RUMELS MANAGEMENT SOLUTIONS

PART - I

PROFITABILITY ANALYSIS OF ARMENIAN BANKING SECTOR 2019/2020

February 2021

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Executive summary

The purpose of this article is to analyze the current profitability level of Armenian banking sector, to identify challenges facing the banking sector and to make recommendations for improving the performance of the banks.

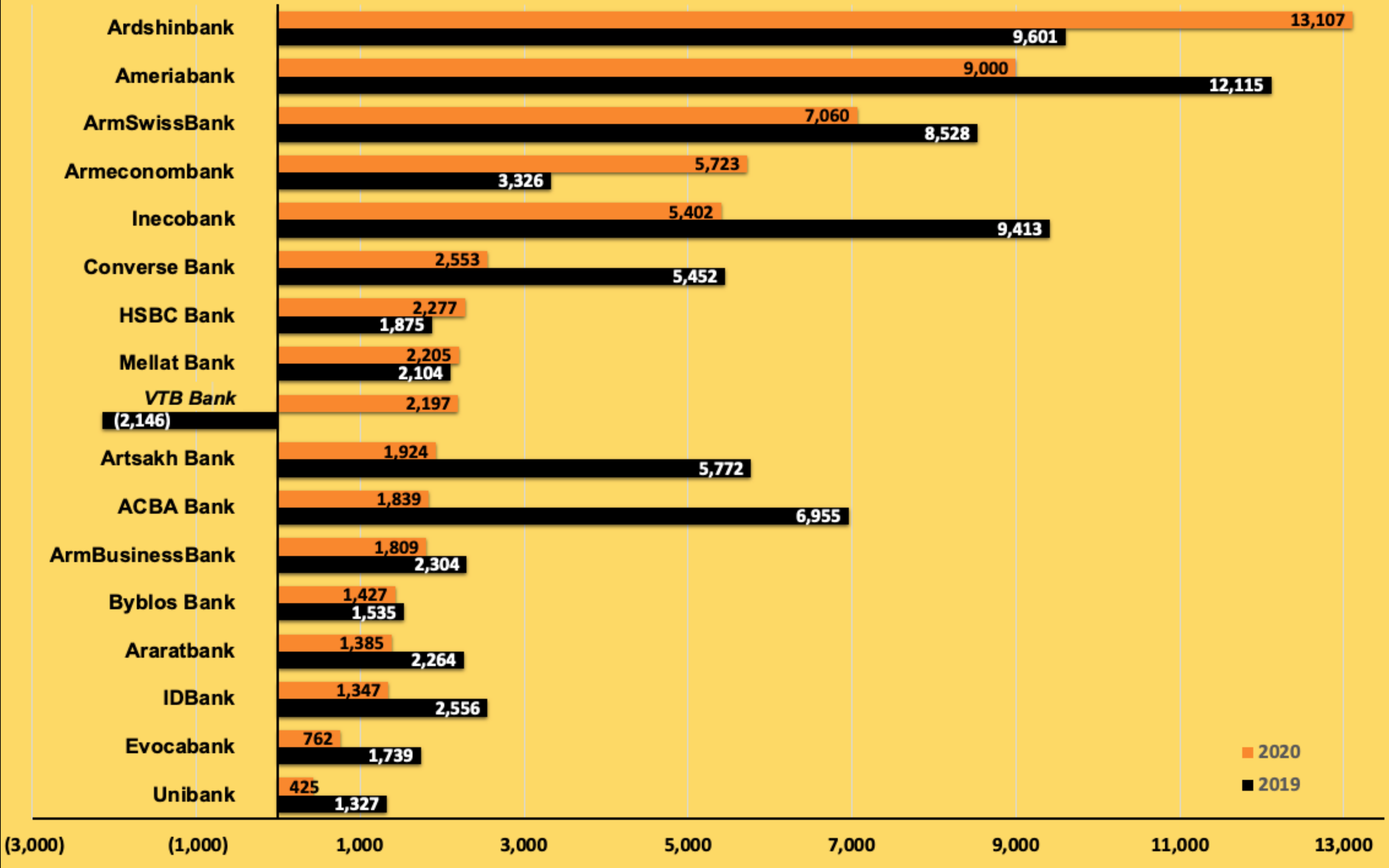
Profitability analysis comprised of net profit comparison analysis, ROAE, ROAA and NIM ratio analysis of banks for 2019 and 2020 financial years.

