Bank Efficiency and Market Structure in Armenia

Consolidation of the banking sector may be important for realizing economies of scale

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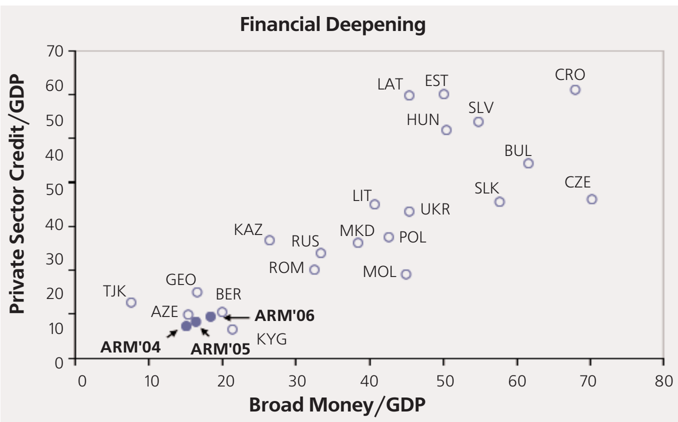
As in other transition countries, the structure of Armenia's banking system has undergone significant changes over the past decade. Bank restructuring and privatization has been accompanied by consolidation, the market entry of foreign banks, an overhaul of the legal framework, and the strengthening of prudential regulation and supervision. As a result, the number of banks has fallen from 74 in 1994 to 21 currently. All banks are now privately owned. Foreign participation in the banking system increased following the removal of limits on foreign ownership, and foreign banks now account for 60% and 70% of loans and deposits, respectively. However, with one key exception, foreign investors are mainly from other CIS countries and Armenian diaspora individuals.

Despite reforms and prolonged macroeconomic stability and economic growth, financial intermediation remains low by regional standards (see Figure). At the same time, interest rate spreads have remained persistently high and well above those in most transition countries, averaging over 12% since 2003.

High interest rate spreads are an impediment to financial intermediation, as they discourage potential savers with low returns on deposits and increase financing costs for borrowers, thus reducing investment and growth opportunities.

Regional Comparison: Financial Deepening, 2005



Foreign Bank Entry Has Not Resulted in Lower Spreads

Using a panel dataset of 20 commercial banks, we analyze the determinants of Armenian banking sector efficiency; specifically, the role of bank characteristics, market structure, and macroeconomic factors in determining spreads and interest margins. Our results show that:

- *Interest spreads* are influenced by bank size, the extent of market power, overall market concentration, return on assets, liquidity, and loan portfolios, in particular the share of agricultural and consumer loans.
- *Net interest margins*, by contrast, are negatively associated with deposit market shares, possibly indicating aggressive pricing strategies of individual banks to gain market share. Furthermore, margins are decreasing in banks' capital adequacy, and increasing in the return on assets.
- *Macroeconomic factors* have a negligible impact on interest spreads.
- In contrast to the experience of other transition and developing countries, *the presence of foreign banks* has not yet directly contributed to lowering spreads and margins. However, foreign bank origin matters for banking efficiency, with the presence of the first-tier western bank having a spill-over effect in lowering spreads. Other types of foreign banks tend to charge higher spreads.

Sector Consolidation Beneficial

Our empirical findings highlight the importance of bank size for realizing economies of scale. In this respect, a competition policy that fosters bank growth and cost rationalization, for example through mergers and acquisitions and/or the entry of first-tier international banks, can help to reduce lending rates and spreads. Consolidation of the banking sector should, however, proceed through a market-driven process rather than through regulatory measures, such as further increases in minimum capital requirements, which are already high in relation to the size of the banking system.

Another factor that would help to create a more competitive banking market and decrease market segmentation is improvement of information about borrowers for banks, and about banks for depositors. The introduction of a credit registry in 2003 and the establishment of a private credit bureau in 2007 have been important steps towards improving information sharing on the creditworthiness of borrowers. It will increase borrower discipline by reducing moral hazard, and mitigate the information monopoly that banks have over their existing clients, thus reducing bank switching costs.

At the same time, increased public information about banks as well as bank ratings by international rating companies could contribute to improving market transparency, the functioning of market forces, and depositor confidence. Banks should improve provision of information about current bank services and pricing, and regulations should require banks to regularly disseminate relevant market information. The Central Bank of Armenia could also publish regular non-market sensitive reports on banking supervision.

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