Market Assessment for Microenterprise Services in the Republic of Armenia

A Task Order Report Under the SEGIR Financial Services IQC

Contract No. PCE-1-00-99-00007-00

Submitted to:
USAID

Submitted by:
Chemonics International Inc.

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ACRONYMS

ACBA	Agricultural Cooperative Bank of Armenia
ACDI/VOCA	Agricultural Cooperative Development International / Volunteers for Overseas Cooperative Assistance
AMD	Armenian Dram
AREGAK	Sustainable Guaranteed Agricultural Assistance for Women Program
CAMEL	Capital adequacy, Asset quality, Management, Earnings, and Liquidity management
CBA	Central Bank of Armenia
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
CRS	Catholic Relief Services
ECLOF	Ecumenical Church Loan Fund
EBRD	European Bank for Reconstruction and Development
FINCA	Finance for International Community Assistance
FSU	Former Soviet Union
GAF	German Armenian Fund
GDP	Gross Domestic Product
GOA	Government of Armenia
GTZ	German Technical Cooperation Agency
ha	Hectare
IESC	International Executive Service Corps
INGO	International Non-Government Organization
IOM	International Organization for Migration
IPC	Internationale Projekt Consult GmbH
KfW	Kreditanstalt fur Wiederaufbau (German Bank for Reconstruction and Development)
LoCB	Law on the Central Bank of Armenia
LoB	Law on Banks and Banking
MAP	Marketing Assistance Project
MDF-Kamurj	Microenterprise Development Fund – Kamurj
MF	Microfinance
MFI	Micro Finance Institution
ME	Microenterprise
NBFI	Non-Bank Financial Institution
NK	Nagorno-Karabakh
NGO	Non-Government Organization
NOVIB	Netherlands Organization for International Development
NSS	National Statistical Service
pa	Per Annum
PCC	Production Credit Club
SAVE	Save The Children Foundation
SEF	Small Enterprise Fund (World Vision)
SAS	Shorebank Advisory Services

SME	Small and Medium Enterprise
SOW	Scope of Work
SWOT	Strengths, Weaknesses, Opportunities, and Threats
TACIS	Technical Assistance for the Commonwealth of Independent States
UMCOR	United Methodist Committee on Relief
USAID	United States Agency for International Development
USDA	United States Department of Agriculture
WCC	World Council of Churches

Executive Summary

Introduction

USAID/Armenia is currently reviewing its microenterprise (ME) [1] development strategy. The findings of this market assessment for microenterprise services are a key input into the Mission's deliberations for refining its strategy. The market assessment analyzes the nature of microfinance (MF) [2] demand in Armenia, evaluates the performance of key microfinance institutions (MFIs), and outlines niche growth areas. The overriding objective of the market assessment is to quantitatively and qualitatively analyze the market for MF services and identify opportunities to support the ME sector so as to program USAID/Armenia resources in the most effective and efficient manner.

The Assessment Team followed a "Financial Systems" approach to its evaluation of the Armenian ME sector. Besides an in-depth assessment of the supply and demand for MF services, our analysis of Armenia's MF market included a brief discussion of the relevant policies, laws, regulations and supervision practices as well as socioeconomic trends within the country that can influence the size, nature, quality and development of MF services.

Main Findings

Socioeconomic environment. With substantial donor support, Armenia has made progress in boosting its economy since 1994. After recording negative GDP growth during 1991-1993, economic growth has been positive since 1994 with average year-to-year increases in excess of five percent. Since 1996, the government has managed to hold inflation at relatively low and stable levels and the exchange rate of Armenia's currency (drams) with the US$ has remained steady. Armenia's growth is aided by substantial donor support: between 1995-2000, donors contributed roughly seven percent to Armenia's GDP in the form of grants and low-interest credits. It also benefits by a considerable inflow of remittances and private transfers that account for 7-8 percent of GDP a year (World Bank 2001, p. 8 – 20). However, the government continues to run a fiscal deficit of 5-6 percent of GDP. Given the low level of domestic savings by Armenians, the government deficit absorbs what little deposits there are in the banking system and this contributes to high interest rates.

Despite Armenia's economic growth performance, there is little evidence that this resulted in any noticeable reduction in poverty as GDP growth was greatest in sectors with low employment and overall it did not lead to an increase in the number of jobs available. The incidence of poverty remains at around 55 percent of the estimated population of 3.1 million (World Bank 2001, p.18

[1] For the purposes of this assessment, microenterprises employ 10 people or less and have need for financing that is generally $1,000 or less but may occasionally go up to $10,000.

[2] Microfinance (MF) is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to the poor and low-income households and their microenterprises (MEs). MF in the Armenian context generally refers to loans amounting to $1,000 or less (although in some cases loans up to $5,000 may apply) and other financial services targeted as described above.

–19). Unemployment among women is particularly acute. Only 23 percent of working age women (15-60 years) are among the employed compared to 53 percent for men. It is the economically active segment of Armenia's poor population, particularly women, who are historically targeted by microfinance programs.

Legal and Regulatory Framework. Over the last several years, Armenia adopted a number of laws and regulations that are building the infrastructure for a market economy. USAID assists these efforts by implementing initiatives aimed at Accounting Reform, Banking Supervision, Tax and Fiscal Reform, establishment of Commercial Rule of Law, Privatization, and Capital Markets Development. While substantial progress has been made in all areas, there remain factors that continue to constrain the development of efficient financial markets, including microfinance.

Armenia's underdeveloped legal system with respect to marketable property rights results in weak collateralization of claims and inadequate contract enforcement mechanisms. Legal definitions for various types of marketable property rights as well as registration of titles for marketable property rights is nascent and still under development. Settlement of claims, repossession, etc. remains time consuming and costly, contributing to weaknesses in the secured transactions framework. These weaknesses prohibit many microentrepreneurs from providing collateral that are most often required by lenders, despite the fact that surveys of MEs show that more than 80 percent expressed willingness to do so.

Most of the 29 banks in Armenia are small size with the three largest accounting for 35 percent of total bank assets in mid-2000 and the largest 10 banks about 75 percent. As of May 31, 2001, the Central Bank of Armenia (CBA) raised from $1.5 million to $5 million the minimum capital requirement that banks will have to meet by January 1, 2005. Of the 29 banks operating in Armenia as of the end of September 2001, most will have difficulty meeting the new minimum capitalization requirement. Banks that do not will be closed or face a forced change to their status.

Because of Armenia' low savings mobilization rate (due in part to a lack of confidence in the banking system and to a large informal sector), credits to the ME sector would be constrained were it not for donor-funded credit lines who increased their share of credits to the ME sector from 5.3 percent ($4 million) in 1997 to 19.6 percent ($18.9 million) in 1999 (World Bank 2001, p. 80). While the credit lines provide banks additional liquidity for on-lending, in nearly all the donor-funded credit lines, the risk of non-payment is borne by the bank, which encourages them to set high collateral requirements on the borrower. As a result, many larger MEs as well as small and medium enterprises (SMEs) are denied access to credit.

Although all microfinance institutions (MFIs) currently operate within Armenia's existing legal framework, there are three movements proposing that the government pass special legislation that could impact MFIs. The Ministry of Finance (MoF) and the CBA have each drafted legislation that would permit banks (presumably those unable to meet the $5 million capital requirement) to transform into "limited license" non-depository banks. There is also a movement by those with interest in the agriculture sector to adopt legislation to legitimize the existing Production Credit Clubs (PCCs) initiated by USDA. A third stakeholder group, the Micro Credit

Forum, is comprised of senior managers of several leading MFIs who are contemplating submitting their own draft legislation.

Characteristics of Microenterprises. A survey by the Assessment Team, and reviews of other ME surveys, showed that the majority of MEs were sole proprietorships, sometimes managed with the help of a spouse. In terms of educational attainment, three-quarters of the men indicated they had a university degree compared to about half of the women. About 80 percent of microentrepreneurs were between 31-50 years old. Despite the education and experience of most microentrepreneurs, however, monthly income generated by their business was low with about 83 percent earning less than $150 per month from the business (96 percent earned less than $300 per month). The low level of income is likely associated with operation of the microenterprise as a subsistence activity rather than a profit-making venture. Between 80-90 percent of borrowers from UNCOR's AREGAK program, MDF-Kamurj, and FINCA are engaged in trading.

Microcredit Demand and Supply. We estimated the total potential demand for microcredit in Armenia to be between 36,000-54,000 MEs, which correlates to $27-$41 million in potential microcredit loans. We also determined the total amount of outstanding microcredit in Armenia that is supplied by formal or semi-formal MFIs to be about $11.5 million in 34,000 microloans. Up to 80 percent of these loans may be to women. The policy to lend only to women is based on the mission of the parent organization and not a reflection of market demand forces. At least 80 percent of the total microcredit provided is based on the group lending methodology. Four institutions (MDF-Kamurj, FINCA, AREGAK/UMCOR, and ACBA) account for 94 percent of the estimated microloans outstanding and 90 percent of their estimated value. The average loan size from these four was the equivalent of $347.

Comparing the actual microcredit outstanding to the potential demand, we find that the number of outstanding microloans is about two thirds of the total estimated number of MEs that would be willing and able to borrow at any given time. However, only about one-third of the potential microloan value demanded is currently satisfied. This difference may be due to the fact that the average loan size of current supply is less than that demanded. Also, some of the microloans outstanding are financing the same business though how many is uncertain.

The assessment identified three possible causes of the disequilibrium between satisfied and potential demand that helps one understand why otherwise credit-worthy or "bankable projects" cannot get funded: (1) underdeveloped legal system, particularly with respect to marketable property rights (i.e., collateral, contract enforcement mechanisms), (2) ME licensing, registration, inspection, and reporting requirements that are underdeveloped or unclear, and (3) insufficient institutional capacity of microcredit providers. In addition, potential reasons given for the depressed ME demand included: government corruption, the continued blockade, poor infrastructure (telecom, water, road, rail, and air transport), the small domestic market (the negative effects of which continue to be exacerbated by continued emigration) and weak training and information support for current and would-be microentrepreneurs.

Assessment of MDF, FINCA, AREGAK/UMCOR. The three MFIs that we were assigned to analyze (MDF-Kamurj, FINCA, and AREGAK/UMCOR) are all semi-formal MFIs. From the standpoint of the depth and breadth of their loan portfolio outreach, all three have achieved substantial success in the few short years since starting their microlending operations by supplying small loans to large numbers of borrowers.

However, our analysis shows that they can do better, and that there is considerable progress to be made on the development of internal capacity and the acquisition of proper institutional structures that will permit them to progress toward financial self-sustainability. In short, institutional transformation is needed to move them from project based, donor-funded programs to self-reliant organizations that are fully staffed with long-term management who receive professional oversight provided by an elected Board of Directors.

Some MFIs such as MDF-Kamurj and the Small Enterprise Fund (SEF) have taken strong steps in the direction of commercialization and are transforming into more formal microfinance institutions, but others are well behind. A positive point is that all are aware of the need for adoption of a more “commercial orientation” and are willing to work toward this end. For each of the three, the areas of constraint identified were: (a) clarity of strategic mission consistent with commercialization; (b) ensuring adequate ownership and governance, as well as human resource development and training; (c) client targeting and retention; (d) development of demand-driven products and services; (e) risk management; and (f) management information systems (MIS).

The Assessment Team was also asked to review the microfinance program of USDA/Armenia. In our opinion, the USDA’s credit activities in Armenia distort the market for loans to agriculture-related producers in Armenia and are not at all sustainable. USDA/Armenia’s credit programs are part of their Marketing Assistance Project (MAP) that provides substantial technical assistance to agro-businesses. Despite combinations of generous technical assistance subsidies, grants and below market interest rates on loans (some even interest free), many of the USDA loans are non-performing and a large portion of loans has been rescheduled.

Recommendations

The Assessment Team identified four activity areas as part of a comprehensive and synergistic strategy to support Armenia’s ME sector. These were: (1) short-term capacity building of MFIs, (2) short-term and medium-term enabling environment work, (3) short-term and medium-term support to the Micro Credit Forum, and (4) medium-term development of advisory services for existing and potential MEs.

Short-term capacity building of MFIs. Armenian MFIs would benefit by performance-based support to build their institutional capacities to capitalize on their outreach achievements and move toward greater financial self-sustainability. Once substantial cost efficiencies are achieved, the aim would be to transform them into more formal MFIs with commercial orientations and strong institutional identities that are self-reliant, market-responsive, and financially self-sustainable. Development and donor organizations can help to build capacity by providing exposure to and training in microfinance best practices, along with performance-based technical assistance, for MFIs to expand their outreach and to develop cost-effective, sustainable operations. Whenever possible, local experts or suppliers should be engaged (using a bidding process) to provide the service or products requested by the MFI under a cost-sharing arrangement with between the grantor and grantee. This has the benefit of building local capacity to support the ME sector as well as being responsive to the changing needs of MFIs.

With the exception of ACBA, MFIs are unable to raise loan capital from savings mobilization. This is indeed a large risk to their sustainability should they encounter a dramatic drop in repayment rates, suffer an unplanned loss of revenue due to decreasing interest rates, or be unable to fund larger loans promised to existing clients.[3] Therefore, the Assessment Team is not against the idea of providing additional loan capital support to the MFIs for the right reasons. We would like MFIs; however, to put more effort into forecasting their cash flow and loan capital liquidity needs. In addition, we would suggest that the reasons for client attrition be determined and existing loan products be adjusted accordingly before any expansion of their loan product line. The high client drop-out rates found support a consolidation of loan products with emphasis on developing a few, demand-driven products that can be designed and tested using proven microfinance “best practices” in market research. If the provision of additional loan funds are considered, it is suggested that they be transferred as long-term loans that can be converted into restricted grants to loan capital provided agreed upon performance parameters are met.

Short-term and medium-term enabling environment work. Development and donor organizations should work with national governments to create an enabling environment for microfinance. This includes improving the macroeconomic and sectoral policy environment, as well as the legal, regulatory, and supervisory framework, to allow innovative financial institutions to extend a wide variety of microfinance services to the poor on a sustainable basis. Direct financial sector interventions by the government should be minimized to prevent market distortions and to allow private sector provision of microfinance services using proven methodologies for sustainable microfinance delivery.

Some of the activities that donors can support to create an improved enabling environment in Armenia are:

- Policy awareness seminars and workshops scheduled for members of Parliament, the Central Bank and the Ministries of Finance and Justice.

- Conferences and training programs for selected government officials to attend as well as study tours for appropriate individuals to countries where progress has been made to establish an appropriate legal and regulatory environment for microenterprise development (several African [e.g., Zambia] and Latin American countries [e.g., Bolivia]).

- Consideration might be given to encouraging new legislation to enable savings mobilization by appropriately regulated MFIs. This entails a medium-term component to develop regulation and supervision that would be needed to implement the new legislation.

- Direct work with the CBA to improve understanding of microfinance issues and capacity building to effectively regulate and supervise MFIs in a way that leads to a strengthening of the sector and services provided. Further strengthening of the CBA in its capacity to supervise commercial banks activities in microfinance (and the MFIs that may come under

[3] MDF-Kamurj, AREGAK/UMCOR and FINCA practice “stepped” lending programs where borrowers are promised access to increasing loan sizes provided they fulfill program conditions. If an MFI were to have a loan capital liquidity crisis, the MFI would necessarily default on its moral commitment and there is a risk is that clients will leave the program.

the proposed legislation to enable them to engage in savings mobilization) would be a medium-term activities.

- Given the binding constraints of the current system that prevent “bankable projects” from getting funded because of a loan applicant’s lack of adequate collateral that is acceptable to lenders, the proposed Lease Law, Law on Pledges of Movable Property, and the proposed Law on State Registration of Pledges and Other Interests in Movable Property should be supported. Development of the regulations and supervision procedures governing lending under these Laws would also be a medium-term exercise.

- Investigation can be made into the design of an electronic payment or cash transfer system within Armenia.

Short-term and medium-term support to the Micro Credit Forum. Support should be given to the Armenia Micro Credit Forum. Microfinance associations, networks, and support programs have several important roles to play in the continued promotion of sustainable microfinance systems. They can spread awareness of key features of the financial systems approach to microfinance among policy makers, development agencies and donors, and practitioners. Also they help to integrate microfinance more with the general financial sector and ensure complementary approaches are considered. In addition, they can collect and disseminate microfinance “best practices” to accelerate the outreach and financial self-sustainability of their member MFIs in terms of cost-saving technological developments, creation of linkages to expand outreach, and lessons learned from transformation and experiences. Support to the Micro Credit Forum can be provided in the short-term to accomplish the above tasks, additional technical assistance required over the medium-term to assist the Micro Credit Forum to design financial and non-financial consulting services to facilitate its becoming financial self-sustaining.

Medium-term support for the developing a private credit bureau. To provide lenders with a means to control risk of loan default by means other than requesting 300 percent collateral, we believe a well-functioning credit bureau is needed. The Assessment Team only learned of informal exchange of credit information between MDF, AREGAK, and FINCA, and it is not aware of any formal or informal system of information exchange takes place between other institutions or commercial banks regarding loans under $10,000. However, the benefits of such a structure are clear in terms of reducing risk in microcredit lending.

Medium-term support to develop business advisory services for MEs. Any decision to support the ME sector in Armenia should not fail to consider the importance of including business development services (BDS) in the package. All the microfinance lending agencies the Assessment Team contacted cited their belief in the importance of this non-financial service support to businesses. A BDS survey for MEs should be under undertaken to determine what services are being offered by whom as well as how closely the available services match those for which current and potential clients express a willingness to pay. The BDS survey should also evaluate the level of client satisfaction with any BDSs currently available and identify what level of cost coverage could be expected related to various types of BDS support.

Market Assessment for Microenterprise Services in the Republic of Armenia

1 Introduction

1.1 Assessment Rationale and Objectives

USAID/Armenia is currently reviewing its microenterprise (ME) [4] development strategy. The findings of this microfinance (MF) [5] market assessment are intended to be a key input into the Mission's review. To this end, the assessment analyzes the nature of demand for MF in Armenia, evaluates the performance of key microfinance institutions (MFIs), outlines niche growth areas for MF product development, and makes recommendations to guide future support for the development of the ME sector. The overriding objective of this market assessment is to quantitatively and qualitatively analyze the market for MF services and identify opportunities to support the ME sector so as to program USAID/Armenia resources in the most effective and efficient manner. The Scope of Work (SOW) guiding the production of this assessment is provided as Appendix 1.

Assessing the nature of demand for MF in Armenia includes analysis of the current and potential market (for example, size, location, and types of clients; and gender issues) for financial services to MEs in the country. The focus was on quantitatively and qualitatively analyzing the scale and scope of ME demand for various financial services. The assessment also discerns market trends that indicate service areas that could be expanded and products that could be introduced (for example, larger individual/collateralized loans or innovative savings mechanisms). In addition, the discussion outlines non-financial services that might also be helpful to ME development (for example, marketing or input supply assistance, training, or administrative services). Finally, the assessment also reviews the possible constraints that prospective microfinance providers would face in serving the identified markets.

The performance of key MFIs (in terms of outreach and financial self-sustainability) is also analyzed. The specific objectives related to MFI assessments are to identify:

- Current target markets (for example, size, location, and types of clients; while noting gender issues, as appropriate), current products and methodologies;
- Stated intentions for new markets, products, services, and expected donor support;
- Timing and duration of proposed projects and their exit strategies, if any; and
- How the above cooperate or compete (actually or potentially) with other MFIs.

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[4] For the purposes of this report, microenterprises (MEs) are considered to be businesses employing 10 or fewer persons.
[5] Microfinance (MF) is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to the poor and low-income households and their MEs. Microfinance in the Armenian context generally refers to loans amounting to $1,000 or less (although in some cases loans up to $5,000 may apply) and other financial services targeted as described above.

The institutional and financial evaluations of the top three semi-formal MFIs[6] (using the criteria of outreach and financial self-sustainability) in Armenia, (FINCA, MDF-Kamurj (Save the Children/CRS), and AREGAK (UMCOR), includes the following:

- Review financial statements, policies, guidelines (for example, pricing policies, loan loss reserve practices, operating manuals, loan policies, personnel policies, client services, and group formation);
- Identify current clients served (e.g., client microenterprise size, location, type), current products, methodologies, and the extent to which the MFIs are meeting client needs;
- Outline relationships with other MFIs;
- Outline stated intentions for new products, markets, and expected donor support;
- Evaluate the impact of the program on clients based on the responses of clients interviewed and any qualitative/quantitative information provided by the organization;
- Estimate level of sustainability and cost coverage;
- Describe and evaluate how the organization's strategy for sustainability addresses the organization's capital requirements;
- Describe any relations with and usage of domestic banks and evaluate the potential for deepening the relationship; and
- Outline the strengths, weaknesses, opportunities, and threats (SWOT analysis) of each institution.

1.2 Assessment Framework, Methodology, and Organization

1.2.1 Framework

The analysis of Armenia's MF market includes a brief discussion of the relevant policies, laws, regulations and supervision practices as well as socioeconomic trends within the country that can influence the size, nature, quality and development of MF products and services. The decision to include such factors is based on the relatively new school of thought called the "Financial Systems" paradigm that has replaced the traditional paradigm of subsidized, targeted credit. [7] Following the Financial Systems approach, our assessment analyzes the policy environment from both the macro and sectoral points of view, including a discussion not only of fiscal and monetary policies but also of the relevant policies affecting the agricultural and financial sectors. In addition, issues in the legal environment and in current or draft banking regulation and supervision are included as part of the analysis.

[6] "*Formal institutions* are defined as those that are subject not only to general laws and regulations but also to specific banking regulation and supervision. *Semi-formal institutions* are those that are formal in the sense of being registered entities subject to all relevant general laws, including commercial laws, but informal insofar as they are, with few exceptions, not under bank regulation and supervision. *Informal providers* (generally not referred to as institutions) are those to which neither special bank law nor general commercial law applies, and whose operations are such that disputes arising from contact with them often cannot be settled by recourse to the legal system" (Ledgerwood 1999).

[7] The Financial Systems approach generally considers microfinance as part of a country's overall financial services market, focuses on the development of sustainable financial institutions (able to cover all operational and financial costs with revenues), and recognizes that microfinance clients are willing to pay the full cost of these services if they are designed and delivered consistent with their specific needs (Otero and Rhyne 1994 and Von Pischke 1998).

1.2.2 Methodology

This report is the product of consultation through individual meetings with a wide variety of microfinance stakeholders including domestic and international nongovernmental organizations (INGOs), government-funded development agencies, project implementing agencies, donors, commercial banks, foundations, limited liability companies, consultants, and microentrepreneurs (a list of all persons consulted is included as Appendix 2). To assist in the interviews, the Assessment Team developed two questionnaires for this study that helped to collect comparable information and to quantify the responses. The first questionnaire was used to determine the nature of MF demand and the second to analyze the Armenian MFIs (see Appendix 3: Survey Questionnaire of Microfinance Demand and Appendix 4: MFI Questionnaire Parts 1 and 2).

Because of the short duration of this assignment, the sample size of the MF market demand survey was limited to 30 interviews of MFI clients conducted in Yerevan, Gyumri, and Ararat regions. However, to supplement these, the Assessment Team secured a number of recent market studies from other sources including the three main MFIs (MDF-Kamurj, FINCA, AREGAK/UMCOR), as well as from the World Bank, and Shorebank Advisory Services (SAS). With this additional market research, we were able to compare our original survey data with other sources to arrive at conclusions on the nature of the demand for microfinance services in Armenia.

Regarding the analysis of MF supply, the team collected information on all major MFIs, but focused the greatest attention on MDF-Kamurj, FINCA, and AREGAK/UMCOR, as requested in the SOW. The assessment team used elements of three popular MFI assessment tools: CAMEL (Capital adequacy, Asset quality, Management, Earnings, and Liquidity management); CGAP (Consultative Group to Assist the Poorest) Format for Appraisals of MFIs (or simply, Appraisal Format); and MAGI (Microfinance Alliance for Global Impact) – a Catholic Relief Services (CRS) MFI rating instrument.

The CAMEL methodology was originally developed to enable North American bank regulators to assess and measure the financial and managerial soundness of commercial lending institutions. It was later refined for use in MFI evaluations by ACCION International, an American NGO. The CAMEL methodology analyzes the MFI by focusing on key financial and loan portfolio ratios, performance indicators, and institutional policies and procedures. To conduct a field evaluation using CAMEL, ACCION recommends a level of effort of three to four persons working 10 days at the MFI being evaluated. The CGAP Appraisal Format requires substantial data collection by the MFI that are furnished to the Assessment Team prior to its arrival. CGAP estimates that the length of time needed to conduct a field assessment of one MFI is two to three weeks of an analyst’s time. The MAGI methodology applies a standard set of MF best-practice norms against those actually in place at the MFI to arrive at a baseline assessment of the institution along with a plan to improve its performance. A team of three to four persons normally conducts the MAGI over a three-day site visit that includes review of documentation prepared in advance of arrival by the MFI Assessment Team. Due to the short time available for the assessment, coupled with the fact that the three MFIs were not aware of their required inputs before the team arrived, we decided to analyze the MFIs using a mix of the key elements from the CAMEL, CGAP Appraisal Format, and MAGI assessment tools, incorporating them into our MFI questionnaire.

It is important to note that the portfolio and financial data from the MFIs are based on self-reported information that is not necessarily based on CGAP accounting guidelines. Though all three MFIs were extremely cooperative in replying to requests for information by the Assessment Team, for the most part, the MFIs do not have the systems or procedures in place to collect all of the needed information, and they are not in the habit of collecting it. Though this prevented the team from conducting a more rigorous financial analysis, it allowed clear identification of areas in which the MFIs need to improve.

1.2.3 Organization

The organization of the rest of this report is as follows. In Section 2, we examine the environment for MF, including: (i) key socioeconomic data, (ii) macroeconomic and sectoral policies, (iii) the legal framework as well as prudential regulation and supervision issues, and (iv) core aspects of MF market development. Section 3 looks at the demand for MF and includes an analysis of the current and potential microenterprise market size and its characteristics. Section 4 reports on the estimated supply of MF, including: (i) extent of regional coverage, (ii) types of products and services, and (iii) growth trends. Additionally, Section 4 includes a performance and needs assessment of MDF-Kamurj, FINCA, and AREGAK/UMCOR with a SWOT analysis of these three MFIs plus the microcredit programs of USDA. Section 5 concludes the study by recommending a number of appropriate support options to develop Armenia’s ME sector through the expansion of access to demand-driven MF services.

2 The Environment for Microfinance

Key factors in the environment for MF in Armenia are described below. These include the country’s socioeconomic conditions, macroeconomic performance, sectoral (especially agricultural and financial) policies, and the legal and regulatory framework. Understanding the country context reveals what impact policy and the legal and regulatory framework have had on the development of the MF market, the development of MEs, and what impact future changes may have.

2.1 Key Socioeconomic Data

2.1.1 Macroeconomic Data and Labor Statistics

With substantial donor support, Armenia has been making progress in boosting its economy since 1994. After recording negative GDP growth during 1991 – 1993 (of -11.7, -41.8, and -8.8 percent, respectively), economic growth has been positive since 1994 with average year-to-year increases in excess of five percent (World Bank 2001, p.8). At the same time, the government has managed to hold inflation at relatively low and stable levels since 1996 and the Armenian dram’s (AMD) exchange rate with the US$ has also remained steady. [8]

[8] Exchange rates listed in Table 2.1 will be the conversion rate used throughout this report unless stated otherwise.

Table 2.1: Key Macroeconomic Indicators

	1994	1995	1996	1997	1998	1999	2000
Real GDP growth (%)	5.4	6.9	5.9	3.3	7.3	3.3	6.0
Annual inflation, CPI	4,962	176	18.7	14	8.7	0.6	-0.8

Source: World Bank 2001, p. 8

	1995	1996	1997	1998	1999	2000	2001
Average yearly exchange rate AMD:US$	405.8	413.4	490.7	504.9	535.1	539.5	621.3

Source: Armenia Economic Trends 3rd Quarter 2001. www.economic-trends.org

Armenia's economic growth showed a remarkable degree of resilience in the face of two major shocks during the late 1990's. First, in the face of the Russian crisis, Armenia avoided both an exchange rate crisis and an acceleration of inflation and, after a brief slow-down, the economy continued to expand. Then in October 1999, several leading Armenian politicians, including both the Prime Minister and the Speaker of Parliament, were assassinated. The political aftermath led to a considerable deterioration in fiscal and investment performance. Nonetheless, economic growth resumed by mid-2000 and GDP growth reached six percent for 2000.

Factors that contributed to Armenia's economic expansion in 1995 – 2000 were: (i) recovery in electricity supply, (ii) increase in external private transfers that fueled domestic demand, [9] and (iii) a major program of international assistance that made Armenia a leading recipient of donor funding in per capita terms. Between 1995 and 2000, donors contributed roughly seven percent to Armenia's GDP in the form of grants and low-interest credits (World Bank 2001, p. 20). Economic growth was also supported by impressive progress in establishing a suitable framework of structural reforms.

Despite this apparent strong economic performance, there are disturbing indications that Armenia's recent growth is unsustainable. The strongest growth took place in sub-sectors (power generation, mining, agriculture) that will be difficult to maintain given Armenia's scarcity of natural resources. In the meantime, Armenia's highly educated population (literacy rate of 99 percent and approximately 22.8 percent of its working age population having had a higher education) sits underutilized with nearly half of the population unemployed (PwC 2000, p. 46).

The exchange rate of the dram showed major appreciation; in early 2001, the real value of the ADM was 25-30 percent higher relative to a basket of Commonwealth of Independent States (CIS) currencies than in early 1997 (World Bank 2001, p.8). At the same time, the ADM mildly depreciated relative to the rest of the world. While this made the cost of imports from the CIS less costly, a strong Dram forms a serious obstacle for future expansion of Armenian exports since many exporters have insufficient skills to penetrate new markets outside of the Former Soviet Union (FSU) and thus cannot easily switch their exports in response to exchange rate movements. Indeed, the nominal values of merchandise exports declined by about 15 percent between 1995 and 1999 and by the end of 2000 amounted to only 16 percent of GDP (World Bank 2001, p. 40). Yet, Armenia desperately needs to export given the small size of its domestic population.

[9] Armenia continues to benefit from the inflow of private transfers (currently 8-9% of GDP per year), which mostly come from relatives who either recently emigrated or who temporarily work abroad. According to household surveys, not less than 15% of families were recipients; for 8% of households such transfers represented a major element of income support in 1999 (World Bank 2001, p. 17).

Nor did the population enjoy the benefits of the recent decade equally. A closer examination of the economic growth shows it was supported neither by traditional enterprise restructuring nor large numbers of new private businesses. While the nominal wage doubled from July 1997 to July 2001 and real wages grew in all sectors except agriculture, the improvement disproportionately benefited labor in a relatively few sectors that employed a small percentage of total labor. For example, it is estimated that 1,000 employees in the Armenia diamond industry are currently responsible for US$70 million in manufacturing exports (30 percent of total manufacturing exports in 1999) while another thousand employees produce approximately US$18-20 million in exported software. In addition, while real wage rates increased in sectors such as industry, construction, transportation, and communication, these same sectors intensively shed employees in the recent decade (World Bank 2001, p. 20-22). Revenue collection, while improved compared to 1996-1997, is still far below expectations due in part to the high share of people working in the informal economy and remaining weaknesses in tax and customs administration. On the expenditure side, there is a need for a considerable reallocation of funds in order to concentrate limited resources in the most critical areas, especially those related to support of primary social services and basic infrastructure. Without this reallocation, erosion of Armenia's comparative advantage in its human capital will continue, which would increase potential costs for future broad-based growth.