Published financial statements of Armenian banks were used for the preparation of the article.

Net profit analysis

- Total net profit (unaudited) of all 17 Armenian banks for 2020 is equal to **60.4 bln AMD,** which is by **14 bln AMD (**by 19%) less, than was recorded in 2019.
- In 2020, three Banks (Ardshinbank, Ameriabank and ArmSwissBank) generated almost 50% of net profit of banking sector of Armenia.
- It is assumed, that financial statements are prepared in accordance with IFRS.

Net profit of Armenian banks (in mln AMD)



Profitability analysis of Armenian banking sector 2019/2020

Net profit analysis

- In 2020, the operating income (net interest income and non-interest income) of banking sector was increased by **41 bln AMD** or 14%, but it was not sufficient to cover increase of credit loss allowances, which was increased by **58 bln AMD** or 101%.
- Non-interest expenses were increased slightly, by 2%.
- Decrease of profit tax expenses is due to decrease of taxable profit and decrease of tax rate from 20% to 18%.

Decomposition of net profit decrease in 2020

Banking sector	2019 (in mln AMD)	2020 (in mln AMD)	Difference. (in mln AMD)	Difference (in %)
Net profit	**74,719**	**60,443**	**(14,276)**	**-19.1%**
Decomposition of net profit				
Increase of operating income	297,453	338,359	**40,906**	**14%**
Increase of credit loss allowances	(56,696)	(114,214)	**(57,518)**	**101%**
Increase of non-interest expenses	(144,389)	(147,678)	**(3,288)**	**2%**
Decrease of profit tax expenses	(21,648)	(16,024)	**5,624**	**-26%**

Profitability ratios

To determine the profitability of banks, simply looking at absolute net profit figures isn't quite enough. It's also important to know how efficiently a bank is using its assets and equity to generate profits. For this reason, three key profitability ratios to look at when evaluating a bank's performance are:

- Return on equity (ROE)
- Return on assets (ROA)
- Net interest margin (NIM)

- Return on Average Equity (ROAE)

Return on Equity is an important measure of a bank or country's banking sectors profitability. Review of pay incentives for bank executives in the US, France and elsewhere in Europe shows that absolute or relative ROAE targets are included in the bonus criteria for bank executives. ROAE is calculated by dividing net income for the period by average total shareholders' equity.

- Return on Average Assets (ROAA)

Return on Assets is a ratio of net income produced by total assets during a period of time. In other words, it measures how efficiently a Bank can manage its assets to produce profits. ROAA is calculated by dividing net income for the period by average total assets. Higher ROAA indicates more asset efficiency.

