



# Report and Recommendation of the President to the Board of Directors

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Project Number: 50074-001  
November 2016

## Proposed Loan Finca Armenia UCO CJSC Rural Financial Inclusion Project (Armenia)

This is an abbreviated version of the document approved by ADB's Board of Directors that excludes information that is subject to exceptions to disclosure set forth in ADB's Public Communications Policy 2011.

**Asian Development Bank**

## CURRENCY EQUIVALENTS

(as of 4 November 2016)

Currency unit	–	dram (AMD)
AMD1.00	=	\$0.0021
\$1.00	=	AMD476

## ABBREVIATIONS

ADB	–	Asian Development Bank
EBRD	–	European Bank for Reconstruction and Development
FIAR	–	Finca Armenia UCO CJSC
GDP	–	gross domestic product
IFC	–	International Finance Corporation
IFI	–	international financial institution
MSMEs	–	micro, small, and medium-sized enterprises
SMEs	–	small and medium-sized enterprises
TA	–	technical assistance

## NOTES

- (i) The fiscal year (FY) of Finca Armenia UCO CSJ ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.

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## I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan of up to \$6,000,000 or dram equivalent to Finca Armenia UCO CJSC (FIAR) for the Rural Financial Inclusion Project in Armenia.<sup>1</sup>

## II. THE FINANCIAL INTERMEDIARY

### A. Investment Identification and Description

2. Armenia's economy has undergone profound transformation since independence from the former Soviet Union in 1991. Ambitious reforms, as well as the inflow of capital and remittances, helped create a market-oriented economy. Gross domestic product (GDP) growth for 2007, before the onset of the 2008 financial crisis, was 13.7%. Economic growth was driven by the real estate and construction industries, as well as strong remittance inflows. Armenia has one of the highest emigration rates in the world with net migration flows of -3.2% from 2008 to 2012.<sup>2</sup> Remittances from migrant workers therefore play an important role in Armenia's economy and are estimated at 16% of GDP. This is twice as much as foreign direct investment and four times more than official government inflows, such that remittances finance roughly two-fifths of Armenia's imports. The large Armenian workforce in the Russian Federation contributes between 80% and 90% of all remittances.<sup>3</sup> Armenia's economy is very closely tied to the Russian Federation because it is the country's main trade and investment partner.

3. The global financial crisis hurt the country considerably—GDP growth slowed to 2.2% in 2010, and only slightly recovered thereafter to 3% in 2015.<sup>4</sup> Rural and urban poverty in Armenia increased sharply. The Asian Development Bank (ADB) estimates that 32% of the population lives below the poverty line, compared with 28% in 2008. The geography of poverty in Armenia also shows marked gaps between the capital city of Yerevan (25.2%), rural areas (29.9%), and other urban areas (35.1%).<sup>5</sup> Many Armenians are engaged in low-productivity agriculture, trapped in low-wage jobs, or suffer from long-term unemployment (footnote 2). Owing to the deteriorating macroeconomic performance of the Russian Federation, which has added stress to the Armenian economy, remittances declined significantly since 2014. At the end of 2014, Armenia experienced a 20% drop in the value of the dram. However, the currency depreciation was still less than in other neighboring countries and has since stabilized, with slight appreciation during 2016. Thanks to a recovery in the industrial sector (excluding construction) and services, the economy is strengthening somewhat—growth is estimated at 2% for 2016 and 2.3% for 2017 (ADB forecast).

4. **Micro, small, and medium-sized enterprises and agriculture.** Micro, small, and medium-sized enterprises (MSMEs) account for the vast majority of enterprises in Armenia but contribute a disproportionately low amount to GDP (43%), employment (41.7%), foreign trade, and foreign investment. The informal economy represents a significant part of Armenia's economy and has a particular effect on MSMEs, especially in the retail sector, where up to 50%

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<sup>1</sup> The design and monitoring framework is in Appendix 1.

<sup>2</sup> EV Consulting. 2014. *National Competitiveness Report of Armenia, 2013-2014*. Yerevan.

<sup>3</sup> International Monetary Fund. 2013. *Fifth Review for EFF and ECF, IMF Country Report No. 13/34*. Washington, DC.

<sup>4</sup> World Bank (WB). 2016. *Global Economic Prospects*. Washington, DC.

