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**CORPORATE GOVERNANCE IN THE
ETHIOPIAN FINANCIAL SECTOR**

By Martha Kibru

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October, 2008

ADDIS ABABA UNIVERSITY
SCHOOL OF GRADUATE STUDIES

**CORPORATE GOVERNANCE IN THE
ETHIOPIAN FINANCIAL SECTOR**

By **Martha Kibru**

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Addis Ababa University in partial fulfillment of the
requirements for the Degree of Master of Science in
Economics (Economic Policy)

October, 2008

**ADDIS ABABA UNIVERSITY
SCHOOL OF GRADUATE STUDIES**

**“Corporate Governance in the Ethiopian Financial
Sector.”**

By

Martha Kibru Melese

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ACRONYMS

AGM:	Annual General Meeting
AIDB:	Agricultural and Industrial Development Bank, former DBE
CBB:	Construction and Business Bank
CBE:	Commercial Bank of Ethiopia
CEO:	Chief Executive Officer
CIPE:	Center for International Private Enterprise
DBE:	Development Bank of Ethiopia
EIC:	Ethiopian Insurance Corporation
ETB:	Ethiopian Birr
GDP:	Gross Domestic Product
GLS:	Generalized Least Squares
HSB:	Housings and Savings Bank, former CBB
MFI:	Micro-Finance Institution
NBE:	National Bank of Ethiopia
NGO:	Non-Governmental Organization
OECD:	Organization of Economic Co-operation & Development
PPESA:	Privatization and Public Enterprises Supervising Authority
ROA:	Returns on Asset
ROE:	Returns on Equity
SBB:	Supervision of Banking Business
3SLS:	Three Stage Least Squares



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Acronyms

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ABSTRACT

This study investigates the practices of corporate governance in the financial services sector of Ethiopia. The paper encompasses in-depth literature survey of corporate governance mechanisms focusing on Board of Directors as an internal control mechanism. The Ethiopian financial sector is studied in some detail and corporate governance practices in the sector are analyzed using primary data collected from all banks and insurances in Ethiopia. Furthermore, econometric evidence is provided by exploring eight commercial banks in Ethiopia for five years.

Specifically, this paper traces the relationship between firm performance and board characteristics applying 3SLS (the three-stage least squares) regression analysis on random effect model. The results found are similar to the previous findings. First, the result for board size supports the traditional view that higher performance is recorded for firms with relatively smaller board size. Secondly, the discussion of board composition does not show any beneficial effect of having female directors on the board. Thirdly, this study provides evidence consistent with the positive effect of frequent board meetings on firm performance. Fourthly, firms that have an internal auditor with direct access to the board perform relatively better. Lastly, the study finds that ownership type matters for performance; those commercial banks that are owned by shareholders score relatively better financial performance than government-owned commercial banks.

CHAPTER ONE



INTRODUCTION TO THE STUDY

1.1 Introduction

Corporate governance refers to governance pertaining to corporations. The word 'Governance' stems from a Latin word 'Gobernar', which means to steer or direct. It existed a long time ago and some say, "*It is an old concept in a new bottle*". Previously, it was used synonymously with government (Becht et al. 2002). People started articulating corporate governance in the late 80s and early 90s. The term governance has come to mean the process by which corporations are directed and controlled.

The original need for corporate governance stems from the separation of ownership and control often referred to as the '*principal-agent problem*'¹ (Jensen and Meckling, 1976), which is the key issue in corporate development. The principal-agent problem refers to how the shareholders -the 'principal'- can achieve efficiency, profitability and accountability while also permitting managers -the 'agent'- the necessary degree of autonomy to operate the cooperation in a competitive market environment. Investors/principals seek to invest their capital in profit-making firms so that they can enjoy these profits in the future. Yet many

¹ The *principals* are the investors who supply the capital while managers are the *agents* of the investors who run the company.

investors lack the time and expertise necessary to operate a firm and ensure that it provides an investment return. As a result, investors hire individuals with management expertise to run the company on a daily basis to see to it that the firm's activities enhance the company's profitability and long-term performance. A key drawback of this arrangement is that managers and/or directors are often not owners, and thus they will not bear the brunt in terms of lost investment and lost profits if the company fails to perform. As a result, managers and/or directors may take actions that hurt the value of shareholders' investment (Jean Tirole, 2001). They, for example, may not be as vigilant as they should in overseeing the internal operations of the company, they may take excessive risks when their position is endangered or take insufficient risk when their position is secure. Managers may also be tempted to steal from the company and such behavior obviously harms the performance and financial viability of the firm. This leads to the inference that, if such a corporate governance problem exists, some mechanisms are needed to control the resulting conflicts. The precise way in which those monitoring devices are set up and fulfill their role in a particular firm defines the nature and characteristics of that firm's corporate governance which can be external or internal mechanisms.

“Corporate Governance is concerned with holding the balance between economic and social goals, and between individual and communal goals with the aim to align as nearly as possible the interests of individuals, corporations and society”

Sir Adrien Cadbury, 1993

Various suggestions have been made in the literature as to how this basic principal-agent problem can be ameliorated (Abowd and Kaplan, 1999; Andrade et al, 2001; Hermalin and Weisbach, 2001; Jensen and Meckling, 1976; Jensen and Murphy, 1990; La Porta et al, 1998, 1999, 2000; Shleifer and Vishny, 1986; 1997). Instituting good corporate governance is one means to take care of this problem. It is believed that, good governance generates investor goodwill and confidence (Farinha, 2003). Recent research highlights the importance of corporate governance and suggests empirical relationships between governance and corporate performance. Results indicate that better corporate governance is associated with better performance and higher corporate valuation.

Agency problem is more pronounced in financial sector of developing countries like Ethiopia due to information barriers and other reasons (Levine, 1997). Thus, there is a need for proper corporate mechanisms, which requires an in-depth study of the governance practice in place.



1.2 Statement of the problem

Financial services, which include banking, insurance, microfinance and related services, play an important role for national development by steering the flow of resources within the economy. They are a critical part of any economy, and are particularly important in Ethiopia, employing thousands of people and contributing significantly to the GDP. So if Ethiopia's growth is to be sustained, effective financial system is a clear prerequisite. In practice, however, the Ethiopian financial sector continued to be characterized by shallowness of finance, limited accessibility and excess liquidity despite the various reforms and improvement mechanism in place. Recent studies that investigate the challenge and evaluate the progress of the Ethiopian financial sector identified *weak corporate governance practice* as one impediment and emphasize that good corporate governance practices in the financial sector is imperative if the sector is to effectively play a key role in the overall development of Ethiopia. Such findings complemented by the fact that agency problem is more pronounced in the financial sector makes the study of corporate governance mechanisms essential². This study is therefore, an in-depth analysis of governance practices in the Ethiopian financial sector.

² Agency problem is more pronounced since financial sector is highly characterized by information asymmetry (Arun, T.G. and Turner, J.D.(2004).

1.3 Objectives of the study

The core objective of this study is to review corporate governance in the Ethiopian financial sector. It analyzes the structure of the financial sector, board structure and the cultural and legal environment of corporate governance. It reviews initiatives and impediments for improving corporate governance.

Specifically, this research aims to examine the relationship between financial performance (as measured by profit and rates of return) on one hand and governance practices (such as board size, frequency of board meetings, board diversity in terms of gender as proxied by having female board of directors, internal directors with direct access of the board, and ownership type) on the other hand.

1.4 Knowledge gaps & scientific contribution of the study

Knowledge gaps

Despite the growing concern for corporate governance issue, only few studies examined the relationship between firm performance and corporate governance exploiting firm specific data, industry specific data and across-industry data. Firm specific studies offer a narrow view. Cross industry studies, on the other hand, do not fully exploit differences in industry characteristics that may affect the performance impact of governance practices. Elements like structure and conduct vary across industries and firms.

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Although the subject of corporate governance in developing economies has recently received a lot of attention in the literature (Oman, 2001; Goswami, 2001; Lin, 2001; Malherbe and Segal, 2001), the issue of corporate governance in Ethiopia has been almost ignored by researchers. In a country like Ethiopia where governance is a serious problem³, there are no studies yet that investigate governance practices. This research is meant to fill this knowledge gap. The limited number of academically based studies available and the lack of more comprehensive data set in Ethiopia and the fact that several governance mechanism remained unexplored indicates the need for this study.

Scientific contribution

This study contributes to the empirical research of corporate governance in the financial sector. It attempts to highlight several of the salient corporate governance issues which are relevant to financial sector of Ethiopia. This study aims to provide insights to various governance mechanisms and their relationship to firm financial performance using primary data collected from banks and insurances in the Ethiopian financial sector. Moreover, shareholders aspire to get the best value for their investments: any research that seeks to improve opportunities to exploit for enhanced performance or growth is a significant contribution for shareholders.

³ Scholars discussed the corporate governance problem in Ethiopia at a conference organized by the Ethiopian Chamber of Commerce (June 2008)

1.5 Methodology

This paper studies the governance practices in the financial sector of Ethiopia and attempts to trace the relationship between firm performance and governance practices. In the study of various governance mechanisms and their relevance to performance, I believe corporate governance needs to be disaggregated instead of being treated as gigantic whole. I will then concentrate, for reasons of brevity, in just the board characteristics and take into account the fact that various governance mechanisms might be dependent. For this purpose a mix of methodologies has been applied including:

- Review of existing data, annual reports, studies & policy documents.
- Primary data collected through survey questionnaire and interview conducted with senior executives and board members in all banks and insurances in Ethiopia.

This study includes an econometric analysis of governance practices and performance measures of firms in the Ethiopia financial sector based on data from eight commercial banks of Ethiopia for five years. A random effects model is used to analyze the panel data using the three-stage least square method of analysis.

1.6 Scope and Limitations

This study is only a preliminary step in investigating corporate governance in the Ethiopian financial sector based on both primary data

as well as secondary data collected from banks and insurance companies. There are several limitations that should be acknowledged in this study. Although, MFIs are important part of the Ethiopian financial sector, they are not included in the analysis due to data limitations. Furthermore, the econometric analysis is based on data on eight banks covering only five years due to data availability. The data set is also limited in scope: it focuses on few particular aspects of firm behavior, namely composition and characteristics of the board. However, while these are shortcomings in this study, they can be seen as fruitful avenues for future research under the same theme

The thesis is structured in six main parts, preceded by an introduction. Chapter two reviews the literature on corporate governance and gives the basic insights in the theory of corporate governance. This part is where I address a few fundamental questions regarding what corporate governance is, and the issues it is concerned with, in particular those affecting the financial sector. Chapter three discusses the Ethiopian financial sector in some detail and surveys the governance practices within the sector. Chapter four describes the methodology adopted throughout the study. Chapter five presents the analysis and findings. This paper ends with a concluding note on the implication of the findings and its contribution to knowledge with few pointers for future research.

CHAPTER TWO

LITERATURE REVIEW AND CONCEPTUAL FRAME WORK

This chapter attempts to provide a survey on the growing theoretical and empirical literature on the corporate governance problem. It begins with conceptual issues, followed by the theoretical part that discusses the nature and effects of the conflicts of interests between managers and other stakeholders (principal-agent problem) and the reasons for a governance system. The broad parameters of corporate governance are discussed from a theoretical perspective including the effectiveness of the set of available external and internal disciplining mechanisms. Finally, recent empirical studies are surveyed followed by the general developments in corporate governance.

2.1) CONCEPTUAL ISSUES

At the same time that developing countries are undergoing a process of economic growth and transformation, they are also experiencing a revolution in the business and political relationships that characterize their private and public sectors. In corporations, the shareholder delegates decision rights to the manager to act in the principal's best interests. This separation of ownership from control implies loss of effective control by shareholders over managerial decisions (Jensen, 1993). Partly as a result of this separation between the two



parties, a system of *corporate governance controls* is implemented to assist in aligning the incentives of managers with those of shareholders.

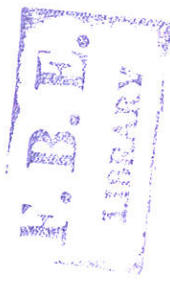
What is Corporate Governance?

In this section some definitions of corporate governance are suggested as a basis for improving the rigour of research and analysis. It may be useful to distinguish between narrow and broad conceptions of corporate governance. *The narrow approach* is about the mechanisms through which shareholders are assured that managers will act in their interest. The phrase corporate governance is often applied narrowly to questions about the structure and functioning of boards of directors or the rights and prerogatives of shareholders in boardroom decision making. *A broader view of corporate governance*, on the other hand refers to the recognition of corporate interest which is achieved only through a holistic approach to corporate governance (that is, taking into account the interests of all stakeholders⁴) rather than on an apartheid approach as in the past where focus was only on shareholders and their stewards. A broader view of corporate governance is one that refers to the whole set of legal, cultural, and institutional arrangements that determine what corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated (M., Blaire 1995).

⁴ To most international experts on the subject, corporate governance is interplay between companies, shareholders, creditors, capital markets, financial sector institutions and company law.

Corporate governance has been looked at and defined variedly by different scholars and practitioners.

- Corporate governance is the body of “rules of the game” by which companies are managed internally and supervised by boards of directors, in order to protect the interests and financial stake of shareholders who may be located thousands of miles away and far removed from the management of the firm (CIPE).
- The OECD defined corporate governance as a system on the basis of which business companies are directed and managed. It is upon this system that specifications are given for the division of competencies and responsibilities between individual included parties (such as the board of directors, the management and shareholders) and spells out the rules and procedures for making decisions on corporate affairs.
- Simply put, corporate governance system refers to the set of laws, institutions, practices, and regulations that determine how corporations will be run and in whose interest (Meginnson, 2005).
- John and Senbet (1998) propose the more comprehensive definition that “corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected”. They include as stakeholders not just shareholders, but also debt holders and even non-financial stakeholders such as employees, suppliers, customers, and other interested parties.



The numerous definitions all share, explicitly or implicitly, some common elements. They all refer to the existence of conflicts of interest, with an emphasis on those arising from the separation of ownership and control⁵, which is obviously the hallmark of the modern corporation. They also highlight the need to devise satisfactory solutions for the problem inherent in such separation rights recognizing the fact that notable strides have been made in aligning the interests of managers and owners, but by and large, problems persist. In short, corporate governance deals with the impact of the separation between ownership and control, as well as with solutions for the resulting agency problems. Therefore, linking definition with theory it is sensible to argue that the standard definition of corporate governance stems from the agency theory⁶.

There is a consensus that the broader view of corporate governance should be adopted in the case of financial institutions such as banking institutions due to the special nature of the institution and the peculiar contractual form which demands that the governance mechanism of banks should encapsulate depositors as well as shareholders (Shleifer and Vishny, 1997; Macey and O'Hara, 2001, Arun and Turner, 2002d). This study therefore adopts the broader view.

⁵ For agency theory & agency problem, see Coase, (1937); Jensen & Meckling, (1976)

⁶ It is important to note that there are other perspectives in corporate governance studies besides 'Agency Theory'.

2.2 THEORETICAL LITERATURE

Corporate governance is a way to alleviate or at least minimize the conflicts of interests among the stakeholders of a corporation. Specifically, Corporate governance is defined as "the determination of the broad uses to which organizational resources will be deployed and the resolution of conflicts among the myriad participants in organizations" (Daily et al., 2003). The various mechanisms of corporate governance that go towards such deployment of resources and resolution of conflict can be explained by multiple theories of corporate governance. But first, it is worth studying the theories behind those conflicts of interests, which led to the need for corporate governance.

2.2.1 Alternative perspectives in corporate governance

There are different approaches to corporate governance in literature. This study considers only two: one from the economic approach namely 'Agency Theory' and 'Stewardship Theory' from sociological and psychological approaches to governance.

a) Agency theory

Theoretical underpinnings for the extant research in corporate governance can be traced back to Adam Smith (Smith 1937). He describes a fundamental agency problem in modern firms where there is a separation of ownership and control as follows:



“The directors of such companies, however, being the managers of other people’s money than their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partner frequently watch over them...Negligence and profusion, therefore, must always prevail more or less, in the management of the affairs of such a company.”

Agency theory deals with the problem resulting from conflicts of interests arising from different subjective interests of contractual parties in the presence of asymmetric information. Initially agency theory was applied to the relationship between managers and equity holders with no explicit recognition of other stakeholders; it posits that in the presence of information asymmetry the agent is likely to pursue interests that may hurt the shareholder. Subsequently, the ‘*Stakeholder Theory*’⁷ was introduced, with a wider scope to include not just the equity holders but all other stakeholders that are interested in the well-being of the firm (John and Senbet, 1998; Jensen, 2001). With its roots in industrial and organizational economics, this approach attempts to align the interests of managers and all stakeholders and/or minimize the cost associated with agency problem.

