2008

Armenian Banking Sector

Investment Handbook

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FINANCIAL SECTOR DEEPENING PROJECT

Armenian Development Agency

This document is for use by foreign banks and private investors considering entry into the Armenian banking market. It is designed to address the main issues of interest to potential entrants, backed by quantitative data. Readers are encouraged to contact the Central Bank of Armenia (CBA) officials or the Financial Sector Deepening Project (FSDP) representatives indicated on Page 4 for additional information.

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1. Armenia at a Glance

Area: 29.8 thousand sq km	Currency: Armenian dram, AMD
Population: 3.2 million	GDP 2007 (PPP): $ 15.5 billion, 13.7% growth, real CAGR 13.1% over the last 5 years
Capital: Yerevan (1.1 million)	GDP per capita: $ 5,178.4
Religion: Christian Apostolic	FDI: $ 2,559.6 million (2007)
Life Expectancy: 73.3 years	Inflation: 3.5% (average over the last 5 years)
Time: GMT +4	Unemployment: 7.4% (2007)

2. Executive Summary

The Armenian banking industry presents significant upside opportunity for entry by foreign investors:

The macroeconomic fundamentals are in place. The Armenian economy has demonstrated strong growth since 2002, with a real GDP Compound Annual Growth Rate (CAGR) of 13%. Projections are for continued, sustained expansion.

The Armenian financial system is growing strongly. The banking sector – which holds more than 90% of system assets – has experienced CAGRs of capital and assets at 34% and 25%, respectively, since 2002.

Growth opportunity exists within the banking sector. The level of total assets in the Armenian banking sector compared to the level in other Newly Independent States (NIS) is very low; Armenia's total banking assets and total loans as a percentage of GDP is also very low, this becomes even more evident when compared to the similar ratios in other neighboring and European countries. This all indicates th e large untapped potential for an expansion in banking services in the Armenian market.

The investment climate is open and positive.

Armenia scores high on the economic freedom indices.

The Government of Armenia's official policy is to attract investors into the banking sector, through either through green field investments or participations in existing banks. The financial sector is regulated by the Central Bank of Armenia.

The law on banking is broadly consistent with international best practices.

Capital requirement for a green field bank is AMD 5 billion (approximately $16.7 million)

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4. Why Armenia? Why Now? Substantial Opportunities for Investment Return

Armenia's overall financial sector is gaining traction within the economy as the government's previous structural reforms take hold and bring the system into a more competitive and open style of business. System assets are growing rapidly as the general public turns more and more to the official financial system for their needs. Per capita incomes are up significantly and savings are increasing.

Lending to the private sector is increasing dramatically reaching $1.54 billion with growth increasing at an average annual rate of 42% over the past four years. Within this, mortgage lending has increased more than four times to the level of US$165.7 million during the past two years.

The Government of Armenia (GOA) is openly and actively promoting the entry of one or more reputable foreign banks into the Armenian market, as a method of further enhancing the financial services provided to both businesses and consumers.

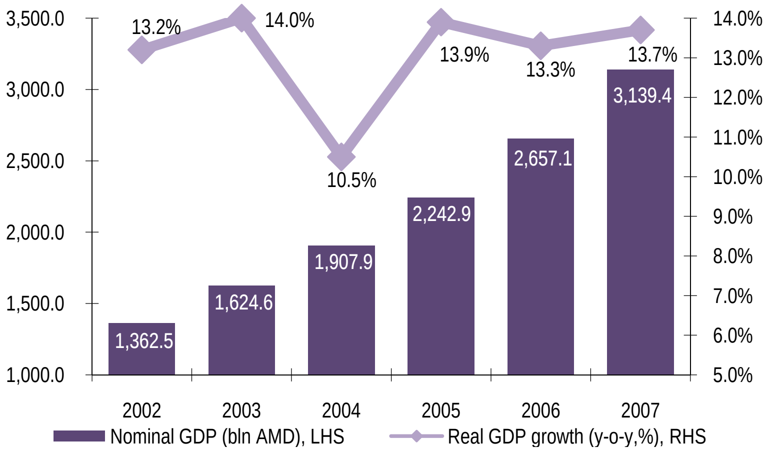
The following material details the various factors that are coming into play to create opportunities for investment returns for banks and individual investors entering this market.

