LIBERALISATION OF ETHIOPIA’S BANKING SECTOR AND ITS LEGAL IMPLICATION ON THE REGULATION OF BANKS

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By

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ACRONYMS

BOD	Board of Directors
BSD	Banking Supervision Department
CAR	Capital Adequacy Ratio
CBE	Commercial Bank of Ethiopia
CB	Central Bank
DBE	Development Bank of Ethiopia
IMF	International Monetary Fund
LTD	Loan-to-deposit
NBE	National Bank of Ethiopia
SARB	South African Reserve Bank
SMEs	Small Scale Industries
SAPs	Structural Adjustment Programmes

CHAPTER ONE

LIBERALISATION OF ETHIOPIA'S BANKING SECTOR AND ITS LEGAL IMPLICATION ON THE REGULATION OF BANKS

1.1 Introduction

Liberalisation of the banking sector is a concept heeded on by international policy makers as a panacea for countries to join the ever-growing global world of finance. Ethiopia however closed the sector to foreign banks. Only Ethiopian nationals can invest in the banking sector.[1] The private sector began to engage in the banking business since 1994, before which the state was the sole owner of the sector. Still today the government is a dominant owner of banking service providers – particularly through the Commercial Bank of Ethiopia (hereinafter CBE) – a situation that is sharply criticised by International Monetary Fund (IMF).[2]

The strong role of government in the banking sector dwarfed the competitive capacity of private banks and arrested the development of the banking sector in Ethiopia. The Ethiopian banking regulatory and supervisory framework is not robust enough to regulate international banks. The regulatory framework and institutional capacity of the banking regulator, the National Bank of Ethiopia (hereafter NBE), is questionable. Effective regulatory framework guarantees the operational independence of the central bank and it ensures its accountability. It is also possible to open the banking sector based on different arrangements that would benefit the Ethiopian banking system and the general economy

1.2 Statement of the problem

In terms of article 3 (1) (a) of Investment Regulation No. 270 of 2012[3] banking is one of investment areas exclusively reserved for Ethiopian nationals. Foreign banking service providers cannot invest in the banking sector of Ethiopia. The government however argues that liberalisation is not necessarily beneficial and it adopted a gradualism approach towards liberalisation and development of the banking sector.[4] The position of the government is based on 'infant industry' argument and the risk associated with entry of multinational banks. The research analyses the tenability of gradualism approach[5] – which is sequential approach to the liberalisation of the banking sector and strengthening

[1] Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Investors Regulation No. 270 of 2012 (hereafter Investment Regulation No 270 of 2012).
[2] T Addison & A Geda 'Ethiopia's financial sector and its regulation' Working Paper Discussion Paper No. 2001/55 9-10.
[3] Investment regulation No 270 of 2012.
[4] A Geda 'The Structure and Performance of Ethiopia's Financial Sector in the Pre- and Post-Reform Period with a Special Focus on Banking' Research Paper No. 2006/112 October 2006; T Addison & A Geda 'Ethiopia's financial sector and its regulation' 1.
[5] A Geda 'Institutional Aspects of Reforming the Financial Sector: The Case of Regulating Banking in Post-Reform Ethiopia' http://www.dpmf.org/images/institutional-reform-finance-alemayehu.html (accessed on 12 September 2017).

the competitive capacity of domestic banks as well as ensuring the autonomy and consolidating the regulatory and supervisory capability of the bank regulator – the NBE. The NBE has no legally recognised independence and freedom to act in the best interest of the financial system. It operates under the legal authority of the chief executive – the Prime Minister.

The issue of opening the banking sector for foreign investment is still under consideration in Ethiopia. In view of that, it is indispensable to analyse the legal implication of the liberalisation on supervision and regulation capability of the NBE. The regulatory and institutional repercussions of ultimate liberalisation of banking sector on the regulation of banking service providers will be scrutinised.

The possibility of political intervention in the supervisory power of NBE and the uncertainty of regulatory framework is very concerning. The NBE lacks robust regulatory framework and institutional capability to regulate multinational banks. If foreign banks eventually enter Ethiopian banking sector, the regulatory capacity of the NBE needs reformulation. Hence, the research would evaluate the soundness of the regulatory and supervisory capacity of the NBE. It analyses the legal implication of liberalisation of banking sector on the already weak and fragile banking regulatory framework and institutional set up.

In analysing, the legal and economic benefit of liberalisation a comparison would be made to the South African banking supervision and regulatory framework and evolving international standards of banking regulation. The South African experience is relevant to evaluate the standard and robustness of Ethiopia's banking supervision, regulation and institutional set up.

South Africa, beyond its advanced system of laws and well-developed financial infrastructure, pursues and implements international standards on banking regulation and supervision.[6] The South African Reserve Bank (hereinafter SARB) performs its duty with independence which is recognised in the constitution of the republic. The Constitution of the Republic of South Africa, 1996 under its section 224 stipulates that the central bank, "in pursuit of its primary object, must perform its functions independently and without fear, favour or prejudice, but there must be regular consultation between the Bank and the Cabinet member responsible for national financial matters". The research will analyse the efficiency of the contemporary regulation and the comprehensiveness of the regulatory framework of banks in Ethiopia in comparison with South African bank regulation and supervision standards and investigates if Ethiopia can draw a lesson from South African banking governance structure.

1.3 Research questions

The research will revolve around finding a critical answer to the following research questions.

What are the legal implications of liberalisation of Ethiopia's banking sector?

Is the Ethiopian government's closed banking system policy tenable?

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6 South African Reserve Bank https://www.resbank.co.za/ (accessed on 20 August 2017).

Is the NBE's operational autonomy enshrined in the law in Ethiopia?

What are the necessary and timely legal and macro-economic measures that Ethiopia should take before opening the banking sector to foreign competition?

1.4 Thesis statement

Financial markets are not only imperfect but also fraught with asymmetry of information.[7] An effective legal framework however will strike a balance. Ethiopia, in due course, may liberalise the banking sector to foreign competition because protecting the domestic banking sector indefinitely is not a viable strategy.[8] It is therefore indispensable to adopt a robust regulatory framework as well as well functioning institutional set up. A subsequent deregulation of the banking sector would then yield a positive result.

Unlike the NBE, which is accountable to the prime minister,[9] the ultimate accountability of the SARB is to the parliament.[10] The NBE therefore lacks autonomy. Its board members are economic advisers to the Prime Ministers and sitting ministers of the economy and they have no specified tenure so they can be removed for any reason at any time.[11] The legal basis for banking supervision of the NBE is inadequate and it is understaffed.

Liberalisation of banking sector would enhance the regulatory framework and help to develop healthy and thriving financial system in Ethiopia. There are mandatory legal reforms that need to be undertaken in view of opening up of the banking sector in order to build robust banking regulation. The contemporary legal structure is not well developed to guarantee the financial health and soundness of the banking sector. With the introduction of new and technologically advanced baking products and services, the need for efficient banking legislations, regulator and skilled human power is very high. The current banking regulation in Ethiopia is not in line with best banking regulation practices and fall short of countries that have better regulatory framework – for instance South Africa. Ethiopian banking governance system should draw a lesson from the success of South African banking regulation.

7 Bascom 1994, Stiglitz 1994 in T Addison & A Geda 'Ethiopia's financial sector and its regulation' 1.

8 G Alemayehu 'The structure and performance of Ethiopia's financial sector in the pre- and post-reform period with a special focus on banking' UNU-WIDER, United Nations University (UNU), Working Paper No. 2006/112 31.

9 Article 3 (4) of the National Bank of Ethiopia Establishment (as Amended) Proclamation No 591/2008.

10 South African Reserve Bank https://www.resbank.co.za/AboutUs/History/Background/Pages/AutonomyandLegalframework.aspx (accessed on 23 September 2017).

11 International Monetary Fund Staff Country Reports 2005 International Monetary Fund 47-48.

1.5 Literature review

Liberalisation of the banking sector enhances competitiveness and efficiency in the banking sector[12], which in turn will positively contribute towards financial stability and access to financial services.[13] As it is, the banking sector in Ethiopia is "almost antediluvian".[14] It is therefore important to reform the sector comprehensively.

Liberalisation of the banking system needs cautious approach for it to be relevant to domestic economy. Multinational banks focus on high return banking, i.e. they focus on big companies in major cities thereby excluding remote rural areas and Small Scale Industries (SMEs) which, in reality, are in dire need of finance.[15] That ultimately would push domestic banks to the narrow direction of least profitable banking services. Besides, foreign banks would bring in capital instead of mobilising it domestically thereby discouraging deposit.

The entry of foreign banks made little impact on the coverage and quality of banking service in the post reform Africa.[16] There is also a risk of financial crisis that might occur because of the entry of foreign banks, especially if not regulated efficiently. Weak regulatory framework is one of the causes of financial crisis; however, financial liberalisation would produce a positive result if backed by sound regulatory framework.[17] . As noted by Stglitz, beyond the liberalisation and deregulation of the banking sector, what is critical is "the construction of the regulatory framework that [will] ensure an effective financial sector".[18]

There are sound reasons behind Ethiopia's gradualism approach in the opening up of banking sector. Efficient regulatory infrastructure, which is a basis for significant social returns accrued from banking service,[19] must be designed. From experience it is possible to realise, that liberalisation is not necessarily and always beneficial to developing countries.[20] In fact, liberalisation, without efficient banking regulatory framework, is infused with risks.[21]

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12 M Zenawi 'African Development: Dead Ends and New Beginnings' Preliminary Draft for PHD Dissertation Chapter 17:2 28.

13 A Bezabeh and A Desta 'Banking Sector Reform in Ethiopia' International Journal of Business and Commerce Vol. 3, No. 8: Apr 2014 25-38 28.

14 The Economist Neither a sprint nor a marathon 'Africa's most impressive economic managers suffer from excessive caution' May 30th 2015.

15 M Zenawi 'African Development' 28.

16 M Zenawi 'African Development' 28.

17 K Kiyota et al 'Case for Financial Sector Liberalization in Ethiopia' IPC Working Paper Series Number 29 INTERNATIONAL POLICY CENTER Gerald R. Ford School of Public Policy University of Michigan 2007 17.

18 Stiglitz, Joseph (1998) 'More Instrument and Broader Goals: Moving towards the Post-Washington Consensus', The United Nations University/WIDER, WIDER Annual Lecture 2 (April 1998), Helsinki 16.

19 T Addison & A Geda 'Ethiopia's financial sector and its regulation' 12.

20 M Dube 'The WTO Non-Agricultural Market Access (NAMA) negotiations and developing countries: In pursuit of the 'development agenda'' Thesis Submitted in partial fulfilment of the requirement for the Degree of Master of Laws University of Pretoria 2010 11.

21 T Addison & A Geda 'Ethiopia's financial sector and its regulation' 1.

On the other hand, banking regulation, in Ethiopia, is fragile and inefficient. The NBE is struggling to regulate the financial sector in its current form and size effectively.[22] It has a limited supervisory and regulatory capability.[23] Before launching a full-fledged liberalisation, it is imperative to put in place a sound "regulatory safeguards".[24] Well-developed commercial law and sound accounting practices must support a robust financial system – both are underdeveloped in Ethiopia.[25]

Sound regulatory framework and institutional capacity is an invaluable requisite to evaluate the quality and then subsequent regulation of foreign banks that will enter Ethiopian market.[26] South Africa has a firm and robust banking regulatory framework as a result of which South African Banks were able to withstand the 2008 world financial crisis and remained profitable.[27] Hence, Ethiopia should adopt a sound legal regime and needs to build dependable institutions. That is the focus of this research.

1.6 Research source and structure

The research would be conducted by a desktop research and analysis. Relevant literatures, books, journal articles, research working papers, reliable internet sources, legislations, government policies and notices would be analysed critically. The research will also scrutinise the South African regulatory and institutional framework and its implication to draw appropriate lessons for supervision and regulation of banks in Ethiopian.

The structure of the research is as follows. The second chapter addresses Ethiopia's current political economy of the banking sector. It explicates the contemporary legal and institutional system that governs the banking business of Ethiopia. This is to lay a background for subsequent legal analysis of the banking sector and to demonstrate the relevance of the study.

Under chapter three, the study analyses the independence and accountability of the NBE and its implication on the banking system of Ethiopia in comparison with South African regulatory and supervisory framework. It delves into the detail evaluation of the regulatory framework that empowers the central bank. It analyses repercussion of the independence of the central bank on the efficiency of the banking system. It evaluates the shortcomings and strengths, if any, of the law that established the banking regulator. The South African system of regulating banks would be evaluated to draw a lesson therefrom for Ethiopian banking governing system.

The fourth chapter addresses the implication of liberalisation of the banking service on its regulation. This chapter evaluates the sufficiency of the contemporary regulation. It analyses the efficiency of the regulators, as they are currently, to govern multinational banks that would eventually enter the

22 T Addison & A Geda 'Ethiopia's financial sector and its regulation' 10.

23 M Asfaw and MK Hagos 'Financial Regulation and Supervision in Ethiopia' Journal of Economics and Sustainable Development 17 2014 64.

24 Stiglitz, Joseph (1999) 'Whither Reform? The Years of the Transition' Paper presented for World Bank Annual Bank Conference on Development Economics, April 28-30, 199, Washington, DC.

25 T Addison & A Geda 'Ethiopia's financial sector and its regulation' 7.

26 T Addison & A Geda 'Ethiopia's financial sector and its regulation' 10.

27 Rene Bosch Homburger Banking Regulation Jurisdictional Comparisons 2012 Thomson Reuters 297-316.

Ethiopian banking sector. The need to reform both the regulation and the institutional structure in order to cope up with multinational banks would be scrutinised. The terms of opening the sector for foreign competition will also be analysed. This is in order to consider the need for protection of domestic banks, which may face stiff competition from international banks.

The fifth chapter concludes and summarises the research and indicates feasible recommendations on how to upgrade bank regulation and supervision in Ethiopia.

CHAPTER TWO

ETHIOPIAN BANKING SYSTEM AND REGULATORY FRAMEWORK IN CONTEXT

2.1 Introduction

Banks are financial intermediaries with a vital role in the financial sector and in spurring economic growth.[28] The banking industry steers the flow of resources within the economy and it contributes to economic development.[29] Banks are mediums where money is deposited and from where loans are provided – which are crucial fuels for economic development.[30] Banking system, however, can also be a source of financial crisis.[31] It is due to the versatility of banks and their sensitive role that governments gravitate towards regulating them strictly and hold them to conservative standards.[32]

Durability of a particular economy can be inferred from the strength and performance of its financial industry.[33] Because, services provided by banks are lifebloods of the economy. Banks are repositories of savings; they provide loans to individuals and businesses and they sustain liquidity, operate payment system as well as serve as information channel between lenders and borrowers.[34].

Ethiopia started to reform its banking sector in 1994. However, the reform so far has been dragged due to repressive policies implemented by the government.[35] Compared to sub-Saharan Africa Ethiopian banking system is dominated by large public banks and it is underdeveloped.[36] The Ethiopian banking sector lacks competition, efficiency and the capability to spur the economic growth.[37] Ethiopian government frequently frowns at the notion of liberalisation arguing, albeit without scientific study, that it might lead to a banking crisis.[38] Though an open banking sector can potentially be a source of financial crisis, it also has an affirmative contribution towards economic development – if well regulated. Ethiopian government however seems to adopt a stubborn approach and refuses to reform the financial sector.

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28 Andreas Busch Banking Regulation and Globalization Oxford University Press 2009 23; JR Barth et al Rethinking Bank Regulation: Till Angles Govern Cambridge University Press 2006 i.

29 Gebrehiwot and Bienen 'Ethiopia's Accession to the WTO and the Financial Services Sector' 1.

30 K van Wyk 'Regulation of the Financial Markets' as referred to in K van Wyk et al Understanding South African Financial Markets Van Schaik Publishers 2012 61.

31 Gebrehiwot and Bienen 'Ethiopia's Accession to the WTO and the Financial Services Sector' 1.

32 Maria-Eleni K. Agoraki et al. 'The effect of board size and composition on bank efficiency' http://www.efmaefm.org/0EFMAMEETINGS/EFMA%20ANNUAL%20MEETINGS/2009-Milan/papers/EFMA2009_0140_fullpaper.pdf 4 (accessed 23 August 2017).

33 Gerard Caprio Luc Laeven and Ross Levine 'Governance and Bank Valuation' NBER WORKING PAPER SERIES *JEL No. G21, G34, K22, G28* http://www.nber.org/papers/w10158.pdf 2003 1-47 (accessed 10 September 2017).

34 Maria-Eleni K. Agoraki et al. 'The effect of board size and composition on bank efficiency' http://www.efmaefm.org/0EFMAMEETINGS/EFMA%20ANNUAL%20MEETINGS/2009-Milan/papers/EFMA2009_0140_fullpaper.pdf 4 (accessed 23 August 2017).

35 Admassu Bezabeh and Aseyehgn Desta 'Banking Sector Reform in Ethiopia' 32.

36 IMF, 2013b as referred to in Nicola Limodio and Francesco Strobbe 'The Development Impact of Financial Regulation: Evidence from Ethiopia and Antebellum USA' Policy Research Working Paper 2016.

37 Admassu Bezabeh and Aseyehgn Desta 'Banking Sector Reform in Ethiopia' 32.

38 Admassu Bezabeh and Aseyehgn Desta 'Banking Sector Reform in Ethiopia' 32.

This chapter contextualises Ethiopian banking system in general and elucidates the contemporary legal regime and the conundrum surrounding the liberalisation of the banking industry.

