% at the end of the year [3].

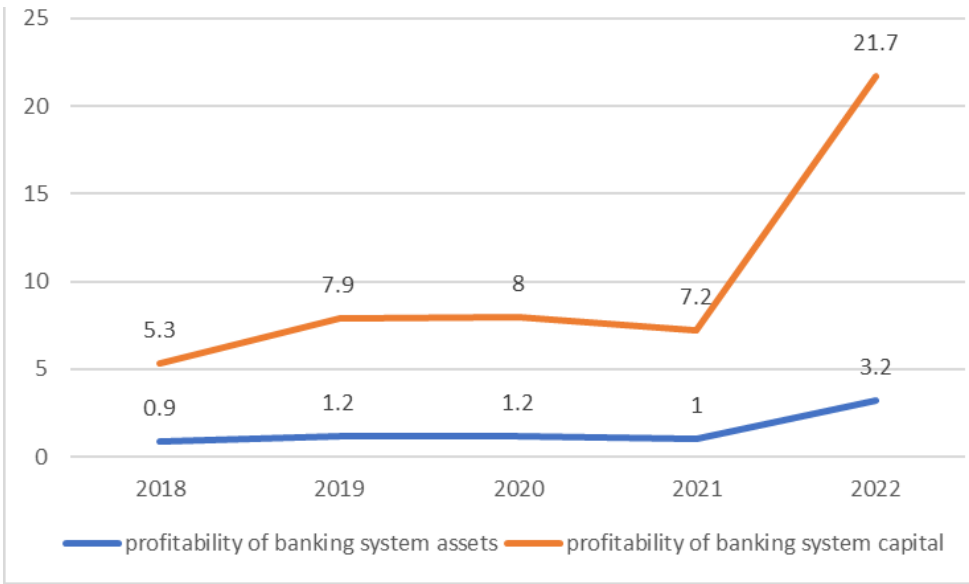
The actual banking system entered 2022 with a high level of capital adequacy, which strengthened further during the year. Total capital adequacy in 2022 in December was 20.3%, increasing by 3.1 percentage points compared to December last year. Capital growth, dram devaluation of risk-weighted assets (loans) as a result of dram devaluation, as well as reduction of the share of foreign currency loans had a positive impact on the change in capital adequacy. The regulatory capital increased by 36%, mainly due to the increase in profit, as well as the statutory capital, and the ratio of regulatory capital/assets increased by about 2 percentage points and made 14.6% at the end of the year [2].

Referring to the ratio of risk-weighted assets to total assets, it should be noted that it has shown a continuous downward trend in recent years, mainly due to the decrease in the share of foreign currency loans. According to the structure of risk-weighted assets, the specific weights of price risks of credit, interest rate, operational, foreign exchange, and capital instruments were 88.3%, 6.9%, 3.5%, 1.1%, and 0.1%, respectively, compared to 84.5%, 10.8%, 3.0%, 1.0%, and 0.1% of the same period of the last year [2; 3].

In 2022 the concentration of the credit portfolio of commercial banks also decreased, in particular, the share of loans granted to large borrowers decreased by 4.1 percentage points.

Analyzing indicators of profitability of banking system assets and capital in recent years, we see the following picture (Diagram 3).

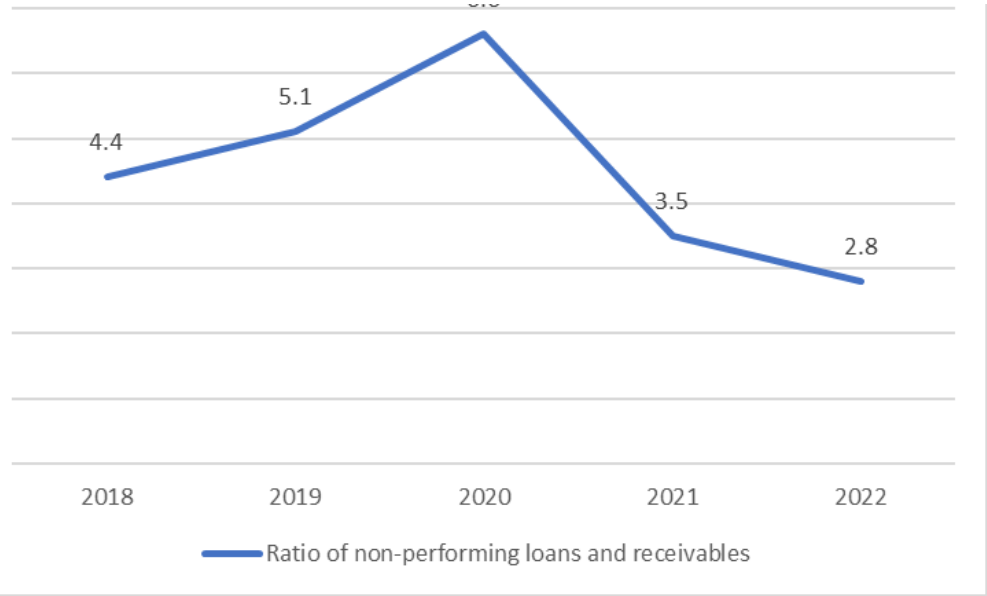
Diagram 3. Indicators of profitability of banking system assets and capital in 2018-2022, %