The calculation of precise unemployment figures in Armenia is difficult due to a number of factors. Emigration numbers are imprecise; the informal sector is not fully counted; there are large numbers of registered businesses that are inactive; family and farm employment, though common, are not always counted. A 1996 survey by the World Bank revealed that up to one-third of industrial employees were not performing any work and had been on administrative leave for a prolonged period, though the government counted them as employed (World Bank 2001, p. 4). In addition, the situation in the labor market has become more and more influenced by the informal sector. Given the weaknesses of the state statistical system in capturing small-scale enterprises and individual start-ups (which are only covered by occasional surveys) data, it is not surprising that official estimates of employment have become less and less reliable.

The table below notes the differences between official and household survey-based estimates of employment by sectors for 1998-1999:

Table 2.2: Employment Data

Sector	Number of Persons (thousands)		
	Household	Official	Discrepancy
Agriculture and forestry*	763	566	+198
Industry and construction	95	266	-171
Transport, trade, communications **	229	164	+66
Other services (private and public)	227	341	-114
TOTAL EMPLOYMENT	1,315	1,337	-22
* Note: All inactive or working age unemployed members of rural households with land are counted as employed in agriculture.			
** Note: All inactive or working age unemployed members of households with income from self- employment or valuable sales are counted as employed in trade.			
Source: NSS and World Bank staff estimates (World Bank 2001, p.28).			

While the two total employment estimates in the table above are quite close, the make-up of each is significantly different, particularly with respect to employment in those categories typically viewed as part of the informal sector – subsistence agriculture and urban informal businesses (typically trade)[10] (World Bank 2001, p. 28). Given the disparity of 198,000 in a single category leads us observe that there are no accurate employment data available, which is typical in FSU countries.

The household survey gives a picture of approximately 50,000 active small-scale private firms led by individual entrepreneurs, many of whom use help from their family members that in total amount to no more than 200,000 people. In addition, there are as many as 5,000 entrepreneurs who hire labor in urban areas, employing around 20,000 workers throughout the year, mostly on casual contracts (without a formal agreement), often invisible to official statistics. Thus, the size and number of MEs in Armenia are perhaps not large with on average four employees, representing not more than five percent of the total wage employment. The pool of workers that are in and out of this casual employment is much greater: an estimated 100,000 individuals who were unemployed in the reference week of the survey had been temporarily employed during the course of the previous year (World Bank 2001, p. 28).

In Armenia non-agricultural, self-employed individuals plus small entrepreneurs account for only four percent of total employment, while in successful transition economies it exceeds 10 percent (e.g., Poland – 14 percent, Hungary – 12 percent). Armenia's low numbers might indicate the existence of serious barriers for the establishment and development of small-scale enterprises, and thus for employment generation. The number of individuals who have tried in the past to establish a business exceeds 100,000—nearly twice the actual estimated number of active entrepreneurs and self-employed workers (World Bank 2001, p. 23). It is estimated that more than one third of Armenia's total labor force is not gainfully employed, and at all age levels, women are more likely to be unemployed than men.

The table below shows the distribution of the non-employed labor force in Armenia by gender:

Table 2.3: Employment by Age Group

Armenian Non-Employment Rates*	Age group (years)			
	15- 24	25-49	50-60	Total
Male	77%	36%	45%	47%
Female	86%	58%	71%	67%
TOTALS:	**82%**	**48%**	**58%**	**58%**
* Non-employed are unemployed and out of the labor force.				

Source: Armenia SDS 1996 Household survey, OECD (1998).

As high as Armenian unemployment is, it would be worse were it not for two processes that have helped to absorb some of the excess labor shed from certain sectors: agriculture and migration out of Armenia. Between 1990 and 1995, agriculture absorbed 250,000 new workers even as

[10] The value added per family helper in subsistence gardening in 1998 was estimated at around $60 annually while the urban informal sector is much more productive with greater revenue streams.

industry and construction laid off 300,000, effectively acting as a safety net for unemployed and displaced workers (World Bank 2001, p.25). Regarding migration, it is estimated that a net 570,000 persons left Armenia between 1988-1994. Though migration rates abated in 1996-1997, it is believed that it picked up again with the political assassinations of 1999 and the drought of 2000 (World Bank 2001, p. 17).

So far, the dynamics of employment in Armenia have been characterized by the absorption of labor into agriculture, small numbers of entrepreneurs, and layoffs in industry. Thus, it is important to closely monitor future changes in the structure of employment by sector rather than simply follow aggregate employment numbers. This is particularly important with regard to developments that can potentially change the nature or number of informal household businesses that typically make up the microenterprise market. It is clear that the informal sector grew substantially, but it is invisible and, therefore, difficult to quantify.

2.1.2 Socioeconomic Data

Despite the average GDP growth rate from 1995-2000 of less than five percent per year, there is little evidence that this growth resulted in any noticeable reduction in poverty, as found from the recent poverty assessment conducted by the World Bank. This “growth without poverty reduction” touched on in the previous section was derived from an unequal distribution of gains associated with GDP growth. GDP growth was greatest in sectors with low employment and overall it did not lead to an increase in the number of jobs available. There was an insufficient number of entries of new labor intensive MEs to take up laid-off labor. In addition, potential income gains from growth in the agriculture sector were largely wiped out by unfavorable changes in relative prices of agricultural goods.

The incidence of poverty (using the comparable poverty line based on the minimum food basket and allowances for essential non-food spending) in Armenia 1996-1999 remained at around 55 percent of the estimated total population of 3.1 million. However the number of very poor persons (in households where consumption falls below the cost of the minimum food basket) fell. An average poor person in 1996 had consumption 40 percent below the poverty line and by 1999 s/he found him/herself still 34 percent below the poverty line. Though nearly all groups of poor shared in this small improvement, the largest gains were recorded for urban dwellers and the rural population who resided in the most productive agricultural areas. The two socio-economic groups who benefited most from the small reduction in poverty were: (1) full-time wage employees (whose risk of being very poor dropped from 25 to 15 percent), and (2) self-employed (20 percent of them were very poor in 1996, by 1999 this share declined to 12 percent). On the other hand, for the unemployed and economically inactive, the risk and severity of poverty remained unchanged or slightly worsened (World Bank 2001, p.18-19).

Typically microcredit service providers specifically target the economically active poor, and this is true for the Armenian microcredit programs of MDF-Kamurj, FINCA, and AREGAK/UMCOR. Though the Assessment Team could not find any baseline and/or impact data to confirm a correlation, it is interesting to note nonetheless that the reduction in poverty among the self-employed poor in urban populations occurred during the time when these three programs became fully operational and began building their client base.

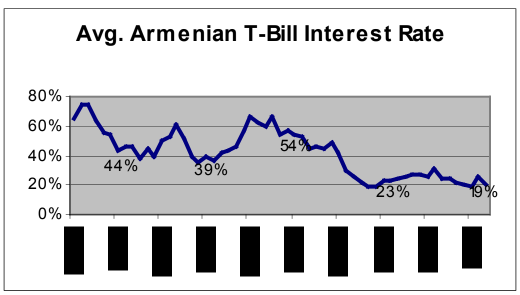
Maternal mortality climbed nearly 70 percent between 1991 and 1997, and abortion rates increased from 325 per 1,000 live births in 1990 to 660 per 1,000 in 1996. A recent World Bank report suggests that Armenia's poor typically experience periods of malnutrition, have insufficient heating in winter, and have less access to health and educational services than before the fall of the Soviet Union.[11] The decline in social services is a major concern affecting people's health and the education of their children. Many of the population perceive a steady decline both in the quality of education and health services, and their availability. [12]

2.2 Macroeconomic and Sectoral Policies

2.2.1 Macroeconomic Policies

In 1998, as part of the global crisis in emerging markets, the Armenia Treasury Bill (T-bill) market came under serious pressures due to a massive withdrawal of foreign investors, including Russian banks. The share of non-residents among T-bill holders fell from 50 percent to 8 percent during 1998-1999. Despite this drastic decline in total T-bill demand, the Government decided to maintain the overall volume of investment and as a result, local holdings of T-bills increased by 9 billion AMD ($17.8 million) or by more than 80 percent.(World Bank 2001, p.11). This increase equaled approximately one percent of GDP. This expansion of local T-bill holdings was possible only by maintaining high interest rates. Moreover, high T-bill yields pushed up other interest rates in the economy and restrained private sector borrowing (World Bank 2001, p. 11).

Chart 2.1: Treasury Bill Interest Rate



Source: Armenia Economic Trends, 3rd Qtr 2001, www.economic-trends.org.

While T-Bill interest rates dropped more than 30 percent from January 1999 to January 2000 (Chart 2.1), the average interest rates on bank loans were reduced but remained high (Table 2.4). The notable exception is the apparent low interest rate on donor-funded credit lines. However, the cost of this capital is not what it seems as it is reported that banks charge various informal fees. Thus, most subsidies intended for the final borrower are in fact captured by the commercial banks themselves (World Bank 2001, p. 81).

[11] USAID 2001 Report to Congress, p 2.
[12] World Bank 2001 Country Assistance Strategy for Armenia.
[13] As an example, John Sax of the Small Enterprise Fund reported to the Assessment Team that he heard some banks would only approve business plans (required to access certain donor-funded credit lines) that were written with the assistance of a certain party.

Table 2.4: Average Interest Rates for Various Types of Loans, (per annum)

	1998	1999	2000
Interest on loans in AMD:			
- Households and individual borrowers	54.6 %	33.9 %	30.7 %
- Legal entities	44.0 %	35.1 %	36.9 %
Interest on loans in US$			
- Households and individual borrowers	47.5 %	47.2 %	35.3 %
- Legal entities	38.0 %	35.3 %	29.4 %
Interest rates under credit lines	12-18 %	12-18 %	12-18 %

Source: Central Bank of Armenia (World Bank 2001, p. 82).

2.2.2 Agricultural Policies

Over the last 10 years, the agricultural sector played an increasingly important role in the economy and currently accounts for roughly 35 percent of Armenia's GDP. As noted earlier, agriculture absorbed considerable numbers of laid-off employees from other sectors. Armenia is still a large net importer of food (more than 30 percent of food consumption is imported) so additional import substitution could serve as a source of further growth in both food processing and agriculture (World Bank 2001, p. 171). However the quality and quantity of farmland is not a source of Armenian comparative advantage. Agricultural land makes up only 1.3 million ha (43 percent of the territory). With about 0.4 ha of agricultural land per inhabitant, the agricultural resource base of Armenia is among the lowest in Europe (World Bank 2001, p. 175).

The Government of Armenia has been pursuing a liberal agricultural policy since the early 1990s. Most subsidies were abolished, while agricultural food prices were liberalized. The country also adopted a liberal import policy on agriculture with duties of 0-10 percent. The major remaining support measures to local producers include VAT and land tax exemptions, subsidies for irrigation water and seed loans. In 2000, government support to the agriculture sector was minimal – about 1.6 percent of GDP not including tax exemptions (World Bank 2001, p 171).

Armenian agriculture was privatized in 1991-1992, when one third of all agricultural land and 70 percent of arable land were transferred to family farms and the Soviet-style collectives were disbanded. The private sector now accounts for 98.5 percent of agricultural production while in 1990 it contributed only 35 percent. There is a regulatory and institutional framework that allows land to be used as collateral; however, the lack of a rural real estate market and the reluctance of Armenians to purchase their neighbor’s land at foreclosure effectively prevent farmland from being used as collateral.

Agriculture’s share of GDP gradually grew as a result of privatization from 15.8 percent of GDP in 1990 to 26.2 percent in 1999 (World Bank 2001, p.171). However, despite an almost 12 percent growth in output from 1995-1999, real farm incomes declined by 40.3 percent (when deflated with CPI) due to increases in the number of agricultural employees and depressed prices (World Bank 2001, p. 174).

Traditionally, Armenia has been a net importer of food and agricultural products, mainly livestock and cereals. Although the transportation blockade of Armenia by Turkey and Azerbaijan provides a certain level of import protection, it also increases transaction costs for exports. While food export increased somewhat after 1996, in 1999 it still remained less than one percent of GDP. However, between January 2000 and September 2001, the share of processed foods in total exports increased from 7.7 percent to 14.8 percent ($3.82 million) (World Bank 2001, p. 173).

2.2.3 Financial Policies

Bank Regulation. The Central Bank of Armenia (CBA) is responsible for regulating Armenia's banking system. It is perhaps one of the most professional public institutions in the country partly due to its policy of paying considerably higher salaries to its employees than the rest of the economy. This policy has ensured lower turnover than that experienced in most other public sector agencies (PwC 2000, p. 44).

All banks are subject to CBA regulations, including: (1) minimum capital; (2) capital adequacy requirements; (3) liquidity requirements; (4) credit exposure limits that apply to insiders and the larger borrowers; (5) provisioning; and (6) foreign reserves management. While the norms are to apply equally to all banks (other than an exception regarding the minimum capital requirement), the CBA is authorized to set stricter economic norms for a bank if (a) the CAMEL rating of such bank is below the level set by the CBA, (b) the financial indicators of the bank have deteriorated, or (c) the bank functions in highly risky sectors. It must be noted that the Civil Code provides that the interest rate on a loan may not exceed two times the accounting rate of bank interest established by the CBA (Lyman 2001, p. 17).[14]

CBA maintains a liberal policy toward the granting of bank licenses (with no limits on foreign shareholding). On May 31, 2001, the CBA raised the minimum capital requirement of banks from $1.5 million to $5 million. Existing banks have until January 1, 2005, to meet the new requirement. The Law on Banks and Banking (LoB) authorizes the CBA to set a different minimum capital requirement that would apply only to newly established banks but not more than once a year (Lyman 2001, p.17).

Most of the 29 banks operating in Armenia at the end of September 2001 are small, with the three largest accounting for 35 percent of total bank assets in mid-2000, and the largest 10 banks accounting for about 75 percent. In June 1995, the 35 percent limit on foreign ownership of banks was removed. Twelve banks are either fully owned subsidiaries of foreign banks or have foreign controlling interests (World Bank 2001, p. 79). Savings Bank, the only state-owned bank, was recently privatized.

Of the 29 banks, most will have difficulty to meet the $5 million minimum capitalization requirement by 2005. Banks that do not will be closed or face a forced change in their status. During the third quarter of 2001, the total capital of the banking sector decreased by 15.5 percent and ended the period at AMD 19.6 billion ($31.5 million). The principal cause of this capital reduction is due to losses suffered by banks that, in some cases, are in the process of bankruptcy or liquidation. As of the beginning of the third quarter of 2001, the total losses suffered in the

[14] While this did not appear to present a problem for the MFIs currently operating in Armenia (i.e., they can achieve sustainability given the current maximum rate), it is possible that a government dictated maximum interest rate may present a problem in the future.

banking sector (attributed to 14 banks) was AMD 18 billion ($30 million).[15] United Bank incurred the largest losses, accounting for 53.2 percent of the AMD 18 billion ($30 million). In 2001, Armenian banks realized 18 percent of their revenue from the sale of repossessed assets while more than 50 percent of expenses were for loan losses, both indicators of the level of risk in bank lending portfolios. The table below shows how bank revenues and expenses were distributed over the third quarter of 2001[16]:

Total for all Banks:	**% of Total Income Earned**
Income:	
- Interest income	64.7%
- Non-interest income	17.3%
- Repossessed assets	18.0%
Expense:	
- Loan loss provision	50.7%
- Interest	21.7%
- Non-interest expense	21.7%

In discussing the new minimum capital requirements that banks must comply with by January 1, 2005, Mr. Vache Gabrielyan, a Council member of the CBA, underscored the importance of averting the bankruptcy of banks (some of which are solvent and financially stable) that will not be able to meet the new requirements. While he seemed to believe averting a crisis in the banking sector could be accomplished through the establishment of a new form of non-bank financial institution (NBFI), he expressed a firm belief that the CBA would and should only regulate and supervise depository institutions (Lyman 2001, p.19).

Mr. Wayne Fralin, Senior Advisor for the USAID CBA Bank Supervision project, believes that the CBA will focus on three areas in the near future: deposit insurance (which will be mandatory for all banks),[17] the establishment of a credit rating agency, and the development of a new legal form for non-bank financial institutions (Lyman 2001, p.20).

Bank Credits. The banking sector requires further deepening if it is to meet the savings and credit needs of businesses and households. A singularly important impediment to the development of Armenia's financial sector and improving access to financial capital is the low level of domestic savings. Further, a government deficit absorbs what little deposits there are in the banking system and generates high interest rates. Over the last four years, the government's fiscal deficit after foreign grants was 5-6 percent of GDP. A significant portion of the deficit was financed b issuing Treasury Bills. As previously noted, when developing market investment declined in 1998, the government competed with its private sector for financing.

A recent review of Armenia's financial sector – conducted by the World Bank – pointed out several factors that hinder improvements in both mobilization of financial savings and efficiency of financial intermediation (World Bank 2001, p.83). These were summarized as follows:

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[15] Armenia Economic Trends, 3rd Qtr 2001, www.economic-trends.org .
[16] CBA Quarterly report, 3rd quarter, 2001 (in Armenian).
[17] The most recent amendments to the LoCB include provisions for the establishment of a deposit insurance fund to be established and maintained by the CBA. According to the LoCB, payments of insurance premiums (to be specified by the CBA) are to commence on July 1, 2003; reimbursement of insured amounts (in accordance with the law and regulations adopted by the CBA) shall commence July 1, 2005.

- High incidence of informal activities reduces the share of total savings available for the formal financial sector.
- Small Armenian banks have higher cost of operations, which drive up lending rates.
- Public sector borrowing through Treasury Bills has driven up market interest rates.
- Limited presence of leading international financial institutions and non-sophistication of local banks result in limited financial instruments available for domestic investors.

Between 1997 and 1999 there was an overall expansion in outstanding enterprise credit, however this was derived exclusively from increased disbursements under donor-funded credit lines. It should be noted that small, newly established firms and borrowers without collateral are often ineligible for these loans.

Table 2.5: Enterprise Sector Credits by Funding Source

Table 2.5: Enterprise Sector Credits by Funding Source						
Monetary Indicator	**1997 (millions)**		**1998 (millions)**		**1999 (millions)**	
	AMD	**US$**	**AMD**	**US$**	**AMD**	**US$**
Credits to the enterprise sector funded by	35,560	$ 72.5	41,059	$ 81.3	41,558	$ 77.6
Credits to the enterprise sector funded	2,000	$ 4	4,769	$ 9.4	10,132	$ 18.9
Share of total enterprise credits, %	**5.3%**		**10.4%**		**19.6%**	
Total credits to the enterprise sector	37,560	$ 76.5	45,828	$ 90.8	51,690	$ 96.6
Source: World Bank 2001, p. 80.						

Despite an overall increase of enterprise credits, a July 2000 SME sector assessment commissioned by USAID concluded that Armenian MEs lack easy access to affordable financing. According to the study, local banks lacked experience lending to private enterprises based on criteria such as business plan analyses, cash flow projections, and market projections. They do not disburse loan funds fast enough and they do not operate lines of credit. Instead, Armenian banks tend to employ their own funds in mostly short-term and highly collateralized lending (sometime up to 300 percent of the loan). These terms make borrowing by smaller businesses without collateral difficult, forcing them to borrow from friends and family, or use a moneylender who charges excessively high interest rates (PwC 2000, p. 17).

The current conditions of the Armenian financial sector create what the World Bank describes as "low-level equilibrium trap" where the following adverse factors have a mutually reinforcing negative impact on Armenia's development prospects (World Bank 2001, p.83):

- More funding is potentially available in the form of credit lines than is actually used due to demand constraints (low quality of business plans, low transparency of borrowers, not properly registered property, etc…).
- Bank financing seems excessively expensive in light of low inflation, stable exchange rate, and Treasury Bill rates.
- Weak judicial protection of lenders' rights and unresolved property rights issues (e.g. for urban land) that limit the scope of potential collateral able to be pledged.
- Low "recycling" of funds due to informality and the confidence crisis and a low share of funds channeled by banks to the formal sector returns back as private sector deposits.

There were some encouraging signs of declining interest rates on credits in the third quarter 2001. The average interest rates on loans extended in Drams were 22.4 percent whereas interest paid on deposits was 15.6 percent. While the average interest rate on deposits in U.S. dollars stayed more or less constant during the last quarter, the average interest rate on dollar loans over the last quarter decreased by 2.3 percent to 15.9 percent per annum. It should be noted that more than 70 percent of both time and demand deposits in Armenian banks are denominated in USD while 80-85 percent of all loans are in dollars. [18] Given limited exports, few borrowers have access to hard currency proceeds, except through foreign remittances. This situation presents a risk for the entire banking system should exchange rates become less stable.

2.3 The Legal Framework, Regulation, and Supervision Issues

The lack of a framework for pledging land or other assets as collateral for loans serves as another barrier to bank finance. While the Civil Code provides the essential legal framework for commercial transactions, other essential laws that would assure surety in property rights and commercial transactions are not yet in place or enforced. Further, although much agricultural land was privatized, as were most apartments, registration of property title is just now starting, as is a system for registering mortgages and other pledges of property. A clear system with well-defined procedures to foreclose on pledged properties, and an active land market that allows for reasonable estimation of the value of pledged land and ready liquidation of pledged assets is needed. Without this, banks will continue be reluctant to lend their own funds against property (PwC 2000, p.22).

2.4 Overview of Microfinance Market Development

Currently, MF in Armenia consists primarily of lending activities, although there are a few banking institutions that offer depository and other financial services to microentrepreneurs. Armenian microcredit service providers derive their loan capital from funds borrowed or granted by their parent organizations or donors, or in the case of commercial banks, via mobilizing savings.
Armenian MF programs operate in the following ways:

1. Project-based lending – either directly or through partner banks – conducted by representative offices of both foreign NGOs and international organizations,
2. Lending by locally registered Armenian foundations using funds borrowed or granted by their parent organizations and by donors,
3. Direct lending by an Limited Liability Company (LLC), and
4. Lending and deposit-taking by banks (including the one existing cooperative bank, ACBA) using funds made available by donor organizations.

It is popular to refer to MF service providers as “institutions” or MFIs. However this overlooks the fact that many of them operate as MF projects within international multi-sector development agencies, frequently NGOs. In this case, the MF program is not within a “Microfinance Institution” but rather within an aid agency (domestic or INGO) that specializes in managing development projects. This distinction is important to note when examining the capacity of the

[18] Armenia Economic Trends, 3rd Qtr 2001, www.economic-trends.org .

organization to respond to market forces and when evaluating the institutional capacity and MF program performance.

All of the MF programs and institutions looked at by the assessment team appear to be functioning within the existing legal and regulatory framework, although most fall under bilateral agreements and therefore are shielded from excessive or intrusive government interference. However, it is likely that the current framework will shift in the near future given the many governmental and non-governmental parties, including lenders and donors, expressed interest in either (i) clarifying the "situation" for MF or for agricultural lending or (ii) addressing the looming issue of the existing banks that are expected not to be able to meet the new minimum capital requirements effective January 1, 2005 (Lyman 2001, p. i).

OXFAM established the first microcredit program in Armenia in 1995. Since then, several others have been created to address the credit needs of MEs. These credit initiatives started mainly with bilateral donor funds channeled through several international non-governmental organizations (INGOs) that were used to capitalize loan funds and subsidize operations. Table 2.8 later in this section provides a summary of programs providing microcredit (and other services) to MEs. Each of the programs is described briefly below; however, AREGAK, FINCA, and MDF-Kamurj programs are described in more detail in Section 4.

2.4.1 Agricultural Cooperative Bank of Armenia

The Agricultural Cooperative Bank of Armenia (ACBA) was established with the help of the European Union through a TACIS program initiative begun in 1993-1994 with a feasibility study followed by a pilot project from September 1994 to December 1995 in three regions (Shirak, Armavir, and Ararat). ACBA received its full banking license on March 29, 1996.

ACBA, the only cooperative bank in Armenia, is modeled on Credit Agricole (France). It has received technical assistance from Crédit Agricole Consultants in cooperation with RIAS (Netherlands) and AG – Agroprogress (Germany). Today it operates in ten marzes (regions) and reaches 500 of Armenia's 800 villages covering 70-80 percent of Armenia's agricultural regions. Its three-level institutional structure starts with Agricultural Cooperative Village Associations (ACVA) comprised of farmer-members. ACVAs elect administrative boards that run day-to-day operations including approval of loan applications. ACVAs are grouped into five Agricultural Cooperative Regional Unions that are the shareholders of ACBA. ACBA's General Assembly is the third level, and the executive body of the Bank. It develops the overall strategy of the Bank, which is implemented by the Bank's Observers Board and elected by the General Assembly. The Board of Directors, headed by the General Manager, manages the current operations.

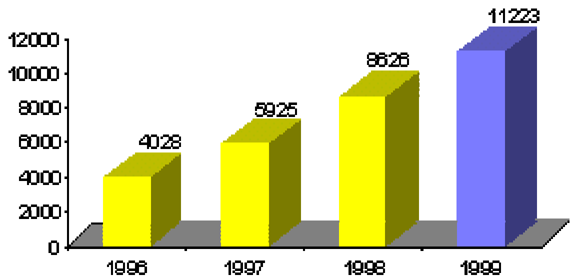
Although the bulk of ACBA's loans are for agricultural credit (90 percent in 1999), over the years, it diversified both its client base and the type of loans offered. Prior to 1999, 99 percent of ACBA's loans were for less than $5,000—typically agriculture loans (in ADM) for less than $2,000 with terms of less than or equal to 18 months. However in 1999, this percentage shrank to 94 percent due to two developments. In 1999 Gold Pledge loans for able-bodied persons were initiated with a duration of one year and an interest rate of 33-36 percent. Also, in 1999 with the

[19] Bilateral agreements cover the microcredit operations of such INGOs as UMCOR, FINCA, and Oxfam.

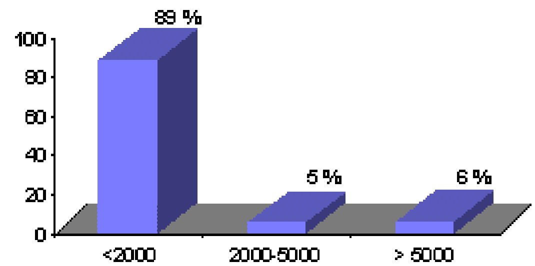
assistance of the German-Armenian Fund (GAF), ACBA started to lend to businesses in the greater urban Yerevan area through its "Micro and Small Business Financing Program." This program targets private enterprises with 50 employees or fewer that are engaged in trade, production or service activities. Loans are denominated in Dram, extend for up to 18 months and carry an annual nominal interest rate of 34 percent. [20]

Thanks to considerable donor assistance and a ready market for its products, ACBA's growth has been rapid since it opened for business. The charts below show a snap shot of its growth and portfolio during its first three years of operations.

Graph 2.2: Total Number of Members of the Agricultural Cooperative Village Associations



Graph 2.3: Distribution of Loans in 1999 (US$)



Source: ACBA, http://www.acba.am/

Besides the technical assistance and funding it received from the European Union and TACIS, ACBA benefited from the receipt of the following funds for on-lending: in 1997, $1,850,000 in assistance from the World Bank for agriculture loans; in 1998, $2,200,000 from the International Fund for Agricultural Development (IFAD) for agriculture loans; and in 1999, $2,600,000 from the German Armenian Fund for SME lending.

ACBA reported excellent results for the year ending December 2001. Its profit, exceeding the previous year by 2.6 times, reached AMD 450 million ($724,000) on loan funds of approximately $10 million. At the end of the third quarter 2001, its total assets were AMD 9.49 billion ($15.3 million) compared to AMD 6.56 billion ($10.6 million) at the start of the year. These results rank ACBA second in the country on the basis of its total capital ($6.7 million) and in the top ten on the basis of its total assets.

ACBA reported that its microcredit portfolio can be divided as follows: it has made about $624 million in loans to 13,000 borrowers who have loans ranging from $100 to $10,000 each, for an average loan size of $480; and it has made about $2.6 million in loans to 309 borrowers in the $10,000 to $60,000 range, with an average loan size of $8,414. Approximately 80 percent of its clients are rural, 20 percent urban. Average loan term is 7-8 months. Recent interest rates were 24-30 percent for ADM denominated loans and 16-20 percent on US$ loans.

[20] ACBA Internet web site: www.acba.am .

2.4.2.Ecumenical Church Loan Fund

Ecumenical Church Loan Fund International (ECLOF) is a church-based organization that makes loans to churches or institutions that promote the life of the church in cases where other affordable credit sources are unavailable. The loans are designed to foster human development in general and, in particular, to promote socioeconomic justice and self-reliance for alleviation of poverty. ECLOF operates in numerous countries around the world through National ECLOF Committees (NECs) that take responsibility for developing appropriate national strategies and determining priorities in accordance with policies and guidelines as defined by the ECLOF board of directors. Based on portfolio performance over time and adherence to ECLOF lending principles and policies, NECs can acquire increasingly higher levels of lending authority up to a maximum of US$ 40,000 per loan, without ratification by ECLOF staff or loan subcommittee of the ECLOF board.

In Armenia, ECLOF started its lending program in 1998 to provide small loans to the self-employed poor following a group lending methodology. It also provides limited technical assistance to loan clients.

2.4.3 IOM/UNDP

The International Organization for Migration (IOM, part of the UN system) started its lending assistance program in 1997 with funding from UNDP and seeks to assist refugees through the provision of credit. It targets refugees by either making loans to businesses owned by them or businesses that employ them. IOM provides loan capital and technical assistance through three Armenian banks and reports 650 active borrowers with an outstanding loan portfolio of about $300,000. Individual loans are made at effective interest rates varying from 24-36 percent per annum (declining balance) and monthly repayments of principal and interest. Loan maturity for individual loans is one year and 6-9 months for group loans. Group loans of $100-$1,000 per member are repaid weekly with an effective interest rate of 36 percent. Clients live in the Yerevan area and Kapan.

2.4.4 Small Enterprise Fund

The Small Enterprise Fund (SEF) started as a project named Armenia Small Business Development Project initiated by World Vision Armenia in 1995. Since its start, it received funding from USAID under an umbrella grant to Save the Children and also funds provided by the Lincy Foundation, GTZ and its parent World Vision, USA and World Vision, Austria. SEF also benefited from a $200,000 grant from USAID through Shorebank Advisory Services (SAS). In 1998, SEF officially registered as an Armenian Limited Liability Company (for profit) that is wholly owned by World Vision. SEF's board is made up of World Vision employees within and outside of Armenia.

SEF shared with the Assessment Team its portfolio and financial statements (profit/loss, balance sheet, portfolio aging, portfolio indicator and impact statements) for the period ending September 30, 2001. All of SEF's statements were presented in MF best-practice format and the data within corresponded with information shared separately in meetings. SAS's technical assistance to SEF on these key management reports speaks for itself. The statements showed SEF had 626 active loans (310 individual loans, 316 group) 132 of which were to women. Outstanding portfolio value was $485,244 ($406,622 current; $28,000 at risk [16 loans]; and $50,341 restructured [18 loans]). For the month ending September 30, 2001 operational self-sufficiency was reported at 182 percent and financial self-sufficiency at 181 percent. However for the year-to-date period it was 69 percent and 67 percent respectively.

