I. Introduction and Context

Country Context

1. Armenia’s remarkable growth in the 2000s was followed by a severe downturn during the 2009 global financial crisis and a slow recovery since then. Real GDP growth averaged 12 percent per year during 2000–08, driven by substantial foreign exchange inflows, mostly in the form of remittances. These inflows boosted domestic investment, primarily in the construction sector. Growth in per capita income, together with improved social safety nets, contributed to a decline in poverty. However, the recent economic crisis reversed some of these achievements when Armenia experienced a sharp downturn with output contracting by 14 percent in 2009. Poverty increased, with 35.1 percent of the population living below the poverty line in 2011, compared to 27.6 percent in 2008. The Government’s strong counter-cyclical fiscal policy focused mainly on increased spending on infrastructure, social protection, and emergency financing for enterprises. While the fiscal expansion helped protect the poor and maintain jobs, the pace of recovery remained slow with only 2.1 percent growth in 2010, picking up to 4.6 percent in 2011, but expected to moderate at
approximately 4 percent in 2012. After pursuing a significant fiscal expansion during the crisis, the Government is focusing on consolidating its fiscal accounts.

2. Progress notwithstanding, the tradable sectors either stagnated or shrank over the past decade. The exceptions were tourism and, more recently, the mining and Information and Communication Technology (ICT) sectors. Armenia’s labor market experienced little transformation during this time. For instance, the bulk of the labor force in tradable sectors is still engaged in low-productivity agricultural activities. Moreover, job creation was unable to compensate for increases in the labor force, resulting in a significant reduction in labor market participation rates, two-digit unemployment rates, and high emigration rates. In 2004, the driver of growth shifted from supply to demand, as evidenced by the widening current account balance that began that year.

**Sectoral and Institutional Context**

3. The government of Armenia is pursuing a new growth model that requires enhanced external competitiveness, and stronger and more diversified integration in international markets. The tradable sector shrank as a percent of GDP, especially as exports fell between 2004 and 2007. The current account deficit is over 10 percent and has significant vulnerabilities. The imports of goods and services are almost three times as large as exports. The gap is being closed equally by private and official flows. To overcome this situation, the Government of Armenia recently adopted an Export-Oriented Industrial Policy. The long-term goal of the strategy is to make export-oriented industries the new growth drivers. It targets an increase in the export-to-GDP ratio from 11 percent in 2011 to 16 percent by 2015, and 19 percent by 2020. The total volume of exports is targeted to reach about US$3 billion, of which US$1.3-1.5 billion would constitute non-metallic and non-diamond exports.

4. Financial intermediation is low and products are limited. Banking sector assets stand at 90 percent of the financial system’s assets and at 58 percent of GDP, with 22 licensed banks as of June 2012. The system has a relatively low level of intermediation with credit to the private sector at 37 percent of GDP. Banks offer just the simple lending products, but some are beginning to develop leasing and factoring. Total regulatory capital to risk-weighted assets stands at 17 percent, liquid assets to total assets at 24 percent, nonperforming loans to gross loans at 4 percent, and provisions to nonperforming loans at 48 percent. ROA and ROE are 1.5 and 8.6 percent respectively. Sectoral distribution of loans to total loans stands at 20 and 14 percent for the trade and industry sectors respectively. The non-bank sector is underdeveloped with a small insurance sector and a tiny capital market.

5. Long-term finance is limited and available only at higher interest rates. Finance beyond 5 year maturity has been growing, but still stands at only 5-6 percent of banks’ total corporate lending portfolio. There are both structural and cyclical constraints to long-term finance. Time deposits over 1 and 5 years account for 15 and 2 percent of the total respectively. Depositor confidence is low, particularly in local currency due to foreign exchange instability. Capital markets are underdeveloped, preventing anything beyond short-term tenors. Parent bank longer term funding has been limited, due to the global financial crisis. Risk management and hedging capacity is low.

6. A development finance institution, the PanArmenian Bank (PAB) has been created to improve long-term finance availability for export-oriented enterprises. PAB is a development bank legally registered in Armenia as an open joint-stock company. It was established by Law in
December 2008 (amended in June 2011) and received its license in June 2011. Central Bank of Armenia (CBA) is currently the sole shareholder through a capitalization of USD 20mn in local currency. Its activities are regulated by CBA similarly to any commercial bank in operation in Armenia.

7. PAB’s current focus is direct lending operations, but it would like to refine and expand its available instruments. Direct lending operations are expected to be long term (over 5 years) and cash-flow (rather than collateral) based, with disbursements through direct supplier payments or upon receipt presentation. Beyond direct lending operations, PAB would like to expand into on-lending operations. PAB has the potential to play a significant role in the Armenian financial sector, providing in time a vehicle to substitute structures that evolved during the crisis for the intermediation of IFI lines of credit due to the lack of alternatives (e.g. the German-Armenian Fund residing on CBA’s balance sheet and intermediating IFI lines of credit).

Relationship to CAS

8. The project is fully aligned with the Country Partnership Strategy (CPS FY09-FY12, Report Number: 48222-AM) objectives of access to finance and boosting competitiveness, as well as the Progress Report (Report Number: 58299-AM) extending the CPS to FY13. It is also fully aligned with the latest Policy Notes (September 2012) that place the promotion of exports and enhancing private sector development as key goals for a new growth path for Armenia.

II. Proposed Development Objective(s)

Proposed Development Objective(s) (From PCN)

9. The Project Development Objective (PDO) is to enhance access to medium and long-term finance for exporters and FX earning enterprises (e.g. tourism, logistics).