In 2022 the banking system has shown a level of profitability typical of non-crisis years, which has significantly improved since the 2nd quarter of the year. According to the reports presented by the Central Bank of the Republic of Armenia, in 2022 the indicators of profitability of the banking system according to assets (RoA) and according to capital (RoE) tripled compared to the previous year and made 3.2% and 21.7%, respectively. The increase in profitability was mainly due to the sharp increase of the volumes of settlement and foreign exchange operations as a result of the large inflow of new customers. In particular, in 2021 compared to the indicators, the net non-interest income of banks increased by 220 billion drams, while the net amount of interest income and expenses and losses from loans increased by only 7 billion drams [2, 3].

Referring to the share of bad-quality loans in the credit portfolio of commercial banks, it should be noted that the latter had a growing trend in the 2018–2020 period, then it started to decrease sharply (Diagram 4).

Diagram 4. The share of non-performing loans and receivables in the credit portfolio of commercial banks in the 2018-2022



As a result of the shocks caused by the pandemic and the humanitarian situation in 2020, the deterioration of the quality of the banks' credit portfolio was recorded. At the same time, the growth of problematic loans was most pronounced in the fourth quarter, which was also preserved in the first quarter of 2021. During the year, the share of non-performing loans in total loans increased by 1.1 percentage points and amounted to 6.6% at the end of the year, while the increase of 0.5 percentage points is attributed to the fourth quarter [4]. The growth of non-performing loans was contributed mainly by an increase in the volume of non-performing loans for consumer loans.

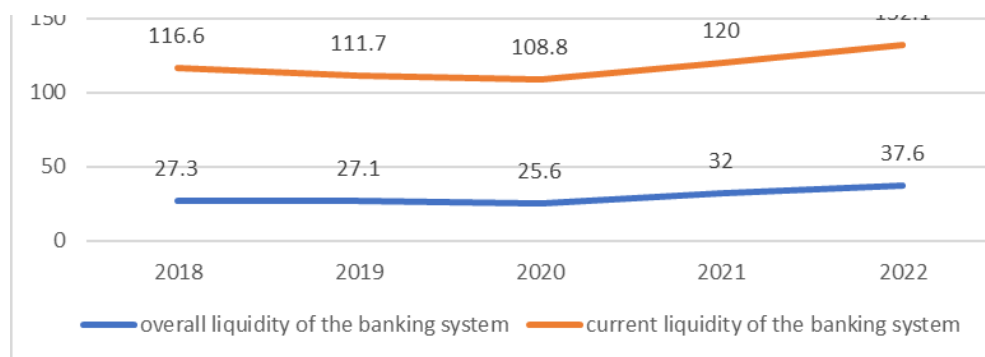
In 2021 the indicators characterizing the credit risk at the level of the general system tended to improve, in particular, there was a decrease in the percentage of non-performing loans in all main types of loans. The share of classified loans (including supervised class loans) in total loans decreased by 3.0 percentage points and made 3.5% at the end of the year. The decrease in the absolute volume of classified loans was mainly contributed by the write-off of non-performing loans in terms of consumer and business loans [3].

In 2022 amid high economic activity and income growth, the weight of non-performing loans, with some fluctuations, continued to remain below both the

long-term average and pre-pandemic levels. The share of non-performing loans was 2.8% at the end of the year [2]. Among the main types of loans provided to residents, the share of non-performing loans increased only in the case of business loans. Compared with 2021, the losses from loans have increased, moreover, due not so much to the increase in the weight of non-performing loans, but to the banks' conservative policy of reserving risky loans on their balance sheets.