SEF follows a group and individual lending methodology. Apart from agriculture group loans, other loans are divided between clients in services (12 percent), commerce (63 percent) and manufacturing (25 percent). Loan sizes range from $500 to $10,000 with subsequent loans increasing if repayment is 100 percent. Primary areas of lending activity are greater Yerevan and Syunik marz. Typical loan products are found below:

Table 2.6: SEF's Loan Products

Loan type / location	Repayment terms over 3-18 months (typical)	Collateral	1st loan max amount	Subsequent loans (max amount)*	Fees (paid up-front)	Interest rate (declining balance)
SME (individual)	Equal principal and interest pmts	Real estate @ 120% of loan	$3,000	$10,000	6%	42%
Gold (Lombard lending) individual	Balloon principal pmt	Gold or jewelry @100% of loan	$2,000	$2,000	$5-$10 per loan	24%
Agriculture (group loan)	Balloon principal pmt	Animals, farm equipment	$5,000 ($300-500 per person)	$10,000	0	24%
Agricultural lending groups range from 10-20 members; SME borrowers may apply for a credit line. SME Loan applicants submit cash flows, SWOT analysis of business and site visits conducted.						

Despite SEF's relatively small loan portfolio, it seems to be a strong institution possessing good control of its operations and financial management as evidenced by the financial reports and operating manuals and procedures it shared with us. Given its lineage and current owners (World Vision), it would like to make loans to marginalized businesses but it needs to watch its portfolio-at-risk to be sure that it does not grow larger than it is at present. SEF's inability to raise loan capital through the mobilization of savings would put its sustainability at risk if it had to write off a significant portion of its loan portfolio as it is just recently able to cover its operating costs. For this reason, it needs to identify ways to increase its loan capital, perhaps through soft loans. SEF could benefit from assistance in determining the risk profile of its clients in order to plan new products or potential growth areas as well as to set its interest rate and fee structure to closely reflect the anticipated loan risk.

2.4.5 OXFAM

OXFAM started its support program to Armenian micro and small businesses in 1995 and works through 2 local Armenian NGO partners: HASK-96 and Kapan Entrepreneurship Support Center. The project is funded by the Netherlands Organization for International Development (NOVIB) that is part of OXFAM International, a union of NGOs that comprises eleven organizations from Great Britain, Belgium, the United States, Canada, Hong Kong, Australia, New Zealand, Spain and Ireland. NOVIB funds projects that support environment, gender, human rights, and institutional development of NGOs with an emphasis on rural development programs. Current funding by NOVIB is $300,000 for the period 2000 – 2002 with the possibility of an extension based on performance.

The Armenian project focuses on providing business training and loans to refugees, or businesses that employ or assist refugees. The methodology is group lending using solidarity guarantees in the areas of Gavar, Vanadzor, Dilijan, Bagramyan, Kapan, and Yerevan. The current portfolio has 1,209 loans (59 percent women) with $679,000 outstanding and an average loan size of $561. MDF, FINCA , AREGAK/UMCOR and OXFAM compete for clients where each is present.[21]

2.4.6 Shen/Aniv

Shen/Aniv is a locally registered Armenian NGO that started a small loan program with the assistance of IFAD. The loan program is a follow-on project started in 2000 to assist micro or small agricultural income generating businesses in rural areas. The original project, also funded by IFAD, was to assist the same target group with social and community development technical assistance.

2.4.7 World Council of Churches

World Council of Churches (WCC) is a church-based organization with headquarters in Geneva, Switzerland. In 1997, WCC started a small-scale assistance program with the goal of reducing poverty in the Echmiadzin area of Armenia.

2.4.8 Shorebank Advisory Services

The Shorebank Advisory Services (SAS) operates to fill what it sees as a gap between the upper limits of micro loans of $1,000 and commercial banks offering loans of $10,000 and more. SAS received funding from USAID to provide financial resources and technical assistance to partner financial institutions and enterprises in the Caucasus region (Armenia, Azerbaijan, Georgia). To gain a broad range of experience with different approaches, SAS executes the program both in conjunction with partner institutions as well as directly through its own country offices. In every case, SAS provides technical assistance and training to local staff.

SAS works in Armenia through the Small Enterprise Fund LLC, FINCA (with which it also works with in Georgia and Azerbaijan), INECOBANK, Armenian Development Bank. SAS recently added MDF-Kamurj to its partner list. SAS has two lending products in Armenia: the Developing Enterprise Loan (DEL) and the Small and Medium-Sized Enterprise (SME) loan. The DELs amount to US$1-12,000 (average loan amount is US$4,500) and the SME loans to US$10,000-75,000 (average loan amount US$40,000). Terms are from three to 24 months. Interest rates on US$ loans vary by institution but are maximum 21 percent per annum for SME loans and 48 percent for the DEL Program. Repayments are monthly and grace periods may be granted when deemed appropriate. Loans must be used for business purposes and collateral may be required. Sectors to which the SME or DEL loans are made are as follows: production, 34 percent; services, 31 percent; and trade, 35 percent.

[21] Information taken from survey completed and returned by Oxfam to Assessment Team.

2.4.9 United States Department of Agriculture (USDA)

The Assessment Team visited the Yerevan offices of USDA to learn more about their activities in Armenia, particularly with regards to their credit program for micro and SME. Besides information gathered in the interview, USDA shared an excerpt concerning its Credit Team Activities from the 6-month report on its Marketing Assistance Project (MAP) for the period Jan-June, 2001. In addition, we also received descriptions of USDA's Production Credit Clubs (PCC). The following description of USDA's activities derives from these sources with the quotes taken from the June 2001 report. USDA Armenia has three credit programs that fall under its MAP: (1) Strategic Loan Portfolio, (2) Production Credit Clubs, and (3) Leasing. Each is described below.

Strategic Loan Portfolio. As part of the USDA's Marketing Assistance Project (MAP), the USDA credit team provides strategic cash or in-kind loans to agriculture clients receiving USDA technical and/or marketing assistance. Loans are disbursed and repaid into USDA accounts at Armenian banks. As of June 2001, the Strategic Loan Portfolio value was said to be $3.6 million. USDA reports: "About one-third of the portfolio is non-performing, i.e. borrowers are not repaying on a timely basis." A closer analysis indicates the Strategic Portfolio value includes loans to enterprises that no longer operate and others that have not made payments since 1998; it also includes numerous rescheduled loans. It was reported that the average loan size as of June 2001 was $42,000, which would put the number of loans at about 86. However, the mean average is skewed toward the high side as loans to canneries average $318,000.

In USDA's own words, its Strategic Loan Portfolio is not diversified as it includes "very large, risky loans with three canneries." Apparently the risk of non-payment is very real as multiple loans to New Wave and Sardarapat canneries totaled nearly $750,000 and these loans, as well USDA loans to the MAP cannery (no loan amounts given), were "non-performing." In the case of the MAP cannery, as of June 2001 USDA received no repayments on an in-kind loan for bottles valued at $240,538.

MAP's Strategic Loan Portfolio also includes in-kind loans. Regarding these, a USDA review in early 2001 concluded that "Some very large in-kind loans made in 1999 and 2000 had been implemented without proper loan agreements and consequently had confusing repayment schedules or no repayment schedule at all." One USDA MAP employee is assigned the responsibility to both procure the in-kind materials for the borrowers as well as to monitor in-kind loans.

Although the USDA uses banks as cashier windows for loan disbursements and repayments, the USDA makes the lending decision and bears all the risk of the loan. It recently found that this risk extends beyond the borrower. In USDA's June 2001 report, it reported that two banks that it used to make Strategic Loans in the past were either in bankruptcy (Shirakinvest Bank, Gumri 1999) or CBA receivership (LEND Bank, Yerevan 2001).

MAP also makes Micro-Enterprise Loans directly to businesses to which it provides technical assistance and marketing support. The loans are not channeled through servicing banks "due to their small size and the often inadequate collateral of borrowers." As of January 2002, there were about 50 Micro Enterprise Loans of less than $10,000 and many of which were less than $1,000. No specific policy on the setting of interest rates and fees for Strategic Loans was provided. However, it was noted that some past loans were interest free and it was stated that in the opinion of USDA's director, it was unrealistic to expect Armenian farmers to pay market interest rates on loans.

Production Credit Clubs. USDA subsidizes the formation of Production Credit Clubs (PCCs) each of which is generally composed of seven to 15 individual member-farmers. The PCC receives access to a line of credit, equal to approximately $900, multiplied by the number of PCC members, which USDA puts on deposit at a local bank, either Agrobank or Ardshinbank. Club members can access the credit line by preparing loan applications that are reviewed by the PCC membership who act as a loan committee. USDA encourages loans to be for not more than one year and for such working capital requirements as the purchase of input production supplies or services such as labor. If the loan is approved, 10 percent of the principal amount is withheld and deposited into a "refundable club membership account" and 5 percent of the principal is withheld and deposited into an "interest earnings account." The remaining amount of loan principal (85 percent) is disbursed to the borrower to be repaid interest-free into USDA's bank account. The local bank charges USDA a 0.5 - 1 percent processing fee on the credit line that is not covered by the beneficiaries.

After one year of operation, the PCC is to hold an annual meeting at which time the interest earning account is distributed equally to each member providing all loans are current. Members who wish to withdraw may do so and receive whatever money they contributed to the "refundable club membership account," provided that they are not in arrears on any loans received.

At mid-year 2001, USDA reported that it considers the "PCCs one of the most successful MAP programs." Details of the PCC portfolio through June 2001 can be found in Appendix 5 and a summary is provided in the table below:

Table 2.7: USDA's PCC Performance Indicators

Year PCC formed	# PCCs		# Members		Portfolio Value (US$)	
	Rescheduled	Performing or New	Rescheduled	Performing or New	Rescheduled	Performing or New
1998	-	1	-	15	-	$8,900
1999	5	4	106	71	$79,758	$53,136
2000	4	8	73	98	$51,317	$122,165
2001	-	6 (new)	-	82 (new)	-	$87,239
2001	2 PCCs closed					
Subtotal	9	19	179	266	$131,075	$271,440
Total	28		445		$402,515	
% Of total	32%	68%	40%	60%	33%	67%

Source: USDA June 2001 MAP Report.

Observations concerning the true health of the PCC portfolio based on the data above, are that two PCCs were closed in 2001 and 21 percent of the listed portfolio value is to new members who have been in the program less than 6 months. It is hoped that these new members do not have the same problems with loan repayments as their predecessors. If the 82 new members are removed from the current total of 445 members, the 179 members who have rescheduled would represent 49 percent of that amount.

As of January 1, 2002, there were 32 PCCs with 500 members. The USDA plans to add 6 to 8 new PCCs in 2002. It also plans to continue lobbying members of the Armenia Parliament to draft a special law to recognize the legal rights of the PCC to operate and to provide credit to its members.

Agro-Leasing, LLC. USDA's MAP created a private leasing company in 2000 to lease equipment to Armenian agriculture and agricultural processing businesses. Typical lease terms are for 3-5 years at 8 percent annual interest rates plus the cost of insurance which ranges from 3.5 percent p.a. for vehicles and 0.6-0.95 percent for other equipment. Through the first six months of 2001, USDA reports that 90 percent of the lease repayments were on time, considerably better than MAP's Strategic Loan Portfolio or PCC programs.

Analysis of USDA's Credit Programs. By any conventional measures of best-practice lending, the USDA credit programs score low. All credit is heavily subsidized with no attempt to provide financing at commercial rates or at rates that consider USDA's cost of credit delivery, even if the business may be willing and/or able to pay higher costs to have access to credit. Besides receiving subsidized cash and in-kind loans, businesses also receive substantial subsidies under the MAP in the form of free technical assistance and occasional grants.

Prior to 2001, the operational aspects of the MAP credit program showed lack of attention to basic details such as ensuring that loan documents were accurate and complete and that repayment schedules were respected. It is likely that this lack of rigor and professionalism in the lending operations gave the impression to borrowers that they were beneficiaries of a generous donor project instead of clients of a financial service provider. In an attempt to turn this around, MAP's credit program team undertook a special effort to work with delinquent borrowers, taking some to court for collection. In their own words, there was a concern at USDA that MAP's beneficiaries were "developing the attitude that you do not have to repay loans from assistance organizations."

The net value of MAP's Strategic Loan Portfolio (outstanding loans less loan loss provision) is far less then its reported value of $3.6 million through June 2001. As a donor project, conventional banking practices of developing portfolio aging reports, following written accounting policies of loan provisioning and write off, and generating separate portfolio reports for restructured loans were not followed. In fact, it is likely that USDA management lacked accurate or complete information on the Strategic Loan Portfolio status during much of the last four years. In the mid-year 2001 report, the chief accountant and members of the credit team were said to be completing work to enable USDA to "identify every individual loan, assigning separate loan accounts, and tracking additional key information" so that "the finance department will be able to provide accurate reports on loans."

While some may argue the merits of subsidized credit for equipment or certain extraordinary expenses, it is clearly not sustainable to provide highly subsidized loans for working capital claiming the borrower cannot afford commercial rates of credit unless the lender plans to provide that type of financing indefinitely. Despite claims to the contrary, the PCCs have not performed well as measured by the large extent of rescheduling of members' loans. While USDA believes that the PCCs would help small farmer-producers to provide inputs to larger MAP beneficiaries, if the larger beneficiaries are in financial difficulty, the PCC members that supply them will not be able to repay their loans either. Perhaps the best indicator that a better methodology exists with which to deliver credits to agriculture-related businesses is the Agro-Leasing LLC USDA helped to set up. Although it also is not operating sustainably by charging eight percent interest when close to 10 percent of its portfolio is at risk, it has a much better repayment performance than USDA's PCCs or its Strategic Loan Portfolio.

It is clear that USDA's credit activities distort the market for loans to agriculture-related producers in Armenia. For a population that is inexperienced with credit, there is also a risk that entrepreneurs will acquire bad habits pertaining to the use and risk of financial leverage in their businesses. In the opinion of this Assessment Team, it would be best if USDA's MAP stopped directly providing credits to businesses and instead provided financing through commercial lenders that would share lending risk with the USDA on loans to targeted businesses. In special cases, the USDA might consider grant funding to certain agri-business sectors provided that the grant recipients are selected following clear and transparent guidelines and that the grant does not cause a competitor not benefiting from a grant to be at an economic disadvantage (See Appendix 7 for USDA SWOT).

2.4.10 German Armenian Fund

The German Armenian Fund (GAF) was established in late 1998 by the Armenian and German governments based on an agreement on financial cooperation to support and promote SMEs. The Kreditanstalt fur Wiederaufbau (KfW) provides funds and designed the project that is implemented by Projekt Consult GmbH (IPC) with the Central Bank of Armenia (Armenian counterpart to the German Ministry for Economic Cooperation and Development (BMZ)). The Central Bank allocates the fund among commercial banks approved to participate in the program that includes the ACBA, Armekonombank, Bank Anelik, and Armagrobank. The fund totals DEM 14 million ($6.3 million) with an option to increase to a maximum DEM 24 million ($11 million).[22]

The GAF provides two loan products through participating banks: (1) Microloan Financing Program, and (2) Small Loan Financing Program. The Microloan program for enterprises employing up to 20 persons extends loans in drams up to AMD 5 million ($9,000). The Small Loan program is for enterprises employing up to 50 persons and offers loans in drams from AMD 5 million to 33 million ($9,000 to $60,000). Any type of business may request financing, provided it meets environmental requirements set by Armenian legislation and KfW and is not a gambling or speculation type of business.

The suggested interest rates are 18.96 percent to 30 percent pa for Microloans and 18.96 percent to 24 percent pa for Small Loans. However, the final rates are determined by the banks as they ultimately assume the risk of non-payment on loans; partner banks frequently add various processing fees that make the effective interest rate to the enterprise much higher. Repayment

[22] The GAF provided the Assessment Team with a Project Profile document to help with writing this section.

periods for both types of loans are up to 3 years with equal monthly repayments; grace periods are available only on an exceptional basis. All loans must be secured by collateral. The GAF program entails training of bank officers and provision of technical assistance aimed to strengthen the capacity of partner banks to lend profitably to micro and small enterprises. Special

GAF units have been established in the participating banks and on the job training of loan officers lasts one year. The partner banks are covering all their administrative costs related to the GAF operations.

While initially focused on the urban area of Yerevan, the GAF covers rural areas as well through its partnership with ACBA. Rural loans typically range from the equivalent of US$100 to US$5,000. The total GAF portfolio across all partner programs is distributed by loan amounts as follows: 73 percent loans less than US$5,000; 10 percent loans between US$5,000-10,000; nine percent loans between US$10,000-30,000 and eight percent loans over US$30,000.

2.4.11 Summary Matrix of Satisfied Demand for Microcredit

Table 2.8: Summary of Microcredit Programs and Satisfied Demand

Program Name (legal operating	Main Support (current and past)	Scale and Scope of Activities	
		Microcredit Indicators / Methodology	Non-Financial Assistance
AREGAK	UMCOR project	• Started lending in 1997	-Basic
FINCA	FINCA International	• Started lending 1999	No
MDF-Kamurj	Registered Armenian	• Merger of CRS and SAVE programs in Oct 2000	- Trade fairs
SEF (Armenian	World Vision owned	• WV's MED started in 1996 and SEF est. 1998	Business
OXFAM (works	OXFAM UK	• Started in 1995 – works with 2 local NGO	-Business
PCCs and	USDA	• PCC loans: avg. <$1k; 32 PCCs; 500 members;	Marketing and
IOM/UNDP	IOM	• Started in 1997 works through 3 banks	
Ecumenical	ECLOF International	• Started in 1998 to provide small-scale loans to	TA to
Shen-Aniv	Shen (a local NGO)	• From 2000, Aniv Rural Small Business Support	
World Council	Headquarters in	• Started in 1997 to reduce poverty in the	
Shorebank	SAS	• In Armenia, SAS funding channeled through	TA to local
German	KfW with technical	From 1999, soft loan funds provided by KfW are lent	
ACBA	Credit Agricole	• Registered as Cooperative Bank in 1996	Technical

2.4.12 Other Organizations Facilitating Credit to SMEs

European Bank for Reconstruction and Development (EBRD)

As of 30 June 2001, the EBRD had seven projects in Armenia totaling €144.1 million ($130 million). The projects included a variety of equity investments, soft loans for on-lending through banks, letters of credit to a financial institution and capacity building technical assistance.

In December 1999 under an existing multi-project framework facility with the Commercial Bank of Greece, EBRD signed a €1 million ($900,000) equity participation in International Commercial Bank Armenia (ICB), a start-up commercial bank with a full banking license.

The EBRD aims to develop and support Armenian financial institutions that can serve as intermediaries in financing SMEs. This strategy also focuses on the institutional strengthening of private banks. The approved Multi-bank Framework Facility of €10 million ($9 million) provides local private banks with equity capital or credit lines that broaden their capital base for on-lending to SMEs. EBRD's interest rate on the credit line to banks is LIBOR + 6 percent or 10-12 percent per year; the banks are free to set their own loan terms and conditions for on-lending. A €750,000 ($675,000) technical cooperation package is being provided for the administration of the facility, and for developing local commercial banks and their SME clients. Under this framework facility EBRD provided Armeconombank a US$ 1 million credit line to expand its SME loan portfolio (EBRD 2001)

The EBRD's role in the financial sector will include the establishment of a privately managed venture capital fund, aimed at providing currently unavailable capital in the form of direct investment in SMEs with growth potential. In March 2000, the Bank made its first investment in a private Armenian company, when it approved a loan of US$ 23.6 million to the Yerevan Brandy Company. Other proposals concerning industrial and manufacturing projects have been presented to the Bank, and cooperation with foreign partners is being explored. The chemical, electronics and pharmaceutical industries show promise.

Additional support to SMEs will be given through enhanced policy dialogue with the Government, aimed at improving the business climate in Armenia. The EBRD will support legislative measures intended to encourage and facilitate the creation of an improved legal environment for the conduct of commercial transactions, particularly those facilitating foreign direct investment. Further assistance will address the institutional strengthening of local banks.

At the time of this report it was rumored that EBRD and the German KfW were in the planning stages of developing an assistance package to one or more commercial banks that would encourage development of loan products targeting MEs. Unfortunately when contacted by the Assessment Team, the EBRD's Head of the Resident's office refused to discuss whatever plans EBRD might have in the works.

The Lincy Foundation Loan Program

The Lincy Foundation funds loans under a $100 million Entrepreneurial Lending Programme (ELP) that it hopes will create employment, alleviate poverty, and boost Armenia's economic development. The ELP started in July 1998 and runs for 6 years. Businesses with a minimum of 51 percent Armenian ownership and no more than 20 percent government owned may apply for a loan through one of 14 domestic banks. Loan sizes are from a minimum of $100,000 to a maximum of $1 million and according to ELP loan terms, they must not carry an interest rate that exceeds 15 percent, though banks are allowed to add processing fees and additional charges to the loans that increase the effective interest rate to the borrower.

One hundred percent of loan repayment risk is borne by the lending bank. However the ELP program provides liquidity to banks to make the loans by making interest free loans to the Central Bank of Armenia which then on-lends the funds to participating banks at a 3 percent interest rate. The implementing government agency within the Ministry of Finance and Economy established a commission whose role is to approve the participating banks. Based on the recommendation of the implementing agency, loan agreements are signed by the GoA, the CBA and the local banks.

The Izmirlian-Eurasia Foundation Small Business Loan Program
The Izmirlian Foundation is Eurasia Foundation's financial partner in a program to provide credit, with funding assistance from USAID, to Armenian SMEs. Borrowers may be in manufacturing, services, or agribusiness, but the business may not be involved in alcohol and tobacco production, gambling, activities deemed to be harmful to the environment or related to the military. Only 100 percent privately owned companies are eligible.

Qualified businesses submit loan applications to the program's local bank partners that include Anelik Bank, Armagrobank, Credit Service Bank, LendBank, and ShirakinvestBank. The Eurasia Foundation's credit committee reviews the loan application and makes the final decision since they are the lender of record on the loan contract. Processing time takes an average one and a half months. Loan sizes are in excess of $10,000.

2.4.13 Commercial Banks in Microcredit Lending

As described earlier, there are several donor-led programs that provide financing to micro and SME businesses in Armenia through local banks. However, many of these programs require the commercial bank to assume 100 percent of the lending risk. This leads banks to request, whenever possible, the maximum amount of collateral to secure the loan. In addition, they frequently add various processing fees that increase the effective interest rate paid by the borrower on the loan. As a result, any donor subsidies on these funds accrue to the benefit of the bank and not the final borrower – the Armenian business.

The SME sector study by Price Waterhouse Coopers reported that these circumstances have resulted in a great deal of frustration on the part of SMEs who feel their need for reasonably priced and accessible credit financing remains out of their reach despite a plethora of donor programs ostensibly targeting them. However, according to recent World Bank study quoted earlier (Table 2.5) donor funded credit lines were responsible for 19.6 percent of all enterprise credits in 1999, up from 5.3 percent in 1997. Nonetheless it is also true that donor credit lines are not fully utilized indicating that the supply of credit may be at terms that are unacceptable to the potential clients. High collateral requirements, high loan interest rates compared to the cost of funds and a scarcity of bankable projects has led to an under-utilization of available SME Credit at the commercial banks. Hence the term "low-level equilibrium trap" used by the World Bank to describe this financial sector condition seems apt. Because of the problems cited with Armenian commercial banks relating to the fact that many are small, weak, and undercapitalized making financing through credit lines difficult, non-bank financial institutions may offer the best means by which to finance micro and small enterprises.[23]

3 Estimated Demand for Microfinance

[23] Country Assistance Strategy 2001, p. 16, World Bank.

This section qualitatively and quantitatively analyzes the characteristics of demand for MF in Armenia. The analysis is divided into three parts. Sub-section 3.1 focuses on satisfied demand for MF (current supply) based on the most recent data available from the main MF providers on the breadth and depth of their activities. The potential demand for MF is estimated in sub-section 3.2 using two techniques to gauge how large the total market for MF is and what types of financial and non-financial services might be most helpful for microenterprise development. Sub-section 3.3 explores two sets of reasons why the (satisfied demand) current "supply" of microcredit does not equal (potential) "demand." The first set relates to the causes of market disequilibria to understand better why otherwise credit-worthy or "bankable projects" cannot get funded. The second set of reasons for depressed demand explain why MEs may not be seeking credit in the first place. As appropriate throughout this section, attention is paid to the particular MF-related issues facing women, the population still suffering from the effects of the 1988 earthquake, and those affected by the Nagorno-Karabakh dispute, including refugees and internally displaced people.[24]

As part of the examination of satisfied and potential demand, the Assessment Team carried out a survey of 30 current microcredit borrowers in Yerevan (covering Hayastan market, Hrazdan market, Malatsia market, Cinema Airarat, Metro Yeritasardakan, and Vernisage), Gyumri and Artashat. Respondents were chosen to obtain an approximately equal mix of borrowers across the agricultural (split evenly between animal husbandry and crop production), manufacturing, service, and trade sectors as well as an even split between newer borrowers (in their first or second credit cycles) and older clients (who have borrowed five times or more). Findings from this survey are included, as appropriate, in the following discussion on the nature of satisfied demand and potential demand for microcredit addressed in the next sub-section. Results from earlier surveys are included, where applicable, to augment the examination of demand.

3.1 Satisfied Demand (Current Supply)

Overemphasis on Credit. Analysis of satisfied demand for MF is simplified by the fact that Armenian MF providers generally provide only microcredit. With the exception of ACBA, no MF service providers mobilize substantive microsavings or other services such as money transfers or insurance. This is mainly due to the types of organizations active in microcredit and limitations on activities imposed by their legal status. The largest significant formal provider of MF is ACBA and as a commercial bank, ACBA is allowed to mobilize deposits. However, since no information was available to the Assessment Team concerning the number or amounts of accounts considered as microsavings, only information on its microlending is included in the analysis of satisfied demand. All other notable MF providers are semi-formal institutions with no legal ability to mobilize deposits or engage in other activities commonly provided by MFIs.[25]

Aggregate Numbers and Amounts of Microcredit and Main Suppliers. The Assessment Team estimates that the total amount of microcredit outstanding in Armenia that is supplied by formal or semi-formal institutions is about $11.5 million on about 34,000 loans. The single largest supplier of microcredit in Armenia is ACBA with an estimated 39 percent of the total

[24] These include a survey of almost 400 MEs in Yerevan conducted during July 2000 by students from the Institute of National Economy for Shorebank Advisory Services, a survey of 109 MEs in Yerevan by five FINCA credit officers during April 27-28, 1999, a survey of 20 MEs in Yerevan's Hrazdan Market surveyed by FINCA credit officers on March 23, 2000, a survey sponsored by Save the Children and carried out August 3-Sept.15, 1999 by a local consultant contracted to survey a representative sample of 389 women-only MEs in Syunik Marz, and a follow-up Save the Children survey conducted in Yerevan.
[25] An MFI is defined herein as an organization or a unit whose primary business is microfinance within a single or multi-purpose institution.

number of borrowers and 54 percent of the portfolio outstanding. As of December 31, 2001, ACBA had outstanding the equivalent of about $6.24 million for 13,000 microloans[26] (average loan size was about $480 for loans of <$10,000). These microcredits carried a nominal interest rate of 24-30 percent for ADM denominated loans and 16-20 percent on US$ loans.[27]

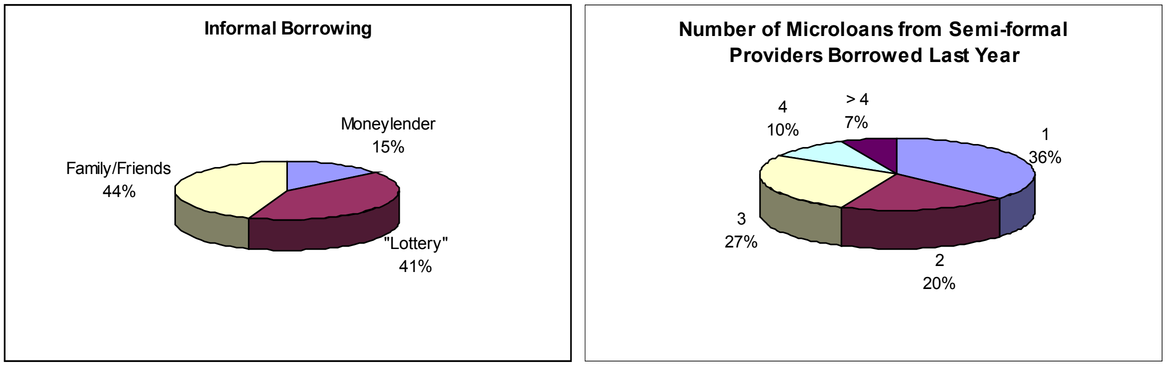
UMCOR's AREGAK program is the leading semi-formal microcredit provider in terms of the number and amounts of microloans with the equivalent of about $1.81 million in 8,626 microloans as at the end of last year (average microcredit is $210). MDF-Kamurj is the second leading provider with just over $1.14 million in 5,895 microloans outstanding as of December 31, 2001(with an average microcredit amount of $193). FINCA is next with $1.20 million in 3,609 microloans outstanding as of the same period (an average microcredit amount of $333). The effective annual interest rates charged by each of the top three semi-formal microcredit providers was from 55 percent up to 85 percent, when incorporating the different interest rate bases (for example, on a declining or flat basis), application fees, and repayment rates and frequencies.

The only other semi-formal microcredit provider with more than 1,000 outstanding loans to clients was OXFAM with an estimated $679,000 in about 1,209 microloans (and average microcredit of $560 as of December 31, 2001). Its effective interest rate on microloans is approximately 30 percent. World Vision's SEF can also be considered a significant microcredit provider, but with only $550,000 outstanding in less than 400 outstanding loans with an average outstanding microcredit amount of $1,500 (mainly due to larger individual loan sizes, the average size of new individual loan is about $3,500), it is clear that SEF is serving the upper end of the MF market but with relatively lower outreach.

Borrowing from informal sources was prevalent among microentrepreneurs, even among those that had borrowed from semi-formal sources in the last year. More than half of our survey sample (18 of 30) borrowed from an informal source in the last year despite having had access to one or more microcredit loans from a semi-formal provider (Graphs 3.1 and 3.2 on the following page). Almost half of the sample had borrowed from family or friends with the next popular method of borrowing being based on the "Lottery" form of an informal peer group, Rotating Savings and Credit scheme (ROSCA). Borrowing from moneylenders was rarer, with only 15 percent of our sample accessing that source of funds.