<sup>5</sup> National Statistical Service of Armenia. 2015. *Social Snapshot and Poverty in Armenia, Statistical Analytical Report*. Yerevan.

of total sales are unregistered.<sup>6</sup> According to ADB estimates, the informal economy represents 11.3% of total GDP and is highest in agriculture (22.4%), construction (15.4%), and wholesale and retail trade (14.8%), the sectors with the largest MSME share. Given the large share of the informal economy, the importance of MSMEs may be underestimated in official statistics.

5. Agriculture is one of the most important sectors in the Armenian economy, accounting for more than 35% (2015) of total employment. It is the largest contributor to GDP at 21.9%.<sup>7</sup> Armenian agriculture consists of 68% plant growing and 32% animal husbandry. Small farms and households play a key role in the production of whole milk and meat, for instance. They contribute more than 90% of the country's meat production. The sector has significant potential for growth through further investment and productivity improvements. However, agriculture production and value chains still lack adequate investment and working capital. The majority of Armenian banks refrain from agriculture financing because of the high risks of the sector. In 2015, only 5% of total commercial banking credit went to agriculture.<sup>8</sup> Despite these limitations and challenges, the sector has performed well from 2013-2015 and recorded a growth rate of 13.2% in 2015, although helped by very favorable weather conditions.

6. **Finance sector.** The Armenian finance sector is heavily dominated by banks, which account for about 90% of sector assets. The banking subsector consists of 21 banks, is relatively fragmented, and dominated by foreign-owned banks, which account for over 50% of total banking assets. The largest bank, Ameriabank, has a market share of around 14.8% in terms of total assets. To drive consolidation and strengthen the banking system, the Central Bank of Armenia has increased the minimum capital requirements for commercial banks from AMD5 billion (\$10 million) to AMD30 billion (\$60 million) by 1 January 2017.

7. Low access to finance is a significant problem in Armenia. Only 18% of adults aged 15 and above have a bank account compared with an average of 43% for lower middle-income countries. The World Bank estimates that, out of the 130,000 small and medium-sized enterprises (SMEs) in Armenia, 50% have no access to finance, and this figure increases to 60%–70% in rural areas.<sup>9</sup> The banking industry lacks some important funding tools (e.g., a well-functioning interbank market or developed capital markets) and is not effectively supplemented by nonbank financial institutions, nor supported by institutional investors. Banking has low credit penetration—credit to the private sector stands at less than 45% of GDP (2014) compared with 60% in the Russian Federation and Ukraine, 50% in Georgia, and 38% in Azerbaijan. Bank lending is highly concentrated in Yerevan (two-thirds of total bank lending), even though two-thirds of the people live in the regions.<sup>10</sup> Low population density, riskiness of agriculture loans, lack of financial information on borrowers, and lack of real estate collateral in rural areas are major obstacles to lending in the regions. Given the need to increase access to finance in Armenia, some international financial institutions (IFIs) and bilateral institutions are active in the country and play an important role in providing finance.

8. ADB's nonsovereign support for private finance in Armenia has focused on funding banks that support MSME activities, in addition to the Trade Finance Program. In 2011, ADB

<sup>6</sup> European Investment Bank. 2014. *Private Sector Financing and the role of Risk-bearing Instruments*. Luxembourg.

<sup>7</sup> WB. 2016. *World Bank Open Data*. Washington, DC.

<sup>8</sup> Central Bank of Armenia. 2016. *Statistics of Financial Organizations*. Yerevan.

<sup>9</sup> WB. 2016. *Financial Inclusion Data*. Washington, DC.

<sup>10</sup> Central Bank of Armenia. 2015. *Financial System of Armenia*. Yerevan.

approved loans totaling \$65 million to four Armenian banks for onlending to SMEs.<sup>11</sup> Continued support is needed to strengthen the finance sector and help develop MSMEs, as well as the agriculture sector in Armenia. The MSME funding gap in Armenia is most evident in the case of affordable local currency loans, especially at a longer tenor, because commercial banks themselves do not have access to such funds to onlend. Banks deem a large number of MSMEs “unbankable”, especially those that lack the required collateral. Such entities are more likely to be in rural areas, engaged in agriculture, and classified as either micro or small enterprises. In addition, insufficient financial literacy means that many MSMEs are not aware of all the products available to them. Operating in Armenia for over 15 years, FIAR, a part of FINCA International Inc.’s network, was identified by ADB as a good candidate for local currency funding to help improve access to finance in Armenia’s rural regions. FIAR has 38 branches spread across the country and a strong emphasis on rural and agriculture lending. It also undertakes financial literacy training to help raise awareness and understanding of standard bank products. In 2015, FIAR was recognized as the year’s “Best Credit Organization in Armenia”, according to the results of a public opinion poll, conducted by the Armenian representation of Gallup International.