2.2 Ethiopian banking system in general

Investment in the banking sector is exclusively reserved to Ethiopian nationals[39] – for good reason, according to the Ethiopian government. Foreigners are outlawed from opening a bank or branch offices or subsidiaries of banks in Ethiopia or acquire the shares of Ethiopian banks.[40] Currently there are 19 commercial banks (3 public and 16 private) in Ethiopia.[41] NBE is a regulator and supervisor of commercial banks.[42] So far, the NBE is regulating and supervising domestic banks fairly well mainly because the current structure of domestic banks is not very complicated[43] – and dominated by government owned banks.

Ethiopian banking industry is well capitalised, its capital adequacy ratio (CAR) from 2008 to 2011 has been around 18 per cent – above regulatory minimum of 8 per cent. However, in 2012 there is a sharp decline of CAR from 18.1 per cent to 13.6 per cent possibly indicating the rise of risk-weighted assets driven by high domestic growth to finance public enterprises.[44] Over a period of 2008 to 2011, the aggregate Loan-to-deposit (LTD) ratio has remained within a good margin of 80 percent, only to hike in 2012 to more than 92 per cent indicating the urgency of strengthening oversight.[45]

2.2.1 Performance of Ethiopian banking sector

Ethiopia hosts a banking industry which is far below African and international standards with low coverage of banking services, excessive urban concentration and inefficient and ineffective central bank.[46] It is also characterised by poor infrastructure; rudimentary payment system, and suffer from shortage of skilled human power.[47] Compared to international and African standards financial services cover is the lowest at about 166 000 people per branch and bank branches are concentrated in urban areas.[48] In contrast, as of 2012 South African financial inclusion rate is 67 per cent.[49] In

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39 Article 2 (1) (a) of Regulation No. 270 of 2012 Council of Ministers Regulation on Investment Incentives and Investment Areas Reserved for Domestic Investors.

40 Article 9 of Banking Business Proclamation No. 592 of 2008.

41 National Bank of Ethiopia http://www.nbe.gov.et/financial/banks.html (accessed 20 September 2017).

42 Article 5 (7) of Proclamation No. 591 of 2008.

43 A Geda Institutional Aspects of Reforming the Financial Sector: The Case of Regulating Banking in Post-Reform Ethiopia http://www.dpmf.org/images/institutional-reform-finance-alemayehu.html (accessed 27 August 2017).

44 International Monetary Fund 'The Federal Democratic Republic of Ethiopia: 2012 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; Staff Statement; and Statement by the Executive Director for Ethiopia' IMF Country Report No. 12/287 2012 11-12.

45 International Monetary Fund 'The Federal Democratic Republic of Ethiopia: 2012 Article IV Consultation—Staff Report 11-12.

46 Gebrehiwot Ageba and Derk Bienen 'Ethiopia's Accession to the WTO and the Financial Services Sector' 6-7.

47 Gebrehiwot Ageba and Derk Bienen 'Ethiopia's Accession to the WTO and the Financial Services Sector' 6-7. The shortcomings observed in the Ethiopian banking sector adversely affect the availability of reliable information and financial intermediation especially in risk management area.

48 M Wiedmaier-Pfister et al 'Access to finance in Ethiopia Sector Assessment Study' http://www.microfinancegateway.org/sites/default/files/mfg-en-case-study-access-to-finance-in-ethiopia-sector-assessment-study-volume-2-jul-2008.pdf 2008 (accessed 21 August 2017) 19.

Ethiopia, loan is not easily accessible, and whenever it is available, a high collateral is required jeopardising the chance of small businesses to get credit.[50]

A significant number of people in Ethiopia have no access to credit services since credit finance is available mostly to large companies in particular to government owned enterprises.[51] Private Banks ignores agriculture irrespective of its relevance to economic growth. The banking system is also prone to, and marred with worrisome (and obscure[52]) bank corporate mal practices.[53] Private sector competition is also impaired due to the participation of political entities in the operation of business enterprises.[54]

The government owned CBE is huge and monopolistic enough to set price.[55] Its worth is equivalent to two-third of banking sectors' asset.[56] Though there is an excess liquidity in the banking sector especially in public banks, retail lending however is underdeveloped. The ratio of liquid asset to total asset was over 30 per cent from 2008 to 2011, it however plummeted to 19 per cent in 2012. According to IMF staff reports the sudden decline of CAR and the liquidity ratio coupled with the sharp increase in LTD in 2012 could indicate initial symptoms "that vulnerabilities might be building in the sector" – though the IMF staff did not have had access to adequate data to analyse the implications of aforementioned financial sector indicators comprehensively.[57]

In 2015 the average risk-weighted, over all capital adequacy ratio was 16.6 per cent – twice the minimum requirement and the sector accrued robust profit with its non-performing loan ratio only at 2.4 per cent.[58]

Ethiopia has both public and private banks that are secluded from international competition. The NBE as a central bank is also inefficient. Moreover, its banking sector is one of the most poorly developed in the world.

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49 The Banking Association South Africa 'Financial Inclusion Review' http://www.banking.org.za/what-we-do/overview (accessed 23 September 2017).

50 Admassu Bezabeh and Aseyehgn Desta 'Banking Sector Reform in Ethiopia' 26.

51 M Wiedmaier-Pfister et al http://www.microfinancegateway.org/sites/default/files/mfg-en-case-study-access-to-finance-in-ethiopia-sector-assessment-study-volume-2-jul-2008.pdf 18.

52 Corporate disclosure in Ethiopia is inadequate – the industry tightly controls corporate information, which makes it very difficult to investigate the scale of the mal practices.

53 Asnakech Getnet Ayele 'Revisiting the Ethiopian Bank Corporate Governance System: A Glimpse of the Operation of Private Banks' Law, Social Justice & Global Development (An Electronic Law Journal) 2013 3.

54 Asnakech Getnet Ayele 'Revisiting the Ethiopian Bank Corporate Governance System' 2.

55 Gebrehiwot Ageba and Derk Bienen 'Ethiopia's Accession to the WTO and the Financial Services Sector' 6-7.

56 International Monetary Fund 'The Federal Democratic Republic of Ethiopia 2015 Article IV Consultation—press release; Staff Report; and Statement by the Executive Director for the Federal Democratic Republic of Ethiopia' IMF Country Report No. 15/300 2015 13.

57 International Monetary Fund 'The Federal Democratic Republic of Ethiopia: 2012 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; Staff Statement; and Statement by the Executive Director for Ethiopia' IMF Country Report No. 12/287 2012 11-12.

58 International Monetary Fund 'The Federal Democratic Republic of Ethiopia 2015 Article IV Consultation' 13.

2.3 The contemporary banking sector legal regime

In terms of Ethiopian Constitution, the federal government has the power to administer the national bank and to regulate foreign exchange and money circulation.[59] Accordingly, the federal government issued a proclamation to establish the NBE as a central bank.[60] The NBE first comes into being in 1963 pursuant to Order No. 30 of 1963. Article 3 (1) of the National Bank of Ethiopia Establishment (as Amended) Proclamation No. 591 of 2008 endorsed Order No. 30 of 1963. Subsequently, Proclamation No. 592 of 2008 broadened the autonomy of the NBE and it clarified its regulatory and supervisory role. It has the power to issue banking license and supervise banks and it is accountable to the Prime Minister of Ethiopia.[61] The NBE has the mandate of achieving monetary stability; a robust financial system; ensuring exchange rate and price stability; and to maintain sound financial system.[62]

The NBE, based on the power conferred upon it by Proclamation No 591 of 2008, can stipulate the eligibility requirement for bank directors, managers and has the power to reject the appointment of nominees who are not up to the set standards. It also has the power to direct banks to make financial statements available to the public, to monitor transactions that could trigger conflict of interest, to regulate shareholders right as well as banks risk management systems. The NBE also has the power to make sure that banks comply with the rules through on-site and off-site supervision mechanisms as well as by imposing sanctions in cases of non-compliance.

The regulatory framework adequately provides for regulation of disclosure of information so the NBE can arm-twist commercial banks and order them to submit information on, for instance, name and voting rights of shareholders, the age, marital status, employment history and education level of potential chief executive officers and bank directors.[63] The NBE is duty bound to make sure that every bank has appointed competent auditors who can analyse policies adopted by government.[64]

The NBE has the power to gather any information from banks and other financial institutions and it is under no obligation to disclose that information except in few exceptional circumstances.[65] The NBE have the power to issue directives for the implementation of National Bank of Ethiopia Establishment Proclamation No 591 of 2008 and regulations issued pursuant to the establishment proclamation.[66]

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59 Article 51 (7) of the Federal Democratic Republic of Ethiopian Constitution Proclamation No. 1 of 1995.

60 Proclamation No. 591 of 2008.

61 Articles 5 (7) and 3 (4) of Proclamation No. 591 of 2008.

62 Article 4, 5 (7) of Proclamation No 591 of 2008.

63 Article 10 (2) and (5) of Proclamation No. 592 of 2008; Licensing and Supervision of Banking Business Directive No. SBB/39/2006 Amendment for New Bank Licensing and Approval of Directors and CEO.

64 Art 26 (1) and Art 27 of Banking Business Proclamation No. 592 of 2008; Art 370 of the Commercial Code of Ethiopia Proclamation No 166 of 1960; Licensing and Supervision of Banking Business Directive No. SBB/19/96 Approval of an Independent Auditor.

65 Article 22 of Proclamation No 591 of 2008.

66 Article 27 of Proclamation No 591 of 2008.

2.3.1 Corporate disclosure

A corporate regulatory regime should be designed to boost the culture of transparency and timely disclosure of information on relevant issues such as ownership and governance of a company, its financial status and performance.[67] In order to ensure sound regulatory system in the banking sector NBE needs to set strong and conservative transparency and disclosure requirements. All commercial banks are required to submit a duly signed balance sheet to the NBE within one month after the end of each financial year.[68] In terms of article 28 of Banking Business Proclamation No. 592 of 2008, every bank is required to make its financial statement available to the public by disclosing it at every place of its business throughout the year and publish its balance sheet and profit and loss statement in a newspaper of wide coverage. In practice, however, no bank bother to exhibit such information at its place of business and neither is it published in any of the daily newspapers in the country.[69]

One of core regulatory mandate of the NBE is to monitor compliance with relevant provisions on the appointment and the responsibilities of board of directors.[70] The NBE approves the appointment of directors of a bank provided they fulfil the requisite criteria such as a minimum of first degree, adequate experience in the management of banking business and being a person of good character in terms of his/her integrity, honesty and diligence.[71] The NBE also approves chief executive officer of a bank who should be competent and has a demonstrable command of technical requirements of banking business as well as risks and management process needed to run banking business and fulfils the fit and propriety criteria.[72]

2.3.2 Risk management

Owing to the special nature of banks, both depositors and shareholders need legal safeguard.[73] More importantly, the health of the entire financial system and the general economy is intertwined with the prudence of banking industry. As a result, governments take explicit measures such as deposit insurance and implicit ones such as bank bailouts to prevent bank runs and to preserve the stability of financial system.[74] Government also keeps a close eye on the operation and direction of banks.

The NBE has the power to monitor all commercial banks to make sure that each one of them has thorough risk management policies and robust principles, and to ensure that banks take necessary measures to prevent and manage risks.[75] Taking into account the risk profile of each bank, the NBE is

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67 OECD Principles of Corporate Governance https://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf (accessed on 14 September 2017) 2004 49.

68 Article 28 of Proclamation No. 592 of 2008.

69 Asnakech Getnet Ayele 'Revisiting the Ethiopian Bank Corporate Governance System' 16.

70 Article 14-16 of Proclamation No. 592 of 2008; Directive No SBB/39/2006.

71 Article 14-16 of Proclamation No. 592 of 2008; Directive No SBB/39/2006.

72 Article 14-16 of Proclamation No. 592 of 2008; Directive No SBB/39/2006.

73 T.G Arun and J Turner (eds) Corporate Governance of Banks in Developing Economies: Concepts and Issues http://unpan1.un.org/intradoc/groups/public/documents/nispacee/unpan015471.pdf (accessed 22 August 2017) 4-8.

74 H Westman 'The role of ownership structure and regulatory environment in bank corporate governance' Journal of Economics Literature classification: G21, G28, G32, G38, 2010 1.

75 NBE Risk Management Guideline, http://www.nbe.gov.et/bankrisk/bankingbusiness.html 2010 (accessed August 23 2017) 1-2.

responsible for determining minimum capital and reserve amount that should be retained by commercial banks.[76] In terms of article 21(7) of Banking Business Proclamation No. 592 of 2008 banks are required to maintain a special reserve account as a guarantee for loss that might be caused by negligent and dishonest actions of directors or employees. Aforementioned provisions strengthen the role of the NBE in the daunting task of risk management in the banking sector.

2.3.3 Banking business

Ethiopian legal regime also incorporates a law that regulates banking business. Banking business is defined as a business of receiving funds from the public and using the funds for loans or investment at the risk of the person undertaking banking business. It also includes buying and selling of gold and silver and foreign exchange; the transfer of funds to other local and foreign persons; as well as discounting promissory notes, drafts, bills of exchange and other debt instruments.[77] Banking Business Proclamation No. 592 of 2008 incorporates the detail regulatory framework for licensing and supervision of banking business.

2.4 The contemporary political economy of Ethiopian banking system

There is a mixed public private ownership in the banking sector in Ethiopia. The NBE has no political and operational independence and its governor is a political appointee. The banking sector is also characterised by high level of protection for domestic banks. State ownership of banks presents an inherent conflict of interest because the government acts both as an owner and as regulator, thereby creating a glitch to corporate governance.[78] Moreover, government owned banks are managed by bureaucrats who are concerned about accommodating an interest of a particular group over optimising the value of the institution.[79]

The Ethiopian banking regulatory framework suffers from a dwindling credibility due to the NBE's apparently lenient approach towards government owned commercial banks while adopting a hard-line approach against private commercial banks.[80] The public do not have confidence in the banking sector – a fact that negatively affects the level of financial intermediation in Ethiopia.[81] A fragile supervisory system, large-scale public ownership of banks, and the NBE's involvement in directing lending practices contributed to the erosion of public confidence in the banking industry.[82] Besides, the banking industry frowns whenever there is an attempt to study its operation. The activities of private banks and the NBE's inspection report on private banks are also not accessible and

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76 Article 18 and 20 of Proclamation No. 592 of 2008.

77 Proclamation No. 592 of 2008.

78 Muhamet Mustafa et al 'Improving Corporate Governance and Transparency in Banks and Insurance Companies in Kosova' http://www.cipe.org/sites/default/files/publication-docs/CG%20in%20Banks-Ins%20Comp%20Kosovo%20Riinvest.pdf April 2009 (accessed 11 September 2017) 10.

79 Muhamet Mustafa et al 'Improving Corporate Governance and Transparency in Banks and Insurance Companies in Kosova' 10.

80 Asnakech Getnet Ayele 'Revisiting the Ethiopian Bank Corporate Governance System' 2.

81 Admassu Bezabeh and Aseyehgn Desta 'Banking Sector Reform in Ethiopia' 27.

82 Admassu Bezabeh and Aseyehgn Desta 'Banking Sector Reform in Ethiopia' 27.

transparent enough.[83] Private bank officials are also not comfortable in disclosing information on their operation.[84]

The restriction on foreign financial intermediaries is still in place in Ethiopia under the pretext of preventing or mitigating the macro-economic risks associated with liberalised financial sector.[85] The Ethiopian government opts to rely on the channel of advisory assistance for the transfer of foreign financial technology and expertise.[86] Allowing entry of foreign financial intermediaries, (commercial presence of foreign financial institutions) is considered as the most crucial means to advance the scale and quality of financial services.[87] Ethiopian government, however, suspects that with liberalisation comes the risk of losing control of financial sector.

The contemporary financial sector is underdeveloped and marred with challenges such as non-performing loans in public banks and the need to restructure it, easing bank procedures, improving service delivery and streamlining cost structure.[88] Retail lending is underdeveloped and there is an excess liquidity in the banking sector especially in public banks.[89] In its long-term strategy study, the ministry of finance noted "... the range of formal financial assets and available saving instruments to the private sector and individual households in particular in rural areas is still limited".[90] The Ethiopian government in its financial sector policy emphasises on how to strengthen corporate governance and hold financial institutions accountable as well as building the capacity of financial sector professionals.[91]

The position taken by Ethiopian government is infelicitous and possibly counterproductive given the positive effects of liberalisation as demonstrated by various studies provided it is adequately regulated in order to avoid the adverse problem of balance of payments.[92] Critics argue that opening

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83 Asnakech Getnet Ayele 'Revisiting the Ethiopian Bank Corporate Governance System' 4 (in the footnote).

84 Asnakech Getnet Ayele 'Revisiting the Ethiopian Bank Corporate Governance System' 4 (in the footnote).

85 M Wiedmaier-Pfister et al http://www.microfinancegateway.org/sites/default/files/mfg-en-case-study-access-to-finance-in-ethiopia-sector-assessment-study-volume-2-jul-2008.pdf 20.

86 M Wiedmaier-Pfister et al http://www.microfinancegateway.org/sites/default/files/mfg-en-case-study-access-to-finance-in-ethiopia-sector-assessment-study-volume-2-jul-2008.pdf 20.

87 Stern et al (April 2007) as referred to in M Wiedmaier-Pfister et al http://www.microfinancegateway.org/sites/default/files/mfg-en-case-study-access-to-finance-in-ethiopia-sector-assessment-study-volume-2-jul-2008.pdf 20.