⁷ The stakeholder view of a firm considers that investors, employees, suppliers, customers and stakeholders generally both contribute and receive benefits from a firm. In addition, other parties may be involved in relationships such as unions, trade associations, government and even political groups (Donaldson & Preston 1995).

This specific research is based on the microeconomic literature on governance conflicts between managers and shareholders, which is the major conflict analyzed in the context of corporate governance. A considerable number of studies have found evidence suggesting the prevalence and importance of *agency conflicts* between managers and owners associated with the horizon, risk differential, perquisite and shirking problems. These findings relate in particular to conflicts of interest over issues of compensation, diversification, investment, managerial behavior during takeovers and the adoption of anti-takeover devices. The theoretical motives for these agency problems are analyzed by Jensen and Meckling (1976), whose particular focus is the contract of an agency relationship between a principal (the external owner of the firm) and an agent (the owner-manager, or entrepreneur). They described problems related to managers such as shirking. A further problem is associated with managers having a different horizon than shareholders. This is because while firms have an indefinite life, and thus its shareholders are concerned with an infinite stream of cash-flows, managers' horizon is usually limited to the cash-flows received during employment. This problem is naturally aggravated as managers approach retirement. An additional source of conflict between agents and principals is related to different risk preferences.



b) Stewardship theory

Although Agency Theory is the dominant perspective in corporate governance studies, "*Stewardship Theory*" is proposed as an alternative perspective to Agency Theory. Stewardship theorists assume that managers are good stewards of the firms. They are trustworthy and work diligently to attain high corporate profit and shareholders' returns (Donaldson & Davis 1994). These stewards can cooperate and work closely with the principal to achieve a "goal alignment" (Davis et al.1997). In contrast to the agency theory where managers act as agents, in stewardship theory managers act as stewards (Davis &Donaldson, 1997).

The sociological and psychological approaches to governance such as the stewardship theory are depicted by collective, pro-organizational, trustworthy behavior. In contrast, the economic approaches to governance such as agency theory tend to depict subordinates as individualistic, opportunistic, and self-serving. As a result the manager's and principals interests diverge.

This study is based on the theoretical framework of "*Agency Theory*", which assumes that human behavior is opportunistic and self-serving. To protect shareholder interest, minimize agency costs and ensure agent-principal interest alignment agency theorists prescribe various governance mechanisms.

The Need for Corporate Governance

There is a global consensus on the need for corporate governance. Corporations need to be governed in order to mitigate the agency problem that may arise between different stakeholders due to conflicts of interests or information asymmetries. In the age of globalization corporate governance determines the fate of individual companies as well as entire economies. Instituting corporate governance is not only a means to survive in today's world, it is strategy to prosper! In theory, good governance is related to high corporate valuation. The literature shows that good governance generally pays for firms, for markets, and for countries (CIPE). Investors seek out companies that have sound corporate governance structures. Corporations must act in a democratic and transparent manner so that their owners can effectively judge whether their interests are being served and make educated decisions about their investments. This is what corporate governance is all about. The Center for International Private Enterprise (CIPE) notes that;

Good corporate governance systems allows organizations to realize their maximum productivity and efficiency, minimize corruption and abuse of power, and provide a system of managerial accountability especially in case of most developing countries as they move from closed, market-unfriendly, undemocratic systems towards open, market-friendly, democratic systems.

What is often overlooked is that corporate governance is just as important for public sector firms as for private sector companies. Instituting corporate governance within public sector firms has recently begun to receive increased attention. The Center for Private Enterprise (CIPE) indicated that this is particularly the case when countries are attempting to curb widespread corruption within the public sector, or when they are preparing public enterprises for privatization. In either scenario, sound corporate governance measures help to ensure that the public gets a fair return on their national assets. I believe this makes the corporate governance issue relevant to Ethiopia. Before investigating corporate governance in Ethiopia, we need to explore the various corporate governance models around the world.

2.2.2 Models of Corporate Governance

There are many different models of corporate governance around the world depending on the variety of capitalism in which they are embedded. The most notorious model of corporate governance of US, the intricate shareholding structures of keiretsus in Japan, the heavy presence of banks in the equity of German firms and many others are examples (Ooghe, H. and Vuyst, De V., 1997).

a) Anglo-American model

The modern *Anglo-American* corporation has evolved from peculiar English forms of doing business. The primary participants in this model of corporate governance are the shareholders/owners, the board of directors/supervisors and the officers/management. Unlike other models, in this model, stakeholders other than shareholders (suppliers, customers, community and environmental concerns...) play a relatively moderate role; it tends to give priority to the interests of shareholders. It is generally referred to as the “*shareholder approach*”: owners of the firm control the firm. It is also known as the “*outsider mode*”. It is based on widespread shareholding with major contributions by institutional investors and an active takeover markets (Van den Berghe and De Ridder, 1999). This model is characterized by dispersed ownership implying the need for legal protection. Accountability to the community is enforced through external legal constraints imposed on management through a well-developed legal and regulatory system.

Stephen et al. (1996) puts the US and UK predominantly market based models of corporate governance under the Anglo-American Model. In these countries, a corporation is governed by a Board of Directors, which is nominally selected by and responsible to the shareholders. The board is often referred to as a model based on “outside” control since shareholders are numerous or passive institutional investors with little day-to-day interest in the cooperation. In other words, independent

directors on the board and a non-hierarchical board construct are the norm. This model is characterized by “*one-tier board system*”⁸ which has the advantage that the common responsibility of its members for management and control provides much more flexibility for board organization, as well as ensuring that the necessary information will be available to all its members. But it lacks independence of control with board members too often dependent on the CEO.

b) Non Anglo-American model

In contrast to the Anglo-American model, this model follows what is known as the ‘*stakeholder approach*’. It is an ‘*insider control*’ system with a clear stakeholder orientation, based on concentrated shareholding with relatively limited contribution from institutional investors. In this insider model few large stakeholders supervise the firm. It encourages competition as well as cooperation through a complex institutional system of ownership and governance. This model is present in continental Europe and Japan, where managers have big say in the control of the firm. It encompasses the German and the Japan models of corporate governance.



⁸ A *unitary board* doesn't distinguish between supervision and policy execution unlike the *dual system* where the management tasks are clearly separated from the governance and supervision tasks; there is a separate management board and a separate supervisory board.

The *German Model* is also referred to as '*bank-based system*'. Companies, banks and governments own a large percentage of the share in Germany corporations. As the name implies, the main bank provides a significance share of finance and governance to each firm unlike the Anglo-American model where finance is provided by large number of investors and takeovers play a key governance role. This model is superior in a sense that far-sighted banks enable firms to focus on long term investment decisions, banks deliver capital to firms facing liquidity shortfall, thereby avoiding costly financial distress. It replaces the expensive and disruptive takeovers with more surgical bank intervention when the management of the borrowing firm underperforms. Schmidt (2003) studied the German corporate governance system from an economic perspective and found that governance is exercised by a coalition of active stakeholder groups. Germany has the most inclusive representation with its "two-tiered board system"⁹, which includes strong labor representation. The board consists of the supervisory board and the management board whereby the supervisory board, elected by shareholders and labor, controls the management not only on behalf of the shareholders, but also protects the public interest. Thus, from the perspective of stakeholders, the two-tier model is a precondition for stakeholder representation and especially for codetermination.

⁹ See under the next section (2.2.3):- two-tier/dual board system

The *Japanese Model* of Corporate Governance is another Non Anglo-American model. Unlike other systems that rely on clear legal and regulatory monitoring with different degrees, this system provides for a somewhat less transparent, but generally effective, monitoring of management through financial intermediary (Ooghe et al. 1997). Residual control of the Japanese corporation lies with its owners, the shareowners, a large part of which is composed by financial institutions. The formal mechanisms of Japanese corporate governance afford only modest opportunity for shareholders to influence day-to-day corporate operations. Banks have a combined role of shareholder, trustee and business partner in Japanese corporations. Because of their vast lending and business experience, banks and other financial institutions are well positioned to take a lead in enterprise governance. The Japanese model is quite unique in the sense that banks and financial institutions have substantial holdings of debt and equity in these corporations. The mode of the operation of the board is hierarchical. The boards are generally larger in number than those in the USA. The board is composed primarily of insiders and a few outsiders. This makes it more likely that the loyalty of board members will lie with the employees rather than the shareholders.

Table 2.1 Corporate governance models

	Anglo-American (US, UK)	Non Anglo-American (German, Japan)
Type	Shareholders' model Market-based, liberal	Stakeholders' model Bank-based, coordinated
Board System	Outsider control One-tier/unitary	Insider control Two-tier
Shareholding structure	Widespread	Concentrated

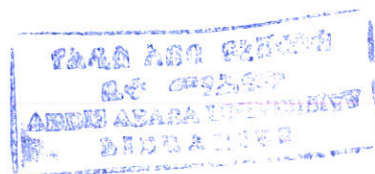
Source: Author

Few researchers made a comparative study of corporate governance systems across countries and recognized that both models have distinct competitive advantages, but in different ways (Levine, 2002; Ooghe and Vuyst, 1997). In his assessment of competing theoretical views of financial structure; Levine suggests that *bank-based systems* do a better job than market-based financial system at mobilizing savings, allocating capital and exerting corporate control particularly at early stages of economic development and in weak institutional settings. In contrast, the *market-based view* emphasizes that markets provide key financial services that stimulate innovation and long-run growth. Ooghe and Vuyst investigate the “*Coordinated Model*” and “*Liberal Model*” finds that the liberal model of corporate governance encourages radical innovation and cost competition, whereas the coordinated model of corporate governance facilitates incremental innovation and quality competition.

The non Anglo-American model, specifically the German model has attracted considerable interest because it is thought to address corporate governance problems more effectively than the Anglo-American model. The German model of corporate governance with its concentrated shareholdings and strong presence of banks has been advocated as a model for developing countries, where financial markets can not be expected to play an important role in the financing of corporations.

The need for flexible corporate governance mechanism

Despite the globalization of the economy, many differences still exist between countries, both in terms of corporate environment and cultural patterns. The circumstances surrounding each corporation are different and changing implying the need for flexible corporate governance mechanism. 'Corporate governance' still remains an ambiguous and misunderstood phrase. There is no unique structure of 'corporate governance'; nor is one particular type unambiguously better than others. Every country needs to implement effective corporate governance systems tailored to their local realities. There is a need to promote corporate governance in developing countries by designing models for local realities and challenges instead of adopting international models to local conditions (CIPE).



The existence of the several corporate governance models is because they operate in different business contexts. These different models of corporate governance allow implanting countries to choose from among the different features of different models that suit their economic set up best. There are a number of models of corporate governance that are followed in different parts of the world today. Each model has its own unique set of characteristics that suit the dynamics of the countries where it originated. Other countries and territories emulate these models and adopt the ones that might fit best with their socio-economic conditions (Classens et al., 2000).

There is no single universal model of corporate governance but that the issues of governance vary from country to county depending on the level of development of capital markets, legal institutions, ownership structures, existing rules, codes and laws, receptiveness of masses to change, and culture (CIPE, 2002).

2.2.3 Corporate Governance Mechanisms

Jensen and Meckling (1976) pointed out that residual agency costs are significant and that mechanisms for controlling the dimension of these agency costs are available and include external and internal disciplining devices. Effective corporate governance system relies on a combination of internal and external controls (CIPE, 2002). Firms may

choose different mixes of monitoring mechanisms according to their own specific characteristics. Let's proceed by looking at a number of external and internal disciplining mechanisms that firms may face in their efforts to reduce the underlying agency costs, their limitations and applicability to individual firms.

a) External control mechanisms

External disciplining devices include the managerial labor market, mutual monitoring by managers, takeover threat, reputation, regulation, competition in product and factor markets and financial analysts. It was observed that due to important theoretical and practical limitations, these external-disciplining devices couldn't alone solve the corporate governance problem, although they may be important in some particular circumstances. Firms therefore have to adopt complementary internal disciplining devices in order to minimize their total agency costs.

b) Internal control mechanisms

Internal corporate governance mechanisms are arrangements within a corporation that define the relationship between managers, shareholders, boards of directors, and stakeholders. Such mechanisms monitor activities and then take corrective action to accomplish organizational goals. The importance of internal governance mechanisms is recognized in literature (Fama & Jensen, 1983; Hermalin et al., 2003). These mechanisms are made by choice and are called internal

accordingly. They include ownership type, the functions of the CEO and the board, the composition of the board of directors, compensation packages, financial policies (dividends and debt), etc.

This paper makes an attempt to review extensively the literature and empirical research addressing corporate governance and corporate performance, and the roles and effectiveness of various governance institutions and mechanisms, in particular the board of directors. Corporate governance research and organizational studies increasingly recognize that boards of directors have a central role in reducing agency problems, and the board structure and characteristics may influence strategic choices (Zahra and Pearce, 1989). So here it will be fruitful to frame the discussion around aspects of management that the board is supposed to monitor and control, and around factors that can impair the board's ability to discharge these responsibilities.

Board of Directors

By law a corporation must have a board of directors elected by its shareholders who have a fiduciary duty to the shareholders (OECD). The fiduciary/legal duties of board members are now being delineated and clarified by law and are enforceable. While management runs the company and undertakes day-to-day affairs of the cooperation, it is the board of directors that "governs" the corporations by overseeing management and representing the interest of the firms' shareholders.

The board's function is not to run the enterprise or even to instruct the CEO in how to run it, rather they should concern themselves only with policy matters and they should operate under the motto, "*as little intervention as possible, as much intervention as necessary*" (Dr Zewde Shibre, 1997)¹⁰. The board of directors often plays a key role in corporate governance. The role and fiduciary duties of the board has been the central theme in the corporate governance literature from its inception. Internationally recognized package of tasks of boards comprises the following (OECD):

- Boards manage the cooperation on behalf of the shareholders and through them shareholders exercise their interests.
- They are expected to assume a primary responsibility of fostering the long-term business of the organization consistent with their fiduciary responsibility to shareholders. It is their responsibility to endorse the organization's strategy.
- They perform a balanced and understandable assessment of the financial position of the company.
- They ensure that effective risk management systems are in place.
- They appoint, supervise and remunerate senior executives.
- They ensure accountability of the organization to its owners and authorities.

¹⁰ Taken from proceedings of a conference organized by Association of Management Professionals

- Ratification of management decisions and the monitoring of management performance. Effective monitoring and service roles are usually a function of structural factors like the proportion of independent directors on the board, CEO/Chairman roles held jointly or separately, etc. (Daily et al., 1999; Zahra and Pearce, 1989; Young et al., 2001).

International codes of corporate governance note that directors shall perform their duties fairly, with prudence and faithfulness, in the best interest of the corporation and its shareholders. According to the OECD, the board should have a core group of excellent, professionally acclaimed directors who understand their dual role: of appreciating the issues put forward by management, and of honestly discharging their fiduciary responsibilities towards the company's shareholders as well as creditors. King (2008)¹¹ considers the board as the '*heart, mind and soul of the absolutely incapacitated entity*'. This means that the board of directors, which has the duty of taking care of an entity should act in the best interest of the institution. King emphasized '*Intellectual honesty and loyalty*' as the foundation of good corporate governance. He starts by explaining that intellectual energy is created when people sit around a table to make decisions and better business judgment calls are made whenever the board members make rational decisions based on facts.

¹¹ Mervyn King, a former judge, who published the first report of South African corporate governance guidelines gave a speech at a conference organized by the Ethiopian Chamber of Commerce (June 2008).



There are different board structures, which are optimal for different firms. A board structure and its mode of operation should be selected in light of prevailing socioeconomic condition and specific characteristics of an organization.

- **The one-tier/unitary board system:** refers to the case where board of directors includes both *inside-active directors*¹² and *external non-active directors* (Baysinger and Butler, 1985). Here the division between policy and governance is not always clear. The different functions of the CEO and the chairman of the board are usually exercised by one and the same person. This raises a problem and therefore demand is increasingly being heard for the division of tasks of chairman of the board and of CEO (who manages day-to-day policy). This system is internationally the most prevalent due to its advantages of the higher level of independence it gives to the board of directors, the more attention paid to the interests of the shareholders, power concentration is discouraged and more effective board of directors are produced.
- **The two-tier or dual governance system** has two individual boards-*management board* and *supervisory board*; the former is responsible for day-to-day policy which is composed exclusively of executives and the latter is made up of exclusively of non-active directors, whose functions are largely limited to that of oversight

¹² Inside or active directors also fulfill management functions within the company.

and review. Their main role is to appoint and remove the management board's members, elect its president, and set compensation. The management tasks are clearly separated from the governance and supervision tasks (Van den Berghe and De Ridder, 1999). It is a hierarchically partitioned group (into two), operating relatively independently, and responsibly of the management of the organization's functions at different levels. An example of 'two-tiered board system' is found in Germany. Members of a supervisory board are not allowed to be members of the management board. In practice, however, the supervisory board is dependent on the management board. This is because firstly, the supervisory board collects the necessary information from the management board-the body which it should control. Secondly, former member of the management board often become ordinary members or even president of the supervisory board.

