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Microfinance in Armenia: Sector characteristics and adaptation strategies

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Abstract

The microfinance sector is relatively new in Armenia, and has shown significant increase over the last decade. We designed a qualitative research to explore the main characteristic and adaptation strategies of the microfinance sector in this country. Our findings indicate that the emergence of MFIs was subject to offering a complementary effort in filing the gap in the financial services industry. Its main objective was to address the increasing unemployment and poverty resulted from transitional shock. The microfinance market is segmented with different programs serving different populations. We found range of microfinance services, unequal coverage in terms of geography and of business sectors, revenues, unequal VAT treatment between commercial banks and MFIs, regulated Microfinance operations, and lack of cooperation within the Microfinance sector and government support as main problems of the sector development.

Keywords: Microfinance (MFI), adaptation strategy, poverty alleviation, developing economies, not for-profit firms.

INTRODUCTION

Microfinance is an innovation launched in Bangladesh in the 1980s within the framework of a very poor economy (Yunus, 1995; Rahman, 1999). Recent years have experienced global reforms and changes in financial systems around the world. A revolution is occurring in finance for low-income people in order to mitigate poverty level and to smoothen their income generation. Microfinance is seen as one of the successful tools, which comes to fill in the gap left by larger conventional financial intermediaries. The term microfinance usually implies very small loans to low-income clients for self-employment, often with the simultaneous collection of small amounts of savings (Karlan and Goldberg, 2010). The main objective of microfinance is to serve the population at highest risk and those who are considered "unbankable". The uniqueness of microfinance practice lies in its ability to combine both financial and social intermediation, which is known as double bottom line, in achieving its goals.

Microfinance as a development intervention and poverty alleviation tool grew rapidly in region of Eastern Europe and Central Asia (ECA) during the 1990s. In the early 90s international networks (i.e. FINCA, CARE International) and religious charities (i.e. Catholic Relief) initiated microfinance activities in the ECA region. These initiatives later grew into independent institutions, which completed the scene together with newly created donor-based MFIs. The World Bank, United States Agency for International Development (USAID), and the German Development Agency (GTZ) were among the first to provide the microfinance institutions (MFIs) with capital supply as well as technical expertise. In parallel with the industry commercialization, financial donors and investors offered gradually more commercial bank loans at the market rate of interest than grants for the establishment of microfinance activity in the ECA. However, as compared to other regional MFIs, there were also disadvantages challenging the sector development. The lack of entrepreneurial discipline and the mistrust to entrepreneurs typical to transition economies have lead government and regulatory authorities to the tendency of overregulation of entrepreneurial activity rather than creating an enabling environment. With this respect MFIs in the ECA region have adapted their lending methodologies and managerial practices in order to meet the best regulatory requirements and clients demand.

The paper will not address whether or not, not for-profit microfinance is better or more efficient to impact poverty but rather to analyze the main problems. The role of the actors is essential because the microcredit "markets" do not only result from supply confronting demand, but instead, are social, historical and political, constructs (Morvan-Roux et al., 2014)

Previous research demonstrates that MFIs in ECA are among the youngest in the microfinance industry, while their performance ranks among the best (Berryman, 2004). Recent developments in global economic and financial environment have brought serious preoccupations for microfinance practitioners and regulatory bodies in the region.

In particular, according to a joint report of Microfinance Information Exchange (MIX) and Consultative Group to Assist the Poor (CGAP) (2011) the financial crisis of 2008 hit MFIs in ECA the hardest of all regions worldwide, with the effects of the crisis felt strongly across all sub-regions. Consequently, MFIs in ECA showed the lowest profitability indicators worldwide and the worst portfolio quality since the inception of the sector. Unfavorable macroeconomic conditions such as decreases in economic activity and remittance flows from developed countries, increases in unemployment made it harder for clients to repay their loans and resulted in deterioration of MFIs' financial performance. Moreover, according to the same report many banks in 2009, some credit unions and some microfinance programs of

downscaling banks closed, while more new nonbank financial institutions (NBFIs) in Central Asia were registered. At the same time the negative effects of the crisis had an impact on financing of MFIs. While total outstanding debt financing decreased for MFIs, cross-border funders continued to increase their commitments to microfinance. For institutions allowed to take deposits, deposits proved to be a reliable source of domestic funding, and unlike loan portfolios, savings portfolios increased. In the coming years there may be newcomers in the provision of deposit services, as several large NBFIs in Central Asia have received deposit licenses.

On a positive note, this situation prompted many ECA MFIs to put more effort into social performance management and tracking. A healthier sector is likely to develop now when industry actors are more willing to engage in responsible lending to both clients and MFIs, support portfolio growth with more adequate risk management, and have a greater understanding of target clients through tracking of social performance indicators.