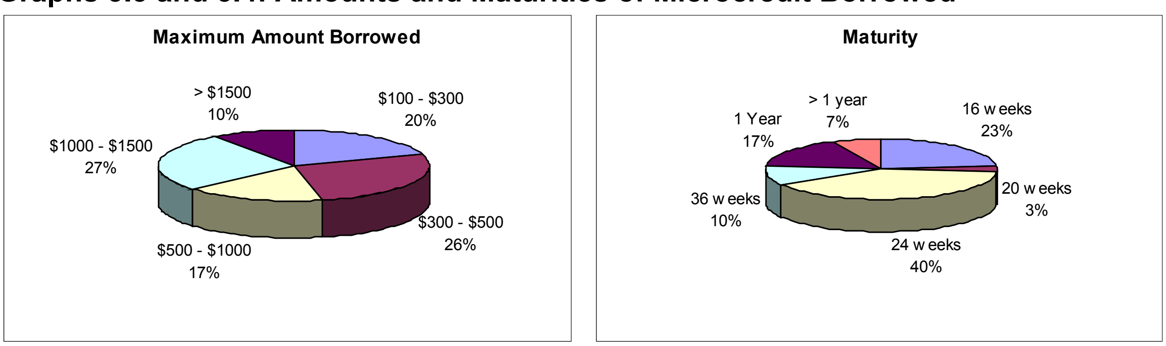
[26] ACBA's microloans are defined as loans having an equivalent value of less than US$10,000.
[27] ACBA effective rates are not quoted since information on whether ACBA charges loan processing fees or requires mandatory savings on loans made to its members were not available.

Graphs 3.1 and 3.2: Types and Numbers of Microcredit Borrowed



The maximum amount borrowed from any credit source varied significantly among microcredit clients with borrowing being fairly evenly distributed between $100-$300, $300-$500, $500-$1,000, and $1,000-$1,500 ranges (Graphs 3.3 and 3.4 below). Loans above the equivalent of $1,500 comprised only 10 percent of the sample. However, this survey result is likely skewed by our sampling technique since we chose respondents from the population of current borrowers of MDF-Kamurj, FINCA and AREGAK whose average loan size is less than $350 and which only recently offered loans greater than $1,000. Findings from earlier surveys based on more representative samples indicate that about 75 percent of informal borrowing is for amounts less than $100 with a distribution of: 73 percent working capital, 13 percent investment purposes, and 14 percent for consumption. These findings on loan uses are generally in line with previous surveys. The most common loan maturity was 24 weeks (six months) with all loans in our sample having terms of one year or less.

Graphs 3.3 and 3.4: Amounts and Maturities of Microcredit Borrowed



Attributes of the Microcredit Borrowers and their MEs. The majority of MEs in the survey were sole proprietorships, sometimes managed with the help of a spouse. In terms of educational attainment, three-quarters of the men indicated they had a university degree compared to about half of the women. About 80 percent of microentrepreneurs were between 31-50 years old. Most of the businesses were well established, 75 percent of which had been in existence for more than 2 years. Of the women-owned businesses, 65 percent had been operating for two or more years. Despite the education and experience of most microentrepreneurs, the monthly income generated by their business was low with about 83 percent earning less than $150 per month from the business (96 percent earned less than $300 per month). The low level of income is likely associated with operation of the microenterprise as a subsistence activity rather than a profit-making venture. The number of home-based businesses indicates that at least one-third of business locations are chosen on the basis of convenience rather than market forces where the entrepreneur seeks the most advantageous location.

Between 80-90 percent of borrowers from UNCOR's AREGAK program, MDF-Kamurj, and FINCA are engaged in trading. The breakdown of MDF-Kamurj's lending is indicative. In Yerevan, 90 percent of MDF's clients are involved in trading with the main types being ready-made clothes (40 percent); fruits and vegetables (11 percent); variable goods (12 percent). Loans for production make up seven percent and services three percent. In the rural areas of Sisian, Gyumri and Vanadzor the distribution of loans is different but the types of businesses are generally not.

Likely due to the low average value of capital and physical assets involved with trading activities (as opposed to manufacturing or services, which usually require more productive assets and employment of more than one person), at least 80 percent of the total microcredit provided is based on the group lending methodology. About one-third of all microloans (provided by UMCOR's AREGAK program and FINCA) are to clients who are members of five-person groups. The microlending by MDF-Kamurj is to members of slightly larger groups of between 7-20 women. It is probable that as much as two-thirds of all microcredit is directed toward women. An exact percentage is difficult to ascertain, however, since ACBA does not disaggregate its lending by gender. In the case of MDF-Kamurj and AREGAK, current internal policy dictates that they lend only to women; whereas, for FINCA, 40 percent of its clients are men. The policy to lend only to women is based on the mission of the parent organization and not a reflection market demand. In fact, some data suggests that only 30 percent of market traders in Yerevan are women though a formal study of this has not been done to the Assessment Team's knowledge.

Age of the business matters to determine an ME's access to credit. UMCOR's AREGAK program is virtually the sole source of microcredit for ME start-ups. FINCA and MDF-Kamurj require microentrepreneurs to have been in business for at least six months before becoming eligible to apply for a loan although they need not be legally registered.

Almost 5 percent of Armenia's total outstanding microcredit is directed toward refugees and people internally displaced by the Nagorno-Karabakh conflict. About 50 percent of OXFAM's microloans (about 600 outstanding loans as of December 31, 2001) and virtually all loans offered by IOM (about $300,000 in 650 outstanding loans as at the same date) are targeted to these groups. AREGAK and SEF were the only two microcredit providers that stated a focus on persons still affected by the 1988 earthquake although no data breaking out their lending to this group was available.

3.2 Potential Demand

Although satisfied demand (current supply) of microcredit is estimated to be about $11.5 million in around 34,000 loans, the potential demand is expected to be larger as unmet demand for microcredit is assumed to exist. To assess the total potential demand for microcredit, two estimation techniques are employed. The first is based on the numbers of businesses registered, taking into account earlier findings on the percentage that would qualify under the definition of an ME as well as a conservative assumption about the numbers of MEs that register. The second technique derives from a popular four-step method elaborated by Robert Christen that uses the estimated number of MEs and persons employed per business as benchmarks. [28]

Estimation Technique No. 1 Based on Business Registrations. The total number of businesses that were registered as of January 1, 2000 was 43,313. Table 3.1 below provides a breakdown of business registration by sector. About one-quarter of these (around 11,000) were individual and family-owned businesses. For estimation purposes, the approximate number of registered businesses that qualify as MEs is estimated to be 14,423, or one-third of the total. If we assume that only between 20-30 percent of the ME population is registered, that leaves a total potential number of MEs of between 48,073-72,116. This estimate is roughly in line with World Bank estimates of about 55,000 MEs (World Bank 2001, p. 28). Considering that at most three-quarters of these may be willing and able to borrow at any given time, the number of potential ME clients (potential total number of microcredit loans demanded) would be between 36,000-54,000. Assuming the desired loan amount for which an ME would qualify (i.e., "effective demand") would be between $500 and $1,000 (demand for loans of at least $500 is strongly supported by survey findings) this correlates to a total amount of $27-$41 million in potential microcredit loans demanded (applying an average loan amount of $750 to between 36,000-54,000 clients).

Table 3.1: Business Registration by Sector, as of 01-Jan-00

Business Sector	Number	% of Total
Agriculture, hunting, forestry, and fishing	2,479	5.7%
Mining and utilization of open deposits	7,785	18.0%
Processing	380	0.9%
Energy, gas, and water supply	2,331	5.4%
Construction	22,169	51.2%
Wholesale and retail trade, vehicle repair, motorcycles, and household appliances	1,178	2.7%
Hotels and restaurants	1,318	3.0%
Transport, warehouses, and communication	133	0.3%
Real estate transactions, leasing, and commercial activities	2,373	5.5%
Government, defense, social insurance	57	0.1%
Education	492	1.1%
Health care and social services	849	2.0%
Public utilities, and other social and individual services	1,699	3.9%
Total	**43,313**	**100%**

Source: PwC, p. 34.

Estimation Technique No.2 Based on Household Surveys. A popular method for inferring potential demand for microenterprise loans is to use the results from household surveys and several basic assumptions about percentage of the population working in MEs, average number of employees per business, and average ability and willingness of microentrepreneurs to borrow funds. Two shortfalls of this method are that it does not take into account potential demand for consumption loans (noted as an important use of microcredit above) and it gives no indication for potential demand for such other types of MF services as saving, payments, transfers, or insurance. Nevertheless, the estimated potential demand following the steps outlined below

[28] Christen, Robert Peck, 2000. Commercialization and Mission Drift: The Transformation of Microfinance in Latin America. Occasional Paper No. 5, Washington, D.C.: CGAP.

provides some indication for how large the microcredit market may be depending on one's acceptance of the assumptions.

The steps to follow are to:

1. Take the size of the economically active population from census data (adjusted, as necessary);
2. Determine the percentage of the population that is self-employed or working in enterprises with fewer than five employees and apply it to the economically active population to derive the number of people working in MEs;
3. Make an assumption about the average number of employees per enterprise, to derive the number of potential MEs; and
4. Apply a discount factor (often 50 percent) to take into account that not all MEs qualify for or wish to have a loan at any given time (Christen 2000, pp. 22-23).

Applying this method, we determine Armenia's estimated microcredit demand:

- Although the "working age" population (people 17-60 years old) is estimated to be about 1.86 million based on adjusted census data (3.1 million instead of 3.8 million), the "economically active" population is estimated to be about 1.4 million;
- While official statistics report that almost 1.4 million people work, on the basis of recent household surveys only about 1 million people are estimated to be employed. This leaves about 400,000 that are either self-employed or working in farm or non-farm enterprises with fewer than five employees;
- Average employment of ME has been estimated to be about four persons each, suggesting the number of potential MEs is about 100,000 (400,000/4=100,000); and
- Applying a discount factor (often 50 percent) to take into account that not all MEs qualify for or wish to have a loan at any given time suggests that there are about 50,000 MEs that are potential microcredit clients (100,000/2=50,000).

Again, this finding is generally consistent with the number of potential clients based on the first estimation technique and the World Bank (2001) findings. In terms of the potential demand for microcredit by amount, if we again assume that average loan amounts range between \$500-\$1,000 (which is supported by survey findings), then the total potential demand is between \$25-\$50 million, just slightly lower than the previously estimated range. Comparison of the total potential demand with the currently satisfied demand (supply) indicates that in terms of number of microcredit clients, the current market may be as much as two-thirds (assuming 34,000/54,000) saturated but in terms of the number of microcredit amounts, there may be still considerable scope to satisfy potential demand for larger loan sizes (the equivalent of \$1,000 and above, as opposed to the current average outstanding loan amount of just over \$300). Comparing the total potential demand with the currently satisfied demand (supply) indicates that in terms of amount of microcredit, the current market may be only about one-third (assuming \$11.5 million/\$41 million) saturated.

Satisfied Demand by Gender. Many of the larger microcredit programs target their loan products exclusively to women. This fact becomes important when considering what the estimated satisfied demand of microentrepreneurs is, by gender. The total number of active women borrowers for the major microcredit programs is summarized in Table 3.2 below.

Table 3.2: Estimate of Satisfied Demand for ME Credit to Women

	Total No. of Outstanding Loans	Total Value Loans US$	% Women	No. Loans to Women	Value Loans to Women
MDF-Kamurj	5,895	$1,141,042	100%	5,895	$342,313
AREGAK	8,625	$1,814,662	100%	8,625	$544,399
FINCA	3,609	$1,204,382	60%	1,082	$361,315
ACBA	13,000	$6,240,000	30% *	3,900	$1,872,000
OXFAM	1,209	$679,000	60%	725	$203,700
TOTALS	**32,338**	**$11,079,086**		**20,227**	$3,323,726

* *ACBA does not disaggregate its loans by gender. For purposes of this exercise, the Assessment Team used 30 percent which it considered to be a conservative figure in line with what it understood to be the proportion of women microentrepreneurs.*

According to conversations with supervisors at major retail markets in Yerevan, the general opinion was that 30 percent of the market's businesses were women owned. [29] If we use this figure and apply it to the estimated total demand for ME microcredit as calculated above (from method 1: (36,000-45,000) *30 percent; method 2: (50,000 *30 percent)), we arrive at an estimate of the total number of women-owned MEs: that is, 10,000 to 15,000. When we compare this figure to the number of loans currently outstanding to women in Table 3.2, we see that the number of existing loans exceeds our estimate of women-owned MEs.

How then does one explain the fact that there is an estimated 20,227 loans outstanding to women when women may own only an estimated 10,000-15,000 MEs? Before attempting to answer this question, it must first be said that agencies such as MDF and AREGAK who lend only to women recognize that the MEs are often family ventures and that women only need be actively involved in the business and not necessarily an owner.[30] MDF estimates that 20-30 percent of its loans to women are actually to businesses owned by men. Another explanation may be that businesses are using more than one loan from different agencies. As noted earlier in this section, average loan sizes are in the $300 range and businesses report their credit needs often are greater than this. Many MFIs practice "stepped lending," which controls the initial loan size and the growth in loan value from one loan to the next.

The brief analysis of satisfied loan demand in Section 3.1 and potential demand in Section 3.2, indicates that the existing microcredit suppliers are already reaching most of the MEs. If this is the case, then future growth in Armenia's MF is most likely to come from: (i) larger loans with existing clients, (ii) expansion of microcredit services to new geographical areas or market niches in Armenia that are not currently served or are less saturated than those currently being served, (iii) addition of new MF products or services to existing or new markets (i.e., savings products, insurance, business development services, etc.).

[29] This figure corresponds with the survey conducted for the SME Sector Assessment, which reported women accounted for 28% of vendors and marketing personnel. PwC 2000, p.38

[30] This point was confirmed in household surveys conducted for the World Bank, which found that MEs typically employed an average of 4 employees (World Bank 2001).

3.3 Reasons for Microfinance Market Disequilibrium and Depressed Demand

Although in terms of the number of microloans the market is expected to be two-thirds saturated, this figure actually ranges between 60-90 depending on the assumptions one elects to believe concerning the number of potential MEs that are willing and able to borrow at any given time (assumptions elaborated above). On the other hand, the market for microcredit may be considered to be only about one-third satisfied in terms of the total potential value of microloans. Two sets of reasons may explain the disparity between satisfied demand (current supply) and potential demand and these are explored below. The first set relates to the causes of market disequilibrium that helps one understand why otherwise credit-worthy or "bankable projects" cannot get funded. The second set of reasons as to why demand is depressed addresses why MEs may not be seeking credit in the first place.

3.3.1 Causes of Market Disequilibrium

Segmented and shallow financial markets are but symptoms of underlying causes of market disequilibrium that can lead to otherwise bankable projects not being funded. It is noteworthy that only one formal financial institution, ACBA, is a significant provider of microcredit (and deposit mobilization). The rest of Armenia's microcredit is provided through (i) project-based lending, either directly (i.e., AREGAK/UMCOR, FINCA) or through partner banks, (ii) lending by local Armenian foundations (MDF-Kamurj), and (iii) direct lending by a limited liability company (SEF). Only in these relatively few cases, and generally with the help of donor financial and technical assistance have these lending programs managed to overcome the root causes of disequilibrium in the microcredit market, although not completely, as the disparity between satisfied and potential demand indicates.

Causes for the disequilibrium can be segregated into three types. Perhaps the primary cause stems from Armenia's underdeveloped legal system, particularly with respect to marketable property rights, that results in weak collateralization of claims and inadequate contract enforcement mechanisms. Legal definitions for various types of marketable property rights (for example, titles for land, buildings, and various types of movable property) are very new and in most cases, in draft form. Registration of titles for marketable property rights is also nascent and still under development. Settlement of claims, repossession, etc. remains time consuming and costly, contributing to weaknesses in the secured transactions framework. These weaknesses prohibit many microentrepreneurs from providing collateral. More than 80 percent of MEs surveyed in Yerevan expressed willingness to pledge collateral, including one or a combination of the following, provided that there was a mechanism to do so (Shorebank Advisory Services, 2000 Yerevan Survey):

Real Estate	Movable Collateral	Other
• 45% private residences	• 25% vehicles	• 19% gold
• 42% business premises	• 21% business equipment	

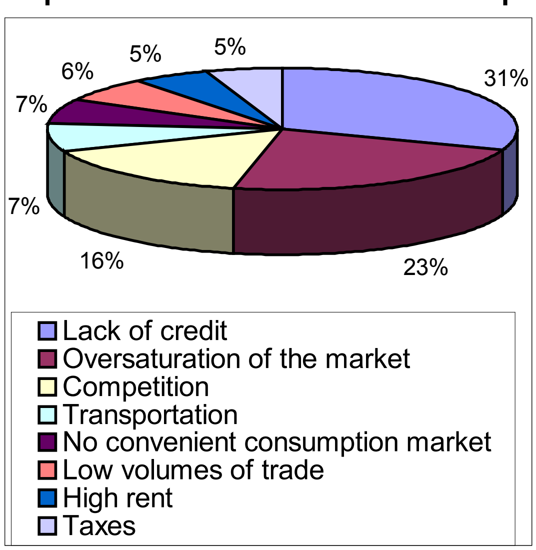
A second cause concerns ME licensing, registration, inspection, and reporting requirements that are underdeveloped and/or unclear. Stringent or arbitrary behavior of tax and customs agents worsens the situation. Political instability and uncertainty add to the risks of applying for credit, even though the underlying ME might be creditworthy. Related, the forced business plans and cash flow disclosures required by some microcredit providers makes many would-be borrowers uneasy about applying for a loan because of their cautiousness in making their assets and profits known.

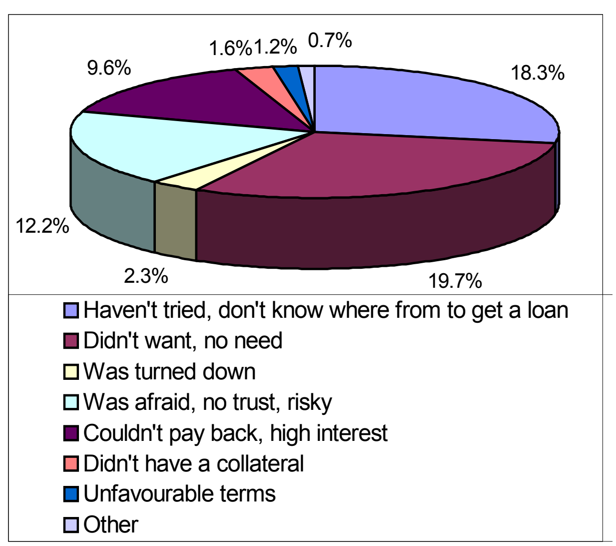
Insufficient institutional capacity of microcredit providers is a third major cause of market disequilibrium. Best practices in terms of designing loan products that are demand driven with incentives to increase the likelihood of timely and complete repayment are either not well known or adhered to. For example, although stepped lending is often incorporated in Armenia as a risk-reducing feature, other incentives such as interest rate rebates (upon on-time, full repayment of the loan) and MFI employee bonus programs based (in part) on loan repayment performance are not utilized.

3.3.2 Factors Contributing to Depressed Demand

ME survey results indicate that demand for microcredit is indeed depressed. After, "lack of credit" the most often cited constraints to ME development were "over-saturation of the market" and "competition" (Graph 3.5 below). These results correspond to responses to a related question about why microentrepreneurs did not seek a loan. More than half of the responders either did not try to obtain a loan, did not know where to go to apply, or had no need or desire (Graph 3.6 below). These survey results are similar to responses elicited on every survey reviewed by the Assessment Team. At least five factors may account for these findings: government corruption, the continued blockade, poor infrastructure (telecom, water, road, rail, and air transport), the small domestic market (the negative effects of which continue to be exacerbated by continued emigration) and weak training and information support for current and would-be microentrepreneurs. Another likely factor contributing to depressed demand may be the fact that MFIs are relatively new institutions in Armenia and many people may not yet know about their services.

Graph 3.5: Constraints to ME Development Graph 3.6: Reasons Not to Borrow





Source: Save the Children, Yerevan Survey. Source: Save the Children, Yerevan Survey.

Excessive interference (corruption and lack of governance) in business activity by poorly paid government officials has increased significantly the perceived costs of doing business as well as made it difficult to attract new entry (World Bank CAS, p. 6). Survey results suggest that small firms find both taxes and tax administration somewhat more constraining than larger ones. This may be due in part to the inexperience of smaller firms in dealing with issues of financial management. However, it is likely also attributable to Armenia's having unnecessarily complex tax rules (such that there are economies of scale for firms to deal with their complexity), taxes biased against smaller firms, or a system subject to the influence of larger and more influential firms.

Although a cease-fire was reached between Armenia and Azerbaijan over Nagorno-Karabakh (NK) in 1994, the borders between the two countries remain closed and trade, officially, still does not exist. A key economic consequence of the NK conflict - the closure of two-thirds of Armenia's borders (those with Azerbaijan and Turkey) - have cut off Armenia's rail links with countries other than Georgia (and because of an internal rift in Georgia, the rail link north from Armenia does not currently extend through to Russia). Trans-shipment of Armenian goods though Georgia is also compromised by weak management, corruption, inefficiencies, and theft resulting in high costs for all modes of transport (road, rail, and port), which creates a serious setback for Armenia's competitiveness. In addition to the direct additional transportation costs, the blockade affects the economy through a number of other channels, increasing overall price levels for various tradables, eliminating potential incomes from transit, and inflating both risks and uncertainty of economic transactions (World Bank 2001, p. 84). In addition to the need to resolve the NK conflict, infrastructure essential for ME development such as telecommunications, urban water supply, and road, rail and air transport should be improved.

Armenia's domestic market is exceedingly small. Based on Purchasing Power Parity GDP, the Armenian economy is equivalent to a US city of 325,000; based on the dollar value of its GDP (which is probably a more relevant measure for foreign investment and trade), the Armenian economy is equivalent to a US city of 57,000 (PwC, p. 19).

Despite a large and growing number of registered small businesses and a network of business support centers assisted by a variety of donors, training and information support for businesses is generally inadequate be it in entrepreneurship, business start-up, operations improvement, marketing, etc. Self-help business and enterprise start-up literature is generally not available, in contrast to the plethora of such literature in the CEE and other NIS countries. Small business entrepreneurs (70 percent of whom have a university degree) cite marketing and advertising as their highest priority for training followed by financial management and business planning (PwC, p. 20).

4. Microfinance Supply

By convention, the term "microfinance" applies to a variety of financial instruments or services that help microentrepreneurs to support their businesses. The most common form is debt financing (credit), but MF also applies to the provision of such services as savings products, insurance policies, trade credit, leasing, and barter to name just a few. For organizations whose principal activity is to provide loans to microentrepreneurs, such as those programs evaluated in Armenia, it would be best to label them as microcredit providers since Armenian law prevents them from mobilizing and using clients' savings to capitalize their loan funds. However, some Armenian microcredit programs also provide limited business development services (BDS) to MEs (see Table 2.8) and the largest is registered as a commercial cooperative bank (ACBA).

This section continues the description of microcredit providers that was begun in Section 2.4 – Overview of Microfinance Market Development by analyzing the microcredit operations of MDF-Kamurj, FINCA, and AREGAK/UMCOR. However as requested in the SOW, there is a greater depth of analysis for these three organizations, which are current recipients of donor assistance (mostly from USAID) and that supply a substantial amount of Armenia's estimated satisfied microcredit demand. The three account for 55 percent of the total of loan outstanding but only 36 percent of total loan value. The market share of ACBA is nearly the reverse as it has about 39 percent of the satisfied demand's number of loans but about 54 percent of the total value. This difference in performance is explained by the average loan size (Table 5.1 below)

Table 4.1: Market Share of Satisfied Demand

Organization	Microloans Outstanding		Microloans Outstanding		
	Number	% Share	Avg. Loan Size	Value	% Share
MDF-Kamurj	5,895	18%	$ 194	$ 1,141,042	10%
FINCA	3,609	11%	$ 334	$ 1,204,382	10%
AREGAK	8,626	26%	$ 210	$ 1,814,662	16%
Subtotal	18,130	55%	$ 229	$ 4,160,086	36%
ACBA	13,000	39%	$ 480	$ 6,240,000	54%
Others (estimated)	2,000	6%	$ 550	$ 1,100,000	10%
TOTAL MARKET SUPPLY	33,130	100%	$ 347	$11,500,086	100%

The assessment of the three organizations follows the methodology described elsewhere in Section 1.2.2. All of the information used to evaluate MDF-Kamurj, FINCA, and AREGAK/UMCOR was acquired on site, with no advance preparation by the organization beforehand. On the one hand this led to lengthy delays in receiving certain information, but on the other hand it afforded an opportunity for the Assessment Team to see what information the institution normally collects and analyzes and what it does not. In the end, the ease with which information was provided and the level of its accuracy and completeness helped us to assess what aspect of the organization appeared in need of strengthening.

All three institutions cooperated completely with the Assessment Team and attempted to supply all of the information asked of them. When they could not, it was because they did not have the systems or procedures in place to collect the information. This was particularly true with regards to financial statement information. Not surprisingly, MDF-Kamurj had the least problem with this as it is the only one of the three that is a stand-alone institution and for accounting purposes treats itself as an accounting entity. On the other side of the scale is AREGAK who had difficulty providing separate financial statements for its MF activities. This is because AREGAK is a department within a large NGO with multi-sector programming activities and the administration costs incurred by UMCOR on behalf of its AREGAK program were not allocated to AREGAK operating expenses. Without this being done, accurate estimates of the level of financial and operational sustainability are not possible.

The structure of this section will be to give a short background section on each of the three organizations followed by an evaluation of each in the four areas of Planning, Services, MIS, and Financial Administration. A SWOT Analysis of each can be found in Appendix 7.

4.1 MDF-Kamurj Assessment

Background. MDF-Kamurj (MDF) registered as an Armenian not-for-profit foundation in April 2000. MDF is the result of the merger in November 1999 of two separate lending projects initiated by Save the Children (SAVE) and Catholic Relief Services (CRS). At the time of the merger, the former assets from the MF projects of SAVE and CRS were transferred to MDF. SAVE operated its program in Yerevan and Sisian whereas CRS operated in Vanadzor and Gyumri. Both programs utilized a group lending methodology exclusively targeting women who form solidarity groups of 7-20 members. Each member guarantees the repayment of loans made to other members of the same group.

CRS and SAVE are USA-based NGOs that operate internationally to carry out multi-sector development programs focused on the alleviation of poverty and suffering with an emphasis on working with women and families. CRS and SAVE support MF programs in many countries around the world and each has considerable institutional capacity in this regard. This is particularly true with respect to their ability to rapidly transfer their group lending methodologies to local partners thereby achieving significant breadth and depth of outreach in a short period of time to the most vulnerable portions of the population.

In Armenia, SAVE and CRS had country offices that pre-dated their start-up of the predecessors to MDF-Kamurj. By adding MF to their existing portfolio of development projects in Armenia, the initial cost of program start-up was lower than it would be if introduced in a "green-field" manner since many administrative costs are already covered. With a fully staffed country program office that can attend to such things as financial management, accounting, purchasing, and staffing, the start-up MF project is free to concentrate on program issues such as solidarity group formation, marketing, loan monitoring, and operational planning. However, the MF staff must eventually assume full responsibility for all administration and programming if it strives to become a best-practice MF institution focused on effectiveness, efficiency, and achieving financial self-sustainability.

By nearly all accounts, MDF is managing the transition to institutional independence extremely well. It separated itself administratively from both CRS and SAVE when it registered as a separate foundation and it is attempting to put in place the necessary organizational structure, support systems, procedure and policy manuals, and management information systems (MIS) it needs to succeed on its own. A capable Armenian Executive Director (with a hands-on management style) who is intent on seeing MDF develop into a best-practice model institution leads MDF. Under his leadership MDF has made significant progress in the development of its institutional capacities and it can lay claim to the achievement of full operational cost coverage.

Documentation Reviewed. The assessment team utilized the questionnaires and survey instruments described elsewhere to examine MDF and its institutional capacity to supply appropriate and sustainable MF services. MDF made available to the team: financial statements, loan portfolio reports, operating manuals, project documents, external assessment reports, market studies, and lending policy and procedure manuals. Gagik Vardanyan, MDF's Executive Director, fully supported the assessment process and saw that all requests made by the assessment team were fulfilled. Lastly, a field visit was made to MDF's office in Gyumri to interview clients.

Also participating in the MDF meetings was Craig Feinberg, SAVE employee and Technical Advisor to MDF. Additionally, a member of the team met with the CRS Armenia Country Representative and a visiting manager from CRS's MF program quality support department in Baltimore, MD.

4.1.1 MDF Planning

The starting point of an MFI plan is its vision and mission statement that outlines the overall goals of the institution, its core values and the market it wishes to serve. MDF provided us the following statements:

Vision: "To become Armenia's leading national microfinance institution providing sustained access to credit, savings and other financial services to women micro-entrepreneurs in under-served rural and urban markets."

Mission: "We provide accessible, long-term financial services to women micro-entrepreneurs to improve their businesses and families' well-being."

Values and priorities:

- Customer satisfaction
- Commitment to mission
- Solid relationships
- Quality Products
- Learning, continued improvement
- Excellence
- Teamwork
- Mutual support
- Professionalism
- Accountability
- Transparency

We find MDF's Vision, Mission, and Values and Priorities to be exceptionally well-stated and complete. Not only is the market it wishes to serve clearly described, but also the manner in which it intends to operate its business is clearly stated. Comprehensive statements such as these can serve as excellent guidelines to MDF management as it develops its business plans and sets operating policies.

Looking forward, MDF Vision statement covers products it does not currently have but may wish to develop in the future – savings and other financial services however, it does not cover the limited BDS that it offers and has stated it would like to expand. Further, its decision to provide financial services to only women may prove a severe constraint in the future, especially given our estimation of the small number of unsatisfied ME demand.

Strategic Planning. MDF actively collects information on its market as well as its capacities to serve that market. In October 1999, MDF commissioned external consultants to conduct market studies described earlier that quantitatively and qualitatively profiled MEs in Syunik and

Yerevan. It used this report to determine the potential size of its market and to guide new loan product development. MDF hopes to conduct an updated survey of Yerevan in Spring 2002 with funding from Shorebank.

MDF participates in regional and global initiatives to further MF best practices. This involvement helps MDF to measure itself against other programs outside of Armenia, and to develop strategic plans in areas needing improvement. It regularly submits its performance indicators to Micro Banking Bulletin, and is a member of the microfinance Center (MFC) in Warsaw. MDF is also actively involved in the overall development of the MF sector in Armenia. It is a founding member of the informal MicroFinance Forum that brings together stakeholders from MF organizations, donor agencies, international NGOs, government, and Armenian individuals to discuss issues of importance to the Armenian MF sector.

MDF commissioned, with the help of SAVE and MFC, a “Survey of the Legal and Regulatory Environment for MFI in the Republic of Armenia” in December 2001 to better understand MDF’s legal standing and make strategic plans to ensure the continued legality of its operations.

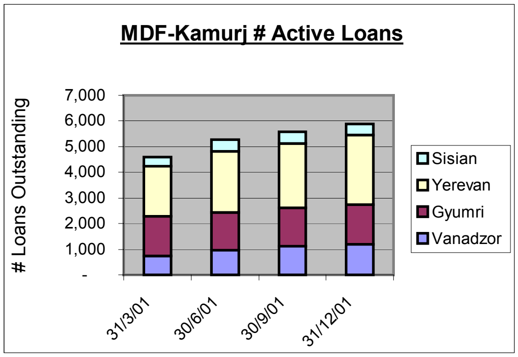
The core of MDF’s strategic plan is to increase the number of clients through expansion of the loan portfolio, achieving financial sustainability, and operating legally in Armenia. The actions described above are positive steps to achieving that goal.