2.3 EMPIRICAL LITERATURE

Corporate governance and firm performance

Corporate governance affects the whole organization and its stakeholders. The question is does it affect economic performance? The point of departure for this study is that corporate governance influences performance as suggested by recent research that highlights the importance of corporate governance in developed and emerging markets

and suggests empirical relationships between governance and corporate performance. Results indicate that better corporate governance is associated with better performance and higher corporate valuation. Researchers studied the impact of various governance mechanisms on firm valuation exploiting data on specific firms, across firms in an industry and across industries.

From firm-specific studies, Mersland and Strom (2007) trace the relationship between firm performance and corporate governance in MFIs utilizing a comparatively large and unique self constructed global panel data set on rated MFIs collected from a third-party collecting agencies. The data includes 226 MFIs spanning 57 countries for four consecutive years. They study how various internal and external governance mechanisms (board characteristics, ownership types, competition and regulation) influence different dimensions of financial performance and outreach using the Three-Stage Least Squares method of analysis. They found out split roles of CEO and chairman, a female CEO, and competition are important explanations. Also Hartarska (2005) investigates the relationship between firm performance and governance mechanisms (board characteristics, CEO compensation, and ownership type) utilizing three surveys of rated and unrated East European MFIs in the period 1998-2002 and found that a more independent board has better ROA, but a board with employee directors gives lower firm performance. All firm-specific studies however offer a narrow view.

On the other hand, few researchers study corporate governance of different types of firms together. A study by Sanda, Mikailu, and Garba, (2005) includes a sample of 93 different firms quoted on the Nigerian Stock Exchange over the period 1996–1999. Using pooled ordinary least squares regression, their result shows that firms run by expatriate CEOs tend to achieve higher levels of performance than those run by indigenous CEOs. The results also argue for the separation of the posts of Chief Executive Officer (CEO) and Chair. Another recent study by Tang (2007) examines the significance of corporate governance mechanisms using a sample of 117 non-financial Japanese firms listed on the Tokyo Stock Exchange over the period 1989-2001. Using a different econometric approach from that of previous studies, the relationship between board composition and firm performance is examined with a simultaneous framework of equations in order to tackle potential endogeneity problems between board composition, governance and performance variables. The results show a significantly negative relationship between turnover of members of the board of directors and firm performance; board size reduction is significant, but there is no evidence of consistent relationship between outside directorship and firm performance. Studies that exploit data from across firms and industry have a limitation in that they don't fully exploit differences across firms and industries.

In general, researchers have documented relationships between corporate governance frameworks on the one hand and performance valuation on the other hand. The suggested explanation by empirical studies is that good governance is a signal of lower agency cost. Therefore, they conclude that establishing good corporate governance practices is essential to sustaining long-term development.

Many studies attempt to study corporate governance on an integrated and overall basis and try to relate various internal and external mechanisms with firm performance. Other researchers believe that it is better to disaggregate it and scrutinize specific governance mechanism such as corporate boards (Zahra and Pearce, 1989). Researchers have developed new theory, methods, and data sources, including surveys of board members that have helped create a more detailed and integrative understanding of board composition, practices, processes, and performance. For those board characteristics that have been studied few governance practices are identified to lead to more effective firm performance. A number of studies try to link board characteristics directly to firm performance. Melvin D. Ayogu (2001) reviewed the institutional record of corporate governance in Africa with the underlying thesis of '*a crisis of governance is basically a crisis of board of directors*' and offered some policy directions for improving performance. The key to good corporate governance is a well functioning, informed board of directors. The international evidence on the role of

boards in corporate governance and their impact on corporate performance is sketchy. Some of the solutions proposed to help reduce the agency problem are related to the structure and composition of the board that includes:

i) Board size

Recent thinking has leaned towards smaller boards as supported by empirical research, as too big a board is less effective, harder to coordinate and discuss and process problems (Jensen, 1993 and Lipton & Lorsch; 1992). Moreover, smaller boards also reduce the possibility of free riding by, and increase the accountability of, individual directors. The arguments in favor of small board size include Yermack (1996) and Eisenberg et al. (1998). In a review of the earlier work of Monks and Minow (1995), Yermack argues that large boardrooms tend to be slow in making decisions, and hence can be an obstacle to change. He examines the relation between board size and firm performance, concluding that the smaller the board size the better the performance, and proposing an optimal board size of ten or fewer. John and Senbet (1998) summarize an empirical study by Yermack (1996) on board size. The main findings are that, the market penalizes large boards. Hartarska (2005) adds the same negative impact of larger boards for MFIs.

On the other hand, there is a view that larger boards are better for corporate performance because they have a range of expertise to help make better decisions, and are harder for a powerful CEO to dominate. Adams and Mehran (2003) found supporting evidence for banks in the USA: larger boards improve performance as measured by Tobin's Q. Perhaps, this is a good justification for differences across industries.

ii) Outside directors / board independence

On the basis of member composition boards can be classified into '*Inside Boards*' and '*Outside Boards*'. Inside Boards includes mostly the company's executives, employees of or directors that are affiliated with the firm. They are more familiar with the firm's activities, well informed about internal operations and are usually available for discussion. However, they lack independence since they are immersed in day-to-day operations with their colleagues. On the other hand, outside directors have an independent and objective judgment. But, they lack the time and intimate knowledge of the company's operation. No clear conclusion is reached whether directors should be insiders or outsiders. Empirical research results are mixed; some argue for more outside directors. Hermalin and Weisbach (1991) found positive relationship between firm performance and the proportion of outside directors sitting on the board. They said outside directors are better able to challenge the CEOs unlike inside directors. Fama and Jensen (1983), who identified board

composition as relevant source of monitoring, found evidence that the proportion of outside directors affects future firm performance. Consistent with the importance of external directors as monitors, Rosenstein and Wyatt (1990) report abnormal increases in firm value after the appointment of additional outside directors.

A common theme in most recent studies is an agency-theory perspective that seeks to strengthen the role of the board as the representative of the company's shareholders by increasing independence of directors. Researchers argue that independent board members tend to disclose information openly and equitably, assess managerial performance objectively, and to protect shareholders' rights vigorously. Brickley et al (1994) discusses the governance impact of alternative board composition by examining whether boards with a higher percentage of independent members from outside the firm are associated with greater valuation. Similarly, Xie et al. (2002) tests the effect of independent boards of directors in preventing the manipulation of earnings statements. Results suggest that independent board and audit members, especially those with appropriate areas of expertise, effectively lower the discretionary current accruals showing in corporate financial reports. Fan, P. (2004) documents a positive relationship between presence of independent directors and firm performance in his study of boards of the largest firms in China.



iii) CEO-chairperson duality

Researchers find mixed evidence on the issue of whether CEO and chairman positions should be held by one person. Faleye (2003) argues that no "one hat fits all" and board leadership structure should depend on individual firm characteristics such as organizational complexity, availability of alternate governance mechanisms, and CEO reputation and power. Financial economists have paid considerable attention to the role of boards in monitoring managers and in removing non-performing CEOs. With respect to this, Jensen (1993) voices his concern that a lack of independent leadership makes it difficult for boards to respond to failure in top management team. Fama & Jensen (1983) also argue that concentration of decision management and decision control in one individual reduces board's effectiveness in monitoring top management. Independent boards are considered better able to monitor the CEO on the behalf of the owners. Relating CEO duality more specifically to firm performance, researchers however find mixed evidence. Daily & Dalton (1992) found no relationship between CEO duality and performance in entrepreneurial firms. Brickley et al. (1994) also indicated that CEO duality is not associated with inferior performance; he did not find that firms with a CEO-chairman split outperformed those with a CEO-chairman duality. On the other hand, a study by John and Senbet (1998) found that the market rewards the separation, within the same company, of the positions of CEO and Chairperson of the Board.

In financial sector, the board is supposed to be better aligned if the CEO and chairman are different persons. Hermalin and Weisbach (1991, 1998) believe that a CEO-Chairman duality may be a sign of CEO entrenchment (i.e. the opposite of independence) since then the CEO may pursue policies that give him private benefits.

iv) Multiple board appointments

There are cases where directors serve for more than one board at the same time. The issue of multiple board appointments attracts considerable debate. Some shareholder activists criticize multiple board appointments because directors who hold such appointments are ineffective in discharging their function to monitor managers. Empirical research to date however find no or weak evidence that multiple directors shirk their responsibilities and that multiple directorships and poor regulatory compliance in firms are related. But obviously, it will not be fair for directors with full-time jobs to serve on more than two or three other boards since they may not have time for regular board meetings.

There is, however, another case known as '*Interlocking Directorates*', which occurs when a person from one organization sits on the board of directors of another company. In other words, it is when current senior managers and/or directors of two companies simultaneously serve on each other's boards for reason of resource dependence whereby directors could exchange resources, e.g. capital,

industry information, and market access to reduce environmental uncertainty faced by firms so as to enhance firm performance (Fan, 2004). A recent empirical case study in Singapore (Phan et al. 2003) shows positive relationship between interlocks and firm performance for only inter-industry case.

v) Board Meetings

The board must meet regularly to carry out its function. In addition to these ordinary meetings, there are also special meetings. The frequency of meeting varies depending on different characteristics of the board and the company. The board must meet as frequently as necessary for the directors to discharge their duties. Some empirical evidence shows that meeting frequency is an important dimension of an effective board. Lipton & Lorsch (1992) find that the most widely shared problem directors face is lack of time to carry out their duties, and that board meeting time is an important resource in improving the effectiveness of a board. The contents and quality of board meetings, is the other important if not the most important dimension of an effective board. Monks and Minow (2001) noted that for efficient use of the board's time, the directors should receive sufficient information for the meeting in advance. Moreover, they also suggest working through committees such as Audit, Operation and Remuneration Committees. The number of members in a committee has to be large enough to provide the

managerial capabilities required but compact enough to function as a reasonably efficient committee. Working through committees raises the issue of “board room culture” which in turn brings into the analysis, the role of tradition, expectations, perceptions and morality. However, this area remains largely under-researched, probably due to the absence of reliable data.

vi) Board diversity

With globalization and technology advances bringing about diversity in clients, operations and market competitions; board diversity in terms of gender, races, nationality (local or foreign) of directors and their background, expertise and experience have recently attracted increasing interest in research. In very recent times, researchers began to look at how board diversity might enhance corporate governance and firm performance (Fields & Keys 2003). Some empirical research finds that board diversity is positively correlated with firm value: Carter et al. (2003) find significant evidence of a positive relationship between board diversity, proxied by the percentage of women and/or minority races on boards of directors, and firm value. Empirical studies on the relationship between board diversity and firm performance remain sparse to date.

vii) Board Activism

The determinants of corporate performance (strategic, managerial and organizational) are complex and interrelated, and in the last decade other determinants may have canceled the positive effect of board activism. A test for “active governance” is required, recent empirical tests indicates that such behavior generates improved corporate performance. There is little doubt that an active board aligned with shareholder interests would attempt to enhance value to shareholders. However, it is unrealistic to think that singular changes in board structure alone, without accompanying new activist behavior, would affect corporate performance. Empirical research demonstrates a substantial and statistically significant correlation between an active, independent board and superior corporate performance.

All in all, a brief review of literature clearly suggests that there are significant potential benefits that can be realized from good governance such as effective board. These benefits may be reflected in the greater efficiency and productivity of financial institutions as well as other sectors. The higher is the score on different dimensions of board’s characteristics the better is financial. However, there is a need to identify the effect of other determinants as well and attempt to control for them given that board performance is not the sole determinant of economic performance.

This study focuses on the financial sector and this is an important issue given the essential role financial sector plays as an engine of economic growth. The next paragraph argues that financial sector is unique in nature; it requires the adoption of a broad view of corporate governance, which encapsulates all stakeholders. Moreover, the nature of the sector is such that regulation is necessary to protect the stakeholders. Using this insight, the financial sector in Ethiopia will then be examined in the next chapter.

The Special Nature of the Financial Sector

The financial sector is believed to play a crucial role in economic growth. In recent years, the policy advice and technical support of the World Bank and other international financial institutions were/are motivated by the view that *stable, efficient and competitive financial systems are necessary for growth and development in a market oriented economy* (World Bank, 1989). Among the main factors that support the stability of any country's financial system include:

- good corporate governance,
- strong prudential regulation and supervision,
- accurate and reliable accounting in financial reporting systems,
- sound disclosure regimes,
- enforcement of effective laws.

Contemporary researchers believe that sound corporate governance is particularly important for financial institutions due to reasons like the rapid changes brought about by globalization, deregulation and technological advances which are increasing the risks in financial systems. Moreover, unlike other companies most of the funds used by financial institutions such as banks to conduct their business belong to their creditors, in particular to their depositors. Linked to this is the fact that the failure of a bank affects not only its own stakeholders, but may have a systemic impact on the stability of other banks. All the more reason therefore to try to ensure that financial institutions are properly managed.

Levine (1997) emphasizes the importance of corporate governance of financial institutions such as banks in developing economies since they have an overwhelmingly dominant position in developing-economy financial systems, and are extremely important engines of economic growth. Furthermore, the fact that many developing economies have recently liberalized their financial systems makes managers of their financial institutions obtain greater freedom in how they run their institution.

Researchers observed that governance in financial institution is a considerably more complex issue than in other sectors. In addition to the requirement to comply with the similar codes of good governance as other companies, in case of financial institutions factors like risk



management, capital adequacy and funding, internal control and compliance all have an impact on their matrix of governance.

The financial sector is unique for different reasons. It is highly characterized by *information asymmetry* and therefore *agency problem* is more pronounced. In their discourse on concepts and international observations on corporate governance of banks, Arun and Turner (2004) argue that the *opaqueness* of the banking industry along with *pervasive government regulations* severely limits effective corporate governance of banks. They observe that banks are particularly opaque (informational barriers) and hence it is very difficult for outsiders to monitor and evaluate bank managers. This opaqueness makes it more difficult for diffuse equity and debt holders to write and enforce effective incentive contracts, to use their voting rights as a vehicle for influencing firm decisions, or to constrain managerial discretion through debt covenants. They argue further that government regulations frequently exacerbate corporate control problems in banks. Moreover, they discuss that governments themselves are frequently the biggest problem as government regulators and supervisors typically have their own agendas that do not coincide with maximizing bank value. Governments therefore, may directly hurt bank performance and stability by imposing their own preference on bank managers.

Many argue that the special nature of the financial sector, specifically banking, implies that it is more appropriate to adopt the broader view of corporate governance, which views the subject as the method by which suppliers of finance control managers in order to insure that their capital cannot be expropriated and that they earn a return on their investment (Shleifer & Vishny, 1997; Vives, 2000; Oman, 2001). Notably, Macey and O'Hara (2001) argue that a broader view of corporate governance should be adopted in the case of banking institutions, arguing that because of the peculiar contractual form of banking; corporate governance mechanisms of banks should encapsulate depositors as well as shareholders.

CHAPTER THREE

THE ETHIOPIAN FINANCIAL SECTOR

Financial services play an important role for national development by steering the flow of resources within the economy. Ethiopia has a wide range of informal, semiformal and formal financial sectors providing financial services. The formal financial sector of Ethiopia mainly consists of the banking system, insurance companies and microfinance institutions (MFIs). Table 3.1 below shows that the financial sector in Ethiopia, as in most developing countries, is dominated by the banking sector in terms of both asset and capital. The banking sector accounts for about 86 percent of the capital and 96 percent of the asset of the financial sector. Although MFI is growing, it holds only 9.6 percent of the capital and three percent of the financial sector asset.

