ADB

Extended Annual Review Report

Project Number: 45903-044
Investment Number: 7346
Loan Number: 2813
September 2017

Senior Loan
Inecobank
Small and Medium-Sized Enterprise Finance
(Armenia)

Asian Development Bank

CURRENCY EQUIVALENTS

Currency Unit – Armenian dram (AMD)

		At Appraisal	At Project Review
		22 November 2011	23 June 2017
AMD 1.00	=	$0.0026	$0.0021
$1.00	=	AMD383.7742	AMD480.0700

ABBREVIATIONS

ADB	–	Asian Development Bank
CAGR	–	compound annual growth rate
CBA	–	Central Bank of Armenia
DEG	–	Deutsche Entwicklungs- und Investitiongesellschaft
DMF	–	design and monitoring framework
EBRD	–	European Bank for Reconstruction and Development
ESMS	–	environment and social management system
IFI	–	international financial institution
NPL	–	nonperforming loan
PFI	–	participating financial institution
Q	–	quarter
SMEs	–	small and medium-sized enterprises
TA	–	technical assistance

NOTE

In this report, "$" refers to US dollars.

Vice-President	D. Gupta, Private Sector and Co-financing Operations
Director General	M. Barrow, Private Sector Operations Department (PSOD)
Director	C. Roberts, Private Sector Portfolio Management Division, PSOD
Team Leader	S. Hruschka, Principal Investment Specialist, PSOD
Team Members	M. Del Rosario, Associate Investment Officer, PSOD
	M. Manguiat, Safeguards Officer, PSOD
	R. Samiano, Safeguards Officer, PSOD

CONTENTS

BASIC DATA

Senior Loan: Inecobank
(Loan No. 2813 – Armenia)

Key Project Data	As per ADB Loan Documents ($ million)	Actual ($ million)
Total Project Cost:		
ADB Loan	10.0	10.0
Total Investment:		
Committed	10.0	10.0
Disbursed	10.0	10.0
Outstanding	3.3	3.3
Supplementary Cofinancing	0.0	0.0

Key Dates	Expected	Actual
Concept Clearance	2011	4 July 2011
Board Approval	2011	22 November 2011
Investment Committee Approval[a]	2012	11 December 2012
Loan Agreement	2013	8 August 2013
Loan Effectiveness	2013	8 August 2013
First Disbursement	2013	13 August 2013
Loan Maturity	2018	8 August 2018

Project Administration and Monitoring	Number of Missions[b]	No. of Person-Days
Concept Clearance	…	…
Due Diligence Mission	1	6
Private Sector Credit Committee Meeting	…	…
Board Approval	…	…
Project Administration	5	32
XARR	1	6

… = data not available, ADB = Asian Development Bank.
[a] Endorsement of pricing and material terms.
[b] All missions undertaken for the Small and Medium-Sized Enterprise Finance Program.

EXECUTIVE SUMMARY

In November 2011, the Board of Directors of the Asian Development Bank (ADB) approved a small and medium-sized enterprise (SME) financing program of $65 million for Armenia, comprising senior unsecured loans to four Armenian banks to enhance their capacity to undertake SME lending. ADB identified Armenia as a recipient of its support through the SME financing program because of (i) the financial obstacles experienced by the country's SMEs, and (ii) the program's potential of contributing significantly to economic development. Through the program, ADB expected to develop partnerships with key Armenian banks to further financial sector development.

This extended annual review report covers Inecobank (Ineco)—one of the four participating financial institutions (PFIs) with a loan amounting to $10 million. Ineco was established in 1996 and is a pioneer in introducing SME-focused lending techniques in Armenia. Of 21 Armenian banks, Ineco was the 10th largest bank in terms of assets in 2011, ranking 5th in the SME market segment. It was majority-owned by two individual investors, Avetis Baloyan with 37% of the share capital and Karen Safaryan with 33%. Ineco also had two international financial institution shareholders: Germany's Deutsche Investitions- und Entwicklungsgesellschaft with a 13.5% shareholding and the International Finance Corporation with a 10% stake. In 2008, ADB lent Ineco $3 million under its microfinance and small business banking program.

Opportunities in the Armenian market improved as the economy recovered from the effects of the 2008–2009 global financial crisis. Ineco took advantage of these opportunities, which led to good asset, income, and funding growth beginning in 2011. However, in 2014, the Russian economy suffered a contraction and its currency depreciated because of the sharp fall in oil and commodity prices as well as sanctions imposed by the European Union. This affected the Armenian economy, which is closely tied to Russia because of trade, investment, and remittance flows, and started to impinge on the performance of Armenian banks, including Ineco. However, because of the bank's robust business franchise, it is steadily recovering from the challenging operating environment.

In December 2015, Ineco acquired ProCredit Bank of Armenia (ProCredit), a relatively smaller bank that also specializes in micro and SME lending. The acquisition was mainly in response to the Central Bank of Armenia's mandated capital increase beginning January 2017. The transaction was also in line with Ineco's strategy of strengthening its presence in the micro and SME segment. The European Bank for Reconstruction and Development funded the transaction, which led to its 22.7% ownership in the merged bank.

Overall, development results are rated *satisfactory*. In particular, the effect of the ADB loan on private sector development and ADB strategic objectives is rated *satisfactory*. The project contributed measurably to (i) increased access to finance for SMEs, (ii) the enhanced capacity and diversification of Ineco, (iii) the development of new financial products and approaches, and (iv) enhanced outreach to less-developed areas outside the capital Yerevan.

Economic performance and business success are rated *satisfactory.* Ineco serves a broad and growing range of clients. From 2011 to 2016, it increased its overall lending by a compound annual growth rate of 17.3%, thereby helping increase access to finance for SMEs, larger businesses, and households. While asset quality weakened because of the economic downturn and the effect of the merger with ProCredit, Ineco continued to be a major SME market player, with competitive profitability metrics, and reasonable liquidity and capitalization indicators.

Environmental, social, health, and safety performance is rated *satisfactory*. Ineco had existing environment and social management system policies at the time of loan origination that focused on complying with applicable national laws and requirements of other multilateral stakeholders. It has established an enhanced environment and social management system deemed appropriate by ADB to manage the environmental and social risks of SME subprojects and meet applicable national laws and regulations and ADB requirements. No involuntary resettlement or impacts on indigenous people were observed as a result of the lending activities of the bank.

ADB additionality is rated *satisfactory.* The ADB loan was timely in providing long-term resources when these were not available in the market and in adding technical assistance that was essential for serving the target market effectively. Therefore, ADB played a critical role in enabling Ineco to expand its SME lending and develop other product lines with significant growth and impact potential, such as consumer and corporate lending, and internet and mobile banking.

The investment profitability of the project is rated *satisfactory*. ADB’s Office of Risk Management approved the loan pricing, which was within the recommended pricing for similarly rated and structured transactions based on ADB's pricing model. The loan is current, has not had any payment delays, and is expected to be repaid in full and on time.

ADB’s work quality is rated *satisfactory* based on its (i) screening, appraisal, and structuring of the project; and (ii) monitoring and supervision. The program-based approach enabled ADB to diversify its exposure and broaden the development impact of the project. Furthermore, the approach achieved efficiencies in terms of processing, monitoring, and technical assistance (TA) implementation. The TA has been an important component of the program, helping ensure an impact that goes beyond the deployment of ADB funding. ADB carefully supervised various aspects of the account to ensure risk and client service quality requirements were managed.

This extended annual review report rates ADB’s investment in Inecobank *successful* overall. Ineco has met all of the key targets set at approval, and the ADB project has contributed to a stronger and more diversified banking system in Armenia with improved access to finance for the entire economy. The multibank, programmatic approach, as well as the implementation of TA for capacity building, are viewed to be effective and should be considered for similar future operations. ADB should continue exploring the viability of extending local currency loans to Armenian banks that may mitigate the impact of currency devaluations in Armenia’s highly dollarized banking system.

I. THE PROJECT

A. Project Background

1. In November 2011, the Board of Directors of the Asian Development Bank (ADB) approved a small and medium-sized enterprise (SME) financing program of $65 million for Armenia, comprising senior unsecured loans to four Armenian banks to enhance their capacity to undertake SME lending.[1] This extended annual review report covers one of the participating banks—Inecobank (Ineco). Ineco was already specialized in SME lending and sought long-term funds to support its growth strategy in this sector as well as develop new markets and products. Separate extended annual review reports cover the other participating banks—Ameriabank, Ardshinbank, and ACBA-Credit Agricole.

2. Ineco was a relatively smaller bank (10th largest in Armenia in terms of asset size in 2011) but was an important SME lender with about a 10% share of the total SME market. Ineco saw opportunities to further expand its SME lending as the economy recovered following the 2008–2009 global financial crisis. It also saw opportunities to develop other market segments and new products, such as retail lending, mobile banking, corporate banking, and deposit collection.

3. Ineco had exposure to international financial institutions (IFIs) through loans and equity participations prior to the ADB project. However, Armenia was still affected by the aftermath of the global financial crisis, resulting in high cost and short tenor of both local resource mobilization and foreign commercial financing. Armenian banks traditionally sought to balance short-term local deposits with long-term financing from IFIs, which were the only affordable source of long-tenor funds, to meet the needs for investment financing from borrowers while minimizing maturity mismatches. An analysis of SME financing needs compared with available IFI financing, including unmet existing and expected additional needs as well as scheduled IFI repayments, revealed an SME financing gap of about $700 million for Armenia and $8.2 million for Ineco (footnote 1).

B. Key Project Features

4. ADB adopted a programmatic approach for this project, making an overall envelope of up to $65 million available to four potential participating banks to create equal treatment, broaden impact, enhance competition in the banking sector, and diversify ADB risk. Participating financial institutions (PFIs) all had strong management and financial indicators, and a demonstrated ability and interest to serve the SME market. Ineco was specialized in micro and SME lending and had developed a profitable franchise in this largely underserved market segment. Therefore, it had a strong basis from which to expand micro and SME lending as well as reach other market segments and develop new financial products.

