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**IMPACT OF GOVERNEMENT BANKING POLICIES ON PRIVATE BANKS
COMPETITIVENESS IN ETHIOPIA FROM 1994-2015**

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ABSTRACT

This study is intended to review impact government banking policies and directives on private bank competitiveness from year 1994 to 2015. The study is done with the main objective of assessing effects of regulations on resource mobilization and allocation decisions of these private banks. To do so, the study employed qualitative research approach in order to get better and deep information. Besides, both primary and secondary data sources were used to examine the issue under discussion. To this end, review of different secondary data was administered. In addition, to better triangulate the study findings, interview with key informants was held.

Drawing documentary study and data from the primary sources, various issues of government policies and directives was assessed. The study found out that despite progress, Private Banks in Ethiopia have challenges from government policies and directives which hinder their competitiveness. The empirical results show that, there is no equal playing field between private and state owned banks, to begin with, the NBE Bill is applicable only to private banks, Secondly public sector offices and enterprises are forced to work with CBE and also resources for condominium housing was mobilized only by the public owned CBE, so, this unequal treatment of private and state owned banks negatively affected private banks. Thus, government bodies should revisit some directives issued on private banks, encourage the participation of the private banks so as to play a vital role in the economy and private commercial banks should strive to expand and grow since, their share is significant in terms of branch networks and capital.

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CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

A bank is an institution, which accepts demand and time deposits from businesses, institutions and individuals and engages in both business and consumer lending (MC Vash, 1977). Bank helps to mobilize and distribute the idle resources to potentially productive sectors, aiming to raise the level of economic development as a whole. In modern times, commercial banking occupies quite important place in every economy. If the banking industry does not perform well, the effect to the economy could be huge and broad, because, banks are the critical part of financial system, play a pivotal role in contributing to a country's economic development (Rasidah and Mohd, 2011). Athanasoglou *et al.* (2006) stated that the importance of banks is more pronounced in developing countries because financial markets are usually underdeveloped, and banks are typically the only major source of finance for the majority of firms and are usually the main depository of economic savings. The global financial crisis of 2007/2008 also demonstrated the importance of banking performance both at national and international economies and the need to keep it under close supervision.

It is very true that a nation's policy based on the governing ideology and outlook has an impact on the growth and development of overall economy in general and specifically on financial institutions and their role in the economy. Hence the development of financial institutions, especially of banking sector has gone through various aspects that has contributed to its development or hampered its development for the matter related to financial policy of various governments that ruled over Ethiopia. As indicated in Zerayehu *et al.* (2013), government's economic policy and strategies have significant impact on competition in the banking industry.

State-dominated banking sector that existed in Ethiopia during the military government (1974-1991) was a major hindrance to economic growth (Admasu and Assayehegn,

2014). Since it took power in 1991, the current government has implemented a number of reforms, for instance, in 1994; it legalized domestic private investment in the banking industry reversing the nationalization decision of the Socialist Military Government (Proclamation No. 84/1994). In addition, it restructured the two government owned banks, the Development Bank of Ethiopia and the Construction and Business Bank as commercial, and issued a new Banking and Monetary Proclamation No . 591/2008 dated August 11, 2008 that gave more autonomy to National Bank of Ethiopia and further clarified the National Bank of Ethiopia's activities as the regulator and supervisor of the both the public and private banks . Although these measures have led to improvements in efficiency and competition of banking activities, there is a great need for additional market oriented reforms (Admasu and Assayehegn, 2014). Though it is generally agreed that government financial policies have an impact on overall banking operation in the country, The outlook for the banking sector does, on the surface, look somewhat threatening given some rather unconventional policy interventions such as lending quotas and windfall taxes – that private banks have had to deal with in the past year (Access capital, 2010) .

There is a positive relationship between financial sector openness and economic growth as Mattoo (in Kiyota *et al.* 2007), emphasized that the key elements of financial openness are domestic market competition, foreign ownership, and limited capital controls, all of which are lacking in Ethiopia. Whereas Global experience suggests that greater competition among domestic and foreign banks can bring greater benefits in the form of improving efficiency. Fundamental market-oriented measures are therefore needed to further strengthen the financial sector in order to accelerate Ethiopia's economic growth (Admasu and Assayehegn, 2014). However Ethiopian banking sector is dominated by one large state-owned bank, the Commercial Bank of Ethiopia (CBE), Moreover, bank concentration, defined as the asset share of the three largest banks, is 87.9 per cent in Ethiopia, which is the highest in East Africa, (Kiyota *et al.* 2007).

In countries like Ethiopia, whereas financial sector is dominated by banking industry, effective and efficient functioning of bank has significant role in accelerating economic growth. To enhance the role of banks in an economy, competition is an important driving force; without competition, it is unlikely to bring about efficiency and foster financial sector development. In other words, insufficient competition may result in substantial social losses on account of higher price, higher transaction cost, and lower credit supply, lack of innovation and poor service quality (Zerayehu *et al* 2013).

Spong (2000), noted that banking regulation must be evenhanded in its effects on various groups. Regulation should not give preferential treatment to financial institutions or to their customers, and it should not favor one size or type of financial institution over another. Banking regulation must take an approach that does not restrict activities of commercial banks, place them at a competitive disadvantage with less regulated firms, or hinder the ability of banks to serve their customers' financial needs, regulation should foster a banking system that can adapt and evolve in response to changing economic conditions and technological advances. As stated in Kaoma (2000), the key objective of supervision should be to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors; Supervisors should encourage and pursue market discipline by encouraging good corporate governance and enhancing market transparency and surveillance.

Rules that interfere with the market may have unforeseen side effects. Any such intervention in banking operation is often likely to be unsuccessful, or nearly so, since borrowers and other customers can frequently shift their business into "favored" areas or switch to less regulated entities. In the interest of a competitive and efficient banking system, good bank regulation should have minimal effects on credit and resource allocation decisions and should not encourage costly efforts, (Spong, 2000). Increasing transparency and the role of market forces and limiting distortions imposed by public sector policies; would strengthen financial systems, (Kaoma, 2000).

Therefore, the purpose of this study is to assess the major challenges of private banks in Ethiopia vis -a-vis banking regulation, which restrict their activities in terms of capital formation, resource mobilization and allocation the mobilized resource in the form of loans, and also the study assesses if there is unequal treatment between Government banks and private banks.

1.2 Statement of the Problem

Banking sector efficiency is a key contributor to a macroeconomic stability and economic growth. However, this sector has many challenges that affect its performance and competition. As stated in Zerayehu *et al.* (2013) government's economic policy and strategies have significant impact on competition in the banking industry.

In Ethiopia, some government policy and regulations related to Private banks , reduces the ability of the banks to mobilize resource (deposits), which in turn hinders bank lending to business and entrepreneurial developments , generally it restrict economic growth potential of the country. Investment in Ethiopia is comparatively slanted toward the public sector, which has led to a restriction in private sector investment participation and growth, which are more likely working with private banks, this problem can be explained by, public sector banks which finance investment in key developmental projects such as those involving infrastructure, but broad-based development is required in order to create sustainable economic growth, and this investment typically comes from private sector banks as their deposit base grows. Therefore the development of private banking sector work is considered important to Ethiopia's economic progress.

Looking at major government policies, procedures and regulations regarding private banks one can come to observe the following, The National Bank of Ethiopia issued a directive on April 6, 2011 instructing private commercial banks to buy government bonds worth of 27 percent of the loan disbursements they have made since July, 2010. This measure was set to earn 3 per cent; the deposit rates set by the National Bank stand

at 5 percent (Admasu and Assayehegn, 2014). This directive diverted financial resources from the private to the public sector. The government also imposed credit ceilings on private banks, which reduced the volume of credit, (It was removed on April 1, 2011). These and other government policies have negatively affected the performance of private commercial banks.

In this regard identifying the factors which are related to government policies and directives that affect private bank performance and examining their impact is vital. Therefore, this study would seek to fill the gap by:-

- * Providing information about challenges as a result of government policies, regulation and directives which hinder private banks competitiveness.
- * Identifying whether banking regulation in Ethiopia is evenhanded in its effects on various groups, should it favor Government banks over private banks.
- * Identifying the effects of banking regulation on capital formation, resource mobilization and allocation decisions of these private banks.

1.9 Core Argument

Private Banks in Ethiopia have challenges as a result of government policies, regulation and directives which hinder their competitiveness in terms of capital formation, resource mobilization and allocation of the resources in the form of loan.