5. The Macroeconomic Fundamentals Are In Place

With a CAGR of 13%, real GDP for Armenia has demonstrated rapid and sustainable growth over the last 5 years. This strong growth places Armenia second among the CIS countries and the first among countries without oil reserves.

For the same period, Armenia's nominal GDP CAGR 18%, a key benchmark figure for developing countries.

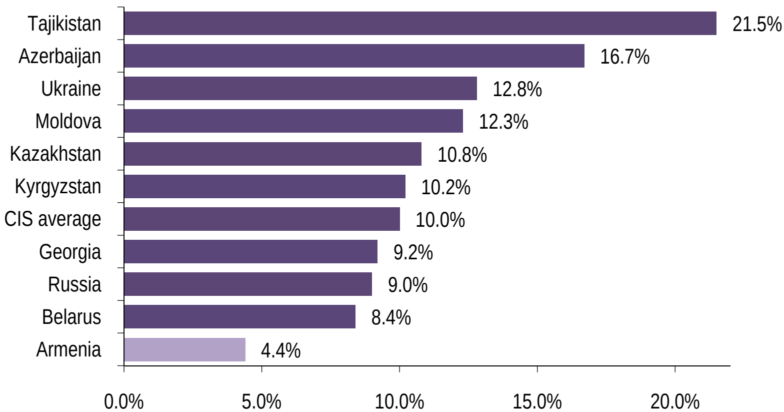
GDP Growth for the Period 2002-07



Per capita incomes matched Armenia's growth, with purchasing power parity reaching $5,178.4 in 2007 allowing growing "discretionary spending" levels.

At the same time inflation has been held in check. Average inflation for the past 5 years was 3.5% per annum, the result of an effective monetary policy implemented by the CBA.

Consumer Price Index in CIS Countries, Growth % (Year over Year)



Moody's Investors Service says its Ba2 rating for local and foreign currency debt obligations and “stable” outlook balances the low debt burden of the government and economy as a whole against the country's weak institutional capacity and modest level of economic development.

The following material details the various factors that are coming into play to create opportunities for investment returns for investors entering this market.

Key Macroeconomic Indicators

	2002	2003	2004	2005	2006	2007
Nominal GDP (bln AMD)	1,362.5	1,624.6	1,907.9	2,242.9	2,657.1	3,139.4
GDP per capita ($)	1,099.4	1,084.9	1,259.4	1,983.4	2,333.7	2,976.4
Real GDP growth (y-o-y, %)	13.2%	14.0%	10.5%	13.9%	13.3%	13.7%
Consumer Price Index (y-o-y, %)	1.1%	4.7%	7.0%	0.6%	2.9%	4.4%
Fiscal Balance (% of GDP)	-2.5%	-1.2%	-2.3%	-2.0%	-1.5%	-0.8%
FDI inflow ($ mln)	209.3	190.5	166.6	256.6	295.1	358.2
Loans (% of GDP)	5.9%	6.0%	6.9%	8.0%	8.6%	13.1%
Market cap (% of GDP)	0.4%	0.9%	0.5%	0.9%	0.8%	1.0%

Source: National Statistical Service of Armenia, Central Bank and ARMEX

6. The Armenian Financial Sector Has Gained Traction

Armenia’s financial system consists of 22 banks (with 347 branch offices), 11 insurance companies, 21 non-bank credit institutions (with 40 branch offices) and 18 securities broker-dealers.

Composition of Financial Sector as of December 31, 2007

Sector	AMD bln	%
Banking Assets	784.1	90.4
ARMEX Market Capitalization	31.8	3.7
NBFIs	43.3	5.0
Insurance Company Assets	7.9	0.9

7. The Banking Sector Possesses Three Main Characteristics

First, the banking sector dominates the financial system, holding over 90 percent of the system's assets.