88 M Wiedmaier-Pfister et al http://www.microfinancegateway.org/sites/default/files/mfg-en-case-study-access-to-finance-in-ethiopia-sector-assessment-study-volume-2-jul-2008.pdf 19.

89 M Wiedmaier-Pfister et al http://www.microfinancegateway.org/sites/default/files/mfg-en-case-study-access-to-finance-in-ethiopia-sector-assessment-study-volume-2-jul-2008.pdf 18-19.

90 Ministry of Finance and Economic Development (MoFED) Ethiopia: Building on Progress A Plan for Accelerated and Sustained Development to End Poverty (PASDEP) (2005/06-2009/10) http://www.afdb.org/fileadmin/uploads/afdb/Documents/Policy-Documents/Plan_for_Accelerated_and_Sustained_%28PASDEP%29_final_July_2007_Volume_I_3.pdf (accessed 12 August 2017).

91 M Wiedmaier-Pfister et al http://www.microfinancegateway.org/sites/default/files/mfg-en-case-study-access-to-finance-in-ethiopia-sector-assessment-study-volume-2-jul-2008.pdf 20.

92 Tutwa Consulting Group 'Ethiopia's guarded financial sector' http://www.tutwaconsulting.com/ethiopias-guarded-financial-sector/ 2015 (accessed 12 August 2017).

the banking sector improves service delivery. The government however asserts that local banks capacity building would do that.[93]

Ethiopia in general lacks a robust corporate governance system. The legal regime that governs modern and sophisticated banks is non-existent – a factor that contributes to banks inefficiency. Shareholder protection regime is inadequate – which are main factors for lax legal safeguards for businesses leading to the expropriation of shareholders wealth.

2.5 Intermingled banking business and politics

Banking business operates under the troubling shadow and adverse influence of powerful political operatives. One among endowments in Ethiopia known as EFFORT[94] is the only shareholder of Wegagen Bank – a bank controlled by the ruling political party (Ethiopian People's Revolutionary Democratic Front).[95] Political party also owns three recently established banks; they are Abay Bank, Lion International Bank, and Debub Global Bank.[96] The Chief of Staff of the National Army of Ethiopia General Samora Yenus and Sebehat Nega, the founder of Tigrean Peoples Liberation Front (TPLF) – the major strain of the ruling party – are among individuals that establish Lion International Bank.[97] A member of the executive committee of the ruling party the Ethiopian People's Revolutionary Democratic Front (EPRDF) Mr Tadesse Kassa is a chair of Abay Bank and Mr Shiferaw Shigute, the former Minister of Ministry of Education, is one among the super patrons of Debub Global Bank.[98]

Seen from the perspective of competitive free market, the heavy hand of ruling parties in the ownership and operation of private banks creates doubt regarding the equal treatment of private and government affiliated banks.[99] In light of the fusion of politics and business, the probability of business decisions being made based on political grounds as opposed to sensible business tenets is also very high.[100] Without free fair and competitive business environment it is hardly possible for the private sector to thrive based on free market principles.[101]

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93 Amdissa Teshome 'The Compatibility of Trade Policy with Domestic Policy Interventions in Ethiopia' Paper Presented at a Workshop on "Staple Food Trade and Market Policy Options for Promoting Development in Eastern and Southern Africa"' March 1-2 2007 12.

94 EFFORT is a multi-billion dollar business giant whose objective overtly is rehabilitation of Tigray regional state.

95 Poulos Milkias 'Ethiopia, TPLF and Roots of the 2001 Political Tremor' A paper presented to the Proceedings of the International Conference on Contemporary Development Issues in Ethiopia, Ethiopian American Foundation, Western Michigan University, Aug. 18, 2001 18.

96 Asnakech Getnet Ayele 'Revisiting the Ethiopian Bank Corporate Governance System' 11.

97 Asnakech Getnet Ayele 'Revisiting the Ethiopian Bank Corporate Governance System' 11.

98 Asnakech Getnet Ayele 'Revisiting the Ethiopian Bank Corporate Governance System' 11.

99 Genet Mersha 'Increased Role of Party-Owned Enterprises and the Economy Raises Several Serious Concerns in Ethiopia' http://nazret.com/blog/index.php/increased_role_of_party_owned_enterprise?blog=15 2010; Document of the World Bank 'Toward the Competitive Frontier: Strategies for Improving Ethiopia's Investment Climate' https://openknowledge.worldbank.org/discover 2009 54-55 (accessed 11 August 2017).

100 Asnakech Getnet Ayele 'Revisiting the Ethiopian Bank Corporate Governance System' 12.

101 Asnakech Getnet Ayele 'Revisiting the Ethiopian Bank Corporate Governance System' 12.

2.8 The future of Ethiopian financial policy

Ethiopia aligns its financial sector policies with its development strategy – these policies so far are responsible for strong economic growth and the NBE is tightening its control of the financial sector to make sure that it is stable. The banking industry however is under a regulatory and bureaucratic siege. Though profitable, it is yet to be fully guided by free market principles and it is secluded from international competition.

Opening just for the sake of liberalising the financial sector would result in unwanted consequences. It is therefore imperative to develop Ethiopia's financial infrastructure before opening banking business for foreign banks.[102] It is relevant to develop appropriate economic and financial infrastructure and to galvanize political platform before allowing foreign banks into the country. Reasonable caution is an important strategy - liberalisation that starts with freeing domestic goods market followed by opening to international free trade and then liberalising domestic financial services and finally freeing capital account is a sound strategy. That is incremental reform and in Deng Xiaoping's words "*crossing the river while feeling the rocks*".[103]

Hence, it is important not to hastily reverse an apparently realistic stance of Ethiopian government that keeps foreign banks at bay until vigorous financial sector infrastructure is developed. The government's position might be realistic, especially in light of the weakness of domestic banks (in terms of competitiveness for instance) and the possibility of pulling out of a capital by foreign banks at any given moment thereby leading into instant collapse of the financial system. However, it is also possible to open the sector for foreign competition with prudent regulations in place that will avert the potential risks that comes with hasty liberalisation.

What are those regulatory measures that should be put in place ahead of the opening of the sector for foreign competition? That is a question the research will address in subsequent chapters (Chapter three and four).

2.9 Conclusion

Ethiopian banking system, though in the course of reform, is hampered due to legislative and institutional handicaps. The banking sector lacks competition and it is one of the underdeveloped in sub-Saharan Africa. It suffers from poor financial and technological infrastructure and lack of skilled professionals.

The sector is closed to foreign banks and the government insists that opening the sector to international banks will lead to financial and economic crisis. The banking sector is exclusively reserved for Ethiopian nationals and government owned banks dominates it. Banks are regulated and supervised by the NBE, which is in turn administered by the federal government. The NBE has broad powers over bank's functions and their internal corporate governance. The NBE issues regulations

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102 Charles Wyplosz 'How Risky is Financial Liberalization in the Developing Countries?' G-24 Discussion Paper Series http://unctad.org/en/Docs/pogdsmdpbg24d14.en.pdf 2001 20-21 (accessed 21 August 2017).

103 John W Bruce and Zongmin Li "Crossing the River While Feeling the Rocks" Incremental Land Reform and its Impact on Rural Welfare in China IFPRI Discussion Paper 00926 2009 V.

and oversees the appointment of governors and board of directors (hereinafter BOD) of banks. It also oversees the risk management operations of banks. Even though the NBE has broad powers over the governance of banks, its governance and governing body is under the shadow of politicians.

Ethiopia also features a banking sector where the government owned banks have the lions share in the sector. On top of that, the NBE’s leniency towards private banks (non-government affiliated banks) erodes its credibility.

In the forthcoming chapter, the independence of the banking regulator – the NBE in comparison with the SARB – would be analysed.

CHAPTER THREE

THE INDEPENDENCE AND ACCOUNTABILITY OF THE BANK REGULATOR

3.1 Introduction

A bank is a company licensed to engage in banking business as defined under s 2 (1) of Banking Business Proclamation No. 592 of 2008. A banking business is a business activity that *interalia* involves receiving funds from the public, using the funds for loans or investment at the risk of the person undertaking banking business.[104] Bank, under South African law, is defined as a public company registered as a bank pursuant to the BA or registered branch of foreign bank.[105] Banks are bloodlines of economy with the integral role that they play. They carry out both public and private functions.[106]

The NBE is the central bank of Ethiopia.[107] It has a power to oversee and regulate the banking industry[108] and to approve, supervise and control banks.[109] The SARB likewise is in charge of banking regulation and prudential supervision.[110] South African banking sector is based on robust licensing and corporate governance regime and the sector has a stable anatomy.[111] South Africa has an advanced system of law and an independent and impartial judiciary. The SARB is a pillar of financial stability and South Africa is home to banks that are profitable with adequate capital. The SARB "is a proactive supervisor, with a high level of compliance with international standards on effective banking supervision".[112]

A central bank has a crucial function in a particular domestic economy. It is the responsibility of central banks to take necessary pre-emptive measures in order to maintain a domestic economic environment with sound financial system and a healthy balance between inflation and economic growth.[113] To develop a resilient financial sector affective regulation and supervision are

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[104] S 2 (2) of Proclamation No. 592 of 2008

[105] Section 1 of Banks Act 94 of 1990.

[106] S Gleeson International Regulation of Banking Capital and Risk Requirements 2nd ed. Oxford University Press Oxford 2012 21.

[107] S 2 (12) of proclamation no 591 of 2008.

[108] S 5 (7) of proclamation no 591 of 2008.

[109] For detail, refer to Proclamation No. 592 of 2008.

[110] Basel Committee on Banking Supervision Regulatory Consistency Assessment Programme (RCAP) 'Assessment of Basel III LCR regulations – South Africa' Bank for International Settlements June 2015 6 http://www.bis.org/bcbs/publ/d323.pdf (accessed 20 September 2017).

[111] International monetary fund report 'South Africa Financial System Stability Assessment' 2014 64. In terms of World Economic Forums Annual "Global Competitiveness Report" South Africa ranked 6th in 2009; and 2nd (behind only Canada) in 2012 in its score for financial regulation and soundness of its banks. This is an indication of how sound, stable and robust South African banks are with their earning and capitalisation growing. (Oxford Business Group The Report, South Africa 2013 53-56.)

[112] International Monetary Fund Report 14/340 South Africa: Financial System Stability Assessment 7.

[113] BEKINK BERNARD and CHRISTO BOTHA 'The Role of a Modern Central Bank in Managing Consumer Bankruptcies and Corporate Failures: A South African Public-Law Angle of Incidence' 2009, 21, SA Merc LJ 74–91 91.

important.[114] The ineffectiveness of financial regulation is one of the main causes of the 2007/08 world economic crisis.[115] Domestic regulatory structures were failed to effectively discipline the financial service providers with in their jurisdiction.[116]

It is imperative to put in place a strict regulation and supervision system to ensure the resiliency of the financial system.[117] The core objective of bank regulation is to achieve financial soundness and disciplined management of banks.[118] Supervisor's objectives, their operational independence and enforcement powers should be enumerated in legislation and the ground for government intervention must be legally prescribed.[119] The independence of the regulator is an indispensable variable in the effectiveness of the financial system. It is also crucial to design a regulatory framework that can effectively regulate financial institutions in order to avoid future financial and economic crisis.[120] South African banks were able to resist financial crisis mainly due to the soundness of regulations and effectiveness of the banking sectors governance. The South African banking regulatory framework is also based on proven expertise that ensures compliance with conservative and prudent regulation.[121]

Hereunder the independence of the regulators of the Ethiopian and South African banking system and the relevance of ensuring the autonomy of bank regulator will be discussed. The health and soundness of the financial system depends upon the effectiveness and efficiency of the regulator. In addition, the effectiveness and efficiency of the regulator in turn would be affected by the operational independence it enjoys and the degree of accountability it is subjected to. Hence, the independence and the corollary accountability of the banking system regulator is an important subject matter that demands discussion.

3.2 The independence of the banking regulator

The independence of the banking system regulator is a core issue in the governance realm of the banking system. It demands critical consideration in designing sound supervision of financial system. In undertaking banking reform and developing a stable banking system, designing an efficient and effective regulatory framework for supervision of banking and financial institutions is mandatory.[122] The banking regulator's institutional and regulatory set up should be based on solid ground that recognise and enhance its operational autonomy while ensuring accountability of the supervisors.[123]

114 International Monetary Fund Report 14/340 South Africa: Financial System Stability Assessment 7.

115 Daniel Bradlow as referred to in KK Mwenda Legal Aspects of Banking Regulation: Common Law Perspective from Zambia, Pretoria University Law Press (PULP), 2010, Pretoria, xiii.

116 Daniel Bradlow as referred to in KK Mwenda Legal Aspects of Banking Regulation xiii.

117 International Monetary Fund Report 14/340 South Africa: Financial System Stability Assessment 7.

118 Heidi Mandanis Schooner & Michael Taylor Global Bank Regulation: Principles and Policies, Academic Press, 2010, xii.

119 International Monetary Fund Report 14/340 South Africa: Financial System Stability Assessment 6-7.

120 Daniel Bradlow as referred to in KK Mwenda Legal Aspects of Banking Regulation xiii.

121 Marcus Garvey, Oxford Business Group The Report South Africa 2013 56-57.

122 KK Mwenda Legal Aspects of Banking Regulation 67.

123 International monetary fund report 'South Africa Financial System Stability Assessment' 2014 23.

The independence of the central bank, according to Oelkers,[124] connotes central banks operational autonomy to perform its functions free from political, economic and legislative interference. Politicians would not get to tamper with the operation of the central bank provided it is independent.[125]

The independence of the central bank, however, is an idea marred with controversies.[126] Politicians have always been sceptical of the idea of granting independence to the central bank.[127] Former United States President Andrew Jackson, when the bill that re-chartered the second bank of the United States passed in 1836, commented that “such concentration of power in the hands of a few men irresponsible to the people” should be rejected.[128] An independent central bank however is a corner stone for effective and professional regulation and supervision of the banking service providers.

3.2.1 The Relevance of independence of the central bank

A central bank is a nucleus of a particular banking system because it is a source of liquidity to commercial banks and consequently to the general economy.[129] Historical developments indicate that the responsibility of the central banks to have a role in and oversee the financial system of a nation has grown to be a customary role.[130] Central banks evolved over time to be autonomous and separate in a banking system – they become a head of the monetary and banking system of a state.[131] An independent central bank would take a pre-emptive measure to rescue banks from lapsing into distress and crisis. Since banks are intermediaries through which credit is injected into the economy, the failure of even a single major bank would jeopardize the economic realities, at least in short term and the crumple of several banks *a fortiori* have only worse consequences.[132]

There is some consensus that the effectiveness of the central bank would be enhanced by its autonomy.[133] The efficiency of the regulator and the robustness of the regulatory framework enabled South African banks to lead the edge of global changes in financial regulations.[134] Operational independence of the regulator in South Africa, unencumbered by political calculations – and its decision guided by market forces and what is best for the economy – contributed to the efficiency of

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124 Felix Oelkers Das Recht der South African Reserve Bank. Ein Beitrag zum neuen Sadafrikanischen Verfassungsrecht (1999) 27 as referred to in F. R. Malan; J. T. Pretorius, ‘The Reserve Bank, Banks, and Clearing Houses in South African Law: Part 1’ 13 S.Afr. Mercantile L.J. 35, 69 2001 39.

125 Ross Cranston Principles of Banking Law 2nd ed. Oxford University Press New York 2002 113.

126 F. R. Malan; J. T. Pretorius, ‘The Reserve Bank, Banks, and Clearing Houses in South African Law: Part 1’ 38.

127 F. R. Malan; J. T. Pretorius, ‘The Reserve Bank, Banks, and Clearing Houses in South African Law: Part 1’ 38.

128 JV Mattingley 'Independence of Central Banks. The US Federal Reserve System' (1995) 3 Current Legal Issues Affecting Central Banks 213 at 215 as referred to in F. R. Malan; J. T. Pretorius, ‘The Reserve Bank, Banks, and Clearing Houses in South African Law: Part 1’ 38.

129 Ross Cranston Principles of Banking Law 110.

130 BEKINK BERNARD and CHRISTO BOTHA ‘The Role of a Modern Central Bank in Managing Consumer Bankruptcies and Corporate Failures’ 77.

131 Esmé du Plessis ‘The Structure and Operation of the Reserve Bank and Its Relationship to the Government’ (1980) 2 Modern Business Law 86 at 86 as referred to in BEKINK BERNARD and CHRISTO BOTHA ‘The Role of a Modern Central Bank in Managing Consumer Bankruptcies and Corporate Failures’ 77 (foot note).

132 S Gleeson International Regulation of Banking Capital and Risk Requirements 21.

133 F. R. Malan; J. T. Pretorius, ‘The Reserve Bank, Banks, and Clearing Houses in South African Law’ 38.

134 Oxford Business Group The Report, South Africa 2013 54.

the regulator. The independence of the central bank enhances and helps to maintain the stability of the economy as demonstrated by empirical researches.[135]

The independence of central bank is a notion that has also been advocated for by IMF worldwide.[136] Central bank independence is a crucial means of ensuring price stability and fending off politically motivated government interference in the monetary affairs of the state.[137] In fact it is not the role of central banks to be 'crowd-pleasers', it is however mandatory for them to take necessary measures that would achieve the objective of their establishment.[138] To avoid financial distress and consequential consumer bankruptcies as well as corporate recession, central banks must fulfill their responsibilities and do so in an impartial manner. The operational independence of the central bank would enhance the professionalism and impartiality in its function of safeguarding the stability of the financial system.