1.10 Objectives of the Study

The main objective of this thesis is to review government banking policies and directives and show their impacts on private banks competitiveness in Ethiopia from 1994-2015. Specifically, it would address the following objectives;

- * To identify challenges as a result of government policies, regulation and directives vis -a-vis private banks,

- * To examine about the factors which restrict the activities of private commercial banks,
- * To explore whether banking regulation in Ethiopia evenhanded in its effects on various groups, should it favor Government banks over private banks.
- * To identify the effects of regulations on resource mobilization and allocation decisions of these private banks.
- * To propose possible recommendations to show the way forward.

1.11 Research Questions

The core research question of this study is that what is the impact of government banking policies and directives on the performance of private banking in Ethiopia since 1994? The study also has the following specific question:-

- * Which part of government banking policies and directives restricted activities of private commercial banks?
- * How banking regulation in Ethiopia favor government banks over private banks?
- * What are the effects of regulations on capital formation, resource mobilization and allocation decisions of these private banks?
- * How did private banks reacted to cope up with the difficulty they faced with regard to government banking policies?

1.12 Significance of the Study

The study identified effect of government policies on private bank performance. Thus, it will give signal to the Government to take remedial action, and also it will provide full information of these factors for private banks themselves, to look for solution. Furthermore, other interested researchers may take this study as a base for detailed and further st

1.13 Scope and Limitations of the Study

This study focused on assessment of government banking policies issued by NBE directives on private commercial banks in Ethiopia by analyzing policies and directives issued after Proclamation (84/1994) of 1994, which legalized domestic private investment in the banking industry in Ethiopia.

The study comprised all sixteen private commercial banks which started their operation after the above Proclamation .The first limitation of the study is, out of the sixteen private commercial banks, five private commercial banks namely, Bank of Abyssinia, United Bank, Lion International Bank, Buna International Bank and Abay Bank were included in Key informant interviews, since other private Banks official's were reluctant to give interviews and also because of time limitation.

1.14 Organization of the Paper

The rest of this paper is organized as follows: - Chapter two presents the literature review; this includes the theoretical review in its first section which is followed by the review of previous studies related to the area and conclusion and knowledge gap finally. Documentary analysis and interview of key informants and their result are presented in chapter three. Chapter four presents the conclusions and recommendations. Finally, "Reference" of related literature is referred while writing the paper and appendices are included after chapter four.

CHAPTER TWO: LITERATURE REVIEW

2.5 Introduction

Banks are unique from other business organizations. They are unique because they provide the most important contribution to any economy; they are key players in the payment and settlement system for the government, business sector and households; they are deposit takers, they play a major role in the allocation of financial resources, acting as an intermediary between depositors of surplus funds and borrowers in need of funds. As Roland (2008), pointed out the banking sector serves three important functions in an economy. First, it ensures the orderly flow of funds between economic agents through the provision of payment services. Second, it mobilizes resources in the form of savings by offering attractive investment opportunities; third, it pools savings and allocates them in the form of loans to investment projects. The banking sector thus acts as an intermediary between savers and investors in an economy and as a result enables the decentralization of economic decisions in a market economy.

A healthy and vibrant economy requires a financial system that helps in effective and efficient allocation and utilization of scarce resources, the banking sector is the largest component of the financial system, and its roles impinge on all aspects of the economy. According to Getnet (2010), the unique feature makes banking a risky business whose failure may result in systemic risk and necessitated special and strict regulatory intervention by governments. Among the various regulatory intervention mechanisms, investment limitation in banks, reserve requirements and liquidity requirements, found to be essential factors that affect them.

This chapter is devoted to review of theoretical and empirical evidences focusing on the effect of government banking policies on private bank performances. The chapter is divided in to two section accordingly, the first section, presents theoretical and empirical evidences related to the issue so; it will cover other countries experience with this regard. The second section, presents overview of the banking system in Ethiopia

which includes review of earlier studies on Ethiopian banking industry finally concluding remarks for the chapter is presented.

2.6 Review of Theoretical Evidences

There is broad consensus in the literature that the mobilization of savings and the allocation of capital have positive repercussion on the overall economy. This suggests a question: Under which coordination mechanism, state or market, does the banking sector best perform its functions?

2.6.1 Banking Performance under Market Economy

The proponents of financial liberalization argue that imposing repressive policies such as artificially low real interest rates, directed credit programs and excessive statutory preemption on banks can have a negative effect on both the volume and the productivity of investments, which in turn inhibits economic growth (Roland, 2008). Advocates of 'free banking' argue that the financial sector would work better without regulation, supervision and central banking. They argue, many of bank crises was because of the failure of regulation, in the absence of government regulation, banks would have greater incentives to prevent failures. Regulation is a costly business and the costs of compliance with the regulatory process will be passed on to consumers, resulting in higher costs of financial services. In addition, regulatory costs may act as a barrier to entry in the market and this may consolidate monopoly positions (Casu *et.al.* 2006).

2.6.2 Banking Performance under State Involvement

From both a development and a political perspective on state involvement, the state is better suited than the market to ensure that the banking sector performs its growth-enhancing functions. According to Roland (2008), government can achieve this either through direct ownership of banks or with restrictions on the operations of banks. It is argued that the government can ensure a better economic outcome than the market, for example by channeling savings to strategic projects that would otherwise not receive funding or by creating a branch infrastructure in rural areas. In this context, active

government involvement in the banking system is the trigger for the growth enhancing effect. Bank regulation, therefore, creates a regulatory framework that encourages efficiency and competition throughout the economy (Spong, 2000).

Commercial banks are strictly regulated by the central bank to prevent failures because of fraud, mismanagement etc. Commercial banks must comply with all applicable laws, such as statutory reserve requirements, liquidity requirements, laws relating to taxation and accounting procedures, opening of new branches, mergers, etc. Frame *et al*, (in Rasiah ,2010).

After the Second World War, economists and governments alike advocated government ownership of enterprises in order to avoid possible inequities or imperfections in the markets. As a result, many countries nationalized "strategic" sectors of their economies including banks. Another strategy besides complete nationalization of banks was the imposition of restrictions and regulations. The underlying rationale for these policies was the desire to achieve higher investment and saving ratios in controlled financial sector .The main reasons for financial sector regulation are to ensure stability; to provide smaller, retail clients with protection; and to protect consumers against monopolistic exploitation (Roland, 2008).

2.6.3 Reasons for State Involvement

According to Casu *et.al*. (2006), regulation is needed to ensure consumers' confidence in the financial sector. The main reasons for financial sector regulation are to ensure stability; to provide smaller, retail clients with protection; and to protect consumers against monopolistic exploitation. Broadly speaking, proponents of a controlled banking sector hope to achieve three types of goals through state ownership of banks or restrictions on their operations (Roland, 2008). These goals are economic, developmental and political are explored in the following section.

Enhancing economic efficiency in the light of market failures is one of the key reasons for state involvement in the economy. This also holds true for the banking sector. Market failures occur where the conditions for the proper functioning of markets are not fulfilled. This results in welfare losses for consumers or producers. The most

frequent types of market failures are natural monopolies, external effects, ruinous competition, and information asymmetries.

Another argument for government involvement in the banking sector is that it supports the development of the domestic economy. This development view stressed the necessity of financial development for economic growth in order to achieve social objectives.

The political goals for state involvement in the banking sector are closely connected to the development goals. While the development view stresses government involvement in order to achieve social objectives, the political view emphasizes political objectives as the main motivation for intervention. In this view governments take control over banks to provide direct or indirect benefits for their supporters. Such political goals can be achieved either through outright ownership or through regulations. Besides financing politically desirable projects, state-owned banks can also be an easy source of money for the government to finance budget deficits. This can be achieved through reserve requirements, provision of credit to the government at artificially low rates, or by demanding that banks hold government bonds (ibid).

2.6.4 Instruments of State Involvement

There is a large range of financial restraints and competitive restrictions that governments can use to intervene in a banking sector. Financial repression or financial restraints are policies that inhibit the operation of the banking sector at its full potential. Financial repression can take various forms. As quoted from (ibid), there are three frequently-used policies: - statutory preemptions, regulated interest rates, and directed credit programs.

It can take the form of reserve and liquidity requirements. Reserve requirements oblige banks to deposit a certain percentage of deposits at the central bank. While this is common practice in many countries, it becomes a repressive policy if the amount of funds preempted is above the level required to ensure an orderly functioning of the monetary policy. Liquidity requirements are similar in nature and oblige banks to keep

a certain percentage of deposits in government bonds or other approved securities. Statutory preemptions result in an under-supply of credit by taking liquidity out of the market and in an artificial demand for government securities.