Narrowing down our study to a particular country from the ECA region, one may highlight that microfinance is a relatively young and very actively developing sector in Armenia. Started since 1995, microfinance sector has been expanding quite intensively in the last few years both in terms of volume and territorial coverage. Armenia, having undertaking the transition from centrally- planned to liberal economy based on free competition, has still a significant part of its population (35.8 percent in 2010, World Bank) living in poverty. There has been almost 10 percent increase in the poverty headcount ration at national line as compared to 2008 (27.6 percent) although the Poverty Reduction and Growth Facility (PRGF)-supported program helped declining poverty rates. Also, informal sector in Armenia is estimated to be more than one third of the registered economy (Planet Finance, 2007). Poverty alleviation is given high priority by the government and with the support of international organizations measures are being undertaken for this purpose. Nowadays, according to studies conducted by both international and domestic organizations, there is a growing demand of microfinance services among poor households and start-ups in the capital as well as in the regions of Armenia.

All the above-mentioned development process and stages bring forward the innovation in the developing economy's financial system. This system contributes also to the creation of social practices, which target low-income population and combined with financial intermediation aim at fighting poverty, inequality and enhancing their well-being. Those new practices include mainly health care, education, financial consulting services.

In light of the above outlined distinctive features and sector developments of the MFIs in the ECA region we carry out this study with the objective of investigating the characteristics and adaptation strategies of microfinance sector in Armenia. Therefore, we formulate our research questions as:

What kind of adaptation strategies have contributed to the enhancement and institutionalization of MFIs practice in Armenia ? What are the characteristics - actors, development paths and problems - of microfinance sector in Armenia?

This issue is important at least for two reasons. First it is fundamental for guiding the regulation of the microfinance market. Second it is important to understand what parameters are susceptible to widen the market.

Even if the practice of microfinance is unchanged, it is often necessary to adapt it to the technical, cultural and political features of the new context in order to facilitate its adoption and subsequent diffusion (Akrich et al., 2002; Ansari et al., 2010). This is a unique study in its kind taking into account the relatively unexplored sector and the insights collected from semi-structured interviews with experts in all 11 regulated Armenian MFIs (Appendix

A) and commercial banks offering microfinance services, which report to the MIXMARKET and also experts of the field.

We contribute to the microfinance literature by considering an original survey concerning a country which was little studied until now. Our results suggest that the market is not mature, the microcredit should again progress when certain obstacles will be raised.

The remainder of the paper is structured as follows. We first present the country profile of Armenia to highlight its political, economic and financial characteristics. We then outline the methods of our study, which comprise the selection of case studies, research design, data collection and analyses processes. In the section 3, we present the actors. In the section that follows we describe our findings related to our research question and outline characteristics of microfinance sector in Armenia. We conclude with a discussion where we interpret our findings and give a possible desirable direction of microfinance sector development.

1. ARMENIA: COUNTRY PROFILE AND MAIN MACROECONOMIC INDICATORS

This part aims to present overall picture of current Armenian economic, political as well as business environment. This empirical analysis helped to draw out the major achievements, strengths and will highlight business opportunities. Also existing country risks and ongoing reforms in each sector are presented. Both domestic information sources, such as Armenian National statistical service, Ministry of Finance and Economy of the Republic of Armenia, etc. as well as publications and ratings of international organizations- World Banks, International Monetary Fund (IMF), Heritage Foundation and others- served as basis for collecting data, information and statistics. Country reports, reviews, published articles of these institutions provided the macro environment overview in Armenia from different perspectives. Finally, the interview with the ex-Prime Minister of Armenia and well known economist Hrant Bagratyan helped to understand that currently the economy of Armenia is heavily dependent on political will of the current government. The objective of presenting the country's macro overview is to have an idea on development of Microfinance sector in Armenia.

1.1. Political overview

Being part of Soviet Union Armenia based its economy mostly on industrial production. 1988 was a remarkable year as the country's economy entered a period of decline. The accelerator of this process was a massive and devastating earthquake which struck Armenia's north-western region, including Gyumri, the country's second largest city. The economy became more vulnerable when the Soviet Union collapsed and Armenia declared its independence in 1991. Of course political factors such as continuing conflicts and blockade by neighbors-Azerbaijan and Turkey- had also their destabilizing impact. Armenian is under a transition economy from a centrally-planned to a market economy like other Caucasian countries, with many structural problems. This transition allows for the development of microfinance and private entrepreneurship.

On the other hand the political instability because of the problem of the current president legitimacy, high levels of corruption and oligarchic clans concentrating in their hands imports and domestic production do not allow to create favorable business environment and to have a fair competition. Armenia became independent in 1991, and adopted a democratic republic.