3.3 The legal framework on the independence of the NBE and SARB

The central bank is the governor of the banking system and more importantly, it is "the banks' bank and the government's bank".[139] It is a lender of last resort and whenever the commercial banks lost public confidence, it is a source of extra reserve to prevent financial crisis.[140] It is important to legally prescribe how the central bank carries out its basic functions. Core Principle 2 of the Basel Core Principles for Effective Banking Supervision provides that a banking regulator, the NBE for instance, should have "operational independence, transparent processes, sound governance … and adequate resources, and is accountable for the discharge of its duties". Basel core principles are benchmarks for supervisory functions.[141] In terms of these core principles, the law must clearly incorporate the supervisor's operational autonomy, accountability and governance. The government and the industry that is being regulated must not engage in the actions that would jeopardize the operational independence of the supervisor.[142]

The independence of the central bank can be eroded if the law allows the executive to interfere in the function of the former.[143]

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135 Kahsay G. Medhn 'Authority and Independence of National Bank of Ethiopia: Assessment of the Parent Act' International Journal of Innovative Research and Development vol 5 issue 3 February 2016 75.

136 Ross Cranston Principles of Banking Law 113.

137 Christopher Crowe and Ellen E. Meade, Central Bank Independence and Transparency: Evolution and Effectiveness, Working Paper Series 2008 http://w.american.edu/cas/economics/repec/amu/workingpapers/2007-20.pdf accessed 29-08-2017 3-4

138 BEKINK BERNARD and CHRISTO BOTHA 'The Role of a Modern Central Bank in Managing Consumer Bankruptcies and Corporate Failures' 91.

139 Ross Cranston Principles of Banking Law 110.

140 Ross Cranston Principles of Banking Law 110.

141 Basel Committee on Banking Supervision Core Principles for Effective Banking Supervision September 2012 available at http://www.bis.org/publ/bcbs230.pdf (accessed 20 August 2017).

142 Basel Committee on Banking Supervision Core Principles for Effective Banking Supervision September 2012 available at http://www.bis.org/publ/bcbs230.pdf 22 (accessed 20 August 2017).

143 KK Mwenda Legal Aspects of Financial Services Regulation and the Concept of a unified Regulator Law, Social Justice and Development Series 2006 65.

3.3.1 The NBE

Under s 51 (7) of the FDRE Constitution the federal government of Ethiopia have the power to administer the NBE. The powers, responsibilities and functions of the NBE are vested upon its BOD.[144] The governor of the NBE, as the chief executive officer, has the power to direct and supervise the administration and operation of the bank.[145] The governor may also exercise the entire power of the BOD through delegation by the latter to the former.[146] In carrying out his/her responsibilities, the governor, is required to be guided by the purpose of the NBE.[147] The purpose of the NBE is to maintain stable rate of price and exchange, to foster a healthy financial system and to undertake such other related activities as are conducive to rapid economic developments of Ethiopia.[148] The legislation does not specify the power of the NBE to decide on matters that would help to achieve rapid economic development or to ensure sound financial system.

Under s 3 (6) of the National Bank of Ethiopia Establishment (as Amended) Proclamation No 591 of 2008 the members of the BOD of the NBE are appointed by the government. The chief executive, as the head of the government, therefore appoints the seven members of the BOD, including the governor and vice governor. Even though the provision does not mention removal, presumably the one who appoints have the power to relieve the governor, vice governor and members of the BOD from their duties for any reason.

3.3.2 The SARB

The Currency and Banking Act of 1920, which was repealed by the South African Reserve Bank Act 29 of 1944, initially established the SARB. Currently the SARB has its legal basis in the SARB Act 90 of 1989, as amended by SARB Amendment Act no 4 of 2010. In terms of s 223 of the South African Constitution (1996) the SARB is the central bank of South Africa and it is regulated in terms of parliamentary legislation. A board of fifteen directors governs the SARB.[149] Among the board members, the republican president appoints the governor and three deputy governors, after consultation with the minister of finance and the BOD. The president also has the power to appoint four more directors after consultation with the minister of finance.[150]

The shareholders of the SARB elect the remaining seven directors from candidates confirmed by the panel. The panel is established and convened by the governor and it is composed of the governor (who is a chairperson), a retired judge and one other person (both nominated by the minister of finance), and three persons nominated by NEDLAC[151] – the nominated panel members are appointed by the governor.[152]

[144] S 9 (1) of Proclamation No 591 of 2008.
[145] S 10 (1) of Proclamation No 591 of 2008.
[146] S 9 (10) of Proclamation No 591 of 2008.
[147] S 10 (5) of Proclamation No 591 of 2008.
[148] S 4 of Proclamation No 591 of 2008.
[149] S 4(1) (a) of SARB Act no 90 of 1989, as amended.
[150] S 4(1) (a) of Act no 90 of 1989, as amended.
[151] National Economic, Development and Labour Council, established in terms of s 2 of the National Economic, Development and Labour Council Act No. 35 of 1994.
[152] S 4 (1) (b); s 1C (a) & (b); s 1D (a), (b) & (c) of Act no 90 of 1989, as amended.

Before the advent of constitutionally guaranteed independence of the SARB, the bank enjoyed a remarkable level of autonomy.[153] Due to significant influence central banks have over domestic economies, the South African constitution incorporated a protection framework for the SARB.[154] The activities and overall functions of the SARB can be regulated by parliamentary legislation; the constitutive provisions of the SARB however have roots in the fundamental law of the land.[155] In terms of South African constitution at the heart of the objective of SARB is the protection of the value of the currency to create a durable and balanced economic growth. For realization of this objective the SARB is empowered to

> perform its functions independently and without fear, favour or prejudice, but there must be regular consultation between the Bank and Cabinet Minister responsible for financial matters.[156]

The power of the SARB however is limited to those provided in the statutes. The SARB, as an institution constituted by legislation, is deprived of any powers sourced in common-law, as powers exercised and functions discharged by it are solely statutory.[157]

The SARB through its BSD, whose mandate is to promote and ensure that banking system is sound and stable, monitors the deposit taking activities of banks.[158] It is empowered to exercise powers and carry out functions that are "customarily exercised and performed by central banks".[159] The details of the powers and functions of the SARB are enumerated in the SARB Act 90 of 1989.[160] The SARB, under S 10 (1) (v) of the SARB Act 90 of 1989, have the powers to perform the functions allocated to it in terms of the Banks Act 94 of 1990, which is now amended by the Financial Sector Regulation Act No. 9 of 2017. Under S 1 (a) of Financial Sector Regulation Act No. 9 of 2017, the SARB is responsible for protecting and promoting financial stability.

Financial Sector Regulation Act No. 9 of 2017 also established a Prudential Authority that should operate within the administration of the SARB.[161] Under the administration of the SARB, the Prudential Regulation Authority has the objective of promoting and enhancing the safety and soundness of financial institutions and market infrastructure.[162] In pursuit of its institutional

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153 Du Plessis op cit note 1 at 93 and Oelkers op cit note 1 at 51-52 as referred to in F. R. Malan; J. T. Pretorius, 'The Reserve Bank, Banks, and Clearing Houses in South African Law: Part 1' 36-37.

154 BEKINK BERNARD and CHRISTO BOTHA 'The Role of a Modern Central Bank in Managing Consumer Bankruptcies and Corporate Failures' 77.

155 BEKINK BERNARD and CHRISTO BOTHA 'The Role of a Modern Central Bank in Managing Consumer Bankruptcies and Corporate Failures' 77.

156 Section 224(2) of Constitution of the Republic of South Africa, Act no 108 of 1996.

157 s 225 of Act 108 of 1996 mentions that "[t]he powers and functions of the South African Reserve Bank are those customarily exercised and performed by central banks, which powers and functions must be determined by an Act of Parliament and must be exercised or performed subject to the conditions prescribed in terms of that Act".

158 South African Reserve Bank 'Bank supervision' https://www.resbank.co.za/RegulationAndSupervision/BankSupervision/Pages/BankSupervision-Home.aspx (09 august 2017)

159 S 225 of the Constitution of the Republic of South Africa, Act No 108 of 1996.

160 Refer for instance to S 10 of Act No 90 of 1989.

161 S 32 (1) & (2) of Financial Sector Regulation Act No. 9 of 2017.

162 S 33 (a) & (b) of Act No. 9 of 2017.

soundness objective the Prudential Regulation Authority regulate and supervises financial institutions and the market infrastructure.[163]

The prudential authority, in the pursuit of its objective and discharging its functions, shall operate 'without fear, favour or prejudice'.[164] The prudential authority is managed by chief executive officer appointed by the governor of the SARB with the concurrence of the minister of finance.[165] The term of office of the chief executive officer – to be determined by the governor of SARB – is limited to five years of two terms.[166] The act also subjects the removal of the chief executive officer to a due process and if the chief executive officer is finally removed after legislative due process, the Minister of Finance, within 30 days, is obliged to 'submit a report and findings of the independent inquiry to the national assembly'.[167] The law diminished a discretional removal of the chief executive officer of the prudential authority thereby strengthening an impartial and fair execution of the legislative mandate given to the SARB.

Hence, the SARB is in full command of the newly established prudential regulation authority, which is in turn responsible for overseeing, and regulation of the banking (and other financial service providers) sector for its robust operation. That is why the independence of the SARB is indispensable as it is the ultimate power holder in deciding on the financial wellbeing of banks.

3.4 Analysis of the independence of the banking regulators

The independence of the central bank, according to Hasse,[168] involves independence in three areas, *viz* personnel, financial and policy related independence of the central bank from the influence of the government. Personnel independence connotes the exclusion or limiting of the involvement of the government in the appointment process (appointment, term of office and removal) of the personnel (governors and BOD) of the central bank (hereinafter CB). Financial independence indicates the limitation placed on the access to credit of the CB by the Government and policy independence is where the CB has a flexibility to design and execute the monetary policy.[169]

There are reasons behind advancing the notion of CB independence. With guaranteed independence for CB, it prevents elected officials from twisting monetary policy to stimulate the economy as a disguise for short-term political gain.[170] The regulation and supervision of the banking sector would also be protected from the political good will of the government rather based on rule of law and

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163 S 34 (1) (a) (i) & (ii) of Act No. 9 of 2017.

164 S 34 (5) of Act No 9 of 2017.

165 S 36(1) of Act No 9 of 2017.

166 S 38 (1) (a) (b) of Act No 9 of 2017.

167 S 39(1) and (5) of Financial Sector Regulation Act No 9 of 2017.

168 Jiji T Mathew, Measuring Central Bank Independence in Twenty- Five countries: A New Index of Institutional Quality http://www.igidr.ac.in/conf/money/mfc_08/Measuring%20Central%20Bank%20Independence...%20Jiji%20J.%20Mathew.pdf 5 (accessed on 29 August 2017).

169 Jiji T Mathew, 'Measuring Central Bank Independence in Twenty- Five countries' http://www.igidr.ac.in/conf/money/mfc_08/Measuring%20Central%20Bank%20Independence...%20Jiji%20J.%20Mathew.pdf 5 (accessed on 29 August 2017).

170 Ross Cranston Principles of Banking Law 113.

professional implementation of the rules and regulations. According to Cukierman and Webb[171] the CB's independence is vulnerable to influence from political sensitivity. How autonomous the CB is from political agents significantly determines policy decisions and economic operations.[172] The main rational for guarantying operational autonomy of CB regarding monetary policy is because interest rate determination is a victim to political abuse.[173] In the realm of supervision identical political abuse can happen, for instance ordering a bank to be under statutory management could be politically sensitive.[174]

The regulation and supervision of the banking system was largely developed around the end of the 20th century. Around the world, CBs are mainly responsible for monetary policy and stability; provision of basic financial system and ensuring financial stability.[175] Failure of CBs to effectively accomplish their mandate or if they embrace an arbitrary approach towards their responsibility it would lead to a devastating consumer bankruptcies and corporate breakdown.[176] Contemporarily the responsibility of ensuring financial stability is generally regarded as crucial feature of central banking.[177] That is, CBs control over other banking and financial institutions is an indispensable role. Because these financial service providers are the main sources of money to the public and business entities.

The independence of the CB transcends the task of price stability and encompasses independence from interference from the executive branch of the government in the functions of the CB. A CB that is exposed to the influence and dictation from the executive is not independent.[178]

3.4.1 Appointment and Removal

3.4.1.1 The NBE

S 3 (5) of the National Bank of Ethiopia Establishment (as Amended) Proclamation No 591 of 2008 empowers the government to appoint the governing organ of the NBE. It however is not clear as to which branch of the government – legislative, executive or judiciary – is entitled to appoint the governing body. Does the legislature have the power to confirm the governor and vice governor after the chief executive nominates? The law is not specific enough in empowering the executive or legislature in the task of appointing the governing body of the NBE. In practice the Prime Minister

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171 A Cukierman and Steven B. Webb 'Political Influence on the Central Bank: International Evidence' The World Bank Economic Review Vol. 9, No. 3 397-423.

172 A Cukierman and Steven B. Webb 'Political Influence on the Central Bank' 397.

173 David Archer 'Roles and objectives of modern central banks' http://www.bis.org/publ/othp04_2.pdf 53 (accessed on 22August 2017).

174 David Archer 'Roles and objectives of modern central banks' http://www.bis.org/publ/othp04_2.pdf 53 (accessed on 22August 2017).

175 David Archer 'Roles and objectives of modern central banks' http://www.bis.org/publ/othp04_2.pdf 53 (accessed on 22August 2017).

176 BEKINK BERNARD and CHRISTO BOTHA 'The role of a modern central bank in managing consumer bankruptcies and corporate failures' 90.

177 David Archer 'Roles and objectives of modern central banks' http://www.bis.org/publ/othp04_2.pdf 53 (accessed on 22 August 2017).

178 KK Mwenda 'Legal Aspects of Financial Services Regulation and the Concept of a unified Regulator Law' 81.

appoints the governor, vice governor and board members.[179] This seems to be derived from the provision of s 3 (4) of the National Bank of Ethiopia Establishment (as Amended) Proclamation No 591 of 2008 which makes the NBE accountable to the prime minister. Hence, the power to appoint the governing personnel of the NBE belongs to the head of the government in Ethiopia.

The chief executive, who might have a political motive, may not act solely on professional considerations. The law does not stipulate the requirements the prime minister have to take into account in the process of appointing the NBE's governing officials.[180] The prime minister's power of appointing the governor, vice-governor and the members of the BOD is not subject to any system of checks and balance. There is also no conditions or qualifications required by legislation that has to be complied with in the appointment process. The prime minister, in short, has an unfettered power to hire the governors and members of the BOD of the NBE.

The power to appoint coupled with the accountability of the NBE to the chief executive would jeopardize how the governing personnel of the NBE conduct their responsibilities. If the chief executive is given a blank check on how the central bank governor should conduct his/her responsibilities, it will have catastrophic consequences. Joseph Mabiru, the governor of the central bank of Uganda during Idi Amin's reign (president of Uganda, 1971-79), was allegedly assassinated by Idi Amin himself, for his refusal to heed on the presidents order for printing of more money.[181] This might be a singular instance; however, it indicates that the governor and other governing personnel of the CB would be a victim of political manipulation and retribution provided they do not have a legally recognized independence. A political instability that would have dire consequences for politicians will provoke the executive to establish a tight grip on the CB so that it can be manipulated to be a vanguard of political power.[182]

Granting the executive unlimited discretionary power, with no effective checks and balances, to meddle in the functions of the CB would increase the likelihood of abuse of the power.[183] The executive arm of the government oftentimes has short-term political and electoral motives, so unchecked discretionary power; free from scrutiny is prone to abuse.[184] Ethiopia has legal frameworks that allow the chief executive to have an unfettered discretionary power over the regulatory and supervisory body of the financial system. In such legal environment, one of the supervisory responsibilities of the CB – regulatory forbearance – cannot be executed properly.[185]

Would it be easy for a NBE board member to act apolitical and conduct his/her function in a solely professional manner – without meditating to accommodate the prime minister's political or otherwise

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179 See for instance Addis Fortune New vice Governor Takes up Post from Retirement available at https://addisfortune.net/articles/new-vice-governor-takes-up-post-from-retirement/ (accessed on 30 August 2017).

180 In Zambia, for instance, the members of the board of directors are appointed by the ministry of finance who shall consider the individuals "professional and academic experience in the business and financial matters and who are not employees or officials" of the central bank. (s 13 (1) (b) of Bank of Zambia Act 1996.

181 For detail refer to KK Mwenda 'Legal Aspects of Financial Services Regulation and the Concept of a unified Regulator' 86-87.

182 A Cukierman and Steven B. Webb 'Political Influence on the Central Bank: International Evidence' 399.

183 KK Mwenda Legal Aspects of Financial Services Regulation and the Concept of a unified Regulator Law 84.

184 KK Mwenda Legal Aspects of Financial Services Regulation and the Concept of a unified Regulator Law 84.

185 KK Mwenda Legal Aspects of Financial Services Regulation and the Concept of a unified Regulator Law 65.

intention? Doing so would be a difficult task with perhaps dire consequences. According to Mwenda,[186] political appointees have a tendency “to appease the appointing authorities as a way of retaining and consolidating their power-bases”. The one to be appeased in the Ethiopian case, for instance, would be the prime minister or his/her proxies.