Operational Planning. MDF’s operational plan seems to be embedded in project funding documents, as MDF’s business plan was not revised since written in 1999. MDF’s project documents describe the number of loans and size of the portfolio to be attained over the project period. These are then translated into operational plans covering staffing, procurement, and office leasing. A better method would be if MDF decided what it wanted to look like and then sought financing to support it.

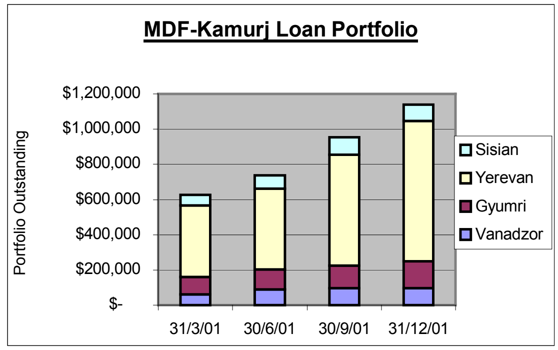
Financial Planning. MDF should improve its financial planning to develop more detailed cash flow forecasts and proforma financial statements under a number of scenarios. These are not currently produced, though this may be due more to deficiencies in MDF’s MIS system than to a lack of interest in preparing them. In any event they are needed urgently. Weak financial planning introduces high risk to MF programs that follow a step-lending methodology (like MDF) since clients expect to have continuous access to new loans that may increase in size. Indeed, borrowers often cite access to new larger loans as a prime motivation to repay. If MDF’s loan fund is insufficient to cover clients’ demand for loans, this will likely lead to escalating arrears and increased client dropout rates.

The two graphs below show the growth in the number and value of loans outstanding over the past 9 months for MDF by branch location. Note that while the number of clients increased by 29 percent, the portfolio value increased by 82 percent over the same period. This corresponds to an increase in average loan size (loan portfolio value / total loans outstanding) from $137 to $193. Also, its clear that the Yerevan branch is growing more quickly than the others in terms of both percent of total loans and percent of loan portfolio. The data supports MDF’s contention that most Yerevan MEs have need for larger loans sizes than are currently offered.

Graph 4.1: MDF Growth in No. Loans



Graph 4.2: MDF Growth in Portfolio Value



This data also shows that MDF's total loan capital requirements are increasing at an accelerating rate. However, since non-bank institutions in Armenia are prohibited from mobilizing savings, loan capital requirements must come from either donor funds, retained earnings, or leveraged MFI assets.

MDF cites the need to increase its loan capital as its primary concern. Over the years it received grants to loan capital from GTZ and CRS private funds. However its principal donor source has been USAID via SAVE and CRS assistance projects. Currently, MDF is in the 2nd year of a two-year Implementation Grant Program (10/2000 – 9/2002) issued to SAVE by USAID's Global Bureau. The total value of this grant is approximately $1million of which 66 percent is budgeted for MDF, most of which is loan capital.

Also, in the last year, Shorebank provided MDF $100,000 loan capital through its USAID-funded regional program described elsewhere in the report. MDF is hopeful to receive additional loan funds from this source before Shorebank's project ends in June 2002.

The assessment team estimates that if the growth trend in loan fund size continues, MDF will have an outstanding loan portfolio of $1.5 million by the end of June 2002. MDF forecasts that its loan capital will be fully lent by mid-year 2002.

Strategic Relationships. MDF and other MF stakeholders meet through the MF Forum to discuss areas of strategic importance. This has included working on such issues as the legal status of microcredit institutions in Armenia, discussion of best-practice principals and how to apply them in their institutions (particularly with regards to setting interest rates to achieve financial sustainability), and establishing a credit bureau for ME borrowers.

MDF, FINCA and AREGAK report that their major competitors are each other, though all three have business missions to provide services to entrepreneurs of the same economic level. However, both FINCA and MDF have different cost structures and less access to ongoing operating subventions than AREGAK who is still within the UMCOR country program. In addition, these 2 have smaller loan portfolios than UMCOR, which means their potential revenue streams are smaller as well. In general, AREGAK's effective interest rates are lower, it requires less frequent loan repayments, and offers grace periods on principal repayments. In addition, AREGAK is not currently constrained by lack of loan capital as are FINCA and MDF.

In April 2001 the three met to formalize a set of guidelines related to the coordination of their MF activities in Armenia. [31] The principal guidelines were to:

1. Adhere to internally-recognized (CGAP, MBP) best practice standards in the MF field particularly related to setting sustainable interest rates that are market-based and calculated to achieve financial sustainability for the organization;
2. Sharing client information (names, passport numbers and credit history) on a monthly basis to promote the establishment of a credit culture in Armenia and to avoid clients borrowing one loan to pay back another.
3. Coordinating MF Operations in Yerevan and Sisian Areas
   a. Yerevan: AREGAK agreed that its loans would start at a minimum $1,000 and carry interest rates that would not undercut those of FINCA and MDF. For their part, MDF-Kamurj and FINCA would not change the range of their group loan amounts (up to $1,000 per client) as well as would not reduce the interest rates on their group loans (3 flat per month and 2-3 percent up front fee) in Yerevan area.)
   b. Sisian: MDF and AREGAK agreed to avoid operating in areas overlapped.

The agreement between the three ran through December 31, 2001 and was not renewed. The exact reasons for non-renewal were not shared with the team however it appeared that MDF and FINCA favored extending it.

4.1.2 MDF Services

MDF focuses primarily on providing loans valued at less than $1,000 to women to use in an established microenterprise. In addition as part of its group lending methodology, it encourages Savings Groups (SG) to make deposits into a reserve fund that acts as a safety mechanism should a group member have a repayment problem. In Gyumri and Vanadzor (ex-CRS locations) the reserve fund is mandatory for the first loan cycle; 8 percent of the first loan amount must be collected from each SG member. [32] This money is collected and kept in the MDF branch office safe. In subsequent cycles, the 8 percent is either compulsory or voluntary, depending on MDF's decision based on its determination of the lending risk. In Yerevan and Sisian (ex-SAVE locations) the group reserve fund is voluntary, based on the SG's decision. No interest is paid on the group reserve fund. MDF is prohibited by law from using these funds.

Definition of Loan Products and Clients Served. MDF operates in four areas (Yerevan, Vanadzor, Gyumri, and Sisian) and its lending methodology is the same in all areas. MDF explains the program to interested clients and lets them self-select one another to form Solidarity Groups of 7-20 members. Potential members must be involved in a microenterprise activity for at least 6 months. Members have access to loans and organize repayments themselves under the leadership of group leaders and treasurers.

[31] Agreement between UMCOR/AREGAK, MDF-Kamurj, and FINCA. April 25, 2001.
[32] The first loan to a client is termed a first cycle loan. Subsequent loans are sequentially numbered and referred to as second cycle, third cycle, etc… The length of the cycle is equal to the repayment period of the loan.

MDF has a well-written and thorough Lending Policies and Procedures manuals that cover the following topics:

- Membership criteria
- Group formation
- Group roles and responsibilities
- Loan processing and approval
- Loan repayment
- Loan repayment of arrears
- Loan products
- Delinquency management

The types of MEs MDF targets are those with rapid sales turnover. MDF appears to have a good understanding of its clients' needs and conducts periodic market surveys in the rural areas as well as Yerevan. In addition, it collects loan impact data and use of loan information. In Yerevan, 90 percent of clients are involved in micro/small-scale trade with the largest subcategories consisting of: ready-made clothes (40 percent); fruits and vegetables (11 percent); variable goods (12 percent). Loans for production make up 7 percent and services 3 percent. In the rural areas of Sisian, Gyumri, and Vanadzor the distribution of loans is different but the types of businesses are generally not.

MDF collects market data on its clients profile and needs and uses this information to develop its loan products. It established a New Product Development Group that meets periodically to ensure that loan products coincide with product demand.

MDF has three basic loan products that vary by repayment terms and the loan amount that are shown in the table below. It should be noted that MDF sets the combination of its fees and interest rates on different repayment frequency in a way that returns an annual effective interest rate on the loan in the range of 80 – 86 percent.

Table 4.2: MDF-Kamurj Loan Products and Terms

Loan type / location	Repayment frequency	Repayment period (weeks)	1st loan max amount	Subsequent loans (max amount)*	Fees (paid up-front)	Interest rate (flat)
Standard / Yerevan	Wkly, Bi-wkly	8, 10, 12, 16, 20, or 25	\$50 - \$500	\$950.	2 – 3 %	3%/month
Standard / Regions	Wkly, Bi-wkly	8, 10, 12, 16, 20, or 25	\$50 - \$250	\$950.	2 – 3 %	3%/month
Seasonal Loans	Wkly, Bi-wkly, Monthly, Bi-monthly	4, 5, 6 ,7, or 8	\$50 – 50% of current loan size		None charged	0.75%/week

Notes:
- Loans are disbursed and paid in AMD;
- Fees (rate x loan amount) are paid at the time of loan disbursal;
- The total interest due (interest rate x loan amount) is distributed equally over repayment due dates, as are principal payments

* The maximum amount of subsequent loans is determined by an assessment of the business's capacity to repay as well as the application of a formula that allows loans to increase by up to 30% in initial cycles then a lesser % as the ceiling amount is approached.

New Products Under Consideration. MDF is considering the introduction of different loan products based on its market surveys and information collected from its clients. Future products under consideration are:

1. Individual loans <$3,000; repayment terms up to 1 year; lower effective interest rates
2. Lower effective interest rates for clients starting in their 12th cycle (less risk)
3. Larger loans collateralized with jewelry or immovable assets
4. Insurance services
5. Loans to men

Service Quality. MDF appears to offer high quality MF services. It solicits feedback from clients through surveys, monitoring, and loan application forms and the information gathered is used to improve financial service products. MDF claims to process and disburse loans within 1-4 days of receipt of the application, which is very good performance.

The solidarity groups (SG) appear to be well managed. MDF does not require that its loan officers be present during mid-cycle meetings however, the SG coordinator and treasurer manage most of the groups' activities and ensure that transactions are recorded and the repayments are deposited.

Due to the short time allowed for the assessment, we were unfortunately not able to verify whether the SG books were up-to-date, accurate, and in agreement with those of MDF. Though we saw no reason to suspect any existence of problems, this is an area that MF institutions must monitor and control very carefully as it is where MFI fraud is most often detected and where unintentional errors in record keeping are transmitted into the organizations' MIS.

The last aspect of Service we looked at was client dropout rates as a proxy for client satisfaction.

Table 4.3: MDF Client Attrition Rates

For the Quarter ending:	Vanadzor	Gyumri	Yerevan	Sisian	Total
30-Nov-00					
No. Clients	686	1,518	1,650	375	4,229
No. Dropouts	21	53	25	23	122
Attrition rate per Qtr	3%	3%	2%	6%	3%
31-Mar-01					
No. Clients	745	1,537	1,994	352	4,628
No. Drop-outs	68	144	124	84	420
Attrition rate per Qtr	9%	9%	6%	24%	9%
30-Jun-01					
No. Clients	961	1,482	2,376	466	5,285
No. Drop-outs	121	266	57	69	513
Attrition rate per Qtr	13%	18%	2%	15%	10%
30-Sep-01					
No. Clients	1,122	1,493	2,507	458	5,580
No. Drop-outs	196	253	117	238	804
Attrition rate per Qtr	17%	17%	5%	52%	14%
31-Dec-01					
No. Clients	1,184	1,556	2,721	434	5,895
No. Drop-outs	191	198	266	188	843
Attrition rate per Qtr	16%	13%	10%	43%	14%
Total drop outs	597	914	589	602	2,702

MDF explains that it records all clients that leave the program, for whatever reason. This includes those who repaid their loan and left voluntarily or someone who has a problem with repayment or with the other members of her solidarity group. It can be seen from Table 4.3 that the attrition rate is significantly higher in rural areas than in Yerevan and that overall, the rates seem to be increasing over time. Over time, the attrition rate such as this should be of concern since it may indicate dissatisfaction with some aspect of the credit product. Also, given the small size of the market, MDF may not be able to replace clients who leave with someone who has not been a client before.

Non-Financial Services. MDF periodically holds trades fairs where its clients display some of their more unique products, including handicrafts. Besides the direct benefit to clients of linking sellers to buyers, the indirect benefits to MDF are publicity and clients with more profitable businesses.

Market surveys and informal discussions with clients suggest to MDF the existence of client demand for certain business training. In July 2000 MDF offered clients training on marketing, customer service, and communication skills. MDF would like to provide some limited training services on a demand driven basis. However it feels that clients are not capable of supporting the full cost of the training and MDF is unwilling to subsidize it since it feels its priority at this time is to build its loan fund.

4.1.3 MDF Management Information Services

MDF's management information system encompassing loan portfolio and financial reports is a "home grown" system based on Excel spreadsheets. Management currently receives a variety of standard MIS reports it uses primarily to track portfolio quality and short-term liquidity requirements. Many reports were initially required by CRS and SAVE and therefore use their standard format. These contain most essential portfolio indicators as well as some financial ratios, such as financial and operational sustainability estimates.

Despite the generally good portfolio data coming out of its MIS, MDF's existing Excel-based system is unable to process all the data it collects. Also, its systems rely heavily on manual transcription of data that is handled several times. This increases the potential for errors in data processing.

In the fourth quarter of 2001, MDF issued more than 2,000 loans per month with either weekly or biweekly repayment schedules. With the many flexible loan products that MDF offers (Table 5.2) with different terms, fees and interest rates, MDF's system is unable to cope. As a result, such important financial statements as accurate forecasts of cash flow and for liquidity management are not produced.

MDF recognized the need to improve its MIS and in September 2001 purchased an integrated loan portfolio and accounting software named "Loan Performer" that is somewhat known in the MF industry. However, changeover has not gone smoothly and the new system is not yet on-line. Modifications to the program must be made to accommodate MDF's wide variety of products and it remains to be seen if and when it will be fully operational.

4.1.4 MDF Financial Administration

Internal Control and Bank Relations. MDF's policy and procedure manuals include internal control guidelines and descriptions on the separation of functions for various tasks. However without more time to fully examine MDF's operations or verify compliance with written procedures, the adequacy of that document or its application cannot be ascertained. Nonetheless in growing MFIs, this is frequently an area that requires close attention.

MDF conducted internal audits of two branches last year and plans to schedule an external audit by KPMG within the next 2-3 months. It has an internal auditor staff position.

The method of disbursement and collection of client loans varies with MDF's branch office:

- *Sissian*: Disbursement and collection are made directly from the local office of a commercial bank. This policy was instituted to reduce the security risk of handling cash in the office and improve the accuracy of repayment information.
- *Vanadzor* and *Gyumri*: Disbursements are made from the local commercial bank. Reimbursements are currently made at the MDF office but it is hoped clients will deposit directly into MDF's bank account in the future.
- *Yerevan*: Disbursements and repayments are made from the MDF office.

Accounting Policies and Procedures. The finance/accounting department routinely produces quarterly balance sheets and income statements that comply with CGAP-recommended formats. Transactions are treated on an accrual basis. MDF's policy to establish the amount of its loan loss provision complies with generally accepted accounting standards.

Analysis of Financial Performance. According to unaudited financial statements prepared by MDF, the institution had a very strong performance in 2001. According to its balance sheet, it has practically no debt as the greater part of its liabilities is to record deferred revenue (project funds received but not yet disbursed). The relatively strong cash position is due to a recent transfer of cash for loan capital from Shorebank.

Table 4.3: MDF-Kamurj Balance Sheet at Dec. 31, 2001

MDF-Kamurj	
Assets:	
Current Assets	$458,779
Net Portfolio Outstanding	$1,133,931
Fixed Assets (net of depreciation)	$53,909
TOTAL ASSETS	**$1,646,619**
TOTAL LIABILITIES	**67,914**
Equity:	
Donated Capital	$1,096,826
Net Surplus (current period)	$481,879
TOTAL EQUITY	**$1,578,705**
TOTAL LIABILITIES + EQUITY	**$1,646,619**

Regarding MDF's Income Statement, it reported gross revenues for the year ending December 31, 2001 of $653,491 against total expenses of $382,600. Net income for the period was therefore $230,161; operating revenues exceeded total costs by 170 percent (See Table 4.4 below)

Table 4.4: MDF-Kamurj Income Statement for the Period Ending Dec. 31, 2001

MDF-Kamurj	
Operating Income	
Interest & Fees from Loans	$627,591
Interest on Savings & Investments	$5,882
Other Income	$1,092
TOTAL OPERATING INCOME	**$634,565**
Operating Expenses	
Bank Charges	$2,877
Loan Loss Provision	$5,875
Loss on Exchange	$13,051
Total Financial Expense	**$21,803**
Net Financial Margin	**$612,762**
Administrative Expense, Personnel	$284,455
Staff Training & Consultation	$13,484
Office Expenses	$51,884
Transportation	$11,447
Depreciation	$21,330
Other Administrative Expense	
TOTAL OPERATING EXPENSES	**$382,600**
NET INCOME FROM OPERATIONS	**$230,162**
Non-Operating Income	
Grant for Operations	$200,512
Other Non-Operating Income	
Non-Operating Expenses	-$802
NET SURPLUS	**$429,872**

MDF's decision to charge up-front fees of 2 percent to 3 percent on its loans and deduct this from the loan at time of disbursement help to improve its cash flow, which will become more critical over the coming year as it uses up its available loan capital. As pointed out earlier, MDF's loan methodology promises clients access to increasing loan sizes. This promise to clients can be considered a "moral liability" that MDF will have enough cash to fulfill the loan request from clients passing from one cycle to the next who qualify for larger loans. It should be remembered that the MDF's loan ceiling amount for its most popular loan product is $1,000, far less than the average loan in the portfolio indicating there will be continued pressure on MDF to find more loan capital. The growth in loan portfolio over the past year can be seen in Table 4.5 below:

Table 4.5: MDF Kamurj Loan Portfolio Performance

Table 4.5: MDF Kamurj Loan Portfolio Performance					
Performance Indicator	**31-Dec-00**	**31-Mar-01**	**30-Jun-01**	**30-Sep-01**	**31-Dec-01**
# Loans outstanding	4,229	4,578	5,285	5,580	5,895
Portfolio outstanding (US$)	$433,279	$625,800	$731,818	$956,043	$1,141,042
Avg. value of loan in portfolio	$102	$137	$138	$171	$194
# Loans disbursed in period	3,613	3,209	4,016	5,215	6,848
Value of loans disbursed in period	$609,484	$703,284	$957,433	$1,370,501	$1,691,190
Avg. value of loan disbursed	$169	$219	$238	$263	$247
Value of loan portfolio at risk (%)	1.7%	2.9%	1.6%	1.5%	1.7%

MDF's reports its borrowers requested access to larger loans more quickly than was permitted under previous loan policy. In response to this, and competitive pressure from FINCA and AREGAK, MDF increased the loan size ceiling for first cycle loans and also increased the ceiling on loans from cycle to cycle. The effect of this can be seen in Table 4.5 by the continuous growth in the average value of the loan in the portfolio over the past year.

Financial Planning. One of MDF's greatest challenge to the sustainability of its program will be to find adequate loan capital to meet existing client needs, however it must develop the means to prepare accurate and timely financial cash flow forecasts so that it can make proper decisions on the maximum number of clients it can carry in its solidarity groups and still satisfy their future credit needs. Until it gets its new loan portfolio and accounting system running, it will be difficult for MDF to carry out the necessary financial planning that it needs to do.

4.1.5 MDF Organizational Structure

Governance. The MDF-Kamurj foundation has a Board of Trustees composed of 7 persons: A department head from the Ardshinbank; an attorney, a women's association director, and 4 vacant seats (2 representatives each from CRS and SAVE). MDF needs to fill the vacant seats on its board and provide guidance to them on their roles and responsibilities. In the absence of an active board, MDF's Executive Director is assuming those responsibilities as well as his normal duties and this situation should be remedied.

Legal Status/Functional Organization. MDF operates as a legally registered Armenian Foundation since April 2000.

HR Management. MDF drafted a human resource manual containing detailed job responsibilities and covering the most important aspects of human resource management. Staff turnover is low and many mid-level and senior positions were filled by promotion. Staff training appears to be seen as a necessary and efforts to send senior persons on training, both within and outside Armenia were made in the past year. This should be continued in the future so that the Executive Director can feel comfortable delegating more of the day-to-day operations in order to liberate him for more medium and long-term strategic planning activities.

4.1.6 MDF SWOT Analysis (See Appendix 7)

4.2 FINCA Assessment

Background. FINCA is a USA based NGO specialized in the start-up of MFIs using a group lending methodology. It began operations in Armenia in 1999 with financial support from USAID via a sub-award from Shorebank that supports three FINCA country programs in Armenia, Georgia and Azerbaijan. The agreement with Shorebank runs from Feb 24, 1998 to August 2002. FINCA Armenia operates as an independent not-for-profit agency under a bilateral cooperation agreement between the governments of the USA and Armenia.

Under the terms of FINCA's agreement with Shorebank, it is to "lay the groundwork for the eventual nationalization of the project" by recruiting local candidates to manage the program and to determine the appropriate legal structure under which to operate. The Country Director of FINCA Armenia is an expatriate and its Advisory Board consists of the Country Director and other FINCA expatriate managers working in the region and Moscow.

FINCA Armenia provides loans in the greater Yerevan area and in 9 major market areas: Yerevan, Abovian, Armavir, Artashat, Ashtarak, Echmiadzin, Masis, Hrazdan, and Gavar. The bulk of its business is in the Yerevan urban area (3,091 of 3,609 total borrowers and $1,063,516 of a total loan portfolio of $1,204,382). Details on the number of clients and portfolio outstanding can be found in Appendix 6.

The assessment of FINCA will cover the areas of Planning, Services, MIS, Financial Administration and Organizational Structure as before. FINCA's SWOT analysis can be found in Appendix 7.

Documentation Review. The assessment team utilized the questionnaires and survey instruments described elsewhere to examine FINCA's institutional capacity to supply appropriate and sustainable MF services.

The documents examined included FINCA's financial and portfolio reports, operating and training manuals, project documents, and savings group policies and procedures. A team member using our client questionnaire surveyed FINCA's clients in Yerevan. Besides head office visits to FINCA, we also met with Shorebank to learn more about their assistance package to FINCA and MDF.

4.2.1 FINCA Planning

As a member of the FINCA global network, the Armenia program management stated that its mission statement is the same as that of its parent organization. However management was unable to recall what it was or explain how it guided strategic decision-making in the FINCA Armenian program. The Assessment Team's research of FINCA Armenia's web site found the following statement[33]:

[33] FINCA Mission and Goals. Armenia internet web site http://www.finca.am/index.html

"FINCA's Armenia program has twin goals:

1. To provide financial assistance to thousands of Armenian microbusinesses.
2. To establish a self-financing local institution that becomes a permanent resource for future generations of low-income entrepreneurs.

These twin goals drive the entire organization."

Unlike MDF, which makes loans only to women due to its parent organizations' preference to target women and families, FINCA permits men and women to join its solidarity groups and receive loans. Its broader mission statement, without limits to gender, opens up a larger market to which FINCA can offer financial assistance.

Strategic and Operational Planning. FINCA's strategic and long-range operating plan can be found in its project document agreement with Shorebank. The document describes in detail the MF service methodology to be followed, institutional development plan, MIS and accounting systems to be used, and the intent to adapt operating systems and manuals in use by FINCA elsewhere. Also, the document names the FINCA's regional support staff who will provide oversight and technical assistance to the project. It is not clearly stated in the project document how the Armenian country program will be established as a local institution and what form it will take.

FINCA prepares 2 month forecasts of its anticipated portfolio size and project budget expenditures using the project document as a guide.

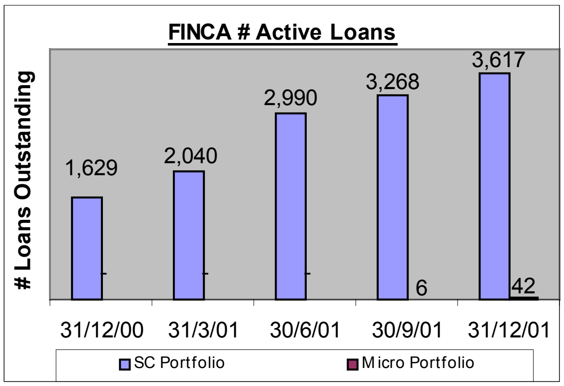
Financial Planning. Financial plans seem driven by existing project documents and donor funds already committed rather than on seizing opportunities in the market. This may be due in part to the quality and timeliness of information coming from the loan tracking systems and FINCA's accounting department. Both loans and accounting transactions are recorded using spreadsheets templates developed in Excel. (More will be said on FINCA's MIS system in a later section.)

It would seem that improvements could be made in the area of FINCA's financial forecasting. This would permit FINCA to more easily develop proforma financial statements and cash flows that could be used to manage liquidity and future loan capital needs. As with most group lending programs, FINCA's loan sizes increase in a step-wise fashion as clients demonstrate the ability to repay prior loans. FINCA's current clients expect to get larger future loans as long as they stay in the system and are below the maximum loan ceiling. As FINCA's average loan size is now $333 and the loan ceiling on its standard product is $1,000 there is potential growth in the loan portfolio.

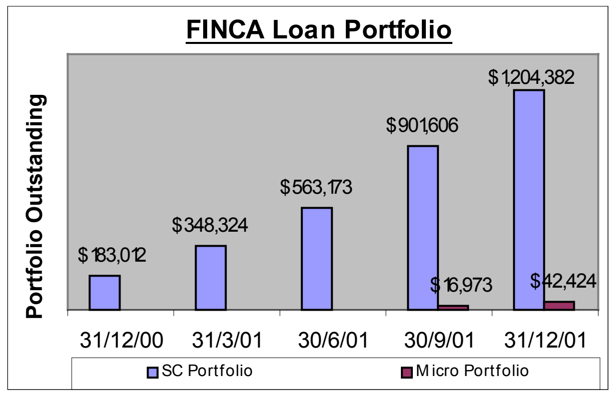
Graphs 4.3 and 4.4 on the following page show the increase in FINCA's loan program over the last year. The growth rate of the loan portfolio size is greater than the growth rate of the number of borrowers, as was the case with MDF. The average loan size for Savings Credit groups (SC) increased from $112/loan in 31/12/00 to $333/loan one year later. This is a much larger increase than that seen with MDF whose average loan in the portfolio increased from $102 to $194 in the same period.

Because of FINCA's focus on the Yerevan market, it needs to be especially concerned that it has enough loan capital to sustain its existing clients. As was pointed out in Section 4, on the average, microentrepreneurs in Yerevan request larger loans then those in rural areas. It is suggested that FINCA's financial planning capacity will need to improve so that it can select the appropriate mix of loan products and terms that grow in step with its cash flows and available loan capital.

Graphs 4.3: FINCA's Growth in No. Loans



Graph 4.4: FINCA's Growth in Portfolio



4.2.2 FINCA Services

FINCA's Savings and Credit groups (SC) range in size from 8 to 20 members, male or female. Originally, group composition was 75 percent female but it is now 60 percent. FINCA prefers to maintain the women to men ratio in its solidarity groups at no less than 60:40 though it sees no difference in repayment rates between groups having different ratios.

The process FINCA follows to form new groups is well documented and takes 3 to 4 weeks from self-selection to disbursement of a member's first loan. FINCA's written loan policies clearly describe the conditions for membership and insist that the person taking the loan use it for a business activity. Loan officers are instructed to verify that loans are used for business purposes.

Definition of Loan Products. FINCA offers an extensive variety of loan products, all with various combinations of repayment terms. The table below describes current loan products offered by FINCA:

Table 4.6: FINCA's Loan Products and Terms

Loan type	Repayment frequency	Repayment period (weeks)	1st loan max amount	Subsequent loans (max amount)*	Fees (paid up-front)	Interest rate (flat)
"Regular" SC Group (min 10 members)	Wkly, Bi-wkly	12, 16, or 24 (note: 80% prefer 16 wks)	\$80 - \$180	\$1,000 (or last loan + 50%)	2 %	3% / month FLAT
"Progressive" SC Group (min 8 members)	Wkly, Bi-wkly, monthly	12, 16, or 24	\$200 -\$300	Same as above	2 %	3% / month FLAT
"Micro" SC Group (min 5 members)	Wkly, Bi-wkly, or Monthly	12, 16, or 24	\$300 – \$500	\$10,000 (or last loan +50% but <= \$1,000)	2%	3% / month FLAT
Individual Loan	Bi-wkly or Monthly	24	\$500 - \$10,000		2%	3% Declining

Notes:
- Loans are disbursed and paid in AMD;
- In progressive groups difference between 2 members' loans may not exceed \$100.
- Progressive clients must have a business for a min. 6 months before group is formed.

* Principal + interest payments on micro loans can not exceed 2/3 of business profits for the period of repayment.
* Individual loans require co-signer, and 110% of loan taken as collateral (fixed assets, jewelry or real estate only)

Unlike MDF, FINCA does not vary its interest rate and fees with different repayment periods and frequencies in order maintain the same effective annual interest rate. What this means to the client is that on a \$300 loan with 16 weekly repayments, the effective annual interest rate is 78.7 percent whereas with monthly repayments the borrower would pay an effective rate of 63.8 percent.

FINCA requires its borrowers to save a mandatory amount during the loan repayment period. Mandatory savings is required on Regular and Progressive loans (20 percent of the first cycle loan amount). On micro loans, 10 percent mandatory savings is required. On future loans, the savings requirement goes down considerably. Savings are managed by the SC group and can be used to make interest free loans to the group members, though most groups choose not to lend this money and instead let it sit idle earning no interest. If the mandatory savings that sit idle and do not earn interest were to be included in the calculation of effective interest to the borrower, the rate would go up several points.

FINCA's mandatory savings policy is not responsive to first time borrower needs since it dramatically increases the cost of a client's first loan. To return to the earlier example of a \$300 loan the with repayment terms of 16 weekly payments, the effect of a mandatory 20 percent savings is to increase the effective interest rate from 78.7 percent to 163 percent.

The assessment team did not receive information on the business sectors most served by FINCA but based on the loan terms it would appear that the majority would be retail traders with quick stock turnover. Indeed, this group of clients is less sensitive to interest rates than those in production sectors. In fact retail clients are frequently able to use the leverage loans give them to achieve large increases in their net income. A typical FINCA client and her story was found on FINCA-Armenia's web site and is reproduced below:

FINCA Client At Work

"Susanna Mkrtchyan, a current FINCA Armenia client, was one of FINCA Armenia's first micro loan recipients. She is a trader working in the Hayastan market in Yerevan selling clothes. Susanna stated that the initial loan size of 252,000 ADM ($450) was helpful for her clothing business and the past and current loans have helped her with a 50 percent increase in inventory and a 40 percent increase in income. She currently has a 500,000-dram ($890) loan and is in the 3rd cycle with FINCA Armenia. Ms. Mkrtchyan plans to take another loan in the next cycle to purchase goods for the upcoming school year."

Source (photo and text): FINCA web site http://www.finca.am/meeting.html

Credit Policy Manual. FINCA's documentation appears to thoroughly cover the necessary information needed by credit program staff. However, no verification was made to determine if staff routinely applied the policies as written.