## **B. Business Overview and Strategy**

9. Founded in 1999, FIAR has grown to become one of the largest nonbank financial institutions in Armenia, with 40% market share among the top five MFIs.<sup>12</sup> Thanks to FIAR’s strong management team and 651 committed staff, FIAR successfully reached new clients in Armenia’s underbanked regions. As of 31 December 2015, FIAR had an outstanding loan portfolio of \$60.6 million, serving more than 52,000 clients, 85% of which belong to regions outside Yerevan. FIAR has developed a rural banking model from inception, based on the village banking model pioneered by its parent, FINCA International Inc. It has designed specific products for rural and agriculture customers and operates through an expansive branch network, giving it a unique advantage in the Armenian market. The FINCA brand name is well known and trusted in Armenia, which helps FIAR attract and retain clients. FIAR is an equal opportunity employer and makes considerable efforts to service women customers. Women borrowers currently represent 30% of the loan volume and 35% of outstanding loans.

10. FIAR caters to low-income individuals and micro and small enterprises in rural and urban areas engaged in manufacturing, services, and agriculture and seeking to expand their business capacity. FIAR competes with other microfinance lenders as well as with informal lenders. To a limited extent, FIAR also competes with banks. However, micro enterprises, which are the main target clients of FIAR, are underserved by commercial banks. Banks extend consumer credit to a number of current or potential FIAR borrowers, but competition with FIAR’s core business from banks’ consumer lending business is limited because consumer lending is heavily regulated, products cannot easily be customized to clients’ needs, and many of FIAR’s target clients would not be able to avail of it on a large enough scale.

11. The primary value proposition that FIAR offers to its target customers is access to credit on terms that differ from those of banks, and better customer service. Its credit products feature low collateral requirements. FIAR’s clients are low-income entrepreneurs and farm households that generate income from diversified farming and business. FIAR expects to grow its loan

<sup>11</sup> ADB. 2011. *Report and Recommendations of the President to the Board of Directors: Proposed Senior Loans to ACBA Credit Agricole Bank, Ameriabank, Ardshininvestbank, Inecobank for the Small and Medium-Sized Enterprise Finance Program*. Manila.

<sup>12</sup> Union of Credit Organizations of the Republic of Armenia. 2016. *Quarterly Financial Report April–June 2016*. Yerevan.

portfolio from \$54.3 million in September FY2016 by 4% annually for the next 4 years. Given the challenging macroeconomic situation at present, management concentrates on prudent lending, customer service, and retention of clients, rather than on aggressive expansion. FIAR's 5-year business plan aims to deepen the relationship with existing customers by offering a broader range of financial products in addition to meeting their credit needs, such as remittances, money transfers, and exchanges. It also plans to work with third-party insurance providers to create other value-added offerings for its clients, i.e., health insurance and motor third-party liability insurance. Moreover, in 2016 FIAR has introduced a consumer loan product and plans to introduce renovation and home improvement loans.

12. During 2016, FIAR is phasing out its two group loan products (group loans and group rural loans), which currently represent 3.2% of the total loan portfolio (September 2016). From 2017-2021, FIAR will concentrate fully on offering individual loans, individual rural loans, and loans to SMEs, in addition to potentially introducing new products as mentioned in paragraph 11. As of September 2016, individual loans made up 39% of the portfolio, individual rural loans comprised 48%, and loans to SMEs totaled 9% of its portfolio. The portfolio mix between these three products is expected to stay fairly constant over the next 5 years. The shift to purely individual lending is market-driven since demand for group loans has been decreasing. In addition, group loans have proven to be of lower credit quality but are costly to monitor. The average loan term is 26 months for individual loans, 27 months for individual rural loans, 40 months for loans to SMEs, and 23 months for group loans. In phasing out group loans, which have a maximum tenor of 96 weeks, FIAR will also shift to longer-tenor lending—168 weeks for individual loans and 240 weeks for loans to SMEs.