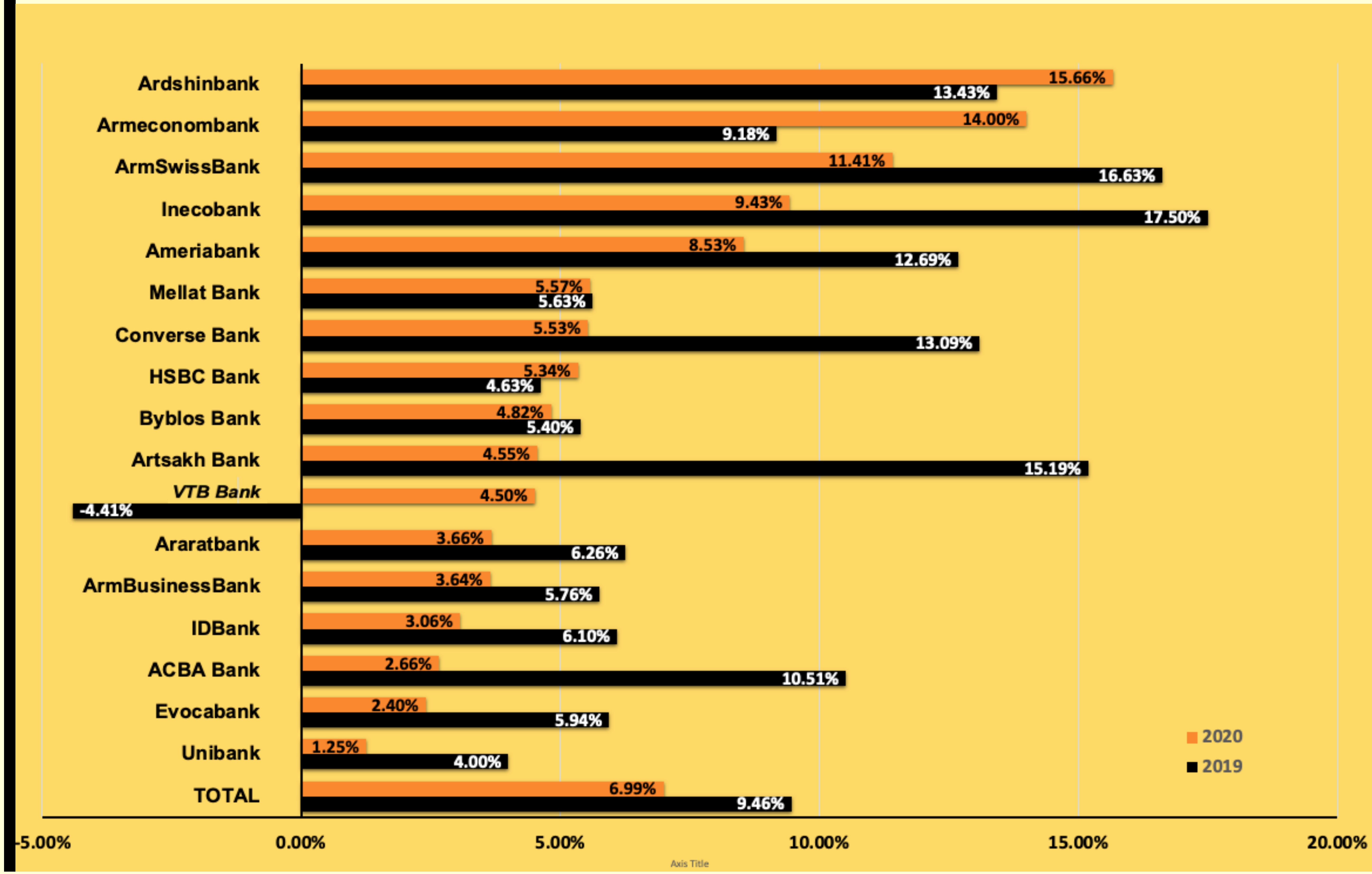
- Net Interest Margin (NIM)

Net Interest Margin is a ratio of net interest income (Interest income – Interest expenses) to the average earning assets. The larger the net interest margin, the more successfully does the bank manage its' interest bearing assets.

Profitability ratios

- ROAE of banking sector is decreased during 2020 by 26% (from 9.46% to 6.99%).
- Equity of banking sector is increased by 7% during 2020 and is amounting to **895 bln AMD** as of 31.12.20.
- All Armenian banks have positive ROE for 2020.
- In 2021, it is expected, that Banks' performance will still remain under pressure, due to COVID-19 pandemic and political instability in Armenia.

