

**ADDIS ABABA UNIVERSITY  
THE SCHOOL OF GRADUATE STUDIES  
FACULTY OF LAW**

**Investment Limitations in and by Banks in Ethiopia**

**Prepared by: Getnet Temechew**

**Advisor: Professor Tilahun Teshome**

**A Thesis submitted to Addis Ababa University, the school of Graduate Studies,  
Faculty of Law in Partial fulfillment of the Requirements for the Degree of  
Master of Laws (LL.M) in Business Law**

**JANUARY**

**2010**

**ADDIS ABABA UNIVERSITY**  
**SCHOOL OF GRADUATE STUDIES**  
**FACULTY OF LAW**

**APPROVAL SHEET**  
**INVESTMENT LIMITATIONS IN AND BY BANKS IN ETHIOPIA**

**By: Getnet Temechew**

**Approved by Board of Examiner's**

**Advisor: Professor Tilahun Teshome**

**Examiners**

**1. Tilahun Teshome**

**/Professor/**

\_\_\_\_\_

**Signature**

**2. Solomon Abaye**

**/PhD Candidate/**

\_\_\_\_\_

**Signature**

**3. Ato Aman Assefa**

\_\_\_\_\_

**Signature**

## **Declaration**

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

## Acknowledgment

This work cannot be accomplished without the contribution of many. And I want to say 'thank you' for all of them. But the following deserve special mentioning: my advisor Professor Tilahun Teshome for his readiness for consultation and insightful advice, Ato Tamrat Talegeta and my brother Ayele Temechew for their editing assistance and moral encouragement.

Last but not least, W/rt. Emebet Zerihun for her diligent Secretarial Services.

I give to all my heart full thanks.

## **ABSTRACT**

This research was conducted as an investigation into the complexities of the attempts of the Government of Ethiopia to control banking business by applying strict regulatory intervention and its impact on the participation of foreigners in the banking business in the country.

To start with, the researcher accepts the universal argument that banks are unique from other business organizations. They are unique because they provide the most important contribution to any economy; they uphold the public trust and confidence; they are key players in the payment and settlement system for the government, business sector and households; they are deposit takers, liable for financial assets that are the property of the entire social system which are to be repaid, in full, on demand or on the date they are due; 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; they are highly leveraged: in comparison to commercial or industrial companies i.e. cash flow sensitive to meet repayments.

This 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 and by banks themselves are found to be essential factors that affect them for good or bad.

The nature and scope of investment in banks and by banks is regulated in different countries differently. At the same time, the performance and stability of banks have got a lot to do with the flexibility or strictness of the regulatory regime concerning investment in and by banks.

The concerns related to protection of infant banking industry against FDI & the regulator's competency issues may not be neglected. But Ethiopian law is too strict in this regard. Hence, at least equity participation of foreigners is advisable.

The other limitation on investment in banks is on national investors. As comparative study shows, limiting investment by 5% of the subscribed capital of a bank is too strict. This affects the capital mobilization capacity of banks in particular when viewed in relation to total exclusion of FDI and prohibition of an influential shareholder not to invest in another bank. This in turn directly affects the efficiency and competitive advantage of banks. Beyond that, this stringent restriction on national investors seems to be against the constitutional right of citizens to acquire property based on the theory of vested rights. Hence, if the intention is to control the power of influential shareholders, the researcher recommends that recognizing nonvoting shares is advisable.

Indeed, the 5% restriction itself seems to be too strict because it affects the capital mobilization, competition capacity and efficiency of banks which needs some relaxation. Moreover, Ethiopian law has neglected all related factors other than ownership as it does not regulate issues of pledgee and usufructory.

With respect to the concern related to investment by banks, this research suggests that scope of economy of efficiency vs undue affiliation with commercial entities, stability vs systemic risk, the degree of investment risk vs loan provision should be analyzed. On the other hand, it is argued that investment as a source of revenue needs due attention.

As part of a concluding remark, the findings of the research confirm that it is difficult to qualify the advantages and risks associated with investment of banks in equity of commercial entities. Hence, without a priori assessment and qualification, it is not easy to suggest the optimal level of mixing. But, generally, comparative study shows that Ethiopian law takes a moderate position. Based on the result of the study, the researcher recommends that this issue demands further economic analysis/research.

# Table of Contents

<b>Title</b>	<b>Pages</b>
Acknowledgment-----	i
Abstract-----	ii
Table of Contents-----	iii
<b>CHAPTER ONE: INTRODUCTION .....</b>	<b>1</b>
A. Background of the Study.....	1
B. Statement of the Problem.....	2
C. Objective of the Study.....	3
D. Methodology .....	4
E. Significant of the Study.....	4
F. Organization of the Study.....	4
<b>CHAPTER TWO: INVESTMENT LIMITATION IN GENERAL.....</b>	<b>6</b>
1.1 Investment Limitations in General .....	6
2.2 Investment Limitations in Ethiopia in General.....	11
<b>CHAPTER THREE: INVESTMENT LIMITATION IN BANKS .....</b>	<b>19</b>
3.1 The special Features of Banking Sector .....	19
3.2 Investment Limitations in Banks in General .....	21
3.2.1 Foreign Direct Investment in Banking: General Trends .....	21
3.2.1.1 The impact of foreign bank participation in developing countries? .....	24
3.2.1.1.1 Competition & Efficiency .....	24
3.2.1.1.2 Access to Credit.....	26
3.2.1.1.3 Foreign bank participation and crises.....	28
3.2.2. Investment Limitation In and By Banks: Separation of Banking and Commerce in General.....	31
3.2.2.1 Investment Limitation in Banks: Limitation on Equity participation in Banks.....	32
3.2.2.2 Limitation on Activities of Banks: scope of banking powers.....	34
3.2.2.3 Limitation on Equity Participation of Banks .....	40
3.2.3 Issues for consideration in Separation of Banking and Commerce.....	42

3.2.3.1 Concerns with Mixing of Banking and Commerce.....	42
3.2.3.1.1 Conflict of Interest .....	43
3.2.3.1.2 Portfolio Risk .....	44
3.2.3.1.3 Concentration and Competition.....	45
3.2.3.1.4 Systemic Risk .....	46
3.2.3.1.5 Small Business lending .....	46
3.2.3.1.6 Financial Markets Development.....	47
3.2.3.2 Potential benefits of mixing banking and commerce .....	47
3.2.3.2.1 Economies of scale and scope .....	48
3.2.3.2.2 Reduction in Transaction Cost of monitoring Creditworthiness.....	48
3.2.3.2.3 Enhances Stability? .....	49
3.2.3.2.4 Global Competition .....	50