13. FIAR's asset growth has mainly been funded by loans from IFIs, microfinance funds, and commercial banks, with which FIAR has established excellent relationships. It has received loans from the International Finance Corporation (IFC), the European Bank for Reconstruction and Development (EBRD), the Black Sea Trade and Development Bank, DWM, and responsAbility. Commercial bank loans tend to be shorter in tenor at typically 12 months. To fund its financing gap of \$30 million in 2017, FIAR intends to diversify its lending relationships and work with new IFIs such as ADB.

### **C. Ownership, Management, and Governance**

14. **Ownership.** FIAR is wholly owned by Netherlands-based FINCA Microfinance Coöperatief UA, which is wholly owned by FINCA Microfinance Holding LLC, Delaware (FMH). FMH is incorporated in the state of Delaware as a for-profit corporation and is owned to 62% by FINCA International Inc. and to 38% by IFIs (such as the Netherlands Development Finance Company or FMO, IFC, and German development cooperation through KfW) and microfinance investment funds (e.g., Triple Jump and Triodos). It has adopted high integrity and responsible finance standards, and is regulated by the Central Bank of Armenia.

15. ADB's review of the ownership structure does not give ADB cause to believe that such entity has been established, or is being used for cross-border tax evasion, money laundering, or terrorism financing in the jurisdictions involved in the investment.

16. **Management and governance structure.** FIAR's corporate governance policies have been heavily influenced by its international shareholders and lenders, such as the IFIs. Local management is of high quality with many years of experience in the Armenian market. The chief executive officer, Hrachya Tokhmakhyan, has been with FIAR since 2007 and was appointed to the top position in 2013. The chief financial officer, Anush Petrosyan, joined FIAR in 2013 with



more than 10 years of external audit experience in leading audit companies in Armenia. The board of directors consists of five members, both internal and external. The Chairman of the Board is part of the senior management of FINCA International Inc. FIAR has a separate audit committee appointed by the general meeting of shareholders. The committee consists of at least three members.

17. **Risk management.** FIAR has a number of internal policies and procedures approved by its board of directors and covering all aspects of risk, including credit, operational, market, liquidity, interest rate, and compliance risks. FIAR has a centralized credit department that reviews all loans above \$5,000. The credit committee composition depends on the loan amount being considered. For any new loan exceeding \$25,000, attendance of a management board member is required. For each loan appraisal, credit assessment is done on the basis of the client's income declaration, credit bureau data, and FIAR's own credit data. Post disbursement, FIAR continues the risk assessment of its clients with regular monitoring and on-site visits. FIAR is implementing a new customer relationship management software that is expected to shorten credit origination time. Automation of certain functions is expected to lower the administration costs, and the savings could then be passed on to the customer.

18. FIAR's lending process is determined by the credit policy and related procedures approved by the Board of Directors. It includes origination, disbursement, loan management and supervision, and loan workout. Similar to the developments at other subsidiaries, FIAR's lending model shifted from group to individual loans in 2013. For loans of less than AMD750,000 (\$1,500), no collateral is required but a spouse or any other family member must act as co-borrower (guarantor), and a guaranty of all formal or informal participants in the business is also mandatory. Loans in excess of AMD750,000 (\$1,500) require either varying types of physical collateral or external guarantors.

#### **D. Financial Performance**

19. **Capital adequacy.** FIAR is well capitalized with a tier 1 ratio of 18.9% (FY2014: 19.6% and FY2013: 19.3%) and a total capital ratio of 19.7% (FY2014: 21.2% and FY2013: 20.9%). The regulatory minimum is 10%. Under FINCA International Inc.'s capital policy, subsidiaries were historically required to maintain common tangible equity equal of at least 20% of total assets. In FY2014, certain subsidiaries, including FIAR, were granted approval to maintain a 15% limit. No dividends were paid for during 2014 and 2015, allowing for some buildup of retained earnings.

