



Report and Recommendation of the President to the Board of Directors

Project Number: 51184-001
September 2017

Proposed Loan and Equity Investment Ameriabank CJSC Strengthening the Banking Sector for Financial Inclusion (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 22 August 2017)

Currency unit – dram (AMD)

AMD1.00 = \$0.0021
\$1.00 = AMD478.18

ABBREVIATIONS

ADB	–	Asian Development Bank
AMB	–	Ameriabank CJSC
CAR	–	capital adequacy ratio
CBA	–	Central Bank of Armenia
CEO	–	chief executive officer
EBRD	–	European Bank for Reconstruction and Development
GDP	–	gross domestic product
IFI	–	international financial institution
IPO	–	initial public offering
IT	–	information technology
LSE	–	London Stock Exchange
RMC	–	risk management center
SMEs	–	small and medium-sized enterprises

NOTES

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

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CONTENTS

Page

PROJECT AT A GLANCE

I.	THE PROPOSAL	1
II.	THE FINANCIAL INTERMEDIARY	1
	A. Investment Identification and Description	1
	B. Business Overview and Strategy	2
	C. Ownership, Management, and Governance	3
III.	THE PROPOSED ADB FINANCING	4
	A. The Assistance	4
	B. Implementation Arrangements	4
	C. Value Added by ADB Assistance	5
IV.	DEVELOPMENT IMPACT AND STRATEGIC ALIGNMENT	5
	A. Development Impact, Outcome, and Outputs	5
	B. Alignment with ADB Strategy and Operations	6
V.	POLICY COMPLIANCE	6
	A. Safeguards and Social Dimensions	6
	B. Anticorruption Policy	7
	C. Assurances	7
VI.	RECOMMENDATION	7

APPENDIXES

1.	Design and Monitoring Framework	8
2.	List of Linked Documents	9

PROJECT AT A GLANCE

1. Basic Data		Project Number: 51184-001	
Project Name	Strengthening the Banking Sector for Financial Inclusion	Department /Division	PSOD/PSFI
Country	Armenia, Republic of		
Borrower	Ameriabank CJSC		
Investee	Ameriabank CJSC		
2. Sector		ADB Financing (\$ million)	
✓ Finance	Finance sector development		30.00
	Small and medium enterprise finance and leasing		30.00
	Total		60.00
3. Strategic Agenda		Climate Change Information	
Inclusive economic growth (IEG)	Pillar 2: Access to economic opportunities, including jobs, made more inclusive	Climate Change impact on the Project	Low
4. Drivers of Change		Gender Equity and Mainstreaming	
Private sector development (PSD)	Promotion of private sector investment	Some gender elements (SGE)	✓
5. Poverty and SDG Targeting		Location Impact	
Geographic Targeting	No	Rural	High
Household Targeting	No	Urban	Medium
SDG Targeting	Yes		
SDG Goals	SDG8		
6. Nonsovereign Operation Risk Rating			
Obligor Name		Obligor Risk Rating	Facility Risk Rating
Ameriabank CJSC		Confidential	Confidential
7. Safeguard Categorization	Environment: FI	Involuntary Resettlement: FI	Indigenous Peoples: FI-C
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		60.00	
Nonsovereign Direct Investment: Ordinary capital resources		30.00	
Nonsovereign LIBOR Based Loan (Regular Loan): Ordinary capital resources		30.00	
B-Loans		0.00	
None		0.00	
Official Cofinancing^a		0.00	
None		0.00	
Others^b		0.00	
Total		60.00	

^a Concessional financing from external sources.

^b Derived by deducting ADB financing, B Loans and Official Cofinancing from Project Total Cost.

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on (i) a proposed loan of up to \$30,000,000 or the dram equivalent to Ameriabank CJSC (AMB) and (ii) a proposed equity investment of up to the dram equivalent of \$30,000,000 in AMB both for the Strengthening the Banking Sector for Financial Inclusion in Armenia.