Regarding the liquidity of the RA banking system, it should be noted that despite some negative phenomena that have occurred in recent years, commercial banks ensured a sufficient liquidity level (Diagram 5).

Diagram 5. Overall and current liquidity indicators of the RA banking system in the 2018-2022



As we see, in 2021 with the growth of deposits and the almost unchanged level of the loan portfolio, liquidity of the banking system has increased significantly. Compared to the beginning of the year, the total liquidity of banks in all currencies increased by 6.4 percentage points and made 32.0%. The current liquidity index increased by 11.2 percentage points and made 120%. The foreign currency liquidity of the system was at an unprecedented high level the – total liquidity in foreign currencies of the first group increased by 10.4 percentage points and made 30.3% [3].

In 2022 the foreign currency liquidity of commercial banks continued to grow due to both the Central Bank's long-term liquidity risk regulation policy and the 2022 developments. As a result of the inflow of deposits of non-residents, foreign currency liquidity was at a historical maximum level. Compared to the beginning of the year, total liquidity in all currencies increased by 5.6 percentage points, and foreign currency liquidity by 12.1 percentage points [2].

The trends of the loan/deposit indexes also indicate the strengthening of the

foreign currency liquidity position of the banks, and the ratio has decreased both at the level of the general portfolio and at the level of residents. The progressive growth of deposits over lending was due to several factors. First, as a result of the low demand for foreign currency loans, the growth of the portfolio was only 4.8%, and the funds attracted from non-residents and based on risk management approaches, were allocated by banks in highly liquid assets. On the other hand, as a result of the increase in interest rates in the international markets, the tendency of commercial banks to replace external sources of financing with domestic deposits has increased.

Improvements in profitability and liquidity in banks have enabled the latter to make smaller adjustments to the increase in credit interest rates, thus mitigating the increase in the burden of servicing loans, and thus also the adverse effects on credit risk. In 2022, consumer lending rates increased by an average of 1.0 percentage points, mortgage lending rates by 0.8 percentage points, and business lending rates by 0.6 percentage points [2].

During 2022, the macroeconomic policy of the Central Bank of RA was aimed at revitalizing the lending market and normal lending of the economy, maintaining the trends that began in 2021, while increasing the ability of the banking system to withstand possible future shocks through the accumulation of capital buffers.

In 2022, the capital adequacy regulation requirements for commercial banks were revised. Since June 2023, the capital adequacy requirement has been set according to three levels of capital:

1. Common Equity Tier 1 (CET 1),
2. Tier 1 capital,
3. Total capital.

At the same time, the minimum limit of 12% of total capital adequacy was reduced by 1 percentage point.

Taking into account that the costs of capital accumulation were low and the level of capitalization of banks was sufficient to maintain the normal growth rates of lending to the economy, the Central Bank decided to increase the countercyclical capital buffer rate. Moreover, the latter was raised twice. Since May 2023, commercial banks had to meet the requirements of a countercyclical capital buffer rate of 1%, and since August 2023 – 1.5%.

Since January 2023, the requirements provided for by the regulation of capital maintenance and buffers of systemic banks have also increased, according to the schedule of the introduction of buffers. The buffers were raised by 0.5 percentage points each and set at 2.0% and 1.5%, respectively [2].

Conclusion

In recent years, Armenia's banking sector has been exposed to a series of shocks and the accumulation of systemic risk, leading to a higher level of dollarization, thus limiting the ability of the Central Bank to influence the economic environment through traditional monetary policy instruments.

However, a comprehensive analysis of early warning indicators of credit market trends, especially in the last two years, allows us to conclude that the credit market is in a moderate growth phase, and cyclical systemic risks are generally balanced, except for mortgage lending, where there are risks of overheating. Complementary increases in mortgage lending and real estate prices may indicate the accumulation of systemic risks in this area.

In the post-COVID period, the macroeconomic policy of the Central Bank of RA was aimed at revitalizing the lending market and normal lending of the economy, maintaining the trends that began in 2021, while increasing the ability of the banking system to withstand possible future shocks through the accumulation of capital buffers. Strengthening the ability of the banking system to absorb losses was considered a priority of the macroprudential policy of the Central Bank of the Republic of Armenia to expand the uninterrupted crediting of the economy in the event of the materialization of cyclical systemic risks.

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