Take several forms. Frequently used controls include ceilings, floors and fixed rates on both deposits and loans. These controls constitute either incentives or disincentives for investment or saving.

A certain portion of bank credit is allocated to specific sectors in the economy which are priority sectors such as agriculture, small-scale industries, small transport operators or the export sector.

2.6.5 Goals of Bank Regulations

Regulation is needed to ensure consumers' confidence in the financial sector. Llewellyn in Casu *et.al.*(2006), pointed out the main reasons for financial sector regulation are: to ensure systemic stability; to provide smaller, retail clients with protection; and to protect consumers against monopolistic exploitation. Banking laws and regulations extend too many aspects of banking, including who can open banks, what products can be offered, and how banks can expand. According to Spong (2000), the accepted goals of bank regulation are Protection of depositors, Monetary and financial stability, Efficient and competitive financial system and Consumer protection.

To provide stability, banking regulation should foster the development of strong banks with adequate liquidity and should discourage banking practices that might harm depositors and interrupt the payments system.

In banking regulation, the objective of monetary stability has been closely linked with the goal of depositor protection. Financial crises and unintended fluctuations in the money supply have been prevented primarily by promoting confidence in banks and guaranteeing the safety of deposits.

Another aspect of a good banking system is that customers are provided quality services at competitive prices. One of the purposes of bank regulation, therefore, is to create a regulatory framework that encourages efficiency and competition and ensures

an adequate level of banking services throughout the economy. Efficiency and competition are closely linked together. In a competitive banking system, banks must operate efficiently and utilize their resources wisely if they are to keep their customers and remain in business. Without such competition, individual banks might attempt to gain higher prices for their services by restricting output or colluding with other banks. Competition is also a driving force in keeping banks innovative in their operations and in designing new services for customers. A further consideration is that for resources throughout the economy to flow to activities and places where they are of greatest value, competitive standards should not differ significantly across banking markets or between banking and other industries.

The promotion of an efficient and competitive banking system carries a number of implications for regulation. Competition and efficiency depend on the number of banks operating in a market, the freedom of other banks to enter and compete, and the ability of banks to achieve an appropriate size for serving their customers. For instance, too few banks in a market could encourage monopolization or collusion, while banks of a suboptimal size might be unable to serve major customers and might be operating inefficiently. Consequently, regulators must be concerned with the concentration of resources in the banking industry and with the opportunities for entry and expansion across individual banking markets. Banking regulation must also take an approach that does not needlessly restrict activities of commercial banks, place them at a competitive disadvantage with less regulated firms, or hinder the ability of banks to serve their customers' financial needs. Finally, regulation should foster a banking system that can adapt and evolve in response to changing economic conditions and technological advances (Spong, 2000).

Another goal of banking regulation is to protect consumer interests in various aspects of a banking relationship. The previous regulatory objectives serve to protect consumers in a number of ways, most notably through safeguarding their deposits and promoting competitive banking services. However, there are many other ways consumers are protected in their banking activities. These additional forms of protection have been

implemented through a series of legislative acts passed over the past few decades. Several basic purposes can be found in this legislation. The first is to require financial institutions to provide their customers with a meaningful disclosure of deposit and credit terms. The main intent behind such disclosures is to give customers a basis for comparing and making informed choices among different institutions and financial instruments. The disclosure acts also serve to protect borrowers from abusive practices and make them more aware of the costs and commitments in financial contracts. A second purpose of consumer protection legislation is to ensure equal treatment and equal access to credit among all financial customers (ibid).

2.6.6 What Bank Regulation Is Not Intended To Accomplish

Should banking regulations and government policies favor certain groups over others? This kind of intervention in banking, except in cases of obvious distortions, is not desirable for several reasons. As (ibid), in a free society, market forces should be free to allocate credit and resources. Rules that interfere with the market are inconsistent with this principle and may have unforeseen side effects. Any such intervention in banking is often likely to be futile, or nearly so, since borrowers and other customers can frequently shift their business into “favored” areas or switch to less regulated entities. Consequently, banking regulation must be evenhanded in its effects on various groups. Regulation should not give preferential treatment to financial institutions or to their customers, and it should not favor one size or type of financial institution over another. In the interest of a competitive and efficient banking system, good bank regulation should have minimal effects on credit and resource allocation decisions and should not encourage costly effect. According to (ibid), increasing transparency and the role of market forces and limiting distortions imposed by public sector policies; would strengthen financial systems.

2.6.7 Basel Committee on Banking Supervision Core Principles for Effective Banking Supervision

The Basle Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of banking supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, the UK and the US. It usually meets at the Bank for International Settlements in Basle, where its permanent Secretariat is located (Kaoma, 2000).

The Core Principles for Effective Banking Supervision are the minimum standard for sound prudential regulation and supervision of banks and banking systems. Originally issued by the Basel Committee on Banking Supervision, they are used by countries as a benchmark for assessing the quality of their supervisory systems and for identifying future work to achieve a baseline level of sound supervisory practices. The Core Principles are also used by the International Monetary Fund (IMF) and the World Bank, in the context of the Financial Sector Assessment Program, to assess the effectiveness of countries' banking supervisory systems and practices (Basel, 2012). The Core Principles for Effective Banking Supervision have become the most important global standard for prudential regulation and supervision. The vast majorities of the countries have endorsed the Core Principles and have declared their intention to implement them. As a first step to full implementation, there should be an assessment of the current situation of a country's compliance with the Principles. Such an assessment should identify weaknesses in the existing system of supervision and regulation, and form a basis for remedial action. In September 1997, the Basle Committee on Banking Supervision published its report on the 'Core Principles for Effective Banking Supervision'. The report says: Weaknesses in the banking system of a country, whether developing or developed, can threaten financial stability both within that country and internationally. It is the view of the Basle Committee that the Core Principles for Effective Banking Supervision should serve as a basic reference for supervisory and other public

authorities in all countries and internationally. The Committee argues that 'national agencies should apply the Principles in the Banking Supervision and Systemic Bank Restructuring (Kaoma, 2000).

The Basle Core Principles comprise 25 basic principles that need to be in place for a supervisory system to be effective (Basel, 2012). These principles cover the following:

1- An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organizations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking organizations and their ongoing supervision; powers to address compliance with laws as well as safety soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

2- The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word 'bank' in names should be controlled as far as possible.

3-The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organization's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.

4-Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

5-Banking supervisors must have the authority to establish criteria for reviving major acquisitions or investments by a bank and ensuring that corporate affiliation or structures do not expose the bank to undue risks or hinder effective supervision.

6-Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those in the Basle Capital Accord and its amendments.

7-An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

8-Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan reserves.

9-Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

10-In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

11-Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

12-Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should

have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

13-Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

14-Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal and external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

15-Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict 'know your customer' rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

16-An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

17-Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.

18-Banking supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.

19-Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

20-An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

21-Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable

the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

22-Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.

23-Banking supervisors must practice global consolidated supervision over their internationally active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

24-A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

25-Banking supervisors must require in the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

As (ibid) the Basle Committee contends that the fundamental precepts drawing up the Core Principles for Effective Banking Supervision are as follows:

- (a) The key objective of supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors;
- (b) Supervisors should encourage and pursue market discipline by encouraging good corporate governance (through an appropriate structure and set of responsibilities for a Bank's board of directors and senior management) and enhancing market transparency and surveillance;

- (c) In order to carry out its tasks effectively, a supervisor must have operational independence, the means and powers to gather information both on and off site, and the authority to enforce its decisions;
- (d) Supervisors must understand the nature of the business undertaken by and ensure to the extent possible that the risks incurred by banks are being adequately managed;
- (e) Effective banking supervision requires that the risk profile of individual banks be assessed and supervisory resources allocated accordingly;
- (f) Supervisors must ensure that banks have resources appropriate to undertake risks, including adequate capital, sound management, and effective control systems and accounting records; and
- (g) Close co-operation with other supervisors is essential, particularly where the operations of banking organizations across national borders.

2.6.8 Framework for Sound Banking

The IMF's Executive Board has broadly agreed that achieving the following objectives would strengthen financial systems (Kaoma, 2000).

- strengthening internal governance by bank owners, boards of directors and managers;
- increasing transparency and the role of market forces;
- limiting distortions imposed by public sector policies;
- controlling risk through regulatory and supervisory oversight;
- strengthening the broader structural framework; and
- fostering national and international supervisory co-ordination.

Further, the IMF is working a code for transparency in monetary and financial policies. This code identifies desirable transparency practices for central banks in their conduct of monetary policy and for central banks and other financial agencies in their conduct of financial policies.