The political environment has been stabilized over the past years. Political tensions after presidential election (2008), huge protests against unfair and no democratic elections, declaration of state of emergency on the 1st of March 2008 have lead to political and economic destabilization. This in its turn affected the international reputation and credibility of Armenia apart causing domestic loses.

There are several exiting problems the country has to confront on its way to development: increasing transparency and good governance, decreasing corruption level, putting into practice regulations and legal acts yet remained only on the paper.

1.2. Economic Structure

Statistics come to show that there has been a steady GDP growth of the last past years which in its turn had a stabilizing impact on the macroeconomic environment in the country. This increase actually is based on the sector of construction meanwhile the situation is bad in the other branches of economy: industry, agriculture.

According to International Development Agency (IDA) Armenia's economic potential is constrained by closed borders. Armenia is a landlocked country and does not have navigable waterways. Because of this geographical location and political isolation with Turkey and Azerbaijan, Armenia has high transportations costs. The main surface trade links are limited to a low-capacity rail and road connections with Georgia and its Black Sea ports, and a single road with Iran. This is highly important issue as Armenia is dependent on outside supplies of energy and most raw materials. Having limited access to international fuel market because of its geographical location Armenia is heavily dependent on imported energy. All natural gas is imported into Armenia through a gas pipeline from Russia via Georgia. Refined oil products are imported mainly from Georgia. The only domestically produced primary energy is electricity from hydropower plants and a single nuclear plant. That is why the need to develop alternative energy sources is very important and encouraged also by the European Union.

Once the independence was declared the government undertook a wide range of structural reforms: privatization of land and of state-owned enterprises, liberalization of prices, of trade and business environment, reforms in tax administration and financial sector.

Currently, among other ongoing programs of structural reforms the government adopts measures to strengthen financial institutions and improve governance by increasing transparency and reducing corruption level. Main economic sectors which contributed to development and GDP growth were construction, precious stone cutting, services and agriculture. GDP growth is problematic and metamorphoses of the politics are transferred into the country's economy resulting in controls over all the importations, investments and presentation of statistical figures being far from reality. This concerns particularly the budget.

Another problem that is often highlighted by the observers is the self-consumption of its production done nowadays by farmers. This said, they produce mainly for themselves thus having no possibilities of penetrating new markets and targeting new clients which will allow them enlarging their activities and increase profitability. And it is very difficult to calculate what impact the GDP growth and the increasing inflation have on the purchasing power and income level of Armenians.

Poverty reduction remains a top priority for the country. Although the government has implemented Poverty Reduction Strategy Program and the overall poverty ratios have been falling, poverty remains a critical issue, particularly in rural areas and among socially vulnerable groups. Having undertaken the development path, Armenia still has significant level of poverty rates.

Other existing challenges in the Armenian economic sector are the following: per capita

income remains low, large informal sector, the level of financial intermediation is low and the economy remains heavily dollar-dependent. The capital markets are still in their infancy and corruption, while low by regional standards, continues to impose costs on the economy. And as mentioned earlier poverty (especially in rural areas), income inequality and unemployment are also high. In order to support economic development in Armenia the international financial institutions offer their assistance. The International Monetary Fund (IMF), World Bank, European Bank for Reconstruction and Development (EBRD), as well as other international financial institutions have extended considerable financial and technical assistance to the government of Armenia.

New emerging sectors are taking over the traditional sectors: information and communication technology, precious stone processing and jewellery making, tourism. In order to sustain growth and improvement of the population's standards of living, Armenia needs to strengthen its macroeconomic management, including increasing revenue collection, improving the investment climate, and making strides against corruption.

1.3. Financial sector

In Armenia, the capital markets and the financial sectors remain shallow (Pytkowska and Rataj, 2007). The independence brought with it a series of difficulties in financial system reforms. During the years of 1990s and early 2000s a large-scale banking crisis were recorded partially due to the failure of several commercial banks. In order to face the crisis the Central Bank of Armenia adopted a series of measures. The objective was to strengthen the banking sector supervision, encourage privatizations and consolidation, raising mandatory requirements for deposits and impose penalties for non-compliance. Likewise the economic sector, the Armenian financial sector has been benefiting from international organizations support and technical assistance programs.

In the IMF Country report (2006) it is stated: "Notwithstanding important reforms over the past few years, financial sector development in Armenia has lagged behind other transition countries. Deepening of financial intermediation has been hindered by high cash ratios, credit risk, lack of competition, and institutional weaknesses. Armenia has a large shadow economy, which further limits the scope for financial intermediation".

In 2013 commercial banks operating in Armenia account for 20 (compared to 55 in 1994). Currently the financial sector as a whole is liquid, well-capitalized and profitable, but alongside there is significant heterogeneity among banks. One of the main characteristics of Armenian banking operations is high level of dollarization of its significant part, like other sectors of the Armenian economy.