Service Quality. FINCA loan officers are required to attend all SC group meetings. This puts them in frequent contact with clients with opportunity to solicit feedback on program quality. Also, data collection sheets to measure loan impact on the client's business and family are filled but it isn't known whether this data is analyzed and reports circulated in order to make decisions based on the findings.

The underlined cities on the map to the left show where FINCA currently operates. Loan officers, who travel from Yerevan mostly on public transportation, cover clients in the outlying areas. The exact number of clients outside Yerevan though is small*. Due to the poor condition of the roads in winter, it has been difficult for FINCA to cover these areas without opening field offices branch offices.

* See Appendix 6: Matrix of Microfinance Supply for details on loans by cities

Source of map: http://www.finca.am

4.2.3 FINCA Management Information System

System Design. FINCA is able to generate reports that include data on: Portfolio/Outreach, Aging of Arrears (weekly and monthly), balance sheets and income statements. The staff seems satisfied with the reports and the MIS's ability to generate them. However FINCA pointed out that its head office recently developed a new loan tracking and integrated accounting package. It is planned that FINCA Armenia will install it as quickly as possible. However, given the high level of management satisfaction with the current Excel-based system, this will probably be delayed.

Records Management/Security. There was no opportunity to verify if records are kept up to date or if supporting documents are correctly filed.

4.2.4 FINCA's Financial Administration

Internal Control Policies. The assessment team was told FINCA has what it feels are all the necessary manuals, policy and procedure documents that cover internal control and include such things as personnel and accounting manuals, credit and collection policies, and operations manual. However, the Assessment Team did not examine all of the documents said to exist. Those that were seen (Savings and Credit Group Policies and Procedure Manual) was complete as it covered group formation and loan policies.

FINCA recently underwent a routine external audit (called for by FINCA's regional management team) of its operations. The Assessment Team asked to see a copy of the audit report however since the audit team's management letter is still in draft form, it was not shared with us. We were told that no major, critical faults were detected.

Accounting Policies and Procedures. Accounting policies are set by the FINCA head office in Washington DC and it's regional office in Moscow. Although FINCA was certain that it was properly following accounting procedures, the financial statements furnished to us were not in a "best practice" format for MFIs and some of the account categories listed on the financial statement that should have been filled in were not.

Table 4.7: FINCA Balance Sheet at August 31, 2001

ASSETS	
Current	
Cash and equivalents	$84,980
Short-term loans outstanding	$840,919
Less Loan Loss Reserve	(8,438)
Other short-term assets	$4,165
Subtotal current assets	**$921,626**
Non-current	
Net fixed assets	$11,659
TOTAL ASSETS	**$933,285**
LIABILITIES	
Short-term loans	0

Table 4.7: FINCA Balance Sheet at August 31, 2001

Other short-term liabilities	$115,169
Long-term loans payable	$537,794
TOTAL LIABILITIES	**$652,963**
EQUITY	
Owner's equity and capital grants	0
Cumulative surplus (retained earnings)	$52,686
Net Surplus (current period)	$227,636
TOTAL EQUITY	**$280,322**
TOTAL LIABILITIES + EQUITY	**$933,285**

Analysis of Financial Performance. FINCA's fiscal year ends August 31 and its last full year statements are presented above and below. It appears from the Balance Sheet that FINCA is highly leveraged with debt as it listed $652,963 in liabilities. (Table 4.7) However, neither FINCA's Country Director nor the Accountant could explain the source of this debt even though other balance sheet statements shown to us show this amount growing from $652,963 at August 31, 2001 to $838,0920 at December 31, 2001.

FINCA also furnished us an Income Statement (Table 4.8 below). However it reports no financial expenses such as bank charges that it incurs. Also, it did not list the 1 percent affiliation fee expense that FINCA collects as part of its loan processing fees (which should be recorded as a credit to Revenue) and then pays to FINCA's USA headquarters (which should be recorded as a debit to Affiliation Fee Expense).

For FINCA's fiscal year ending August 31, 2001, it reported a total operating income of $271,323 and total operational expenses of $199,216 for a net operating margin profit of $72,107. For the same period ending 2000 and 1999, it recorded net operating margin losses of ($53,616) and ($31,009). While this would seem to indicate a positive trend of improvement, it would be best to withhold final judgment on FINCA's financial performance until full and accurate statements can be furnished and evaluated.

Table 4.8: FINCA Income Statement for the Year Ending August 31, 2001

Financial Income	
Interest and fees on debt for lending	$271,165
Interest on savings	$158
TOTAL OPERATING INCOME	**$271,323**
Financial Expenses	
Interest and fees on debt for lending	0
Interest on savings	0
Subtotal Financial Expense	0
Other Operational Expenses	
Salaries and benefits	$131,201
Operational expense	$61,528
Loan Loss Provision	$6,487
Affiliation Fee (FINCA HQ)	0
Subtotal Other Operational Expenses	**$199,216**
TOTAL OPERATING EXPENSE	**$199,216**

Table 4.8: FINCA Income Statement for the Year Ending August 31, 2001

NET OPERATING MARGIN	**$72,107**
Operating grant income	$181,931
Other non-operating income	$7,214
Subtotal Non-operating Income	$189,145
Other non-operating expenses	$33,617
Subtotal for Non-operating Expense	$33,617
NET NON-OPERATING INCOME	**$155,528**
NET SURPLUS	**$227,635**

Financial Planning. FINCA will need to build the capacity of its finance manager and accountant in order to develop more detailed and accurate internal financial statements for management decision-making. The quality of the financial statements we were furnished, and FINCA's inability to discuss their content, are indicators that the microcredit operation does not yet have an institutional identity of its own. FINCA-Armenia's institutional identity appears to be that of its INGO parent and the financial management of FINCA Armenia seems to be project-oriented. The current Executive Director, an American expatriate, is pursuing a strategy of rapid expansion of the loan portfolio and number of clients. Given the very low arrears rate and the high rates of return, he is confident that this is the best way to build a sustainable institution. However, dependable cash flow projections will be needed to avert a liquidity crisis should average loan sizes continue to increase in size and FINCA not have enough cash to cover loan requests from existing customers.

To determine exactly what loan fund will be required, FINCA will need to also consider the attrition rate of clients leaving the program for one reason or another. As seen earlier with MDF, FINCA's attrition rate is quite high and a cause for concern. Unfortunately, FINCA could not offer an explanation as to why so many clients leave the program. It is strongly suggested that this be looked into. Since we estimate the total microcredit demand to be low, there are not a large number of clients to replace those who leave. Table 4.9 below shows the number of clients leaving FINCA's program over past years. [34]

Table 4.9: FINCA Client Attrition Rates

	Year ending 8/31/00	**Year** ending 8/31/01	**Month** ending 9/30/01	**Month** ending 10/31/01	**Month** ending 11/30/01	**Month** ending 12/31/01
a) # Clients at period start	332	1,261	3,274	3,382	3,495	3,572
b) # Client added in period	1,754	3,618	263	297	283	313
c) # Clients lost in period	(825)	(1,605)	(155)	(184)	206	226
d) # Clients at period end	1,261	3,274	3,382	3,495	3,572	3,659
Attrition rate during period (c/d)	69%	49%	5%	5%	5%	6%
Annualized attrition rate	69%	49%	55%	63%	69%	74%

[34] Data taken from FINCA Armenia's Portfolio / Outreach report.

4.2.5 FINCA Organizational Structure

Governance. FINCA operates in Armenia under bilateral agreements as an INGO. It does not yet have a governing board. FINCA's oversea structure has regional managers and support staff who are available to provide technical guidance and project oversight to country programs. Although this might be considered a form of Advisory Board, it does not involve any outside directors from within Armenia. Strategic and operating plans are those contained within project documents that are used to measure performance against target project indicators.

Legal Status/Functional Organization. Since FINCA is not yet a registered Armenian institution, it is allowed to operate more freely than a regulated financial institution. While other institutions such as MDF-Kamurj (Armenian Non-Profit Foundation) and SEF (Armenian Limited Liability Company) have chosen to register themselves, FINCA has decided its best course of action is to wait until the better choices present themselves. However, the decision to wait also puts off the time when FINCA Armenia starts to act as a separate accounting entity with all that entails in terms of its strategic decision making and organizational management.

4.2.6 FINCA SWOT Analysis (See Appendix 7)

4.3 AREGAK / UMCOR Assessment

Background. UMCOR established offices in Armenia in 1994 in the aftermath of the earthquake, regional conflict and economic distress of that period. Initially UMCOR focused on the distribution of pharmaceuticals to health institutions and clinics. Gradually it transitioned from relief to development activities including microcredit. AREGAK (Sustainable Guaranteed Agricultural Assistance for Women) is the name of UMCOR's microcredit project, which began lending in March 1998. AREGAK operates as a program department within the UMCOR Armenia country program, although in the past year it moved to a separate building apart from UMCOR's main office in Yerevan. AREGAK methodology is based on the Grameen Bank model of solidarity groups and its lending operations are primarily in rural areas and exclusively to women. Since start-up, AREGAK has received donor funding from USAID, USDA, UNDP and UMCOR private funds.

Documentation Reviewed. The assessment team utilized the questionnaires and survey instruments described elsewhere to examine AREGAK/UMCOR and its institutional capacity to supply appropriate and sustainable MF services. In addition, AREGAK made available to the team financial and loan portfolio reports, operating manuals, project documents, internal market studies, and lending policy and procedure manuals. Mariam Yesayan (AREGAK's Microcredit Program Director) and Paul Daniels (UMCOR Head of Mission) fully supported the assessment process. In addition, a field visit was made to AREGAK's field office to interview clients for Section 3.

4.3.1 AREGAK/UMCOR Planning

Vision and Mission. AREGAK's vision and mission is derived from its parent's roots as a relief organization and the fact that AREGAK has been managed as a development project since it began microcredit operations. Its mission statement reads as follows: "AREGAK provides financial services to women and their families to help increase income and raise the living standards of Armenian families."

While the mission statement accurately reflects AREGAK's microcredit work, it does not cover the non-financial services to entrepreneurs that it provides in the form of business training. Also, the statement does not mention other goals such as the sustainability of those financial services or their quality, the nature of the organizational structure that will provide the services, or the relationship AREGAK desires to have with its clients and staff.

However, the Assessment Team learned in meetings with UMCOR and AREGAK management that they are conscious of the need to spin off AREGAK from UMCOR and steps are being taken to evaluate the best way to do that while remaining true to UMCOR's core principals. Until these strategic issues are resolved, AREGAK's vision and mission statements will remain incomplete and unclear.

AREGAK's Armenian program director is actively involved in the Armenia MF Forum and was asked to speak at a poverty reduction meeting last year called by the World Bank and the government of Armenia. She also was recently elected to the Board of Directors of the Micro Finance Center of Poland, a CGAP supported regional support network established to promote MF best-practices.

Strategic and Operational Planning. AREGAK decided that it could best achieve its mission by exclusively targeting women and concentrating in the rural areas. This strategy is common among INGOs whose primary goal is poverty alleviation. Women are often targeted with MF services because it is believed that they are more likely to use their increased incomes to improve the standard of living of their families. In addition, rural populations are frequently poorer than rban and have less opportunity to access credit of any kind.[35]

AREGAK shows sensitivity to the rural market environment in the development of its operational plan. It involves the communities in the design and running of its microcredit program. When AREGAK enters new areas, its initial contacts are with the Village Head who assists by calling as many villagers as possible to attend an introductory meeting. If the village has a minimum of thirty persons wishing to join the program, AREGAK will offer MF services to the community. Once credit groups are formed in an area, AREGAK consults with them on major strategic decisions to be made.

AREGAK's Strategic and Operational Plans are project oriented and focused on a particular area (such as USAID project financing for the NK geographical area) rather than looking at building the capacity of the microcredit program as a whole. Although it is true that UMCOR is investigating its exit strategy for AREGAK, until it decides what it wants to do it should look at current operations with more of an eye toward AREGAK's self-sufficiency. This would entail developing detailed financial plans and projections that include full costing of the considerable administrative support AREGAK now receives from UMCOR that are outside of its reported staffing costs.

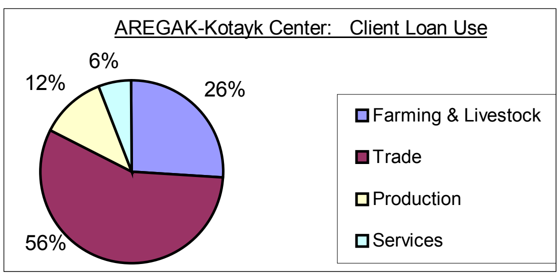
[35] The cost of delivering microcredit services to rural areas is usually greater due to a less concentrated loan demand that results in higher operating costs per loan.

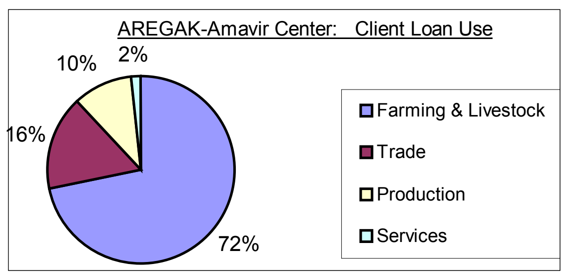
4.3.2 AREGAK Services

AREGAK's group guidelines differ slightly from those of MDF or FINCA. Group sizes are fixed to 5 exactly five members, any women aged 18-65 may join a group provided that group members reside in the same community. Loans are to be issued for business purposes only. Each member must have contributed no less than 50 percent to the pre-business's assets (land and labor not considered as a contribution) and the member's income must derive primarily from the business. Start-up businesses will only be financed if the borrower has cash flow from another pre-existing business. Each loan applicant completes a cash flow for her business along with a survey questionnaire that elicits information on the loan's impact and client satisfaction with AREGAK's lending program.

AREGAK attempts to design its loan products to fit the needs of its clients in the communities it serves. In most rural areas, this means developing credit products applicable to agriculture, agricultural product processing, poultry and livestock. To provide credit to these sectors, AREGAK offers 9 and 12-month loans with 3-month grace periods on monthly principal payments, though monthly interest payments are still due each month. Graphs 4.5 and 4.6 below show how the end use of the AREGAK loans may vary by rural area.

Graph 4.5 and 4.6: AREGAK Loan Uses at Kotayk and Amavir Centers





Definition of Loan Products and Clients Served. AREGAK operates primarily in 5 rural areas of Armenia (Ararat, Armavir, Kotayk, Syunik, Vayots Dzor) plus the NK region. Recently it started offering loans in Yerevan. The breakdown of AREGAK's loan portfolio as of December 31, 2001 is in the table below.

Table 4.10: AREGAK Loan Portfolio by Areas Served

Areas	City / Village	No. Current Loans	Loan Portfolio Outstanding (US$)
Ararat	Masis / Artashat	1,927	404,315
Armavir	Armavir / Echmiatzin	1,610	262,804
Kotayk	Abovyan	1,534	281,679
NK region	Stepanakert / Hadrut / Mardakert / Martuni	1,436	322,648
Syunik	Goris / Kapan	823	182,554
Vayots Dzor	Yeghegnadzor	1,181	246,850
Yerevan	Yerevan	115	113,812
Totals:		**8,626**	**$ 1,814,662**

It is interesting to note that AREGAK's distribution of loans across areas served is quite uniform with the exception of Syunik where it competes with MDF-Kamurj and in Yerevan where it only recently started to offer loans. Table 4.11 below describes the various loan products and terms offered at the present. Compared to MDF and FINCA, AREGAK's terms tend to be of longer duration, repayment frequency is all monthly (instead of weekly or biweekly), and the effective interest rates are lower than those of MDF or FINCA

Table 4.11: AREGAK Loan Products and Terms

Loan type	Repayment frequency	Repayment period (months)	1st loan max amount	Subsequent loans (max amount)*	Fees (paid upfront)	Interest rate (flat)
Loan # 1: no grace on 1st loan; only 3 of 5 members can borrow	Monthly	5 or 9 months	$ 300	40% increase over last loan; not > $1,000	2 %	2% / month
Loan # 1b: 3 months after first 3 members receive a loan and repay, other 2 can get their 1st loan	Monthly	5 or 9 months	$ 300	40% increase over last loan; not > $1,000	2 %	2% / month
Loan Cycle # 2a: Loan without grace period on principal	Monthly	9 or 12 months; No principal repayment for 3 months	N/A	40% increase over last loan; not > $1,000	2%	2% / month
Loan Cycle # 2 b: Loan with grace period on principal	Monthly	9 or 12 months	N/A	40% increase over last loan; not > $1,000	2%	3% FLAT during grace; 2% after
Yerevan: Group loan to 5 persons – each can receive 1st loan at start	Monthly prin + int pmts OR int. each mo. and prin every 3months	6, 9, or 12 months	$1000 MIN	40% increase over last loan; not > $1,000	2%	3% or 3.2% or 3.6% varies with length
N-K Loan (group)	? pilot	? pilot	$3,000	? pilot	2%	2%

Community Group Management. AREGAK put into place a cooperative-like organizational structure to link its solidarity groups together. The five-member solidarity groups elect one person to represent the group on a Coordinating Unit. Each Coordinating Unit then elects one representative to sit on an Advisory Group for a geographic region. Advisory Group can represent anywhere from 20 to 40 Coordinating Units, depending on the density of the geographic area. At the present time there are six Advisory Groups.

AREGAK uses these organs to solicit feedback from the clients on their program as well as to announce recent developments or plans for its MF program. This nascent structure could very well form the basis for a future bank institution formed on Cooperative principals such as that of ACBA.

Service Quality. AREGAK's financial services seem to be of a high quality due to an Operations Manual drafted in July 2001. The manual sets out uniform procedures, policies, and documentation for staff at headquarters and field offices. A noteworthy innovation by AREGAK to rent office space within bank buildings to support its rural lending program in the regions provides clients and AREGAK security and better liquidity management and cash control since repayments may be deposited immediately into AREGAK/UMCOR bank accounts.

Non-Financial Services. AREGAK offers its clients, on a free and voluntary basis, simple business courses that it feels will assist them. It would like to do more in this regard by setting up vocational training centers and employment centers to assist unemployed persons to find work.

4.3.3 AREGAK Management Information Systems

System Design. AREGAK's designed and wrote its own computerized MIS for loan portfolio and accounting recording and analysis on Microsoft Visual Basic. Financial and loan portfolio is transferred from field offices to the Yerevan headquarters on written report forms and on floppy diskettes. Information is entered onto the network server in "batches" (data is not continuously entered as transactions occur). Though the software has been written to analyze data in a variety of ways, it was not designed with all of the features in mind that are needed by a microcredit institution for its portfolio and financial management needs.

Some elements of the software design were clearly intended more for project reporting than for institutional management. For example, the program can provide the total number of loans from the start of the program to the present but it will not provide the number of loans written between two dates in between. In addition, the software program is unstable and crashes frequently. Also, the AREGAK employee who wrote much of the program appears to be the only one able to use it with any degree of accomplishment.

The fact that the MIS is dependent on hand carrying data from the field offices to Yerevan, is another weakness of the current MIS. Management may not be getting timely information on which to make decisions. As for the accuracy of the loan portfolio and financial data, it was not tested and the Assessment Team is not aware of any audits conducted on AREGAK's books. However, AREGAK plans to undergo a full Planet Finance assessment of its microcredit operation in the first six months of 2002.[36]

4.3.4 AREGAK Financial Administration

Internal Control Policies. AREGAK's internal control and accounting policies comply with those of UMCOR. However, the demands of handling cash and recording thousands of loan transactions (disbursements, fees, loan principal and interest repayments) are critical differences between the requirements of UMCOR's internal control needs and those of AREGAK. Unfortunately, the Assessment Team did not have time to analyze what adaptations were made and how well internal control policies were working.

Accounting Policies and Procedures. AREGAK accounting treatment of its financial transactions is according to UMCOR's project accounting policies and procedures. In other words, AREGAK is not treated as an accounting entity by itself, with its own chart of accounts, journal, ledger, accounting policies and so on.

AREGAK tried to prepare financial statements for the assessment team by using a trial balance of UMCOR's project accounts. However, the resulting Balance Sheet and Income Statement

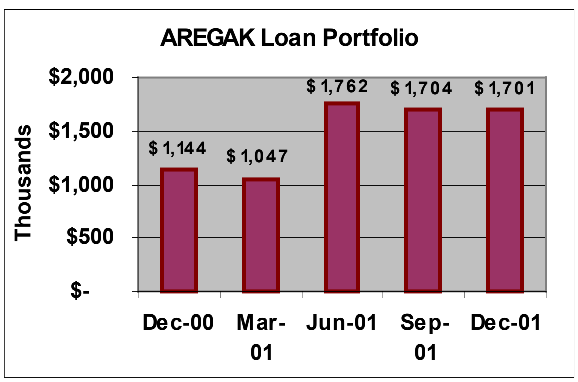
[36] Planet Finance is a French NGO established to support MF development. Institutions wishing to be evaluated by it may apply for a partial subsidy from CGAP to reduce the cost of the assessment. Internet web site: www.planetfinance.org

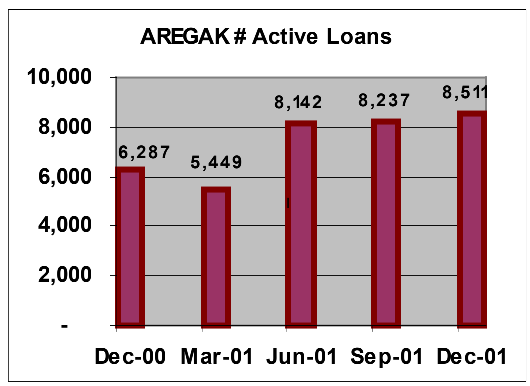
were not adjusted to account for all administration expenses incurred by UMCOR on behalf of AREGAK and it was not clear if generally accepted accounting principals were applied. In the end, the Assessment Team did not have confidence in the accuracy of the figures so they are not presented here.

Analysis of Financial Performance. Because of the lack of financial statements the team is unable to comment on AREGAK's financial performance. What is certain is that AREGAK is covering its direct operational costs from operating revenues and donor subsidies that it now receives. Currently these consist of USAID project funding to expand AREGAK's loan operations in NK as well as unspent funds from USDA monetization grants it received in 1997, 1998, and 1999.

In the absence of financial performance data, the two graphs below show changes in AREGAK's loan portfolio over the past several months. Unlike the graphs presented earlier for MDF and FINCA, AREGAK's loan portfolio growth is not as fast as the others. In fact, since June 2001 the loan portfolio value even decreased in dollar terms.

Graphs 4.7: AREGAK Loan Portfolio





Financial Planning. From the standpoint of forecasting revenues and expenses for microcredit activities, AREGAK does less financial planning than either FINCA and MDF Kamurj. This may be due to the fact that of the three it is has less overall responsibility over its operations since it functions as a program department within UMCOR, a multi-sector development agency. This isn't to say that AREGAK does not track actual versus project budget expenditures which it surely does. What it doesn't do is prepare cash flow forecasts or have an accurate sense of its level of operational sustainability when all current costs (both direct and indirect) are factored in.

This lack of financial planning capacity hinders AREGAK's ability to manage for sustainability. For example, without knowing its cost structure, it can not set interest rates for full cost coverage.

The lack of adequate financial planning also constrains AREGAK's ability to manage risk in its portfolio. Many of its loans are to the agricultural sector as it is primarily a rural lending facility. These loans carry a great risk of default when there are adverse weather conditions, even if current reimbursement rates are at >95 percent as they now are.

4.3.5 AREGAK Organizational Structure

Governance. AREGAK does not have a separate governance structure apart from UMCOR. As for UMCOR's institutional capacities in MF, they do not have many MF programs and AREGAK is its largest program by far.

While UMCOR Armenia's new current Head of Mission is completely supportive of AREGAK, he is far down the learning curve on best-practice MF. A strong plus in UMCOR's favor is that the organization recognizes it needs to build its own capacity in the area of MF and it is in the process of contracting with someone to do an institutional review of UMCOR's institutional capacity to support MF projects in the field. However, while this analysis is taking place, the day-to-day requirements of managing a loan portfolio of $1.8 million dollars spread out over 8,600+ clients goes on.

Legal Status/Functional Organization. UMCOR is registered with the Ministry of Justice of Armenia as a branch of UMCOR-USA. It is a tax-exempted organization under a bilateral agreement between the USA and the Republic of Armenia (Cooperation to Facilitate Humanitarian and Technical Economic Assistance – December 15, 992)

Human Resource Management. AREGAK's human resource function falls under UMCOR's administration. Interestingly, AREGAK's Accountant reports to UMCOR's Finance Manager who reports on a dotted line to the Head of Mission but on a direct line to the Finance Controller in UMCOR's USA headquarters.

One area of possible concern for AREGAK concerns its salary structure, which is set by UMCOR policy. Generally it is considered best practices for an MFI to establish an incentive policy in its salary structure whereas this is not common practice for INGOs. AREGAK expressed interest in moving in the direction of performance-based pay but is not sure whether this will be possible.

4.3.6 AREGAK SWOT Analysis (See Appendix 7)

5 Main Findings and Prioritized Recommendations

The objectives of this market assessment for microenterprise services is to quantitatively and qualitatively analyze the market for MF services and identify opportunities to support the microenterprise sector so as to program USAID/Armenia resources in the most effective and efficient manner.

In carrying out this assignment, the Assessment Team followed a "Financial Systems Approach" in which we analyzed the relevant policies, laws, regulations and supervision practices as well as socioeconomic trends within the country that can influence the size, nature, quality and development of MF services. This was followed by an in-depth study of the characteristics of demand for MF services that looked at satisfied demand and potential demand, which in the Armenian context were quantitatively and qualitatively different. Lastly we assessed the supply of MF with particular focus placed on three MF providers who together supply about 53 percent of the total of the total outstanding microcredits and about 36 percent of their outstanding value.

In this section, we summarize our main findings from earlier sections and then list those areas and activities that we feel will best support the microenterprise sector of the Armenian economy. We do this by first looking at the external environmental factors inhibiting sustainable MF expansion. We then look at institution-specific constraints. Last we provide our recommendations for targeted support to the sector.

5.1 External Factors Inhibiting Sustainable MF Expansion

Despite the Republic of Armenia's consecutive yearly expansion in its economy, this report cited evidence that there was "growth without poverty reduction" due to an unequal distribution of gains associated with GDP growth. GDP growth was greatest in sectors with low employment and overall it did not lead to an increase in the number of jobs available. In addition, potential income gains from growth in the agriculture sector were largely wiped out by unfavorable changes in relative prices of agricultural goods. The incidence of poverty (using the comparable poverty line based on the minimum food basket and allowances for essential non-food spending) in Armenia 1996 - 1999 remained at around 55 percent of the population.

It is generally the entrepreneurial poor who see opportunity in starting MEs to climb out of poverty. As stated earlier, it is the unemployed and economically inactive whose risk and severity of poverty remained unchanged or slightly worsened during the last 5 years.

There are many reasons why Armenia needs to have a healthy and well-functioning microenterprise sector. The importance of MF markets derives from the critical role that financial intermediation plays in enabling general economic growth and poverty reduction. Financial intermediaries essentially: (a) create money and function as a payments system; and (b) mobilize funds and allocate them among competing uses. The efficient provision of loan, deposit, payment, and insurance services is an essential element of an environment that enables entrepreneurship, innovation, and production to develop and flourish. Safe savings facilities, payment services, and reliable insurance mechanisms enable households to smooth consumption and mitigate risk. Timely access to appropriately designed credit products permit farm and off-farm entrepreneurs to take advantage of market and investment opportunities.

Factors in the existing environment that inhibit, or are not present to facilitate, the expansion of MF include: (i) existence of market disequilibrium between MF demand and supply, (ii) banking environment and legal status of MFI.

5.1.1 Microfinance Market Disequilibrium

In perfectly functioning markets, the supply of MF would exactly equal its demand, however, this is not the condition we found in Armenia. What is seen instead is an MF supply that is less than its demand, as well as a demand that could be larger than it is but is depressed.

We suggested two sets of reasons to explain the disparity between satisfied demand (current supply) and potential demand. The first set relates to the causes of market disequilibrium that helps one understand why otherwise credit-worthy or "bankable projects" cannot get funded. The second set of reasons as to why demand is depressed addresses why MEs may not be seeking credit in the first place

Possible reasons why otherwise credit-worthy businesses do not get funding include:

1. Armenia's underdeveloped legal system, particularly with respect to marketable property rights, results in weak collateralization of claims and inadequate contract enforcement mechanisms. Legal definitions for various types of marketable property rights (for example, titles for land, buildings, and various types of movable property) are very new and in most cases, in draft form. Registration of titles for marketable property rights is also nascent and still under development. Settlement of claims, repossession, etc. remains time consuming and costly, contributing to weaknesses in the secured transactions framework. These weaknesses prohibit many microentrepreneurs from providing collateral that are required by lenders, despite the fact that surveys of MEs show that over 80 percent expressed willingness to do so.

   While loans under the equivalent value of $1,000 are offered without collateral under microcredit schemes offered by MDF, FINCA, and AREGAK, nearly all institutions we encountered required some form of collateral for loans $1,000 - $10,000. A clear system with well-defined procedures to foreclose on pledged properties, and an active land market that allows for reasonable estimation of the value of pledged land and ready liquidation of pledged assets is needed. Without this, banks and MFIs will continue be reluctant to lend their own funds against collateral.

2. ME licensing, registration, inspection, and reporting requirements are underdeveloped and/or unclear to businesses. Stringent or arbitrary behavior of tax and customs agents potentially worsens the situation. Political instability and uncertainty add to the risks of applying for credit, even though the underlying ME might be creditworthy. Related, the forced business plans and cash flow disclosures required by nearly all microcredit providers makes many would-be borrowers uneasy about applying for a loan because of their cautiousness in making their assets and profits known.

3. Insufficient institutional capacity of microcredit providers is a third major cause of market disequilibrium. Best practices in terms of designing loan products that are demand driven, including non-collateralized credit of $1,000-$10,000, with incentives to increase the likelihood of timely and complete repayment are either not well known or adhered to. Incentives such as interest rate rebates (upon on-time, full repayment of the loan) and MFI employee bonus programs based (in part) on loan repayment performance are not utilized.

Possible reasons why demand is depressed:

ME survey results indicate that demand for microcredit is indeed depressed. After, "lack of credit" the most often cited constraints to ME development were, "over-saturation of the market" and, "competition." At least five factors may account for these findings:

1. Excessive interference (corruption and lack of governance) in business activity by poorly paid government officials has increased significantly the perceived costs of doing business as well as made it difficult to attract new entry (World Bank CAS, p. 6). Survey results suggest that small firms find both taxes and tax administration somewhat more constraining than larger ones. This may be due in part to the inexperience of smaller firms in dealing with issues of financial management. However, it is likely also attributable to Armenia's having unnecessarily complex tax rules, taxes biased against smaller firms, or a system subject to the influence of larger and more influential firms.
2. Infrastructure essential for ME development such as telecommunications, urban water supply, and road, rail and air transport should be improved. In addition, the closure of borders as a consequence of the NK conflict reduces the free flow of trade in and out of Armenia and increases the overall price levels of goods.
3. Armenia's domestic market is exceedingly small.
4. Despite a large and growing number of registered small businesses and a network of business support centers assisted by a variety of donors, training and information support for businesses is generally inadequate be it in entrepreneurship, business start-up, operations improvement, marketing, etc. Self-help business and enterprise start-up literature is generally not available. Small business entrepreneurs (70 percent of whom have a university degree) cite marketing and advertising as their highest priority for training followed by financial management and business planning (PwC, 2000, p. 20).
5. The cost of credit remains high, though in recent months the trend in interest rates has been downwards. Household and individual AMD loans that commanded an interest rate of 54.6 percent in 1998 fell to 30.7 percent in 2000 and could now be found in the range of 24-30 percent (ACBA). [37]
6. ME surveys indicate that many business owners see their activity as one of "subsistence" only and do not remain committed to the enterprise should another opportunity present itself. Thus, there may be less desire to commit to a loan that is repaid back over a future period.