Table 3.1 Relative Importance of Banking, Insurance & MFIs (In million birr)

	2006/07				2007/08		% change in Capital
	Asset	% share	Capital	% share	Capital	% share	
Banking	80437	96.07	9258	87	11395	86.4	23.1
Insurance	1761	0.69	576.2	5.4	524.9	4.0	(8.9)
Microfinance	2551	3.24	817.3	7.8	1263.8	9.6	54.6
Total Financial services	84749	100	10651.5	100	13183.7	100	23.8

Source: National Bank of Ethiopia

There are 11 banks (excluding, NBE), 9 insurances and 29 MFIs currently in operation in Ethiopia (see Table 3.2). In terms of ownership, only three of the banks and one insurance company are state-owned. The government owned banks and insurances have been in operation for a long time while the private banks and insurances have been in operation for only a decade. The banking sector encompasses development bank, cooperative bank and commercial banks. The services offered by the banks include deposit mobilization; deployment of deposit resources to needy and viable economic sectors in the form of loans, foreign exchange dealings, money transfers, etc. Insurances, on the other hand offer long term insurance coverage and general non-life insurances such as property, pecuniary, and liability insurances.

Table 3.2 The Evolution of Financial Institutions in Ethiopia

<i>INSTITUTIONS</i>	<i>1999/00</i>	<i>2000/01</i>	<i>2001/02</i>	<i>2002/03</i>	<i>2003/04</i>	<i>2004/05</i>	<i>2005/06</i>	<i>2006/07</i>	<i>2007/08</i>
Commercial banks	8	8	8	8	9	9	10	10	10
Privately owned	7	7	7	7	6	7	8	8	8
Branches	267	283	295	339	326	357	389	455	576
Insurance Companies	9	9	9	9	9	9	9	9	10
Privately owned	8	8	8	8	8	8	8	8	9
Branches	91	95	101	105	121	133	139	146	170
Development Banks	1	1	1	1	1	1	1	1	1
Branches	32	32	32	32	32	32	32	32	32
MFIs	16	19	21	22	22	26	27	28	29

Source: National Bank of Ethiopia



3.1 Banking in Ethiopia

Banking was unknown until the 20th century in Ethiopia because, the economy remained non-monetized until Addis Ababa became the capital city of the country. Formal banking commenced when the *Bank of Abyssinia* was established in 1906, which operated more like a central bank. Despite its monopolistic position, the Bank earned no profit until 1914 due to the cost of establishment, marketing and general administration; it earned profits thereafter. The bank offered a limited range of services, and operated inefficiently. It was liquidated and replaced by the *Bank of Ethiopia* in 1931. The bank took over the commercial operations of the Bank of Abyssinia and maintained its branch network until Italians invaded the country 1935, after which several *Italian banks* established branches in the main towns of Ethiopia. Almost all branches, however, ceased to operate following liberation of the country. Another foreign bank, *Barclays Bank*, came to Ethiopia with the British troops in 1941, but it shortly withdrew in 1943. In 1943 the *State Bank of Ethiopia* commenced operation, acting as a central bank; it also acted as the principal commercial bank in the country and engaged in all commercial banking activities. In 1951 the *Development Bank of Ethiopia (DBE)* was established by the Imperial Charter.

The Ethiopian government enacted a Monetary and Banking Proclamation and a Charter on the NBE in 1963 that separated the central and commercial banking functions of the Bank of Ethiopia thereafter; the Bank of Ethiopia was dissolved and *National Bank of Ethiopia (NBE)* was created as the

central bank and incorporated the *Commercial Bank of Ethiopia (CBE)* as a commercial bank. The government also allowed private banks to be established. Foreign banks were allowed to create joint ventures with local banks, but their ownership was limited to 49 percent of capital. In 1964 *Addis Ababa Bank* was established as the first privately owned bank in the country. This bank was a share company and 40 percent of the total share belongs to the National and Grindlay Bank in London.

Until 1991, Ethiopia has a rigidly centralized financial system. The NBE as a supervisory and regulatory authority has been responsible and provided with extended powers in the management of the national economy. It was an apex financial institution. The general economy and ideological environments prevailing at the time justified the nationalization of financial institutions and stimulated the institution of centralized managements of the financial sector. The private sector was suppressed and a large public role in the economy was seen as necessary for development (Girma, 1994). In the system developed NBE directed provisioning by financial institutions mainly on criteria based on government need rather than considerations of the quality of service. The state owned bank, CBE was the largest bank providing common banking service in the country. Other banks such as the Construction and Business Bank (CBB), formerly known as the Housing and Savings Bank and the Development Bank of Ethiopia (DBE), formerly Agricultural and Industrial Development Bank (AIDB) were also operating.

The 1991 economic reform program that meant to transform the Ethiopian economy from a centrally planned economic system to a market driven system made the financial sector undergo fundamental quantitative and qualitative changes. Quantitatively, a significant growth in the number of banks and insurances is recorded. Concerning the banking sector, few years back only a total of four public institutions were in place, but now the Ethiopian banking sector consists of 11 banks (excluding, NBE), 10 of which are commercial and one is a development bank. In terms of ownership, three of them are state owned (CBE, DBE and CBB) while the rest are privately owned. Privately owned banks flourished shortly after the promulgation of the Monetary and Banking Proclamation No.83/1994 and the Licensing and Supervision of Banking Business No.84/1994, which laid down the legal basis for investment in the banking sector. Awash Bank was established in 1994 as the first private bank, followed by Dashen Bank in 1995, Bank of Abyssinia in 1996, Wogagen Bank in 1997, United Bank in 1998, Nib Bank in 1999. Recently Oromia Cooperataive Bank and Lion International Bank started operation. More are under formation to enter the banking sector (Buna International Bank, Zemen International Bank, Birhan International Bank, Oromia International Bank, etc).

Financial services coverage in Ethiopia is far below the international standard though it has improved significantly since the opening to the private sector¹³. The number of bank branches reached 608 after 86 additional

¹³ At the end of 2006/07 it was approximately 158,372 people per branch.

branches have been opened during the third quarter of 2007/08 (see Table 3.3). Looking at the regional distribution, the banking sector is characterized by a high urban concentration of branches. More than 50 percent of the total branches are located in the 6 major towns of the country, which consist of less than 10 percent of the total population. Addis Ababa, the commercial center of the country, alone accounts for 38 percent of the total branches¹⁴. As a result of the skewed distribution of branches the rural area is relatively more under-banked. It is the state-owned CBE, which has most of the branches outside the major urban centers (CBE has about 80 percent of its branches in the regions outside Addis Ababa).

Table 3.3 Branch Networking of the Banking System in Ethiopia

BANKS	2006/07		2007/08		
	Branch	%share	Quarter III		
			A.A	Branch	%share
Private Banks	232	47.64	144	282	46.4
1. Awash International Bank	43	8.82	26	47	7.7
2. Dashen Bank	42	8.62	24	46	7.6
3. Bank of Abyssinia	28	5.74	22	41	6.7
4. Wegagen Bank	39	8.00	17	39	6.4
5. United Bank	27	5.54	22	34	5.6
6. Nib International Bank	25	5.13	25	39	6.4
7. Oromia Cooperative Bank	16	3.28	2	19	3.1
8. Lion International Bank	12	2.46	6	17	2.8
State owned banks	255	52.36	264	326	53.6
9. Commercial Bank of Eth.	196	40.24	205	254	41.8
10. Construction & Bus. Bank	27	5.54	27	39	6.4
11. Development Bank of Eth.	32	6.57	32	33	5.4
TOTAL	487	100	402	608	100

Source: NBE Quarterly Report

¹⁴ In the second quarter of 2007/08, from a total of 522 branches 200 of them were found in Addis Ababa (38%). But in the third quarter, banks opened branches in the regions and the concentration in Addis Ababa declined to 33.9%

Table 3.4 Capital of the Banking System in Ethiopia (In Million Birr)

BANKS	2006/07		2007/08	
	Capital	%Share	Quarter III	
			Capital	%Share
Private Banks	2916	31.49	3674	32.2
1. Awash International Bank	434	4.68	557	4.9
2. Dashen Bank	612	6.61	740	6.5
3. Bank of Abyssinia	419	4.52	486	4.3
4. Wegagen Bank	401	4.33	560	4.9
5. United Bank	359	3.88	446	3.9
6. Nib International Bank	426	4.60	570	5
7. Oromia Cooperative Bank	131	1.41	147	1.3
8. Lion International Bank	134	1.45	168	1.5
State owned banks	6342	68.50	7721	67.8
9. Commercial Bank of Ethiopia	4220	45.58	5500	48.3
10. Construction & Business Bank	257	2.78	304	2.3
11. Development Bank of Ethiopia	1865	20.14	1917	16.8
TOTAL	9258	100	11395	100

Source: NBE Quarterly Reports

According to the report of the National Bank of Ethiopia (NBE), the fourth quarter of 2006/07 witnessed the growth of the banking sector. Total capital of the banking system increased by 30.2 percent and reached ETB 9.3 billion. The deposit mobilized also picked up by 34.2 percent and reached ETB 6.9 billion. The growth in the banking sector is partly contributed by the opening and expansion of the private banks. Although private banks have increased their market shares and recorded dynamic development in deposit mobilization, the public banks still have a dominant position (see Table 3.4). The largest bank alone, the CBE, accounts for perhaps somewhere between 70-90 percent of the commercial banking markets, for about 40 percent of the total branches and two-thirds of total banking system assets. It is thus three

times larger than all private banks combined, and more than 10 times as large as the largest private bank. The private banks account for about 31 percent of the total banking capital, about 48 percent of the total branches. Although more than two-thirds of assets are still held by state-owned banks, the growth of private banks has been much faster than state-owned banks. This implies the inefficiency of state-owned banks in Ethiopia (Kiyota et al., 2007). Appendix-B presents the total assets and return on assets (ROA) of Ethiopian state-owned and private banks from 1998 to 2007. It can be seen that the share of assets of private banks grew from 6.4 percent in 1998 to 32.6 percent in 2007. This in turn implies that the share of state-owned banks significantly declined. Note also that private banks had higher ROA than state-owned banks in most of the years.

The developments in the financial sector of Ethiopia can be assessed by examining various indicators of financial development such as different monetary and credit aggregates. In a study by Professor Ali I. Abdi (2000), a Senior Resident Representative at IMF, all indicators of financial development¹⁵ demonstrate a nascent financial system in Ethiopia. To put the state of financial development in Ethiopia in perspective, he compared its recent development with that of three African countries (Egypt, Kenya, and South Africa), and three industrial economies (France, Italy and the United Kingdom). Ethiopia's financial sector development, as measured by the relationship of

¹⁵ The financial indicators used are (i) the ratio of narrow to broad money (M1 to M2), (ii) the ratio of broad money to GDP, (iii) the share of bank credit to the private sector to total bank credit, and (iv) the ratio of credit to the private sector to GDP. In addition, the author assessed the density of bank branches as an indicator of financial sector maturity.

monetary aggregates and economic output, is well below that of the selected African countries, and is even more starkly rudimentary in comparison to the financial systems of the industrial countries. The share of private sector in total bank credit in Ethiopia was much lower than in all the six comparator countries in the 1990s. This evidently reflects the undeveloped state of the financial sector and the private sector in general in Ethiopia. For instance, at present there are a very limited number of banks in Ethiopia, comprising 10 commercial banks and one development bank (all domestically owned), as compared to 51 banks in Kenya. Policy changes that facilitated private sector economic activity since 1993 have contributed to narrowing the differences between Ethiopia and the comparators.

With the exception of 2001/2002, the banking system, and indeed each individual bank, has been profitable each year since 1997/98. As a result new banks are joining the sector. Recently the banks in operation have been improving their service mainly due to the upcoming fierce competition in the industry. Few banks have networked their branch in the capital city and launched electronic inter-branch transactions. Both Public and private banks are now developing the capacity to evaluate loan risks in the context of a market economy and are yet to offer the full range of financial instruments required by potential clients.

3.2 Insurance in Ethiopia

Modern forms of insurance services were introduced in Ethiopia by Europeans as far back as 1905. History shows that there were nine insurance companies providing insurance service in the country in 1954, most of which were branches or agents of foreign companies. The number of insurance companies increased significantly and reached 33 in 1960 owing to the low paid-up capital requirement to establish an insurance company¹⁶ and the fact that there was no restriction on foreign insurers. All insurances operating were nationalized during the Derg regime. After 1991, private insurance companies flourished following the proclamation for Licensing and Supervision of insurance business. At present, there are nine insurance companies in operation, of which one, the *Ethiopian Insurance Corporation (EIC)*, is state-owned and the remaining eight are private.

The development of the insurance sector since 1994 in many ways resembles that of the banking sector, with the establishment of several new private insurance companies in addition to the state-owned EIC, which continues to be the largest player. The dominance of state-owned insurance firms in terms of capital or number of branches is more limited when compared to banking. EIC's share is approximately 40 percent of the total capitalization and one quarter of the branch network (see Table 3.5).

¹⁶ The minimum paid-up capital required to establish an insurance company was as little as ETB 12,500 as stipulated on the commercial code. But, the current minimum paid-up capital requirement is ETB 4 billion.

Table 3.5 Branch Network and Capital of Insurance Companies
(Branches in number and Capital in Million Birr)

INSURANCE	2006/07				2007/08			
					Quarter III			
	branch	A.A	capital	%share	branch	A.A	Capital	%share
Private Insurance	110	60	325.7	56.5	133	76	301.8	57.5
Awash Insurance	18	11	46.1	8.0	21	12	42.1	8.02
Africa Insurance	9	2	59.6	10.3	13	6	41.2	7.85
NICE	12	7	10.1	1.8	14	8	13.2	2.51
United Insurance	18	12	46.8	8.1	19	13	48.9	9.31
Global Insurance	6	3	17.8	3.1	7	4	20.3	3.87
Nile Insurance	18	9	58.8	10.2	19	10	42.7	8.13
Nyala Insurance	15	7	60.6	10.5	16	8	47.1	8.97
Nib Insurance	14	9	25.9	4.5	16	10	32.6	6.21
Lion Insurance	-	-	-	-	8	5	13.5	2.57
State Owned Ins	36	11	250.5	40.56	37	11	223.1	42.5
EIC								
TOTAL	146	71	576.2	100	170	87	524.9	100

Source: NBE Quarterly Reports

Note: NICE:- National Insurance corporation of Ethiopia
EIC:- Ethiopian Insurance Corporation

Recently no significant change is observed with respect to the number of insurance companies. However, their branches increased by 24 and reached 170 in the third quarter of 2007/08. Similar to the banking system, branches of insurance companies also tend to concentrate in the capital city: about 50 percent of the branches are located in Addis Ababa. It is the state-owned EIC that has many of its branches outside the capital city; it has 25 of its branches in regions outside Addis Ababa. A new privately owned exclusive life insurance company named as "Ethio-Life Insurance" is underway in response to the untapped potential for long term insurance in Ethiopia¹⁷. At the opening of the

¹⁷ Ethio-life insurance started with a paid up capital of over ETB 6 million, which exceeds the minimum legal requirement to establish an insurance company.

company, prominent insurance professionals discussed and noted that the insurance business is vital due to developments such as the change in the structure of our society such as 'extended family' gradually becoming 'less extended', the force of the market increasingly putting pressure on families to be economically independent and plan for the future, the global and national business trend, expansion of private employments, and growing parental concern for siblings. Despite the existence of various insurance companies, the opening of new ones and the resulting competitive situation the insurance market in Ethiopia is at an early level of development and their supervision activities are not well organized.

3.3 Microfinance Institutions (MFIs) in Ethiopia

The commercial banking system is complemented by a number of micro-finance institutions (MFIs), which have dual goal of generating profit for the owners and the social mission of incorporating the poor strata of the population into the banking system that would others have no access to basic banking services. At present there are 29 registered MFIs in Ethiopia. By the end of 2006/07 MFIs having a total asset of ETB 3.58 billion, mobilized a total deposits of ETB 1.04 billion. The total asset in this sector increased and reached ETB 4.8 billion by the end of the third quarter of 2007/08. The period also witnessed an increase in MFIs' capital by more than 50 percent as compared to the previous year and reached ETB 1.62 billion (see Table 3.6).