2.7 Review of Relevant Experience and Lessons

This section shows the relevant experience and lessons from two countries India and China. The experiences of these countries are taken because these countries are emerging economies and adopted financial liberalizations and opened its banking sectors after long period government monopoly of the sector same as Ethiopia did.

India

Knowing the evolution of Indian banking industry and to examine the policy changes since the early 1990s that transformed the Indian banking system to a market-driven and sound banking system from a highly regulated and financially repressed system is important for this study. It has been observed that from the early 1970s through the late 1980s, the role of market forces in the Indian banking system was almost missing, and excess regulation in terms of high liquidity requirements and state interventions in allocating credit and determining the prices of financial products resulted in serious financial repression (Kumar and Gulati, 2014).

After increasing government involvement from the 1960s until the end of the 1980s, India's banking sector is now transforming from state direction to a market base. Prior to 1991 India's banking sector showed a significant degree of state ownership and extensive regulation, among others of the allocation of credit and the setting of interest rates. Following the balance of payments crisis in 1991, structural reforms were introduced that were a clear departure from the previous economic policy, in which the state was supposed to take the "commanding heights" of the economy (Roland, 2008).

Realizing the presence of the signs of financial repression and to seek an escape from any potential crisis in the banking sector, the Government of India embarked upon a comprehensive banking reforms plan in 1992 with the objective of creating a more diversified, profitable, efficient and flexible banking system. The main agenda of reforms process was to focus on key areas: (i) restructuring of Government banks by giving more autonomy in decision making, and by infusing fresh capital through

recapitalization and partial privatization; (ii) creating contestable markets by removing entry barriers for domestic private and foreign banks; (iii) improving the regulatory and supervisory frameworks; and (iv) strengthening the banking system through consolidation. To meet this agenda, the policy makers heralded an episode of interest rates deregulation, standardized minimum capital requirements as per Basel norms, prudential norms relating to income recognition, assets classification and provisioning for bad loans, and changes in the legal and supervisory environment (Kumar and Gulati, 2014).

China

The banking sector in China has been strongly influenced by the pre-dominant political philosophies. Since the foundation of the People's Republic of China in 1949, the banking sector has undergone several distinct policy changes. A watershed was the opening up of the Chinese economy in 1979, since then the banking sector has steadily evolved from a state directed mono banking system into a fairly open commercial banking system. The major development phases since 1979 have been: the creation of a two-tier system between 1979 and 1985; the commercialization of the banking system through the foundation of new (policy) banks between 1985 and 1994; the build-up of infrastructure and regulation between 1995 to about 2002; and the preparation for the opening up of the banking sector between 2002 and 2006 after the agreement to the World Trade Organization (WTO) (Roland, 2008).

1979-1985: Two-tier banking system

In 1979, China established a two- tier banking system. It founded three state-owned banks - the Agricultural Bank of China (ABC), the Bank of China (BOC) and the China Construction Bank (CCB). The ABC was charged with the task of providing banking services to rural areas and townships. The BOC was supposed to act as an urban bank providing different banking services, while the CCB, took responsibility for financing large capital intensive projects, especially in the construction sector. This was an important first step in creating a more diversified banking system.

1985-1994: Commercialization of the banking system

Between 1985 and 1994, several important steps were taken to further commercialize the banking system. These included the formulation of a credit plan that instituted an aggregate credit ceiling for each branch. Within these credit ceilings, the branches gained increasing autonomy to make credit decisions.

1995-2002: Build up of infrastructure and regulation

A further important step toward the establishment of a more market-based banking sector was the enactment of the Commercial Banking Law of 1995. This law required the banks to operate as commercial entities with responsibility for profits and losses. The Commercial Banking Law also required banks to focus on efficiency and liquidity in their operations, as well as to make inquiries into the creditworthiness of their customers.

2002-2006: Opening of the banking sector

Accession to the WTO required China to successively open up its banking sector between 2002 and 2006 in terms of business reach and geography. Until 2002, foreign banks had only been allowed to serve foreign companies and foreign individuals. This was extended to Chinese domestic companies in 2005, with the commitment to lift all restrictions in 2006 so that services can be offered to Chinese individuals as well (Roland, 2008).

2.8 Overview of the Banking System in Ethiopia

Traditional financial system in Ethiopia has long history and paramount contribution to economic betterment and social wellbeing of the society. Traditional institutions organized with a sense of cooperation and risk sharing has enabled Ethiopians to experience saving and financial management within its cultural context, eqqub and edir are some of the informal financial institutions.

The first bank to be established in Ethiopia was the Bank of Abyssinia in 1905. It was owned and managed by the British-owned National Bank of Egypt. It was given a

banking monopoly for fifty years, including the right to issue notes and coins. Three other banks were established in the next ten years. In 1931, the Bank of Abyssinia was replaced by the Bank of Ethiopia, which was wholly owned by the government and members of the Ethiopian aristocracy, becoming the first 100 percent African-owned bank on the continent; it was also authorized to issue notes and coins and to act as the government's bank. It operated for only a few years, being closed after the Italian invasion. During the Italian occupation, several Italian banks opened branches in Ethiopia. After the liberation in 1942, the State Bank of Ethiopia was established. It became operational in 1943, and acted as the country's Central Bank. The Bank also acted as the country's main commercial bank, while a few much smaller foreign banks continued to operate. The country's first development bank was founded in 1951 Belay Gidey (in Harvey, 1995).

In 1963, a new banking law spitted the functions of the State Bank of Ethiopia into central and commercial bank as the National Bank of Ethiopia and the Commercial Bank of Ethiopia, respectively. Both of which were government-owned. The 1963 banking law provide other commercial banks to operate. This included foreign banks provided they were 51percent owned by Ethiopians. The biggest of these was the Addis Ababa Bank. It was 40 percent owned by Grindlays Bank (British owned). There were also two foreign commercial banks: the Banco di Roma and the Banco di Napoli. In addition to the commercial banks, the government established two development banks, both of which were 100 percent state owned. The Agricultural and Industrial Development Bank (AIDB) was set up in 1970, taking over two earlier development banks: the Development Bank of Ethiopia and the Ethiopian Investment Corporation which were established in 1963 as the Investment Bank of Ethiopia. AIDB was 100 percent government owned, and provided short, medium and long-term loans to the agricultural and industrial sectors. The Housing and Savings Bank was created in 1975 out of a merger between two earlier housing finance institutions created in 1962 and 1965(ibid).

The fall of the imperial government in 1974 led to a major change in economic policy. The new military government declared Ethiopia to be a socialist state. The government steadily extended its control over the whole economy. The nationalization of all large corporations was one of the instruments for establishing this centralized control. As far as ownership of financial institutions was concerned, this made little difference, since the remaining private sector commercial banks were relatively small; they were nationalized and concentrated into the Commercial Bank of Ethiopia (CBE). The new government merely shifted, therefore, from owning most of the banking system to owning it completely. The practice of banking changed fundamentally, the banks' large customers became public enterprises, and the banks were instructed to lend to them in support of the government's development plans. The banks were not able to refuse to implement these instructions on the basis of commercial lending criteria (ibid).

Proclamation No. 84/1994 of Transitional Government of Ethiopia (TGE) that allowed the private sector to engage in the banking business marked the beginning of a new era in Ethiopian banking. Following this proclamation Ethiopia witnessed a proliferation of domestic private banks. At present there are sixteen private banks with a total of 1,205 branches (NBE, 2014). Ethiopia's private banks registered very strong growth in 2010 in all three banking operations: mobilizing deposits, providing loans, and dealing in foreign exchange (Admasu and Asayehegn 2014).

The main institutional changes of Proclamation No. 84/1994 of TGE, being limited to the following:

- To allow private sector banks to operate, but only if 100 percent locally-owned
- To allow the two development banks, AIDB and the Housing and Savings Bank, to become commercial banks and to compete with the CBE and with each other but to keep the three government banks in 100 percent government ownership.

Banks play a key role in the endeavors to improve economic efficiency by channeling funds from resource surplus unit to those with better productive investment opportunities. Banks also play key role in trade and payment system by significantly reducing transaction costs and increasing convenience. In less monetized countries, like

Ethiopia, whilst financial sector is dominated by banking industry, effective and efficient functioning of the banks has significant role in accelerating economic growth. To enhance the role of banks in an economy, competition is an important driving force; without competition, it is improbable to bring about efficiency and foster financial sector development. In other words, insufficient competition may result in substantial social losses on account of higher price, higher transaction cost, lower credit supply, lack of innovation and poor service quality (Zerayehu *et.al*, 2013).