5.1.2 Banking Environment and Legal Status of MFIs

The Central Bank of Armenia is responsible for regulating Armenia's banking system that is comprised of 29 banks, as of the end of September 2001. Many of these will have difficulty to meet a new $5 million minimum capitalization requirement. Banks that do not will be closed or face a forced change to their status. The uncertainty over which banks will remain open or close may have the dual effect of reducing deposits from risk-adverse savers and causing bankers to be conservative in their lending practices to reduce capital losses.

The relevant financial sector laws in Armenia currently subject only banks (depository financial institutions) to prudential regulation. Microlending by an NGO – whether a foundation or branch or representative office of a foreign non-profit organization – is not currently subject to any form

[37] While low cost of credit is good for borrowers, it is bad for Armenia's MFIs since they do not operate on the spread between interest on deposits and interest on loans. Since only banks may mobilize deposits for lending, the amount of their loan capital is fixed and dependent upon either attracting additional donor funds or through retained earnings. However only one, MDF Kamurj, has shown a net excess of revenues over expenses over the last year. Further, most have only a small amount of un-lent loan capital, which will limit their ability to cover the reduction in revenue from an interest rate cut by increasing their loan portfolio outstanding.

of prudential regulation or supervision, [38] although various suggestions for self-regulation and regulation by a governmental body (CBA or MoF) are being discussed. (Lyman 2001, p.5).

The restriction on foundations (i.e., MDF-Kamurj), international NGOs (i.e., AREGAK/ UMCOR, FINCA), and limited liability Armenian companies (SEF) to mobilize savings or introduce innovative financial instruments targeting MEs is a constraint to the development of a sustainable microenterprise sector. Furthermore, the considerable interest by the government of Armenia to consider passing special legislation to regulate MF or non-bank financial institutions may at best help to remove these constraints or at worst curtail current activities of MF service providers under the institutional form they currently operate.

Currently, the CBA is authorized to establish a maximum rate of interest for all lenders. Thus far, MFIs in Armenia have been able to set interest rates that are high enough for them to work toward both operational and financial sustainability. However, as the interest rates for microlending are typically higher than the rates for conventional commercial lending (due to higher administrative costs as well as other factors), it is possible that the CBA might in the future establish a maximum rate that would be above the market rate for commercial loans but below the rate necessary for MFIs to achieve and maintain sustainability (Lyman 2001, p.36)

5.2 Institution-Specific Constraints

Currently, MF in Armenia consists primarily of lending activities, although there are a few banking institutions that offer depository and other financial services to microentrepreneurs. Armenian microcredit service providers derive their loan capital from funds borrowed or granted by their parent organizations or donors, or in the case of commercial banks, via mobilizing savings.

With the exception of ACBA, which is a formal MFI governed by banking regulation, the three main MF service providers that we were asked to analyze (MDF-Kamurj, FINCA, AREGAK/UMCOR) are all semi-formal MFIs. Recommendations for support to these three MFIs derives from our assessment of their progress toward the commercialization of their services and establishment of an institutional structure that permits them to perform as specialized financial service entities.

From the standpoint of the depth and breadth of their loan portfolio outreach, all three have achieved substantial success in the few short years since starting their microlending operations by supplying small loans to large numbers of borrowers. In the aggregate, their average loan size is the equivalent of $229 and they provide microcredit to 18,130 active borrowers (53 percent of satisfied demand). At the same time, they are accomplishing this while maintaining a repayment rate of nearly 99 percent.

However, our analysis shows that they can do better, and that there is considerable progress to be made on the development of internal capacity and the acquisition of a proper institutional structures that will permit them to be self-sustaining and permanent. In short, institutional

[38] There is some disagreement among public officials about whether an institution that borrows funds for the purpose of on-lending should be subjected to the regulation and supervision applicable to banks.

transformation is needed to move them from project based, donor funded programs to self-reliant organizations that are fully staffed with long-term management who receive professional oversight provided by an elected Board of Directors.

Some MFIs such as MDF-Kamurj and SEF have taken strong steps in this direction of commercialization and becoming formal MF institutions, but others are well behind. A positive point is that all are aware of the need for transformation to a more “commercial orientation” and are willing to work toward this end. For each of the three, constraining issues in each of the following areas will be discussed in the following subsection: a) strategic mission; b) ownership and governance and human resources; c) client targeting and retention; d) products and services; e) risk management; and f) MIS.

Strategic mission. An MFI’s vision and mission statement is the starting point for its business plan. It should outline the overall goals of the institution, its core values, and the market it wishes to serve.

All three of the MFIs were originally started as projects by parent organizations whose missions, as they related to MF, were to alleviate poverty and help create economic opportunity for disadvantaged members of the population. This initial focus can be found embedded in the three mission statements described earlier. However, a closer examination of the three provides an indicator of the level of development each of the three has achieved on its path to self-sustainability and permanence. It should not be surprising, on the basis of its well-thought out and described mission and vision statements, that the most profitable by far of the three MFIs is MDF-Kamurj. It is also the only one of the three who is a legally registered Armenian entity.

The strategic mission statement of FINCA is the next most complete and it also is further along than AREGAK in terms of striving to create a self-reliant structure. Its mission statement mentions the fact that it intends “to establish a self-financing local institution that becomes a permanent resource…” However management-wise, FINCA is heavily reliant on expatriates’ expertise, inside and out of Armenia.

In final position on the institutional development curve is AREGAK whose strategic mission statement mentions only that it desires to “provide financial services to women and their families…” with no mention of how it will do this (i.e., self-sustainably, efficiently, etc…)

Ownership, governance and human resources. MDF-Kamurj was established by the merger of CRS and SAVE who transferred all assets they formerly managed (including loan fund) to the new Armenian foundation. Both Save, CRS and other local directors have seats on the board though not all directors have been named. However, the board has not met regularly and its members are not clear on their roles. Although the elements are mostly in place, board development is needed here.

FINCA-Armenia is a project office of FINCA-USA. It has no formal governance structure and its management’s goals and objectives are written into multi-year project documents that also set out the composition of the senior management structure. This structure includes the Armenia

Country Director (expat) as well as members of FINCA's Regional Team (all expats). FINCA intends to register as a local institution but is unsure as to what its best options would be.

AREGAK/UMCOR is fully owned by UMCOR who also are ultimately responsible for its governance and management. AREGAK maintains programming responsibility and UMCOR provides full administrative support, including financial management through its Director of Finance and executive direction through its Head of Mission.

Client targeting and retention. MDF-Kamurj and AREGAK currently target women borrowers exclusively. While MDF would like to furnish services to men as well in the near future, AREGAK wishes to remain exclusively with women. FINCA has mixed men and women lending groups and wishes to maintain its client ratio 60 percent women to 40 percent men.

The Assessment Team looked at retention rates of clients for MDF and FINCA (AREGAK's were not available). For both MDF and FINCA they were very high, as much as 50 percent-70 percent per year. An explanation is needed as to why clients are not staying in the program. It is always more expensive to find new clients than to retain them.

Targeting primarily, or in some cases exclusively, women borrowers is a constraint to the development of the microenterprise sector that encourages a lack of transparency amongst men who desire financing and must send a female to request the loan. Also, the reasons behind the large number of people abandoning microcredit services should be determined to see whether better-designed products could improve retention rates. Given the small size of the ME demand, Armenian MFIs cannot readily replace lost clients with new ones.

Products and services. All three MFIs provide a wide range of product terms and repayment schedules in the belief that such a wide variety is needed to suit client needs. However, it is difficult to imagine that clients need such variety to match their business cash flows. None of the three MFIs are producing their own cash flow statements to manage liquidity and accurately project future loan capital needs. The multitude of products is no doubt complicating this calculation since no institution currently has an MIS that can keep track (in real time) of thousands of clients repaying on different schedules. In addition, the cost of providing such a wide variety of loan repayment schedules must be weighed against the marginal benefit, if there is one, to the client.

As mentioned earlier, the only financial serviced products currently supplied are microcredits. Although as part of the three MFIs' lending methodology, there is some form of mandatory and/or voluntary savings that accompany microcredits. However, the MFI does not manage these funds and they are not designed for the convenience of the client but rather to serve mostly as a reserve fund in case of repayment problems. [39]

The three MFIs have recently relaxed their minimum loan amounts as well as the amount of increases in loan amounts from one loan cycle to the next. This should help those

[39] Although the MFIs are prevented by law from using this money, and all three claim to be in compliance with this regulation, this money is sometimes held by the MFI in their bank accounts or in their offices. It is recommended that the MFIs look closely at this practice to ensure that the cash is controlled and recorded on their accounting books for the time it is in their possession.

microentrepreneurs that ME surveys indicate would like access to larger loans. More study is needed to better understand the size and term of credits clients really need and how long they are willing to wait in the program to have access to the loan size that they want.

FINCA and AREGAK now offer individual loans requiring collateral, which is a new credit methodology for them, and MDF expressed interest in developing new products as well. However, this is a departure from the loan methodology that is the core competency of FINCA, CRS, and SAVE and something new to AREGAK as well. One reason that each may be interested in adding individual, larger size loans is to access additional donor funds that are now available through SAS and others. There is a lot of best-practice experience on how to go about diversifying a MF product line that could be useful here.

Financial and risk management. All three MFIs have room to improve their finance and accounting systems and procedures. Some have participated in external audits or are planning to do so in the near future. In the case of AREGAK (also perhaps to a lesser extent, FINCA) its accounting books were set up to process financial transactions for project accounting purposes (which fit the needs of their parent organizations). Since this system cannot be abandoned as it is needed by their parent, it would need to set up a parallel set of books that treats their operation as a separate accounting entity. In this way, they would be better able to generate reports and statements useful for the measurement and control of risk as well as the appropriate setting of interest rates, and new product design and costing.

A key risk for all institutions is the reduction in revenue earned as a result of likely interest rate reductions. The MFIs' maintenance of high effective interest rates on loans in light of the overall decrease in market rates risks alienating their clients as well as contributes to diminished demand (and increasing the number of client drop-outs).

Despite the fact that each of the three MFIs has someone listed on their organigram as an "audit person" the size of their operations and the quantity of transactions processed would indicate that more could be done. Fraud is a real and constant risk in any operation that disburses and collects cash. Though the Assessment Team found no evidence to suggest that there were current problems at any of the institutions it visited, financial and operational control systems are essential and are often found to be weak in MFIs.

MIS. A common need for rapidly growing MFIs, is a fully functional MIS that can analyze data and generate management reports that are timely, complete, and accurate to be used for the management functions of planning, deciding, implementing and controlling. An MIS is not simply a computer system and software package but rather it involves the full range of data collection (with proper reports on which to record), data analysis, and report distribution.

Both MDF and FINCA are generating portfolio reports and recording their accounting using Excel. AREGAK invested in the local development of an integrated accounting and loan portfolio software written on Visual Basic that in the opinion of the Assessment Team was not fully meeting current needs. MDF purchased specialized MF software called Loan Performer (integrated portfolio and accounting package) but has been unable to get it to run. FINCA has available to it a recently designed MF software developed by its parent that is available for purchase. It is not known whether this software is suited to FINCA Armenia's needs or whether it can be adapted to its current products.

It is felt that all three institutions could benefit by improvements to the design and implementation of a fully functional MIS that would meet all the demands of a regulated formal financial institution.

5.3 Recommendations

5.3.1 Short-term Capacity Building of MFIs

Development and donor organizations can help to build institutional capacity by providing exposure to and training in MF best practices, along with performance-based support for capacity building, for MFIs to expand their outreach and to develop cost-effective, sustainable operations. As an alternative to long-term grants to MFIs, there is considerable support for the use of short-term grant programs that evaluate demands from MFIs for specific, targeted assistance and that are performance based. Whenever possible, local experts or suppliers are engaged (using a bid process) to provide the service or products requested by the MFI and approved by the grant manager. This has the benefit of building local capacity to support the ME sector as well as being responsive to the changing needs of MFIs.

With the exception of AREGAK/UMCOR who has adequate loan capital via donor funding already available to it, the others (FINCA, MDF-Kamurj, SEF) where claiming it was their main need. The MFIs inability to raise loan capital from savings mobilization is indeed a large risk to their sustainability should they encounter a dramatic drop in repayments or demand (possibly due to factors out of their control, i.e., climatic conditions, macroeconomic forces, massive commercial bank failures and lost client deposits, etc…). However remote these risks may or may not seem, the risk of a sharp reduction in their revenues due to an interest rate cut is very likely if not unavoidable in the next few months. The interest rates on their loans are well above market and this difference is not easily sustained. Even in the absence of serious competition besides each other, there is the risk of the loss of client goodwill.

Therefore, the Assessment Team is not against the idea of providing additional loan capital support to the MFIs for the right reasons. We would like them however to put more effort into forecasting their cash flow and loan capital liquidity needs so that the amount of loan funds requested will be based on solid analysis and built on justifiable assumptions. In addition, we would suggest that the reasons for client attrition be determined and existing loan products be adjusted accordingly before any expansion of their loan product line. If the provision of additional loan funds are considered, it is suggested that they be transferred as long-term loans that can be converted into restricted grants to loan capital provided agreed upon performance parameters are met. These performance parameters could include such things as quarterly financial statements (in MF best-practice format of course) as well as portfolio reports, including aging of arrears.

Some of the MF best practice topics that could be useful to Armenian MFIs are:

1) Ownership and governance
2) Design of accounting systems development of appropriately formatted financial statements
3) Internal control and audit functions
4) Financial management: cash flows, liquidity management, ratio analysis
5) MIS design, development, and implementation
6) Accounting and loan portfolio software selection issues
7) Performance indicator reporting
8) Research, design and introduction of demand-driven MF products (microcredit and others). This encompasses the development and piloting of new or adapted delivery methods and products that can be used to increase access by underserved groups to financial services and the social intermediation that might be required by certain target groups to be able to use MF productively. Some possible non-credit MF service products include: savings, insurance, leasing, household loans
9) Design of marketing and advertising campaigns for MFI services
10) An explanation as to why both programs recorded such high numbers of persons leaving the program

5.3.2 Short-term and Medium-term Enabling Environment

Development and donor organizations should work with national governments to create an enabling environment for MF. This includes improving the macroeconomic and sectoral policy environment, as well as the legal, regulatory, and supervisory framework, to allow innovative financial institutions to extend a wide variety of MF services to the poor on a sustainable basis.

The main roles for governments are likely to remain in creating and maintaining an enabling macroeconomic and sector policy environment and an adequate legal, regulatory, and supervisory framework for MF. Direct financial sector interventions should be minimized to prevent market distortions and to allow private sector provision of MF services using proven methodologies for sustainable MF delivery.

Some of the activities that could help create an improved enabling environment are:

1) Several government officials expressed interest in learning about MF "success stories" from other countries, as well as the attributes of the legal and regulatory environments in which MF has flourished. Policy awareness seminars and workshops should be scheduled for members of Parliament, the Central Bank and the Ministries of Finance and Justice.
2) Such seminars and workshops can be an effective forum for explaining to policy makers not only the benefits that a robust MF sector may offer their country, but also the need for a "safe legal space" for MF in order to ensure that a robust sector develops. Given that the government is already in the midst of grappling with the creation of legal options for new forms of non-bank financial institutions, it is advisable that such events be organized in the near future. This workshop could focus

on draft legislation regarding non-bank financial institutions and MFIs, as a separate tier of regulation and supervision adapted to the operations of MFIs.

3) Another method of sensitizing government stakeholders to the special needs of MF and ME support are through the use of study tours, conferences and training programs for select individuals to attend.
4) Missing from MFI support to Armenia's MEs is appropriate and secure savings services. Access to liquid and term deposit services encourages remunerative saving and the accumulation of financial assets for "lumpy" investments. In addition, these types of deposit services allow consumption smoothing by offsetting irregular income flows and mismatched expenditures (whether expected or unforeseen). Consideration might be given to encouraging new legislation to enable savings mobilization by appropriately regulated MFIs.
5) Investigation can be made into the design of a payment or cash transfer system within Armenia. Access to safe and reliable payment services allow transfer of remittances between rural and urban areas, providing another method to increase investment and reduce vulnerability to risk.
6) Direct work with the CBA to improve understanding of issues, capacity building to effectively regulate and supervise MFIs in a way that leads to a strengthening of the sector and services provided.
7) The proposed Law on Pledges of Movable Property and the proposed Law on State Registration of Pledges and Other Interests in Movable Property, if passed, would contain the most advanced features found in the highly developed economies of North America and elsewhere. (Lyman Annexes Commentary 4-20-01). Given the binding constraints of the current system that prevent "bankable projects" from getting funded because of a loan applicant's lack of adequate collateral that is acceptable to lenders, this proposed law should be supported
8) Support should given to ensure that the draft Lease law Lease legislation is passed. This could open up the possibilities of new MF products to offer MEs.

5.3.3 Short-term and Medium-term Support to the Micro Credit Forum

As described earlier, there has been the ad hoc development of regular meetings of a group of MF stakeholders to discuss issues of common interest that have called itself the Micro Credit Forum.

MF associations, networks, and support programs have several important roles to play in the continued promotion of sustainable MF systems. They can spread awareness of key features of the financial systems approach to MF among policy makers, development agencies and donors, and practitioners. Also they help to integrate MF more with the general financial sector and ensure complementary approaches are considered. In addition, they can collect and disseminate MF "best practices" to accelerate the outreach and financial self-sustainability of their member MFIs in terms of cost-saving technological developments, creation of linkages to expand outreach, and lessons learned from transformation and experiences.

Depending on the level of interest the informal members of the Micro Credit Forum have in expanding the role of their group and helping to ensure its permanence through financial and in-kind support, there are a number of activities that we see it may carry out. It would not be necessary to create a large staffing structure, simply a small secretariat office with a manager assisted by an administrator/secretary. Staff can be drawn on a volunteer basis from member organizations as needed for special events/activities.

Some of the possible activities envisioned in the short-term for the Micro Credit Forum include:

1) Assist in the identification of local capacity building needs; gather and disseminate information on local adaptation of best practices.
2) Coordinate on the delivery of technical assistance and training to MFIs and other stakeholders.
3) Assist in the provision of technical assistance or training to MFIs, as capable.
4) In consultation with others and its Board, lead the development of standards and ratings for Armenian MFIs.
5) In consultation with others, lead the Armenian MFIs' adaptation of standardized accounting and reporting formats.
6) Receive member MFI statements and compile the data in order to inform members and other stakeholders on the development of microenterprise services and their socio-economic impact.
7) Be a contact point to coordinate donor support to the sector and to serve as an interface between the MF service providers and relevant government ministries and departments.
8) Support relevant enabling legislation important the development of the ME sector.
9) Improve on the current ad-hoc system of credit reference reporting initiated by MDF, FINCA, and AREGAK/UMCOR. (i.e., duplicate loans, blacklisted clients)
10) Carry out relevant research and development on issues important to the development of the sector.

Some of the possible activities envisioned in the medium-term for the Micro Credit Forum include:

1) Coordinate or conduct sub-sector analyses (in-depth market research noting growth areas, contractions, etc..)
2) If there is sufficient demand for the service, develop linkages with other MF networks, such as the Micro Finance Center in Poland to carry out training for MFIs in the Caucasus region
3) Establish linkages with commercial banks
4) Develop and implement, or assist another to develop, a Credit Bureau for ME and SME borrowers.
5) Conduct or participate in Business Development Service surveys and market assessments

5.3.4.Advisory Services for New and Small Business

Any decision to support the microenterprise sector in Armenia should not fail to consider the importance of including business development services (BDS) in the package. All of the MF lending agencies we contacted cited their belief in the importance of this non-financial service support to businesses.

Over the years, MDF-Kamurj has occasionally held free business training for clients that covered topics of marketing and general business planning. In addition, at various times throughout the year they sponsor trade fairs where their clients may present the range of goods that they wish to sell and these events are highly appreciated. While MDF acknowledged that it is not possible to recover the full cost of training microenterprise owners as small as theirs, they nonetheless would like to do more in this area. However, their current focus is on achieving financial sustainability for their microcredit operations and they are not willing to subsidize an expansion in their BDS activities without donor support.

A similar story for the need for BDS was heard from AREGAK and to a lesser extent from FINCA. AREGAK prepared a project proposal for vocational and business training that was shared with us and they are seeking donor financing for this.

Since the evaluation of BDS was not a focus of the Assessment Team's SOW, we do not have any recommendations to make on possible strategies to employ since suggestions we may make might already be in place and funded by other donors. Nonetheless we would encourage BDS support to be considered as a complement to MF services.

5.4 Suggested Topics for Future Research

Possible areas of future research would be to conduct a BDS survey for micro and SME enterprises. The survey would determine what services were being offered and by whom as well as how close did the available services match up to those which were desired and/or needed. Also, what was the level of satisfaction with BDS currently available and what is the level of cost coverage possible to expect of the various types of BDS support?

Lastly, in order to provide lenders with a means to control risk of loan default by means other than requesting 300 percent collateral, we believe a well-functioning credit bureau could prove useful in this respect. A credit bureau could be used to share information between lenders. Since the Assessment Team only came across the informal exchange of credit information between MDF, AREGAK, and FINCA it is not aware whether a formal or informal system of information exchange takes place between other institutions or commercial banks regarding loans under $10,000. However, the benefits of such a structure are clear in terms of reducing risk in microfinance lending.

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APPENDIX 1

Scope of Work

I. Introduction

USAID/Armenia is currently reviewing its microenterprise development strategy. The results of the microenterprise sector assessment, to which this SOW pertains, will be a key input into Mission deliberations for refining its strategy. Towards this end, the assessment will analyze the nature of demand for microfinance in Armenia, evaluate the performance of key microfinance service providers, outline niche growth areas, and make recommendations to guide support for the development of the microenterprise sector. The objective of the Market Assessment is to quantitatively and qualitatively analyze the market for microfinance services and identify opportunities to support the microenterprise sector so as to program USAID/Armenia resources in the most effective and efficient manner.

II. Background

The USAID program in Armenia is based on the belief that a more open and democratic civil society coupled with a dynamic and equitable free market economy are essential for improving the quality of life for all Armenians. The private sector is the primary vehicle for exploiting economic opportunities and increasing incomes among a broad base of the population. Within the private sector, the Mission believes that support to microentrepreneurs is a primary means of expanding economic opportunities for the economically active poor.

In support of market reform, USAID is currently implementing initiatives aimed at Accounting Reform, Banking Supervision, Tax and Fiscal Reform, establishment of Commercial Rule of Law, Privatization, and Capital Markets Development. In the medium-term, these initiatives are expected to support the development of SMEs and to a lesser extent that of MEs. In addition, USAID and other donors currently support a wide range of business skill enhancement and SME finance programs. With USAID financing, direct firm-level technical assistance is furnished via IESC, AED, and ACDI/VOCA. USAID supported SME lending initiatives include World Vision, ShoreBank, and the Eurasia Foundation (SBLP). The U.S. Department of Agriculture (USDA) supports a variety of activities through its monetization programs (ATG, UMCOR) and directly implements credit programs ($1,000-$150,000 loans), marketing technical assistance, and a leasing program. The European Union's TACIS program provides direct firm-level technical assistance, support to consulting firms, and started the Agricultural Cooperative Bank of Armenia (ACBA), which provides agricultural production credit (loans from $1,000-$3,000). The World Bank, EBRD, and Lincy Foundation have each instituted relatively large credit programs ($100,000-3,000,000 loans).

USAID is currently supporting microfinance programs being implemented by FINCA, which has 2,800 clients with an outstanding portfolio of $530,000 (primarily in Yerevan) and Save which has 4,578 clients, with an outstanding portfolio of $626,000 (in Yerevan, Gyumri, and Vanadzor). USAID/Armenia believes that increased support for Microfinance Institutions (MFIs) in Armenia will enable them to become more efficient and increase their outreach to effectively meet the needs of additional microentrepreneurs. This assessment will help inform and guide

Mission decision-making regarding possible new activities or expansion/modification of existing activities.

III. Objective

The assessment will analyze the nature of demand for microfinance in Armenia, evaluate the performance of key microfinance service providers, outline niche growth areas, and make recommendations to guide support for the development of the microenterprise sector. [40] The objective of the assessment is to quantitatively and qualitatively analyze the market for microfinance services and identify opportunities to support the micro-enterprise sector so as to program USAID/Armenia resources in the most efficient and effective manner.

IV. Tasks

1. Meet with the Mission for an initial briefing and discussion of the content and deliverables associated with the SOW. (.5 day)
2. Office visits to review micro and small-scale enterprise lending activities being carried out by SEF (WV), German Armenian Fund, ACBA, USDA (Production Credit Club Program), and Shorebank Advisory Services (Direct Lending). Some of these organizations are servicing very small clients (e.g., loans in the $1,000 to $10,000 range) and should be considered in any microenterprise development strategy. (3 days)

   - Identify current target markets (size, location, types of clients), current products and methodologies;
   - Outline stated intentions for new products, markets, and expected donor support;
   - Solicit length of the project and exit strategy; and
   - Outline how the above cooperate or compete (actually or potentially) with other microfinance providers.

3. Visit Head Offices and selected client MEs to gather information for the review and evaluation of the FINCA, MDF-Kamurj (Save the Children/CRS), and AREGAK (UMCOR) microenterprise development programs. (9 days)

   - Review Financial Statements, Policies, Guidelines (for example; pricing policies, reserving practices, operating manuals, loan policies, personnel policies, client services, and group formation);
   - Identify current clients served (client microenterprise size, location, and type), current products, methodologies, and the extent to which the MFIs are meeting client needs;
   - Outline relationships with other MFIs;
   - Outline stated intentions for new products, markets, and expected donor support;
   - Evaluate the impact of the program on clients based on the responses of clients interviewed and any qualitative/quantitative information provided by the organization;
   - Estimate level of sustainability and cost coverage;
   - Describe and evaluate how the organization's strategy for sustainability addresses the organization's capital requirements;

---

[40] Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to the poor and low-income households and their MEs. Microfinance in the Armenian context generally refers to loans of amount $1,000 or less (although in some cases loans up to $5,000 may apply) and other financial services targeted as described above.

- Describe any relations with and usage of domestic banks and evaluate the potential for deepening the relationship; and
- Outline the strengths, weaknesses, opportunities, and threats (SWOT analysis) of each institution.

4. Analyze the nature of demand for microfinance in Armenia. This includes analysis of the current and potential market (size, location, and types of clients, gender, as well as services and/or products) for financial services to MEs in the country. The focus is on quantitatively and qualitatively identifying the depth of the markets for various services. Identify market trends that point towards service areas that could be expanded and products that could be introduced (for example, larger individual/collateralized loans or innovative savings mechanisms). Outline non-financial services that might also be helpful to microenterprise development (for example, marketing or input supply assistance, training, or administrative services). Review and assess the possible constraints that prospective MFIs would face in servicing the identified markets. (4 days)

5. Recommend to the Mission prioritized support options to develop the microenterprise sector.

V. Deliverables

1. Before leaving Armenia, debrief the Mission and produce a draft of the report with the following format:

   a. Executive Summary: objectives of the activity evaluated, the purpose of the evaluation, the study method, findings, conclusions, and recommendations.
   b. Body of the Report

   - Quantitatively and qualitatively detail the nature of demand for microfinance services in Armenia. Include a clear description of the targeted clientele (socioeconomic status, type of activity, size and status of business). Outline the extent to which and by whom these markets are currently being serviced.

   - Address the crosscutting issue of gender by outlining current industry standards on the role of gender in microenterprise development. Based on the current services and identified markets, outline any significant gender related variables. If the provision of financial services to men is identified as an underserved market, outline how this market may be supported without undermining the efforts to engage women (supplementing as opposed to displacing female clients).
   - Summarize and evaluate the activities of FINCA, MDF-Kamurj (Save), and AREGAK (UMCOR) using the bullet points in IV.3 above as guidelines.
   - Recommend to the Mission prioritized support options to develop the microenterprise sector.

Appendixes

   a. Matrix of microfinance service providers (FINCA, MDF-Kamurj [Save], and AREGAK [UMCOR]) by geographic service area(s) and product(s);

b. Matrix of market demand for microfinance service (by microenterprise types, number of employees, amount of loan desired, place of business, etc.)
c. List of documents consulted, individuals and agencies contacted; and
d. SWOT analysis of FINCA, MDF-Kamurj (Save), AREGAK (UMCOR), and USDA microfinance program.