The financial intermediary capacity of the banking system of Armenia remains vulnerable. There is a need of further development of the overall financial sector taking into consideration the main existing weaknesses: High lending rates (typically 18-19%) as a consequence of high risks and high operating costs, limited access of SMEs to medium and long term financing for, minor role of capital market, insurance or leasing products as well as other non-banking services need to be improved. Other challenges include strengthening accounting and continuing to reduce red tape in tax and customs in order to promote private growth and encourage companies to move into the formal sector.

As notes it Salim (2013) : "For conventional banks, the objective function frequently taken by the economists studying them is profit maximization. Much of the standard microeconomic analysis is built on this assumption. For microfinance institutions operating with a social cause in a developing country, this may not be the best model of objective function to take to the data." In light of this remark, we consider poverty targeting to be the alternative objective to profit maximization in order to analyze the Armenian microfinance market.

2. METHOD AND DATA

2.1. Research Design

Given that our main research interest lies in studying the characteristics of microfinance sector in Armenia and its adaptation strategies we adopted a multi-case study research design (Eisenhardt, 1989; Yin, 2003). Relying on evidence from multiple cases allows for triangulating data, a process that enhances qualitative analyses validity and robustness (Yin, 2003). Qualitative research is required when the purpose of the study is to increase understanding of a phenomenon about which little is known (Ghauri and Grønhaug, 2005), which is the situation of the present research. Also Lee (1999) argues that qualitative research is appropriate when contextualization, vivid description under study is important. Contextualization is central to our inquiry as we aim at clarifying the adaptation process of traditional microfinance practice within the new specific context.

The cases have been sampled to include all 11 microfinance institutions in Armenia listed in the MIXMARKET report. All these MFIs are representative of the diversity of development paths and problems, approaches to traditional microfinance practice and their adaptation into the local Armenian context. We hold that the variety of stakeholders to whom their offer is addressed as well as the origins of these institutions (NGOs or Universal Credit Organizations) give birth to different strategic positions and often explain the adaptation intensity. Table 1 outlines the key descriptors of all 11 microfinance institutions in Armenia.

Table 1: Microfinance service providers in Armenia

Name	Report date	Gross loan portfolio (USD)	Number of active borrowers
ACBA-Credit Agricole	2014	415,025,705	121,503
ANIV	2005	1,193,151	213
AREGAK UCO	2012	28,254,463	28,102
ECLOF - ARM	2012	2,450,946	1,898
Farm Credit Armenia	2012	9,387,978	1,952
FINCA - ARM	2012	43,826,367	52,450
INECO	2013	195,588,648	-
KAMURJ	2012	17,703,734	14,269
Nor Horizon	2013	7,995,278	4,016
ProCredit Bank - ARM	2012	82,839,625	-
SEF-ARM	2012	14,344,806	15,601

Source: MIXMARKET, 2014, www.mixmarket.org

2.2. Data collection and analysis

Interviews were chosen as our primary source of data and the preferable means of gathering the information as it gives better access to individual strategies and allows disclosing

complicated, sensitive and firm specific information due to the personal touch. Additionally, interviews enable the interviewer to ask for further elaboration of answers and attitudes (Ghauri and Grønhaug, 2005). Our interview grid includes questions that cover topics related to the microfinance sector characteristics as well as specificities of adaptation strategies in Armenia. Given the purpose of our study, we focused on informants who could provide us with evidence in regard to development path and adaptation strategies of MFI practice in Armenia. We interviewed (interviews are still in progress) founders, chairmen of Microfinance institutions/microfinance divisions, but also field experts including Ex-Prime Minister of the Republic of Armenia (Hrant Bagratyan). All the interviews were run face-to-face and, on average, lasted 60-90 minutes. Most of the interviews were conducted by both authors. The language of interview was Armenian except one case, where the interviewee preferred to be interviewed in English. We complemented and double-checked our first hand information with reports and data gathered from Microfinance Centre, MixMarket, Microbanking Bulletin, The Consultative Group to Assist the Poorest (Washington DC, CDFA, Planet Finance, IFIs-International Monetary Foundation, World Bank, local newspapers, and Ministry of Finance and Economy of the Republic of Armenia.

This triangulation of data sources results in a comprehensive understanding of the research topic and permits to have greater accuracy from the multiple viewpoints and possibly uncover new, deeper dimensions, which can provide fresh insights on the phenomena being investigated (Jick, 1979).

Our analysis combines several techniques to make sense of the process data we collected and to build an understanding of the MFI practice development and adaptation in Armenia (Miles and Huberman, 1994; Langley, 1999). Across-case analyses are held, following design indications for comparative qualitative research by Miles and Huberman (1994). In this study, we use the qualitative analysis software QSR NVivo® as a tool to assist with the coding process and to identify adaptation strategies. The first stage of our data analysis refers to our first research question and consists in revealing the characteristics (development, actors and problems) of Microfinance sector in Armenia. The second stage involves understanding the adaptation strategies and how the latters contribute to the institutionalization of Microfinance practice in Armenia.