5. ADB financing consisted of a senior unsecured loan of $10 million. The ADB loan was tied to subloan limits aimed at sharpening focus on the SME market[2] and targets for subloans to borrowers outside the capital city Yerevan.[3]

---

[1] ADB. 2011. *Report and Recommendation of the President to the Board of Directors: Proposed Senior Loans—ACBA Credit Agricole Bank, Ameriabank, Ardshininvestbank, Inecobank Small and Medium-Sized Enterprise Finance Program.* Manila.

[2] The ADB loans were to be utilized exclusively for SMEs, defined as enterprises employing less than 250 employees and with either (i) sales not exceeding AMD1.5 billion ($3.9 million equivalent, 22 November 2011 at $1 to AMD383.774) or (ii) assets not exceeding AMD1 billion ($2.6 million, 22 November 2011 at $1 to AMD383.774).

[3] On average, 30% of ADB funds should be on-lent to SMEs located outside Yerevan.

6. At the same time, PFIs were to receive assistance under ADB's SME capacity building technical assistance (TA).[4] The TA is covered by a separate evaluation report, but the changes it introduced are considered as part of the overall impact of ADB's intervention (para. 41).

C. Progress Highlights

7. As the Armenian economy recovered from the effects of the 2008–2009 global financial crisis, Ineco implemented its plans of expanding SME lending and developing other market segments and products. IFI funding, mostly in foreign currency, was made available to support the financing needs of the Armenian banking system and end borrowers. Market opportunities in Armenia improved after 2010, supported by a strengthened macroeconomic framework and a resumption of growth in Russia, the main export market and source of investment and remittances for Armenia. Russia accounts for around 20% of exports and 80% of remittances received by Armenia. Consistent with the more favorable environment, Ineco developed new products and services, strengthened its distribution network, and obtained additional funding. As a result, the bank recorded healthy growth in assets, income, and funding beginning in 2011.

8. ADB and Ineco signed the loan in August 2013; the first disbursement followed shortly, and the second and final disbursement took place in November 2014. The loan disbursements were timed after the full repayment of another ADB loan to Ineco in September 2012[5] and were in line with the schedule of the bank's funding needs for SME lending.

9. In 2014, Russia suffered a sharp recession and currency depreciation because of falling prices for oil and other commodity exports as well as the impact of the United States and European Union sanctions. Because of Armenia's significant economic reliance on Russia, the situation in Russia started to negatively affect the Armenian banking sector in terms of profitability and asset quality in 2014.[6] The Central Bank of Armenia (CBA) tightened its monetary policy in late 2014 to mitigate the impact on the local currency and stabilize market conditions.

10. Because of adverse economic developments, Ineco recorded covenant breaches in the open foreign exchange position in the fourth quarter (Q4) of 2014 and the nonperforming loan (NPL) in the beginning of Q2 2015.[7] The breach in the open foreign exchange position was eventually cured in Q1 2015 because of the bank's corrective actions to control its unhedged open position and CBA's timely market interventions to abate further sharp AMD depreciation. However, the NPL breach persists in the following quarters after Q2 2015 because of the impact of the economic downturn on the repayment capacity of borrowers and the merger of Ineco with ProCredit Bank of Armenia, a bank with a good SME market niche but with weaker asset quality than Ineco.

---

[4] ADB. 2010. *Capacity Building for Financial Institutions, Phase 2.* Manila.

[5] ADB. 2007. *Report and Recommendation of the President to the Board of Directors: Proposed Loans and Guarantees, Micro- and Small Enterprise Financing Facility*. Manila.

[6] On 15 January 2015, Moody's Investors Service downgraded Armenia's issuer and government bond rating to Ba3 from Ba2 and changed the outlook to negative from stable. Likewise, on 30 January 2015, Fitch Ratings downgraded Armenia's IDR to B+ from BB- with a stable outlook.

[7] The facility agreement requires Ineco to maintain (i) an open foreign exchange position to capital ratio in any single currency of not more than 7% at all times and (ii) NPL to gross loans of not more than 5%. An open foreign exchange position has been defined as the difference between foreign currency liabilities and assets in relation to a currency (short or long) that is net of foreign exchange cover, hedging, or other similar arrangements. NPLs are defined as (i) loans greater than 90 days past due, (ii) loans placed on non-accrual status, (iii) full repayment is doubtful even if loan is current or less than 90 days past due, and (iv) loans restructured within the last 12 months.

11. In December 2015, Ineco acquired ProCredit, the 18th largest bank in terms of assets among the 21 banks in Armenia at that time, through European Bank for Reconstruction and Development (EBRD) funding. The acquisition was mainly in response to the CBA-mandated capital increase among banks from AMD5 billion to AMD30 billion beginning in January 2017. The transaction was also consistent with Ineco's strategy of strengthening its position in the micro and SME markets. Ineco and ProCredit legally merged in May 2016. EBRD's capital injection led to its 22.7% ownership in the merged bank.

12. While the merger carried potential merger synergies, it also contributed to the breach in the NPL covenant given the additional NPL coming from the ProCredit portfolio. Recognizing Ineco's satisfactory asset quality based on local standards,[8] strong profitability, and loss absorption capacity, along with its proactive remedial management efforts, ADB waived the NPL covenant from Q1 2016 to Q4 2017.[9]

II. EVALUATION

A. Project Rationale and Objectives

13. Armenia experienced rapid growth following the collapse of the Soviet Union and the adoption of market-oriented reforms in the 1990s. The 2008–2009 global financial crisis disrupted its growth, which was exacerbated by continued tensions with neighboring Azerbaijan, but growth was expected to resume following the return of stability in 2010–2011. The Armenian economy is heavily dependent on Russia because of remittances, trade, and investment flows (para. 7), and Russia's rapid growth stemming from strong energy and commodity exports and prices was expected to exert a favorable influence on the Armenian economy.

14. SMEs played an important and growing role in the Armenian economy following the introduction of market-based reforms. SMEs contributed about 42% of gross domestic product and employment, and represented about 98% of all businesses in Armenia in 2011 (footnote 1). As in other developing member countries (particularly formally centrally-planned, transitional economies), SME growth is a key factor for private sector development, inclusive economic growth, and employment generation.

15. However, SMEs faced severely constrained access to long-term financing, which hampered their investment, competitiveness, and growth. The following were identified as key constraints for SME growth: access to long-term financing, a small domestic market, difficult access to export markets, and inflation and exchange rate instability.[10] The local banking sector generally focused on large corporate clients and heavily collateralized short-term loans, leaving little resources for fixed asset investment by SMEs.

[8] Armenian banks comply with two sets of accounting rules: (i) local standards set by the CBA and (ii) International Financial Reporting Standards (IFRS). The NPL ratios based on IFRS are generally higher than those based on CBA standards because of the difference in the treatment of asset write-offs. The CBA standards recognize full write-offs and 100% provisioning of loans that are more than 270 days past due, while IFRS recognize write-offs of assets only when there is no realistic prospect for future recovery and all collateral has been enforced. Reported breaches in the NPL covenant of Ineco are based on IFRS, the accounting standard required by the facility agreement.

[9] From Q2 to Q4 2017, ADB provides a prospective waiver but on the condition that a modified NPL definition be adopted. The new definition deducts loans with full provision and collateral coverage based on local standards from the IFRS-based facility agreement-defined NPLs. ADB will revisit in Q4 2017 the appropriateness of applying the new NPL definition up to the remaining 8 months in the life of the loan should indicators point to a covenant breach beyond the end of 2017.

[10] ADB. 2011. *ADB Financial Sector Development Community of Practice. Financial Sector Operational Plan.* Manila.

16. The objective of the project was to enable PFIs to expand their SME lending as well as generally strengthen their operations and ability to meet the needs of a wide range of clients. For Ineco, the project aimed to support the continued growth of SME lending as well as entry into other high-potential market segments and products by providing the bank with the long-term financial resources, technical know-how, and strategic guidance needed to effectively develop its activities.

B. Development Results

17. The project's development impact is rated *satisfactory* overall.

1. Contribution to Private Sector Development and ADB Strategic Development Objectives

18. The effect of the ADB loan on private sector development and ADB strategic objectives is rated *satisfactory*. The project contributed measurably to the (i) increased access to finance for SMEs, (ii) enhanced capacity and diversification of Ineco, (iii) development of new financial products and approaches, and (iv) enhanced outreach to less developed areas outside the capital city Yerevan. ADB support, along with other IFIs, helped Ineco meet or exceed the key output and outcome targets specified in the project design and monitoring framework (DMF) (footnote 1).

19. **Growth in small and medium-sized enterprise lending.**[11] Ineco successfully enhanced its SME lending and further strengthened the relevant operational procedures and lending techniques, as well as marketing efforts and staff training (supported partly by ADB TA). Ineco also focuses increasingly on retail lending, particularly installment loans and credit cards, because it is a lucrative and underserved market segment. Ineco acquired a considerable agricultural loan portfolio from ProCredit, a relatively new activity for Ineco with high growth and impact potential. However, Ineco has deferred the planned redesign and relaunch of the agriculture loan product given the need to reassess the performance of the acquired agricultural portfolio and market prospects. Ineco's growth in SME lending is reflected in the following:

(i) The bank's SME portfolio (including microenterprises) increased from AMD24.8 billion at the end of 2011 to AMD73.6 billion at the end of 2016, reflecting a compound annual growth rate (CAGR) of 15.4% in US dollar terms and 19.9% in local terms, well within the DMF target of 10.0%. The addition of the ProCredit portfolio has led to a significant further increase in the combined banks' SME loan portfolio by an estimated 38% at the time of initial consolidation at the end of 2015.