**CHAPTER FOUR: INVESTMENT LIMITATION IN AND BY BANKS IN ETHIOPIA.....51**

4.1 The Ban on Participation of Foreign Investment in Banks: The Nationality Requirement .....	51
4.2 Limitations on Investment in Banks: Limitation on Equity Participation in Banks .....	56
4.3. The Scope of Banking Business in Ethiopia .....	67
4.4. Limitation on Equity Participation of Banks .....	69

**CHAPTER FIVE: CONCLUSION AND RECOMMENDATION.....71**

Bibliography.....	76
-------------------	----

# **CHAPTER ONE**

## **INTRODUCTION**

### **A. Background of the Study**

It is a matter of common knowledge that the banking business has been subject to stricter rules of regulation than other sectors of the business. The fundamental rationales that gave rise to such special attention and regulation of banks are basically tied to the unique features that the sector possesses. In the first place, banks conduct most of their business with funds drawn from depositors while their capital contribution to that effect remains very low when compared to other enterprises. What is more is that depositors as creditors of a bank are too dispersed and unsophisticated so that there is little or no chance of scrutiny of the status of the bank. Second, banks engage in numerous and large transactions with liquid assets which make banks ready subjects of insider abuse and embezzlement. Third, given the pivotal role of banks in the payment and credit system of the economy, failure of a single bank would result in substantial implication than failure of any other enterprise. What is worse is that banks are peculiarly susceptible to systemic risk due to the contagious nature of a bank failure. Failure of a single bank erodes public confidence in other banks as well so that the failure would spread to other banks due to unexpected demand for payment from depositors. Failure in one bank may lead to failure of all banks thereby damaging the entire economy.

Owing to these and other peculiarities, regulators have pervasive and at times unique grounds of intervention in the banking sectors so as to ensure safe and sound operation and continuity of banks.

Regulators found that the identity of investors, and the amount of investment in banks, and the equity investment by banks as well as the scope of economic activities to be carried out by banks have important bearing on addressing the special sensitivity and accompanying problems in banks.

Cross-country survey of bank regulations displays that regulators have maintained limitations both on investment in banks and investment and other activities of banks themselves. Investment limitations in banks focus on either total or partial exclusion of foreign direct investment (FDI) and limitations on the level of equity to be held by a single investor or related investors in a bank. On the other hand, limitation on investment by banks stresses the need to limit the level of equity investment by a bank in other firms and limiting the scope of permissible economic activities to be carried out by banks.

The issues of limitations of FDI in banks are usually entertained as part of the general investment policy of nations and receive varying treatment in different countries. The other investment limitations by banks are generally matters of regulating the scope of investment in banks by eligible investors and controlling the scope of services to be rendered by banks and scope of equity investment by banks. This two way restriction is often entertained in literature under the caption "separation of banking and commerce. The doctrine of separation of banking and commerce has its origin in the 17<sup>th</sup>C in England. The principle and its jurisprudence have spread to almost every jurisdiction but only with wide divergence from country to country.

## **B. Statement of the Problem**

While both categories of investment limitations i.e. FDI and separation of banking and commerce have been adopted in almost all nations including Ethiopia, their scope and the trend generally have been a subject of controversy both in theory and practice.

Historically, banking sector has been among the sectors from which FDI has been totally abrogated or allowed under severe restrictions. The past decade has been marked by progressive liberalization of the sector for FDI in most developing countries while some countries like Ethiopia kept the sector away from FDI.

In relation to separation of banking and commerce regulators and a number of scholars provide numerous premises alluding that independent, impartial and sustainable operation of the banking sector demands its separation from commerce while at the same time counter arguments are also abundant.

Beyond the theoretical discourse, the practices of states in the implementation of separation display great variation. Some maintained a relaxed relation between banking and commerce while others preferred more strict separation.

Theories suggest that the degree of limitation substantially affects the performance and safety of banks. Appropriate level of investment limitation in banks depends much on the specific context of the country and demands adjustments in time depending on emerging internal and external forces in the era of globalization.

Hence, the issue being an issue in a very sensitive and at the same time very crucial economic sector, inquiry in to the existing regime and exploring the way forward is indispensable in the Ethiopian context.

### **C. Objectives of the Study**

The main objective of this study is to appraise the existing legal regime in Ethiopia on investment limitations in and by banks as well as the scope of banking powers in order to come up with suggestion if adjustments are needed.

The researcher is puzzled by the opposing arguments and realities on separation of banking and commerce. This research, therefore, encompasses the exposition of the theoretical underpinnings for both sides of the arguments and the experience of other countries. In particular, the research will examine the nature and extent of the restrictions on investment in and by banks as endorsed in the current laws of Ethiopia and evaluate their appropriateness in the Ethiopian context.

### **D. Methodology**

The researcher employed a combination of several approaches. In the process of explicating the theories supporting or assaulting the investment limitations, reliance is made on exposition based on literature review. The exposition of the nature, rational and scope of separation in place in Ethiopia is made based on analysis of the relevant laws and interviewing concerned authorities.

The exposition of the theoretical underpinnings for opposing arguments, appraisal of the experience of other countries in their laws and how their banking sector performed are used as a framework to evaluate the Ethiopian legal regime and as premises indicative of what changes may be appropriate for the Ethiopian legal regime.

### **E. Significance of the Study**

The research, as far as the knowledge of this researcher goes, is the first of its kind in Ethiopian context. And the researcher believes that it would be a good starting point for future researchers in the area and a good reference for those interested to have basic knowledge of the issue. Moreover, it would provide a benchmark for the legislature and regulators to consider and evaluate their stance either to maintain or modify the existing laws and regulations.

### **F. Organization of the Study**

In brief, this study has attempted to explore and explain theoretical discourses, the experience of some countries and the Ethiopian legal regime as pertaining to investment limitations in and by banks. In so doing, the writer has opted to organize the study into five chapters.

Chapter One, which is generally captioned as introduction, comprises of background of the study, statement of the problem, objective of the study, methodology, significances and organization of the study.

Chapter Two provides a brief overview of investment limitations in general. It explores the common forms of investment limitations in particular as pertaining to FDI and highlights the underpinnings thereof. It also provides survey of the general investment limitations in Ethiopian investment law.