3.4.1.2 The SARB

The SARB has a constitutionally guaranteed autonomy and independence in pursuit of its primary object, which is protecting “the value of the currency in the interest of balanced and sustainable economic growth”.[187] A constitutional recognition of the CB independence solidifies it, for, constitutions, unlike statues, are not subject to immediate and easy amendment.[188] The constitution, as the fundamental law of South Africa,[189] is a corner stone for the independence of the SARB. The independence of the SARB in carrying out its primary objective of regulating inflation is also a basis for the autonomy of the SARB in its responsibility of supervising and regulating banking service providers.

The SARB, in pursuing its primary object, is under constitutional obligation and protection, to operate independently and without fear, favour or prejudice.[190] The SARB is also required by the constitution to engage in a regular consultation with the minister of finance.[191] The powers and functions customarily exercised or performed by central banks is vested upon the SARB by the constitution – which must be determined by parliamentary legislation and implemented according to such legislation.[192] Malan and Pretorius[193] likened the autonomy of the SARB, to discharge its responsibilities “independently, and without fear, favour or prejudice”[194] to a judicial independence of performing its duties “impartially and without fear, favour or prejudice”.[195]

The independence of the SARB faced resistance, for instance, from labour unions during the negotiation and drafting process of the constitution. Labour unions were of the opinion that constitutional independence of the central bank would constrain the discretion of the government to freely navigate fiscal policy and deliver an economic growth for the disadvantaged.[196] The relevance of independence of the SARB however overrides ultimately.

The South African Constitution, under s 2, states any law or conduct inconsistent with the constitution is invalid. This provision of the constitution applies equally to the independence of the SARB as it applies to the bill of rights. The South African Constitution

186 KK Mwenda Legal Aspects of Financial Services Regulation and the Concept of a unified Regulator Law 90.
187 S 224 (1) and (2) of Act No 108 of 1996.
188 Ross Cranston Principles of Banking Law 113.
189 S 2 of Act No 108 of 1996.
190 S 224 (2) of Act 108 of 1996.
191 s 224 (2) of Act 108 of 1996.
192 S 225 of Act No 108 of 1996.
193 F. R. Malan; J. T. Pretorius, ‘The Reserve Bank, Banks, and Clearing Houses in South African Law’ 40.
194 S 224 (2) of Act No 108 of 1996.
195 S 165(2) of Act No 108 of 1996.
196 George Devenish ‘Constitutional Law’ in: WA Joubert (founding editor) The Law of South Africa vol 5 part 3 2 ed (2004) in par 370 at 399-400 as referred to in BEKINK BERNARD and CHRISTO BOTHA ‘The Role of a Modern Central Bank in Managing Consumer Bankruptcies and Corporate Failures’ 79.

> provides for a new constitutional ethos and legal dispensation in which particular fundamental rights and values are entrenched, and as a result the business of the South African central bank cannot only concern interest rates and market trends.[197]

The South African CB's business, therefore, transcends the concern of interest rates and includes the regulation, supervision and disciplining of banking service providers with its operational autonomy legally guaranteed. Regarding interest rate Kleynhans and Meintjes[198] analyzed the adjustment of interest rate by the SARB over a course of time and concluded that the SARB acts independently, without succumbing to political pressure and free from fear, favour or prejudice.

The Prudential Authority recently established by the Financial Sector Regulation Act 9 of 2017 is legally required to carry out its responsibilities 'without fear favor or prejudice'. The Prudential authority therefore is legally bound to refrain from considering what the republican president or any other executive official would think of its decision. It should be solely guided by the legally prescribed power of pursuing its objective. This enhances the operational independence of the SARB and stability of the financial system. The SARB is adequately guaranteed with legal protection and it has a practically valued operational independence.[199]

A chief executive, with political motive at heart that wilfully appoints and dismisses the personnel of the CB compromises the operational autonomy of the CB.[200] In Zambia, for instance, the president after ratified by the parliament appoints the governor of the CB.[201] A system that entitles the parliament to ratify the nominee of the chief executive is commendable, as it helps to check and balance the probable ill motive in the process of appointment. However, the president in Zambia have unlimited political power of removing the governor of the CB whenever the president deems appropriate.[202] The same is true in Ethiopia. Such boundless political power bestowed to the executive (because there are no framework of checks and balances) to fire the governor of the CB undermines the political independence of the CB.[203]

3.5 The consequences of interference in the functions of the CB

One of the main causes for world economic crisis and failure of global financial system is the unguarded interference of the government in the monetary regulation function of the central banks.[204] In a jurisdiction such as Ethiopia where the legal framework fails to install the operational autonomy of the CB, there are no legal safeguards against ill informed and unenlightened intrusion in the affairs of the CB. For a governor appointed by the chief executive, operating without political considerations and second-guessing what the chief executive is thinking and solely on professional basis, is very

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197 BEKINK BERNARD and CHRISTO BOTHA 'The Role of a Modern Central Bank in Managing Consumer Bankruptcies and Corporate Failures' 79.

198 Kleynhans, E.P.J and Meintjes, R., 2013 'Political Independence of the South African Reserve Bank: Managing interest rates' available at https://repository.nwu.ac.za/handle/10394/13342 (accessed 04 September 2017).

199 International monetary fund report 'South Africa Financial System Stability Assessment' 2014 61.

200 Alex Cukierman, Steven B. Webb, and Bilin Neyapti 'Measuring the Independence of Central Banks and Its Effect on Policy Outcomes' The World Bank Economic Review, Vol 6, No. 3 353-398.

201 S 10 (1) & (2) of the Bank of Zambia Act 1996.

202 S 10 (7) of the Bank of Zambia Act 1996.

203 KK Mwenda Legal Aspects of Financial Services Regulation and the Concept of a unified Regulator 86.

204 Kahsay G. Medhn 'Authority and Independence of National Bank of Ethiopia: Assessment of the Parent Act' 70.

difficult.[205] Whenever the regulation of the financial sector succumbs to political interference, it would exacerbate a financial crisis – as the experience of East Asia, Russia, Turkey and Latin America shows.[206] Ruth de Krivoy,[207] the former president of the Venezuelan Central Bank, mentions ineffective regulation, fragile supervision and political interference as factors that erode the banking system stability during the 1994 Venezuelan banking crisis.

The banking sector grow fragile in Indonesia mainly because the supervisors failed to effectively enforce regulations and become reluctant in disciplining banks which have political connections especially with Suharto's family.[208] In Indonesia, it was claimed that, under the president's direct order, the CB procedure for providing liquidity support to distressed banks were overridden.[209] The banking reform was continuously obstructed by political interference even after the removal of Suhort's family. Moreover, the credibility of the Indonesian Bank Restructuring Agency's effort of bank reform was undermined by blatant interventions from Indonesia's Financial Sector Action Committee, which was composed of heads of economic ministries and presided by the co-ordinating minister.[210]

3.5.1 The functions of the NBE in light of political interference

The NBE pursues and works for the realisation of goals and objectives set by the government that are palatable for Ethiopia's economic growth. It cannot independently make goals for the regulation and supervision of the banking sector. It has the power to issue directives for the enforcement of laws and regulations.[211] Those directives are however susceptible to manipulation by politically motivated and misguided executive.

The NBE, while it decides on its internal affairs without government influence – because its BOD is the ultimate holder of the powers and duties of the bank,[212] – is under the influence of the executive regarding the appointment of its governing body and setting of its crucial policy and regulatory goals. The NBE, under s 4 of the National Bank of Ethiopia Establishment (as Amended) Proclamation No 591 of 2008, has the mandate *inter alia* to perform "such *other related activities* as are conducive to rapid economic development of Ethiopia". (Emphasis added) It is not clear as to what accounts as "other related activities" that will yield economic development. Neither is it clear as to who have the power to determine the "activities" by which the actions of the governor of the NBE are mandatorily guided by as stated under s 10 (5) of the National Bank of Ethiopia Establishment (as Amended) Proclamation No 591 of 2008. Irrespective of their consequences or the motive behind their determination or whoever determines, the NBE is legally obliged to enforce the "other related activities" if they presumably produce economic development.

205 KK Mwenda Legal Aspects of Financial Services Regulation and the Concept of a unified Regulator 86.
206 KK Mwenda Banking Supervision and Systemic Bank Restructuring: An International and Comparative Legal Perspective Cavendish Publishing 2000 29-30.
207 KK Mwenda Legal Aspects of Financial Services Regulation and the Concept of a unified Regulator 30.
208 KK Mwenda Banking Supervision and Systemic Bank Restructuring 31.
209 KK Mwenda Banking Supervision and Systemic Bank Restructuring 31.
210 KK Mwenda Banking Supervision and Systemic Bank Restructuring 31.
211 S 27 (2) of Proclamation No 591 of 2008.
212 S 9 of Proclamation No 591 of 2008.

3.5.2 The implication of the autonomy of SARB

Based on the measure of 'independence index' the SARB is very well shielded from undue influence of government.[213] Besides the SARB's independence is rooted in the constitution which is a very crucial aspect in cementing its autonomy. An autonomy based in the constitution will not be affected by any subordinate legislation that contradicts the constitution.[214] The founding principles and the bill of rights of the constitution of South Africa have a profound impact on the operation and functions of the SARB.[215] The constitution is the fundamental law of the land, 'value-orientated approach' is applied to constitutional issues – that is the fundamental values, and principles of the constitutional system are implemented practically.[216]

The fact that the SARB enjoys constitutional protection has considerable repercussions for the implementation of administrative law principles and administrative measures to be taken.[217] SARB's power and function, by legislation, are public.[218] The activities of the SARB have the public interest, not profit making, at the core[219] and the fundamental law of the land and the South African Reserve Bank Act 90 of 1989 regulate the SARB. The ill motive and unenlightened intrusions in the functions of the SARB are therefore unlawful.

Under S 37 of SARB Act no 90 of 1989 the minister of finance have the power to direct the SARB to comply with the Act or regulations, however the minister does not have the power to supervise the SARB. The minister has to apply to the Supreme Court division for an order directing the SARB to remedy any default the latter is alleged to have been committed.[220] This is an indication of the lawmaker sparing the CB from the daylight intrusion of the executive. However, before the independence of the SARB was entrenched in the constitution, the Currency and Exchanges Act 9 of 1933 under s 9(1) and (3) entitle the president to issue regulations or else to "suspend in whole or in part this Act or any other Act of Parliament or any other law relating to or affecting or having any bearing upon currency, banking or exchanges". This aspect of the law solicited a comment from Governor Stals, the former Governor of SARB, who mentioned that "t]he present institutional structure in South Africa makes the South African Reserve Bank relatively independent, as long as its

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213 F. R. Malan; J. T. Pretorius, 'The Reserve Bank, Banks, and Clearing Houses in South African Law: Part 1' 39.

214 F. R. Malan; J. T. Pretorius, 'The Reserve Bank, Banks, and Clearing Houses in South African Law: Part 1' 39.

215 BEKINK BERNARD and CHRISTO BOTHA 'The Role of a Modern Central Bank in Managing Consumer Bankruptcies and Corporate Failures' 79-80.

216 Cumulative reading of s 2, 7 and 39 (2) of Act No 108 of 1996. Refer also to BEKINK BERNARD and CHRISTO BOTHA 'The Role of a Modern Central Bank in Managing Consumer Bankruptcies and Corporate Failures' 79-80.

217 S 239 cum s 33 of Act No 108 of 1996. Refer also to BEKINK BERNARD and CHRISTO BOTHA 'The Role of a Modern Central Bank in Managing Consumer Bankruptcies and Corporate Failures' 79-80.

218 S 239 (b) (ii) of Act No 108 of 1996 cumulative reading with Act No 90 of 1989.

219 Oelkers op cit note 24 at 704 as referred to in BEKINK BERNARD and CHRISTO BOTHA 'The Role of a Modern Central Bank in Managing Consumer Bankruptcies and Corporate Failures' 79-80.

220 S 37(2) of Act No 90 of 1989.

independence is respected by government".[221] The independence of the SARB was based on the good will of the chief executive until the autonomy of the SARB was constitutionally recognised.

Adequate operational independence is a relevant question that should be addressed in the legal framework. The term of office of the governor and members of BOD and the appointment and removal procedure, if explicitly provided by the law, strengthens the autonomy of the CB.[222] The governing body of the supervisory authority should have a minimum term of office and should be appointed and removed in a transparent process.[223] Curtailing the politically motivated involvement of the chief executive in the appointment or dismissal of the CB governing body and ensuring longer term of office for the governor more guarantees the independence of the CB.

It is crucial to design a legal framework that confers the power of appointing and dismissing the governor of the CB on the legislature, together with grounds for appointment or removal of the governor.[224] The power of the executive should be limited to nominating qualified individuals from which the legislature can consider and approve for appointment. In such a way, it is possible to install the independence of the CB into the legal framework and institutional set up of the banking system.[225] The banking system legal framework in Ethiopia needs to enshrine the independence of the NBE in the appointment and removal of NBE's governing personnel.

The independence of the CB is also strengthened by limiting the government's access to credits and advances from the CB. In addition, if the CB has a discretionary power to decide on policy matters that is also a guarantee for the stability of the financial system. Whether or not there is a limitation on the government's right to acquire credits and advances from the CB is another standard for ensuring the independence of the CB.[226] In this regard, there is a superficial limitation placed on the right of the Ethiopian government to get credits and advances from the NBE – the amount of credits and advances the government is entitled to get should be consistent with the NBE's duty of maintaining price and exchange rate stability.[227] Apart from such a sketchy limitation, the reality is that the ownership and governance of the NBE is under the total control of the government. Hence, what pleases the government of Ethiopia is what determines the course of the NBE.

3.6 Accountability of the central bank

Independence of the banking regulator goes hand in hand with its accountability. Independence and accountability are two sides to a coin. It is relevant to incorporate the accountability of the banking

221 Oelkers op cit note 1 at 51 as referred to in F. R. Malan; J. T. Pretorius, 'The Reserve Bank, Banks, and Clearing Houses in South African Law' 37.

222 KK Mwenda Legal Aspects of Financial Services Regulation and the Concept of a unified Regulator 82-83.

223 KK Mwenda Legal Aspects of Financial Services Regulation and the Concept of a unified Regulator 82-83.

224 KK Mwenda Legal Aspects of Financial Services Regulation and the Concept of a unified Regulator 88.

225 KK Mwenda Legal Aspects of Financial Services Regulation and the Concept of a unified Regulator 88.

226 Alex Cukierman, Steven B. Webb, and Bilin Neyapti 'Measuring the Independence of Central Banks and Its Effect on Policy Outcomes' 353-398.

227 S 13 (1) of Proclamation No 591 of 2008.

regulator in the legal framework.[228] The independence of the CB does not connote unconditional independence from government. It is an independence based on accountability that should enable the CB to perform its duties of price stability and supervision of the financial system free from government and industry interference or favouritism. While it is appropriate to fend off external influence that would jeopardise the independence of the CB, whenever there is a value to it, it would be also constructive to consider the interest of external pressure groups.

The NBE is accountable to the prime minister.[229] The accountability of the NBE to the executive diminishes the political independence of the bank.[230] Political independence of supervisory authority is better safeguarded where the central banks is answerable to the lawmaker.[231] The governor of the NBE has no legally predetermined tenure and just as he/she can be handpicked by the prime minister there is also a possibility that he/she would be vetted and evaluated on pure political ground.[232] The governor therefore cannot exercise operational independence and perform his/her duty freely, objectively and without politically motivated duress. Experience of different countries demonstrates that fixed and long-term tenure enhances the independence of the central bank. [233]

The SARB, while independent is also accountable to the legislature and operates within the realm of parliamentary democracy and the constitution as well as valid subordinate legislations.[234] Its accountability is to the parliament to which it also submits a report annually.[235] The Governor of the SARB is required to submit a report to the minister of finance regarding the implementation by the bank of monetary policy.[236] It is important to note that SARB is government's banker, financial agent and advisor.[237] The SARB is bound to transmit a statement of asset and liabilities of the bank to the department of finance, which in turn is required to publish it in the Gazette.[238] The SARB is also required to submit its annual report to the department of finance and the minister of the department of finance is obliged to lay a copy of the report it received from the SARB before parliament.[239] Hence, the SARB, in discharge of its duties is accountable to the Parliament.[240]

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228 'Fundanga calls for delinkage of BOZ chief's tenure of office' Times of Zambia 20 September 2004, http://www.times.co.zm/news/veiwnews.cgi?category=4&id=1095648645 (accessed 20 September 2004) as referred to in KK Mwenda Legal Aspects of Financial Services Regulation and the Concept of a unified Regulator 83.

229 S 3 (4) of Proclamation No 591 of 2008.

230 M Asfaw and MK Hagos 'Financial Regulation and Supervision in Ethiopia' 71.

231 M Asfaw and MK Hagos 'Financial Regulation and Supervision in Ethiopia' 70-71.

232 M Asfaw and MK Hagos 'Financial Regulation and Supervision in Ethiopia' 71.

233 M Asfaw and MK Hagos 'Financial Regulation and Supervision in Ethiopia' 71.

234 F. R. Malan; J. T. Pretorius, 'The Reserve Bank, Banks, and Clearing Houses in South African Law: Part 1' 40.

235 BEKINK BERNARD and CHRISTO BOTHA 'The Role of a Modern Central Bank in Managing Consumer Bankruptcies and Corporate Failures' 82.

236 S 31 of Act No 90 of 1989.

237 Du Plessis op cit note 8 at 91 as referred to in BEKINK BERNARD and CHRISTO BOTHA 'The Role of a Modern Central Bank in Managing Consumer Bankruptcies and Corporate Failures' 84 (foot note).