II. THE FINANCIAL INTERMEDIARY

A. Investment Identification and Description

2. **Finance sector.** The Armenian finance sector is heavily dominated by banks, which account for about 90% of sector assets. The banking subsector, consisting of 17 banks, is fragmented and is dominated by foreign-owned banks, which account for more than 50% of total banking assets. AMB is the largest bank and has a market share of about 17% in total assets. To drive consolidation and strengthen the banking system, the Central Bank of Armenia (CBA) increased the minimum capital requirements for commercial banks from AMD5 billion (\$10 million) to AMD30 billion (\$60 million), effective 1 January 2017, which led to a consolidation of the sector from 21 to 17 banks. The banking industry lacks some important funding tools (e.g., a well-functioning interbank market and developed capital markets) and is not effectively supplemented by nonbank financial institutions, nor supported by institutional investors.

3. **Small and medium-sized enterprises.** Access to finance in Armenia is problematic, particularly for mid-sized and small enterprises, and microentrepreneurs. The World Bank estimates that 50% of Armenia's 130,000 small and medium-sized enterprises (SMEs) have no access to finance, and this figure increases to 60%–70% in rural areas.¹ Banks have traditionally had larger exposures to corporate clients, which were perceived to be lower risk. SMEs account for the vast majority of enterprises in Armenia but contribute a disproportionately low amount to gross domestic product (GDP) (43.0%), employment (41.7%), foreign trade, and foreign investment. According to Asian Development Bank (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%)—sectors with the largest SME share. Given the large informal economy share, the importance of SMEs may be underestimated in official statistics.

4. Some banks in Armenia have started shifting their strategies to target this untapped segment because of rising demand and higher yields for the banks, coupled with better understanding of SMEs and corresponding underwriting practices. AMB is one such bank and has been identified as a strong partner for ADB to help improve access to finance in the country. To better match the needs of SME borrowers in terms of loan tenors and products, the bank needs longer tenor debt, which is not readily available in the market. ADB also has the opportunity to support AMB through an equity investment and in preparation for a planned initial public offering (IPO). Fresh equity is needed to fund future growth, help AMB develop into a universal bank, and maintain healthy capital adequacy levels. As per its business plan, AMB needs to raise \$60 million of fresh equity until the end of 2019 to maintain its target Tier 1 capital adequacy ratio (CAR) at 15%. It plans to raise \$30 million in FY2017 from a high-quality shareholder and views ADB as a strong partner, which will not only support its growth but also build its profile among international investors. This will be ADB's first equity investment in Armenia. The proposed funding deepens

¹ World Bank. 2016. *Financial Inclusion Data*. Washington, DC.

ADB's relationship with AMB. AMB is a participating bank in ADB's Trade Finance Program and in 2011 received an ADB loan, which has been fully repaid.²

B. Business Overview and Strategy

5. AMB is the largest bank in Armenia in terms of assets (\$1.48 billion; 17% market share) and loan portfolio (20% market share). The bank primarily serves corporate customers (about 75% of its portfolio), with the remainder SMEs and retail customers. It has 13 branches throughout Armenia and more than 600 employees. Fitch has assigned AMB a Long-Term Issuer Default Rating of "B+" with a stable outlook, in line with the sovereign. The rating reflects reasonable financial metrics, sizeable liquidity cushion, manageable refinancing risks, and solid domestic franchise.