The Third chapter entertains common investment limitations related to the banking sector. It briefs on historical antecedents on FDI in banking, current trends in different regions of the world and exposes potential gains and possible adverse consequences pertaining to FDI in banking. The separation of banking and commerce as explored in relation to the experience of some countries that offers framework for assessing Ethiopian scenario is also dealt in this chapter.

Chapter Four is devoted to the appraisal of the Ethiopian legal regime on investment limitations in and by banks. It commences with the explanation of regime on FDI, limitations and conditions on equity participation by a single or related investors, the scope of banking powers in their business engagements and the scope of banks equity participation permissible in Ethiopian law. This factual exposition is followed by assessment of potential impacts of current limitations so as to provide ground rules for conclusion and recommendation. The Fifth chapter concludes the research and embodies suggestions that the researcher deems appropriate.

## **CHAPTER TWO**

### **INVESTMENT LIMITATIONS IN GENERAL**

#### **2.1. Investment Limitations in General**

The economic policies pursued by states differ from country to country and from time to time in relation to the role and scope of the state and the private sector in the overall development strategies. Despite the divergence in the scope allocated to each, it has not been contested that both have a share in the economic sector.

Whatever the economic ideology may be, the regulatory power of the state over the economic activities in its jurisdiction has not been contested but only the scope it should assume. In line with this accepted principle, states formulate and pursue policies and laws so as to regulate the investment activities in their jurisdiction. Many countries now have laws controlling investment. Limitations on outward and inward investment are imposed by these governments in an overall effort to regulate the domestic economy. Restriction policies may vary dramatically from country to country. In general, states determine who can invest in what sector? and upon what conditions? In other words investment limitations may take the form of total or partial exclusion of all or some category of private investors from all or some sectors of the economy based on certain parameters, which we may call it sector based restriction; and in cases where the sectors are open to the specified category of investors, the state may use its regulatory power to subject investment in such sectors to be contingent upon compliance with certain conditions which generally encompasses all regulatory measures that could have actual or potential impact on investment in the sector.

Investment limitations based on economic sectors are probably the most common forms of limitations. Based on the governments' economic policy, some investment areas are totally closed to private investment either domestic or foreign. Investment laws often determine areas reserved for the government, domestic investors and foreign investors as well as areas in which they might participate only in joint venture. According to Jeswald W. Salacuse, the basic considerations include: national security, protection of strategic industries and the need to control the commanding heights of the economy.<sup>1</sup>

---

<sup>1</sup> Jeswald.W.Salacuse, "*Direct foreign investment and the law in Developing Countries*", Foreign Investment Journal (Vol.15,No. 2,2000),p.378.

The total exclusion of any private investment, whether of foreign or domestic origin, applies mostly in relation to certain "key" sectors of the economy that are regulated predominantly for the public benefits and strategic consideration. In Zambia, for instance, areas where only government investment is allowed include: arms and ammunitions, public utilities, power, water, telecommunication, and wholesale outlets for general goods.<sup>2</sup>

A distinction is also made between domestic investors and foreign investors in relation to sectors of investment in which they can engage. There are, of course, sound economic reasons for excluding foreign investors from certain industries including the need to retain that basic industries which could easily be undertaken by local entrepreneurs, the desire to prevent vital public services from falling under foreign control and some countries pre-occupied with national security in case of engaging in production of war materials and other related areas.<sup>3</sup> In this regard the limitations range from absolute exclusion or limiting the scope of involvement of foreign direct investment (FDI) in all or certain sectors of the economy or allowing participation on stringent conditions than it is the case for domestic investors.

Approaches towards foreign direct investment have been controversial both in theory and in practice. Neoclassical economic theory<sup>4</sup> propounds that FDI contributes positively to the economic development of the host country alleging that foreign investors usually bring capital into the host country, thereby influencing the quality and quantity of capital formation in the host country; ensures that domestic capital available for use could be redirected to other uses;<sup>5</sup> reduces the balance of payments constraints of the host country,<sup>6</sup> and increases government revenue via tax and other payments. Dependency theory<sup>7</sup> is opposite to neoclassical theory and takes the view that foreign investment does not bring any meaningful economic development to the host country.<sup>8</sup>

---

<sup>2</sup> .Kamuwanga Mwangala, *Negotiating Investment Contracts: Investment Law in the Context of Development*(1989),p.4

<sup>3</sup> Wolfgang Friedmann,, *Legal Aspects of Foreign Investment*(1959),p.747.

<sup>4</sup> The definition of neoclassical economics is not perfectly clear. It has had a variety of technical meanings as to its central problem: "the mechanics of utility, price determination or operation of price mechanism, the working of free enterprise system, the operation of pure markets, the mechanics of the pure theory or logic of choice, constrained maximization decision making and the like. See Sherif H.Seid, *Global Regulation of Foreign Direct Investment*(Ashgate, 2002),p.9

<sup>5</sup> M.Sornarajah, *The International Law on Foreign on Investment* (Grotius publications, 1994) p. 38).

<sup>6</sup> Seid, *supra* note 1, p.10.

<sup>7</sup> Roughly understood, the dependency theory claims that development in a certain region is dependent on the underdevelopment of a certain region i.e. they are two aspects of a single global process. Should a country develop, the theory alleges, it is necessary to dissociate itself from the world market and strive for national self reliance. See *Id.*p.20.

<sup>8</sup> J.M. Rothbeb," *Investment Dependence And Political Conflicts in Developing Countries: A Comparative Regional Analysis*" in S. Chan (ed)*FDI in a changing global political economy* (St.Martin's Press,1995) P. 189). The theory argues that growth is supposedly slowed for several reasons: FDI is mostly made by multinational corporations (MNCs) that normally devise global policies in the interest of developed countries in which they have their headquarters and shareholders in the home countries;<sup>8</sup> as much as there is an initial inflow of capital, there is

The post-war period was the period where FDI was regarded most favorably in the developed as well as the developing world alike while in the 1960s and 1970s attitudes towards FDI in most host countries, particularly developing countries, were hostile or skeptical. However, these attitudes have changed since then and countries are becoming increasingly appreciative of the benefits that can be gained from FDI. It now appears that there is an emerging broad consensus among both developing and developed countries that FDI can hasten economic growth and that any possible adverse effects can be controlled.<sup>9</sup>

Generally, economic sectors either wholly or partially closed to foreign investors include defense, utilities, transportation, communications (including media), banking, insurance, and other financial institutions, certain natural resources, and farm and ranch land.<sup>10</sup>