3. THE MFI COMMUNITY

3.1. Evolution of Microfinance market in Armenia

The first initiatives in microfinance sector in Armenia were made some years after the country declared its independence in 1991. Those activities were supported by a number of international organizations, among which World Vision, OXFAM, Save the Children, UMCOR etc. According to Alpha Plus Consulting (2001) an increasing number of donor organizations were providing microfinancing facilities in Armenia by the end of the 1990s (Appendix B)

Over the last decade microfinance in Armenia has been expanding quite intensively both in terms of volume and in terms of territorial coverage. Currently, lending activities are dominant among other microfinance services, although there are several banking institutions that offer depository and other financial services to micro entrepreneurs and other microfinance customers. MFIs in Armenia offer primarily group loans to self employed entrepreneurs engaged in trade, as well as individual loans to entrepreneurs and micro and small business engaged in agriculture, services and manufacturing.

In Armenia the emergence of MFIs was subject to offering a complementary effort in filing the gap in the financial services industry. Its main objective was to address the increasing unemployment and poverty resulted from transitional shock. In this situation self-employment became one of the best alternatives to unemployment in the country. However, project of microbusinesses which were lacking credit histories and financial means, were ignored by commercial banking institutions. Microfinance has been put forward as a flexible tool to help individuals exploit new opportunities in transition economies.

Currently, the financial system evolution has intensified the competition between commercial banks and UCOs (Universal credit organizations) with regard to the serving marginalized population as well as start-ups. The demand for micro-scale financial services is increasing in rural and in urban zones. The commercialization process of microfinance leads the commercial banks to become closer to and more accessible for villagers, poor households and micro-entrepreneurs by not only adjusting products to meet their financial needs but also by providing them non financial services, such as trainings, consulting, accounting classes etc.- in order to support the borrowers' projects successful accomplishment.

The essential advantage that a specialized credit organization has lies in its ability to create closer ties with borrowers and efficiently manage long-term relationship with them. The most successful practices are being exercised in communities where the reputation factor plays a significant role, and guarantees the fulfillment of lending requirements. Following this logic, Aregak delivers services at its clients' places; officers visit clients and does monitoring of their businesses on spot.

According to the World Bank (2005), "MFI's clients seek loans to serve one or a combination of the following needs: (i) working capital to sustain crop cultivation and animal breeding cycles; (ii) small investments and/or operating capital for retail business operations and small trading concerns; and (iii) supplementary liquidity to smooth family consumption needs" (p.23).

In terms of the ratio of microfinance customers to total population (also known as microfinance penetration percentage), Kwon (2010) observes high percentages in Armenia (5.1 per cent) as well among other countries such as Bangladesh (14.9 per cent), Mongolia (13.2 percent), Bosnia and Herzegovina (9.4 per cent).

3.2. The actors

The microfinance market is segmented with different programs serving different market segments (USAID, 2006). For instance, ACBA-Credit Agricole bank services were initially designed for commercial farmers and small and medium enterprise (SME) agribusinesses, which are able to provide collateral. In 2009, interest rates required for these services are relatively low ranging from 16 percent to 20 percent per annum. Another market segment is formed by low-income borrowers, which are not able to meet collateral requirements. Those borrowers form groups as a guarantee condition and usually pay higher interest rates 28 percent to 39 percent per annum. Such services are provided by Aregak Universal Credit Organization and Kamurj (former MDF Kamurj), for instance. In other words, Aregak and Kamurj practice group guarantee lending. Another microfinance provider Aniv has targeted on individual agricultural credit for SMEs with no access to commercial credit.

When studying Armenian MFIs and the models based on which they have been founded it become clear that Kamurj, started by Save the Children and Catholic Relief Services (CRS). This MFI was established in 1998 as a nonbank financial institution to provide accessible long-term financial and nonfinancial services to low-income families to improve their well-being. As for Aregak, it was funded by United Methodist Committee on

Relief (UMCOR) in 1998 as a nonbank financial institution to support economic empowerment and to improve living standards for low-income families, as well as small- and medium-sized entrepreneurs.

According to Dalyan and Graham (2006) non-profit MFIs have a much stronger position in the market than the other actors. They serve over 82 % of the known borrowers. The authors reported that the consolidated outstanding portfolio of the three largest MFIs accounts for 72 percent of the total portfolio outstanding of the seven main MFI (these are Aregak, FINCA Armenia, MDF-Kamurj, SEF-ARM International, Aniv Fund, ECLOF – ARM and Horizon Fund).