Table 3.6 MFIs Operating in Ethiopia as of March 31, 2008 (In Thousands of Birr)

Micro-Financing Institutions	Regions	Total Capital	Saving	Credit	Total Assets
1. Amhara Credit & Saving Ins.	Amhara	344,874	598,181	1,137,520	1,425,001
2. Dedebit Credit & Saving Ins.	Tigray	329,146	321,410	1,202,101	1,671,822
3. Oromia Credit & Saving S.C	Oromia	176,512	190,435	509,886	658,103
4. Omo Credit & Saving Ins.	SNNP	35,842	91,184	229,348	323,210
5. Specialized Finan. & Pro.Ins.	A.A	14,237	13,116	28,024	34,904
6. Gasha Micro-fin. Ins.	A.A	4,746	5,351	14,171	19,663
7. Wisdom Micro-financing Ins.	A.A	32,523	17,438	67,991	87,680
8. Sidama Micro-finance Ins.	SNNP	12,098	6,103	24,379	30,997
9. Aser Micro-financing Ins.*	A.A	281	217	178	528
10.Africa Village Financial Service	A.A	9,122	3,178	9,649	14,932
11.Bussa Gonofaa Micro-fin. Ins.	Oromia	13,143	4,887	23,422	29,859
12.Peace Micro-finance Ins.	A.A	12,416	8,060	31,507	38,739
13.Meket Micro-financing Ins.	Amhara	2,446	563	2,221	3,355
14.Addis Credit & Saving Ins.	A.A	185,957	57,126	234,865	270,252
15.Meklit Micro-financing Ins.	A.A	5,239	5,722	16,668	18,607
16.Eshet Micro-financing Ins.	Oromia	11,550	4,649	35,860	41,281
17.Wasasa Micro-financing Ins.	Oromia	11,598	9,445	30,671	38,940
18.Benishangul-Gumz MFI	Benishangul	18,119	9,496	24,235	39,219
19.Shashemene Idir Yelmat Agar	Oromia	3,190	775	2,871	4,460
20.Metemamen MFI	A.A	7,635	1,577	6,838	9,316
21.Dire MFI	Dire Dawa	19,567	3,140	13,884	30,497
22.Agar MFI	A.A	3,258	2,342	4,632	6,528
23.Harbu MFI	Oromia	2,586	2,943	5,783	8,140
24.Ghion MFI	Amhara	162	293	295	464
25.Leta MFI	Oromia	883	74	617	962
26.Digaf MFI	A.A	275	617	766	927
27.Harar MFI	Harari	6,336	651	4,617	7,075
28.Lefayeda and Saving Inst.**	A.A				
29.Tesfa Micro-finance Ins.**					
Total		1,263,738	1,358,972	3,662,998	4,815,460

Source: NBE Quarterly Reports

* The data from the 1st quarter is used since data was not available for the 3rd quarter

** Data is not available for newly established MFIs

The MFI sector is characterized by high degree of concentration. The top five largest MFIs account 90 percent of the total asset and 85 percent of the total capital of the sector (see Table 3.6). When we see client outreach as one indicator of MFIs performance, the number of clients served by MFIs in Ethiopia exceeds 1.6 million. Although about 40 percent of the MFIs are located in Addis Ababa, MFIs primarily focus on rural areas; more than 80 percent of MFI clients are in rural areas (SIDA 2003). Two-thirds of total MFI clients are served by the top two largest MFIs.

In synopsis, there are stirrings of change in Ethiopian finance some of them are vigorous. Strengthened by the various reforms over the past decade, financial institutions in Ethiopia have begun to diversify their activities and increase their outreach with new products and technology. But there is still a long way to go. A framework that fosters a flexible yet safe and sound financial system is, therefore, crucial. To further improve the performance of financial sector there is a need to better understand the influence of different corporate governance mechanisms in the specific industry since these mechanisms are industry specific. To this end, this study attempts to empirically explore the governance practices in the Ethiopian financial sector, specifically banks and insurance companies. Corporate governance of MFIs is a broad subject, which needs to be studied independently due to the unique nature of the business. This can be a fruitful avenue for research in the near future given the rapid growth of the sector.



Issues of Corporate Governance in view of the Ethiopian Institutional

Framework

The commercial code of Ethiopia promulgated in 1960 includes all the legal frameworks that provide a footstep in agency theory and corporate governance. The code discusses general provisions, the rights and duties of stakeholders, and various disclosure and transparency issues related to ownership, financial performance, auditing and so on. The commercial code indicates that the formation of a company shall be by '*Memorandum of Association*' as well as '*The Articles of Association*', which governs the operation of the company (Article 313-314). In addition to the Commercial Code that defines the contractual relationship between management and the providers of capital, the legal framework of bank corporate governance in Ethiopia is based on the National Bank of Ethiopia (NBE), the regulator that ensures timely disclosure of company financial information and adequate transparency necessary for efficient financial market operations.

Financial institutions in Ethiopia are governed by Board of Directors, which is charged with the responsibility of managing the firm and its operation. According to Commercial Code Art.347 a company shall have not less than three or more than twelve directors who shall form a board of directors and be appointed based on the memorandum of association for only three years but are eligible for re-election unless otherwise provided in the memorandum or articles of association (Commercial Code Art.350). There is unlimited term for board membership in state-owned banks and insurances unlike the case in the

private counterparts, where board members serve for a maximum of two terms only (i.e a total of six years). At the end of each term, there will be another board election where at least one-third of the previous board members must be re-elected for the sake of sustainability of the operation of the board as well as the institution (this is supported by the bylaws of many institutions). Once directors are appointed by majority shareholders vote for a single term at Annual General Meetings, the board in turn shall elect a chairman from among its members and it shall appoint a general manager/president of the institution (Commercial Code Art.348), who carries out the day-to-day management with the assistance from the vice presidents and department managers with high academic qualification and long years of professional and sectoral experience.¹⁸ Both the Commercial code and NBE directive impose that the same individual should not hold the position of the chairman and the CEO (Commercial Code Art. 348(4)). The rationale for this was to ensure high level of monitoring by company boards by introducing more independence to prevent any one individual from dominating the board. Although the positions of the CEO and the board chairman are occupied by separate individuals, the effective powers are not still independent.¹⁹

Board directors have fiduciary or legal duties that are explained by the law and are enforceable. According to the Ethiopian Commercial Code Art.362, boards have the responsibility to maintain the value of the firm and ensure

¹⁸ The CEO and the top management are accountable to the board and are required to submit periodic reports of their stewardship to the board.

¹⁹ See page for more explanation of the independence in practice.

good practice in terms of audit, transparency and accountability. They are responsible to undertake their duties as explained by the institution's memorandum of association and the company bylaw. The duties specified by the Commercial Code (Art. 362) include the following:

- keeping regular records of the management and of meetings,
- keeping accounts and books, the company's operations including a financial statement to the meeting,
- setting up the reserve funds,
- applying to the court where company stops payments with view of either to a composition with creditors or the winding up of the company.

Boards need to be supplied with relevant, accurate and timely information to enable them discharge their duties. Boards are in turn expected to annually disclose a consolidated report of annual report, policies for remuneration including incentives for the board and senior management. According to the Commercial Code and the Company Law the board is expected to provide the shareholders with the necessary information so that there should be shareholders' participation in major decisions of the company.

Board members will be held legally responsible for damage caused by their failure to properly discharge their duties. The Commercial Code of Ethiopia states that directors "shall be jointly and severally liable to the company for damage caused by failure to carry out their duties" (Art. 364(2)) and "when they fail to take all steps within their power to prevent or to mitigate acts prejudicial to the company which are within their knowledge" (Art. 364(4)).

The directors receive compensation for their services on the board. According to the Commercial Code Art.353, boards are entitled to a pay which will be included in the company's expenses. The amount of the pay is decided at the annual general meeting. In addition, boards get some percent of the institutions' annual net profit based on company's memorandum of association.

There are many rules and regulations for ensuring that management of companies act in the interest of investors and of the firms. Among those are the shareholders' meetings which have supervisory functions over the companies; the requirements that financial accounts of companies be certified by external auditors; the different returns the companies are expected to send to regulatory agencies like NBE, which has regulatory and supervisory mandate for licensed banks and other financial institution.

- *The Annual General Meeting* with its power to appoint and remove directors as well as approve their remuneration is expected to act as check on the performance of directors. Accordingly directors will endeavor to bring to the Annual General Meeting results that will win the approval and commendation of shareholders. Shareholder meetings may be general or special where general meetings may be ordinary or extraordinary and special meetings comprise only shareholders of specific class (Commercial Code Art.390). The voting rights to ordinary or dividend shares shall be in proportion to the amount of capital

represented, and every share carries at least one vote which will be limited by memorandum of association.

➤ Financial institutions are required to have their financial statements *externally audited* by independent external auditors, which are appointed by shareholders at Annual General Meetings²⁰ for a single term of three years (Commercial Code Art. No.368). The auditors may at any time make on the spot such audits and checks as they think necessary and may call for any information and documents as may be required for the proper execution of their duties. External auditors are accountable to shareholders. They are responsible to a set of tasks set in the company law and the Commercial Code (Art. No.374). The tasks include:

- examine the accounts and securities of the institution,
- ensure the validity of the balance sheet and profit and loss records,
- evaluate the accuracy of the board's reports,
- report to Annual General Meetings in accordance with the Commercial Code Art. No. 375,
- announce non-compliances to the board as well as at general meetings,
- scrutinize the finance and management of the institution, and
- undertake other delegated tasks

²⁰ In case of state-owned banks and institutions, external auditors are appointed by Board of Management.

MFIs are regulated separately from the banks due to their dual goal of development and financial performance. They are meant to reach poor clients in financial sustainable way. This indicates that governance structures are industry specific. Hence, to improve the performance of MFIs there is a need to better understand the influence of different corporate governance mechanisms in the specific industry (Hartarska, 2005). It is often argued that MFIs need to have appropriate governance structure including an effective independent board, composed of members with the required professional qualification and relevant experience. However, most MFIs in Ethiopia have weak system of governance: those in boards and management lack Individual commitment and dedication and this is aggravated by the presence of incentive problem (Gebrehiwot, 2000). He indicated that such governance failures cause the institution's interest to be compromised by its dealers, or its staff conducting business in an unethical or risky manner.

Although there is no detailed information on the composition of board members, a study by Gebrehiwot (2000) gives some evidence that many have NGO background. MFIs in Ethiopia are licensed as share companies to deliver financial services to the poor. However, there is limited sell of share since it is unattractive business for private investors²¹. Consequently, MFIs depend on foreign donors²².

²¹ This is due to the high-risk environment and the major bottlenecks identified in the industry that includes lack of capital, limited number of potential borrowers, lack of profit and business oriented MFIs (NBE, 2006/07).

²² MFIs are highly dependent on other capital sources since less than half of their loans are financed from own-deposit mobilization. The share of donated capital on total capital is continuously decreasing as regional governments as well as individuals start taking part in MFIs.

The legislative requirement that MFIs should be registered private share companies (Proc. No. 40/1996) restricts NGOs from directly engaging themselves in micro finance activities. They had to establish MFIs using nominal shareholders while they provided the required capital. Gebrehiwot (2000) indicates that this has an implication for the governance of MFIs. The 'individual' shareholders are nominal shareholders, they do not really own the shares, and so they lack the incentive to monitor both the board and management. Thus, MFI should be regulated taking into account their important role in the country's development.

Review of corporate governance in Ethiopia shows clearly that by and large, there is weak legal and regulatory system, disclosure requirements are insufficient and there is inadequate protection of shareholders. To further compound the problem, enforcement of the law is uneven and often selective reflecting a critical shortage of skills and often abuse of power. It is therefore suggested that for Ethiopia to reap the benefits of effective corporate governance there is need to strengthen the enforcement mechanism of the regulatory institutions. The problems further call for legal and policy reform such as the following²³:

- Developing systems for monitoring and evaluating compliance with good corporate governance practices and strengthening the incentives for good corporate governance.

²³ These reforms are recommended in a research paper by Yishak Worku (2006).

- Developing and improving institutions that have the capacity to implement and enforce best practices including regulators in the financial sector.
- Developing and adopting supervisory arrangements that effectively place risk management responsibility with the Board of Directors instead of passing the same to the supervisory agencies.
- Establishing well-regulated, well functioning and competitive capital and financial markets, which provide a disciplinary mechanism.
- Building capacity by upgrading the capabilities of the existing leaders of business through advocacy, awareness raising and training and preparing the next generation of professionals by introducing the subject of corporate governance into education program at all levels.
- Strengthening of initiatives such as the Pan African Consultative Forum on Corporate Governance, which will facilitate cooperation and exchange of best practices throughout the region.
- Developing working relationships between initiatives focusing on corporate governance and others where there is a commonality of interests such as professional associations so as to exploit synergies with a view to developing and effectively enunciating corporate governance principles.

CHAPTER FOUR

METHODOLOGY

This paper is an in-depth study of corporate governance in the Ethiopian financial sector. It aims to provide insights into the relationship between governance mechanisms and firm financial performance. In order to achieve these objectives, two methods are applied: *descriptive and econometrics methodologies*.

4.1 Descriptive Methodology

A survey is conducted for the Ethiopian financial sector that includes banks, insurances and MFIs. Both quantitative and qualitative data is collected using three main methods:

- A questionnaire with both structured and open-ended questions was distributed to board members and management of all banks and insurances in the Ethiopian financial sector (refer to Appendix A). The survey questionnaire constitutes a qualitative assessment of governance in Ethiopia. The questionnaire includes questions related to:
 - the management and the board,
 - corporate risk management and social responsibility,
 - disclosure and transparency, and
 - shareholders' and stakeholders' information



- In-depth interviews were conducted with senior executives and board of directors and subjective data were collected. The study intended to focus on respondents who were able to give an overall understanding of the banks' management systems, functions, and procedures.
- Secondary data from published reports and other documents. The accounting data and those related to governance practices were collected from the NBE.

The data collected from the survey were encoded and analyzed. Both quantitative and qualitative methods of analysis are used. Quantitative analysis is performed using STATA with both descriptive and inferential statistical procedures being employed. In order to understand the key characteristics of variables relating to the governance practice of banks and insurances in Ethiopia, descriptive statistics such as simple average, median, percentiles and so on are used for the key variables of interest. Complementary information is provided using tables..

4.2 Econometric Methodology

This part of the study provides econometric evidence. It investigates the empirical relationship between governance mechanisms and performance of commercial banks in Ethiopia. To this end, data from eight commercial banks was collected for a period of five years (2002/03-2006/07) and analyzed using Three-Stage Least Squares method.

The econometric research on corporate governance concerns mainly the relationship between various categories representing firms' performance and the variables describing their governance level such as ownership structure, composition of supervising body, board characteristics, competition, regulation, and so on. Studies indicate that corporate governance is an important determinant of performance.

Variables Definition

There is a consensus on the relationship between governance practices and firm performance. The question has been on defining consensual measures of firm performance and indeed also of corporate governance indexes and on identifying the direction of causation. I list different variables to incorporate in the model; those relative to performance, used as dependent variables (gross profit, Return on Asset/ROA and return on equity/ROE) and a set of variables relative to corporate governance (board size, frequency of board meeting, female directors and dummy variables for ownership type and internal auditors).

Profits and rates of return are the most popular variables used to assess firm performance. Gross profit (profit before tax) is taken as one measure of performance in this study. Profitability, however, depends on many factors outside the direct control of firms and may not be a true measure of firm performance that can be attributable to firm specific characteristics. Thus, this measure is questioned and calls for an alternative measures of performance: rate of returns (return on assets/ROA and return on equity/ROE).

ROA is an indicator of how profitable a company is relative to its assets. It gives investors an idea as to how efficient management is at using its assets to generate earnings. It is computed as:

$$ROA = \frac{NetIncome}{TotalAssets}$$

ROE is also a measure of a corporation's profitability which reviews how much profit a company generates with the money shareholders have invested. It is computed as:

$$ROE = \frac{NetIncome}{Shareholder'sEquity}$$

ROE is usually preferred for comparing the profitability of a company to that of other firms in the same industry. On the other hand, ROA is best to compare it against previous ROA of the same company or the ROA of a similar company.²⁴

The explanatory variables representing governance mechanisms of the commercial banks in Ethiopia include board size, frequency of board meeting, female directors and dummy variables for ownership type and internal auditors. The definitions of the different variables used in this study are consistent with previous studies on corporate governance. Table 4.1 illustrates the detailed explanations of all the independent variables with their expected sign of relationship with the dependent variables based on previous studies.

²⁴ ROA for public companies can vary substantially and will be highly dependent on the industry.

Table 4.1 Definitions of independent variables and their hypothesized signs of relationship with the dependent variable of performance indicators.

VARIABLE	EXPLANATION	HYPOTHESIS
Ln(asset)	The natural logarithm of assets measuring firm size	
Board size	The total number of directors on the board	-/+
Female directors	The no. of female directors divided by board size	+
Ownership type	Dummy indicating state-ownership when 1	-
Board meetings	Frequency of board meeting per year	+
Internal auditors	A dummy being 1 if internal board auditor reports directly to the board	+

➤ **Board size** refers to the total number of board members. There are contradicting findings on board size. There is a view that larger boards are better for corporate performance because they have a range of expertise to help make better decisions, and are harder for a powerful CEO to dominate. Adams and Mehran (2003) found supporting evidence for banking firms in the USA: larger boards improve performance as measured by Tobin's Q. On the other hand, few empirical studies provide results in favor of smaller boards and argue that large boards are less effective, harder to coordinate and discuss and process problems (Jensen, 1993 and Lipton & Lorsch; 1992). Yermack argues that large boardrooms tend to be slow in making decisions, and hence can be an obstacle to change. He concludes that the smaller the board size the better the performance. Jensen (1993) and Lipton and Lorsch (1992) suggest that a large board of directors can be less effective than a small board. They argue that small boards communicate and coordinate better and are quicker to respond to problems, whereas large



boards may become bureaucratic, develop cliques and foster a passive membership. Firm performance (Yermack, 1996) and firm value (Eisenberg et al, 1998) have been found to decrease as board size increases.