The other category of limitations pertains to the issue of requirement of compliance with certain conditions so as to invest in the jurisdiction of a certain state. In other words, in cases where the sectors are open to investors the state uses its regulatory power to make such investment contingent upon certain conditions. In this regard as well distinction may be made among the different category of investors. As summarized by Earl H. Fry, such forms of limitations as applied to FDI include the following.<sup>11</sup>

---

subsequent repatriation of capital and profits from the host country which according to some studies, twice as the capital they brought in.<sup>8</sup> It is claimed that FDI creates a foreign dominated local high income-group or elite who formulate policies and enact laws that protect foreign interests and ignore the needs of the people.<sup>8</sup> It is said that the technology that is brought into the developing host country is usually outdated or capital intensive, thus not satisfying their needs. FDI is also blamed for increasing unemployment or not generating significant employment by using capital-intensive techniques designed for developed economies, rather than labor-intensive techniques believed to be more appropriate for developing countries.<sup>8</sup> Indeed, if the proper regulatory systems are not in place, FDI may cause considerable environmental damage.<sup>8</sup>

<sup>9</sup> C.R.Kennedy, *Relation between Multinational Corporations and Host Countries: A Look to the Future* (1992) p.69.

<sup>10</sup> Earl H.Fry, the *Politics of International Investment* (McGraw-Hill Book Company, 1983) p.133.

<sup>11</sup> See Id.p.134. In fact most of these limitations apply to domestic investors as well.

1. Government monopolies not open to overseas investors	24. Non nationals required to obtain national status Within a number of years.
2. 51 to 100 percent mandatory local ownership	25. Local office in host country required.
3. Screening and prior approval for projects.	26. Nationalization
4. Limits on repatriation of profits.	27. Expropriation.
5. Export controls.	28. Ethnic-group ownership stipulations.
6. Limits on foreign ownership of land..	29. Boycott and anti-boycott provisions.
7. High income tax on profit remittances.	30. Investment to be channeled through specific Financial institutions.
8. Antitrust legislation.	31. No transfer of capital for portfolio investment.
9. Price controls.	32. Mandatory investment in secondary industries.
10. Strict licensing arrangements.	33. Government delays in processing investment Applications.
11. Rigorous exchange controls.	34. Medium and long-term financial credit prohibited for alien investors.
12. Investments required to be above a minimum Amount.	35. Minimum and maximum lengths of time for investments.
13. Raw materials must be purchased domestically.	36. Mandated percentage of capital to come from abroad.
14. Very high duties, taxes and levies.	37. Penalties for invalidating agreements.
15. No tax treaties.	39. Mandated research-and-development stipulations.
16. Complicated value-added tax provisions.	40. Extensive use of local suppliers.
17. Managing director and large percentage of Members of the board must be nationals.	41. Takeover bids require prior approval of company to be acquired.
18. Government option to purchase percentage of stock.	
19. Only leasehold land available.	
20. Percentage of total production must be exported.	
21. Ineligibility for soft loans and case grants.	
22. Limit on amount of stock held by single investor.	
23. Joint ventures only.	

## 2.2. Investment Limitations in Ethiopia in General

We have seen that investment limitations in different countries might take different forms and might even discriminate among investors based on different parameters and often against foreign investors as the concerned country sees fit. The trend similarly applies to the Ethiopian scenario as well and now we will have a cursory review of the basic limitations. In the past decade, the Ethiopian legal framework for investment has undergone recurrent amendments with a view to improve investment opportunities in the country.<sup>12</sup> The principal legislation currently

---

<sup>12</sup> Following the fall down of the socialist regime the transitional government of Ethiopia has made a shift in economic policy i.e. to market oriented economy. Accordingly, it first came up with the Investment Code No.15/1992, and

governing investment is Proclamation No.280/2002 as amended by Proclamation No.373/2003. In general investment participants in Ethiopia are classified as domestic investors and foreign investors.<sup>13</sup> Nevertheless, based on the treatment they receive we can categorize them into the Government<sup>14</sup> itself, domestic investors<sup>15</sup> and foreign investors.<sup>16</sup> Or looking from the other perspective, under Ethiopian law economic sectors is categorized into the following groups based on the investors that might participate in them. These are:<sup>17</sup> areas exclusively reserved for the government; areas reserved for joint venture with the government; areas exclusively reserved for domestic investors; and areas open to all investors including foreign investors.

The Ethiopian government is the most privileged investor followed by domestic investors and foreign investors taking the threshold favorable treatment. There are two areas of investment that are exclusively reserved for the government. The first one is transmission and supply of electric energy through the Integrated National Grid system.<sup>18</sup> This implies that the production of electric energy is open for private investors in general and there by foreign investors in so far as it does not constitute transmission and supply of electric energy through the Integrated National Grid system. But there is a concern for private investors that the government may control them for all purposes (for example, fixing of fee) since the government in charge of transmitting and supplying it. The second area is postal services with the exception of courier services.<sup>19</sup> For strategic considerations, ordinary postal service is not open to private investors while courier service is. The investment proclamation No.280/2002 of Ethiopia opens more areas of investment for private investors or at least allows joint venture with the Government, which were under exclusive domain of the government under proc.37/96 (as amended).<sup>20</sup>

---

then proclamation No.37/1996 followed by amendment Proclamation No.116/1998 and ultimately Proclamation No.280/2002 as amended by Proclamation No.373/2003.

<sup>13</sup> . Investment Proclamation No.280/2002, Fed., Neg. Gaz., Year 8, No. 27 (hereinafter Proc.No.280/2002) Art.2(4).

<sup>14</sup> The term Government includes both the Federal Government of Ethiopia as well as any of the Regional Governments in Ethiopia. See Proc.No.280/2002, Art.2(11).

<sup>15</sup> Domestic investor is defined broadly as “an Ethiopian or a foreign national permanently residing in Ethiopia having made an investment ,and includes the Government ,public enterprises as well as a foreign national, Ethiopian by birth and desiring to be considered as domestic investor.” See Proc.No.280/2002, Art. 2(5).

<sup>16</sup> Foreign investor is defined as a foreign national or an enterprise owned by foreign nationals, having invested foreign capital in Ethiopia, and includes an Ethiopian permanently residing abroad and preferring treatment as a foreign investor. See proc, No.280/2002,Art.2(7).