In Ethiopian context, one cannot confidently argue that there has been rigorous banking competition. During the pre-1975 imperial period, there were few banks dominated by foreign ownership and the absorptive capacity of the economy was too low even to accommodate moderate competition. In the *Derge* (1975-1991), private banks were fully nationalized and no room was for competition. After the down fall of the *Derge* in 1991, private banks were again allowed to operate consistent with the ideology of market oriented economic policy of the new government (Alemayehu, 1986). Accordingly, new private banks were established and their role and position in the industry have been flourishing from time to time. However the Ethiopian banking sector is dominated by one large state-owned bank, the Commercial Bank of Ethiopia (CBE). In 2010, CBE alone held approximately 63.5 percent of deposits and 38 percent of bank loans in the country ((Admasu and Asayehegn 2014)). Moreover, bank concentration, defined as the asset share of the three largest banks, is 87.9 percent in Ethiopia, which is the highest in East Africa (Kiyota *et. al.* 2007).

There is a positive relationship between financial sector openness and economic growth as Mattoo (in Kiyota *et.al.* 2007), emphasized that the key elements of financial openness are domestic market competition, foreign ownership, and limited capital controls, all of which are lacking in Ethiopia.

Conclusion

So far discussed theoretical and empirical evidences focusing on the effect of government banking policies. In this regard we come across two views about banking regulation.

Proponents of strict regulatory intervention by governments, by imposition of restrictions and regulations like, investment limitation in banks, interest rate fixing, high liquidity requirements, found to be essential factors and active government intervention mechanisms in the banking system is the trigger for the growth. Financial regulation, which depends mainly on various market imperfections and failures, in the absence of regulation, would produce sub-optimal results and reduce consumer welfare. The main reasons for financial sector regulation are to ensure stability; to provide smaller, retail clients with protection; and to protect consumers against monopolistic exploitation.

The proponents of financial liberalization (Market Economy) take an opposite stance. They argue that imposing repressive policies such as artificially low real interest rates, directed credit programs and excessive statutory pre-emption on banks can have a negative effect on both the volume and the productivity of investments, which in turn inhibits economic growth. The majority of empirical studies support the view that repressive policies have a negative effect on both the banking sector and the economy as a whole. This study give more weight to market forces will, stimulate financial development and promote stronger economic growth, Bank regulation should creates a regulatory framework that encourages efficiency and competition throughout the economy and a well-designed regulatory framework is also necessary to ensure consumers' confidence in the financial sector.

This study also believe that the Basel Core Principles for Effective Banking Supervision which are the minimum standard for sound prudential regulation and supervision, should be used as a benchmark for assessing the quality of supervisory systems.

CHAPTER THREE: RESEARCH METHODOLOGY

This chapter discusses the research design and methodology. The chapter is organized in six sections. The first section 3.1 discusses the Method of the research. Sources of data and Instruments of data collection are presented in section 3.2. Data Collection Techniques is presented in section 3.3. In section 3.4 Sampling methods and sample size is presented. In section 3.5 Data analysis methods is presented. Lastly, Ethical consideration is presented in section 3.6.

3.7 Method of the Research

The study adopted qualitative approach which involves documents review and analysis and interviewing key informants to realize the stated objective. As quoted in Bhattacharjee (2012), the advantage of using qualitative research is that, it is well-suited for exploring hidden reasons behind complex, interrelated, or multifaceted social processes, such as inter-firm relationships or inter-office politics, where quantitative evidence may be biased, inaccurate, or otherwise difficult to obtain. Secondly qualitative approach usually employs small, focused samples that fit the phenomenon of interest, rather than large, random samples.

3.8 Sources of Data and Instruments of Data Collection

In this study both primary and secondary data sources were used. With regard to primary data, it was collected through interview with purposively selected key Officials and experts at the private Banks and National Bank of Ethiopia.

In addition, from secondary data sources, relevant information was collected by consulting different documents pertinent to the study, these include documents like:- annual reports, financial statements, newspaper articles and websites at the selected banks and, Directives of NBE and Proclamations of the Government. Finally, this information was fine tuned and made ready for data analysis and presentation.

3.9 Data Collection Techniques

This research employed the following data collection techniques in order to collect both primary and secondary sources. These includes: consulting different documents pertinent to the study and semi-structured interviews with key official and experts. A semi-structured interview is chosen because it provides uniform information which assures the comparability of data. It also requires a few interviewing skills than does unstructured interview. Accordingly, this activity was undertaken with purposely selected sample, key officials and experts working at finance, Risk and credit department who have different responsibility, expertise and experiences about the major challenge encountered. Thus, interview guides which comprises of semi-structured questions were developed.

3.10 Sampling Methods and Sample Size

The population of this study included all private commercial banks in Ethiopia (for the secondary data). However, only five private commercial banks were included in key informant interview, which are:-Bank of Abyssinia, United Bank, Lion International Bank, Abay Bank and Addis International Bank.

3.11 Methods of Data Analysis

After relevant information is collected data presentation and analysis was the necessary step. So that, the information collected from both primary and secondary data sources through review of different documents and interview with key informants was organized and narrated.

The data were analyzed using descriptive statistical methods which is percentages. The presentation of data was made using tables and figures, moreover, explanations were supplied for each question along with respondents' justification; ultimately, generalizations were made and presented accordingly for the qualitative data by way of narrating and interpreting the situations.

3.12 Ethical Consideration

Since research often involves a great deal of cooperation and coordination among many different people in different organization, many of ethical standards to promote the values that are essential to collaborative work are considered, that researcher also consider potential risks and ethical conflicts when designing and conducting research accordingly, a formal letter was written by Addis Ababa University Business and Economics faculty to concerned Banks to permit us to conduct the research .

Informed verbal consent was secured from all study subjects before conducting the actual study. Confidentiality was maintained at all levels of the study. Respondents who were unwilling to participate in the study and those who wanted to quit the interview or discussion at any point in time was informed to do so without any restriction.

CHAPTER FOUR: DATA PRESENTATION, DISCUSSION AND ANALYSIS

4.1 Introduction

The purpose of this chapter is to present, discuss and analyze data obtained from secondary source documents. Beside, primary data were also generated with the help of Key Informant Interviews with senior officials and experts of NBE and private banks, namely, Bank of Abyssinia, United Bank, Lion International Bank, Buna International Bank and Addis International Bank were included in Key informant interviews, to assess how this policies and directives affected their performance.

Commercial banks are strictly regulated by the central Bank of Ethiopia to prevent failures because of fraud, mismanagement etc. Commercial banks must comply with all applicable laws, such as statutory reserve requirements, liquidity requirements, laws related to taxation and accounting procedures, opening of new branches, mergers, etc. Frame *et al.* (in Rasiah, 2010).

The development of financial institutions, especially of banking sector has gone through various aspects that has contributed to its development or hampered its development for the mater related to financial policy of various governments that ruled over the country. As indicated in Zerayehu *et al.* (2013), Government's economic policy and strategies have significant impact on the banking industry. The financial sector under previous government constituted only three banks each enjoying monopoly in its respective market. After the country adopted market economic policy in 1991, a series of financial sector reforms had been introduced; Monetary and Banking Proclamation No. 83/1994 restructured the National Bank of Ethiopia as a judicial entity, separated from the government and outlined its main functions. This Proclamation was repealed and replaced by "the National Bank of Ethiopia Establishment (as Amended) Proclamation No. 591/2008, in order to increase the autonomy of the National Bank of Ethiopia, which among other things clarified the role of the National Bank as the regulator and supervisor of the banking sector. As per article 4 of this Proclamation, the

purpose of the National Bank of Ethiopia is to maintain stable rate of price and exchange, to foster a healthy financial system and to undertake such other related activities as are conducive to rapid economic development of Ethiopia. As stated in FDRE (2008), The National Bank shall have the powers and duties for the fulfillment of its purposes, to mention some of them, which are related to this study:-License and supervise banks, insurers and other financial institutions; the relation of the National Bank with Banks, Insurance companies and other financial institutions is: - The National Bank shall license and regulate banks, insurance companies and other financial institutions in accordance with the relevant laws of Ethiopia. The National Bank shall also have the power to regulate and determine the supply and availability of money and credit as well as the applicable interest rates and other charges; but money literatures claim that, to enhance the banking sector's ability to mobilize deposits and efficiently allocate savings, all interest rates should be market determined.

Regulation is needed to ensure consumers' confidence in the financial sector. The main reasons for financial sector regulation are: to ensure systemic stability; to provide smaller, retail clients with protection; and to protect consumers against monopolistic exploitation. NBE has made a rigorous effort to develop its capabilities over time. As a consequence, the public has gained greater confidence in the banking sector, which has led to growth in banking sector, from levels that were among the lowest in Africa.