(ii) The number of SME customers excluding microenterprises grew by 67.2%, from 329 at the end of 2011 to 550 at the end of 2014, significantly above the DMF growth target of 25.0%. However, the number of SME customers including microenterprises rose from 2,689 at the end of 2011 to 3,149 at the end of 2014, an increase of 17.1%. The takeover of ProCredit in 2015 has further added about 2,500 micro and SME customers, nearly doubling the total number of SME customers (including microenterprises). Regarding ADB

[11] The project defines eligible SMEs as enterprises that employ fewer than 250 employees and have either (i) sales not exceeding AMD1.5 billion (around $4 million equivalent at the time) or (ii) assets not exceeding AMD1 billion (around $2.7 million at prevailing exchange rates) with maximum sub-loan amounts of $500,000 for Ineco. The bank uses the terms "SME loan," "micro loan," and "agricultural loan" to denote eligible enterprises. In particular, SME loans also include SME loans under the corporate loan segment and agricultural loans classified under the retail loan segment. For the purpose of this report, the term "SME" is used for all enterprise clients that meet the SME definition.

funds, around 200 eligible SME borrowers benefited, including some 20 enterprises owned or managed by women.

(iii) The maturity profile of SME loans improved as loans maturing within 3 to 5 years increased to 16.0% of the total at the end of 2016 from 3.9% in 2011. SME borrowers benefit from medium to long-term funds from IFIs, including ADB, for capital investments that can improve their efficiency and competitiveness.

20. **A stronger and more diversified bank**. Ineco has had a healthy overall performance since loan approval and appears to have benefited from the continued growth in SME lending and expansion of other product lines. The bank also generally expanded the range and quality of services offered to its customers. Ineco's improvements include the following:

(i) Although the sharp slowdown and currency depreciation dented its profitability and asset quality performance in 2015 and 2016, Ineco is expected to weather the crisis in a manageable position. Capital adequacy, liquidity, and other indicators of long-term financial viability are generally within acceptable levels (para. 33 to 37).

(ii) The NPL ratio for the SME portfolio generally fluctuated between less than 1% and 2% from 2011 to 2014, well below the 5% ceiling defined in the DMF. The ratio rose sharply in 2015 and remained elevated in 2016 because of the sharp depreciation of the AMD in late 2014, the deteriorating performance of the Armenian economy, and the impact of the merger with ProCredit. The NPL ratio for SMEs reached 6.1% at the end of 2015 but improved to 5.3% at the end of 2016, and that for the overall portfolio at 7.3% at the end of 2015 7.6% at the end of 2016. The NPL ratio for the overall portfolio was above the 5% maximum limit, thus resulting in a breach of the NPL covenant. However, the bank took proactive steps to write off certain problem loans, increase loan-loss reserves, recover NPLs, and realize collateral. Because of Ineco's actions, the stabilizing macroeconomic environment, the healthy profitability prospects, and the strong capitalization of the bank, ADB approved the waiver of the NPL covenant from Q2 2015 to Q4 2017.

(iii) A significant number of new products, tools, and approaches were introduced by Ineco beginning in 2011, in line with the DMF targets, including many which were directly driven or indirectly supported by the ADB project, such as (a) SME lending techniques were improved, with greater use of statistical criteria for credit analysis and loan pricing; (b) the risk management department was strengthened, focusing on overall portfolio analysis, stress tests, compliance with CBA requirements and IFI loan covenants, and other bank-wide risk factors; (c) a customer-centric approach was adopted, with relationship managers put in charge of all transactions relating to specific clients; and (d) new products were launched, such as point-of-sale loans for appliances, mobile, and internet banking, and energy efficiency loans.

(iv) Ineco maintained a healthy balance between micro, SME, corporate, and retail lending. The greater diversification compared with 2011 is a direct result of the strategy adopted at the time, and has already proven its worth in the relative resilience shown to the current crisis.

21. **Outreach to rural areas**. Ineco increased its lending as well as deposit collection in rural areas, at least partly as a result of the ADB project. From 2011 to 2016, the branch network increased from 15 to 22, with nine branches located outside of Yerevan at the end of 2016. The bank also embarked on an ambitious initiative to establish small, automated branches, consisting

of an ATM and a bank officer, across the country. From 2011 to the time of the initial consolidation of Ineco and ProCredit's portfolios at the end of 2015, the number of SME borrowers located outside of Yerevan grew 11.7% (CAGR) to 1,035. The proportion of the ADB loan that went outside of Yerevan stood at an average 34.5% from the time of the disbursement up to 2016, well within the minimum 30.0% target stipulated for the use of ADB funds.

22. **Greater attention to environmental and social management systems**. The ADB project supported greater awareness of ESMS risks and the inclusion of ESMS risk assessments into loan appraisals. Specific aspects like labor standards and resettlement received additional attention because of the ADB project. In addition to individual loan officers, ESMS risks are monitored by credit committees and risk management departments.

23. **Transfer of know-how and skills**. The strategic operational views supported by the ADB project, and the related ADB capacity building TA, resulted in the transfer of significant know-how and skills to Ineco. Given Ineco's strong market presence in the SME sector, it is likely that some of these techniques have already or will be adopted by other financial institutions in Armenia. Among other things, the capacity building TA focused on new lending procedures and structures adapted to SME lending and related shifts in marketing and staff skills. It also supported key aspects of strategic planning, profitability analysis, and human resource management. ADB also supported improvements in ESMS systems, corporate governance, and anti-money laundering standards in participating banks.

2. Economic Performance

24. The economic performance of the project is rated *satisfactory*. Ineco serves a broad and growing range of agricultural, microenterprise, SME, corporate, and retail clients. It increased its overall lending by 17.3% (CAGR) from 2011 to 2016, helping increase access to finance for all businesses and households in Armenia. Ineco also participated in several government or donor-supported programs targeting agriculture, tourism, women entrepreneurs, and clean energy.

25. Ineco's takeover of ProCredit's activities and portfolio has generated particularly important economic benefits beyond the scope of the ADB project but drawing on the financial resources and know-how supported by it. Through the takeover, credit continued to be made available to an estimated 2,500 ProCredit SME customers as well as a significant portion of its agriculture portfolio. Likewise, Ineco absorbed 160 employees of ProCredit while continuing to provide employment to more than 600 existing employees as of 2016. The merger, combined with a fresh equity injection by EBRD, has helped Ineco meet the significantly tighter capital requirement set by CBA for Armenian banks starting in 2017.

26. The continued existence of well-capitalized banks like Ineco, willing to take advantage of long-term growth opportunities and maintain or expand activities in a difficult operating environment, plays an important role for the continued availability of financing and employment for the Armenian economy.

27. Ineco, along with other PFIs covered by the ADB project, introduced a range of new and more convenient financial products since 2011 : (i) internet, mobile, and phone banking; (ii) expansion of the ATM network, including cash-in terminals that allow deposits as well as cash withdrawals; (iii) online payments including tax bills and traffic fines; (iv) point-of-sale loans and

credit cards; (v) point-of-sale loans[12]; (vi) energy efficiency loans, including for solar panels, window replacements, and energy-saving refrigerators; (vii) credit scoring for the smaller-end of the SME market; and (viii) custodian services for pension accounts. These products have created new choices for Armenian businesses and individuals and generated significant economic, social, and environmental benefits.

3. Environmental, Social, Health, and Safety Performance

28. Environmental, social, health, and safety performance for Ineco is rated *satisfactory*. ADB's loan was classified as being in the financial intermediary category on environment and in the financial intermediary category treated as C on involuntary resettlement and indigenous peoples under ADB Safeguards Policy Statement (SPS, 2009). No involuntary resettlement or impacts on indigenous peoples were observed as a result of the lending activities of the two banks.

29. Ineco had existing ESMS policies at the time of loan origination. The bank's ESMS was already in accordance with the International Finance Corporation Deutsche Entwicklungs- und Investitiongesellschaft (DEG), and other IFI requirements prior to ADB's involvement. The environmental and social risk assessment process was integrated in the credit risk management system, and specific teams in the banks were tasked to implement those policies. Existing policies focused on complying with applicable national laws and requirements of foreign or multilateral stakeholders.

30. The bank adopted certain enhancements to its policies to be fully compliant with ADB's requirements under the project. These enhancements include the following: (i) update Ineco's existing exclusion lists to incorporate ADB's prohibited investment activities list, (ii) review the project classification in accordance with ADB's definition, and (iii) create more comprehensive environmental and social screening checklists. Certain aspects, like labor standards and resettlement, received additional attention because of the ADB project. Corporate loan officers have primary responsibility for conducting risk assessment and managing low-risk loans, while credit committees and the risk management department handle medium and high-risk loans.

31. Ineco also enhanced its environment and social reporting in relation to the sub-borrowers of ADB funds, by including a number of additional indicators on top of the basic eligibility requirements. The bank conducts site visits and requires sub-borrowers to submit periodic E&S monitoring reports to review the compliance of sub-borrowers with national laws. The bank submits to ADB annual environmental and social performance reports, which include the risk classification of projects in the portfolio and any environmental and social non-compliance of sub-borrowers. Ineco submits these reports together with the financial reports to ADB the first quarter of every year. Ineco also enhanced its environment and social reporting output providing additional information for sub-borrowers of ADB funds, including social and environmental risk categories and mitigation measures; and other social dimensions such as compliance with core labor standards and information on women-owned or women-managed borrowers. Regarding women-owned or women-managed borrowers, Ineco conducted a focus group analysis with the help of the International Finance Corporation to assess obstacles for women entrepreneurs accessing finance; it found few gender-specific obstacles in Armenia compared with other developing member countries, but there are continued general obstacles for SMEs accessing finance.

[12] These were pioneered by Ineco and are now widely used for appliance purchases, as they provide instant, in-store loan approval.