6. AMB's business strategy for 2017–2020 has four key priorities:

- (i) **Become Armenia's first universal bank.** AMB's goal is to be the first universal bank in Armenia providing a complete range of banking services. It plans to strengthen its market share to 20% in 2020 and grow its loan book by 10%–12% annually until 2022. During this period, management plans to increase its SME and retail portfolio by leveraging technology, launching new customized products, and targeting high-growth, promising sectors of the economy (e.g., agriculture, information technology [IT], energy, renewables, and services). The bank's product mix will be gradually balanced, increasing the share of SME retail loans over total loans from 23.6% in FY2016 to more than 30% in FY2020.
- (ii) **Reduce funding cost.** AMB plans to strengthen its position in the deposit market by FY2019 through mobilizing deposits and diversifying funding sources. The bank has 18% of the market by current account and time deposits. Customer deposits are expected to reach \$1.12 billion from \$980 million in FY2016. As part of its funding strategy, AMB aims to strengthen relationships with its existing and new international financial institution (IFI) partners, and target \$434 million in IFI funding by FY2019. AMB actively issues bonds in the local market, and will continue to do so, as this offers a cheaper and stable funding source.
- (iii) **Reinforce institutional capacity and efficiency.** AMB aims to improve its capacity and efficiency with new distribution channels, digital finance, improved human resource processes, and branding. While AMB is the largest bank by assets, it is still significantly smaller than some of its peers in physical presence. It has 13 branches compared to the 66 branches of Ardshinbank (ranked second in the market) and 50 branches of Armbusinessbank (ranked third). AMB has managed its growth and leadership by careful selection of branch sites and effective use of digital channels to reach its target customers. Since 2012, AMB has been investing heavily in IT solutions to strengthen its position as a digital bank and plans to launch a first-of-a-kind multichannel distribution channel in Armenia. Management expects that the investments in IT and digital channels will also improve its cost-to-income ratio from 43.2% in Q1 2017 to 41% by Q4 2019.
- (iv) **Initial public offering.** AMB plans to be the first Armenian international financial group, and it aims to have an initial public offering listing on an international stock exchange. It believes that an international listing is critical to its strategic plans, as this will enhance its corporate governance framework and provide access to a broader pool of investors to fund its growth plans. AMB has taken several steps to prepare for a listing on an international exchange. An in-house IPO team is tasked

² ADB. 2015. *Extended Annual Review Report: Small and Medium-Sized Enterprise Finance Program*. Manila.

to implement all milestones needed for the listing, including setting up an investor relations function, implementing a corporate governance framework that aligns with listed companies on the LSE, and enhancing disclosure and transparency standards.

7. **Small and medium-sized enterprises strategy.** In 2010, AMB shifted its strategy to emphasize the importance of SME lending. Since then, strong growth of this market segment has been recorded. The compound aggregate growth rate of the SME portfolio for the last 5 years was 45.9%, compared to 30% for the overall loan portfolio. As a result, SME loans reached \$158.7 million by FY2016, and AMB is among the top three banks lending to the SME segment. Based on current projections, the average growth of the SME portfolio will be 20% and will reach \$188 million by FY2017 and \$241 million by FY2019. The share of SME and retail loans in the total loan portfolio will increase by about 10% in 3 years. The portfolio's growth will be driven mainly by the application of flexible lending mechanisms during the financing process, individual approach to clients, and high-quality service. AMB has conducted detailed market analysis of the SME segment and plans to roll out products tailored to SMEs' needs. AMB has invested in new branches and sales points, as well as improvements to its multichannel distribution network.

C. Ownership, Management, and Governance

8. **Ownership.** AMB (formerly Armimpexbank CJSC) was established in July 1992. In 2007, AMB was acquired by TDA Holdings Limited, which purchased a 96.15% shareholding. TDA Holdings Limited was renamed to Ameria Group in 2011. In 2013, Ameria Group Limited increased its share in AMB to 100%. On 23 December 2015, the European Bank for Reconstruction and Development (EBRD) purchased newly issued shares in AMB. On 21 December 2016, ESPS Holding Limited purchased 13.5% of AMB shares from Ameria Group.³ As of August 2017, the AMB shareholders were Ameria Group (65.80%), EBRD (20.69%), and ESPS Holding Limited (13.51%). These shareholders are looking to enhance the bank's shareholder base of high-quality institutional investors to strengthen its profile and corporate governance ahead of the planned IPO. This may result in further dilution of Ameria Group's stake in the bank.

9. Integrity due diligence has been conducted in accordance with ADB's Integrity Due Diligence Guidelines for Nonsovereign Operations.⁴ No significant or potentially significant integrity issues were identified. Tax integrity due diligence was also conducted because of the presence of intermediate jurisdictions (Cyprus and Liechtenstein) in the ownership structure.⁵ ADB's review of the entity 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.