238 S 32 (1) and (2) of Act No 90 of 1989.

239 S 32 (1) and (3) of Act No 90 of 1989.

240 SARB Autonomy and Legal Framework https://www.resbank.co.za/AboutUs/History/Background/Pages/AutonomyandLegalframework.aspx (accessed on September 13 2017).

In ensuring the stability of the financial system, the SARB is bound to 'act within a policy framework agreed between the Minister [of Finance] and the Governor'.[241] Would this policy framework to be agreed between the Minister of Finance and the governor of the SARB tear into the autonomy of the latter? From the provision of s 11 (2) (a) the policy framework to be agreed up on is a mutual document upon which the Governor and the minister of finance have an equal say. If they cannot agree the Minister of Finance, do not have the power to impose such policy framework. Since the governor is not in any way subordinate to the minister of finance, failure to reach an agreement on a policy framework that would guide the SARB in discharging its responsibility of ensuring financial stability, would leave the SARB to continue to discharge its constitutional and legislative mandate of upholding the financial stability.

3.7 Conclusion

This chapter demonstrates that the banking regulator in Ethiopia functions under a regulatory framework that stripe off its independence. The fact that the NBE is accountable to the prime minister erodes its operational independence and further drains its credibility as an impartial regulator in the banking business. The governor's and BOD of the NBE are political appointees that operate at the good will of the chief executive. They do not have any legally recognised operational autonomy and tenure of office. In contrast, the operational independence of the SARB is enshrined in the constitution and the SARB enjoys a tangible practical autonomy in discharging its functions.

The government prescribes the policy direction and the activities that the NBE has to engage in. As the government is the dominant owner of commercial banks and given the number of government affiliated banks or banks owned by political operatives of the government the effectiveness and impartiality of the NBE could not be trustworthy. That ultimately affects the expansion and growth of financial services in the economy that needs it the most.

[241] S 11 (2) (a) of Act No. 9 of 2017.

CHAPTER FOUR

LEGAL IMPLICATION OF BANKING SECTOR LIBERALIZATION ON THE REGULATION OF BANKS IN ETHIOPIA

4.1 Introduction

Building a prudent financial system is essential for transforming the economic realities of Ethiopia. However, full-fledged liberalisation and developing regulatory and supervisory capability of the NBE remains a challenge. An effort to open the financial sector of Ethiopia to foreign banks demands caution and understanding of the pros and cons. Painful financial crisis has taught the world that without strong prudential standards, qualified supervisors and well-capitalised banks (which can do business with profit and prudence) it is not wise to liberalise a banking system.[242] It may lead to systemic risk with consequences of eroding public funds.[243]

Banks are custodians of power and oftentimes there is "unease of the political authority with the economic power of the banking industry".[244] The economic power of international banks is even more concerning as they can migrate with capital at any given moment thereby ruining a certain financial system. Systemic crisis is costly. That is why much of banking regulation around the world focuses on its avoidance.[245] It is very important to focus on the issue of sequencing before proceeding to liberalisation because "the key issue should not be the liberalisation or deregulation but construction of the regulatory framework that ensure an effective financial sector".[246]

Financial system and institutions have a fundamental role in the economic development of a country. Prudent financial institutions mobilise financial resources and avail them for worthy investments. Liberalisation enhances competition and efficiency thereby defying monopolistic tendencies in the banking system.

Governments adopt strict regulatory and supervisory framework due to special nature of banks and the optimal performance of banks depends largely on those frameworks.[247] Legal certainty is the basis of financial markets.[248] Adopting strong banking regulation is relevant for investor and consumer protection as well as combating financial crimes.[249] Even though the notion of liberalisation is a headline of the contemporary world, financial system the regulatory regime of banks is also

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242 Seminar Lecture by J. Caskey, "Reform Sequence," at a World/IMF seminar course Overview of Financial Sector Issues and Analysis, (Washington DC: World Bank, January 13th 2000), p. 2 as referred to in Kenneth Kaoma Mwenda Legal Aspects of Banking Regulation 67.

243 Heidi Mandanis Schooner and Michael W. Taylor Global Bank Regulation XVII.

244 F.R. Malan and J.T. Pretorius, 'The Reserve Bank, Banks, and Clearing Houses in South African Law: Part 1' 56-57.

245 Heidi Mandanis Schooner and Michael W. Taylor Global Bank Regulation XVII.

246 Joseph Stiglitz 'More Instrument and Broader Goals: Moving towards the Post-Washington Consensus' 16.

247 Asnakech Getnet Ayele 'Revisiting the Ethiopian Bank Corporate Governance System' 3.

248 Simon Gleeson International Regulation of Banking Capital and Risk Requirements 31.

249 Ross Cranston Principles of Banking Law 63.

tightened.[250] The task of enhancing the NBE's competence to regulate and supervise the banking industry therefore demands an urgent and serious attention.[251]

Under this chapter, the notion of liberalisation will be discussed in the context of Ethiopia's economic and legal reality. The legal and institutional pillars that must be built before Ethiopia proceeds with liberalisation would be analysed.

4.2 Liberalisation of the banking system in Ethiopian current context

4.2.1 Ethiopian liberalisation strategy

The Ethiopian government adopts a gradualism approach towards the country's financial sector transformation.[252] The strategy focuses on developing the operational and competitive capacity of domestic financial industry before liberalisation – by interalia precluding foreign banks and upgrading the NBE's capacity of regulating banks.[253] In Ethiopia, there is a strong focus on maintaining macro-economic stability.[254] Ethiopian banking sector is inefficient, unable to effectively enhance intermediation of private sector savings and it still is monopolistic, so its contribution to Ethiopia's economic growth is miniscule.[255] The strategy in Ethiopia has the purpose of strengthening the domestic financial capacity and solidifying the central banks capability for prudential regulation and supervision before proceeding with liberalisation.[256] Banking industry is underdeveloped, closed and significant portion of it (two-thirds of the banking sector asset) is owned by the state.[257] If the status quo of Ethiopia's banking industry continue the overall economy of the country will be starved of the necessary capital even though the domestic banks might stand to gain.[258]

The shallowness observed in the financial sector is the consequences of government ownership of banks, lack of competition in the banking sector due to in part preclusion of foreign banks from entering the domestic banking sector.[259] Inflation – main monetary policy focus of the Ethiopian government – subsists as a stubborn challenge.[260] There is also a challenge of coordinating fiscal and monetary policy and controlling the alarming debt to create a stable macro economy and financial

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250 Ross Cranston Principles of Banking Law 63.

251 Alemayehu Geda and Tony Addison Ethiopia's New Financial Sector and Its Regulation WIDER Discussion Paper, 2001/55 7 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2528086 (accessed on 01 September 2017).

252 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation: What is New after a Decade and Half Strategy of Gradualism in... Working Paper · February 2017 2 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

253 Alemayehu Geda Institutional Aspects of Reforming the Financial sector https://www.eeaecon.org/node/5279 (accessed on 20 September 2017).

254 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

255 Admassu Bezabeh and Aseyehgn Desta 'Banking Sector Reform in Ethiopia' 26.

256 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

257 Admassu Bezabeh and Aseyehgn Desta 'Banking Sector Reform in Ethiopia' 26.

258 Gebrehiwot Ageba and Derk Bienen 'Ethiopia's accession to the WTO and The Financial Services Sector' 1.

259 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

260 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

system.[261] The current government of Ethiopia however considers foreign banks as a threat to the country.[262] The government argues, domestic banks are yet to develop and be able to compete at an international level and that there is a link between openness in the banking sector and subsequent banking crisis.[263] It is true that studies indicate a credible and positive link between financial liberalisation and consequent banking crisis – especially in countries where there is no strong institutional environment, Ethiopia for instance.[264] Empirical studies also proved that governments worry is misguided. According to these studies, strong regulatory and supervisory frameworks and sound supervision significantly reduce the probability of a banking crisis.

The Ethiopian government also argues that foreign banks may have a tendency to pursue large business clients, such as big commercial agriculture, real estate, industrial and services industries. Besides, foreign banks are seen as focusing on lending instead of mobilising savings from domestic households and small businesses. Another reason forwarded by Ethiopian government is lack of experts, especially financial experts who are capable of drafting and operating the regulatory and institutional frameworks required for supervising banking industry. [265] There is a [serious] brain drain in Ethiopia and it does not have experts that possess the necessary competence to regulate the operations of banks.[266] Though the IMF/World Bank help can be factored in the ultimate success of banking industry transformation depends on the positive response from Ethiopia.

Admasu and Aseyehgn[267] argues that government is relying on infant industry argument only as a cover not to take risks that comes with liberalisation which is potential economic crisis and as a consequence political instability. Foreign banks are intermediaries for capital inflow and outflow so they can be a conduit for capital flight whenever they felt that banking crisis is looming. Capital outflow could result in economic collapse then developing into political instability, a scenario government consider as a threat for its political control. So the government does not want to take risk and as a result collapse with political instability. Banking collapse is an imminent reality in a weak macroeconomic environment especially when there is high inflation but low economic growth.[268] Ethiopian economy features inflation, currency depreciation and unstable economic growth, so the likelihood of political instability is existent.

Part of the reason why the Ethiopian government resists liberalization is not only the justification that it provides that the domestic regulatory framework has to be strengthened and the competitive capacity of the domestic banks needs to grow as well as the ills that would come with foreign banks,

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261 Alemayehu Geda and Addis Yimer (2015), 'The Political Economy of Growth, Poverty and Inequality in Ethiopia, 2000–2013', in Dessalegn Rahmato, Meheret Ayenew, Asnake Kefale and Birgit Habermann (eds.), Reflections on Development in Ethiopia: New Trends, Sustainability and Challenges, Forum for Social Studies, 2014 31-67.

262 Admassu Bezabeh and Aseyehgn Desta 'Banking Sector Reform in Ethiopia' 34.

263 Admassu Bezabeh and Aseyehgn Desta 'Banking Sector Reform in Ethiopia' 34.

264 Williamson and Mahar (1998), Kaminsky and Reinhart (1999), Demirguc-Kunt and Detragiache (2001), Weller (2001), Eichengreen and Arteta (2002) and Noy (2004). Demirguc-Kunt and Detragiache (2001) as referred to in Admassu Bezabeh and Aseyehgn Desta 'Banking Sector Reform in Ethiopia' 34.

265 Admassu Bezabeh and Aseyehgn Desta 'Banking Sector Reform in Ethiopia' 34.

266 Admassu Bezabeh and Aseyehgn Desta 'Banking Sector Reform in Ethiopia' 34.

267 Admassu Bezabeh and Aseyehgn Desta 'Banking Sector Reform in Ethiopia'.

268 Asli Demirguc-Kunt and Enrica Detragiache 'The Determinants of Banking Crises in Developing and Developed Countries' IMF Staff Papers Vol. 45, No. 1, 1998 83.

but also it might lose the freewheeling control and interference it currently possesses over banking sector which in fact might result in systemic risks and which allows it to continue to abuse the banking sector for political and personal ends - such as connected lending and ownership of private banks by politicians and their close proxies. Even though the banking sector is expanding with considerable domestic resource mobilization and improvement in the facilities of loans and advances, the financial sector is still shallow. It is dominated by public banks and the private banks need to be upgraded to broaden the financial system.[269] Geda[270] underscores Ethiopian government's policy of gradualism as plausible and which must be supported by the World Bank and IMF on the ground that recognising and addressing structural problems and institutional building should precede a successful and stable financial reform.

4.2.2 Pros and cons of liberalisation

While there are socio-economic benefits accrued from liberalisation it also poses serious risks – that is why prudence dictates in depth consideration of benefits and risks before liberalisation.[271] Ethiopia needs to modernise its financial sector by promoting competition, innovation and enhancing efficiency. Liberalisation paves a way for capital inflow, and access to modern banking technologies. Pressure filled competition, unscrupulous activities and recklessness, inadequate diversification of assets and excessive exposure to bad loans and proprietary trade losses are the results of liberalisation.[272] These issues are attributed to bank failure.[273] Hence, the need for crisis management and bank rescues. According to studies conducted by Thakor (1996), Bencivenga and Smith (1991), Greenwood and Jovanovic (1990) the more competitive and efficient a banking system is the more it solidify financial stability, enhance innovation of new financial products and ease the accessibility of financial services.[274] On the contrary, a banking industry characterised by domination of a state and monopoly is inefficient and it erodes the prospect of economic growth.

Opening the banking sector attracts foreign direct investment, improves the efficiency of the Ethiopian banking sector, and enhances the banking regulatory and supervisory framework. Goldberg[275] argues that foreign banks pave a way for introduction of sound and robust regulation, provided they are strong and healthier than domestic markets thereby contributing to the prudence of local banking system. The financial sector would be strengthened by the entry of foreign banks and contributes to the economic growth. As Demirguc-Kunt, Levine and Min[276] and Mattoo, Rathindran,

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269 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

270 Alemayehu Geda Institutional Aspects of Reforming the Financial sector https://www.eeaecon.org/node/5279 (accessed on 20 September 2017).

271 Gebrehiwot Ageba and Derk Bienen 'Ethiopia's accession to the WTO and The Financial Services Sector' 1.

272 Ross Cranston Principles of Banking Law 93.

273 Ross Cranston Principles of Banking Law 93.

274 Thakor (1996), Bencivenga and Smith (1991), Greenwood and Jovanovic (1990) as referred to in Admassu Bezabeh and Aseyehgn Desta 'Banking Sector Reform in Ethiopia' 28.

275 Linda S. Goldberg 'Financial sector FDI and Host Countries: New and Old Lessons' FRBNY Economic Policy Review 2007, 1 – 17.

276 Asli Demirguc-Kunt and Enrica Detragiache 'The Determinants of Banking Crises in Developing and Developed Countries'.

and Subramanian[277] concluded liberalisation of the financial sector and economic growth have a positive relationship. The more competitive the financial sector is the larger the supply of the financial services and the lower the costs of financial intermediation.[278] According to Pasiouras et al analysis, banking regulatory framework that impose market discipline and strengthen regulators supervisory power makes the banking sector more profitable and cost effective.[279]

Liberalising the financial sector would enhance the financial development and may contribute to long-term economic growth. Liberalisation might also lead to financial crisis.[280] Banking crises occur commonly in countries that have opened the sector while the risk is greatest in countries that lack strong regulatory institutions.[281] Ethiopia's critical approach towards liberalization of the financial sector is backed with some valid arguments and investing in regulatory capacity has significant social returns.[282]

Without robust banking structure and vigorous regulatory capacity, "foreign financial service providers encourage the development of oligopolistic, rather than competitive, banking structures".[283] After the happening of the Asian financial crisis in late 1990s and the 2008 world financial crisis it is not recommended to liberalize the financial system by experts – at least it needs to be approached by caution.[284] After Asian and Latin American economic crisis was attributed to the immediate withdrawal of foreign capital, inflow of foreign fund and investment's role in development has been viewed with concern.[285] Besides, foreign banks are profit oriented so they tend to focus on big corporate clients and at largest urban centers. In doing so, they push local banks to smaller towns and rural areas so liberalization cannot necessarily improve the quality and range of services.[286]

Financial Liberalisation was promoted by IMF and World Bank and developing countries were exhorted to adopt it as part of Structural Adjustment Programmes (SAPs).[287] However many

277 Aaditya Mattoo, Randeep Rathindran, and Arvind Subramanian 'Measuring services trade liberalization and its impact on economic growth: An illustration' Journal of Economic Integration 21(1) 2006 64-98.

278 International monetary fund report 'South Africa Financial System Stability Assessment' 2014 28-29.

279 Pasiouras F, Tanna S, Zopounidis C The impact of banking regulations on banks' cost and profit efficiency: Cross-country evidence. International Review of Financial Analysis 18(5) 2009 294–302.

280 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

281 Demirguc-Kunt, A. and E. Detragiache (1999). 'Financial liberalization and financial fragility', as referred to in B. Pleskovic and J. Stiglitz (eds) Proceedings of the 1998 Annual Bank Conference on Development Economics, Washington DC: World Bank 303-31; Arestis Philip, Financial Liberalization, the Finance-Growth Nexus, Financial Crisis and Policy Implications, Paper presented at 'Financial Liberalization: Past, Present and Future Conference', The Cambridge Trust, Cambridge University 2016.

282 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

283 Gebrehiwot Ageba and Derk Bienen 'Ethiopia's accession to the WTO and The Financial Services Sector' 3.

284 Arestis Philip, Financial Liberalization, the Finance-Growth Nexus, Financial Crisis and Policy Implications, Paper presented at 'Financial Liberalization: Past, Present and Future Conference', The Cambridge Trust, Cambridge University 2016.

285 M Sornarajah The International Law on Foreign Investment 3rd ed. Cambridge University Press 2010 3.

286 Meles Zenawi 'African Development: dead ends and new beginnings'.

287 Alemayehu Geda 'The Structure and Performance of Ethiopia's Financial Sector in the Pre- and Post-Reform Periods' 3-4.

developing countries have not been able to rip the fruit of financial reform (as part of SAPs) after they painfully implemented the reform – though what was promised was a thriving financial sector.