32. In October 2012, ADB sponsored a training program in Tbilisi, Georgia to support private sector financial institution clients in Central and West Asia to enhance their capacity to implement ESMS policies during project implementation, monitoring, and reporting. Various ADB partner banks including Ineco attended the training. Aside from enhancing the participants' skills to adequately assess social and environmental risks, the activity also made the participants appreciate the benefits of an established ESMS, including the reduced environmental and social risks of investments, which in turn can improve the overall performance of the bank.

4. Business Success

33. Business success for Inecobank is rated *satisfactory* (Appendix 1). This report uses ADB evaluation rating standards for nonsovereign operations to assess the bank's business success.[13] Inecobank continued to strengthen its business franchise, a key advantage in maintaining strong market presence in major segments such as SME lending and point-of-sale finance. In 2016, Inecobank was the second most profitable bank in Armenia in terms of net income after tax. The bank also increased its share of the general loan market since 2011 as new products and services were offered. Its overall lending volume grew by 17.3% (CAGR) from 2011 to 2016.

34. The bank's liquidity position remained within comfortable levels and well supported by diversified funding sources led by customer deposits and IFI borrowings. Loan to deposit ratios have declined beginning in 2015 to below 200%, aided by the healthy growth in deposits, while lending remained reliably supported by several IFI partners with long-term borrowings as well as equity relationships.

35. Capital adequacy indicators continue to be strong, supported by healthy profitability, and well within regulatory and covenant limits. The merger with ProCredit and fresh equity infusion by EBRD have enabled Ineco to meet the tightened new capital requirement imposed by CBA and are a sign of confidence by key international institutions of its continued viability and profitability.

36. The asset quality of Inecobank remained acceptable. A challenging operating environment characterized by slowing growth, depreciating currency, and tightening monetary policy affected the performance of Ineco along with all Armenian banks in 2015. The bank's continued efforts to maintain a healthy balance between retail, SME, and corporate lending; and to diversify exposures by developing new products, such as point-of-sale loans or mobile banking, will continue to lower the overall risk profile.

37. Appendix 1 contains a more detailed analysis of the bank's financial performance from 2011 to 2016 based on its (i) capital adequacy, (ii) asset quality, (iii) management, (iv) earnings, and (v) liquidity. Financial highlights from this period include (i) a compound annual growth rate in assets of 18.1%; (ii) a compound annual growth rate of 24.6% in deposits; (iii) a compound annual growth rate of 12.1% in net income; and (iv) a ratio of highly liquid assets to demand liabilities ranging from 177% to 274%, significantly above the industry average of around 139% and the CBA and/or covenant requirement of 60%.[14]

[13] Specifically, alternative 4: Business Performance and Prospects of Institutions Supported under Other Financial Market Projects in Appendix 1 of ADB. 2014. *Guidelines for the Preparation of Project Performance Evaluation Reports on Nonsovereign Operations*. Manila.

[14] Based on CBA's Regulation of Banking, Prudential Standards for Banking, highly liquid assets include cash, correspondent accounts and deposits, bank gold, transfer notes issued by the Ministry of Finance of Armenia with maturity of up to 1 year, corporate bonds rated at least A+ by Standard & Poor's, Moody's Investors Service, and Fitch Ratings.

C. ADB Additionality

38. ADB additionality is rated *satisfactory*. SMEs in Armenia faced a substantial financing gap at the time of the ADB loan: SMEs' needs for long-term financing to support capital investment exceeded the availability of IFI financing (net of scheduled repayments) by an estimated $700 million for the entire Armenian banking system and by around $8 million for Ineco. Access to commercial financing was severely constrained in the wake of the global financial crisis, while local deposits were predominantly short-term and the domestic capital market underdeveloped. The combined effect of these factors made access to long-term resources from IFIs like ADB critical to support continued SME lending, in particular for the longer maturities needed to support capital investment by SMEs.

39. A precise assessment of the incremental impact of the ADB project is inherently difficult, given the relatively limited size of ADB financing compared with total borrower needs and the overlapping benefits of facilities from other IFIs. Nevertheless, it appears that the ADB loan was timely both in providing long-term resources when these were not available in the market and in adding TA and strategic guidance that were essential for serving the target market effectively. Thus, ADB played a critical role in enabling Ineco to expand its SME lending.

40. Compared with other IFIs, ADB placed particular emphasis on (i) targeting the use of its funds in the SME market by setting relatively strict sub-loan criteria and (ii) encouraging lending outside Yerevan by setting relevant loan allocation targets. While Ineco was already specialized in SME lending, the ADB requirement on lending outside Yerevan helped it focus on this important and underserved market segment.

41. Another key contribution of the ADB project was the role played by the accompanying TA in encouraging banks to adopt loan approval and monitoring procedures adapted to the SME market, which differ from both the corporate and retail market because they involve a mix of quantitative (e.g., credit scoring) and individual analysis (e.g., credit bureau data, financial information). Although Ineco was relatively more advanced in this regard and had pioneered the application of SME-specific lending techniques in Armenia, it benefited substantially from the additional expertise and up-to-date know-how provided by the ADB TA.[15]

D. ADB Investment Profitability

42. ADB profitability is rated *satisfactory*. The loan pricing was approved by the Office of Risk Management and was within the recommended pricing for similarly rated and structured transactions based on ADB's pricing model.[16]

43. The interest margin over 6-month London interbank offered rate of the ADB loan was also broadly in line with comparable market transactions in 2012 (footnote 16). The loan is current, has not had any payment delays, and is expected to be repaid in full and on time.

E. ADB Work Quality

44. ADB's work quality is rated *satisfactory*.

---

[15] Frankfurt School of Finance and Management. 2014. SME Lending Capacity Development in Armenia and the Kyrgyz Republic Project: Draft Final Report: Inecobank. Frankfurt. Frankfurt School of Finance and Management. 2014.

[16] Office of Risk Management's Credit Note for Armenia: SME Finance Program – Investment Committee endorsement of Inecobank CJSC, 19 November 2012.

1. Screening, Appraising, and Structuring of the Project

45. ADB's work in screening, appraising, and structuring is rated *satisfactory*. The loan facility was structured in a program-based approach covering four commercial banks in Armenia. The approach enabled ADB to diversify its exposure and broaden the development impact of the project. Furthermore, the approach achieved efficiencies in project processing, monitoring, and TA implementation.

46. The banks were selected based on their intention and ability to grow their SME loan portfolios and other high-potential activities. The banks' credit profiles and their interest in establishing cooperation with ADB were also important factors in the selection. Thorough financial and integrity due diligence were conducted as part of the selection process. Ineco's pioneering experience and expertise serving the SME market made it well suited to expand its activities in this area and to develop other markets and products.

47. The implementation of a TA alongside the loan has been an important component of the program in enhancing Ineco's SME lending and general capabilities.[17] The strategy helped ensure a lasting impact of the program beyond the deployment of ADB funds. Likewise, the TA provided support in enhancing corporate governance policies and anti-money laundering frameworks of the banks.

2. Monitoring and Supervision

48. ADB's monitoring and supervision for Ineco is rated *satisfactory*. The bank is systematically monitored in terms of compliance with reporting and financial covenant requirements in the facility agreement. Additionally, the bank is monitored through review missions and periodic monitoring reports. Regular review missions provided the project team a more realistic perspective of Ineco's operations and market conditions. They also facilitated opening and maintaining communication lines with the client to meet their service quality requirements.

49. The monitoring reports mainly cover the evaluation of country, industry and company developments, and prospects and how these affect the bank's risk profile. Since the initial rating process during the approval stage of the project, the Private Sector Operations Department (PSOD) has recommended to the Office of Risk Management appropriate adjustments on the bank's risk rating to capture relevant changes in the operating environment and intrinsic performance of the banks.

50. PSOD also assisted Ineco in obtaining needed waivers and amendments of certain provisions in their facility agreements (e.g., regarding the breach in the open foreign exchange position in February 2015, the proposed merger with ProCredit, and a breach of the NPL ratio beginning in 2015).

51. PSOD's safeguards team also helped Ineco monitor the implementation of its annual environment and social management systems. Upon each submission, the safeguards team checked the conduct of monitoring procedures and whether the bank had achieved its objectives.

[17] ADB. 2010. *Capacity Building for Financial Institutions, Phase 2*. Manila (TA-7707).

F. Overall Assessment

52. ADB's senior loan project with Inecobank is rated *successful* overall (Table 1).

Table 1: Evaluation of the Senior Loan to Inecobank

Item	Unsatisfactory	Less than Satisfactory	Satisfactory	Excellent
A. Development Results			√	
1. Contribution to private sector development and ADB strategic development objectives			√	
2. Economic performance			√	
3. Environment, social, health, and safety performance			√	
4. Business success			√	
B. ADB Additionality			√	
C. ADB Investment Profitability			√	
D. ADB's Work Quality			√	
1. Screening, appraisal, and structuring			√	
2. Monitoring and supervision			√	
	Unsuccessful	**Partly Successful**	**Successful**	**Highly successful**
Overall Rating			√	

ADB = Asian Development Bank.
Source: Asian Development Bank.

III. ISSUES, LESSONS, AND RECOMMENDED FOLLOW-UP ACTIONS

A. Issues and Lessons

53. The multibank, programmatic approach adopted in this project has been effective and should be considered for similar future operations. It has allowed reaching SMEs through a number of PFIs. This facilitated increased competition in the banking sector and enhanced access to finance for SMEs while minimizing credit risk for ADB. All PFIs, as well as other banks, have indicated that competition in the SME market has increased substantially following the ADB project and that SMEs now have a wider range of financing options available.

54. The project underscores the importance of choosing the right PFIs as partners and the right timing for ADB interventions. For Ineco, there was strong overlap between ADB's strategic objectives and its capabilities and interests at the time, resulting in effective implementation of the ADB project and accompanying TA.