Banking laws and regulations extend too many aspects of banking, including who can open banks, what products can be offered, and how banks can expand. The accepted goals of bank regulation are protection of depositors, Monetary and financial stability, efficient and competitive financial system and Consumer protection. Hence, NBE plays pivotal roles to protect the public and the economy of the country as a regulatory body. Due to the risky nature of certain activities, banks are highly supervised entities worldwide. Basle (2012) argues that the key objective of supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors.

The Licensing and Supervision of Banking Business Proclamation No. 84/1994 of the Transitional Government of Ethiopia provides the general framework. (This Proclamation was replaced by Banking Business Proclamation No. 592/2008). From then on, a series of directives setting out the specific rules and regulations, the quantified requirements and compliance impositions are released and enacted by the NBE. To look in to some important points of the banking business proclamation No. 592/2008, outlines:-

The requirement for obtaining a banking business license in Ethiopia, in these are included, prohibition of foreign nationals or organizations fully or partially to allow opening banks or branch offices or subsidiaries of foreign banks in Ethiopia or acquiring the shares of Ethiopian banks. The government's concern for prohibiting foreign bank was that, entry at this time would prevent the domestic banks from being weakened because of unfair competition from foreign banks. The other issue contained in proclamation No. 592/2008 was; - limitations on the acquisition of shares, no person, other than the Federal Government of Ethiopia, may hold more than five percent of a bank's total shares either on his own or jointly with his spouse or with a person who is below the age of 18 related to him by consanguine to the first degree it also insist an influential shareholder of any bank may not to acquire shares in other banks. This limitation of share holding might work to protect influence of major share holders and make minority share holders to participate in decision making, but it has also an adverse effect in limiting the bank's capital base. After the proclamation No. 84/1994, promulgated, private banks start to emerge. As a result of this, the Ethiopian banking system now comprises sixteen private banks along with three publicly owned banks.

To explore (address) the research objectives, factors such as Share of bank branches, Capital, Deposit mobilized by banks, Loan disbursement, NBE bills amount must be examined.

4.2 Branch Network of Banks

Table 4.1: Branch Network of the Banking System, March 31, 2015. (Branch in Number)

Banks	Branch Network											
	2013/14-III Quarter				2014/15-II Quarter				2014/15-III Quarter			
	Regions	Addis Ababa	Total	% Share	Regions	Addis Ababa	Total	% Share	Regions	Addis Ababa	Total	% Share
1-Public banks												
Commercial Bank of Ethiopia	680	147	827	39.2	755	178	933	37	771	186	957	36
Construction & Business Bank	68	46	114	5.4	68	50	118	5	69	51	120	5
Development Bank of Ethiopia	31	1	32	1.5	31	1	32	1	31	1	32	1
Total public banks	779	194	973	46.2	854	229	1083	43	871	238	1109	42
2-Private banks												
Awash International Bank	54	87	141	6.7	86	100	186	7	95	110	205	8
Dashen Bank	67	65	132	6.3	73	81	154	6	76	88	164	6
Abyssinia Bank	52	53	105	5	62	61	124	5	63	67	130	5
Wegagen Bank	49	47	96	4.6	56	51	107	4	63	56	119	5
United Bank	39	54	93	4.4	57	63	120	5	61	64	125	5
Nib International Bank	39	54	93	4.4	43	60	103	4	45	65	110	4
Cooperative Bank of Oromiya	83	21	104	4.9	93	33	126	5	102	35	137	5
Lion International Bank	34	26	60	2.8	43	34	77	3	49	37	86	3
Oromia International Bank	70	26	96	4.6	89	38	127	5	99	47	146	6
Zemen Bank	3	6	9	0.4	6	6	12	0	5	2	7	0
Buna International Bank	39	20	59	2.8	46	29	75	3	46	34	80	3
Berhan International Bank	17	20	37	1.8	31	35	66	3	32	36	68	3
Abay Bank	54	16	70	3.3	66	18	84	3	69	18	87	3
Addis International Bank	5	13	18	0.9	9	20	29	1	10	22	32	1
Debub Global Bank	12	7	19	0.9	12	8	20	1	13	9	22	1
Enat Bank	0	3	3	0.1	3	6	9	0	3	6	9	0
Total Private Banks	617	518	1135	53.8	775	644	1,419	57	831	696	1,527	58
3.Grand Total Banks	1,396	712	2108	100	1,629	873	2,502	100	1,702	934	2,636	100

Source: NBE 2014/2015 III Quarter Report

The number of bank branches has increased by almost 30 per cent annually over the last 5 years. The total number of branches before 10 years was 421 now, it reached 2,636 at the late March 2015 (see table 4.1). Continuous expansions in branch network year after year imply the intensification of competition.

As it has seen from the above table, the share of private banks from the total bank branches in the country has increased from time to time and maintains more than half that is 58 per cent. So private banks have substantial role in facilitating access to unbanked people who have no access for banking system (see table 3.2). As per NBE (2008/09 & 2013/14) branch to population ratio improved and declined from 1: 117,474 people in 2008/09 to 1:39,402 in 2013/14. It should be noted, however, that significant part of branch expansion is in the capital city, Addis Ababa, where a great deal of business activities is executed. Out of the total branch 35.4 per cent is found in the capital city of the country. This shows that the banks have still limitations in reaching out the unbanked population. IMF staff report IMF (2013), indicated only 7.1 million people have deposit accounts, which is less than 8% of Ethiopians have a bank account.

Commercial Bank of Ethiopia's (CBE) branch network consists of 957 branches equal to 36 per cent of all bank branches in the country, which shows, dominant state ownership of the banking sector, as stated in Kiyota *et al.*(2007) Ethiopian banking sector is dominated by one large state-owned bank, the Commercial Bank of Ethiopia (CBE), Moreover, bank concentration, defined as the asset share of the three largest banks, is 87.9 per cent in Ethiopia, which is the highest in East Africa.

Table 4.2: Share of private bank branches, March 31, 2015

(Branch in Number)

Year	Public Banks				Private Banks				No. of Branches		
	Region	A.A	Total	% age share	Region	A.A	Total	% age share	Region	A.A	Total
Jun-06	187	49	236	56.1	86	99	185	43.94	273	148	421
Jun-11	371	112	483	49.8	250	237	487	50.2	621	349	970
Jun-12	532	143	675	52.4	327	287	614	47.6	859	430	1289
Jun-13	689	180	869	50.3	457	402	859	49.7	1146	582	1728
Jun-14	799	204	1003	45.4	656	549	1205	54.6	1455	753	2208
Mar-15	871	238	1109	42.0	831	696	1527	58.0	1702	934	2636

Source: Own computation and compilation from NBE, Annual and Quarter report of various issues.

It can be seen from the above table, the share of bank Branches of private banks grew from 43.94 per cent in June 2006 to 58 per cent in March 2014. With the objective of enhancing domestic resource mobilization in the country to finance the five years Growth and transformation Plan, public banks are being encouraged to expand their branch network ,as a result, in recent years public banks increased their branches and private banks are also trying to cope with the adverse implication of the NBE bills by expanding their branches to small towns to mobilization deposit which increased their expenses in terms of office rent and running cost of the branches , this, of course has unintended result that improves access to banking service for people who have no access for banking system before.

4.3 Total Capital of the Banking Sector

Total capital of the banking system showed an annual growth and reached Birr 30.5 billion, of which 55 per cent was that of private banks at the late March 2015. It is worth, to know the increasing contribution of the private banks to the total capital of the banking sector. The share of public banks in total capital was 45 per cent of which

Commercial Bank of Ethiopia accounted for 35 per cent while Development Bank of Ethiopia and Construction & Business Bank held 10 percent (Table 4.3).

Table 4.3 Capital share of the Banking System

(Capital in Billions of Birr)

Banks	June 30,2006		June 30,2011		June 30,2012		June 30,2013		June 30,2014		March 30,2015	
	Amt.	%age	Amt.	%age	Amt.	%age	Amt.	%age	Amt.	%age	Amt.	%age
Government	3.50	64.8	8.71	54.7	9.13	50.7	12.04	51.6	11.8	44.7	13.71	45
Private	1.90	35.0	7.23	45.3	8.87	49.3	11.30	48.4	14.6	55.3	16.71	55
Total	5.40	100	16.00	100	18.00	100	23.35	100	26.4	100	30.50	100

Source: Own computation and compilation from NBE, Annual and Quarter report various issues.