ROAE comparison 2020 vs 2019

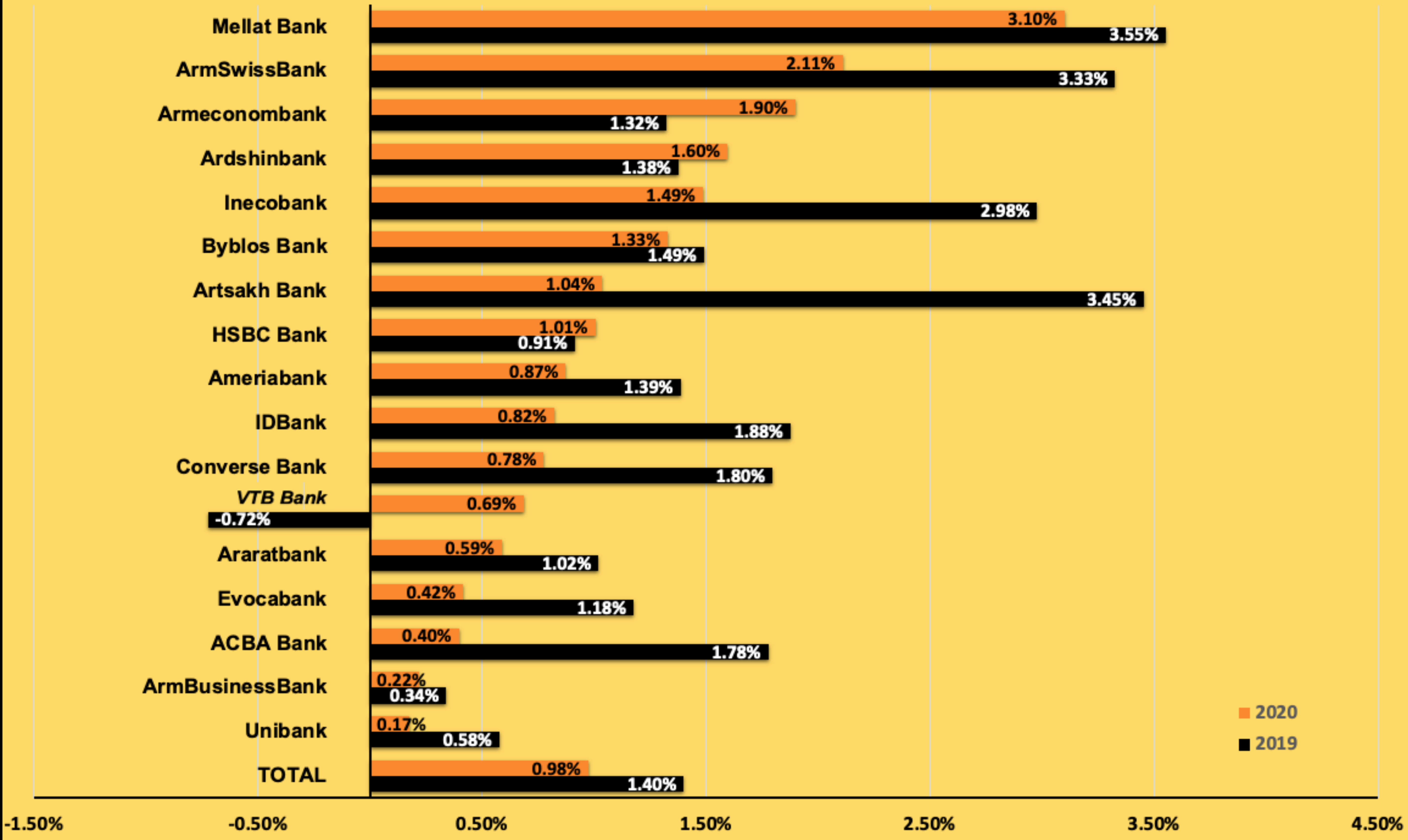


Profitability analysis of Armenian banking sector 2019/2020

Profitability ratios

- ROAA of banking sector is decreased during 2020 by 30% (from 1.40% to 0.98%).
- All Armenian banks have positive ROA in 2020.
- Total assets of banking sector are increased by 15.5% during 2020 and are amounting to **6,643 bln AMD** as of 31.12.20.
- Increase of total assets of banking sector in 2020 is amounting to 891 bln AMD.

