

**RESEARCH ON REGULATORY REGIME IN
MICROFINANCE:
THE ARMENIA EXPERIENCE**

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1. Emergence of microfinance in Armenia in the context of transition to market economy and poverty reduction

1.1. Microfinance specifics of 1990s

The history of microfinance in Armenia can be traced back to early 1990s when the newly independent nation was struggling with the economic consequences of the disintegration of the Soviet Union, the devastating 1988 earthquake and the blockade resulting from the Nagorno Karabagh conflict. The rupture of economic ties and the emergence of borders in the post-Soviet space led to a massive economic recession and, consequently, a sharp decline in the population living standards. The transition turned out to be particularly painful for Armenia which did not have its own fuel and energy resources and, as a landlocked country, depended heavily on highways, railroads and pipelines through the territory of the neighboring countries.

From 1989 to 1993 Armenia suffered a drop in the Gross Domestic Product (GDP) by 55.6%, in electric power production,

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by 57% and in industrial production, by 60%.³ The disruption of intra-Soviet Union economic links led to a slump in demand for important commodities produced in Armenia and, as a result, to massive closedowns of industrial facilities. For instance, from 1987 to 1993, Armenia has seen a 84.8% decrease in the production of metal-cutting machines, a 95.5% drop in the production of power transformers, and a 99% reduction in the production of artificial rubber. In human terms, all this meant layoffs and rampant unemployment.

The liberalization of prices had a high human cost as well. State price controls on fuel and raw materials that were formerly in place translated into a favorable trade balance for Armenia. The removal of price controls meant an instant increase in export prices and, as a result, the prices skyrocketed to international levels.

It is against this backdrop of economic instability and the resulting lack of regular salaried employment that the first microfinance initiatives – focused exclusively on microlending – were launched in Armenia. The first microfinance facilities were set up by various charities, such as Save the Children, Catholic Relief Services (CRS), United Methodist Committee on Relief (UMCOR), Armenian Ecumenical Church Loan Fund, World Vision, and FINCA, seeking to create jobs and improve living standards through better access to credit services. Their microfinance programs were of non-profit nature and focused on microlending to microbusinesses set up by entrepreneurs from program-identified vulnerable groups. For instance, AREGAK, UMCOR's microlending program launched in 1998, targeted economically active low income rural women and their families, women-headed households, refugees and internally displaced people. The Microenterprise Development Fund KAMURJ, the result of merging the Save the Children and CRS microlending programs, prioritized promoting women's entrepreneurship. The

³ See UNDP Yerevan, ARMENIA HUMAN DEVELOPMENT REPORT 1995, Section 2.1.1.

prevailing tendency by non-profit microfinance institutions (MFIs) was to fund microlending programs to support specific target groups or regions rather than based on market principles.

Overall, these early microfinance programs enjoyed considerable success and were soon able to develop solid client bases and sizeable portfolios. Armenian MFIs were also able to reach a substantial level of diversification as far as their depth of outreach was concerned, serving all groups of clients from unregistered businesses (notably in the open-market trade) and farmers' collectives to better-off registered businesses in urban areas. The MEDI-MIX Armenia Benchmarking Report⁴ cites 30% as the depth of outreach ratio, as measured by average loan size over gross national income per capita, of the largest MFI surveyed, with the same ratio of the smallest MFI being around 660%.

1.2. SME sector growth in 2000s and the emergence of banks as microlending actors

Even though mostly successful, the 1990s MFIs still had to overcome their financial dependence of donor funding and to learn to abide by market principles. The 2002 Law on Credit Organizations (discussed at a greater length under Section 3, *Legal and regulatory framework for microfinance*) that allowed new types of credit organizations to provide microlending services, have intensified competition in the microfinance market and precipitated the transition from donor-funded, program goal-driven microlending programs to more market-oriented services.

By the beginning of 2000s, Armenia started to emerge from the economic crisis. The 2005 report on the Development of Entrepreneurship and SME Sector in the Republic of Armenia⁵

⁴ Vahe Dalyan (USAID MEDI) and Matt Graham (Microfinance Information Exchange (MIX)), ARMENIA BENCHMARKING REPORT 2004, February 2006, at p. 2.

⁵ Armen Gevorgyan, Ishkhan Karapetyan, Anna Petrosyan, DEVELOPMENT OF ENTREPRENEURSHIP AND SME SECTOR IN THE REPUBLIC OF ARMENIA, UNECE

reports real economic growth on average level of 10.5% during 2000-2004, with the state budget deficit coming down to 2.6% of GDP, and around 80% of GDP provided by Armenia's private sector.