10. **Management.** The management board consists of 10 members with considerable experience in banking, telecom and advisory businesses – coming from local and international firms.

11. **Governance structure.** AMB's corporate governance is good and further improvements have been made given the bank's plans for the IPO. As part of the IPO development plan, in 2016

³ ESPS Holding has shares of AMB's management team vested under the employee stock ownership plan.

⁴ ADB. 2015. *Integrity Due Diligence Guidelines for Nonsovereign Operations*. Manila.

⁵ ADB. 2016. *Anticorruption Policy: Enhancing the Role of the Asian Development Bank in Relation to Tax Integrity*. Manila.

AMB established three board-level committees, each comprising three members: an audit committee chaired by an independent director, a remuneration committee, and a nominations committee. Moreover, the board was increased to comprise seven directors (from five), three of whom were appointed in 2016. One of the new directors is the EBRD nominee director (A. Germanovich), who brings considerable external expertise in multiple business sectors. Although there is no formal requirement to have an independent director, AMB has four independent members on its board. In November 2013, A. Mkrtychyan, the CEO of Ameria Group, became the board chair, replacing R. Vardanyan, who remains a board director. A. Mkrtychyan has a background in public and private sector advisory and investment banking. R. Vardanyan, a Russian-Armenian, the founder and the president of Troika Dialog, the first investment bank in Russia.. He is a prominent investment banker and recognized for his philanthropy.

12. **Risk management.** AMB is governed by a board-approved risk management policy that oversees all aspects of risk including credit, operation, market, liquidity, interest rate, and compliance. AMB's chief risk officer reports directly to the board, and the board is updated regularly on the risks and mitigating actions taken to manage them. The risk management center (RMC) is a dedicated department reporting directly to the management board. The RMC consists of five units: credit risk analytics, business credit risk, retail credit risk, operational risk, and market risk. The internal audit and financial monitoring services report directly to the board.

13. Credit risk management is the responsibility of the RMC's corporate credit risk and retail credit risk units, which focus on overall portfolio assessment, and the review and monitoring of business loans. For business loans, there is a clear segregation of duties: client managers originate loan applications and pass them on to the corporate loan department, which prepares a credit report. This is then independently reviewed by the RMC before being considered at the credit committee. The RMC does not have explicit veto power, but its disagreement with a credit proposal automatically escalates it to the large credit committee, attended by the RMC head, where decisions are based on a majority vote. Credit approval levels are granular and vary by product. All related party exposures require board approval.

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III. THE PROPOSED ADB FINANCING

A. The Assistance

14. The proposed ADB assistance consists of (i) an equity investment of the dram equivalent of up to \$30 million, and (ii) a 5-year senior unsecured loan of up to \$30 million or (at ADB's discretion) its dram equivalent to support SMEs in Armenia.⁶ **CONFIDENTIAL INFORMATION DELETED**

B. Implementation Arrangements

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15. **Reporting arrangements.** ADB's Private Sector Operations Department will carry out project monitoring of ADB's debt and equity investments. AMB will provide ADB with financial reports at agreed intervals and as requested. These will include (i) quarterly unaudited financial

⁶ For the ADB loan, SMEs are defined following the European Union definition as having up to 250 employees and either (i) an annual business turnover of up to AMD1,500 million or (ii) assets of up to AMD1,000 million.

statements, (ii) compliance certificates for financial covenants, (iii) annual audited financial statements, (iv) reports on characteristics of AMB's loan portfolio, (v) annual reports on selected development indicators agreed between ADB and AMB, and (vi) annual environmental and social safeguard monitoring and compliance reports.

C. Value Added by ADB Assistance

16. **Economic growth and access to finance.** SMEs in Armenia have very constrained access to finance. Banks often find it difficult to service this segment because of perceived higher risks, difficulties in obtaining information, and collateral requirements. ADB will support AMB in providing funding to this important customer segment and expanding new product offerings, thus supporting overall economic growth, job creation, and diversification.