ROAA comparison 2020 vs 2019

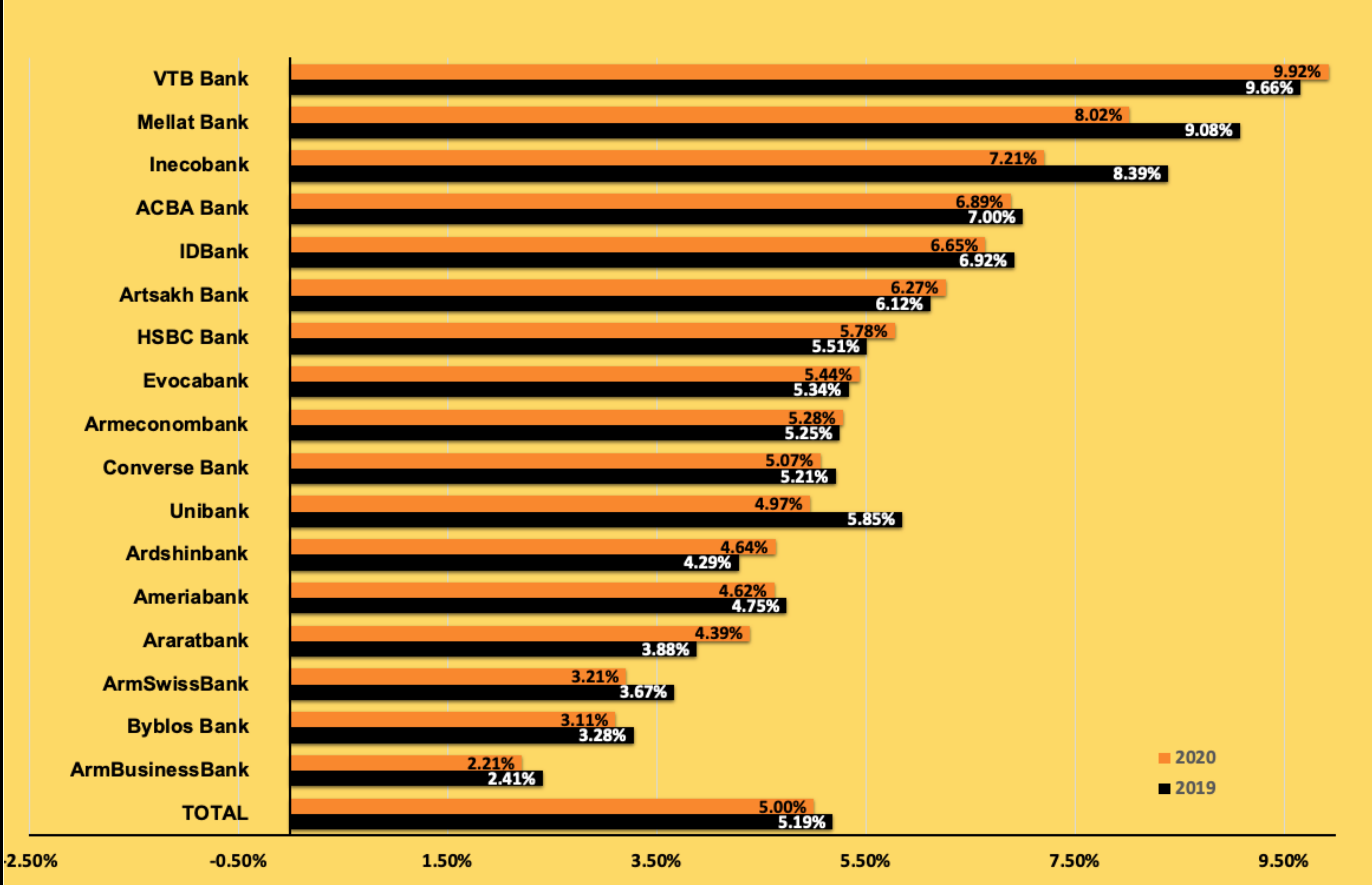


Profitability analysis of Armenian banking sector 2019/2020

Profitability ratios

- Net Interest Margin (NIM) of banking sector is decreased during 2020 by 3.5% (from 5.19% to 5.00%).
- Erosion of banks' NIMs is also a current trend in banking sectors of advanced economies.
- NIM varies among banks depending on their business models and their total asset structure.
- Earning Assets to Total Assets ratio of banking sector of Armenia is about 81%.