20. **Portfolio and asset quality.** FIAR's loan portfolio is well diversified, with an average tenor of 23 months. Given its high number of borrowers and small average loan size of \$1,160 (2016), it is highly granular, providing a favorable risk profile. FIAR's rural presence is strong, with agriculture and food processing loans representing 50% of its loan book (2016). The bulk (78%) of its lending is outside Yerevan. Other loan segments include trade (24%), industry and production (7%), construction (3%), and transport (5%). FIAR's loan portfolio is denominated in dram (45%) and in US dollars (55%). While it is highly concentrated in the agriculture sector, the agriculture portfolio itself is also highly diversified: 75% involves mixed farming by individuals or businesses engaged in several types of agriculture production.

21. FIAR's credit policy and underwriting standards are prudent and supported by a rigorous client selection and monitoring process. FIAR's nonperforming loan ratio increased to 4.01% in FY2015 (from 1% in FY2014 and 1.93% in FY2013) as a result of the difficult economic situation in FY2015 and the depreciation of the dram in the fourth quarter of 2014, which caused financial

strain on borrowers of US dollar loans. As noted, 55% (August 2016) of the portfolio is denominated in US dollar loans. FIAR has been proactive in rectifying the situation through early restructuring of outstanding loans, as well as the engagement of a law firm that specializes in collections. Given the improved economic outlook and the stability of the dram, nonperforming loans are expected to decrease. In addition, the weaker dram is benefiting the export sector, particularly agriculture and food processing, which constitute 50% of FIAR's loan book. In FY2015, restructured loans accounted for 62% of nonperforming loans. FIAR's provisioning policy is prudent, with loan loss provisions representing 39% of nonperforming loans (FY2015). This is a decline from 55% in FY2014 but decreasing nonperforming loans and increasing profitability will boost the ability to increase the provisioning coverage. The 20 largest loans represent only 0.2% of FIAR's portfolio.

22. **Earnings and profitability.** For FY2015, net income fell to \$0.1 million, from \$1.3 million in FY2014, owing to the challenging economic situation, the devaluation of the dram, and higher provisioning. Return on average equity decreased to 1.19% in FY2015, from 11.24% in FY2014. FIAR expects a recovery in profitability in FY2016 and forecasts after-tax profit of \$0.9 million and return on average equity of 7.6% for the year. Since March 2016, FIAR's monthly profit on average exceeded \$100,000 and is significantly ahead of budget. The net interest margin is healthy and stood at 17.63% in 2015, compared with 21.19% in 2014—a result of the changing currency composition of the loan portfolio as customers once again preferred US dollar loans because of lower interest rates and the stability of the dram. Typical for MFIs with a high unit cost, the margin is high. FIAR's cost-income ratio was 84% in 2015, compared with 79% in 2014. This is expected to fall with increased profitability, and FIAR is considering closing a costly branch in Yerevan and instead opening an additional branch in a rural area to save costs.

23. **Funding and liquidity.** As a nonbank and non-deposit-taking financial institution, FIAR's funding entirely relies on borrowings and equity. FIAR depends mainly on funding by IFIs, microfinance investment funds, and commercial banks. As of May 2016, FIAR had signed agreements with local banks and International Financial Institutions (IFIs) for total funding of \$10 million. The average tenor of these borrowings is 2 years. FIAR is in negotiations with another IFI for a \$6 million, 4-year loan to be funded in dram. Currently, FIAR's local currency funding comes from Armenian commercial banks and is very short term with a maximum tenor of 1 year. In 2015, 67% of borrowed funds were in US dollars, compared with 46% in 2014. At year-end 2015, the ratio of gross loans to total assets was 93.7% (89.7% in 2014).

### III. THE PROPOSED ADB ASSISTANCE

#### A. The Assistance

24. ADB will provide a loan to FIAR in an amount of up to \$6 million or dram equivalent. ADB's funding will be used to support MSMEs<sup>13</sup> and the agriculture sector, primarily outside of the capital. Up to 75% of ADB's funding will go to MSMEs outside of Yerevan, and up to 70% will be used to onlend to agri-borrowers. ADB will also be providing technical assistance (TA) in an amount of up to \$200,000 funded from an existing TA.<sup>14</sup> The TA will support the development of a credit scoring system and "Smart" certification<sup>15</sup> of FIAR.

<sup>13</sup> For the purpose of the loan, MSMEs are defined in accordance with the definition of the European Union as having an annual business turnover of up to AMD1,500 million and up to 250 employees.

<sup>14</sup> ADB. 2014. *Technical Assistance for Promoting Financial Inclusion and Stability in ADB's Transition Member Countries into Regional Cooperation*. Manila. .