Second, the banks have significant and geographically widespread foreign ownership. Institutional investors include HSBC, Credit Agricole, VTB (Russia), Troika Dialog (Russia), Byblos Bank (Lebanon) and GazpromBank (Russia). High net worth individuals also own significant portions of other Armenian banks.

Third, growth has been strong. Since 2002 banking sector capital and assets showed CAGR growth of 34% and 25% CAGR, respectively. Banks are expanding into new financial products' markets, especially into different types of consumer credit and mortgage markets. Mortgage lending has accelerated markedly since 2004, with the volumes increasing by 170% over the last year. In 2007, the banking sector experienced more than 82% growth of credits to the private sector against a 35% growth in deposits. All of the above reflects increased public demand and competition within the banking sector.

Banking Sector Asset Growth

Especially over the past five years, there has been strong growth in the Armenian banking sector, with total assets reach AMD 784 billion (US$ 2.6 billion) at the end of 2007:

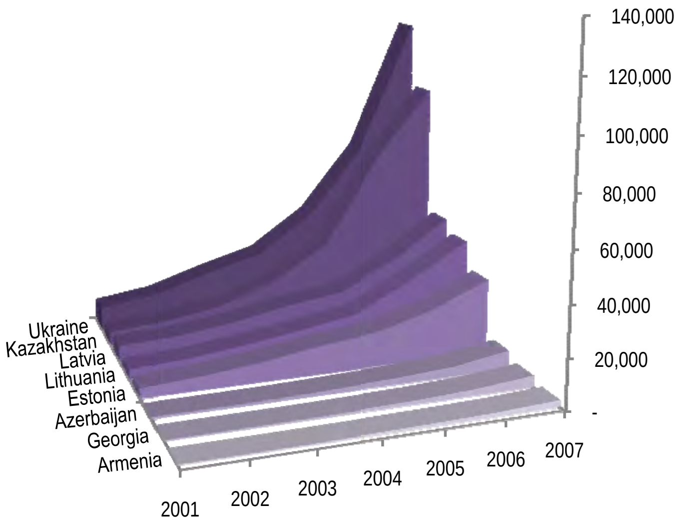
Period	Total Assets AMD (billion)	% Increase
2001	239	-0.2%
2002	257	7.7%
2003	292	13.2%
2004	369	26.7%
2005	455	23.2%
2006	544	19.5%
2007	784	44.1%

While the banking sector in Armenia has been growing at an impressive rate over the past five years, the level of banking assets held by Armenian banks remains relatively constant as a percentage of the country's GDP:

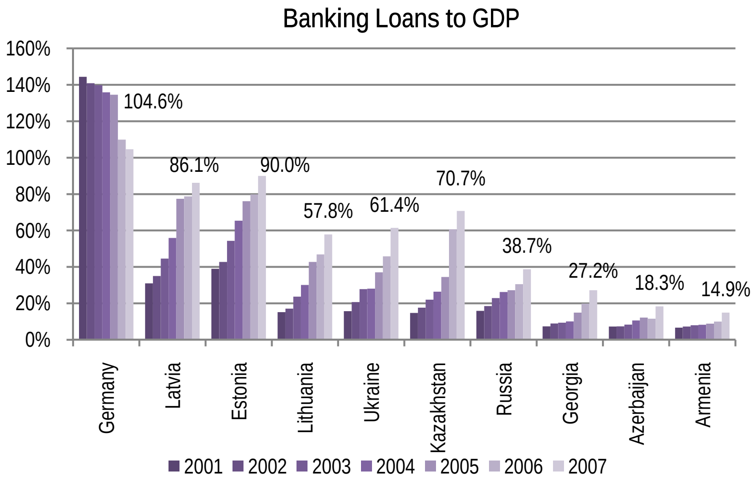
Year	Banking Assets As % of GDP
2001	19.3%
2002	18.1%
2003	17.4%
2004	18.3%
2005	20.0%
2006	20.4%
2007	25.0%