Early 2000s saw a considerable growth of the small and medium enterprise (SME) sector, partially owing to the success in providing affordable business financing services. The Development of Entrepreneurship and SME Sector report indicates that 20,000 SMEs were established over 2002-2005, which is an impressive figure given the total population size.⁶

As the economic and social situation in Armenia gradually improved, banks began to aggressively enter the microlending market. With international donors' focus experiencing a shift from humanitarian relief to development assistance, more and more funds were invested in building Armenian banks' lending capacities. The EBRD and USAID co-funded Armenia Microlending Program is one such example.

Currently, most of Armenia's major banks, including ACBA-Credit Agricole, Anelik Bank, Arexim Bank, Armeconombank, Converse Bank, Ineco Bank, Unibank, extend microloans to businesses. This is evident of positive dynamics (compare with the situation of 2002, when ACBA-Credit Agricole was the only local bank providing microlending services). ProCreditBank expanded its operations by opening a bank in Armenia, with the declared intention to become "the bank number one for small and medium enterprises."⁷

Forum "After Fifteen Years of Market Reforms in Transition Economies: New Challenges and Perspectives for the Industrial Sector," May 2005, at p. 3.

⁶ The population of Armenia is slightly under 3 million (2,968,586 according to the July 2008 estimate by the CIA World Factbook).

⁷ Interview of Deputy CEO of ProCreditBank Armenia Mr. Ashot Abrahamian to ARKA news agency (

1.3. First steps in the direction of microfinance expansion beyond microlending

The 2000s saw the Armenian microfinance sector expand beyond microlending into previously untapped areas such as leasing and savings. The legislative developments that accompanied this process (the adoption of the 2002 Law on Credit Organizations) came at a right time to create the legal basis for microfinance expansion. The new law introduced a typology of credit organizations that included organizations such as savings unions and leasing institutions, providing MFIs with a firm foothold in the leasing and savings sphere.

A pilot leasing program was launched by the U.S. Department of Agriculture (USDA) Agricultural Marketing Assistance Program as early as in 2000. The \$550,000 USDA credit, among other uses, helped establish Armenia's first leasing company, AgroLeasing, serving businesses operating in diverse areas of rural economy and food industry, such as the procession of agricultural raw materials, winemaking, cheesemaking, dairy production, meatpacking, etc.. AgroLeasing was established partly in response to the generally insufficient development of the Armenian banking system in the beginning of 2000s, as well as to the inability of the courts to process bankruptcy proceedings.

ACBA Credit Agricole soon followed suit, coming to be a pioneer among Armenia's commercial banks in the provision of leasing services. In March 2003, it established a subsidiary company, ACBA Leasing, offering leases to SMEs and individual farmers. As of July 2004, the company already had more than 80 separate leases signed, involving \$1 million worth of equipment.

Despite the limited extent to which microleasing has developed to date, the future of microleasing in Armenia looks promising. The unique structuring and pricing scheme of leasing services, including their reduced reliance on credit history or

<http://www.arka.am/eng/interviews/2008/02/01/7907.html>; visited on September 23, 2008).

physical collateral, makes them a good alternative to loans for start-up businesses in particular.

2. Government action and priorities

Microfinance development is seen by the government and the donor community alike as an obvious tool to reduce poverty and specifically to create opportunities for the rural poor. In 2001, as a result of an effort to ensure that economic growth translates into better social welfare and higher human development indicators, the Government of the Republic of Armenia adopted the 1st Poverty Reduction Strategy Paper (PRSP-1) as a strategic priority. The PRSP-1 became an outcome of a participatory process involving experts and stakeholders, and led by the Coordination Board presided over by the Minister of Finance and Economy. The PRSP-1 specifically mentioned better access to financial and credit resources, and the introduction of “microcredit facilities for the development of cooperatives, self-employment opportunities, and small businesses,” as a priority for mitigating rural poverty and inequality.⁸ It proceeded to note that “[t]he promotion of self-employment and small businesses through the establishment of micro-crediting facilities is a priority for the most vulnerable groups as well, such as households headed by women, the unemployed, refugees and displaced persons.”⁹ Rural poverty reduction was seen not only through the prism of the assistance to farmers, but especially as creating jobs outside the farming sector, and the development of a viable microcredit mechanism for rural SMEs

⁸ Poverty Reduction Strategy Paper 1, para 116 (“In the area of mitigating rural poverty and inequality, the priorities are in accelerating growth in incomes from sales of agricultural produce, introducing insurance schemes (co-financed by the government and agricultural firms) against natural and climatic risks, increasing access to financial and credit resources, creating an effective land market, introducing of micro-credit facilities for the development of cooperatives, self-employment opportunities, and small businesses.”)