4.2.3 Pre-liberalisation measures

Building the institutional and regulatory framework is a crucial policy approach that should precede liberalisation. Vos[288] noted that the success of financial liberalisation in Asian countries – for instance, South Korea and Taiwan – and its failure in Latin American countries is attributed to the role of government in monitoring and intervening to tackle structural problems without eroding market based performance standards. Gradualism and developing a robust supervision system is not only relevant to solve financial sector problem but it must also precede fundamental financial sector reform.[289] It is crucial to have a stable political platform and resilient economy to liberalise the banking sector.[290] Hence, liberalisation should be preceded, at least supplemented by, efficient banking supervision and regulatory framework, robust macroeconomic management and a financial system free from different abuses and politically motivated intrusion – in lending for instance.[291]

Effective and efficient financial regulation and supervision ensures the stability of the financial system and enhance its performance.[292] Countries that tighten their regulatory and supervisory framework prior to liberalisation benefited much better from it than countries that liberalised first.[293] Thailand for instance saw the collapse of many of its banks because it fully liberalised the financial system while maintaining lax prudential regulation (it led to over exposure of banks to highly risky sectors). In the case of Ethiopia, in light of the fragility of the regulatory capacity of the NBE opening the capital account, for instance, will pave a way for foreign banks to be a tunnel for capital flight via capital and money market transactions, credit operations, personal capital movement etc. Outward flow of capital might lead to illiquidity and shortage of foreign exchange.[294]

China adopted a very cautious approach towards financial reform – a reform they call “crossing the river by feeling the stones under foot”.[295] While China reformed its financial sector gradually, it also managed to record an economic growth.[296] Given the ills that will follow prompt liberalisation it is not unseemly to adopt an approach that will ensure a significant growth with modest but less than perfect institutions.[297] Since effective financial sector, reform requires building institutions and

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288 Rob Vos Financial Liberalization, growth and adjustment: some lessons for developing countries’, Working papers – Money, Finance and Development 1993.

289 Rob Vos Financial Liberalization, growth and adjustment: some lessons for developing countries’, 1993.

290 WTO Trade in Services Division A Handbook on the GATS Agreement Cambridge University Press 2005 33.

291 WTO Trade in Services Division A Handbook on the GATS Agreement 33.

292 E. Kane, “Understanding financial crises: a developing country perspective,” in Annual World bank Conference on Development Economics, pp. 67–73, 1996 as referred to in Themba Jeremiah and Bonu Narayana Swami The Impact of liberalization of regulations in Banking Sector: Case Study of Botswana Banking Sector Open Journal of Finance Volume 1, Number 1, August 2014 16.

293 Gebrehiwot Ageba and Derk Bienen ‘Ethiopia’s accession to the WTO and The Financial Services Sector’ 10.

294 Gebrehiwot Ageba and Derk Bienen ‘Ethiopia’s accession to the WTO and The Financial Services Sector’ 12.

295 Gros, D. and A. Steinherr Winds of Change: Economic Transition in Central and Eastern Europe Longman 1995 109.

296 Gros, D. and A. Steinherr Winds of Change: Economic Transition in Central and Eastern Europe 108.

297 Yingyi Qian The Institutional Foundations of China's Market Transition, ADB Institute Working Paper Series No. 9 1999 6.

systems it is recommended to adopt a second best principle until institutional and regulatory framework is well built. Otherwise, "removing one distortion may be counterproductive in the presence of another distortion".[298] The approach adopted by Ethiopia – ensuring macro-economic stability even though the financial system is inefficient – may therefore be a tenable approach in the second best principle.[299]

4.3 The NBE capability to regulate multinational banks

As discussed under chapter three the NBE is victim to the executive arm of the government without legally recognised operational independence. Even though ensuring the independence of the supervisor enhances the efficiency of the banking system[300], the NBE is made to be under the dictate of the chief executive. It is an extension of the executive policy implementation tool. The banking service in Ethiopia is dominated by the government owned banks, which works in close cooperation with the NBE. Hence the NBEs capacity to control a more competitive and freer banking intermediaries with several and up-to-date banking products is questionable – primarily due its legislative basis and its capacity to issue reasonable and fair directives guided by market demands.

Government owned banks over which the regulatory oversight is loose dominates Ethiopian banking system. In a system where there is a significant government ownership of banks coupled with government's dominant role in supervising and regulating banks as well as lax monitoring in the private sector and restricted entry, there is a higher level of government corruption and lack of integrity.[301] With the intertwined nature of the banking ownership by government, political party leaders and the freewheeling government control over the NBE, the likelihood of regulatory forbearance is very real. Regulatory forbearance, which is the main weakness of the banking regulation,[302] is a situation where bank regulators fails to properly implement regulations and to swiftly intervene in resolving the problem of distressed banks.[303] Affiliation of banks with political parties and/or politicians and bureaucrats skews the balance of competition in the banking sector.

In this regard, the activities of the BDE and how the NBE addresses them signals the stain in the governing task of banks in Ethiopia. The actions of the government owned banks might pose a systemic risk. DBE, for instance, "generally does not obey to sound finance and regulatory practice both historically and today".[304] The DBE significantly finances politically connected and party owned companies to the level of covering 60 percent of the project costs and cancelling some of the loans

298 Yingyi Qian The Institutional Foundations of China's Market Transition 6.

299 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

300 Chen Lin, Yue Ma and Frank M. Song What drives bank operating efficiency? The role of bank competition and credit information sharing as referred to in James R. Barth, Chen Lin and Clas Wihlborg Research Handbook on International Banking and Governance Edward Elgar 2012 87-120.

301 James R. Barth, Gerard Caprio Jr. and Ross Levine Bank regulation and supervision: what works best? Journal of Financial Intermediation 13 2004 205–248 231.

302 Kenneth K. Mwenda Legal Aspects of Banking Regulation 73.

303 M Brownbridge and SM Maimbo 'Can prompt corrective action rules work in the developing world?' Journal of African Business 4 2003 47-68.

304 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

while also providing loan to the same businesses again.[305] The activities of the DBE are more political and less economic – whose political analysis gives more perspective to its function than economic analysis.[306] In the Ethiopian banking system and in the effort to admit foreign banks into the country, this raises a red flag of systemic risk.

> Unless the government pursues impartial and professional sound surveillance and closely monitors their lending activity to public and semi-public entities; and, more importantly, reduces its own pressure on the public banks to finance such unviable public and semi-public owned projects, a systemic banking sector risk is unavoidable.[307]

Besides the politically motivated intervention in the operation of the NBE erodes its credibility, jeopardises its capacity to actively strengthen its regulatory arm and its effort to build the professionalism and expertise of its staff. The firm grip of the government on the banking sector, by interalia controlling the NBE, owning the lion's share of the banking sector itself or through government operatives and by adopting biased policies that favour the public over private banks not only dwarf the competition in the sector, it also erodes the credibility of the banking system and diminishes the potential of the sector to grow.[308]

The government adopts policies that are biased against private banks by putting a lending cap on their loan portfolios, by making public banks the custodians of its big accounts and making a precondition of having a bank account at public banks to benefit from governments low income housing loan provision.[309]

The Basel Accord is not implemented by the NBE phase by phase, rather the NBE uses the principles as it fits Ethiopian circumstance.[310] According to Christine Lagarde it is important to balance the need to adopt global standards in order to strengthen regulation and supervision with appropriate consideration for domestic contexts.[311] Global financial institutions however advocates for standardisation of regulation and supervision.[312] So aligning domestic regulation with international standards is relevant.

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[305] Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

[306] Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

[307] Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

[308] Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

[309] Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

[310] Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

[311] Speech by IMF Managing Director Christine Lagarde on a conference on Cross-Border Banking and Regulatory Reforms: Implications for Africa from International Experience, held in Mauritius on February 1-2 https://www.imf.org/en/News/Articles/2017/02/10/NA021317-Pan-African-Banking-Finding-its-Stride (accessed on 09 September 2017).

[312] Alemayehu Geda Institutional Aspects of Reforming the Financial sector https://www.eeaecon.org/node/5279 (accessed on 20 September 2017).

There are no signs of immediate risks to the prudence of the Ethiopian banking sector according to the 2014 IMF study – though the conclusion is unwarranted.[313] The study further states that the banks have adequate capital and accrue profit.[314] The IMF study also noted that the NBE would manage and supervise the banking sector without trouble because the sector lacks financial depth and sophistication. According to IMF, study the systemic importance of the CBE and the concentration of its operation through large exposures to public sector demands cautious approach.[315] It is however imperative to develop the regulatory capacity of the NBE by installing various elements of good regulatory governance in particular by ensuring its independence and transparency as well as making sure that it is accountable – those are antidotes for varied problems that are metastasizing in the NBE.[316] The NBE capacity to regulate the financial system needs to be guided by public interest at its core.[317]

4.3.1 Introducing consolidated supervision

International financial conglomerates require the adoption of a sophisticated supervisory system.[318] Basel Core Principles of 1997 states that the mandate of supervising an international bank should be given to home country regulator while host jurisdictions are expected to apply same standards to both domestic and international banks.[319] BCBS Core Principles for Effective Banking Supervision (which are statements of best practices for bank regulation) stated, "[w]eaknesses in the banking system of a country...threaten financial stability both within that country and internationally".[320] This demonstrates that the main issue to be addressed by international bank regulation is to avoid "spill over of banking problems from one country to another".[321] There is no agreement at international level that ensures coordination of governmental regulatory measures to address a failure of multinational bank. Banks are, as often times said, "'global in life but national in death'".[322]

Unified supervision is indispensable to regulate financial institutions that operate across borders.[323] A consolidated supervisory system helps to streamline information exchange, enhances accountability

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313 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

314 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

315 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

316 Marco Arnone Salim M. Darbar and and Alessandro Gambini 'Banking Supervision: Quality and Governance' IMF Working Paper https://www.imf.org/external/pubs/ft/wp/2007/wp0782.pdf 2007 5-6 (accessed 12 September 2017).

317 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

318 Maria-Cristina Ungureanu Importance of Effective Regulation and Supervision for Banks' Corporate Governance: European Integration Context 10 https://pdfs.semanticscholar.org/f133/21dda59e7c770a14470031fc80f692fdd1c5.pdf (accessed 01 September 2017)

319 Ross Cranston Principles of Banking Law 108.

320 Basel Committee on Banking Supervision Core Principles for Effective Banking Supervision http://www.bis.org/publ/bcbs129.pdf 2 (accessed September 20 2017).

321 Heidi Mandanis Schooner, Michael W. Taylor Global Bank Regulation XVII.

322 S Gleeson International Regulation of Banking Capital and Risk Requirements 36.

323 Maria-Cristina Ungureanu Importance of Effective Regulation and Supervision for Banks' Corporate Governance 14 https://pdfs.semanticscholar.org/f133/21dda59e7c770a14470031fc80f692fdd1c5.pdf (accessed 01 September 2017)

and goes along new market developments.[324] South Africa engages in consolidated supervision to regulate bank subsidiaries and affiliates of domestic financial groups and to unincorporated branches and affiliates of non-domestic financial groups.[325] It is mandatory to introduce legal framework that entitles the NBE to link up with home or host country regulators to regulate the international banks effectively. A consolidated supervisory system is vital to create an effective platform for international banks.[326]

Even though the NBE currently has a strong control over banks, it would be erroneous to therefore assume its capability to regulate further liberalisation because the level of control increases and regulating international banks is a sophisticated task.[327] In international banking business

> [a] bank that bases its operations in a jurisdiction offering light regulation can pose significant risk in the other jurisdictions through the banks cross-border operations. Moreover, the lightly regulated bank puts more rigorously regulated banks at a competitive disadvantage.[328]

Host country regulators concern is the repercussions of a possible failure of a foreign bank on domestic banking system especially if there is a lack of information about the parent bank.[329] Hence, appropriate information exchange between the host and home country supervisory bodies is essential for effective international coordination.[330] It is a crucial issue for government to come up with the best way of addressing failure of multinational banks.[331] Governments need to negotiate on how to solve the problem of collapse of cross border multinational banks in terms of how they would manage the claims of creditors, depositors, and other claimants. [332]

Co-operation and coordination between bank regulators of different countries is only one aspect of realising the practical implementation of prudential standards. Arguably, it demands a centralised regulatory body at an international level.[333] International collaboration in the regulation and

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324 Maria-Cristina Ungureanu Importance of Effective Regulation and Supervision for Banks' Corporate Governance 14 https://pdfs.semanticscholar.org/f133/21dda59e7c770a14470031fc80f692fdd1c5.pdf (accessed 01 September 2017).

325 Maria-Cristina Ungureanu Importance of Effective Regulation and Supervision for Banks' Corporate Governance 14 https://pdfs.semanticscholar.org/f133/21dda59e7c770a14470031fc80f692fdd1c5.pdf (accessed 01 September 2017).

326 Maria-Cristina Ungureanu Importance of Effective Regulation and Supervision for Banks' Corporate Governance 14 https://pdfs.semanticscholar.org/f133/21dda59e7c770a14470031fc80f692fdd1c5.pdf (accessed 01 September 2017).

327 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 12 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

328 Heidi Mandanis Schooner, Michael W. Taylor Global Bank Regulation XVII.

329 Maria-Cristina Ungureanu Importance of Effective Regulation and Supervision for Banks' Corporate Governance 9 https://pdfs.semanticscholar.org/f133/21dda59e7c770a14470031fc80f692fdd1c5.pdf (accessed 01 September 2017).

330 Maria-Cristina Ungureanu Importance of Effective Regulation and Supervision for Banks' Corporate Governance 9 https://pdfs.semanticscholar.org/f133/21dda59e7c770a14470031fc80f692fdd1c5.pdf (accessed 01 September 2017)

331 S Gleeson International Regulation of Banking Capital and Risk Requirements 36.

332 S Gleeson International Regulation of Banking Capital and Risk Requirements 37.

333 Ross Cranston Principles of Banking Law 109.

supervision of the banking system enhances financial stability.[334] Cross-border banking activity and sophisticated financial institutions requires consolidated supervision to create an efficient platform for cross border banks.[335] At the global level, consolidated supervision is a "brake on banks escaping the prudential standards of a home jurisdiction by moving business into subsidiaries abroad".[336]

Host country regulators are also expected to monitor the operations of international banks to make sure that prudential standards are complied with.[337] Governments can pave a way for their regulators to cooperate with fellow regulators at international level irrespective of the type of banking crisis to be solved, however when the crisis involves committing taxpayers money it is not as a smooth process for governments to cooperate internationally.[338] In addition, college of supervisors who might perform very well in a stable environment, but may face an uphill challenge where a bank they supervise faces an imminent risk of failure.[339]

Consolidated regulation and supervision needs to be consistent and coordinated by inter alia aligning the risk and prudential requirements and, creating a platform for coordination and cooperation of regulatory and supervisory authorities and by streamlining regulations.[340]

4.3.2 NBE's staff professionalism in bank regulation

Institutionally the NBE lacks skilled human power. Ethiopia, after 15 years since it embarked upon financial reform program, still lacks an effective and efficient supervisory capacity.[341] There is a scarce human and financial resource in the supervision department of the NBE.[342] The NBE has not adopted the Basel Principles and comprehensive free market policy tools.[343] The NBE lacks sophisticated supervisory methods required by the Basel accords.[344] The supervisor should be provided with adequate resources for conducting effective supervision.[345] Adequate budget needs to

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334 Maria-Cristina Ungureanu Importance of Effective Regulation and Supervision for Banks' Corporate Governance 14 https://pdfs.semanticscholar.org/f133/21dda59e7c770a14470031fc80f692fdd1c5.pdf (accessed 01 September 2017).

335 Maria-Cristina Ungureanu Importance of Effective Regulation and Supervision for Banks' Corporate Governance 14 https://pdfs.semanticscholar.org/f133/21dda59e7c770a14470031fc80f692fdd1c5.pdf (accessed 01 September 2017).

336 Ross Cranston Principles of Banking Law 109.

337 Ross Cranston Principles of Banking Law 109.

338 S Gleeson International Regulation of Banking Capital and Risk Requirements 38.

339 S Gleeson International Regulation of Banking Capital and Risk Requirements 38.

340 Maria-Cristina Ungureanu Importance of Effective Regulation and Supervision for Banks' Corporate Governance 14 https://pdfs.semanticscholar.org/f133/21dda59e7c770a14470031fc80f692fdd1c5.pdf (accessed 01 September 2017)

341 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 12 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

342 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 12 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

343 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 12 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

344 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 12 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

345 Principle 2 of Basel Committee on Banking Supervision Core Principles for Effective Banking Supervision September 2012.

be allocated that enables the supervisor to attract and retain a qualified staff and the staff must demonstrate professionalism and integrity in their duty.[346] With tight grip over the operation of the NBE and lack of skilled staff, it is unlikely for the NBE to build regulatory sophistication required by global financial conglomerates. In South Africa, the banking supervision department (BSD) of the SARB has been provided with resources and imminently qualified human power, which is also bolstered by considerable amount of specialist skills.[347] The NBE needs to strengthen its human power and expertise team before liberalization.

The legal framework in Ethiopia should be amended to ensure the NBE's operational independence, to provide adequate budget, technological and human resources in order to effectively govern the sophistication posed by global banks. Monitoring unscrupulous banks demands effective regulatory framework. Analysing and interpreting banking information requires an expert knowledge, which unsophisticated depositors just cannot afford. Besides, the manoeuvre that may lead to insolvency of some banks is dishonesty – which naturally is a hidden business.[348]

The NBE need to be equipped with staffs that has the necessary skill, qualification and merit within a specified timeline.[349] It is imperative to invest in skilled human power for effective supervision. Developing supervisory skills is a time consuming activity. It would take 5-10 years of significant training to some countries before they can develop a capability comparable to industrial countries.[350] Hence, given its fragile regulatory and supervisory capacity the NBE should be concerned about the inflow of foreign banks in the form of investment banking and branch offices as it has yet develop a capacity to govern them.[351]

The NBE should also worry about the systemic risk the CBE and Development Bank of Ethiopia (hereafter DBE) might cause as they are engaging in "connected and hence poor quality lending" and "from their exposure to unviable or poorly managed public and semi-public sector projects".[352] It is also important for the NBE to focus on the potential financial crisis that might happen due to macroeconomic instability from inflation and foreign exchange shortage.[353] The skill, quality and professionalism of the staff of the NBE need to be ahead of the fast growing financial need and system of the country. Currently, it is behind.