55. The project also underscores the validity and importance of adding TA to investments where relevant to enhance the development impact and the financial viability of the project.

56. Some of the targets in the DMF may have been set with reference to corporate banks covered under the program who were seeking to embark on SME lending as a strategic diversification; they may have been less appropriate for banks that were already heavily focused on the SME market and seeking to develop other business lines in addition to SMEs. For programs involving several PFIs, targets should either be defined at the overall program level or differentiated according to the starting position of each PFI.

B. Recommended Follow-Up Actions

57. ADB should continue exploring the viability of extending local currency loans to Armenian banks that may facilitate diversification towards more local currency assets. Through this, the negative impact of significant currency devaluations in the highly dollarized banking system of Armenia may be reduced. ADB might be able to achieve this goal through the issuance of a local currency bond or a cross-currency swap with the CBA.

BUSINESS PERFORMANCE

A. Financial Highlights

Table A1.1. Inecobank Financial Highlights

Indicator	2011	2012	2013 Amount (AMD million)	2014	2015	2016	CAGR (%) 2011–2016
Balance Sheet							
Gross loans	63,618	78,680	84,587	110,027	159,162	166,092	17.3
Total assets	87,230	110,029	130,559	159,817	236,402	236,196	18.1
Total deposits	29,465	34,060	38,080	47,693	84,711	110,360	24.6
Total liabilities	72,231	91,999	107,096	133,717	195,636	192,731	17.8
Shareholders' equity	14,999	18,030	23,463	26,100	40,766	43,465	19.4
Income Statement							
Net interest income	5,114	6,938	8,619	9,815	9,547	13,821	18.0
Net non-interest income	1,174	1,378	1,494	2,024	2,946	3,858	21.9
Operating expense	(2,934)	(3,581)	(3,878)	(4,419)	(4,644)	(7,042)	15.7
Provisions	(374)	(518)	(627)	(2,204)	(2,693)	(4,586)	51.9
Net income	**2,603**	**3,649**	**4,887**	**4,790**	**4,816**	**5,158**	**12.1**

( ) = negative, CAGR = compound annual growth rate.
Source: Inecobank audited financial statements, 2011–2016.

B. Portfolio Growth

Table A1.2. Loan Portfolio by Segment

Segment	2011	2012	2013 Amount (AMD million)	2014	2015	2016	CAGR (%) 2011–2016
Large corporates	17,082	18,221	15,331	22,548	27,565	33,339	11.8
Microenterprises and SMEs	24,793	33,929	36,220	48,118	82,347	73,583	19.9
SMEs	19,928	27,673	29,578	41,532	69,661	63,125	21.2
Microenterprises	4,864	6,256	6,642	6,585	12,685	10,459	13.6
Consumer	8,296	10,328	15,112	18,568	22,120	28,939	23.2
Mortgage	3,208	3,860	4,218	6,024	8,867	7,750	15.8
Credit cards	2,789	4,163	4,914	7,312	9,103	10,439	24.6
Gold-secured	5,176	5,837	6,235	4,865	3,645	3,851	(4.8)
Others	2,274	2,343	2,556	2,592	5,514	8,190	23.8
Total	**63,618**	**78,680**	**84,587**	**110,027**	**159,162**	**166,092**	**17.3**

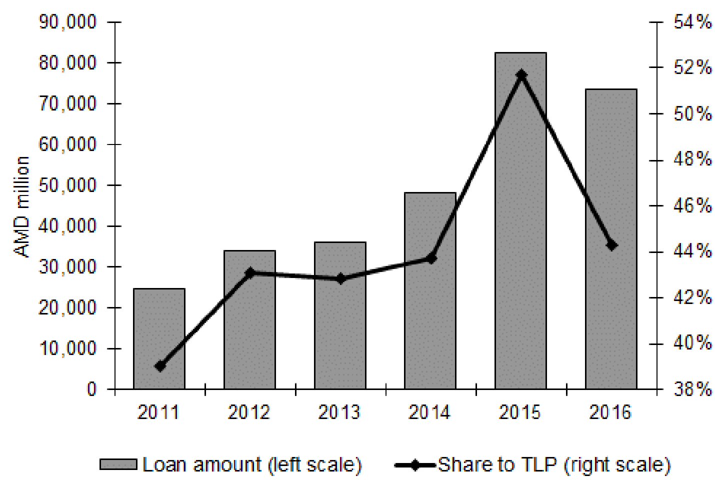
( ) = negative, CAGR = compound annual growth rate, SMEs = small and medium-sized enterprises.
Source: Inecobank audited financial statements and management reports.

Table A1.3. Inecobank Market Share, Distribution Network, and Manpower, 2011–2016

	2011	2012	2013	2014	2015	2016
Loans market share (%)	5.0	4.9	4.7	5.0	7.5	6.8
Deposits market share (%)	2.9	2.8	2.4	2.7	4.3	4.6
Assets market share (%)	4.2	4.5	4.4	4.7	6.8	5.9
Number of branches	15	15	16	16	27	22
Number of ATMs	22	22	25	32	46	64
Number of staff	497	576	587	678	846	793

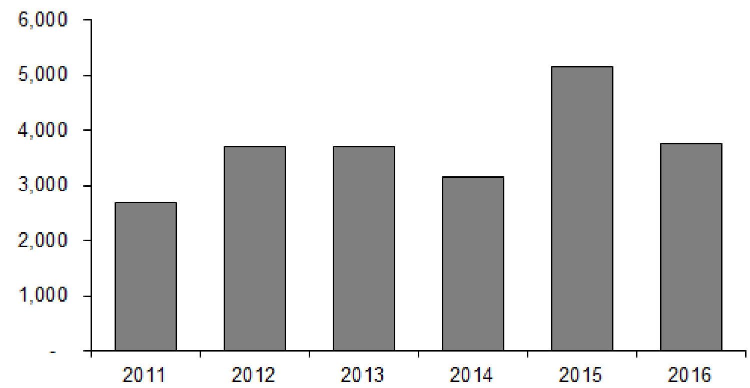
Note: Denominators of market shares were based on Central Bank of Armenia industry data
` Sources: Inecobank management report, June 2017; Central Bank of Armenia; Asian Development Bank.

Figure A1.1. Small and Medium-Sized Enterprise Loans, Inecobank



TLP = Total Loan Portfolio.
Source: Inecobank audited financial statements, 2011–2016.

Figure A1.2. Small and Medium-Sized Enterprise Borrower Count, Inecobank



Source: Inecobank management report, June 2017.

C. Business Analysis

1. Capital Adequacy

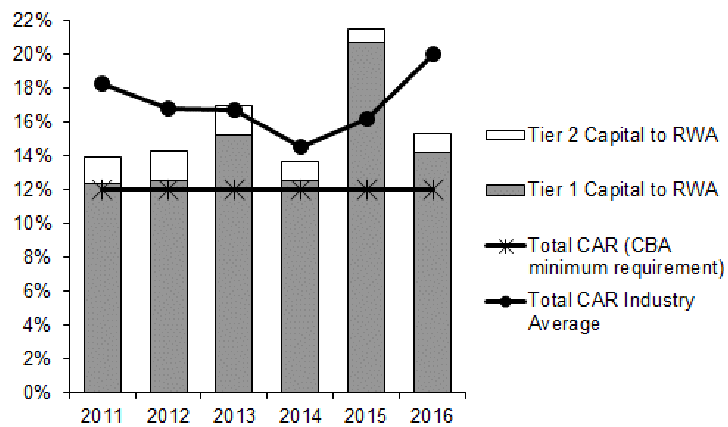
1. Capital for Inecobank is rated *satisfactory* (Figure A1.3). The bank's capital adequacy ratios (CAR) remained well within regulatory and covenant limits. Although the total CAR declined in the beginning of 2011,[1] the composition of the bank's capitalization remained predominantly core capital. The decline in the CAR resulted largely from the banks' strong loan growth coupled with the conservative risk treatment of foreign currency assets by the Central Bank of Armenia (CBA). Recognizing the higher risks coming from a highly dollarized banking system, the CBA raised the risk-weight for foreign currency loans to 150% from 100% beginning in 2011.

2. Inecobank has restrained dividend distribution and retained the bulk of its profits, boosting its capitalization. From 2011 to 2016, Ineco distributed only 22.8% of its net income as dividends, adding total retained earnings of AMD20 billion to its equity.

3. As of the end of 2016, Inecobank had a total regulatory CAR of 15.28% and a tier 1 CAR of 14.25%, well above the CBA regulatory minimum of 12.00% for total CAR. Capitalization is supported by strong profitability, based on the bank's established franchise and expertise in its core business. Furthermore, the entry of the European Bank for Reconstruction and Development (EBRD as a shareholder in line with the acquisition of ProCredit has resulted in a higher capital base, exceeding the new regulatory minimum of AMD30 billion starting in 2017. The presence of Deutsche Entwicklungs- und Investitiongesellschaft (DEG), the International Finance Corporation, and EBRD as major shareholders further bolsters the stability of the bank's capital position because it also provides comfort to other investors.

[1] Inecobank's CAR from 2006 to 2010 ranged from 18.12% to 32.21% before dropping to 13.46% in 2011 based on its audited financial statements for the given years.

Figure A1.3. Inecobank Capital Adequacy Indicators – Central Bank of Armenia standards



RWA = risk-weighted assets, CAR = capital adequacy ratio, CBA = Central Bank of Armenia.
Source: Inecobank audited financial statements, 2011 to 2016; CBA.