10. An additional objective is to help build the institutional capacity of PAB to deliver on the PDO.

Key Results (From PCN)

11. Achievement of the PDO will be measured by Core Outcome Indicators measuring the improvement of medium and long-term finance extended by PAB and PFIs to targeted ultimate beneficiaries: outstanding medium and long-term loan portfolio; number of targeted enterprises financed; portfolio at risk; return on assets and /or equity.

12. In addition, additional indicators will aim to measure: (i) the higher level objective of improved productivity and growth for targeted enterprises (e.g. change in sales, exports, entry into new markets, jobs created); (ii) PAB’s institutional capacity improvements (e.g. successful implementation of select indicators under the institutional capacity development plan currently under development, to include credit risk appraisal and management, financial and operational risk management, treasury function and asset/liabilities management).

III. Preliminary Description

Concept Description

13. The proposed lending instrument is a Financial Intermediary Loan (FIL), using IBRD funds, with PanArmenian Bank (PAB) as the Borrower and implementing agency. The credit line will be guaranteed by the Armenian government. The project will include three key components: (i) a component for on-lending to Private Financial Intermediaries (PFIs) that will make sub-loans to
the final beneficiaries, expected to be the largest share of the project; (ii) a component for direct lending by PAB on niche market areas that avoid distorting the private sector; (iii) a component focusing on the implementation of an institutional capacity strengthening plan to assist PAB's evolution and growth. The loan will be extended in foreign currency, the currency to be agreed during project preparation. The discussions have taken place in the context of USD, given that trade is currently carried mostly in that denomination. The definition of FX earners will be agreed upon during project preparation.

14. Under the on-lending component, the Line of Credit (LoC) could use a flexible model with “open doors” for interested banks that are able to satisfy the eligibility criteria prescribed in the World Bank’s Operational Policies for LoC projects. The on-lending component will be the largest share of the project, given that a sufficient size will be necessary to attract a desirable number of PFIs. The exact percentage devoted to the on-lending component will be determined during project preparation. Interested banks will need to be appraised by the World Bank to confirm that they meet the standard eligibility criteria (Annex 2 and 3) and any additional one to be defined during project preparation. Banks that meet the eligibility criteria will be asked to sign the Subsidiary Finance Agreement (SFA) with PAB and get the PFI status allowing access to the LoC funding on an “as-needed” basis. The PFI status will not impose any cost, or oblige the bank to actually use the LoC funding. New banks interested in becoming PFIS, may ask to do so at any point during the LoC project implementation.

15. Once a PFI needs funding, it will make a request to PAB to refinance the sub-loan to be extended to its client (final borrower) for the related sub-project. The subsidiary-loans to PFIs will be made back-to-back to PFI sub-loans to the final borrowers, with the same amount, maturity and grace period. Preliminary eligibility criteria for final borrowers, sub-projects and sub-loan terms are described in Annex 4, to be agreed upon during project preparation. Current discussions focus on Investment Sub-loans with maturity of up to 10 years, maximum grace of 18 months, and maximum amount of USD 1 million, including incremental working capital ranged from 30 to 50 percent of the total sub-loan. The principles behind the interest charges are described in Annex 4. Banks have also expressed interest in working capital finance sub-loans, to be further discussed during project preparation. Once the withdrawals start, the PFI will be charged interest for the amounts withdrawn. The PFI Subsidiary Loan amount will be equivalent to the aggregate amount of principals of all sub-loans made by the respective PFI. The PFIs will be required to repay interest and principal of PFI subsidiary-loans semiannually, and to make payments regardless of whether or not they have received payments from their final borrowers. The repayments will be collected in a Revolving Fund (RF) and will be used to provide funding for new sub-loans.

16. PAB will evaluate each PFI application to ensure that the final borrower and the sub-project request meet the agreed eligibility criteria and that the PFI’s sub-loan appraisal and approval conforms to the Operations Manual (OM) and the principles of sound banking. PAB functions will also include authorization of withdrawal applications, disbursement of subsidiary loans, project accounting including financial reporting, auditing of project accounts, general procurement and project reporting.

17. Regarding the direct lending component, PAB will provide loans to the final borrowers through project finance on the basis of future cash flows and preferably in syndication with a commercial bank. PAB will also follow the Operations Manual and observe the eligibility and other criteria applicable to the sub-projects, with the difference that the PAB sub-loan amount would be in
the range of USD 1-2 million. This is expected to be discussed and confirmed during project preparation.

18. An amount may be necessary to cover project management, administration and critical investments in the first year of project implementation. While PAB will charge a spread for subsidiary financing to PFIs, the start of the Project may be slow. On the other hand, the PAB operating cost will be very high in the initial stages, due to the learning process. The slower start implies that PAB will not be able to fully cover its expenses with the agreed spread, or else that the spread would have to be rather high. Therefore, an amount expected to cover the PAB cost of project management and administration in the first year, as well as investments in the IT systems and application software and other necessary items, could be covered as part of the project.

19. The institutional capacity building component will strengthen PAB’s ability to deliver in its developmental agenda. It should include building of the necessary institutional capacity for: i) on-lending, including meeting all applicable World Bank requirements related to project management and administration, and observance of Bank’s safeguards and fiduciary requirements; ii) credit risk appraisal and management; iii) financial risk management (liquidity, interest rate risk, currency risk and market risk); iv) operational risk management; v) treasury function and asset/liabilities management; vi) internal audit and controls function. Initial technical assistance is expected to be provided by a Project Preparation grant that the team and PAB have applied for (under the ECA Region Capacity Development MDTF).

IV. Safeguard Policies that might apply

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V. Financing (in USD Million)

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VI. Contact point

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