<sup>15</sup> The Smart Campaign. <http://www.smartcampaign.org/index.php>

## **B. Implementation Arrangements**

25. **Monitoring and reporting.** ADB's Private Sector Operations Department will carry out project monitoring. FIAR will provide ADB with financial reports at predetermined regular intervals and as requested. These will include (i) quarterly unaudited management accounts, (ii) quarterly compliance certificates for financial covenants, (iii) semiannual performance reports, (iv) annual audited financial statements, and (v) annual gender, environmental and social safeguard monitoring and compliance reports.

26. **Evaluation.** Monitoring reports will be prepared and submitted to ADB regularly, and at least annually. The first report will be submitted no later than 12 months after the first disbursement.

## **C. Value Added by ADB Assistance**

27. **Economic diversification and widening of access to finance.** As noted, access to finance is very constrained for lower-income individuals and smaller enterprises in Armenia, particularly in rural regions. Banks do not generally service this segment because of perceived higher risks, difficulties in obtaining information, and collateral requirements. ADB's funding will support FIAR's funding to this customer segment and diversification into new financial products. In addition, ADB's funding will support FIAR's efforts to lend to women. The long tenor of the ADB loan will support FIAR's growth focus on individual loans that have relatively longer tenors, thereby enhancing the impact of the transaction.

28. **Access to local currency funding.** ADB's funding is expected to be in local currency. ADB's Treasury Department has obtained the necessary approvals to raise dram through a local currency bond issuance. To date, EBRD and IFC have issued local currency bonds in the market. Although the market is small, preliminary indications are that demand is strong enough to support \$6 million equivalent of funding. Providing local currency funding to FIAR will help reduce the currency mismatch and lower the foreign exchange risk for FIAR's borrowers. More broadly, access to long-term funding for nonbank financial companies and banks in Armenia is difficult. ADB's funding will help narrow this market gap and thus strengthen the finance sector.

29. **Better risk management and consumer protection practices.** The TA will help FIAR improve its risk management by introducing a credit scoring system that will allow FIAR to increase the quality of its credit underwriting process, potentially lowering the risk of nonperforming loans, and reduce the cost of loan processing for loans of up to \$5,000 by at least 50%. Such an increase in both efficiency and quality of service will enable FIAR to serve a greater number of low-income and rural customers. Under the TA, FIAR will also participate in "Smart" certification, which will help it strengthen its consumer protection practices. "Smart" certification will award FIAR a client protection certification, an independent, third-party evaluation to publicly recognize financial institutions that meet adequate standards of care in how they treat clients.

## **D. Risks**

30. **Country risk.** Armenia has shown resilience to the current adverse economic environment when compared with other countries in the region. However, financial institutions will continue to be exposed to the macroeconomic situation, as well as to any political tensions. Dissatisfaction with President Serzh Sargsyan continued to rise, and political instability remains

a risk. A resolution of the Nagorny Karabakh dispute with Azerbaijan (fighting erupted between Armenian and Azerbaijani forces on 2 April 2016) and normalization of relations with Turkey are unlikely in the near future. Armenia's accession to the Eurasian Economic Union, which was launched on 1 January 2015, has further increased economic and political dependence on the Russian Federation. The recession in the Russian Federation and lower remittances will remain a drag on growth. ADB expects Armenia's GDP to grow by 2% in 2016.

31. **Asset quality.** Asset quality has weakened following the 2014 currency devaluation and macroeconomic downturn. Although the nonperforming loan ratio is lower than the industry average, the current challenging economic environment and any future devaluation of the dram may expose FIAR to higher credit risk. FIAR is limiting this risk by thorough due diligence on borrowers and prudent underwriting and collection practices.

32. **Currency risk.** The dram has demonstrated some resilience relative to other regional currencies. It has stabilized since the 20% depreciation in the fourth quarter of 2014 and no further depreciation is expected. FIAR's loan book is split almost equally between the dram and US dollar. FINCA has a foreign currency risk management policy in place, and is mitigates currency risk with foreign exchange forward and swap deals, by increasing or decreasing lending in the respective currency, and by sourcing adequate funding from IFIs and commercial banks. If ADB is able to provide a dram loan, this will also help lessen foreign exchange risk for FIAR and its borrowers.