2. Asset Quality

4. Asset quality is rated *less than satisfactory* (Table A1.4). The NPL ratio started to rise in 2015 as the economic situation in Armenia deteriorated, with a sharp slowdown in remittances and consumer spending and growth, a sharp depreciation of the AMD in late 2014, and the merger with ProCredit in 2016. Ineco thus started to breach the NPL ratio covenant beginning in the second quarter of 2015. However, the bank took proactive steps to write-off certain problem loans, increase loan-loss reserves, recover NPLs, and realize collateral to mitigate the impact of the asset quality deterioration. While the breach is based on International Financial Reporting Standards, Ineco's NPL ratio based on CBA standards shows NPL ratios below the 5% maximum limit because of required write-offs.[2]

Table A1.4. Asset Quality Indicators (%)

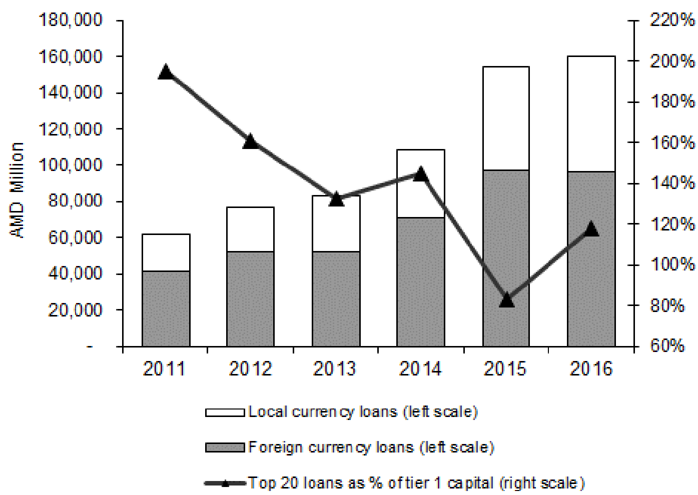
Indicator	2011	2012	2013	2014	2015	2016
Gross NPLs as a percentage of gross loans	4.3	6.3	2.7	4.6	7.3	7.6
Gross NPLs as a percentage of equity and total LLR	16.8	25.1	9.0	18.1	25.5	25.6
Total LLR as a percentage of NPLs	49.6	35.6	73.0	36.0	39.1	46.9
Related-party loans as a percentage of gross loans	0.2	0.2	0.0	0.0	0.0	0.0

NPL = nonperforming loans, LLR = loan loss reserves,
Note: Gross NPLs were computed based on the definition provided in the facility agreement.
Sources: Inecobank audited financial statements, 2011–2016; Asian Development Bank.

[2] Armenian banks comply with two sets of accounting rules: (i) local standards set by the CBA, and (ii) International Financial Reporting Standards (IFRS). The NPL ratios based on IFRS are generally higher than those based on CBA standards due to the difference in the treatment of asset write-offs. The CBA standards recognize full write- offs and 100% provisioning of loans that are more than 270 days past due, while IFRS recognize write-offs of assets only when there is no realistic prospect for future recovery and all collateral has been enforced. Reported breaches in the NPL covenant of Ineco are based on IFRS, the accounting standard required by the facility agreement.

5. Loan portfolios of Armenian banks have been structurally predisposed to large borrowers and foreign currency concentrations (Figure A1.4). Ineco's top 20 loan exposures have declined from 2011 to 2016 as a percentage of gross loans, and even more so as a percentage of tier 1 capital. As a result, its share of tier 1 capital declined to 110% in 2016, well below the covenanted ceiling of 150%. Foreign currency loan concentration has been declining but was still relatively high at 58% of total loans at the end of 2016. However, this is a recurrent feature in the Armenian banking system, and Ineco's credit assessment includes a careful appraisal of clients' exposure to foreign exchange risk and the availability of explicit or natural hedges.

Figure A1.4. Inecobank Loan Concentrations



Sources: Inecobank audited financial statements, 2011–2016, Asian Development Bank.

3. Management

6. Management of Inecobank is rated *satisfactory*. A board of directors and a management team with strong professional finance credentials and track record supervise the bank. The shareholding structure has remained stable from 2011 to 2015. As of December 2016, two prominent businesspeople who were cofounders of the bank remained its major shareholders (Avetis Baloyan with stakes of 27.4% and Karen Safaryan with 23.7%). Deutsche Entwicklungs- und Investitiongesellschaft (DEG) owned 9.6% and the International Finance Corporation owned 7.1% of the share capital. The entry of EBRD as a new major shareholder with a 22.7% share has resulted in a corresponding dilution of existing owners, but it is not expected to materially alter management arrangements. The absorption of ProCredit will further enhance governance and management as Ineco incorporates the best practices followed by ProCredit institutions around the world.

7. Ineco remains committed to strengthen governance and management by balancing composition and qualifications of members of the board and management, continuously training staff, and enhancing risk management systems. Notable improvements in risk management are the refinements in its internal rating and credit scoring systems for credit risk monitoring and adherence to internal and regulatory credit limits. The bank also performs periodic stress tests

under various risk scenarios to assess potential impact on its operations, the results of which are used as inputs in the bank's decision-making process.

4. Earnings

8. Profitability for Inecobank is rated *satisfactory* (Table A1.5, figures A1.5 and A1.6). Occupying a significant industry position in the small and medium-sized enterprise sector, the bank consistently recorded above-average profitability from 2011 to 2016. While profitability declined in 2015 with rising loan-loss provisions, the bank remained profitable and suffered only a slight compression in net income margin (NIM) from 8.4% in 2013 to 6.0% in 2015 but recovered to 7.3% in 2016, while registering a return on equity of 14.4% in 2015 compared with an industry average of -3.5%.

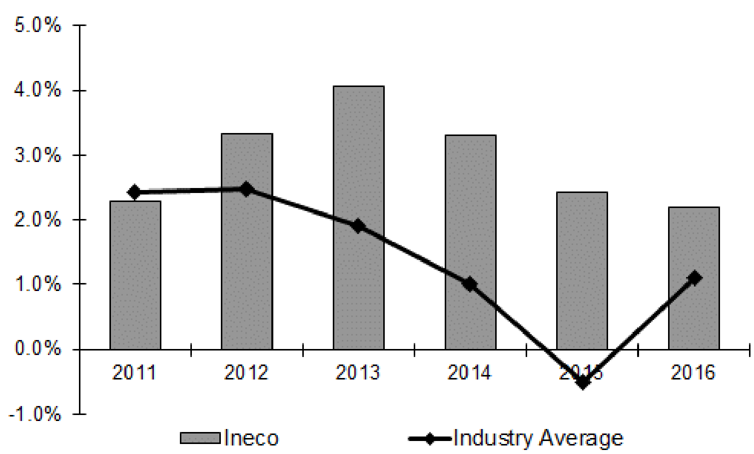
9. The bank's sound profitability comes from its healthy NIM, derived from established core banking operations and strong operating efficiency. In 2016, the bank ranked third in the industry in terms of NIM and cost-to-income ratio.

Table A1.5. Profitability and Efficiency Indicators (%)

Indicator	2011	2012	2013	2014	2015	2016
Net Interest Margin	8.4	7.4	8.4	8.2	6.0	7.3
Non-interest Income as a percentage of operating income	18.7	16.6	14.8	17.1	23.6	21.8
Provisions as a percentage of pre-provision income	11.1	10.9	10.1	29.7	34.3	43.1
Pre-provision income as a percentage of average total assets	4.4	4.3	5.2	5.1	4.5	5.1
Cost-to-income ratio	45.0	41.3	36.4	35.4	35.0	38.8

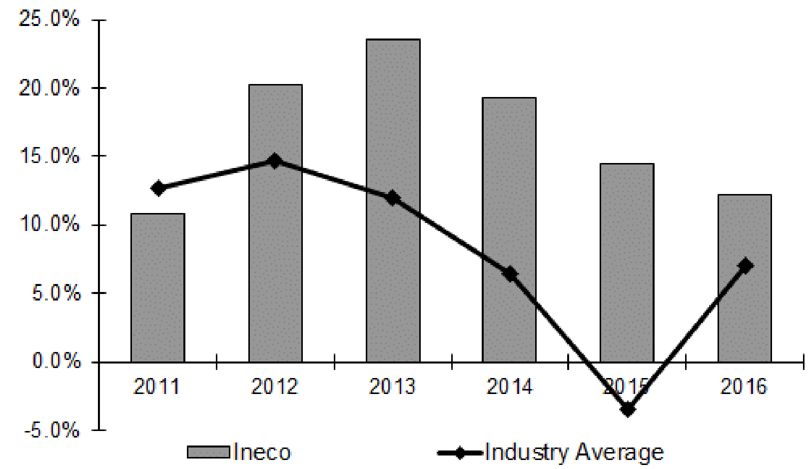
Sources: Inecobank audited financial statements, 2011–2016; Asian Development Bank.

Figure A1.5. Return on Assets, Inecobank



Sources: Inecobank audited financial statements, 2011–2016; Central Bank of Armenia.

Figure A1.6. Return on Equity, Inecobank



Sources: Inecobank audited financial statements, 2011–2016; Central Bank of Armenia.

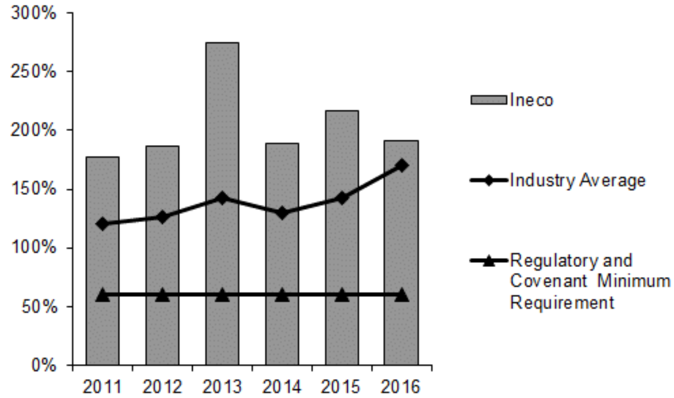
5. Liquidity

10. Liquidity for Inecobank is rated *satisfactory* (Figures A1.7 and A1.8). The liquidity position of the bank remained well above regulatory and Asian Development Bank covenant requirements for general and current liquidity from 2011 to 2016.[3] The ratio of highly liquid assets to demand liabilities ranged from 177% to 274%, significantly above the industry average of about 139% and the CBA and covenant requirement of 60%. Highly liquid assets also represented 19% to 28% of total assets, well above the 15% minimum CBA and covenant requirement.