The total capital of the banking sector reached 30.5 billion birr in late March 2015 which was higher by six fold of June, 2006. Before 10 years, government banks took a significant share of the industry's capital. Trend wise, concentration of capital has been slightly declining, attributed to improvement in the asset position of private banks. Private Banks improved their share in the total capital from around 35 percent in June 2006 to 55 per cent in March 2015. This in turn implies that the share of state-owned banks significantly declined. Note, however, that, the values of total capital increased from 2006 to March, 2015 for both state-owned and private banks. Even though Directive No. SBB /47/ 2010 forces private banks' share holding in excess of 5 per cent, per person of total subscribed capital of the bank should be reduced such holding to 5 per cent or less; and influential shareholder in a bank shall abandon his share holdings in another bank. According to responses from the key informant interviewees the directive is claimed to reduce the ability of private banks to further improve their capital, which would resulted weaker growth in their balance sheets. If banks not grow up in their balance sheets they will not have enhanced resources to lend, this in turn affects negatively the banks income and growth.

4.4 Deposit Mobilization

As depicted on table 4.4 below, total deposit liabilities of the banking system (saving, demand and time) reached Birr 337.29 billion in late March 2015. The growth in deposit mobilization was attributed to an expansion in the number of bank branches. The share of public banks in total deposit was 67.55 per cent while the private banks constituted the remaining 32.45 per cent during the time period. So, there was also deposit shares concentration in favor of government banks.

Table 4.4: Deposit mobilized by commercial banks

(Amount in Billion Birr)

Year	Public Banks per cent age share	Private Banks per cent age share	Total Amount
June 2006	70.7	29.4	44.50
June 2011	64.5	35.5	140.53
June 2012	68.1	31.9	187.29
June 2013	67.7	32.3	237.20
June 2014	68.5	31.5	292.85
March 2015	67.5	32.5	337.29

Source: Own computation and compilation from NBE, Annual and Quarter report various issues.

As clearly seen from the above table, the share of private banks in deposit mobilization does not have a material change from year to year, even if there was an increase in number of branches and growth in capital, the following are reasons for this:-

As key informant interviewees of private banks reported that, sector offices and enterprises are forced by the government to work with public owned Commercial Bank of Ethiopia (CBE) as a result, significant number of their customers has moved to CBE this implies that their deposit was affected negatively by this government action. The

other issue raised by private banks is related with government policy of 10/90, 20/80 and 40/60 per cent arrangement of condominium housing. The government issued a new program that allows citizen to buy condominium apartments by paying 10 per cent, 20 per cent, and 40 per cent first in some year's time and the balance to be settled in long-term loan basis. All these resources are mobilized and administered by the public owned CBE. The other reason is the requirement to present 27 percent of their loans to the government by private banks at an interest rate of 3 percent, diverts a huge amount of resources from the private banks to the public banks. This makes private banks to look for other quick means of mobilizing deposit; hence, private banks have increased interest rate on time deposits up to 10 per cent to attract deposit from the market to cover their deposit shortage by competing among themselves. According to Spong (2000) banking regulation must take an approach that does not unnecessarily restrict activities of commercial banks, place them at a competitive disadvantage with less regulated firms, or hinder the ability of banks to serve their customers' financial needs. Regulation should foster a banking system that can adapt and evolve in response to changing economic conditions and technological advances.

4.5 Disbursement of Fresh Loans

As depicted on table 4.5 below, disbursement of fresh loans by the banking system was Birr 22.6 billion, at the end of March 2015. Public banks disbursed Birr 16.44 billion (72.74 per cent), while private banks disbursed Birr 6.13 billion (27.12 per cent).

Table 4 .5: Fresh Loans disbursement**(Loan in Billion Birr)**

Year	Amount disbursed			% age share of loan	
	Public banks	Private banks	Total loan	Public banks	Private banks
June 30-2006	5.12	7.28	12.40	41.29	58.71
June 30-2011	21.96	20.25	42.21	52.03	47.97
June 30-2012	36.95	19.15	56.10	65.86	34.14
June 30-2013	33.24	21.00	54.24	61.28	38.72
June30-2014	38.93	21.03	59.96	64.93	35.07
March 30-2015	16.44	6.13	22.57	72.84	27.16

Source: Own computation and compilation from NBE, Annual and Quarter report various issues.

The above table shows that, the share of private banks in loan disbursement was decreasing from year to year for several reasons:-

With the objective of controlling inflation in the country, the NBE placed restrictions on the activities of the commercial banks. It raised the reserve requirement of commercial banks (both public and private banks) from 5 per cent to 15 per cent effective from April 2008 (Directive No. SBB/45/2008), which states “ Any bank operating in Ethiopia shall at all times maintain in its Reserve Account 15 per cent of all Birr and foreign currency deposit liabilities held in the form of demand (current) deposits, saving deposits and time deposits”. NBE revised the reserve requirement downwards to 10 per cent effective January 2012 (Directive No. SBB/46/2012) and further to 5 per cent effective March 2013 (Directive No. SBB/55/2013).

Second, Directive which set the credit cap (credit ceilings) also reduced the capacity of banks for loan disbursement. NBE has set the maximum net credit that can be provided by each commercial bank for each year since March 2009 up until March 2011. This

measure contributed significantly to a reduction of the inflation rate. It was removed on April 1, 201.

Another directive that significantly affected the capacity of private banks on loan disbursement was Directive No. MFA/NBE BILLS/001/2011, which introduced NBE-Bill on April 4, 2011, with the objective of mobilizing resources from domestic banks to finance priority sectors that are identified as key for long term growth of the economy. MFA/NBE BILLS/ 002/2013 which replaced the above directive, defines NBE-Bill as a long term obligation of the National Bank of Ethiopia having maturity period of five years and sold to banks, other Article 3 of this Directive insists that Banks to buy the NBE-Bills by calculating their own allotment based on monthly plan of loans and advances disbursement. The applicable ratio for the allotment shall be 27 per cent of such disbursement. Article 9 of this directive shows tenure of the NBE-Bills, which is maturity period of five years and interest rate for each bill to be 3 per cent per annum.

According to responses from the key informant interviewees made with different officials and experts of private banks, the requirement to present 27 percent of their loans to the government by private banks at an interest rate of 3 percent, diverts a huge amount of resources from the private banks to the public banks, as a consequence, credit became tight and expensive, because, lending some amount of money will tied up 27 per cent of the amount lent. According to Spong (2000), intervention in banking, except in cases of obvious distortions, is not desirable for several reasons. In a free society, market forces should be free to allocate credit and resources. Rules that interfere with the market are inconsistent with this principle and may have unforeseen side effects. Any such intervention in banking is often likely to be unproductive to the economy, since borrowers and other customers can frequently shift their business into favored areas or switch to less regulated entities.

Table 4.6: Total outstanding loan of private commercial banks and NBE bills**(Loan in Billion Birr)**

Year	June 30-2011	June 30-2012	June 30-2013	June 30-2014
Total loan by private banks	26.94	36.74	47.62	53.69
NBE bills (27%)	6.3	12.84	18.85	26
NBE bill share of total loan (%)	23%	35%	40%	48%

Source: Own computation and compilation from NBE, Annual report, various issues

As of June 2014, the NBE bill constitutes 48 per cent of the total loan advanced by private banks. The amount of NBE bill is even growing much faster than the total loan and advances of private banks (Table 3.6). As the key informant interviewees pointed out, The NBE bills have caused portfolio adjustment by banks. The adjustment taken by private banks was shifting to long-term loans so as to reduce the amount of NBE bills since the turnover of short-term loans is high. NBE was aware of private banks' reaction such as shifting to long-term loans, and came up with Article 5 of Directive No. MFA/NBE Bills/002/2013, that forces all private banks' short-term loans to constitute at least 40per cent of total loans. What makes matters worse is the change in the definition of short-term loans from up to 24 months maturity in the past to a maturity of only 12 months. Before the issuance of the above directive, the maturity period for short term loan was two years (Directive no.SBB/ 52/2012).This could lead to more funds to be taken up by the NBE each time a short-term loan is advanced by banks.

The response from private banks is to making different adjustment to cope up with the difficulty they faced. Regarding this issue, an interview conducted with different officials and experts of private banks has shown that the banks are aware of the consequences of the 40 per cent directive on liquidity through more NBE bills. Their adjustment was to increase lending interest rate to compensate lower returns on NBE bills holding. Interest rate on loan has increased up to 17 per cent to 18 per cent, since,

NBE has no control on lending rates and the minimum & maximum rates are determined by the market .To mobilize deposits banks have increased interest rate on time deposits up to 10 per cent as a means of quick deposit mobilization since, NBE only set minimum interest rate on deposit, which is now 5 per cent per year, some banks are paying voluntarily highest rate to attract deposit ,this has also changed the trend of the structure of deposit mobilization and also increased the lending interest rate, because private banks are paying bigger interest on resources they collected for lending. Almost all private banks are also trying to cope with the adverse implication of the NBE bills through aggressive deposit mobilization and expanding their branches. This, of course, has a resulted in improving financial accesses to the public.