33. **Profitability.** Increased provisioning led to a decline in profitability in 2015. FIAR is expecting a recovery in 2016. Midyear results show that since March, monthly profit has exceeded \$100,000 on average and reached \$267,556 in September, permitting some capital buildup. Nonetheless, FIAR's small size and limited economies of scale has created a high operating cost base. FIAR's growth focus on the regions and efforts to boost the efficiency of its relatively costly business model help mitigate this risk. Net interest margins remain strong and are expected to be stable.

34. The proposed loan of up to \$6,000,000 to FIAR has an obligor risk rating and a facility risk rating of NSO 10.

#### IV. DEVELOPMENT IMPACTS AND STRATEGIC ALIGNMENT

##### A. Development Impacts, Outcome, and Output

35. **Impacts.** The impacts will be (i) improved availability of credit to MSMEs and agriculture, and (ii) expanded private financial services in Armenia's regions outside of Yerevan.

36. **Outcome.** Sustainable growth in MSME- and agriculture-related loans demonstrated, as evidenced by an increase in the number of microfinance loans outstanding from 27,474 to 28,862, and of agribusiness loans outstanding from 24,613 to 25,946 by 2022.

37. **Output.** FIAR will expand its financing to MSMEs and agriculture in rural areas, as evidenced by an increase in disbursements from \$26.9 million to \$34.1 million for agribusiness loans, and from \$26.0 million to \$39.3 million for microfinance loans by 2020.

## B. Alignment with ADB Strategy and Operations

38. **Consistency with ADB strategy and country strategy.** Under ADB's Midterm Review of Strategy 2020, ADB aims to strengthen its support for the finance sector by assisting the development of financial infrastructure, institutions, and products and services; and by promoting inclusive growth.<sup>16</sup> FIAR's emphasis on lending to segments with a high potential for employment and income generation will support inclusive growth. The ADB loan will help the borrower provide loans to MSMEs to realize their investment needs. This is consistent with the government's efforts to promote growth and economic diversification, and ADB's country partnership strategy with Armenia, 2014–2018.<sup>17</sup>

39. **Consistency with ADB operations.** ADB plays a tangible role in supporting the deepening of financial services in Armenia. In 2011, ADB supported four banks in Armenia through senior loans totaling \$65 million. ACBA Credit Agricole, Ameriabank, Ardshininvestbank, and Inecobank were the banks selected in ADB's Small and Medium-Sized Enterprise Finance Program (footnote 11), through which ADB loan proceeds were onlent to SMEs. The loan to FIAR will continue ADB's efforts to strengthen and develop Armenia's financial market and support MSMEs. It complements sovereign programs in the finance sector such as the Women's Entrepreneurship Support Sector Development Program (2012).<sup>18</sup>

## V. POLICY COMPLIANCE

### A. Safeguards and Social Dimensions

40. In compliance with ADB's Safeguard Policy Statement (2009), the senior loan is classified category FI based on potential impacts on the environment, and category FI treated as C for impacts on involuntary resettlement and indigenous peoples. Subloans under environment category A, and social safeguard categories A and B will not be financed under the loan. The subloans under the proposed ADB loan are expected to have minimal or no adverse environmental and social impacts. No land acquisition, physical or economic displacements, nor impact on indigenous communities is foreseen in relation to any activities of the subborrowers. The environmental and social management system established by FIAR will be enhanced to comply with the Safeguard Policy Statement, and will be adopted before the first disbursement for subloan financing. FIAR will apply ADB's prohibited investment activities list, exclude all projects that will have adverse environmental and social safeguard impacts, ensure that investments using ADB funds abide by applicable national laws and regulations, and comply with the Safeguard Policy Statement. FIAR will confirm this in its periodic report to ADB. FIAR will monitor and provide information on its compliance with the Safeguard Policy Statement and with relevant national laws, standards, and guidelines in the annual report. The loan is categorized as some gender elements because the number of subloans for businesses owned by women is expected to increase by 7.9% (microfinance segment), 72% (SMEs), and 6.4% (agribusinesses) by 2020.

### B. Anticorruption Policy

41. FIAR was advised of ADB's policy of implementing best international practice relating to combating corruption, money laundering, and the financing of terrorism. ADB will ensure that

<sup>16</sup> ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

<sup>17</sup> ADB. 2014. *Country Partnership Strategy: Armenia, 2014–2018*. Manila.