<sup>17</sup> .see Proc.No.280/2002, Arts.5(1)&(2), 6,&8.

<sup>18</sup> Proc.280/2002,Art. 5(1)(a).

<sup>19</sup> . Proc.280/2002,Art. 5(1)(b)

<sup>20</sup>.Investment Proclamation No.37/1996,Fed.Neg.Gaz.,Year 2,No.25, Art. 5 and Council of Ministers Regulation No.84/2003 (schedule; Art.2). Areas liberalized are air transport service using aircraft with seating capacity of up to 20 passengers, rail transport services, production of electric energy, manufacturing of weapons and ammunitions, and telecommunication service.

Some sectors are reserved for investment only in partnership with the government. Under the current Ethiopian law, investment areas that are to be undertaken only in joint venture with the government are manufacturing of weapons and ammunitions, and telecommunication services.<sup>21</sup>

Next to the Government, Ethiopian nationals constitute second category of privileged investors. Ethiopian nationals have got some investment areas exclusively reserved for them from which other domestic investors,<sup>22</sup> and foreign investors are excluded. The following areas of investment are exclusively reserved for Ethiopian nationals.<sup>23</sup>

- banking, insurance and micro credit and saving services;
- travel and shipping agency services;
- broadcasting services; and
- air transport services using aircraft with a seating capacity of up to 20 passengers.

In the preceding legislations broadcasting services, Micro credit and saving services and air transport services using air crafts with a seating capacity of up to 20 passengers were generally open for domestic investors regardless of nationality but now they fall under the exclusive domain of areas reserved for nationals. On the other hand small scale electricity generation and supply, which was exclusively reserved for Ethiopian nationals is now removed from that category. In relation to limitations upon financial sectors we will see in the next chapter in detail.

Domestic investors (including the Government and Ethiopian nationals and others) constitute the third preferred investors to whose advantage foreign investors are excluded from a number of economic sectors. In Ethiopia, areas reserved as exclusive domain of domestic investors are provided herein below.

**The following areas are exclusively reserved for domestic investors:<sup>24</sup>**

- retail trade and brokerage;
- wholesale trade (excluding supply of petroleum and its by-products as well as wholesale

<sup>21</sup> Art.5(2) of Proc.No.280/2002. As per Art.7 of Proc.No.280/2002,the supervising authority of public enterprise takes the mandate to receive investment proposal from any private investor intending to invest in joint venture with the government and submit same to ministry of trade and industry for decision and designate the public enterprise to invest as partner in the joint investment.

<sup>22</sup> Art. 2(5) of proc.280/2002 defines domestic investor broadly as an Ethiopian or a foreign national permanently residing in Ethiopia having made an investment , and includes the Government( of Ethiopia), public enterprises, as well as a foreign national, Ethiopian by birth and desiring to be considered as domestic investor. residing abroad

<sup>23</sup> Art. 6 of Proc.No.280/2002 and Regulation No. 84/2003

<sup>24</sup>Art. 6 of Proc.No.280/2002 and Regulation No. 84/2003

by foreign investors of their products locally produced);

- import trade (excluding LPG, bitumen and up on the approval of the Council of Ministers; materials used as inputs for export products);
- export trade of raw coffee, chat, oil seeds, pulses, hides and skins bought from the market and live sheep, goats and cattle not raised or fattened by the investor;
- construction companies excluding those designated as grade 1;
- tanning of hides and skins up to crust level;
- hotels other than those star-designated, motels, pensions, tea rooms, coffee shops, bars, night clubs and restaurants excluding international and specialized restaurants;
- travel agency, trade auxiliary and ticket selling services;
- car-hire and taxi-cabs transport services;
- commercial road transport and inland water transport services;
- bakery products and pastries for the domestic market;
- grinding mills;
- barber shops, beauty saloons, and provision of smith workshops and tailoring services except garment factories;
- building maintenance and repair and maintenance of vehicles;
- saw milling and timber making products;
- customs clearance services;
- museums, theaters and cinema hall operations;
- printing industries.

This list for domestic investors together with the specifications for the government or in joint venture with the government and those reserved for Ethiopian nationals determine the areas open to foreign investors. In simple language Art.8 of Proc.No.280/2002 summarizes the subject matter stating that all areas of investment, other than those exclusively reserved under this Proclamation for the government or joint venture with the government or for Ethiopia nationals or other domestic investors shall be open to foreign investors.

Somehow broad areas are closed to foreign investors but the broad definition of domestic investor attempts to minimize the scope of exclusion as foreign investor. Of course, in as pointed above, there are sound economic reasons for excluding foreign investors from certain industries

including the need to retain basic industries which could easily be undertaken by local entrepreneurs, the desire to prevent vital public services from falling under foreign control and others. Indeed, even the developed countries maintain limitations or even prohibitions on foreign investment participation. Majority domestic ownership requirements airlines in the European Union and North American countries, telecommunications in Japan, and coastal and freshwater shipping in the United States,<sup>25</sup> and exclusive domestic ownership in the fishing and energy sectors in Iceland, and in the oil sector in Mexico are typical instances.<sup>26</sup>

Apart from the sector based limitations, other limitations do have their parallels in Ethiopian law. Here it suffices to mention some of the typical limitations as applied to specific category of investors. An attempt to deal with each and every condition attached investment in Ethiopian investment law would take out of scope. Investment permit requirement/screening, minimum capital requirement, and employment of expatriates are some of them.

In most cases obligatory screening and approval procedures are employed in particular by developing countries often in relation to foreign investors so as to evaluate whether investments are in line with intended objectives deemed appropriate.<sup>27</sup> Pursuant to Ethiopian law, foreign investors and domestic investors who are foreign nationals are always required to obtain investment permit while Ethiopian investors are required to obtain investment permit only if they want to invest in sectors eligible for investment incentives or if they want to invest in partnership with foreign investors.<sup>28</sup> And the law requires approval or otherwise decision must be made within ten days,<sup>29</sup> is cited as best practice on UN publication-Survey of Best Practices in Investment promotion.<sup>30</sup> Such prior approval requirement could be taken as a sign of an ambivalent attitude towards investment even though it may not be vigorously enforced. Apart from that the constraining effect of such procedures depends on the actual implementation of the process.

Also some countries insist that the foreign investors should bring in all or a certain percentage of its capital from overseas so as to realize the perceived advantage of alleviating domestic capital shortage.<sup>31</sup>

---

<sup>25</sup> OECD, *supra* note 27.