- **Female director** represents the number of female board members divided by the total number of board members. Recent empirical research find that board diversity is positively correlated with firm value: Carter et al. (2003) find significant evidence of a positive relationship between board diversity, proxied by the percentage of women on boards of directors, and firm value.
- **Board meetings** refer to the frequency of board meeting per year. Meeting frequency is an important dimension of an effective board since the regular board meetings allow potential problems to be identified, discussed and avoided. Better performance is observed in firms where the boards meet more frequently than other firms with busy directors that lack of time to carry out their duties (Lipton & Lorsch, 1992; Conger et al. 1998).
- The **internal auditors** variable is measured using a dummy variable that equals one if internal board auditor reports directly to the board, and zero otherwise. Internal auditors are expected to provide independent and objective assessment of the appropriateness of the firm's internal governance structure and its effectiveness. Recent research shows that allowing internal auditors to report directly to the board enhances performance (Mersland and Strom, 2007). They argue that having an internal auditor reporting to the board is a way to connect board governance with internal firm governance.

- **Ownership type** is represented by a dummy variable, which indicates state-ownership when one. This dummy variable is used to explore the effects of ownership types (private, state-owned) on corporate performance. Comparative studies of state-owned versus privately-owned share companies demonstrate that state-owned companies record less performance due to the inefficiency, lack of autonomy and the higher degree of agency problem (La Porta et al. 1999).
- In accordance with the theory that argues for the inclusion of other variables that explain the dependent variable in addition to the corporate governance variables, we include the natural logarithm of asset - ***ln(asset)*** - as a measure of firm size, which has an impact on firm performance.

The first empirical step is to verify the correlations among the governance measures. We intend to produce comparisons between the ownership type, board structure and composition to gauge how closely associated they are (refer to Appendix D for the correlation matrix). For the results in this study not to be obscured by the problem of multicollinearity, a conservative approach is used to examine whether or not the variables are highly correlated and variables with high correlation coefficients are removed. In order to avoid multicollinearity problems among explanatory variables, the most likely candidates in literature, such as external governance mechanisms like competition and regulation that are most likely to be correlated with ownership type are excluded (Roy and Oystein, 2007). The second step is to study the

relationship between governance characteristics and firm characteristics, such as firm size, which may directly or indirectly affect firm performance²⁵.

Modeling the relationship between corporate governance and firm performance indicators has generally been approached through standard econometric techniques, such as regression analysis. The real problem revolves around the issue of *endogeneity*. A major issue that plagues empirical research in the field is the joint-endogeneity problem and the resulting simultaneous-equations bias. Although there is evidence on the relationship between governance and performance, there is a need to recognize that such a demonstrated correlation does not prove causation. Therefore, the problem of endogeneity has to be taken in to consideration in the analysis of the relationship between governance mechanisms and firm performance.

Problems of joint endogeneity are prevalent in empirical studies on board directors and corporate governance. For example, changes in board structure affect firm performance and corporate governance attributes, in turn, may affect board structure. Thus, it is uncertain whether a firm's performance is affected by board changes or by governance features. Hermalin and Weisbach (2001) provide an example of this problem. They observe that firm performance is affected by actions of previous board directors and, itself, is a factor that can exert influence in the appointment of subsequent directors. Similarly, Yermack (1996) identified endogeneity in board size. In his examination of the interplay between board size and firm performance, he found that 'firms with small

²⁵ To control for such effects, researchers introduce variables identified to be related with governance measures.

board size perform better than their counterparts with larger board size'. This finding might be interpreted in two ways: Small boards could contribute to better performance or, firms might adjust board size in response to past performance. Generally, it is important to examine the factors influencing a firm's choice of board structure and/or composition prior to examining the impact of that structure and/or composition on firm performance. Failing to account for the endogeneity problem can result in a spurious relation between firm performance and board characteristics.

To address endogeneity problems, researchers use different methods. Hermalin and Weisbach (2001) used lagged variables to tackle the joint endogeneity problem. In addition, they suggested the simultaneous equations approach, which Tang (2007) also used. He applied two-stage least square (2SLS) method to study the effects of board and governance characteristics on performance. Other researchers used Instrumental Variables (Yermack, 1996; Filatotchev, Lien and Piesse, 2003). Yermack (1996) estimates the model of firm value and board size in an instrumental variables framework, using lagged values as instruments for the current values. He concludes that the evidence supports the interpretation that past board size influences current firm value, rather than the opposite – that past performance influences current choices of board size. Filatotchev et al. (2003) argue that the use of the Heckman two-step procedure addresses self-selection and the endogeneity issue of omitted variable bias associated with the private information behind a firm's choice of board structure and composition (decision to have female director, internal

auditor with direct access to the board and small board size). However, other factors beyond their own private information may affect the board structure, composition and firm performance measures. It is possible to incorporate firm level fixed effects as means for controlling for the endogeneity problem of omitted variable bias. The disadvantage of this method is the greater reliance upon within-firm variation for its explanatory power and if the key explanatory variables do not vary much, the power of the test will be weak. Another technique for addressing the endogeneity issue is to regress the endogenous variable, say female director, on a set of instruments correlated with this variable and yet uncorrelated with the error term in the performance regressions (Yermack, 1996). Using the remaining variables makes use of all available information within the system. However, this approach has a disadvantage in that it does not correct for the self-selection of female directors and it forces all the control variables to have the same slope for firms with female directors and those without. Several studies attempt to control for endogeneity by using simultaneous-equations methods (Hermalin and Weisbach, 1991; Tang, 2007). Hermalin and Weisbach (1991), for example, use lagged performance as instruments for current performance to assess the relation between board composition and firm performance. One problem that arises when using simultaneous-equations method is that there is relatively little theoretical guidance concerning the selection of the appropriate instrumental variables.

Instead of developing statistical test of exogeneity, in this study value judgment is used to identify the endogenous variables based on the problem at hand and prior information. Board size, female director, board meeting, internal auditor are candidates for endogeneity problem. They may affect firm performance and, in turn, performance may influence changes in board structure and composition. Hermalin and Weisbach (2003) argue that a promising way to attack the joint endogeneity problem starts with a study of the impact of changes in firm performance on subsequent changes in board characteristics. Obviously, for this paper no change is observed for board characteristics; most directors are elected for three years and thus the explanatory variables relevant to board characteristics are reported once and are held constant for the whole study period. This nature of the data makes the endogeneity test impossible.

Methods of analysis

The first step in the econometric analysis, prior to model estimation, is to apply different panel data tests such as panel data unit root tests whenever there is considerable volatility in the series. However, this is not the case for the data in this study; most of the independent variables specifically those relating to board characteristics are reported once. Moreover, the panel data structure is such that the time variable is limited owing to the fact that almost all the commercial banks have been in operation for only nearly a decade whereas most panel unit root tests are poor when the time dimension is small (Levin and Lin, 1993).

Previous studies used different economic approaches in order to examine the relationship between firm performance and governance mechanisms like board characteristics: Pooled OLS regression (Sanda, Mikailu, & Garba, 2005), Simultaneous Equations Model (SEM), applying Instrumental Variables method, Two-Stage Least Square/2SLS (Tang, 2007), Three-Stage Least Squares/3SLS (Mersland and Strom, 2007), and so on. All these methods have advantages as well as disadvantages as discussed in the previous section. For instance, few researchers used the Simultaneous Equations Model arguing that this framework helps to tackle potential endogeneity problems between board composition, governance and performance variables (Tang, 2007). A problem with simultaneous-equations methods is the lack of valid instruments since there is relatively little theoretical guidance concerning the selection of the appropriate instrumental variables.

Based on the nature of the available data for this study, I intend to follow the 3SLS approach following Mersland and Strom (2007). The panel data structure is such that there are repeated observations on the dependent performance variables for up to five consecutive years, while some of the independent governance variables are assumed constant. For instance, variables relevant to board characteristics and ownership type are constant over time: -being a shareholder owned firm does not change from year to year. As a result, the number of observations on most explanatory variables is far fewer than for the dependent variables. So, random effects method is chosen to estimate the relationship. The random effects model is given as:

$$y_{it} = x'_{it}\beta + (\alpha + u_i) + \varepsilon_{it} \dots\dots\dots (1)^{26}$$

Where, i represents the eight commercial banks & t stands for time, five years

y_{it} is the dependent variable,

x'_{it} is the vector of explanatory variables,

β is the vector of coefficients,

α is the mean of the unobserved heterogeneity,

u_i is heterogeneity specific to firm i , and

ε_{it} is the remaining firm-year heterogeneity.

Thus, this formulation implies that the constant term in the regression must be interpreted as the average firm-year heterogeneity.

The random effects method amounts to transforming the original data.

Using y_{it} , the dependent variable for the i th case in year t , as an example, the transformed y_{rit} is:

$$y_{rit} = \frac{1}{\sigma_\varepsilon} (y_{it} - \theta \bar{y}_i); \quad \text{where } \theta = 1 - \frac{\sigma_\varepsilon}{\sqrt{\sigma_\varepsilon^2 + T\sigma_u^2}} \dots\dots\dots (2)$$

Here, \bar{y}_i is the individual firm average.

σ_ε is the standard deviation of the residual ε_{it} , assumed to be constant.

σ_u is the standard deviation of the firm heterogeneity, also assumed to be constant. And T is the number of years of data, which is five in this case.

²⁶ The random effects model as formulate by Green, 2003 pp.294

To get these standard deviations, we first run a Generalized Least Squares (GLS) regression on the data assuming a random effects structure and then do the transformations in equation (2), and run a Three-Stage Least Squares (3SLS) on the transformed data (Greene, 2003). 3SLS is a valid method since the assumed relationships are linear. This method is advantageous since it does not depend upon assumptions of distributional form such as normality.

CHAPTER FIVE

ANALYSIS AND FINDINGS

5.1) Descriptive Analysis

Large Ethiopian firms take several different legal forms. *Share companies* are the latest form of business organizations. The most likely corporate governance problem in large firms is the conflict of interests between the controlling owner and the management. Thus, companies, banks and financial institutions (FIs) can no longer afford to ignore better corporate practices. Questions about the governance structure of the Ethiopian financial sector can only be answered with empirical evidence. The provision of such evidence is the objective of this paper.

Private financial institutions in Ethiopia are headed by *Board of Directors* (Commercial Code Art.347) while state-owned ones have *Management Board* (Public Enterprise Proclamation No. 25/92). This narrows our analysis to the study of the characteristics of the board and its relationship with other stakeholders of the corporation such as shareholders, executives, employees and auditors.

The key to good corporate governance is a well functioning, informed board of directors. In chapter two, literature supports that every financial institution should be headed by an effective board to offer strategic guidance, lead and control the company (Pei Sai Fan, 2004). Below we see the salient features of the boards in the Ethiopian financial sector.

j) Board nomination and appointment

A formal and transparent procedure is expected both in the nomination of candidates and appointment of directors to the board as discussed by the commercial code as well as the bylaws of many banks and insurances in Ethiopia. All persons offering themselves for appointment, as directors, are supposed to disclose any potential area of conflict that may undermine their position or service as director. In private institutions, each board member is formally nominated and appointed by vote of majority shareholders at Annual General Meetings (Commercial Code Art.350) while in case of state-owned banks and insurances, the government assigns board members composed of outsiders and insiders²⁷ and provides the possibility that the CEO be a non-voting member of the board

All the private banks and insurances say that they follow the ideal way, where shareholders nominate and appoint directors. Few indicate that sometimes the old board nominates but still the approval of appointment is done by shareholders based on the pre-set criteria by the NBE (Directive No SBB.1/94(4)), which include educational background and professional experience: 75 percent of the board members must have at least BA degree while the rest 25 percent must have at least completed secondary education. Furthermore, they must have the know how of how to run a business or must have management experience. The members should be over 30 years old,

²⁷ Insiders are from the institution employees' staff

settled and responsible with no previous criminal convictions of bankruptcy records ("Fit and proper test").

Following the ideal case indicated in the bylaws have implications for shareholders: the shareholders have the authority to ensure that only competent and reliable persons are elected or appointed to the board of directors. But the question is '*do shareholders of banks and insurances in Ethiopia know their right and exercise it?*' In reality only few shareholders with major shares do that. In practice, there is some pre-assembly exercise to prepare candidates, which is not in line with the mandate. Before the general meeting of shareholders, major shareholders normally negotiate amongst themselves to select the list of directors who will act to the best of their interest, and the outcome of this bargaining process very much depends on family networks and contacts. Perhaps, most shareholders go to the meetings with a pre-determined case and are aware of the most likely outcome of the meeting. Such a situation where certain interest groups dominate to maximize their benefit is aggravated by the fact that most shareholders with few shares do not attend the annual general meetings whereas the major shareholders who have invested significant fortune in the financial institutions will not afford to miss such meetings, where decisions on major issues are made. Most important meetings and decisions are, therefore, conducted in an environment dominated by major shareholders (whenever 25 percent or one-fourth of the shareholders is present it is possible to make legally binding decisions as indicated by most share companies' bylaws).

ii) Board structure and composition

Description of the structure and composition of banks and insurance companies currently in operation in Ethiopia is provided in Appendix C. All the surveyed banks and insurances, except Dashen Bank, have *unitary board* structure with the number of board members ranging from five to ten. Such unitary board structure is prevalent in other countries and is believed to produce more effective directors who act to the best interest of shareholders (Cioffi, J. W., 2002). Similar to the U.S. corporate law, only shareholders are entitled to elect directors. As a result, employee representation on the corporate board is quite rare. Another problem with unitary board structure is that the management and supervision tasks are not clearly delineated. Taking this problem into account, NBE has recently required separation of the positions of board chairman and CEO.

When we look at the board composition in terms of *gender diversity*, only two banks and two insurance companies have female board members; Wogagen Bank, Commercial Bank of Ethiopia, Nib Insurance and Awash insurance have each one female director on their boards (refer to Appendix C). Female participation is extremely low when compared with other countries (Bohren and Strom, 2006). The board members are all men except the four cases mentioned with one female board member each. The quite low percentage of institutions that have at least one female director contradicts with the literature that suggests balanced gender in the board. Regarding the composition of the Boards in terms of *professional qualifications*, there exists a

professional mix, which includes Lawyers, Banking and finance specialists, Businessmen, Economists, Management professionals and Insurance specialists. Interestingly, almost all boards (99 percent) have at least one member with finance experience and 81 percent of the boards have at least one director with a legal background.

High numbers on the board size and few board meetings may be seen as signs of agency costs²⁸ (Yermack, 1996). As illustrated in Appendix C, the board of directors consists on average of 7.14 directors. This is among the lower in international comparison²⁹. Firstenberg and Malkiel (1994) found that a small board (not more than eight persons) will function faster; while a larger board has the advantage that more diversified opinions are discussed. There is difference in the size of boards depending on the type of institution. Commercial banks have relatively larger boards (refer to Appendix C). The average board size for insurances (7.28) is relatively slightly lower than the average for commercial banks (9.08). Few researchers explain differences by explaining board size as a function of firm size. Banks in Ethiopia are larger - in terms of assets- than insurance companies and therefore need a larger board. Although, recent research supports smaller boards as effective performance enhancing structure, a larger board may be justified for a large, complex organization.

²⁸ Another sign of agency cost is CEO-chairman duality. At present there is no such duality problem in Ethiopia owing to the recent law issued by NBE requiring the separation of the posts of CEO and board chairman.

²⁹ In the Anglo-Saxon literature, Lorsch and Lipton (1992) state that the maximum size of a board of directors is 10.

Some empirical evidence shows that meeting frequency is an important dimension of an effective board (Lipton & Lorsch, 1992). As indicated in Appendix C, on average, boards of banks and insurances in Ethiopia meet more than 30 times in a year (i.e. more than twice in a month). The reported meetings refer to only the regular board meetings; in addition extra-ordinary meetings are also organized on need basis. The number of ordinary board meetings seems to be close to averages found in other countries.