11. The large margins between actual reported liquidity ratios and regulatory and covenant requirements depict the robust ability of Inecobank to service its short-term liabilities as they fall due.

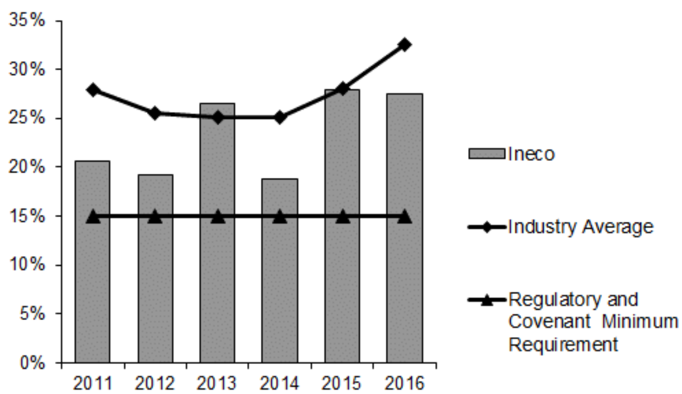
[3] Based on CBA's Regulation of Banking, Prudential Standards for Banking, highly-liquid assets include cash, correspondent accounts and deposits, bank gold, and transfer notes issued by the Ministry of Finance of Armenia with maturity of up to 1 year, corporate bonds rated at least A+ by Standard & Poor's, Moody's Investors Service, and Fitch Ratings.

Figure A1.7. Highly Liquid Assets to Demand Liabilities



Sources: Inecobank audited financial statements, 2011–2016; Central Bank of Armenia.

Figure A1.8. Highly Liquid Assets to Total Assets



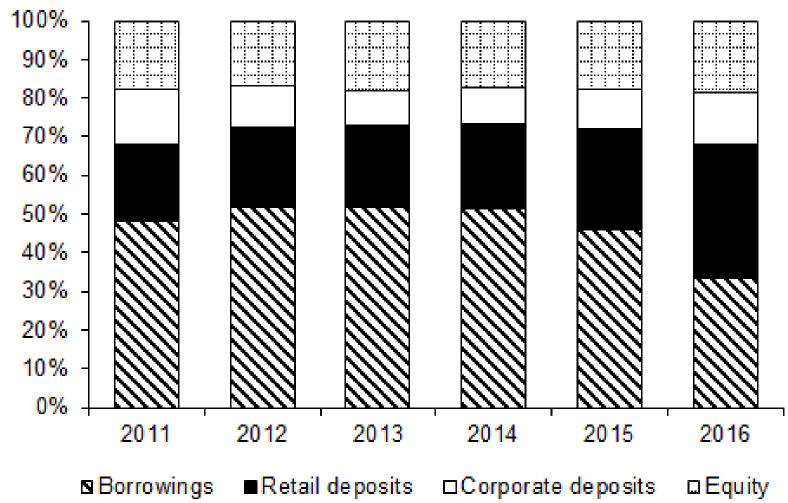
Sources: Inecobank audited financial statements, 2011–2016; Central Bank of Armenia.

12. The bank's funding sources also continued to be well diversified, led by customer deposits and international financial institutions (IFI) borrowings (Figure A1.9). Ineco has been able to increase its deposit base steadily since 2011. At the same time, the share of retail deposits grew from 57% to 72%, auguring well for the stability of the bank's funding sources. Ineco also introduced attractive cash management products for its clients, including mobile and Internet banking and various card products, which will enable it to continue attracting customer deposits. The growth in the small and medium-sized enterprises and agricultural portfolio following the takeover of ProCredit will also allow Ineco to tap into new sources of deposits.

13. Ineco maintains strong relations with a variety of IFIs and bilateral stakeholders, and will be able to rely on them for continued funding support. It also makes use of various government

and donor supported financing facilities for favored activities, such as lending to small and medium-sized enterprises, women entrepreneurs, and energy efficiency.

Figure A1.9. Inecobank Funding Composition



Source: Inecobank audited financial statements, 2011–2016.

14. There were negative maturity gaps in the less than 12 months maturity groups of Inecobank's assets and liabilities beginning in 2014, because of the greater availability of short-term funds vis-à-vis the larger demand for longer-term lending facilities (Table A1.6). The bank continues to obtain longer-term deposits and IFI funds to temper the maturity mismatch. It also continues to strengthen its capital base and to further benefit from the significant additional capital injection by EBRD (AMD3.3 billion, 22.7% of total share capital) and retained earnings.

Table A1.6. Liquidity Indicators (%)

Indicator	2011	2012	2013	2014	2015	2015	2016
Maturity Gap (<1 year) as a percentage of tier 1 capital	84.5	90.5	89.7	(25.6)	(48.1)	(25.3)	(47.2)
Foreign currency deposits as a percentage of total deposits	52.5	57.4	56.5	62.9	62.7	63.0	60.1
Time deposits as a percentage of total deposits	66.3	65.5	68.8	71.3	70.9	67.1	66.6
Retail deposits as a percentage of total deposits	57.3	65.0	69.9	69.6	77.3	71.7	72.2

( ) = negative; < = less than.
Sources: Inecobank financial statements, 2011–2016; Asian Development Bank.

FINANCIAL STATEMENTS

Table A2.1. Statement of Financial Position, 2011–2016
(AMD million)

Indicator	2011	2012	2013	2014	2015	2016
Net customer loans	62,254	76,907	82,942	108,205	154,638	160,155
Other earning assets	10,919	16,750	27,566	21,284	34,794	28,259
Fixed assets, net	3,957	3,993	3,896	3,860	4,400	3,957
Other non-earning assets	10,100	12,379	16,154	26,468	42,570	43,825
Total Assets	**87,230**	**110,029**	**130,559**	**159,817**	**236,402**	**236,196**
Total deposits and money market funding	29,503	34,074	38,085	53,956	86,355	111,842
Other liabilities	13,923	20,749	23,685	42,410	42,946	18,695
Long-term borrowings	28,805	37,176	45,326	37,351	66,336	62,194
Total Liabilities	**72,231**	**91,999**	**107,096**	**133,717**	**195,636**	**192,731**
Common stock (inc capital surplus)	7,894	7,894	7,894	12,050	22,300	22,300
Retained earnings	3,611	7,023	13,229	12,198	17,032	18,709
Reserves	3,494	3,112	2,340	1,852	1,434	2,457
Total Equity	**14,999**	**18,030**	**23,463**	**26,100**	**40,766**	**43,465**
Total Liabilities and Equity	**87,230**	**110,029**	**130,559**	**159,817**	**236,402**	**236,196**

Note: Numbers may not sum precisely because of rounding.
Sources: Inecobank financial statements, 2011–2016; Asian Development Bank.

Table A2.2. Income Statement, 2011–2016
(AMD million)

Indicator	2011	2012	2013	2014	2015	2016
Interest income	8,353	11,994	14,595	16,532	18,198	25,833
Interest expense	(3,238)	(5,056)	(5,976)	(6,717)	(8,651)	(12,012)
Net Interest Income	**5,114**	**6,938**	**8,619**	**9,815**	**9,547**	**13,821**
Net fee and commission income	629	716	816	1,010	921	1,076
Other operating income	545	663	678	1,015	2,025	2,782
Total Operating Income	**6,288**	**8,317**	**10,113**	**11,839**	**12,494**	**17,679**
Less: Operating expense	(2,934)	(3,581)	(3,878)	(4,419)	(4,644)	(7,042)
Pre-provision income	3,354	4,736	6,235	7,420	7,850	10,636
Loss provisions	(374)	(518)	(627)	(2,204)	(2,693)	(4,586)
Income after Loss Provisions	**2,981**	**4,217**	**5,608**	**5,216**	**5,157**	**6,050**
Net non-operating income	232	351	550	740	789	466
Pre-tax income	3,212	4,569	6,157	5,956	5,945	6,517
Taxes	(609)	(919)	(1,270)	(1,167)	(1,130)	(1,359)
Net Income	**2,603**	**3,649**	**4,887**	**4,790**	**4,816**	**5,158**

( ) = negative.
Note: Numbers may not sum precisely because of rounding.
Sources: Inecobank financial statements, 2011–2016; Asian Development Bank.