<sup>26</sup> .Id.

<sup>27</sup> E.I.Nwogugu, The Legal Problem of Foreign Investment in Developing Countries (1956) p.160.

<sup>28</sup> Proc.No.280/2002, Art.12. (1)

<sup>29</sup> Proc.No.280/2002) Art.12(2)&14 (1)

<sup>30</sup> Survey of Best Practice in Investment Practice (United Nations Conference on Trade Development Division on Investment, Technology and Enterprise, UN, New York, Geneva, 1997) p.35.

<sup>31</sup> Krishna Ahojja, "Investment Legislation in Africa".Journal of World Trade Law(Vol.2,No.5 1968),p. 504. With a view to realize it Some African countries such as Egypt, Kenya, Morocco, Nigeria, Tunisia, Zambia and Mauritius do not demand minimum capital as a condition of entry but others such as Senegal, Chad and Burundi do so. OECD, Investment in Developing Countries: OECD/DAS Member Countries Policies with Regard to Private Direct Investment in Developing Countries(1978)p.25.

Beyond the general capital requirements that apply to domestic investors,<sup>32</sup> Ethiopian investment law sets different levels of minimum capital requirement for foreign investors based on different activities and with whom they engage in such investments. Accordingly, in most investment sectors and wholly-owned investment a foreign investor should bring a minimum capital of US\$100,000 while for a foreign investor who want to invest in joint venture with domestic investors this amount is reduced to 60,000 US dollars.<sup>33</sup> In areas of engineering, architectural, accounting and audit services, project studies or business and management consultancy services or publishing, the capital requirement is further reduced to 50,000 US dollars if the investment is made wholly by a foreign investor and to US \$ 25,000 for investment in joint venture with domestic investors.<sup>34</sup> Further more foreign investor re-investing his profits or dividends; or exporting at least 75% of his out puts, the minimum capital requirement is totally removed.<sup>35</sup>

Furthermore, there could be requirements relating to the level of employment of local staff ensuring that the perceived benefits of transfer of skills to the local labor and management are a reality.<sup>36</sup> This might have discouraging effect on investment since foreign personnel may be essential for the efficient operation of the enterprise. Under the Ethiopian investment law, an appropriate investment organ is empowered to issue work permits to expatriate employees.<sup>37</sup> An investor who wishes to employ expatriate staff other than top management position should submit, at the time of his application for investment permit, a statement on time schedule for their replacement by Ethiopians and the training program designed for such replacement.<sup>38</sup>

In Niger, foreign investment is generally not allowed in banking, financial, commercial, and trading and consumers industry sectors which can be developed through indigenous know-how.<sup>39</sup> In Tunisia, foreign capital is placed in high priority areas; especially where new technology is required.<sup>40</sup> Malaysia places foreign investment in export sector thereby promoting the quality of Malaysian goods and their competitiveness on international markets.<sup>41</sup>

---

<sup>32</sup> See for instance Art.306 of the commercial code requires a minimum of 50,000 birr to form a share company and Art.512 requires 15, 000 birr as minimum capital for private limited company. The minimum capital for establishing a bank is elevated to 75 million.

<sup>33</sup> Proc.No.280/2002,Art.11(1)&(2)

<sup>34</sup> Proc.No.280/2002,Art.11(3)

<sup>35</sup> Proc.No.280/2002,Art.11(4).

<sup>36</sup> pap

<sup>37</sup> Proc.No.280/2002,Art.24.

<sup>38</sup> Proc.No.280/2002,Art.13(5)

<sup>39</sup> Salacuse, supra note, p.389-390.

<sup>40</sup> Ibid.

<sup>41</sup> .Id. p.34.

# **CHAPTER THREE**

## **INVESTMENT LIMITATIONS IN BANKS**

It has long been taken for granted that the banking sector should be regulated in a relatively stricter manner than other business engagements. This peculiar approach to banking led the design of special rules in relation to investment in banks also manifests that.

### **3.1 The Special Features of Banking Sector**

The fundamental rationales that gave rise to special treatment of banks in several aspects including in respect of investment are basically tied to the following considerations that the nature of bank contracts are especially in the nature of trust;<sup>42</sup> that banking business is peculiarly susceptible to insider abuse and embezzlement;<sup>43</sup> and that banks are especially susceptible to systemic risk.<sup>44</sup>

To begin with, banks conduct most of their business with funds drawn from depositors while their capital contribution to that effect remains very low. What is more is that depositors as creditors are too dispersed and unsophisticated so that there is little or no chance of scrutiny of the status of their bank. Thus deposits are more of in the nature of trust. Therefore, there exists special reason for regulatory intervention to protect those unsophisticated depositors as creditors.

The second reason that calls for special regulatory regime in general and in respect of investment limitations in banks in particular is that banking business is believed to be especially susceptible to insider abuses. In this regard one author has provided the following explanatory statement:

“... banking is a business that is peculiarly subject to fraud. Banks engage in *numerous, liquid, and large transactions which are ready subjects of forgery and embezzlement schemes...*”<sup>45</sup> (emphasis added) Hence, given such special vulnerability of bank assets limiting the amount of investments in bank tends to be mandatory with a view to control the power of investors with substantial equity holdings.

---

<sup>42</sup> Charles Goodhart et al. ***Financial Regulation Why, How and Were Now?*** (1998) P.10

<sup>43</sup> G.N. Olson, “Government Intervention: The Inadequacy Of Bank Insolvency Resolution-Lesson From The American Experiences” In Rosa M. Lastra (Ed.), *Bank Failures And Bank Insolvency Law In Economies In Transition* (Kluwe Law International, 1999) P.111

<sup>44</sup> Good Hart Et Al, *Supra*

<sup>45</sup> Olson, *Supra* Note 2, P.10

The third compelling reason for having a different perspective on banks pertains to the desire to maintain stability of the financial system and avoid systemic risk. Given the pivotal role of banks in the payment and credit system of the economy, failure of a single bank would result in substantial implication than failure of any other enterprises.<sup>46</sup> What is worse is that in the banking sector disruption in one bank is not limited to that particular bank. It generally erodes public confidence in the overall banking sector.<sup>47</sup> Given the fact that banks are obligated to pay their depositors on demand based on first come first served basis, if depositors fear that their bank would be insolvent, literally speaking, they all may line up at the teller's window and demand payment. On the other hand most bank assets are often in illiquid form.<sup>48</sup> Banks would be forced to liquidate illiquid assets below actual market value. A bank may go insolvent while it should not. This complex relationship might generally lead to disruption of the over all financial system thereby inflicting damage to the entire economy. This is what we call systemic risk.<sup>49</sup> As part of ensuring stable financial system, putting some sort of investment limitation is imperative.