NIM comparison 2020 vs 2019



Profitability analysis of Armenian banking sector 2019/2020

Ways of improving banks' profitability

1. Business realignment

The basic idea of business realignment is to exit business lines that have low margins and move instead into lines that are inherently more cost-effective and increase bank profitability. Counterintuitively, these strategic transitions might require the bank to increase its investment and costs in the short term in order to realize improved margins and efficiency in the long term. In addition, it is vital to introduce different products and services, which generate commission income.

2. Channel optimization

The goal of channel optimization is to assess the various ways customers interact with a bank in order to create a cost-effective combination that is adapted to each bank's specific customer base. Optimization of branch network, especially for banks, which declared digital transformation. Channel optimization should not be about branches alone, as contact centers, online and mobile banking, ATMs, and relationship managers also are important channels for customers.

3. Technology and digitalization

Automatization of processes can significantly increase efficiency of operations. Beyond helping to automate core processes, technology also has an obvious role to play in a bank's channel optimization efforts. It affects not only how customers interact with the bank but also how banks communicate important information internally and how they manage their sales and customer relationship activities. These days, almost every bank has its own branded mobile application —however, just because a Bank has a mobile banking strategy doesn't mean that it's being leveraged as effectively as possible. A bank's mobile experience needs to be fast, easy to use, fully featured (think live chat, voice-enabled digital assistance, and the like), secure, and regularly updated in order to keep customers satisfied.

Ways of improving banks' profitability

4. Review and decrease process costs (Business Process Reengineering)

The goal is to improve the bank's efficiency ratio by reducing the unit cost-to-value ratio of each activity or transaction – such as the cost of opening an account, creating a loan document package, or handling a specific type of transaction. Important trends include greater reliance on electronic documents, automated routing and processing, and process automation driven by machine learning models.

5. Increase of staff productivity

Productivity improvement is not dependent on technology alone. Some of the most significant opportunities involve using established performance management techniques, such as clearly defined expectations and scorecards, improved motivation and rewards systems, and better training and supervision. Many banks also find success in redefining job roles, using more flexible work arrangements and outsourcing more specialized activities.

6. Vendor relationships

Improved vendor management does not mean simply pressuring vendors to lower their prices. Maintaining strong vendor performance is supported by service-level agreements and vendor scorecards to monitor performance issues such as system availability, response times, and direct expenditures. To organize effective, efficient and transparent tender process for vendors' selection.

Ways of improving banks' profitability

7. Ongoing monitoring of cost of funding

To monitor cost of funding and try to decrease it by increasing balance of on-demand accounts, which are inherently cheaper, than term-deposits, considering the possibility of attraction financial resources through IFIs or via issuance of bonds on foreign stock exchanges. Monitor local deposit rates at least on a monthly basis, in order to offer always competitive deposit rates.

8. Effective liquidity management

To ensure, that liquid funds are managed in an efficient manner (short-term intra-bank borrowings, REPO and SWAP deal, absence of over-placements with the Central Bank, in regard of mandatory reservation, etc.).

9. M&A transaction

Properly structured M&A deals among Armenian banks can increase the profitability of the banks mainly due to synergy effects and avoidance of duplications. Major part of non-interest expenses of the Banks is attributable to head office overheads. Thus, main part of mentioned overheads can be avoided in case of M&A deals.

10. To introduce "responsible lending" concept

"Responsible lending" is a concept in the finance industry, ensuring Banks only offer borrowers a loan if it suits to borrowers' needs and circumstances. Deployment of mentioned concept will lead to decreased risks of default.

Looking beyond the 10 specific ways of increasing profitability presented here, it's important to recognize that long-term efficiency is impossible to achieve without a corporate culture that supports and values it.

Banking industry challenges

- **Continuing impact of the COVID-19 pandemic on economic activity**
- **Continuing political instability**
- **Data breaches and cybersecurity -** is one of the leading banking industry challenges
- **Increasing FinTech competition**
- **Focusing on customer experience (CX) -** Customers are looking for an integrated experience, or a “one-stop-shop”, for all of their banking needs

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