Table 5.1 Frequency of board meetings

FREQUENCY OF BOARD MEETING	BANKS		INSURANCES		TOTAL	%
	Public	private	pubic	private		
Monthly	1	5	-	6	12	55
Twice in a month	-	1	1	-	2	9
Weekly	1	2	-	3	6	27
Twice in a week	1	1	-	-	2	9
Total	3	9	1	9	22	100

Table 5.1 shows that boards meet at least once a month for all the surveyed banks and insurances. For about 55 percent of the surveyed institutions, boards have monthly regular meetings while for only nine percent of the institutions, boards meet twice a week. In addition, special meetings will be called for whenever a need arises. There is difference in frequency of board meeting among institutions. Banks meet more frequently than insurance companies. For instance, Board of Directors of the Commercial Bank of Ethiopia meets at least 96 times in a year (at least twice in a week).

There are several ways through which the deliberations from board meetings are communicated to shareholders and other stakeholders. Primarily, they are discussed at shareholders' annual general meetings. In case of issues that need urgent attention, special meetings can be arranged. Moreover, financial statements are another information sources. Also, there is circulation of minutes and memos among executives and employees of the institution. Few companies use internal newsletters and mass media for communication. Note however that majority and minority shareholders do not have similar access to information. Large shareholders have day-to-day information because of their influence. On the other hand, minority shareholders lack coordination and so they face information asymmetry problem.

iii) Roles and responsibilities of the Board

The board of directors is supposed to govern the corporations by overseeing management and representing the interests of shareholders. Board directors have fiduciary or legal duties that are explained by the law and are enforceable. They are responsible to undertake their duties as explained by the institution's memorandum of association and the company bylaw. These duties include:

- Formulate strategies, policies and plans and then monitor and evaluate their implementation;
- Oversee the corporate management and operations;

- Evaluate performance and review viability and financial stability of the institution at least on a quarterly basis;
- Appointment of chief executive and the senior staff, developing appropriate remuneration policy and continuous follow-up;
- Monitor the effectiveness of the corporate governance practice of the firm;
- Approve key financial decisions:-budget, loans beyond certain threshold;
- Ensure compliance with applicable laws, regulations, rules and guidelines; and
- Ensure that the procedures and values that protect the assets and reputation of the institution are put in place.

To examine the effectiveness of boards, let us consider the core issues of the boardroom. The most dramatic change in board structures is the delegation of certain tasks to formal committees. There are special committees in the boards, either *standing* or *ad hoc*, which are meant to facilitate the overall task of the board such as Audit review committee, Loan review committee, Business and institutional development, Risk management, etc. According to this study, all banks in Ethiopia have at least an Audit committee. Only two of the insurance companies (Awash insurance and Nile insurance) have both standing and ad hoc committees, such as Claims committee, Investment committee and Business development committee; 30 percent of the insurances have just ad hoc committees while the rest have none at all.

The board of directors is charged with the responsibility of managing the firm and its operation. There is proper evaluation of performance and effectiveness of the Boards every quarter while individual board members are evaluated annually by the Board of Directors (for about 70 percent of the surveyed institutions). Reports from these assessments are discussed at the Board meetings, Annual General Meetings or special meetings. In some exceptional cases where the board members cannot reach consensus, independent external auditors that are appointed by and are accountable to shareholders can call for general shareholders meeting. Such meetings are possible whenever shareholders with at least 20 percent of the total shares ask for it (Commercial Code Art.377). Thus, especially in shareholder-owned financial institutions, shareholders have the power to ensure that the board is held accountable for the effective running of the institution. They also have power to change the composition of the board that does not perform to expectations or in accordance with the mandate of the institution. In practice, however, only major shareholders exercise their power to ensure board members that act to their best interest are in place. According to the Commercial Code and the Company Law the board is expected to provide the shareholders with the necessary information so that there should be shareholders' participation in major decisions of the company. I never came across such kind of evidence of transparency in this study.

The directors receive compensation for their services on the board as discussed in the Commercial Code and company's memorandum of association. Boards are entitled to a pay the amount of which is decided at the annual general meeting³⁰. In addition, boards of banks and insurances get some percent of the institutions' annual net profit based on company's memorandum of association. Usually, boards in Ethiopia get five percent of the company's net annual profit (the board's share of the profit should not exceed 10 percent as indicated by the Commercial Code No.353)

iv) Roles of Chairman and Chief Executive

A clear separation of the role and responsibilities of the chairman and chief executive ensures a balance of power of authority and provide for checks and balances such that no one individual has unfettered powers of decision making. It creates better understanding and smoother communication (John and Senbet, 1998; Fama and Jensen 1983). The question as it pertains to the Ethiopian experience is '*how independent are boards in Ethiopia?*'

In all the institutions included in the survey, the position of the Chairman and CEO are occupied by separate persons; there is a clear distinction of the responsibilities of the Chairperson of the Board and the CEO. Previously these two positions used to be held by one person, but recently the NBE required the separation of these two positions. In all shareholder-owned banks and insurances in Ethiopia, the CEO is a member of the board. Many

³⁰Board members also receive transport and sitting allowances (For instance, Nib insurance).

advocate this taking into account the need to have someone representing the internal stakeholders that will execute the policies and/or strategies formulated. Although the positions of the CEO and the board chairman are occupied by separate individuals, the effective powers are still not independent. Usually, it is the CEO who sets the agenda for meetings. Moreover, the board depends on the management-the body which it should control-to collect the necessary information. The findings of this study calls for changes in board practices. Most importantly, board participation in agenda setting and in determining information flow should be more active. Furthermore, executive sessions of independent directors, separate from management, rather than being considered to be high treason, have to be used to evaluate management.

v) Disclosure and transparency

Financial institutions in Ethiopia are now required to provide consolidated financial reporting as well as non-financial information on issues such as corporate governance structures and practices, deviations from the corporate governance codes, education and professional experience of directors and key executives and their remuneration (NBE Directive No. SBB/21/96).

The institutions are required to have their financial statements externally audited by independent external auditors that are accountable to shareholders. There are also internal auditors that evaluate and scrutinize the company. Recently, researchers such as Mersland and Strom (2007) consider internal auditors as information variable that provides objective assessment of the

organizations internal governance structure and the operating effectiveness of specific governance activities. They stress the importance of internal audit and recommend that internal auditor reports directly to the board³¹. 75 percent of the private banks and insurances in Ethiopia have internal auditor with direct access to the board. However, internal auditors in Dashen bank and Awash bank report to the CEO. The government banks and insurances also have internal auditors that report to their Board of Management.

All the banks and insurances reported that they have measures in place to ensure that their institution complies with all relevant laws, regulations, commercial codes, NBE directives, governance practices, accounting and auditing standards. External Audit is one measure. Moreover, there are inspections by NBE as well as by the institutions themselves all over their branch networks.

vi) Corporate Social Responsibility

Corporate social responsibility is of growing concern in today's globalized economy, it being at the top of the board of directors agenda and also good for business. McGuire et al. (1988) define it as follows:

“CSR is; Corporations being held accountable by explicit or inferred social contract with internal and external stakeholders, obeying the laws and regulations of government and operating in an ethical manner which exceeds statutory requirements.”

³¹ Having an internal auditor reporting to the board is a way to connect board governance with internal governance.

This “ethical manner” is placed at the core of the entity’s strategy, exemplified by proactive community involvement, philanthropy, corporate governance, corporate citizenship, addressing of social issues, a commitment to the quality of its products and services, human rights, health, safety and the environment and its staff. According to this research, however, only three of the banks have corporate social responsibility programmes that include support of charitable events, community service and conservation programmes.

There are contrasting views regarding the relationship between financial performance and social responsibility. McGuire et al. (1988) noted three views. One view is that firms face a trade-off; firms incur costs from socially responsible actions that put them at an economic disadvantage compared to other, less responsible, firms. A second, contrasting viewpoint considers the explicit costs of corporate social responsibility to be minimal and that firms may actually benefit from socially responsible actions in terms of employee morale and productivity. A third perspective considers the costs of socially responsible actions as significant but is offset by a reduction in other firm costs. In addition, other researchers have suggested that stakeholders may see corporate social responsibility as indicating management skill. In short, a firm has an investment in reputation, including its reputation for being socially responsible. Corporations in Ethiopia should involve in such socially responsible practices and reap the benefits.

All in all, the study of corporate governance in the Ethiopian financial sector is directed to the prevalent board practices. The legal framework for appropriate governance system is already there, the 1960 Commercial Code. The problem is that it is not properly applied. It is important for people to have confidence in both banks and insurance companies of their country. This is possible by ensuring compliance with good governance.

5.2 Econometric Analysis

This part reports results from econometric tests of the relationships between the financial performance on the one hand, and governance mechanisms on the other focusing on board characteristics. Before this, however, we will see the descriptive statistics for the variables intended to be included in the econometric analysis.

Table 5.2: Descriptive statistics on performance & governance characteristics

Variable	Obs	Mean	Std.Dev.	Min	Max
<i>Dependent Variables</i>					
<i>Ln(gross profit)</i>	39	18.16	1.15	15.85	20.81
<i>ROA</i>	40	2.49	1.03	0.40	4.20
<i>ROE</i>	39	26.18	12.47	4.10	54.65
<i>Independent Variables</i>					
<i>Ln(asset)</i>	40	21.74	1.10	20.17	24.75
<i>Board size</i>	40	9	2.09	5.00	12.00
<i>Female director</i>	40	0.03	0.05	0.00	0.11
<i>Board meetings</i>	40	44.40	32.41	12.00	96.00
<i>Ownership type</i>	40	0.25	0.44	0.00	1.00
<i>Internal Auditor</i>	40	0.75	0.44	0.00	1.00

A total of eight commercial banks are considered for the econometrics analyses. Two of the banks are government-owned while the rest are privately owned. The average firm size is 21.74. The board size is among the lower in international comparison. On average, board of a commercial bank in Ethiopia has 9 members. Only two commercial banks have female directors: Commercial Bank of Ethiopia, and Bank of Abyssinia. Each of these banks has only one female board member. As a result the proportion of female directors, defined as a ratio of the number of female board members-to-total board members/board size, is extremely low (0.03). The number of board meetings also seems to be close to averages found in other countries. The average frequency for board meetings is 44.4 (i.e board of directors meet 44.4 times in a year, which is equal to 3.7 times in a month or approximately we can say that the boards meet once every week). More than 60 percent of the banks included in the analysis meet at least once in a week (i.e the average) while all the banks have at least one regular board meeting in a month. The high standard deviation indicates variation in the frequency of board meetings among banks, some meet much more frequently than others. More than 70 percent of the banks have an internal auditor with direct access to the board. Except Dashen Bank and Awash International Bank, in all the banks internal auditors report directly to the board audit committee. This has a good implication for internal governance as well as performance of the banks.

When we look at the financial positions of the banks we see that the sector is relatively profitable as indicated by the average return on assets of

2.49 and the average return on equity of 26.18. For instance, the average ROE of 26.18% implies that a firm with shareholders' investment worth of ETB 3.8 million generates a profit of ETB 1 million. There is visible variation among banks; few are more efficient and are better at converting their investment into profit. Similarly, there is significant difference in the banks size and profit: the median firm has a total asset of ETB 2.04 billion (the minimum is ETB 1.6 billion and maximum is ETB 56.2 billion. The average annual gross profit is about ETB 80.2 million, with the range of ETB 45 million- ETB1 billion.

The next step is to present the results from the regressions and see the relationship between firm performance and governance characteristics. A general representation of our empirical model is given in the equation below for a convenient reference.

$$ROA_{it} \text{ or } ROE_{it} \text{ or } LnGross\ profit_{it} = Intercept + \beta_{1it}(LnAsset) + \beta_{2it}(Board\ size) + \beta_{3it}(Female\ director) + \beta_{4it}(Board\ meetings) + \beta_{5it}(Internal\ auditors\ dummy) + \beta_{6it}(Ownership\ type\ dummy) + v_{it}$$

First, we run Random Effect/Generalized Least squares regression. Table 5.3 below illustrates the results from Random Effect regressions with alternative financial performance measures as dependent variable: natural logarithm of gross profit before tax, return on equity (ROE) and return on assets (ROA). ROE is a better tool to compare performance among the banks since it measures how much profit a company generates with the money invested by shareholders.

Table 5.3 Estimation results: Financial performance measures regressed on governance characteristics. Random effects/GLS estimation.

	<i>Dependent Variables</i>		
	<u>LnGrossprofit</u>	<u>ROA</u>	<u>ROE</u>
Constant	-8.82	-17.07	-249.124
lnasset	1.286**	0.973**	13.791**
Board size	-0.145**	-0.185*	-2.650**
Female directors	-6.807**	-13.540**	-133.763**
Board meetings	0.006	-0.0004	0.034
Internal auditors	0.580	1.358**	5.384
Ownership type	-0.892**	-2.32**	-12.540*
Prop > chi 2	0.0000	0.0000	0.0000
R-squared within	0.8472	0.2384	0.5286
R-squared between	0.9135	0.9305	0.7812
R-squared overall	0.8486	0.4322	0.5912
Sigma_u	0	0	0
Sigma_e	0.4306	0.6853	8.3722
Rho	0	0	0

- Significance results at the 1% (5%) level are marked with ** (*)
- The Wald test (Greene, 2003, p. 107) is here a test of the null hypothesis that the coefficients in the given equation are all zero. A low value indicates null hypothesis rejection.

In all the three regressions, the R-squared overall lies between the R-squared between and the R-squared within. This is in accordance with theory that 'the *Random Effects or Generalized Least Square/GLS estimator can be determined as a weighted average of the between and within estimator*'. We found no correlation for all the regressions as indicated by the zero values of rho, which is our estimate of the correlation of the unobserved heterogeneity and the regressors³². Thus, it is safe to use Random Effects.

³² For instance a company's reputation as unobserved firm heterogeneity is uncorrelated with ownership type or board characteristics.

We get the standard deviations of the residual and the firm heterogeneity from the Random Effects regression and use them to do the transformation as discussed in the methodology part. Then we run a Three Stage Least Squares on the transformed data (refer to table 5.4 below).

Table 5.4 Estimation results: Financial performance measures regressed on governance characteristics. Random effects panel data 3SLS estimation.

	<i>Dependent Variables</i>		
	<u>LnGrossprofit</u>	<u>ROA</u>	<u>ROE</u>
Constant	-20.454	-24.921	-29.895
lnasset	2.984**	1.420**	1.655**
Board size	-0.338**	-0.270*	-0.318**
Female directors	-15.792	-19.769	-16.052
Board meetings	0.013*	-0.001	0.004
Internal auditors	1.345**	1.982**	0.646
Ownership type	-2.069*	-3.387**	-1.505*
Prob>chi2	0.0000	0.0000	0.0000

- Significant results at the 1% (5%) level are marked with ** (*)
- The Wald test (Greene, 2003, p. 107) is here a test of the null hypothesis that the coefficients in the given equation are all zero. A low value indicates null hypothesis rejection.

The coefficients from the 3SLS are simply our GLS estimates multiplied by one over the standard deviation of the residual. This is because of the standard deviations we got when we first run GLS: zero standard deviation for firm heterogeneity in all the regressions ($\sigma_u = 0$). Consequently, θ will be zero.

The standard errors that we get when we run the 3SLS on the transformed data are smaller than the standard errors from the GLS regression.

The final results from the 3SLS are more or less consistent with previous findings. The variable for board size has a negative sign and is significant. This implies that banks with lower board size have relatively better performance than banks with large boards. The result is in line with the recent literature, which is leaned towards smaller boards as supported by empirical studies such as Jensen (1993) who suggests that smaller boards allow more candid discussion and quicker decision making. In case of Ethiopia, firms should reduce the size of their boards with intent to improve board effectiveness. The answer for the potential question to be raised-*'how small should the board be?'* requires further investigation of the nature of the firm and the operating environment. Few researchers suggest less than ten to be small board size (Lorsch and Lipton, 1992) while others say that a small board of not more than eight persons functions faster for financial institutions (Firstenberg & Malkiel, 1994).

The variable for female directors has a negative sign. The result is at odds with common findings in other studies that confirm the importance of board diversity in terms of gender (Welbourne, 1999). However, it is insignificant. According to this research, having a female director does not have any significant impact on firm performance. Similarly, the variable for frequency of board meetings is also insignificant. Although insignificant, it is positive for Grossprofit and ROE regressions: boards that meet relatively more frequently perform better than boards that meet less frequently. This should be the case because at the board meetings various aspects of the organization are discussed; the performance of the firm is evaluated, potential risks are

identified so that appropriate measures can be taken and major strategic decisions are made timely. Especially, in banking sector boards must meet more frequently because major financial decisions require approval from the board; for instance, requests for loan amounts beyond certain threshold set by the bank must get the board's approval. The insignificant results of the variable for board meetings in our regressions indicate that it is not the frequency rate of board meetings that determines performance; perhaps what matters is what happens at the meetings.