With the development of the microfinance industry in the country the legal and regulatory environment for microfinance activities changed. The Law of Republic of Armenia on Credit Organizations adopted in 2002 regulates and supervises the companies and organizations which carry out borrowing and lending activities, such as credit organizations (out of which microfinance organizations), factoring organizations, leasing companies, saving unions. According to this law *"all organizations involved in accepting deposits and/ or lending should be licensed either as a bank or as a credit organization; foundations are not an acceptable legal structure to obtain a license". Accordingly, MFIs in Armenia have been transformed into regulated universal credit organizations.*

In order to respond more efficiently to changes in microfinance sector a number of amendments was made in the law. For instance, in 2005 and the Central Bank of Armenia (CBA) drafted a new law, which included simplified requirements for MFIs in order to transform them into credit organizations. The CBA is considered the supervisory authority for credit organizations and it should focus its off-site supervision on the capacity of these organizations to manage and monitor credit and currency risk. Regarding the on-site supervision which is scheduled every three year, the CBA has the right for instance to check some credit files and financial documents when conducting its analysis and to give recommendations.

Currently credit organizations, as banks, are operating under the Procedure of Classification of Loans and Provisioning. In order to give uncollateralized lending financial institutions have to collect adequate information on the borrower's financial standing, on its repayment capacity with respect to the loan. Moreover, the borrower's analysis should be conducted through a CBA-approved procedure. If not, any uncollateralized loan would be classified as "blank" loan, and would imply the registration of a loss (of the same amount) at the time it is granted, together with the registration of a 100 percent reserve, and the loan shall be written off on the same day[1]. Having said this, it is a hard procedure for microfinance lenders to consider uncollateralized lending.

In order to serve the lowest-income clients they would require various types of guarantees, for instance group guarantees, home appliances, livestock etc. This brings to the problem, that the members of financial market (banks and credit organizations) do not see benefits in doing microfinance, because the risks in microfinancial lending is much higher than in traditional banking.

The MIX, which is the largest microfinance platform, considers that as compared to other ECA countries, the operations of Armenian MFIs are relatively small. The median gross loan portfolio of Armenian MFIs was more than two times smaller than ECA median in 2006. In the same vein, the medium number of active borrowers of Armenian MFIs was below the ECA median of 3,000 and Caucasus median of over 4,000. According to Dalyan and Graham

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[1] Source : PlaNet Finance (2007 April), Country Profile: Armenia, p.12

(2006) the major problem of Armenian MFIs is the lack of market research product development and strategic marketing skills.

4. DISCUSSION : WHAT MODEL OF MFI FOR ARMENIA ?

Based on our interview results and secondary data we identified following existing limits of the current Microfinance industry in Armenia.

Range of microfinance services. The general activity of Armenian Microfinance sector players is giving loans and only few institutions offer other services- checks issuance, money transfers, and technical assistance. The average amount of Microfinance loans in Armenia is about 1 000USD, for instance Nor HORIZON gives maximum 5 000 000 drams. Some commercial banks offer as well consumer loans which support start-ups in their small business. According to PlaNet Finance there is a significant potential for developing other services such as Micro-leasing and Micro-insurance. The Chairman of the Board of Nor HORIZON Mr. Gor Movsesyan mentioned that MFIs (mainly Universal Credit Organizations) cannot provide their clients with saving and insurance products because of restrictions in legislation. He further explained that after the Law on Credit organizations came into force since 2006 already regulated credit organizations are not allowed any more to collect savings and access the market of borrowings through public offers, to collect deposits from clients that is to say to mobilize savings from clients.

Unequal coverage in terms of geography and of business sectors The Law on Credit organizations allows organizations to go to villages and give credits to everyone who shows interest. Than why MFIs are concentrated in the capital? "Turnover cycle is much more rapid in Yerevan than in the regions, for instance trade sector demands about three months circulation, whereas in agriculture sector it is near one year. The infrastructure is better organized in the capital. Giving Microcredit is not difficult; the hard task is to collect repayments"; said Mr. Movsesyan.

Risk. Since the beginning of the transformation, where the role of MEDI (2003-2006) is very significant, from funds and NGOs to Universal credit organizations the latter are modifying the type of their operations entering gradually into the banking market. The transition had at the same time positive and negative aspects: positive - the field is being regulated and the information flow can be well organized, negative – it was very costly for small organizations, even some (ANIV and KAMURJ) currently have serious operational difficulties as a result of not being transformed into credit organization. According to the expert MFIs should not be controlled as strictly as the Central Bank of Armenia is doing currently. This control is very expensive pleasure: when transforming form HORIZON fund into Nor HORIZON Universal credit organization the organization has preserved the same activities but pays double price for control. The transition was organized in a way that the organization remains sustainable. And now being limited in making profits the organization "plays" with its expenses.
In 2004 the creation of ACRA Credit Reporting, a private credit bureau, aims to gather credit information from its members (namely banks, MFIs, utility companies, insurance companies). The main objective of ACRA is to provide lenders with a tool to protect themselves against lending to over-indebted borrowers. As mentioned earlier, the Microfinance sector is regulated by the Law on Credit Organizations adopted in 2002. However, the problem is that a description of Microfinance is defined neither in this law nor in Civil code. The Law does