<sup>18</sup> ADB. 2012. *Women's Entrepreneurship Support Sector Development Program*. Manila.

the investment documentation includes appropriate provisions prohibiting corruption, money laundering, and the financing of terrorism, and remedies for ADB in the event of noncompliance.

**C. Investment Limitations**

42. The proposed loan is within the medium-term, country, industry, group, and single investment exposure limits for nonsovereign investments.

**D. Assurances**

43. Consistent with the Agreement Establishing the Asian Development Bank (the Charter),<sup>19</sup> ADB will proceed with the proposed assistance upon establishing that the Government of Armenia has no objection to the proposed assistance to FIAR. ADB will enter into suitable finance documentation, in form and substance satisfactory to ADB, following approval of the proposed assistance by the ADB Board of Directors.

**VI. RECOMMENDATION**

44. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of up to \$6,000,000 or dram equivalent from ADB's ordinary capital resources to Finca Armenia UCO CJSC for the Rural Financial Inclusion Project in Armenia, with such terms and conditions as are substantially in accordance with those set forth in this report, and as may be reported to the Board.

Takehiko Nakao  
President

15 November 2016

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<sup>19</sup> ADB. 1966. *Agreement Establishing the Asian Development Bank*. Manila.

## DESIGN AND MONITORING FRAMEWORK

<b>Impacts the Project is Aligned With</b>			
Availability of credit to MSMEs and agriculture improved (Armenia Development Strategy for 2014–2025) <sup>a</sup> Private financial services in Armenia’s regions outside of Yerevan expanded (Armenia Development Strategy for 2014–2025) <sup>a</sup>			
<b>Results Chain</b>	<b>Performance Indicators with Targets and Baselines</b>	<b>Data Sources and Reporting Mechanisms</b>	<b>Risks</b>
<b>Outcome</b> Sustainable growth in MSME- and agriculture-related loans demonstrated	By 2022: a. Number of agribusiness loans outstanding increased to 25,946 (2015 baseline: 24,613) b. Number of loans to SMEs outstanding increased to 446 (2015 baseline: 359) c. Number of microfinance loans outstanding increased to 28,862 (2015 baseline: 27,474) d. Nonperforming loans (90 days past due) no more than 0.72% (2015 baseline: 0.86%)	a.–e. FIAR development effectiveness monitoring report	General increase in interest rates dampens demand for loans.  Growth prospects of the MSME segment and agriculture sector are lower than expected.
<b>Output</b> 1. FIAR financing to MSMEs and agriculture expanded	By 2020: 1a. Total amount of agribusiness loans disbursed at least \$34,144,110 (2015 baseline: \$26,896,513) 1b. Total amount of loans to SMEs disbursed at least \$6,733,648 (2015 baseline: \$4,911,700) 1c. Total amount of microfinance loans disbursed at least \$39,314,198 (2015 baseline: \$26,013,348) 1d. Number of microfinance loans outstanding to women or businesses owned by women increased to 11,777 (2015 baseline: 10,912)	1a.–e. FIAR development effectiveness monitoring report	Currency depreciation  Demand for loans by MSMEs and the agriculture sector is lower than expected.

<b>Results Chain</b>	<b>Performance Indicators with Targets and Baselines</b>	<b>Data Sources and Reporting Mechanisms</b>	<b>Risks</b>
	1e. Number of loans to SMEs outstanding to businesses owned by women increased to 167 (2015 baseline: 97)  1f. Number of agribusiness loans outstanding to businesses owned by women increased to 9,122 (2015 baseline: 8,576)		
<b>Key Activities with Milestones</b>			
1. ADB executes loan agreement with FIAR by March 2017 2. Disbursement of loans occurs through March 2018 3. Monitoring and review missions (2017 onward) 4. FIAR adopts updated ESMS satisfactory to ADB prior to first disbursement.			
<b>Inputs</b>			
ADB: \$6 million or dram equivalent loan to FIAR			
<b>Assumptions for Partner Financing</b>			
Not Applicable			

FIAR = Finca Armenia UCO CJSC; MSME = micro, small, and medium-sized enterprises; SMEs = small and medium-sized enterprises.

<sup>a</sup> Government of Armenia. 2014. *Armenia Development Strategy for 2014–2025*. Yerevan.

Source: Asian Development Bank.