⁹ *Id.*, para 117.

working in the services and other non-farming sectors was prioritized.¹⁰ The PRSP-1 indicated that, “[u]nder Armenia’s conditions, micro-credits are especially important in rural areas and small towns to promote non-farming activities.”¹¹

As the reforms proceeded, the need arose for a PRSP update. The updated and revised version of the PRSP – the PRSP-2 – was adopted in 2007 and remains work in progress, with a new update released in 2008. The PRSP-2 includes “securing substantial increase of the level of loan and credit accessibility”¹² as a top priority. It also specifically prioritizes access to “credit funds and expansion of banking and other types of financial opportunities for farms.”¹³

¹⁰ *Id.*, para 161 (“The issue of improving opportunities for non-farm employment will become more urgent with the projected slow changes in employment in the agricultural sector. For this purpose two main mechanisms will be used:

(i) micro-credit mechanisms, which will focus on the development of the services sector, as well as the establishment of non-farm micro-enterprises in rural areas;

(ii) targeted credit mechanisms, which will be used to process agricultural products and improve their packaging. These will be provided mainly to cooperatives or associations of farmers.”)

¹¹ *Id.*, para 224.

¹² Poverty Reduction Strategy Paper 2, para 232.

¹³ *Id.*, para 301 (“Taking into account the need to maintain a level of earned income comparable to non-agricultural sector as well as the impossibility of quick reduction of redundant labor force in agriculture and its transfer to non-agricultural sector during the period of PRSP-2 implementation, this fact presupposes: [...]”)

The development of microfinance facilities is seen as firmly connected to SME development, which is a high priority on the government agenda. In 2000, the Government of the Republic of Armenia adopted the Concept for SME Development Policy and Strategy in Armenia, which outlined the government policy and strategy concerning SME development, as well as served as basis for drafting the Law on State Support to Small and Medium Entrepreneurship that was passed by the parliament later in the same year.

Beginning from 2001, the Ministry of Trade and Economic Development on behalf of the Government of the Republic of Armenia has developed Annual Programs for State Support to SME. In 2002, Armenia established a separate body to implement these Annual Programs – the Small and Medium Entrepreneurship Development National Center of Armenia (SME DNC). It was set up to provide state support to SME, in particular, through its loan guarantee program (aimed at facilitating SME access to loans from SME DNC’s network of partner banks).

3. Legal and regulatory framework for microfinance

Banks and non-banking entities that provide microfinance services operate under different regulatory regimes. Banks are regulated by the 1996 Law on Banks and Banking, while commercial microlending organizations and non-profit cooperatives are subject to the regulation of the Law on Credit Organizations. A separate 2002 Law on Agricultural Credit Clubs regulates the activities of non-profit agricultural credit clubs. The Law on Credit Organizations, for the first time, established a typology of non-bank MFIs that includes credit unions; savings unions; leasing companies; factoring organizations; and other credit organizations.

- increase of availability of credit funds and expansion of banking and other types of

financial opportunities for farms.”)

At the time of the adoption of the Law on Credit Organizations, other non-profit MFIs fell into the category of foundations and were regulated by the relevant provisions of the Civil Code and the Law on Foundations. However, there ensued a debate regarding the legality of their involvement in microlending due to a loophole in the Law on Credit Organizations that neither expressly imposed its licensing requirements on foundations nor excluded foundations from its ambit. The legally stipulated ceiling on administrative expenses not to exceed 20% of the total organizational budget added to the problem.

The reform of the regulatory framework for microfinance sector involved assigning a key role to the Central Bank of Armenia, which emerged as the regulatory body for MFIs under the Law on Credit Organizations, following a heated debate on whether the regulatory powers should be vested with the Central Bank or the Ministry of Finance. Designating the Central Bank as the regulatory body meant that MFIs will be subject to the same regulatory regime as the rest of non-depository credit organizations, and implied that NGO-run microlending facilities would need to be registered as legal entities with subsequent licensing as credit organizations, which was also a way to address the above-mentioned legal loophole concerning foundations.