17. **Access to long-term, local currency funding.** **CONFIDENTIAL INFORMATION DELETED.** The ADB loan will provide critically needed long-tenor funding to AMB to better support SMEs given the absence of long-term funding sources such as well-developed capital markets. The ADB loan will help AMB extend the maturity of its lending and better match the tenor of its SME products, which have an average tenor of 5 years.

18. ADB's debt funding is also expected to be partially 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 the International Finance Corporation have issued local currency bonds in the market. Although the market is small, preliminary indications are that demand is strong enough to support up to \$15 million equivalent of debt funding, and the remaining \$15 million of the loan could be in dollars. Providing local currency debt funding to AMB will help reduce the currency mismatch and lower the foreign exchange risk for AMB's borrowers.

19. **Catalyze capital as a strategic shareholder.** The proceeds from ADB's investment will meet AMB's capital requirements for FY2018 and support its planned IPO. The proposed equity funding will have a multiplier effect. AMB's total-capital-to-gross-loans ratio was 17.07% in FY2016 and 27.58% in FY2015. Hence, leveraging ADB's equity injection will enable AMB to lend a much larger amount to its target customers as it makes a strategic shift to focus more on retail and SME loans. Additional capital will also ensure compliance with CBA guidelines. While AMB's FY2016 CAR of 20.46% is healthy as per Basel 2 standards, it drops to 15.87% once CBA's discretionary adjustments are applied to calculate the risk-weighted assets. Applying the same methodology, AMB's FY2017 CAR is projected at 12.70%. Without additional equity injection, this leaves little cushion over CBA's minimum CAR of 12.00%. ADB's equity investment is also expected to support AMB's IPO by catalyzing other investors. ADB, as a strategic partner, will help enhance AMB's shareholder base of high-quality IFIs and contribute to its ability to reach the underserved SME segment through the transaction technical assistance. ADB will be AMB's only solely Asia-focused equity shareholder.

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IV. DEVELOPMENT IMPACT AND STRATEGIC ALIGNMENT

A. Development Impact, Outcome, and Outputs

20. **Impact.** The impact will be improved availability of credit to SMEs and expansion of private financial services in Armenia.

21. **Outcome.** The outcome will be increased uptake of financial services by SMEs. The project will enable AMB to provide sustainable financial services to SMEs and thereby contribute to the growth and diversification of the Armenian economy as well as to employment creation.

22. **Outputs.** Outputs will be the increased financing capacity of AMB to serve SMEs.

B. Alignment with ADB Strategy and Operations

23. **ADB 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.⁷ AMB's emphasis on lending to segments with high potential for employment and income generation will support inclusive growth. ADB funds will help AMB provide loans to SMEs to meet their investment needs and support overall growth. This is consistent with the government's efforts to promote growth and economic diversification, and with ADB's country partnership strategy for Armenia, 2014–2018.⁸

24. **Sector strategy and ADB operations.** ADB plays a tangible role in the deepening of financial services in Armenia. In 2011, ADB supported four banks in Armenia through senior loans totaling \$65 million. ACBA Credit Agricole, AMB, Ardshinvestbank, and Inecobank were the banks selected in ADB's Small and Medium-Sized Enterprise Finance Program. The loan to and equity investment in AMB will continue ADB's efforts to develop Armenia's financial market and support SMEs. These efforts also complement sovereign programs in the finance sector, such as the Women's Entrepreneurship Support Sector Development Program (2012).⁹

V. POLICY COMPLIANCE

A. Safeguards and Social Dimensions

25. The project is classified category FI for impacts on environment, involuntary resettlement, and indigenous peoples. The project's potential environment and social impacts, its risks associated with AMB's existing and/or likely future portfolio, and its commitment and capacity for environmental and social management have been assessed. AMB subloan subprojects assessed during due diligence have required land acquisition and new subloans will likely also require this. However, no significant involuntary displacement has occurred on AMB-financed subprojects. No AMB subloan subprojects have had impacts on indigenous peoples' communities, and none are expected. The environmental and social management system applies IFIs' prohibited investment activities list, has procedures to address subprojects' environmental and social risks, ensures that investments abide by applicable national laws and regulations, and complies with national labor laws and ADB's Social Protection Strategy (2001). Additional guidelines are available in the environmental and social management system for subprojects that have significant adverse environmental and social impacts, including involuntary resettlement.