RESULTS AND RATINGS FOR PROJECT CONTRIBUTIONS TO PRIVATE SECTOR DEVELOPMENT AND ADB STRATEGIC DEVELOPMENT OBJECTIVES—FINANCIAL INTERMEDIARIES (for Small and Medium-sized Enterprise Financing)

Results Area	Actual achievements	Rating	Justification	Potential future achievements	Risk
1. Financial institution and sub-borrower PSD effects					
1.1 **Improved skills:** (i) Improved SME credit skills in the participant financial institution(s). (ii) Contribution via the participating financial institution(s) to improved sub-borrower skills in operation of their businesses, e.g., via appropriate loan conditions, advisory services by the bank(s).	Since 2012, Ineco has invested in expanding its SME products and capacity to service the SME market, as well as other financial products and market segments. Investments were channelled in the areas of product development, staff training, information technology, and credit processes and systems. Borrower skills were also enhanced by providing training in general business management skills.	Excellent	The ADB TA provided support to the bank to improve its SME procedures and general policies. Specifically, the TA focused on loan assessment and monitoring techniques, SME credit scoring development, risk-adjusted pricing, and stress testing.	Inecobank can further enhance SME skills and develop appropriate procedures for serving the agricultural market. Further skills training to more sub-borrowers can also be provided by the bank in the future.	Low
1.2 **Improved standards:** Improved standards and practices with regard to corporate governance and transparency, stakeholder relations, or ESMS in participating financial institutions or sub-borrowers.	Ineco had existing ESMS policies at the time of loan origination focused on complying with applicable national laws and requirements of other multilateral stakeholders. On top of existing procedures, the bank has established an enhanced ESMS deemed appropriate by ADB to manage the environmental and social risks of SME projects.	Satisfactory	The bank adopted certain enhancements on its policies to be fully compliant with ADB's ESMS requirements (e.g., with regard to labor standards and resettlement). The ADB TA also provided recommendations to enhance corporate governance and anti-money laundering (AML) practices of the banks.	The adoption of ADB TA recommended action plans on corporate governance and AML can further boost the bank's practices in the future. Continued careful implementation of ESMS will further enhance compliance with environment and social risk management standards.	Low
1.3 **Innovation**: Innovative ways of offering effective banking services to SMEs (including new products, services, and technologies)	Ineco introduced a number of new products in Armenia, such as mobile and Internet banking, point-of-sale financing, energy efficiency loans, and custodian accounts for pension management.	Excellent	The bank's growing familiarity with local SME needs and enhanced capacity enabled it to expand SME market coverage as well as serve other high-impact market segments.	The bank can utilize advancements in information technology to create new products and services in response to the growing needs of the SME sector.	Medium

Results Area	Actual achievements	Rating	Justification	Potential future achievements	Risk
1.4 **Catalytic element:** Mobilizing or inducing more local or foreign market financing or foreign direct investment for the supported financial institution or sub-borrowers.	Ineco works continuously to diversify funding sources. The strategic objective is to increase local resource mobilization to gradually reduce reliance on IFI funds. In 2015, EBRD infused additional capital for the acquisition of ProCredit, enhancing both funding diversification and governance standards.	Satisfactory	The presence of ADB and other IFIs and the improvements in product offering and asset quality they supported assisted the bank in mobilizing additional forms of funding.	As financial strength and country risk factors stabilize and improve, Ineco may gain more opportunities to diversify funding sources outside IFIs and customer deposits.	Medium
1.5. **Improved business performance.** Expanded SME lending with good portfolio and sub-borrower performance. Expansion of market share.	The bank expanded SME lending while simultaneously developing other business lines, leading to a more diversified and resilient overall activities mix.	Satisfactory	ADB lending to Ineco and support for the expansion of SME lending demonstrates ADB's commitment to this market and belief in its viability.	With improved capacity of the bank and an expanding SME market in the future, portfolio volume and quality may be expected to improve.	Low
2. PSD effects beyond financial intermediaries and sub-borrowers					
2.1 **Private sector expansion and institutional impact**: 2.1.1 Contribution to an increased private sector share and role in the economy. 2.1.2 Contribution to expanded SME lending in the financial system. 2.1.3 Improved SME access to formal credit and banking services in the economy.	The ADB loan contributed to an increased volume of SME loans in the Armenian financial market along with similar financing facilities from other IFIs. The technical resources provided by the ADB project enabled Ineco to take over the activities of ProCredit Armenia, leading to a substantial expansion of its loan portfolio and continued access to finance for ProCredit's clients.	Excellent	The project contributed to increased competition in the SME lending market as well in other market segments, leading to enhanced access for all borrowers to bank finance. This will have a positive long-term impact on private sector investment, growth, and employment in Armenia, especially as other banks exit the market following the much more stringent capital requirements imposed by CBA beginning in 2017.	SME and general private sector access to formal credit and banking services in the economy is expected to increase further in the future with additional funding, new products and services, and enhanced underwriting and risk management capacity of banks.	Low

Results Area	Actual achievements	Rating	Justification	Potential future achievements	Risk
2.2 **Competition:** Enhanced competition in the SME market segment among local banks or other types of financial institutions (including new product and service offerings, local-currency products), and/or contributions to increased competition in key sub-borrower markets.	Ineco introduced a number of new lending and saving products that offer more choices to local customers. This move resulted in more options for SMEs and other borrowers and savers.	Satisfactory	New products and services introduced in the market by Ineco benefited SMEs, larger businesses and, households in Armenia, given the wider options and competitive terms.	Competition among local banks is expected to grow further given increased awareness among banks of the enhanced demand from the SME sector. Cost efficiencies in product offerings may be achieved by Ineco and other banks in the future, which may bring favourable impact on pricing and income margins.	Low
2.3 **Demonstration effects:** Replication of new ways of offering effective banking services to SMEs by other banks or institutions.	Ineco, being an industry leader, brings market practices and product offerings that may be replicated by other players given favourable market acceptance and impact. For example, the point-of-sale loan product that was pioneered by Ineco is already being followed by a wide range of market participants.	Satisfactory	The project led to the adoption of appropriate lending techniques and new products by Ineco and other PFIs, which are likely to be replicated by a wide range of market participants.	Positive results in terms of asset quality and profitability among banks, which adopted dedicated units within the banks, more targeted risk management processes, and specialized training to bank personnel towards SME lending will encourage other banks to replicate processes.	Low
2.4 **Links:** Contributions to local savings and deposit mobilization via networks of participant bank(s); contributions to notable upstream or downstream link effects to sub-borrowers' businesses in their industries or the economy.	Ineco put increasing emphasis on local resource mobilization as a complement and long-term replacement of IFI funding. Strategic initiatives such as developing corporate lending or providing mobile and internet banking are partly driven by the desire to enhance deposit collection. The point-of-sale loans developed by Ineco also tie directly into lending to the SME retailers, producers, and service providers for the goods concerned.	Satisfactory	Expanded branch and ATM network, and use of internet and mobile banking, contribute to enhanced outreach vis-à-vis local savers and borrowers.	Ineco can strengthen market offerings that can capture other cash management, savings, and investment requirements of customers.	Low

Results Area	Actual achievements	Rating	Justification	Potential future achievements	Risk
2.5 **Catalytic element:** Contribution to the mobilization of other local or international financing for financial institutions with SME business, and by positive demonstration to market providers of debt and risk capital to SMEs.	The ADB loan and the expansion of activities such as lending to SMEs, agriculture, and women entrepreneurs, helped Ineco access special financing facilities established by the Armenian government and bilateral or multilateral donors to target various market segments.	Satisfactory	ADB lending to Ineco and its encouragement of the expansion of its lending to SMEs and other priority sectors demonstrates ADB's commitment to these markets and belief in their viability.	Additional funding from local sources and IFIs continue to come in to support the growth and development of SMEs, favored sectors, and the local banking sector in general.	Low
2.6 **Affected laws, frameworks, regulation:** Contribution to (i) improved laws, regulations, and inspections affecting SME financing; or (ii) a more enabling environment for SMEs via lobby activity, policy dialogue, or otherwise.		N/A			
3. Contributions to other ADB strategic objectives					
3.1 **Inclusion:** Increased availability or reduced cost of financial services for the poor and other disadvantaged groups. Indirect inclusion benefits generated by subprojects and borrowers through forward or backward links to poor, female, or rural entrepreneurs; the provision of services or products for the poor, female, and rural populations; and employment of such groups.	The ADB project enabled Ineco to reach approximately 200 SME borrowers from various industries. Around 35% of lending went to borrowers outside the capital Yerevan, where financing opportunities tend to be more limited.	Satisfactory	Support for SME development through the ADB project will benefit less-advantaged groups, including micro-entrepreneurs who lack adequate financial resources or collateral, and borrowers in rural areas, which were specifically targeted by the project.	Future IFI funding for on-lending to qualified sub-borrowers as well as government financing initiatives targeted to rural areas and disadvantaged sectors will drive further financial inclusion going forward.	Low
3.2 **Job creation**: Creation of additional sustainable jobs or as self-employment. Distinguish between jobs created within supported financial institutions, sub-borrowers and beyond.	For the entire SME portfolio of Ineco, around 15,000 jobs were estimated to have been supported by the SME loans, based on a conservative assumption of three workers for each borrower served. Ineco estimated the number of SME customers at 5,000. For ADB funding, an estimated 4,000 workers were	Satisfactory	Funding support to the bank assisted in the creation of jobs at different levels.	Additional funding from IFIs and improvement in market conditions can provide new and greater demand for loans to fund business activities encouraging job creation.	Low

Results Area	Actual achievements	Rating	Justification	Potential future achievements	Risk
	supported through the sub-loans. Ineco also employs around 800 employees.				
3.3. **Environmental sustainability:** Contribution to reductions in GHG emissions, other environmental improvements through relevant lending policies and practices, and targeting allocations for borrowers with environmentally beneficial investments.	Underwriting and risk rating procedures of all PFIs include the analysis of E&S risks. Ineco maintains certain internal limits of percentages of loan amounts assessed as having meaningful E&S risks. Employees are also given regular environment and social risk management training.	Satisfactory	The project contributed to increased awareness of E & S risks by the bank, and therefore their borrowers as well.	ESMS training programs funded by IFIs and the implementation of ESMS policies as part of standard underwriting procedures can create greater awareness and skills among other banks and sub-borrowers.	Low
3.4. **Regional integration:** Project contributions to regional cooperation and integration by facilitating trade or cross-border financial transactions.		N/A			
3.5 **Any other project development outputs and outcomes**					
4. Overall Rating		Satisfactory			

ADB = Asian Development Bank, AML = anti money laundering, CBA = Central Bank of Armenia, E&S = environmental and social, ESMS = environmental and social management system, GHG = greenhouse gas, IFI = international financial institution, N/A = not applicable, PFI = participating financial institution, PSD = private sector development, SME = small and medium-sized enterprise, TA = technical assistance.
Source: Asian Development Bank