Table 4.7: Loan- to-deposit ratio

(Loan in Billion Birr)

Year	Deposit		Deposit to fresh loan ratio	
	Public Banks	Private Banks	Public Banks	Private Banks
June 2006	31.46	13.04	16.27 %	55.8 %
June 2011	90.64	49.89	24.22 %	40.59 %
June 2012	127.54	59.75	28.97 %	32.05 %
June 2013	160.58	76.62	20.70 %	27.4 %
June 2014	200.60	92.25	19.40 %	22.79 %

Source: Own computation and compilation from NBE, Annual report, various issues.

Private Banks' loan- to-deposit ratio has fallen from time to time, from 55.8 percent in 2006 to just 22.79 percent within nine years. this implies that, banks kept accumulating deposits but were restricted from lending out most of these deposits because of the credit caps, set since March 2009 up until March 2011. Even when credit ceilings on private banks are removed – growth in loan to deposit ratio is expect to take place , but, this is not happened because of the introduction of NBE-Bill on April 4, 2011, which diverted a huge amount of resources from the private banks to the public banks, as a consequence, this has exposed private banks to liquidity problems and affected banks by limiting the size of loans and the losses associated with the yield from the loan.

CHAPTER FIVE: SUMMARY OF KEY FINDINGS, CONCLUSION AND RECOMMENDATION

In this chapter, the major findings of the study are summarized; conclusions are drawn based on the findings and recommendations are forwarded.

The main objective of this study was to identify the impact of government policies and directives on private bank performance in Ethiopia. Specific objectives were to provide information whether the directives restrict or support activities of private commercial banks, place them at either competitive advantage or disadvantage as compared to state owned banks, to identify whether banking regulation in Ethiopia was evenhanded in its effects on various groups and to identify the effects of banking regulations on resource mobilization and allocation decisions of these private banks.

In this study, both secondary and primary data were gathered and analyzed vis-à-vis the objective of the study, with regard to secondary data, analysis was based on data available in the form of documents, like, Directives of NBE, annual and quarterly reports, financial statements, articles and websites at the selected banks and NBE. In relation to primary data, interviews were conducted with key informants; - namely official and experts of the banks under study and major findings of the study are found.

5.1 Summary of key Findings

1. Even though the share of private banks is greater as compared to government banks in terms of branch networks and capital, deposit and loan concentration is found more in government banks.

2. Directive No. MFA/NBE Bills/001/2011, which introduced NBE-Bill, Directive No. MFA/NBE Bills/002/2013, that forces all private banks' short-term loans to constitute at least 40 per cent of total loans, government policy of 10/90, 20/80 and 40/60 per cent, arrangements of condominium housing,

which are mobilized and administered by the public owned CBE and obligation of sector offices and enterprises to work with CBE. All these reduce the capacity of Private Banks to mobilize resource (deposits).

3. There is no equal playing field between private and state owned banks. To begin with, the NBE Bill is applicable only to private banks, Secondly public sector offices and enterprises are forced to work with CBE and also resources for condominium housing was mobilized only by the public owned CBE, so, this unequal treatment of private and state owned banks negatively affected private banks.
4. While share of private banks in loan disbursement has been decreasing from year to year; NBE bills follow provisions of short-term loans and this has exposed private banks to liquidity problems and has adversely affected banks by limiting the size of loans and the losses associated with the yield.
5. The requirement to offer 27 per cent of their loans to the government by private banks at an interest rate of 3 per cent diverts a huge amount of resources from the private banks to the public banks, since this resource is channeled to government banks to finance priority sectors that are identified by the government as key for long term growth of the economy and as a consequence, credit became tight and expensive for private bank borrowers, this will result in shifting of customers to state owned banks.
6. To cope up with the difficulty they have faced, private banks made different adjustment, their adjustment has been increasing interest rate on loan to compensate for lower returns on NBE bills holding. To mobilize deposits, they increased interest rate on time deposits, which increased the cost of bank lending to private bank borrowers which are usually private business

enterprises. As a result potential borrowers are unable to borrow for their need so, innovation and entrepreneurial developments are hindered which generally restrict economic growth potential of the country.

5.2 Conclusions

Based on the findings, it can be concluded that the contribution of private banks is meaningful, these days. This is true in terms of their significant share in branch networks and capital they raised; it would have been more substantial, if there were fair competition and equal treatment among the participants of the banking industry. Public and private banks are competing without having equal footings; consequently, the deposit and loanable fund of private banks are highly affected.

In this research emphasis was placed on various directives that have been issued by regulatory body of the Ethiopia banking system, National Bank of Ethiopia. It has been found that some of the directives that are drawn from the development of the banking systems are hindering fair competition and equal treatments among the participants of the banking industry (directives which introduced NBE-Bill and directive that forces all private banks' short-term loans to constitute at least 40 per cent of total loans). Some government policies hinder competition such as, policy which makes obligatory the mobilization of resource of 10/90, 20/80 and 40/60 per cent condominium housing only by the public owned CBE and obligation of sector offices and enterprises to work with CBE, all these reduce the capacity of Private Banks to mobilize and allocate resource.

5.3 Recommendations

In order to maintain banking sector stability, it is very important to minimize the activities, which restrict the performance of private commercial banks in Ethiopia. Therefore, based on the study results I would like to forward the following recommendations.

- To foster the development of the banking institution, to play a vital role in the economy, the participation of private banks has to be encouraged; accordingly, government bodies should revisit some directives issued in relation to the operation of private banks by consulting with the bankers Association.
- A regulatory framework that encourages efficiency and competition for the banking system should be created by the regulatory body. As Spong (2000), banking regulation must take an approach that does not restrict activities of commercial banks, place them at a competitive disadvantage with less regulated firms, or hinder the ability of banks to serve their customers' financial needs.
- Banking regulations and government policies should not favor certain groups over others. This kind of intervention in banking, except in cases of obvious distortions, is not desirable for several reasons. Rules that interfere with the market are inconsistent with this principle and may have unforeseen side effects (Spong, 2000).
- Regulatory bodies should benchmark the Core Principles for Effective Banking Supervision issued by the Basel Committee and IMF's Framework for sound banking for assessing the quality of supervisory systems such as :-
 - The key objective of supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors.

- Supervisors should encourage and pursue market discipline by encouraging good corporate governance.

Meanwhile, this study focuses on challenges of NBE directives which hinder competitiveness of private commercial banks in Ethiopia; the challenges discussed in the study are not exhaustive, future researchers could include other challenges, such as, government foreign trade policies in relation to the activities of private banks.

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Appendices

Appendix-1

Interview Questions for Key Informants

- 1 Would you please mention government banking policies and directives which restricted activities of your bank?
- 2 Would you please explain how government banking policies and directives restricted activities of your bank?
- 3 How did your bank reacted to cope up with the difficulty it faced with regard to government banking policies, if any?
- 4 How do you explain the reaction of private banks and your bank in particular, with regard to government banking policies, in terms of expansion of branch network, increasing capital, deposit mobilization and loan disbursement?
- 5 How do you observe the application of government banking policies and directives on private banks vis-à-vis Government banks?
- 6 Are there equal playing fields between private and state owned banks? If no what policies are applicable only to private banks?
- 7 What solutions would you suggest for the challenges encountered?

Appendix-2

List of Interviewees

No.	Name	Position	Institution	Date
1	Merga Wakoya	Principal Examiner	Banking supervision Directorate,National Bank of Ethiopia	13/07/2015
2	Eskinder Abere	Banking analysis team leader	Monitering and Financial analysis Directorate,National Bank of Ethipia	13/07/2015
3	Desta Bekelo	Assistant Vice-President Resources	Bank of Abyssinia	16/07/2015
4	Mulugeta Beza	Director	Finance and Accounts Department Bank of Abyssinia	16/07/2015
5	Abreham Gebeyehu	Director	Corporate planning and Marketing Department ,Bank of Abyssinia	17/07/2015
6	Daniel Tekeste	Director	Risk and Compliance Department,Lion International Bank	20/07/2015
7	Taye Getachew	Branch Manager	United Bank	04/08/2015
8	Daniel Legesse	Director	Retail Banking Departement,Abay International Bank	15/09/2015