A comparison of the absolute volume (U.S. dollar equivalent) of Armenia's banking assets to those of other Newly Independent States (NIS) shows that Armenia has significant room for continued growth in the banking sector:

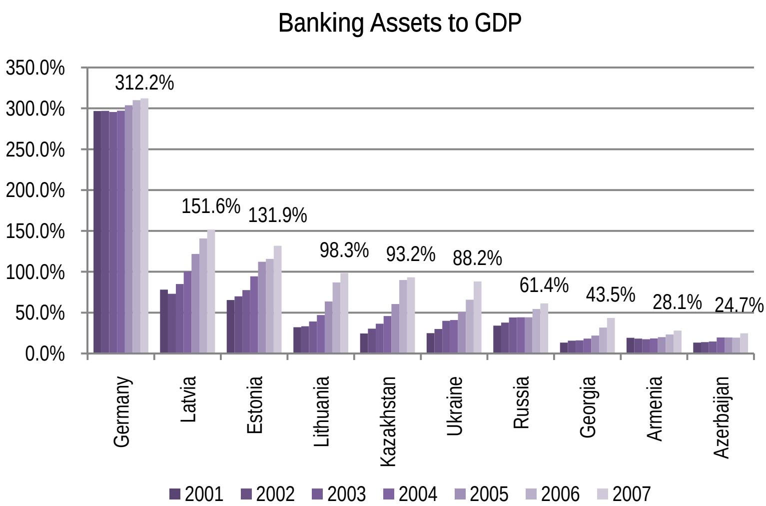
Banking Assets in NIS Countries (USD, millions)



Similarly, a comparison of Armenia's total banking loans outstanding as a percentage of GDP, when compared to other countries shows the potential for significant increases in lending volume that is possible:

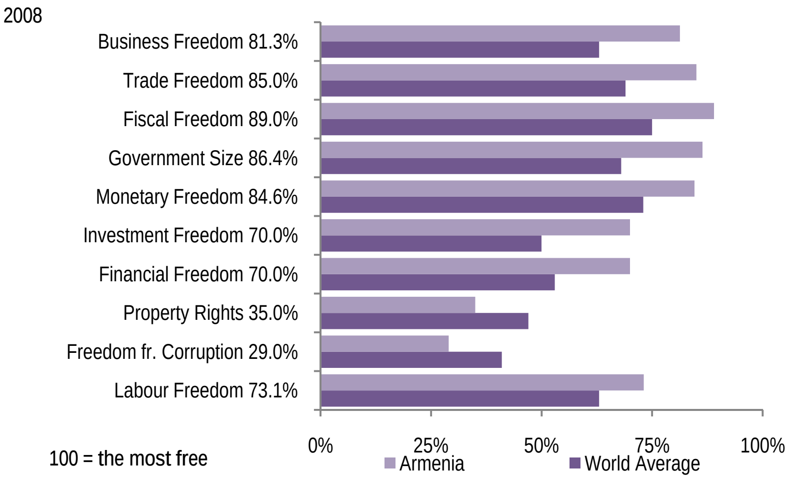


In a like manner, a comparison of Armenia's banking assets as a percentage of GDP to those of other countries in the table above also indicates that there is very large room for continued growth:



Germany is included in the above two tables to show the level of banking assets as a percentage of GDP that can be expected in a fully developed country. The other countries are all former NIS countries. Comparing Armenia's current position to these countries also indicates that Armenia has a large potential for the further development of its banking sector.

8. Armenia's 10 Economic Freedoms



Source: The Heritage Foundation

9. The Investment Climate Is Welcoming

The overall objective of the Government of Armenia is to provide an investment and business framework which combined with global opportunities can substantially and qualitatively change the pace of development in the financial sector and accelerate the catch-up process with developed markets. To this end the Government of Armenia believes that the current knowledge gap is a major impediment to development and that foreign entry of reputable financial institutions will help bring the necessary know-how and management culture.