### **3.2 Investment Limitations in Banks in General**

While many of the general investment limitations apply to the banking sector as well, the special nature of the banking industry makes regulation of investment all the more important. In particular restrictions on FDI, limitations on ownership in banks, restrictions on activities of banks limitation on bank ownership of non-banking companies are the important limitations in banking,<sup>50</sup> and this study will be devoted to examination and analysis of such restrictions at theoretical level and in Ethiopian context.

#### **3.2.1. Foreign Direct Investment in Banking: General Trends**

In many countries and for many years the banking sector has been closed to FDI or permitted under strict terms and conditions. For example, when US was a capital-importing country, banking

---

<sup>46</sup> Ibid, P.113

<sup>47</sup> Good Hart Et Al, Supra Note 1.

<sup>48</sup> Lawrence S. Ritter et al, ***Principles of Money, Banking, And Financial Market*** (Addison-Wesely, 10<sup>th</sup> Ed., 2000) P.293.

<sup>49</sup> Olson, Supra Note 2, P.110

<sup>50</sup> Mehmet Erdem, How to Get the Most Out of Foreign Direct Investment in Commercial Banking, ***Journal of Globalization , Competitiveness& Governability*** VOL. 3 No.1 (Georgetown University – UNIVERSIA, 2009), p.78-84.

was among the few sectors where the federal government had discriminating provisions against foreign firms. It demanded that all directors of national banks have to be American citizens, while depriving foreign shareholders of voting rights in the case of federally-chartered banks. At the state level, there were even more restrictions. Some states imposed more strict capital base requirements on foreign financial institutions, and some even totally banned entry into certain financial industries (e.g., New York state laws banning foreign bank entry).<sup>51</sup>

Until 1999, Canada was one of the few G8 countries that did not allow foreign banks to establish branches on its territory. Instead, foreign investors had to establish separate subsidiaries in Canada that draw on the capital of the parent company. Further, by subjecting Schedule II foreign banks to nearly the same regulation as Schedule I Canadian banks, who were required to have a far smaller equity base, this made it difficult for foreign banks to set up in Canada. Consequently, the number of foreign banks in Canada had declined from 60 banks in 1991 to 48 banks in 1997.<sup>52</sup>

In India, FDI in private banks is limited to 49 percent. Equity participation of foreign banks in Chinese banks should not exceed 25 percent even if they incorporate locally. If a foreign bank continued to run its Chinese operation as branches operated from overseas, the range of services it could offer customers would be limited. Currently, a single foreign-funded institution can hold shares of a Chinese bank with ceiling of 20 percent and that for all foreign investors in a Chinese bank is 25 percent.<sup>53</sup> In Niger foreign investment is generally not allowed in banking and other financial sectors.<sup>54</sup>

However, the trend has changed. FDI in banking has accelerated rapidly in the last decade, especially in Latin American and Eastern European countries. Studies show that between 1995 and 2002 foreign bank participation increased in most developing countries primarily in Eastern Europe and Central Asia, Latin America, and Sub-Saharan Africa.<sup>55</sup>

By 2002, about 40 percent of assets in all three regions were in the hands of foreign banks. On the other hand, in Asia and in the Middle East and Northern Africa, foreign bank participation

---

<sup>51</sup> Ha-Joon Chang, ***Foreign Investment Regulation in Historical Perspective: Lessons for the Proposed WTO Agreement on Investment*** (University of Cambridge, Faculty of Economics and Politics, March 2003).p.1.

<sup>52</sup> "Foreign Bank Regulation in Canada: Barriers to Competition," Submission of Norwest Financial, Inc. and Trans Canada Credit Corporation to the Task Force on the Future of the Canadian Financial Services Sector, October 31, 1997.

<sup>53</sup> Wang Zhaoxing, assistant to chairman of the China Banking Regulatory Commission (CBRC), made the remark in an recent interview to News Agencies, Saturday, December 30, 2006 .

<sup>54</sup> Jeswald.W.Salacuse, "Direct foreign investment and the law in Developing Countries", *Foreign Investment Journal* (Vol.15,No. 2,2000),p.389-390.

<sup>55</sup> Robert Cull et al, (Finance and Private Sector Development Research Group, The World Bank), *Foreign Bank Participation and Crises in Developing Countries: World Bank Policy Research Working Paper 4128*, February 2007,p.3.

has been shown to be low – close to 10 percent of banking sector assets – and stagnant throughout the period. Evidences testify that level of foreign bank participation during 1995-2002 was highest in Sub-Saharan Africa, both the absolute and relative increases in the share of assets held by foreign banks. The share of assets held by foreign banks in Sub-Saharan Africa rose by 9 percentage points from 30 percent in 1995 to 39 percent in 2002.<sup>56</sup> As summarized in one research:<sup>57</sup>

*Foreign bank participation increased in 22 out of the 30 African countries for which we have data on foreign bank participation. In absolute terms (i.e., percentage point changes in the share of assets held by foreign banks), the increase in foreign bank participation was most significant in Mozambique and Cote d'Ivoire, where the share of assets held by foreign banks increased by over 40 percentage points. In Mozambique, foreign bank participation increased from close to 22 percent in 1996 to over 72 percent in 2002. In Cote d'Ivoire, foreign bank presence rose from 20 percent in 1995 to 62 percent in 2002. In relative terms (i.e., with respect to their initial levels of foreign bank presence), both Sierra Leone and South Africa experienced significant increases in the share of foreign bank participation. In Sierra Leone, the share of assets held by foreign banks rose from 0 to over 29 percent and in South Africa it increased from 0.3 to almost 11 percent. On the other hand, the share of assets held by foreign banks declined in 6 countries in the region, namely: Burkina Faso, Burundi, Cameroon, Niger, Senegal, and Zimbabwe. In Ethiopia and Seychelles, foreign participation did not change.*

In Eastern Europe and Central Asia, the increase in foreign bank participation observed over the last decade was also quite pervasive. Out of 25 countries in the region for which data was collected on foreign bank participation, the share of assets held by foreign banks increased in 22 of them: Slovak Republic and Lithuania being the leading in the region with an increment of about 70 percent foreign bank participation within the period 1995-2002.