A number of NGO microlenders, including AREGAK, SEF International (a World Vision-funded and owned MFI), FINCA, and the Ecumenical Church Loan Fund, have to date undergone registration and Central Bank licensing, establishing themselves as credit organizations under the Armenian law.

The body of Central Bank regulations applicable to MFIs include Regulation 13 on credit organization registration and licensing; Regulation 14 on credit organization regulation and the prudential standards for activities of credit organizations; Regulation 15 on reporting requirements for credit organizations; and Regulation 21 on cash transactions in credit organizations. The prudential and reporting requirements for credit organizations were more stringent in the beginning and designed to protect the licensees' solvency, however, the Central Bank gradually came to

realize that non-depository nature of credit organizations implies they do not present a risk of losing public funds, and the prudential standards have been loosened accordingly.

4. Current Trends and Development Priorities

As Armenia enters the path of economic stability and growth, MFIs face growing challenges of surviving and succeeding in an increasingly competitive market. MFIs still have to overcome their reliance on donor funding in order to become fully sustainable. MFIs no longer compete for attracting more clients and more donor funds. The competition in the microfinance sector is getting increasingly market-driven, and MFIs need to become business-savvy and institutionally efficient to stay afloat. The focus of attention of MFIs looking to finance their future growth should shift from donors to commercial debt and equity investors.

In anticipation of this shift, a number of donors, including USAID and EBRD, have funded programs aimed to build institutional capacities of Armenian MFIs to better equip them for competition. Donor priorities have also included assistance in creating a more favorable legislative and regulatory framework for microfinance and strengthening regulatory and supervisory capacities of the Central Bank. In particular, the USAID Strategy for 2004-2008 prioritizes “encouraging new legislation to enable savings mobilization by appropriately regulated MFIs, accompanied by a medium-term component to develop regulation and supervision to implement the new legislation, and “direct work with the CBA¹⁴ to improve understanding of microfinance issues, and further strengthening of the CBA in its capacity to supervise commercial banks activities in microfinance.”¹⁵

The market pressures are intensified by the enforcement of the loan interest rate cap, which is fixed at 2 times the accounting

¹⁴ Central Bank of Armenia.

¹⁵ USAID/Armenia Strategy for 2004-2008, Appendix VI at p. 14.

rate of bank interest established by the Central Bank of Armenia. MFIs can no longer mask inefficient operations by charging overly high interest rates, and they need to look for ways to minimize costs and to boost their efficiency in order to survive.

Tackling delinquency is another challenge that all MFIs will inevitably face. Armenia's first private credit bureau – the Armenian Credit Reporting Agency – was set up in 2004 and to date has contracts with a number of Armenian MFIs to gather and process their credit data. This helps MFIs survive in the market by gaining a better insight into their clients' credit risk by receiving cumulative information on their previous payment behavior patterns and current credit obligations with various institutions, discovering and attracting creditworthy customers, and monitoring irresponsible borrowers.

Despite the proliferation of MFIs, microfinance has not yet become a universally accessible option in Armenia. The research shows that borrowing from informal sources remains widespread, although a tendency towards borrowing more from formal sources such as MFIs has been registered over the recent years. The PRSP-2 data for 2006 show that among the segment of the rural population identified as "poor" the percentage of those who borrowed from formal sources was only 2.8, while for informal sources the percentage was 4.0, and 93.2% of the rural poor did not borrow at all.¹⁶ For comparison, the respective figures for the rural non-poor were 5.9% (formal sources) and 3.0% (informal sources), with 91.1% having not borrowed at all. This demonstrates a high still untapped potential for microlending in rural areas in particular, as well as the need to make microlending services more accessible to the poor.

5. Conclusions

Since its independence in 1991, Armenia has gone a long way to mitigate poverty and enter the path of economic progress. The microfinance sector has both been a driving force in promoting

¹⁶ Poverty Reduction Strategy Paper 2 at p. 46.

economic growth and human development and, as time went by, been affected and shaped by the growing and stronger economy and the increasingly pressing market demands.

While microfinance development in Armenia is overall a success story, with most NGO-established MFIs having achieved self-sufficiency and operating as licensed credit organizations, MFIs still have to overcome reliance on donor funds to become fully sustainable and survive in the market banks and commercial lenders have been so aggressively entering.

The existing high demand for microfinance services in Armenia makes the future of the sector look quite promising. Moreover, as the Armenian microfinance sector develops, it will inevitably expand beyond microlending into other areas such as leasing, savings and insurance, and indeed first steps in this direction have already been taken.