2. USAID/Armenia will provide comments on the draft report within one week of the departure of the Assessment Team from Armenia (January 27, 2001). Incorporate the feedback received from USAID/Armenia by February 2, 2002 and within two weeks of that date provide the following:

One hard copy, by mail to:

John B. Crihfield
G/EGAD/EM
Office of Emerging Markets
Center for Economic Growth and Agricultural Development
Bureau for Global Program
U.S. Agency for International Development
1300 Pennsylvania Avenue, N.W.
Washington, D.C. 20523
202-712-1288

One hard copy and one electronic copy on diskette to:

U.S. Agency for International Development
PPC/CDIE/DI, Attention: Acquisitions
1300 Pennsylvania Avenue, N.W.
Ronald Reagan Building M.01-010
Washington, D.C. 20523

One hard copy and one electronic copy (by email) to:

U.S. Agency for International Development
Attention A. Balian, EREO Deputy Director
U.S. Embassy
18 Baghramian Ave.
Yerevan, Armenia
Email: abalian@usaid.gov

APPENDIX 2

Contact List

Agricultural Cooperative Development International / Volunteers for Overseas Cooperative Assistance (ACDI/VOCA) - Mr. Sevak Manukyan, Armenia Country Representative

Agricultural Cooperative Bank of Armenia (ACBA) - Mr. Hakob Andreasyan, Head of the Credit Department

AREGAK/United Methodist Committee on Relief (UMCOR) - Mrs. Mariam Yesayan, Director; Ms. Yeva Grigoryan, Program Coordinator; Ms. Narine Yedigaryan, Operations Coordinator; Mr. Mkrtich Ashtryan, MIS Manager

Catholic Relief Services (CRS) – Mr. Patrick McCallister, Manager Program Quality and Support Department; Mr. Richard Hoffman, Country Representative

Chemonics International – Mr. Brian Murphy, Chief of Party USAID Armenia Rule of Law and Commercial Law Project

Development Alternatives International (DAI) - Mr. Tom Rulland, Director Armenia Agribusiness SME Market Development Project

European Bank for Reconstruction and Development (EBRD) – Mr. Alexander Witte, Head of the Resident Office for Armenia

Finance for International Community Assistance - (FINCA) - Mr. Charles Crye, Country Director; Mr. Aram Ghukasyan, Operations Manager

German Armenian Fund (GAF) - Mr. Ashot Abrahamyan, Country Director

International Organization for Migration (IOM) - Mr. Khachatur Kazazyan, Project Coordinator

MDF-Kamurj - Mr. Gagik Vardanyan, Executive Director

Save the Children (SAVE) - Mr. Craig Feinberg, Microfinance Technical Advisor to MDF-Kamurj

Shorebank Advisory Services (SAS) - Ms, Marie Florance Stock, Country Director

Small Enterprise Fund (SEF) - Mr. John Sax, Managing Director; Mr. Arsen Kuchukyan, General Manager

World Bank – Mr. Karen Grigoryan, Economist, Operations Manager

World Vision (WV) – Mr. Robert Dira, Country Director

United States Department of Agriculture (USDA) - Mr. Craig Infanger, Project Coordinator and Director; Ms. Marianna Alexandryan, Credit Club Program Advisor

United Methodist Committee on Relief (UMCOR) - Mr. Paul Daniels, Head of Mission; Mr. Qaisar Nadeem, Finance Director

OXFAM – Ms. Margarita Hakobyan, Country Manager

APPENDIX 3

Survey Questionnaire of Microfinance Demand

Questionnaire for Micro and Small-Scale Entrepreneurs

Contents

I. Basic Information

Date of interview: _____/_____/2002
Name of interviewee: _________________________

C1. Number of employees: ___________
C2. Location(s): ____________________
C3. Subsector (note if seasonal, and if so, time and duration of loan needed)
Trading (clothing, food, handicrafts, etc.): _______________________
Services (hairdressing, restaurant, etc.): _________________________
Manufacturing (clothing, handicrafts, furniture, metal work, jewelry, etc.): __________
Agriculture
_____Animal husbandry (types of animal[s]):______________________________
_____Crop production (crop[s]):____
_____Food processing; (food[s]): ____

1. Position: _____owner; _____manager; or _____partner; Hours spent/day: _______
2. Type of Ownership: _____sole proprietorship; _____partnership;
   _____other (specify______________________________)
3. Age: _____; Marital Status (S/M/D/W): _____
4. Sex: _____M; _____F
5. Education: _____primary school; _____secondary school; _____technical education;
   _____university graduate; _____post-graduate
6. Type of other employment: _____other private business; _____private sector employee;
   _____public sector employee; _____none
7. Number of years enterprise has been in operation: _____; in current form of registration: _____.
8. Value of initial investment (start-up cost): __________
9. Most significant source of funds for initial investment and later investments (if any):
   _____cash/retained earnings; _____commercial bank; _____MFI (INGI/NGO, etc.);
   _____moneylender; _____ "lottery;" _____supplier credit; _____family/friends
   Number of employees at start-up: _____; and now: _____
   _____ full time; _____part time; _____seasonal/occasional; _____unpaid/family
   What role does your spouse play in supporting the business: _____management;
   _____marketing; _____production; _____finance; _____formal ownership; _____none;
   _____other (specify) ____
   Business location: _____home; _____street; _____store; _____market; ____other
   Explain choice (cost or other factors):

   Number of dependents: _____; Number of other working adults in household: _____
   Total income generated by other household members per month: ________________
   Total income generated by enterprise (gross [and net] per month, or monthly turnover, etc.): _________________

Contractual Relations with Suppliers
With respect to the raw materials/inputs (most frequently used/largest in volume)
Type of supplier: _____public sector (cooperative); _____private sector; _____import
Average value of monthly purchases: ___________
Form of purchase: _____cash; _____credit; _____combination of the above

10. If entrepreneur does not use supplier credit, have they ever asked for it (y/n): _____

11. If supplier credit has been used, what percentage of purchases was on credit (%): __
Number of credit transactions last year: _____
Average value of credit purchases: _____
Down payment (on delivery): _____
Interest charges (or % difference between cash and credit price): _____
Time elapsed between delivery and full repayment: _____
Collateral required (guarantee, deposit, etc.): _____

II. Contractual Relations with Clients

12. Type of clients: _____public enterprise; _____neighbors; _____middleman; _____ local markets ; _____distant markets>1 hr; _____products exported
13. Form of sales (% of each): _____cash; _____credit
14. If you sell goods/services on credit:
Down payment required: _____
Interest charges (or % difference between cash and credit price): _____
Time elapsed between delivery and full repayment: _____
Collateral required (guarantee, deposit, etc.): _____

III. Informal Borrowing

15. Have you ever requested a loan from an informal source (not a commercial bank or NGO) (y/n) _____
(If no, proceed to Section V.)
16. If yes, from which source: _____moneylender; _____"lottery;" _____friends/family
17. Was the request accepted (y/n): _____
Number and amount of loans borrowed informally last year: ___________________
Down payment: _____
Interest charges/fees: _____
Duration of loan: _____
Collateral required (guarantee, deposit, etc.): _____

IV. Borrowing From Financial Institutions (FI), Commercial Banks, MFIs, and NGOs

17. Have you ever applied for a loan from an FI (y/n): _____
18. If no, why not: _____lack of collateral; _____lack of financial documents; _____high interest and fees; _____difficult and lengthy procedures; _____lack of FI relations; _____fear of inability to repay; _____other (explain) _______

(If no, go to question 22)

19. If yes, and the loan was rejected, why: _____lack of collateral; _____lack of financial documents; _____lack of FI relations; _____business unregistered; _____bad credit history; _____not in business long enough
20. If you received a loan from an FI, how many loans were borrowed in the last year: _____; from more than one FI (list each):___________________________; how much were they: ____
21. For the most important loan in the last year, what FI was it from: _________________
Type of loan: _____working capital; _____investment capital; _____consumption
Days between loan application and disbursement: _____
Amount of loan requested: __________; Amount of loan approved: __________
Maturity: __________; Amount of repayment installment and timing (weekly, monthly, or other): ____
Up-front fees (% or amount): ____
Interest charges (accrual basis):____
Collateral: _____building; _____land; _____machinery; _____inventory; _____bank account; _____guarantor; ; _____jewelry; _____mandatory deposit (terms)________
Collateral as a percentage of the loan: ____
For how long have you been borrowing from your current FI: ____________________

What factors entice you to stay:

Or might make you want to leave:
(go to Section VI)

Potential Demand for Microcredit and Other Services

22. Do you have potential interest in requesting a loan from a bank or NGO (y/n): _____
23. What loan amount would you request: __________
24. Type of loan: _____working capital; _____investment capital; _____consumption
25. For how long with you use the loan (maturity): __________
26. What is the maximum interest rate you would be willing to pay: __________
27. How much in fees do you think you should pay: __________
28. What type of collateral would you be able to provide: _____building; _____land; _____machinery; _____inventory; _____bank account; _____guarantor; _____jewelry; _____mandatory deposit (terms)__________; _____ none of the above

V. Deposits in Financial Institutions

29. Does you have any deposited funds (y/n): _____
30. Do you use an electronic bank card (y/n): _____; Type: _____debit card; _____ATM

31. If you do not use an electronic bankcard, would you like to (y/n): _____
32. Would you be willing to pay for your electronic bank card (y/n): _____; If so, what: ___

VI. Other Deposits and Contributions

33. Does you make contributions to informal groups ("lottery") (y/n): _____
34. Number of informal groups you currently participate in: ____________
35. Number of members in the most significant group: _________
36. How many months has the group been in operation: ________
37. Number(s) and amount(s) of contribution(s) per month: _______________________
38. Why did you join the group (to get a loan, help someone, etc.): _________________

Potential Demand for Deposit and Related Services

39. Are you a member of a savings group (y/n): _____
40. Does the group collect savings from its members (y/n; terms): __________________
41. Do you feel your savings are secure (y/n): _____
42. Would you save more if your savings were guaranteed (y/n; and how much):______

VII. Problems and Constraints

43. What are the first and second most significant problem facing the business now:
_____weak demand; _____marketing/distribution; _____labor; _____raw materials;
_____infrastructure; _____costly financing; _____unavailability of financing;
_____insufficient collateral; _____domestic competition; _____foreign competition;
_____taxation; _____government procedures; _____technology/equipment;
_____supplier problems; _____rent; ______other (specify)______________________

44. How much has the business grown over the last year (%): ______________________
Reason(s) for growth strength or weakness: _________________________________

45. If you had no further access to loans, what might be the effect on your business:

46. If you had no further increases in the size of your loans, how might that affect your business:

47. Is your business registered (y/n): _____; If no, why (tax implications, complicated procedures, lengthy process, don't know about procedures, costly procedures, not enforced, no need, etc.):
____

48. Do you belong to any business/trade or professional association(s) (y/n): __________
If yes, which one(s): ____

If no, do you know of any like organizations (y/n): _____; Would you like to join such an organization (y/n and rationale): ____________________________________

49. If you were given the opportunity for additional training at a small fee to you, in what areas would you like it: _____accounting; _____marketing; _____sources of credit; _____cooperation opportunities; ____legal aspects of business management

What's the maximum you would be willing to pay: _____________________________

APPENDIX 4

MFI Questionnaire – Parts 1 and 2

INTRODUCTION TO SURVEY QUESTIONNAIRE

This survey is addressed to institutions that facilitate directly, or indirectly, the provision of microfinance services. It is part of a larger Market Assessment for Microenterprise Services commissioned by USAID. This particular questionnaire is designed to gather information on the nature of the Armenian supply and demand for microfinancing services targeting micro entrepreneurs. It also seeks information on the supply of financial services targeting the next size of business to which some micro entrepreneurs may grow. It is expected that the knowledge emerging from this study will help to support and improve the provision of demand-driven, sustainable microfinance services in Armenia.

For the purposes of this study, microfinance loans are defined as less than $1,000 USD (approximately 550,000 drams); In the Armenian context, business loans of $1,000 and less are typically sought by microentrepreneurs to support their businesses.

However, from time to time these same MEs may require larger loan amounts. For this reason, as well as to learn more about the next level of financing for loans ranging from $1,000 to $10,000 USD, this survey seeks data on both of these two size ranges of loan products and the institutions offering them.

The utility of the Armenia Market Assessment Report depends directly upon the quality of the data the Assessment Team receives and analyzes. Recognizing this, the team is very grateful for your cooperation and valuable time taken to reply to this survey. We wish to acknowledge your help and thank you for providing us information on your institution's activities in this important development sector.

<table>
<tr><td colspan="2" rowspan="2">Organization name:</td><td colspan="2">Date Survey Completed:</td></tr>
<tr><td colspan="2">City:</td></tr>
<tr><td colspan="2">Legal status in Armenia (write in date of legal registration in Armenia)
If "Other" legal status (describe):</td><td colspan="2">Bank ☐( ) Non-profit foundation ☐( )
Limited liability company ☐ ( ) Other ☐( )</td></tr>
<tr><td colspan="2">Person interviewed:</td><td>Contact tel. #:</td><td>Email address:</td></tr>
<tr><td>Organization makes loans <$10,000:
☐ Yes
☐ No</td><td colspan="3">Organization provides technical assistance and/or loan capital to an institution(s) that operates a microfinance program: ☐Yes
If yes, name the institution(s) that you currently assist and describe the nature and $ amount of assistance (Eg., loan capital, grant for operations, etc…).</td></tr>
</table>

1 Identify current target markets (institution's estimate of target market potential and how much it supplies)

1.1 Loan capital available for microfinance and/or small business loans <$10,000)

Approximate amount of total loan capital your institution has to make loans that are < $10,000 USD: _______________$

Source of funds for loans <$10,000:

Funding source by % of total loan capital on hand: Donor funds__________% Retained earnings__________%; Mobilized savings__________%

Complete the following section if your institution has received donor funds specifically targeted for loans <$10,000.

Donor 1 name: ___________________; Amount ______________ Dates of project: ______________________Funds granted to you ☐ ; or lent ☐

For donor 1 funds lent to you, describe repayment terms:____

If donor 1 funds given for loan capital, does donor share any risk on unrecoverable loans of <$10,000? If yes, describe how:

____

Donor 2 name: ___________________; Amount ______________ Dates of project: _________________Funds to granted you ☐ ; or lent ☐

For donor 2 funds lent to you , describe repayment terms____

If donor 2 funds given for loan capital, does donor share any risk on unrecoverable loans of <$10,000? If yes, describe how risk is shared:

____

(NOTE: If more than 2 donors, use back of survey to record same info.)

1.2 Please list locations where you have clients taking loans of <$10,000.

____

1.3 Types of clients targeted with your loan programs:

Are there any business activities or client groups that you specifically target with your loan products (Eg., women, agricultural loans, poverty lending, displaced persons, size business, etc…)? If so, describe which ones and where:

____

1.4 Loan portfolio:

Approx. what % of your outstanding loans <$10,000 was lent to businesses in: Services_______%; Retail_____%; Mfg._________%

2 Description of your organization's loan products <$10,000 and the lending methodology used:

2.1 Loan Products <$10,000 offered

Describe the different loan products your organization offers. Fill in the appropriate and relevant information in the table below for each product: (Note: Express values in $US; indicate type and % coverage for collateral, if any)

Note: if written loan product terms and policies are available, it is requested that the respondent attach a copy of them to this survey when it is returned.

Product	1st loan max.	2nd + loan max.	Fees*	Nominal interest rate	Repmt. Terms	Collateral (type %)
❖						
❖						
❖						
❖						
❖						

* Fees may include such things as: loan application fees as % of loan; flat amount charges; registration of collateral; approved business plan; etc…

√ Lending methodology you follow for loans < $10,000 is (are): Group lending ☐ AND/OR Individual loans ☐

Describe the type of collateral generally required, according to type of loan offered:

√ Does your organization help to mobilize client savings via the lending methodology? ☐

Are client savings available to your organization to use for lending purposes? ☐

What is the approximate ratio of client savings mobilized to total loan portfolio outstanding for the same clients?
____________________ %

2.2 For each current product offered, please provide loan portfolio data for loans valued < $10,000.

These portfolio indicators should report on the most recent quarter available, as well as for each calendar quarter over the past 1 ½ years.

Note: The historical loan data is very important for the Assessment Team to evaluate trends in supply and demand of loans.

The minimum current and historical data sought is:

- # loans outstanding
- value of loans outstanding
- # lending groups (if group methodology used)
- value of portfolio at risk*
- # loans in arrears
- # loans outstanding segregated by gender
- # new loans written in the period
- value of new loans written in the period
- # of client drop outs in period**

* Portfolio at risk equals the total amount of loan principal outstanding for all borrowers who are in arrears.
** Client drop outs are the number of clients who had a loan at the start of the period, repaid it, and didn't take a new loan during the period.

NOTE: It is asked that the organization attach to this completed survey its customary, quarterly loan portfolio report for all loans under <$10,000 US for the past 1 ½ - 2 years. If possible, the report should list different loan products separately. Also, if possible the portfolio report should also list loan products separately by individual branch offices.

3 Outline intended future loan products <$10,000 US, if any.

NOTE: If you do not intend to introduce new loan products of <$10,000 in the next 12 months go on to SECTION 4

3.1 New loan products <$10,000

What is the range of loan sizes (minimum/maximum) for the new products you plan to introduce?

____

What are the expected collateral requirements and loan principal covered for these new loan products?

____

What are the expected nominal interest rate and fees to be charged? In what region(s) will these new loan products be introduced?

_______________________________________ _______________________________________

Specify how interest rate is calculated and frequency of principal and interest payments; how fees are applied when; length of loan;

____

Will these new loans (<$10,000) be targeting a new type of client or offering existing products in new locations? If yes, please explain.

____

Is your organization expecting to receive donor support to introduce these new products or enter new markets? If yes, describe the support expected/needed (type and value); the time frame for the donor support (when it will start and how long it will last); and possible donor names.

____
_

4 If project funding is currently received to help your organization serve clients taking loans of <$1,000 and $1,000-$10,000US, please complete the following section.

4.1 Name of donor(s): ____

4.2 Implementing agency, if not your own organization: ______________________________________

4.3 Project starting and ending date: ____

4.4 Total value of the project:

____

4.5 Does project budget include funds for loan capital? ☐ Yes

Is it a loan to the institution? If so, does it have to be paid back? Is so, what is the amount and terms of the loan (interest rate, repayment schedule).

____

Is it a grant for loan capital to the institution? If so, when does the ownership of the funds transfer from the donor to the institution?

____

5 Outline how your institution cooperates or competes (actually or potentially) with other microfinance providers.

5.1 Competition for clients seeking loans of <$1,000 and $1,000-$10,000

What organizations compete with you and where for the same clients seeking loans of <$1,000? (name(s) of organization(s) and location(s))

____

What organization compete with you and where for the same clients seeking loans between $1,000 and $10,000 (name(s) of organization(s) and location(s))____

5.2 Cooperation with other microfinance providers

Describe with who and how your organization cooperates with other microfinance providers:

____

Thank you! Please feel free to add information on separate sheets or call if you have any questions.

MFI Assessment Questionnaire – Part 2

I. Please check the statements that apply to the microfinance service provider:

_____ Has two years of financial statements

_____ Operates legally within Armenia

_____ Has a strategic plan

_____ Has a mission statement

_____ Has an active governing body (Board of Directors, Advisory Committee, Assembly, etc)

_____ Has an annual operating plan

_____ Has an annual budget

_____ Has a credit manual

_____ Has an accounting manual

_____ Has institutional by-laws

_____ Has a personnel manual

_____ Has a written credit and collections policies

______ Has a computerized accounting and portfolio management systems

Background Questions

How many active clients does the organization have? _____________

How many active clients does the organization plan to have within five years? ______________

List the credit methodologies employed by the organization:

When did the organization begin providing financial services? _____________

Has your organization had an external audit? If so, when was the last one? ____________

What is the organization's legal status? ____________

Is the organization considering converting into a formal financial institution? ____________

Does the organization carry out activities other than those related to microfinance? If so, describe:

APPENDIX 5

USDA's Production Credit Clubs Portfolio

USDA'S PRODUCTION CREDIT CLUBS (as of June 2001)						
#	Club Name	Location	Year Formed	# of members	Initial Capital	Repayment Status
1	Kurtan CC (milk/potato)	Lori marz, Kurtan vil.	1999	20	$26,600	Rescheduled
2	Aghavnadzor CC (grape)	Vayots dzor marz, Aghavnadzor vil.	1999	28	$18,463	Rescheduled
3	Aigegorts CC (grape)	Vayots dzor marz, Aghavnadzor vil.	1999	26	$12,984	Rescheduled
4	Haghoghagorts CC (grape)	Vayots dzor marz, Aghavnadzor vil.	1999	26	$13,291	Rescheduled
5	Arevik CC (tomato)	Armavir marz, Jrashen vil.	1999	6	$8,420	Rescheduled
6	Kotaik CC (wheat)	Kotaik marz, Hrazdan t.	2000	13	$11,500	Rescheduled
7	Narek 1 CC (seed potato)	Lori marz, Gar-gar vil.	2000	17	$16,730	Rescheduled
8	Yeghegnadzor CC (grape)	Vayots Dzor marz, Yeghegnadzor vil.	2000	28	$12,297	Rescheduled
9	Vedi CC (tomato)	Ararat marz, Vedi t.	2000	15	$10,790	Rescheduled
SUBTOTAL RESCHEDULED LOANS				179	$131,075	
10	Gyumri CC (general)	Shirak marz, Gyumri t.	1998	15	$8,900	Performing
11	Stepanavan CC (milk)	Lori marz, Stepanavan t.	1999	14	$17,800	Performing
12	Arpa CC (grape)	Vayots dzor marz, Aghavnadzor vil.	1999	12	$6,546	Performing
13	Areni CC (grape)	Vayots dzor marz, Areni vil.	1999	35	$13,890	Performing
14	Vosketap CC (tomato)	Ararat marz, Vosketap vil.	1999	10	$14,900	Performing
15	Voske Hask CC (wheat)	Shirak marz, Meghrashen vil.	2000	17	$14,500	Performing
16	Vartablur CC (potato/wheat)	Lori marz, Vartablur vil.	2000	18	$25,500	Performing
17	Lejan CC (milk)	Lori marz, Lejan vil.	2000	22	$12,465	Performing
18	Dashtakar CC (tomato)	Ararat marz, Dashtakar vil.	2000	11	$10,100	Performing
19	Hatsik CC (tomato)	Armavir marz, Hatsik vil.	2000	10	$13,800	Performing
20	Berriutyun CC (tomato)	Armavir marz, Hoktember vil.	2000	7	$15,500	Performing
21	Bambakashat CC (tomato)	Armavir marz, Bambakashat vil.	2000	6	$20,700	Performing
22	Hoktember CC (tomato)	Armavir marz, Hoktember vil,	2000	7	$9,600	Performing
23	Akhurian CC (wheat/potato)	Shirak marz, Akhurian t.	2001	18	$21,356	New
24	Akunk CC (wheat/potato)	Shirak marz, Hatsik vil.	2001	16	$20,300	New
25	Pushkino CC (milk)	Lori marz, Pushkino vil.	2001	12	$10,428	New
26	Vardenis CC (milk)	Gegharkunik marz, Vardenis t.	2001	10	$10,600	New
27	Oshakan CC (general)	Aragatsotn marz, Oshakan vil.	2001	15	$13,100	New
28	Vahan CC (milk)	Gegharkunik marz, Vahan vil.	2001	11	$11,455	New
SUBTOTAL PERFORMING & NEW LOANS				266	$271,440	
TOTAL ALL LOANS				445	$402,515	

Source: USDA MAP 6-Month Report, June 2001

Matrix of Microfinance Supply

Organization	Marz	City/village	No. Loans	Gross Portfolio Outstanding
MDF-Kamurj as of 31-12-01	Lori	Vanadzor	1,184	96,218
	Shirak	Gyumri	1,556	153,713
	Sunik	Sisian	434	94,209
	Yerevan	Yerevan	2,721	796,902
Totals:			**5,895**	**$ 1,141,042**
FINCA as of 31-12-01	Ararat	Masis	8	2,688
	Ararat	Atrashat	53	7,772
	Aragatsotn	Ashtarak	86	27,032
	Armavir	Armavir	101	38,077
	Armavir	Echmiadzin	67	18,339
	Kotayk	Abovian	29	12,757
	Kotayk	Hrazdan	159	33,586
	Gegharkunik	Gavar	15	615
	Yerevan	Yerevan	3,091	1,063,516
Totals:			**3,609**	**$ 1,204,382**
AREGAK as of 31-12-01	Ararat	Masis / Artashat	1,927	404,315
	Armavir	Armavir / Echmiatzin	1,610	262,804
	Kotayk	Abovyan	1,534	281,679
	NK region	Mardakert / Martuni	1,436	322,648
	Sunik	Goris / Kapan	823	182,554
	Vayots Dzor	Yeghegnadzor	1,181	246,850
	Yerevan	Yerevan	115	113,812
Totals:			**8,626**	**$ 1,814,662**

APPENDIX 7

SWOT Analysis of MDF, FINCA, AREGAK, and USDA

SWOT Analysis of MDF-KAMURJ

STRENGTHS	WEAKNESSES
➢ Registered as Armenian Foundation and managed by Armenians ➢ Led by an Executive Director with strong desire to be a "best practice" MFI and financially sustainable ➢ Strives to research client needs and tailor products that suit them (Eg., New Product Development Group) ➢ Extremely strong balance sheet (essentially zero debt with 0.6 percent portfolio at risk) ➢ 170 percent operationally sustainable ➢ Presence in 3 regions and Yerevan	➢ Lack of a fully functioning Board of Trustees ➢ Not enough loan fund to support current clients' natural increase in loan size from cycle to cycle ➢ Many of MDF's written operating manuals are in final Draft form and may not be totally in use. ➢ Audit department needs to have written audit procedures and be adequately staffed to do the work. ➢ Loan tracking and accounting software needs to be installed and running as quickly as possible ➢ Rapid expansion requires new staff that need to be properly trained and oriented. Manuals of procedures need to be finalized to assist in the process and ensure adequate control of operations.
OPPORTUNITIES	**THREATS**
➢ Can increase client retention and reach new clients if it had more loan capital to increase loan sizes and add new products ➢ Willingness to consider men as new target clients would create a larger potential client base in the same market geography.	➢ Lack of adequate financial forecasting and cash flow analysis may lead to liquidity problems that might have been avoidable ➢ If clients are denied loans due to lack of cash, they could lose motivation to repay, leave the program. In a worst case scenario they could also lose business position if they can not obtain other replacement financing ➢ Must find new office location next year as owner reclaims rented property. Since clients come to Yerevan office for reimbursement/disbursement of loans and various group meetings this will disrupt operations and could lead to: increase in delinquency, cause MDF to incur greater overhead cost, and potentially lose clients if location is not as convenient. ➢ Competition from other MFIs could increase causing MDF to reduce its effective interest rates ➢ Interest rate reductions will decrease revenues and threaten sustainability

SWOT Analysis of FINCA

STRENGTHS	WEAKNESSES
➢ High repayment rate ➢ FINCA parent has extensive experience and institutional capacity in microcredit ➢ FINCA has just reached a portfolio size where it is able to cover its operating costs ➢ Decision to offer microcredit services to men as well as women gives it a competitive advantage over its main rivals MDF and AREGAK.	➢ MIS, financial forecasts, and financial statements need to be improved ➢ FINCA needs to build up its national staff and delegate strategic decision-making to local counterparts ➢ May possibly have too many loan products that are confusing to the client and are difficult for FINCA to track ➢ FINCA is unable to mobilize client savings to increase its loan capital ➢ FINCA does not have a branch office structure to expand its lending outside of Yerevan should it need to seek new markets if current ones become saturated.
OPPORTUNITIES	**THREATS**
➢ Country Director (expat) is a chartered accountant who is able to build local capacity in financial management and control systems if this is recognized as a priority ➢ FINCA is experimenting with larger loan sized in the $1,000-$5,000 range and this may help serve clients better and improve FINCA's revenues ➢ FINCA has a great deal of momentum and confidence in itself which should help it to continue to expand and improve its efficiency and effectiveness ➢ FINCA's new proprietary, integrated loan portfolio and accounting software package may be exactly what is needed to improve the MIS	➢ FINCA has low liquidity and not enough loan funds to satisfy natural growth in existing clients' loan sizes ➢ Macro forces in Armenia could worsen ➢ High attrition rate may indicate dissatisfaction with loan products, or accumulation of adequate self-financing resources to not require future loans ➢ Too many decisions may be made by FINCA's expatriates (both within and outside Armenia) to adequately prepare local capacity to take over operations one day. (not all these costs are allocated to current income statements) ➢ FINCA must move from its current offices and new office space will likely be more costly, as a result operational sustainability levels could decrease. ➢ FINCA's interest rates are competitive with other MF providers but are far above other commercial credit rates. If they find they need to reduce interest rates, revenues will fall and sustainability levels will decrease. ➢ The current lending methodology has FINCA's loan officers carrying cash. It needs to be sure adequate controls are in place to prevent loss.

SWOT Analysis of AREGAK

STRENGTHS	WEAKNESSES
➢ Lots of experience working in regions ➢ Have experience working within bank offices in rural areas ➢ Portfolio is performing well ➢ Relatively large access to donor funds for loan capital via donors (USDA/USAID) ➢ UMCOR's support, including private funds ➢ Good inclusion of clients in program decision-making process through establishment of Coordinating Units and Advisory Groups ➢ Top staff of AREGAK have come up through the organization	➢ MIS not adequate to provide up-to-date portfolio and financial information in some of the forms needed by management (cash flows, balance sheets, income statements, ➢ No financial books for AREGAK as an accounting entity (chart of accounts, general ledger, journal) ➢ Disaggregated financial data for AREGAK by itself, with correct cost allocation for UMCOR's contributions are not done ➢ No internal audit manual and need more staff assigned to audit function ➢ Top management are not MF specialists ➢ No policy for setting interest rates (not connected to sustainability question)
OPPORTUNITIES	**THREATS**
➢ Supportive parent (UMCOR) is willing to give AREGAK increasing independence and to spin it off ➢ Detailed strategic analysis of UMCOR along with an outside assessment of AREGAK to be completed in next 6 months should help formulate a strategic plan for institutional separation ➢ UMCOR close to receiving a USDA monetization grant for 2002 which would provide non-restricted subsidies for AREGAK ➢ Recent entry into Yerevan market with larger loans may provide avenue for future growth ➢ Advisory Groups and Coordinating Unit structure may offer option to form register as a credit cooperative structure one day	➢ Additional competitors moving into the regions – ACBA ➢ High dependence on agriculture loans subject to climatic conditions ➢ Armenia's macro forces could worsen ➢ UMCOR managers are ultimate decision-makers not AREGAK's (within and outside Armenia). Top management not specialists in MF ➢ Loss of key staff could be hard to replace (elevated risk if AREGAK is spun-off and it has to assume UMCOR administration functions with new staff) ➢ Interest rate reductions will decrease revenues and threaten sustainability ➢ New law on non-bank institutions and/or MFI could affect current operations

SWOT Analysis of USDA-ARMENIA Microfinance

The following SWOT analysis relates only to loans <$10,000 as part of the Marketing Assistance Project's (MAP): Strategic Loans (cash, in-kind, microenterprise loans), Production Credit Club (PCC) and the Agro-Leasing LLC program.

STRENGTHS	**WEAKNESSES**
➢ Focus on niche markets (for goods produced in especially economically-depressed regions) where there is export potential in food processing (fish, fruits and vegetables processors), wineries, and the milk industry (cow and goat mil, cheese, and other dairy products) ➢ Incorporates otherwise "missing" but necessary non-financial assistance, such as applied on-farm research and variety trials, irrigation improvement, new product development, packaging and labeling improvements, product quality improvements, promotion and advertising, farmer marketing co-ops., market research, and local and export market development	➢ The strategic loan portfolio is not diversified in any strategic sense ➢ About one-third of the Strategic Portfolio is "non-performing" ➢ Some very large in-kind loans made in 1999 and 2000 were implemented without proper loan agreements and consequently had confusing repayment schedules or no repayment schedule at all. ➢ The MAP's credit components are subsidized. The programs are not moving toward self-sustainability and remain almost completely dependent on donor funds. ➢ Small size of MAP credit programs: currently just over 50 SME agri-businesses served throughout the whole country ➢ In the first six months of 2001, 13 PCCs were performing, six were new, 9 had been "rescheduled," and two were closed – not a very strong performance record, despite USDA's claims to the contrary.
OPPORTUNITIES	**THREATS**
➢ Selected export opportunities for assisted businesses in the areas of processed foods (tomato paste, wines, milk, and cheeses. ➢ Since the number of MSMEs served in still relatively small, there is still scope to adjust the terms of the USDA's credit programs to make them progress toward operating on a more financially self-sustainable basis in the near future.	<u>To the USDA credit programs</u>: ➢ Discontinued or decreased funding would have immediate adverse impact on credit programs since they have not been designed in a self-sustainable manner. ➢ There exists no legal basis to continue this type of intervention (although there is a movement supported by those with interests in the agriculture sector to adopt legislation to legitimize PCCs As such, the programs risks closure since the legal basis of its operations remain unclear. <u>To the MSMEs this credit programs supports</u>: ➢ Out migration, especially from villages, continues to shrink the consumer purchasing base and further weakens the domestic demand for processed agricultural products ➢ Export potential for ag. products remains depressed if the N-K conflict is not resolved and exchange rates with CIS countries is high