not provide any definition of Microfinance activities, target groups, the amount of credits, duration of credit repayment etc. In general according to the concept of Microfinance the credit should be less than GDP per capita or small companies with less than 50 employees should be given Microloans. As stated Mr. Gor Movsesyan : "The only more or less official paper where Microfinance is mentioned as a tool for poverty alleviation is the PRSP. There is no license for Microfinance activities. All experts agreed that it is a very essential issue".

Revenues. Another problem is the cap on interest rates in the Civil Code, which do not allow all players to lend Microloans with interest rate higher than double of banking rate, stated by CBA - 11% as of today). This interest rate cap requirement puts a strong pressure on IMFs and credit organizations cannot lend with interest rate more than 22% annual, which is not covering the costs of lending in distant regions. As stated the General Director of FINCA in Armenia, Mr. Yervand Barseghyan, the cost of services is quite high and very often overpasses the double of banking interest rate. This pressure is even harder as the banking rate has decreased - 17% in June 2005, 13% in 2007. As a solution many IMFs charge other fees, for instance front-of fee, monthly fees. All in all the interest rate reaches to 26% after adding up different fees and service charges. Of course, the value of credit given in the capital differs from the one in regions. It is not quit easy to manage such pricing policy as it is time consuming and therefore costly. In addition, clients do not easily accept to pay monthly interest rate and monthly fee.

Unequal VAT treatment between commercial banks and MFIs. For financial services credit organizations as banks do not pay VAT (currently 20%). When it comes to non financial services VAT payment is required for credit organization. According to Mr. Barseghyan commercial banks are exempted from paying VAT when giving loans as this transaction is being recorded as part of client's banking account services. Whereas MFIs pay VAT at 20% on their profits and also 10% nonresident resold tax when they take credits from international organizations. Thus, cost of services is much lower for commercial banks than for MFIs.
Also, banks have wide variety of services which MFIs, particularly specialized Microfinance organizations such as FINCA in Armenia, do not possess. There are some other credit organizations offering customer loans and some other banking operations.

Regulated Microfinance operations. According to the Law on Credit Organizations Microlending is considered as being only "commercial", that is to say granting loans for individual entrepreneurs or for legal entities. However, one of the principles of Microfinance is also to grant loans to individuals whose business is not registered. In Armenia this category represents an important part of small businesses. Although the Law does not allow credit organizations to give credits to individuals 65% of Nor HORIZON"s portfolio is composed of consumer credits out of which 80-90% is given to people whose business is not registered yet. Though CBA closed its eyes on loans to individuals, legislation should also cover this type of loans. Current practice, partially under the pressure of CBA regulations and controls, is turning away from Microfinance concept. Some mortgages are being taken from Microfinance clients as a means of security. These mortgages usually are business assets of clients: their houses, cows, cars etc.

Cooperation within the Microfinance sector. As stated by MicroFianza Rating the Armenian Microfinance sector is "quite loose and lacks internal coordination and transparency". Another preoccupation is that MEDI created and funded by USAID for supporting of the Armenian Microfinance sector and institutions came to an end in late 2006. Currently there is

no an association grouping MFIs for common projects which will strengthen the sector as a whole, provide specialized training and promote studies. However, the Armenian Microfinance players plan to create an association in the near future. My interviewees mentioned that Association of credit organization is planned to be created this year. This initiative is encouraged be the Central Bank of Armenia as it will aim to group Armenian credit organizations among common objectives and goals.

Lack of State support. Another essential problem lies in the lack of state support of microfinance sector development, which is primordial in making this system more accessible and raising its awareness, also developing more market-based products tailored for the low-income market and to communicate more information. The role of the state in redistribution of profits is crucial in developing the sector and forming favorable environment for microfinance operations. As to our interviewees from the Ministry of Finance the promotion of fair competition and better conditions for micro-lending and start-up development definitely will contribute to microfinance sector enhancement in Armenia.

The development potential of the microfinance sector in Armenia is significant taking into account that micro-lending portfolio increases with the increase in the average loan size. A series of innovation are being put into practice regarding new service development, innovation lending methodologies, enhanced conditions and terms etc. With this in mind, the integration of microfinance practice into the financial system will come to complete the financial intermediation allowing to reach untracked population and to offer client-oriented services based on the existing demand and adjusted to clients' changing needs.