26. AMB committed to exclude the ADB loan and equity funds from supporting any activities under the Prohibited Investment Activities List or category A subprojects. ADB will monitor the use of ADB proceeds through AMB's semiannual reporting obligations and application of the environmental and social management system. Semiannual reports will include reporting on the

⁷ ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

⁸ ADB. 2014. *Country Partnership Strategy: Armenia, 2014–2018*. Manila.

⁹ ADB. 2012. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Grant to Armenia for the Women's Entrepreneurship Support Sector Development Program*. Manila.

loan portfolio (by sector as well as average loan size) originated using ADB funds. Any breach on the use of proceeds will result in an event of default under the loan as well as the default put option being triggered for the equity investment. As additional assurance of ADB projects' use on non-category A subprojects only, AMB is committed to consulting with ADB in the screening, reviewing, and finalizing of environment and social assessments for subprojects with potentially significant impacts and risks, prior to AMB credit committee approval.

27. The transaction is classified as having some gender elements. AMB will comply with national labor laws and, pursuant to ADB's Social Protection Strategy, will take measures to comply with the internationally recognized core labor standards. AMB will report regularly to ADB on (i) its compliance with such laws, and (ii) the measures taken. Information disclosure and consultation with affected people will be conducted following ADB requirements.

B. Anticorruption Policy

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

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C. Assurances

29. Consistent with the Agreement Establishing the Asian Development Bank (the Charter),¹⁰ ADB will proceed with the proposed assistance upon establishing that the Government of Armenia has no objection to the proposed assistance to AMB. ADB will enter into suitable finance documentation, in form and substance satisfactory to ADB, following approval of the proposed assistance by the Board of Directors.

VI. RECOMMENDATION

30. I am satisfied that the proposed loan and equity investment would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve (i) the loan of up to \$30,000,000 or its dram equivalent from ADB's ordinary capital resources to Ameriabank CJSC (AMB) and (ii) the equity investment of the dram equivalent of up to \$30,000,000 in AMB for Strengthening the Banking Sector for Financial Inclusion 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

4 September 2017

¹⁰ ADB. 1966. *Agreement Establishing the Asian Development Bank*. Manila.

DESIGN AND MONITORING FRAMEWORK

Impact the Project is Aligned with			
Improved availability of credit to SMEs and expansion of private financial services in Armenia ^a			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
Outcome Uptake of financial services by SMEs increased	By 2022 a. Number of SME loans outstanding increased to 1,100 (2016 baseline: 711) b. Number of SME loans outstanding to female-owned businesses increased to at least 15 (2016 baseline: not available) c. Nonperforming loans (90 days past due) limited to no more than 5.00% (2016 baseline: 4.04%)	a–c. AMB annual monitoring report	AMB asset quality deteriorates
Outputs Financing capacity of AMB to serve SMEs increased	By 2022 a. Total amount of SME loans disbursed at least AMD150 billion (2016 baseline AMD77 billion) b. Amount of SME loans disbursed to women or female-owned businesses at least AMD2.5 billion (2016 baseline: not available)	a-b. AMB annual monitoring report	Demand for loans not as strong as expected Interest rates and inflation increase to unsustainable levels
Key Activities with Milestones 1. Financing capacity of AMB to serve small and medium-sized enterprises increased 1.1 ADB executes loan agreement with AMB by Q1 2018 1.2 ADB executes equity subscription agreement with AMB by Q1 2018			
Inputs ADB: \$30 million (loan) \$30 million (equity)			
Assumptions for Partner Financing Not Applicable			

ADB = Asian Development Bank, AMB = Ameriabank, SMEs = small and medium-sized enterprises.

^a Government of Armenia. 2014. *Armenia Development Strategy for 2014–2025*. Yerevan.

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=51184-001-4>

1. Contribution to the ADB Results Framework
2. Country Economic Indicators