Low tax rates, low government expenditure, and low revenue from state-owned businesses contribute to impressive fiscal and government freedom rankings. Inflation is low, and the banking sector is both wholly-private and well-regulated. Commercial regulations are flexible and relatively simple. Armenia's investment climate is one of its great strengths.

According to the Heritage Foundation assessment, Armenia's economy is 70.3% free, which makes it the world's 28th freest economy. Its overall score is 1 percentage point higher than last year, reflecting some improvements in the investment regulations. Armenia is ranked 15th freest among the 41 countries in the European region, and its score puts it above Europe's average - an impressive feat.

Armenia rates significantly higher than the average in eight of the 10 freedoms.

Business Freedom - 81.3% | The freedom to start, operate, and close a business is relatively well protected by Armenia's national regulatory environment. Starting a business takes an average of 18 days, compared to the world average of 43 days. Obtaining a business license requires about the world average of 19 procedures and about half of the world average of 234 days. Closing a business is easy.

Trade Freedom - 85% | Armenia's weighted average tariff rate in 2001 was a relatively low 2.5 percent. Unpredictable customs valuation, improper implementation of the customs code, inefficient customs administration, and corruption in customs add to the cost of trade.

Fiscal Freedom - 89% | Armenia has low tax rates. The VAT and personal and corporate income tax rates are all 20%. During 2007, overall tax revenue as a percentage of GDP is 17.3 percent.

Freedom from Government - 86.4% | Total government expenditures, including consumption and transfer payments, are low. During 2007, government spending equaled 21.3% of GDP. Despite some delays, privatization has accelerated over the past two years in sectors such as mining and metals.

Monetary Freedom - 84.6% | Inflation is relatively low, averaging 3.5 percent between 2002 and 2007. Relatively stable prices explain most of the monetary freedom score.

Investment Freedom - 70% | By law, foreign and domestic investors are accorded equal rights in establishing businesses in nearly all sectors of the economy. Armenia maintains a liberal trade regime, receiving the highest classification from the IMF. Commercial arbitration laws passed in December 2006 allow a wider range of settlement procedures for parties contracting in Armenia. The IMF reports that there are no restrictions or controls on the holding of foreign exchange accounts, invisible transactions, or current transfers and no repatriation requirements.

Financial Freedom - 70% | Armenia's underdeveloped financial sector is dominated by banking. Following a banking crisis in the 1990s, the government embarked on a process of privatization and regulatory reform that included the adoption of International Accounting Standards. Under the revised rules and standards, many banks have closed or merged. In 2001, there were 31 banks—by the end of 2007, there were 22. The remaining banks are more liquid and profitable. The state no longer has a stake in any bank, and all 22 are privately owned. The Central Bank has intervened in the market to encourage dram transactions, but without much success. The Central Bank of Armenia regulates the small insurance industry. Foreign banks are permitted to operate in Armenia.

Property Rights - 35% | Armenian law provides substantial protection for intellectual property rights and is in compliance with the WTO's Trade Related Aspects of Intellectual Properties (TRIPS) Agreement. The government has increased enforcement of IPR laws.

Freedom from Corruption - 29% | As is the case with many former-Soviet countries, corruption is perceived to be widespread. In recent years, however, the government has introduced a number of significant reforms to combat this problem. Armenia ranks 93rd out of 163 countries in Transparency International's Corruption Perceptions Index for 2006.

Labor Freedom - 73.1% | Armenia's labor market operates under relatively flexible employment regulations. The non-salary cost of employing a worker is moderate, and dismissing a redundant employee is relatively simple.

10. Extracts from The Law on Foreign Investments:

“The legal regime governing foreign investments and the methods of their implementation in the Republic of Armenia cannot be less favorable than the regime governing the property, property rights and investment activities of citizens, legal entities and unincorporated enterprises of the Republic of Armenia.”

“Foreign investments in Armenia may not be subject to nationalization”

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