Conclusion

After the fall of Communism a culture of financial intermediation began to take off in many of Eastern European countries. Armenia is a developing economy, hence poverty alleviation, employment creation and social inclusion remain among the most important priorities of the both governments. In this light, microfinance sector development, as a complementary mechanism to the conventional financial intermediation, is considered highly beneficial.
In this study we explore two aspects of the microfinance sector: its characteristics (actors, development paths and problems) and adaptation strategies, which have contributed to the enhancement and institutionalization of MFIs practice in Armenia.
We conducted a number of interviews with MFIs operation in Armenia and at the same time we have interviewed field experts in our study.
The main findings allow us to conclude that over a very long period microfinance scene has been largely dominated by donation-based insinuations. In Armenia as well the movement started mainly based on donations and subsidized aid (for instance, initially Aregak, ECLOF have been founded as development projects). Throughout the sector evolutions MFIs have experienced that development aid and subsidized credit are not sufficient to cover the demand. As the sector has undergone through the process of commercialization and institutional transformation over the last decade, coping with MFIs outreach and sustainability has become even more important. Diversified funding sources would enhance lending terms and service portfolio of MFIs, which also would benefit lenders.
Commercialization process implies what is called "downscaling" approach. For instance, an established commercial bank (for instance, InecoBank) started to hand out microfinance

services. One should mention that for a very long period this approach used to be considered a rather hopeless endeavour. Even experts who were well informed about the successes of the market-oriented approach to microfinance in the 1980s and the early 1990s were rather skeptical about downscaling projects. The main reason lied in banks' lack of interest in serving low-income customers that gave rise to the idea of microfinance as a tool of economic development.

In Armenia the emergence of MFIs was subject to offering a complementary effort in filing the gap in the financial services industry. Its main objective was to address the increasing unemployment and poverty resulted from transitional shock. In this situation self-employment became one of the best alternatives to unemployment in both countries. In Armenia projects of microbusinesses which were lacking credit histories and financial means, were ignored by commercial banking institutions. Microfinance has been put forward as a flexible tool to help individuals exploit new opportunities in transition economies. From the point of view of the method and of the state of the knowledge, we agree with the conclusion of Steinberg and Weisbrod (2008): "Hundreds of studies compare the performance of non-profit organizations with similar organizations in other sectors, but severe methodological challenges remain."

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APPENDIX A. Interviewee list and details

No.	Interviewee	Position	Name
Interviews with members of Microfinance Institutions			
1	ACBA-Credit Agricole	Head of Division Strategic Planning Analysis and Asset/Liability Management	Styopa Zakinyan
2	ANIV	Executive Director	Hayk Minassian
3	AREGAK UCO	Executive Director	Mariam Yesayan
4	AREGAK UCO	Founder's Representative	Steven Movsesian
4	ECLOF - ARM	Executive Director	Artur Panosyan
5	ECLOF - ARM	Chairman of the ECLOF Universal Credit Organization	Tigran Hovhannisyan:
6	ECLOF - ARM	Microfinance Program Officer, Committee head	Narine Gyoletsyan
7	ECLOF - ARM	Program Assistant	Taguhi Yepremyan
8	Farm Credit Armenia	Financial Director	Ani Sargsyan
9	Farm Credit Armenia	Administrator	Irina Afrikyan
10	FINCA - ARM	General Director	Yervand Barseghyan
11	INECO	Head of micro business support and analysis	Alik Stepanyan
12	KAMURJ	Executive Director	Gagik Vardanyan
13	Nor Horizon	Chairman of the Board	Gor Movsesyan
14	ProCredit Bank - ARM		
15	SEF-ARM	Executive Director	Arsen Kuchukyan
Interviews with field experts			
16	Expert 1	Ex- Prime Minister of the Republic of Armenia economist, author of a number of economic studies and articles	

Appendix B. Microfinance providers in Armenia by the end of 1990s

Provider Organization	Status	Year Launched	Sector
ACBA	Cooperative bank	1998	Agribusiness
ANIV	Foundation Local NGO with no foreign affiliation	2000	Agribusiness
AREGAK	Established by foreign NGO	1997	Trade, agribusiness
ECLOF - ARM	Established by foreign NGO	1998	Agribusiness, trade

WCC	Established by foreign NGO	1997	Agribusiness
FINCA - ARM	Established by foreign NGO	2000	Trade
IOM	Established by foreign NGO	1997	Trade
MDF KAMURJ	Established by foreign NGO	2000	Trade
Horizon (formerly Oxfam)	Established by foreign NGO	1995	Trade, agribusiness
GAF	Bilateral donor agreement program	1999	Trade, manufacturing
SEF-ARM (started by World Vision)	Commercial for profit company	1998	Trade, agribusiness