The variable for internal auditors is positive and significant at 1% level of significance except for the ROE regression, where it is insignificant. Banks that have internal auditors with direct access to the board perform relatively better compared to banks with internal auditors reporting to the CEO.

The dummy variable for ownership type has a negative sign and is significant in all the regressions. This implies that state-owned firms record relatively lower performance in terms of all performance measures as compared to private firms. The inefficiency of state-owned banks in Ethiopia is consistent with previous findings (Kiyota et al., 2007); Private banks show generally better performance than state owned as indicated by the relatively higher cost of state owned banks, their lower ROA, and their smaller interest spread. State-owned commercial banks are inefficient, surrounded by too much bureaucracy, and they are not as advanced as they should be given the long years they have been in operation. Recently, measures such as Business Process Re-engineering

(BPR) programs are being undertaken and reforms are taking place in state-owned firms in order to enhance performance.

The discussion so far yields the following conclusions. First, this empirical research provides further evidence in favor of smaller board size. Second, the discussion of board composition does not show any beneficial effect of having more female directors. In practice, there is a need for frequent board meetings especially in the banking sector; however this study does not support that. Thirdly, banks having internal auditor with direct access to the board have better performance. The fourth main result is that ownership type matters: shareholder owned banks perform relatively better than the government owned banks.

The present study is only a preliminary step in investigating governance practices. There are several limitations that should be acknowledged in this study. Weak results in this study depict that the notion of directors as monitors is too simplistic. Issues dealing with inner workings of the board, such as the board-CEO relationship, complicate the modeling problem. Moreover, group decision-making and the behavior of small groups of individuals could also alter the model as the individuals appear to be governed by issues of emotions, fairness and norm adherent. However, while these are shortcomings in this study, they can be seen as fruitful avenues for future research under the same theme.

CHAPTER SIX

CONCLUSION AND RECOMMENDATION

This study is an in-depth analysis of governance practices in the Ethiopian financial sector. The study encompasses an exhaustive literature review, descriptive analysis as well as econometric analysis that attempts to find evidence for the relationship between governance mechanisms and firm performance using a sample of eight commercial banks in the Ethiopian financial sector for a period of five years.

In conclusion, the descriptive analysis shows that there is no effective compliance with good governance system indicated in the existing institutional framework. The results from the econometrics analysis are more or less consistent with previous findings. These conclusions imply that the financial sector is to undergo major transformation and to remodel its governance structure and practices. There is a need for an effective governance system composed of performance enhancing mechanisms (such as smaller board size, frequent board meetings, internal auditor with direct access to the board, ...).

Recommendation

Corporations need to be governed in order to mitigate the agency problem that arises between stakeholders. Ethiopia needs to implement effective corporate governance system tailored to the local realities. These complemented by the following recommendations may bring about better performance in the financial sector.

- The government together with the concerned bodies should be actively involved to develop *improved corporate governance* that promotes and protects shareholders' rights, ensures timely and accurate disclosure of information, enhances accountability, etc. This requires supporting institutional framework as well as effective enforcement mechanism.
 - The supporting framework of commercial law and accounting practice (both essential to sound financial systems) was articulated in Ethiopia as early as 1960 in contrast to Africa's other transition economies where it is highly underdeveloped. The country should make the best use of the established frameworks applying the necessary modifications.
 - Investment in NBE's capacity to regulate the financial system in the public interest must be a high priority. For people to inspire confidence in the financial institutions, NBE should ensure that banks and insurances operate in line with all prescribed rules and regulations related to good governance.
 - Firms should establish a system of management, which adequately respects the signals arising from shareholders and adjust with the changing features of the system and improve firm performance to a greater extent.
- Narrowly, effective corporate governance can be depicted by autonomous management of financial institutions through boards that have a core group of excellent, professionally acclaimed directors.



Future Research

An increasing number of studies have been recognizing the simultaneous (or interactive) nature of many of the corporate governance mechanisms, suggesting that single-handed interventions on a particular mechanism may not be feasible or effective. Along the same lines, a promising area for future research is the link between the corporate governance characteristics of firms and performance. This research on corporate governance in Ethiopia has raised more questions than answers. In particular, the causes of problems and the consequences of governance structure remains elusive. There is a need for study with a much deeper perspective of the evolving corporate system in Ethiopia. For instance, while evidence supports the notion that smaller boards are more effective, how small should corporate boards be? What is the optimal board structure? The extent to which the boards will change remains an open question.

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APPENDIX A

QUESTIONNAIRE

Study of corporate governance in the Ethiopian financial sector

Date _____

Name and type of the institution _____

A: Introduction

QA1. For how long has this institution been in operation? _____

QA2. Is this institution

- a) entirely privately owned
- b) owned partly by the government
- c) fully government owned & controlled

QA3. Please list down the main range of services the institution offers

B: Management and the Board

QB1. What is the total number of the Board of Directors [_____]

QB2. How are board members nominated?

- a) Shareholders nominate
- b) Former board members nominate
- c) Management nominates
- d) other process [please state] _____

QB3. Is there pre-set criteria for nomination? _____

QB4. To what extent and how does the board of directors nominate candidates for the board? _____

QB5. What requirements must members of the board fulfill?

- a) "fit and proper test" (no criminal convictions or prior bankruptcies) _____
- b) Minimum education and training _____
- c) Professional experience _____
- d) Age _____
- e) Others _____

QB6. How is the board appointed?

- a) by the vote of majority shareholders
- b) by the vote of all shareholders
- c) by the old board when a new one is coming into office
- d) a head hunt by the chairman
- e) other process [please state] _____

QB7. What is the maximum election term for members of the board? _____

QB8. What is the composition of the board in terms of:

<i>Professional qualification (give number)</i>	<i>Proportion of outside directors</i>	<i>Experience in relevant field</i>	<i>Gender (give number)</i>
Lawyers [__] Banking [__] Finance specialists [__] Engineers [__] Economists [__] Management professionals [__] Other professions [list and give numbers]			Male [__] Female [__]

QB9. Does the law, regulations or articles of association require the election of independent directors to the board?

- a) Yes
- b) No

QB10. Does the definition of "independence" exclude persons who are?

Yes No

- Related to management (by blood or marriage)
- Related to major shareholders
- Employees of affiliated companies
- Representatives of companies having significant dealings with the company in question

QB11. Does the law require the separation of Chairman and CEO?

- a) Yes
- b) No

QB12. Specify the prescribed board structure

- a) Unitary board structure
- b) Dual board structure

QB13. How frequently does the Board meet (per year)? _____

QB14. Are there any special committees in the board? (please specify) _____

QB15. Are there any induction programmes in place for new Board members?

- a) Yes
- b) No

QB16. How are deliberations communicated to shareholders and other stakeholders?

QB17. Does the board assess the performance and effectiveness of the following stakeholders? How?

	<i>yes; how frequently</i>	<i>No</i>
The board itself		
Individual members		
Chief executive		
Others(specify)		

QB18. Are reports made from these assessments? [_____]

QB19. At what level are the reports discussed?

Yes No

- board meeting
- Annual General Meetings (AGM)
- special meetings
- others, if any [please specify]

C: Management of corporate risk and social responsibility

QC1. What are some of the key risk areas that are identified by the board?

QC2. What are some of the key performance indicators for the institution?

QC3. What are some of the institution's social responsibility?

D. Disclosure & Transparency

QD1. Does the law or regulations provide for consolidated financial reporting?

- a) Yes
- b) No

QD2. Are companies required to disclose non-financial information on:

- a) Corporate governance structures and practices
- b) Education and professional experience of directors and key executives
- c) Remuneration of directors and key executives
- d) Deviations from corporate governance codes

QD3. Are companies required to have their financial statements externally audited?

- a) Yes
- b) No

QD4. How and by whom are external auditors appointed? _____

QD5. To whom do the internal auditors report? _____

QD6. Who monitors and evaluates the implementation of the bank's strategies, policies, plans and management performance?

- a) the board
- b) the chief executive
- c) share holders
- d) all departmental heads
- e) everybody in the management position including the board and the CEO

QD7. Who reviews the viability and financial sustainability of the institution?

- a) the board
- b) the chief executive
- c) the share holders
- d) all departmental heads
- e) everybody in the management position including the board and the CEO

QD8. How frequently is this done? _____

QD9. Is there any measure in place to ensure that the institution complies with all relevant laws, regulations, governance practices, accounting & auditing standards?

QD10. Who enforces these measures?

- a) the board
- b) the chief executive
- c) share holders
- d) all departmental heads

E: Shareholders' and stakeholders' information

QE1. What financing method does the institution use?

QE2. To what extent do the shareholders exercise the authority to ensure that only competent and reliable persons are elected or appointed to the Board of directors?

QE3. To what extent do the shareholders ensure that the Board is held accountable for the effective running of the company so as to achieve its objectives?

QE4. Do the shareholders have the power to change the composition of the Board that does not perform to expectations or in accordance with the mandate of the bank?

a) Yes

b) No

QE5. How does the institution communicate with its shareholders and stakeholders?

QE6. To what extent is the institution accountable to its shareholders?

QE7. What accounting procedures are there in place to effect this?

QE8. Do you think the members are satisfied with this?

a) very satisfied

b) satisfied

c) not satisfied at all

QE9. What are the rights of employees regarding

a) Information on the company _____

b) Collective bargaining Participation in the board of directors _____

c) Consultation _____

QE10. Can employees participate in the company's profits by

a) Share ownership

b) Share options

c) Profit sharing schemes

QE11. What is the type of corporate ownership structure?

a) Concentrated ownership structure

b) Dispersed ownership structure

QE12. Are there multiple classes of shares where some shares enjoy more voting rights than others? _____



QE13. If insiders own the majority of the company shares and voting rights do large vote holders control management through direct representation on the company board?

QE14. Specify the internal and external stakeholders of the institution?

QE15. Is there a policy which guides how the institution should relate with its stakeholders? _____

QE16. What periodic information are the companies required to provide?

- a) Annual reports
- b) Unaudited semiannual reports
- c) Quarterly financial statements
- d) Others(specify) _____

QE17. What information must be contained in the company's annual report?

- a) General information on the company
- b) Audited annual accounts
- c) Directors reports on past and future operations
- d) Financial status of the company
- e) Consolidated financial reports
- f) Information on corporate governance

QE18. What kinds of voting rights may shares have? _____

QE19. Do shareholders have the right to vote on

- a) Appointment & removal of directors
- b) Appointment & removal of auditors
- c) Issuing shares
- d) Dividend policy
- e) Amendments to company articles or statute
- f) Remuneration of board members
- g) Major corporate transactions (acquisitions, disposals, mergers, takeovers)
- h) Changes to company business or objectives

QE20. Does the law provide for the disclosure of voting agreements?

- a) Yes
- b) No

QE21. Who is responsible for declaring, approving and issuing dividends? _____

QE22. Are there Self-binding instruments applied by companies to protect stakeholder rights? (Specify) _____

APPENDIX B

Total Assets and Return on Assets (ROA) of Ethiopian Banks Value (Millions of ETB)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Commercial Bank of Eth.	17,503	17,434	19,828	21,489	22,146	24,200	27,975	33,169	35,849	43,456
Development Bank of Eth.	2,229	2,502	2,615	2,578	2,569	2,555	4,081	n.a	n.a	n.a
Construction & Bus. Bank	n.a	n.a	974	968	958	942	1,057	1,832	1,797	1,889
Total state-owned banks	19,732	19,936	23,417	25,035	25,673	27,697	33,113	35,001	37,646	45,345
<i>Share (%)</i>	<i>(93.6)</i>	<i>(90.7)</i>	<i>(88.1)</i>	<i>(86.1)</i>	<i>(83.1)</i>	<i>(79.9)</i>	<i>(78.5)</i>	<i>(74.1)</i>	<i>(69.6)</i>	<i>(67.4)</i>
ROA	0.015	0.007	0.011	0.005	-0.004	-0.002	0.005	0.013	0.027	
Dashen Bank	511	674	865	1,100	1,486	1,991	2,677	3,420	4,546	6,041
Awash International Bank	452	536	759	907	1,112	1,401	1,770	2,226	2,954	3,830
Bank of Abyssinia	206	388	718	896	1,142	1,333	1,585	2,057	2,834	3,396
Wogagen Bank	185	366	514	583	646	889	1,140	1,616	2,259	3,480
United Bank	n.a	76	143	214	314	469	674	1,073	1,599	2,183
Cooperative Bank of Oromiy	n.a	n.a	n.a	n.a	n.a	n.a	n.a	129	224	424
Nib International Bank	n.a	n.a	158	336	534	885	1,247	1,732	2,027	2,607
Total Private banks	1,354	2,040	3,157	4,036	5,234	6,968	9,093	12,253	16,443	21,961
<i>Share (%)</i>	<i>(6.4)</i>	<i>(9.3)</i>	<i>(11.9)</i>	<i>(13.9)</i>	<i>(16.9)</i>	<i>(20.1)</i>	<i>(21.5)</i>	<i>(25.9)</i>	<i>(30.4)</i>	<i>(32.6)</i>
ROA	0.005	0.016	0.014	0.020	0.012	0.011	0.021	0.021	0.022	
Total	21,086	21,976	26,574	29,071	30,907	34,665	42,206	47,254	54,089	67,306

Note: n.a:-not available

Sources: Annual Reports of the individual banks.

APPENDIX C

The current structure and composition of boards of Banks & Insurances

	<i>Company age</i>	<i>Board size</i>	<i>Female directors</i>	<i>Board meetings</i>	<i>Internal auditors</i>
BANKS					
Private Banks					
1. Awash International Bank	14	12	0	12	0
2. Dashen Bank	13	7	0	48	0
3. Bank of Abyssinia	12	9	1	48	1
4. Wegagen Bank	11	9	0	12	1*
5. United Bank	10	9	0	12	1
6. Nib International Bank	9	11	0	96	1
7. Oromia Cooperative Bank	3	11	0	12	-
8. Lion International Bank	2	11	0	12	-
9. Zemen International Bank	0	8	0	24	-
<i>Average for private banks</i>	<i>8.2</i>	<i>9.67</i>		<i>30.67</i>	
State-owned Banks					
10. Commercial Bank of Eth	100	10	1	96	1
11. Constr.& Business Bank	65	5	0	48	1
12. Development Bank of Eth	32	7	0	12	1*
<i>Average for public banks</i>	<i>65.7</i>	<i>7.33</i>		<i>52.00</i>	
<i>Average for total banks</i>		<i>9.08</i>		<i>36.00</i>	
INSURANCES					
1. Ethiopian Insurance cor.	31	6	0	24	1
2. Awash Insurance	13	9	1	12	0
3. Africa Insurance	-	-	-	-	-
4. National Ins Co.of Eth.	14	5	0	12	1
5. United Insurance	9	9	0	12	1
6. Global Insurance	-	-	-	-	-
7. Nile Insurance	12	8	0	48	1
8. Nyala Insurance	13	5	0	48	0
9. Nib Insurance	6	9	1	48	1
10. Lion Insurance	-	-	0	12	-
11. Ethio-life	0	7	-	-	-
<i>Average for insurances</i>		<i>7.25</i>		<i>27</i>	
Average for Banks & Insurances		7.48		30.86	

Institutions that have internal auditors with direct access to boards are denoted by one, whereas zero represents internal auditors that report to CEO

** indicates that internal auditors report to both the board and the CEO*

APPENDIX D

Correlation matrix for the dependent variables

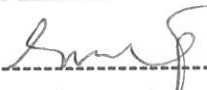
	Ln(asset)	Board size	Female directors	Board meetings	Internal auditor	Owner type
Ln(asset)	1.0000					
Board size	0.2216	1.0000				
Female directors	0.5736	0.1322	1.0000			
Board meetings	0.3248	-0.0364	0.3325	1.0000		
Internal auditor	0.0975	-0.1400	0.3328	0.2598	1.0000	
Owner type	0.4936	-0.4201	0.3011	0.3464	0.3333	1.0000

Declaration

I the undersigned, declare that this thesis is my original work, has not been presented for a degree in any other university and that all sources of materials used for this thesis have been duly acknowledged.

Declared by

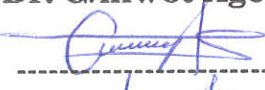
Name Martha Kibru

Signature -----

Date 31/10/2008-----

Confirmed by Advisor

Name Dr. G/hiwot Ageba

Signature -----

Date 31/10/08-----

Place and Date of Submission: Addis Ababa, September 2008