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346 Essential Criteria 5 and 6 of Basel Committee on Banking Supervision Core Principles for Effective Banking Supervision 2012.

347 International monetary fund report 'South Africa Financial System Stability Assessment' 2014 62.

348 Ross Cranston Principles of Banking Law 2002 79.

349 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 18 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

350 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 12 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

351 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 19 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

352 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 19 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

353 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 19 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

4.4 Entry of foreign banks and its legal implication

Only an Ethiopian is legally entitled to engage in banking business.[354] As a market entry requirement, a license to engage in banking business is often preceded by the condition of nationality or legal form requirement.[355] Ethiopia's banking history shows that resistance to foreign banks entry into domestic banking sector have historical roots.[356] The requirement of licensing also helps to avert undesirable activities.[357] In South Africa, the BSD pursues a legally provided system that helps to scrutinise whether new entrants (foreign banks branches included) are eligible to register as a bank.[358] Given a range of restrictions on capital transactions in Ethiopia there is a genuine government concern about the potential negative effect liberalisation might have on the stability of macro economy and financial system given the underdeveloped regulatory and supervisory framework.[359]

There is a considerable challenge that comes with multinational banks joining the domestic banking market.[360] International banks have vast assets, sophisticated networks and technological capabilities and they are well financed.[361] Domestic banks do not have these advantages hence governments, especially in developing countries, inclined to rely on protectionist policies based on infant industry argument in order to protect domestic banks. Due to strict control on entry, the mid 20th century banking system was considered as robust.[362] However many countries simultaneously witnessed the emergence of a cartel characterised with low risk-taking and scant innovation, making modest profits. The robustness was partly rooted in the erosion of efficiency and dynamism.[363] The Ethiopian banking system features domination by gigantic government owned CBE whose dominance hinders competition and efficiency.

Entry of foreign banks ensures competition and efficiency in the banking system. It helps firms and households to benefit from easy access to financial intermediation.[364] Banks cannot operate efficiently in a market where there is bank concentration and regulatory entry barriers.[365] The Ethiopian banking sector is stalled from growing by the governments active measures, which are not

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354 S 3 (1) (a) of Regulation No. 270 of 2012.

355 Solomon Abay Yimer Financial Market Development, Policy and Regulation: The International Experience and Ethiopia's Need for Further Reform Universiteit van Amsterdam [Host], 2011 24.

356 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 3 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

357 Ross Cranston Principles of Banking Law 2002 85.

358 International monetary fund report 'South Africa Financial System Stability Assessment' 2014 63.

359 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 15 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

360 Y Peng 'The Challenges of WTO entry into China's Banking Industry' 9 https://faculty.washington.edu/karyiu/confer/beijing06/papers/peng.pdf (accessed 21 August 2017).

361 Y Peng 'The Challenges of WTO entry into China's Banking Industry' 9 https://faculty.washington.edu/karyiu/confer/beijing06/papers/peng.pdf (accessed 21 August 2017).

362 David Archer Roles and objectives of modern central banks http://www.bis.org/publ/othp04_2.pdf (accessed on 05 September 2017) 26.

363 David Archer Roles and objectives of modern central banks http://www.bis.org/publ/othp04_2.pdf (accessed on 05 September 2017) 26.

364 Gebrehiwot Ageba and Derk Bienen 'Ethiopia's accession to the WTO and The Financial Services Sector' 16.

365 Chen Lin, Yue Ma and Frank M. Song What drives bank operating efficiency? The role of bank competition and credit information sharing as referred to in James R. Barth, Chen Lin and Clas Wihlborg Research Handbook on International Banking and Governance 87-120.

necessarily in the best interest of the sector or the economy of Ethiopia.[366] Restriction on foreign banks entry is affirmatively associated with fragile banking system.[367]

By reserving the banking sector solely to domestic investors, the policy starves the banking industry of the competition it needs to grow, to make capital available at an affordable price and accessibility of technology and best practices in the banking system around the world.[368] There is a positive relationship between the probability of major banking crisis and restriction on foreign bank entry and ownership.[369] On the contrary, there is no evidence that demonstrates the positive contribution of restricting bank entry and bank development and stability.[370]

It is unviable to restrict the entry of foreign banks indefinitely as economic transformation demands capitalisation. Hence, Ethiopia needs to adopt policies that promote domestic resource mobilisation.[371] It is also important to start the process of cautious liberalisation, to ensure that public and private financial institutions have a level playing field and to embark up on time bound task of building the regulatory and supervisory capability of the NBE.[372] It is very crucial to build the NBE's regulatory and supervisory capacity, as it currently is not in a position to manage "further liberalisation that are getting complex by the day".[373]

4.4.1 The regulation of foreign banks

The regulation of cross border banks is a complex task. In South Africa, international banks can engage in the banking business provided they fully comply with preconditions stipulated by the Registrar.[374] The Registrar examines and ensures that the international bank is subject to adequate supervision under the home state supervisory authority before granting the permission to engage in banking business.[375]

It is mandatory to empower the NBE to cooperate with foreign supervisors in the endeavor to strengthen the regulation of international banks before they are allowed to invest in Ethiopia. In South Africa a new bank is expected to persuade the Registrar that it meet the requirements of prudential regulations.[376] The rationale behind this precondition is to make sure that the banking sector is financially stable and to deter bank failures by ascertaining that banks have safety nets. It is

366 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 10 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

367 James R. Barth, Gerard Caprio Jr. and Ross Levine 'Bank regulation and supervision: what works best?' 13.

368 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 10 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

369 James R. Barth, Gerard Caprio Jr. and Ross Levine 'Bank regulation and supervision: what works best?' 13.

370 James R. Barth, Gerard Caprio Jr. and Ross Levine 'Bank regulation and supervision: what works best?' 13.

371 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 18 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

372 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 18 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

373 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 18 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

374 Section 34 (1) of BA.

375 Section 34 (2B) (b) of BA.

376 Section 17 (b) of BA.

mandatory to acquire a banking business license from the Registrar every year.[377] The license can be granted if the concerned bank adheres to the requirements of prudential regulations,[378] for instance the compulsory minimum capital requirement.[379] Even though the criteria of licensing is relevant to control banks, its effectiveness largely depends on the comprehensiveness of the screening, its effective practical implementation, thoroughness of monitoring those to whom license has been granted, and the competence of the regulators to take corrective action in cases of breach of standards.[380]

It is mandatory to lay down a strategy for gradual opening up of the financial sector based on arrangements that benefit the Ethiopian long-term economic and social interest. Allowing foreign banks to carry on banking business through joint venture by reserving majority holding to domestic banks or through management contract and therefrom adopting a robust system from the experience gained.[381] The need for capital justifies the urge to open the financial sector with sound regulatory framework in place and with conditions attached to admission of foreign banks into the domestic financial sector. Countries are, as endorsed by General Agreement on Trade and Services as well, entitled to adopt and apply prudential regulation and macroeconomic policy in order to ensure the stability of their financial sector.[382]

The considerable need for finance from the economy in light of the closed nature of the capital account, Ethiopia may only lose by continuing to block capital inflow.[383] It is therefore important to reconsider the strict capital control exercised by Ethiopia currently. The decline of domestic banks may collapse the financial system especially if there is no robust and sound prudential regulations and efficient supervisory infrastructure.[384] Hence, to make the most out of liberalisation it requires forethought by policy makers especially on the when and how to relax restrictions on foreign banks and make sure that there is sound and strong regulatory and supervisory framework.[385]

Liberalisation in the Ethiopian context need to be preceded by macroeconomic measures such as to introduce a sound policy to address the challenge of capital flight, containing an alarming level of

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377 Section 35 of BA.

378 Section 13 (2) (f) of BA.

379 A minimum capital is a guarantee in case a bank plunges into financial collapse and a shield against insolvency. It also helps regulators to monitor the possible unwarranted actions of bank management, activities such as broadening the type and quality of financial products. Refer also to Prudential Requirements enumerated under Chapter VI of Banks Act No 94 of 1990.

380 Ross Cranston Principles of Banking Law 85.

381 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 18 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

382 Annex on Financial Services https://www.wto.org/english/tratop_e/serv_e/10-anfin_e.htm (accessed 01 August 2017).

383 Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 15 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

384 Stijn Claessens, Asli Demirgüç-Kunt, and Harry Huizinga How does foreign entry affect domestic banking markets? http://siteresources.worldbank.org/DEC/Resources/84797-1114437274304/final.pdf (accessed 23 September 2017).

385 Stijn Claessens, Asli Demirgüç-Kunt, and Harry Huizinga How does foreign entry affect domestic banking markets? http://siteresources.worldbank.org/DEC/Resources/84797-1114437274304/final.pdf (accessed 23 September 2017).

internal and external debt as well as trade deficit.[386] It is also important to have a consolidated public debt, controlling inflation and exchange rate depreciation.[387] Macroeconomic instability can be caused by shortage of foreign exchange and inflation. Given the "exposure of CBE and the DBE to unviable or poorly managed public (and semi-public) projects and connected lending and hence a potential systemic risk" macro-economic instability might cause instability of the financial system.[388]

Ethiopia needs to layout timetable for relaxation of regulation on the financial sector. Different foreign investment banking activities are gaining foothold in Ethiopia using schemes such as equity finance or investment banking and representative office. These recent trend of big international banks entering Ethiopia indicates the urgent need for strengthening the institutional capability of the NBE to govern these financial institutions once the sector is liberalised.[389] In the process of opening up the financial sector, the government can adopt different arrangements. Foreign banks can be limited to businesses of management contract and equity holding with local investors having a majority share.[390]

Entry of foreign banks through equity participation – with less than 100 percent share – boosts domestic banks capital base and enhances their skill base and technology. It would also increase their competitiveness and ascertain their continued existence in the market.[391] However, entry through Greenfield investment presents a formidable challenge to domestic banks especially in light of their financial and human capital and technology and financial products.[392]

4.5 Conclusion

Opening the banking system for foreign banks has far-reaching repercussions. International banks mobilize huge funds, they use sophisticated financial products, and they can pose financial crisis with their mobility or hidden activities. Therefore, the admission of foreign banks demands a careful policy and legal measure. Ethiopia blocks international banks from its banking sector insisting on the policy of gradualism. Though there are real threats of financial crisis and macro-economic instability, financial openness also has affirmative side to it.

However, liberalization should be preceded by robust regulatory and supervisory framework and favorable macro-economic platform. It is imperative to strengthen the regulatory capacity of the NBE. The legal framework should enshrine the operational autonomy of the NBE and it is mandatory to legally avail necessary resources for staffing the NBE with skilled and expertise human power.

[386] Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 15 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

[387] Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 15 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

[388] Alemayehu Geda and Addis Yimer (2015), 'The Political Economy of Growth, Poverty and Inequality in Ethiopia, 2000–2013', as referred to in Dessalegn Rahmato, Meheret Ayenew, Asnake Kefale and Birgit Habermann (eds.), Reflections on Development in Ethiopia: New Trends, Sustainability and Challenges.

[389] Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 15 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

[390] Alemayehu Geda and Tony Addison The Current State of Ethiopian Financial Sector and Its Regulation 15 https://www.researchgate.net/publication/313011588 (accessed on 10 September 2017).

[391] Gebrehiwot Ageba and Derk Bienen 'Ethiopia's accession to the WTO and The Financial Services Sector' 14.

[392] Gebrehiwot Ageba and Derk Bienen 'Ethiopia's accession to the WTO and The Financial Services Sector' 15.

Before inviting foreign banks NBE should be backed with legal structure by which it engages in consolidated supervision with foreign regulators to effectively govern cross order banks. The South African consolidated supervision is a case in point to use cooperation in the regulation of foreign banks. In all its activities, NBE needs to upgrade the professionalism of its staff and understanding of sophisticated financial and technological aspects of international banking.

The entry of international banks can also be properly tailored to fit the Ethiopian special circumstance. In light of the regulatory capacity of the NBE, the law can be adopted that allows only a joint venture with minority shareholding of foreign banks or management contract arrangements. While it is appropriate to be wary of the adverse effects of liberalization, it is equally sound to avail Ethiopia of the competition, innovation, affordable capital and technological advantages attached to opening the financial sector.

CHAPTER FIVE

CONCLUSION

Banking system is a crucial bloodline for economic development of a country. Ethiopian banking system is underdeveloped and dominated by government owned banks. It lacks competition and innovation. It is also closed to international banks. Ethiopia has large number of unbanked population and the domination of the banking system by government banks made competition hardly possible. The banks are concentrated in urban areas and considerable number of Ethiopian population does not have access to affordable finance.

NBE is legally constituted to oversee the banking sector. The federal government is empowered by the constitution to administer the NBE. The NBE however does not have the necessary legally recognized operational autonomy. It is accountable to the chief executive and the BOD of the NBE are political appointees. This legal fact erodes the independence and credibility of the NBE especially in light of its leniency towards government owned banks. The government, which is the owner of the significant portion of banking sector at the same time, have an unfettered power over its regulation. Politicians and veterans of the ruling political party thereby blurring the lines of business and politics also own some of private commercial banks. It all comes down to dwindle and erode the impartial and robust regulation of the banking system by the NBE.

The SARB in contrast enjoys constitutionally guaranteed operational autonomy and it is discharging its functions without fear, favor or prejudice. An independent banking regulator is vital not only in the stability of monetary policy but also in ensuring the financial health and soundness of the banking system.

The governor, vice-governor and the BODs of the NBE are vulnerable to be removed at any time for any reason. It is unlikely for them to decide purely on professional ground without calculating the short term or long term political consequences of their decision in the realm of politicians. Hence, it is mandatory to guarantee the operational independence of the NBE legally. It is equally relevant to make sure that the NBE is accountable, not to the prime minister, as it currently is, but to the lawmaker as in the case of SARB. This system of checks and balance eases the political pressure on the bank regulator. It is recommended to provide term of office for the governing body of the NBE and to introduce a system of checks and balance in the appointment process of the governor and vice governor of the NBE. The chief executive can nominate the governing body of the NBE while the legislature should be empowered to confirm the nominees. It all contributes to the effective regulation of the banking system.

The government sees international banks as a threat to the banking system and considers them as beyond the current regulatory capacity of the NBE. Liberalization is a convoluted issue that needs a cautious approach. In Ethiopia, it is a thorny subject matter. The government of Ethiopia resisted liberalization arguing that domestic banking system is too fragile to be exposed to international competition. Neither is the capability of the NBE viable enough to regulate the banks and its staff lacks the necessary skill and expertise. Besides, foreign banks scramble for large clients instead of unbanked sector of the community. Therefore, hasty liberalization without a strong regulatory framework and sound macro-economic platform may lead to banking and economic crisis. That is why Ethiopia adopted a gradualism approach towards liberalization – a strategy of developing domestic financial system, its regulatory structure and the competence of the regulator before allowing foreign banks into the country.

However, Ethiopian economy and the general population needs affordable capital. The banking system would also benefit from competition and innovation. If governed effectively a liberalized banking system contributes to economic growth. The opposite is also true – as demonstrated by the Asia and Latin American countries. Liberalization should follow a well-built legal, supervisory and macro-economic platform.

The NBE, as banking regulator, is a victim to executive, as it does not have a legally stipulated operational independence. Hence, it is vital to reform the law and guarantee the operational autonomy of the NBE. In an endeavor to govern international banks effectively Basel Core Principles for Effective Banking Supervision stipulates principles of consolidated supervision. Consolidated supervision paves a way to cooperate with different countries regulators in order to effectively understand and regulate cross border banks. South Africa relies on consolidated supervision as a mechanism of controlling foreign bank subsidiaries or branches.

Before liberalization, Ethiopia should adopt a comprehensive law that allows the NBE to link up with foreign regulators and build cooperation to regulate foreign banks effectively. Consolidated supervision is indispensable as international banks are too sophisticated and dynamic. They can move or hide unscrupulous activities from jurisdiction to jurisdiction thereby affecting the health of banking system of different countries at a time. Hence, the cooperation of host and home countries is indispensable for effective governance of international banks.

The NBE also suffers from the lack of skilled human power. Building expertise and professional human power takes years and investment of resources. The Basel accords also stipulate the need to devote resources to bolster the staffing of the regulator with necessary skill and expertise. SARB in contrast is bestowed with necessary resources and it able to build very skilled professionals. The NBE should be legally allocated with the needed resources to build the skill and expertise of its staff before Ethiopia allows the investment of foreign banks.

Apart from strengthening the regulatory framework and building the consolidated supervision and enhancing the skill of the staff of the NBE, Ethiopia should also adopt measures that develop its macro-economic platform and introduce fiscal discipline to get rid of mounting debt. A strong macro-economic environment helps to contain financial instability.

While it is a wise policy direction to exercise the necessary caution before liberalization it is equally important to look for ways of aligning domestic situations with international reality to harness the potential of global financial empire. Hence, Ethiopia can use different arrangements such as joint venture where in domestic banks own the majority holding or management contracts. While allowing foreign banks through Greenfield investment can be challenging limiting the engagement of foreign banks to equity holding or business of management contracts or like arrangements would help to gain the necessary regulatory experience and to keep the potential crisis in check.

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