In Latin America, foreign bank participation increased in 17 out of 23 countries in the Sample: the increment being noteworthy in Mexico and Uruguay. In Mexico, the share of assets held by foreign banks increased from 2.31 percent in 1995 to 61.9 in 2002. In Uruguay, foreign bank participation rose from 24 percent to almost 95 percent in 2002.<sup>58</sup> Of course, some nations, for instance, Azerbaijan<sup>59</sup> provide incentives with a view to attract foreign capital. In sum, the current trends seem to be towards increasing liberalization for participation of foreign banks.

---

<sup>56</sup> Id.

<sup>57</sup> .Id. p.5.

<sup>58</sup> Id.p.7-8

<sup>59</sup> Mikayil Jabbarov And Scott Horton, Foreign Participation in the Azerbaijani Banking Sector, At <http://ourworld.compuserve.com/HOMEPAGES/ USAZERB/424htm>. Accessed On 5/8/2009. The 1997 Legislation provided 10% reduction in tax burden for banks in which 30% or more was owned by foreign capital.

### **3.2.1.1. The impact of foreign bank participation in developing countries?**

#### **3.2.1.1.1 Competition & Efficiency**

The promises of efficiency improvements and greater competition in the banking sector are perhaps the main arguments brought forth by proponents of foreign bank entry. Studies on the impact of foreign bank participation on efficiency and competition seem to be by and large supportive of the claim that foreign banks operating in developing countries are more efficient than domestic banks (i.e., have lower overhead costs), charge lower spreads, and help promote bank competition by pressuring other banks to lower their costs and their spreads.

Using data for 80 countries from 1995 to 1998, Claessens, Demirgüç-Kunt and Huizinga suggest that higher competitive pressure due to foreign bank entry implies an increase in the efficiency of host country banks and thus higher welfare in economies liberalizing their banking markets.<sup>60</sup> Fries and Taci investigated the cost efficiency of banks in Eastern European Countries and find that costs of all banks are lower when the presence of foreign banks in a country is high.<sup>61</sup> When the domestic banking market opens up, foreign banks are given the leeway to enter the market, either via the acquisition of a domestic bank or through a Greenfield investment.

Martinez, Peria and Mody have made distinction between acquisition and Greenfield entry in the context of Latin America. They find that the interest rate spread of foreign banks entering via a de novo investment is lower than that of banks entering via the acquisition of a host country bank. Moreover, their analysis suggests that a higher presence of foreign banks leads to lower costs of all banks operating in the market.<sup>62</sup> Claessens and Lee, focusing on financial systems in 58 low-income countries, find that the increased presence of foreign banks benefited the local banking sector by reducing financial intermediation costs making the banking system more efficient and robust.<sup>63</sup>

Looking at the performance of 219 banks, between 1995-2001, from a sample of ten countries in Central and Eastern Europe (Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovenia, and Slovakia), Uiboupin provides evidence consistent with the notion that foreign bank entry increased competition in those countries. In particular, the study finds

---

<sup>60</sup> Claessens, S., Demirguc-Kunt, A. and Huizinga, H., 2001. "How Does Foreign Entry Affect Domestic Banking Markets?" *Journal of Banking and Finance*, Vol. 25, p. 891-911.

<sup>61</sup> Maria Lehner&Monika Schnitzer, Entry of Foreign Banks and their Impact on Host Countries (University of Munich, Department of Economics, Discussion paper September 2006)p.5

<sup>62</sup>.Id

<sup>63</sup> Cull et al, supra note 13,p.10.

that foreign entry is associated with lower profits, non-interest income, and loan interest rates.<sup>64</sup> Very interesting is the study of Luca Papi & Debora Revoltella whereby they evaluated not only the usual case of studies of foreign bank participation in transitional economies in the form of branches or subsidiaries but also those with minority stakes in the host bank capital during the period 1993-97. Their findings show that a higher profitability is associated with foreign partnerships and corroborates the assumption that foreign participation in a domestic bank does positively affect its profitability, and that the restructuring process takes some time.<sup>65</sup>

On the other hand, some suggested that positive outcomes and foreign bank participation are not always coexistent. A study in Mexico shows that, foreign bank participation has not been found to increase competition and efficiency. Haber and Musacchio show that the entry of foreign banks led, instead, to a retrenchment in lending and no improvements in efficiency and competition.<sup>66</sup> They argue that this is related to the fact that Mexico had an extremely concentrated banking system both before and after foreign bank entry.

Focusing also on the case of Mexico, Schulz shows that foreign bank entry from 1997 to 2004 had no effect on administrative costs and employment levels.<sup>67</sup> He too argues that this lack of impact on the overall efficiency of the sector can be explained as a result of limited competitive pressures. Finally, using data for eight countries in Latin America – Argentina, Brazil, Chile, Colombia, Costa Rica, El Salvador, Mexico and Peru - Levy Yeyati and Micco find that foreign bank penetration weakened competition in the region.<sup>68</sup>

All in all the statistics on competition and efficiency suggests that foreign bank entry can bring potential gains in this area except in environments which limit competitive forces such as when bank concentration is high, bank activities are restricted, and bank entry and exit is difficult.<sup>69</sup>

---

<sup>64</sup> Id.p.11

<sup>65</sup> Luca Papi & Debora Revoltella, foreign direct investment in the banking sector: A Transitional Economy Perspective, (University of Oxford, Queen Elizabeth House, Development Studies Working Papers, November 1999) P. 21.

<sup>66</sup> S. Haber. and A. Musacchio, "Contract Rights and Risk Aversion: Foreign Banks and the Mexican Economy, (1997- 2000." Stanford University. Mimeo. (2005).

<sup>67</sup> H.Schulz, "Foreign Banks in Mexico: New Conquistadors or Agents of Change?" The Wharton School, Financial Institutions Center, Working Paper No. 06-11. University of Pennsylvania, ( 2006).

<sup>68</sup> E. Levy Yeyati and A.Micco, "Concentration and Foreign Penetration in Latin American Banking Sectors: Impact on Competition and Risk." *Journal of Banking and Finance* (2007).

<sup>69</sup> Cull et al, supra note 13,p.12.

### 3.2.1.1.2. Access to Credit

The extent to which foreign banks contribute to greater access to credit, in particular for small firms, in developing countries is perhaps the most controversial aspect of the process of foreign bank participation. Neither theoretical discourses nor empirical evidences are conclusive or harmonious. Those who are against this process argue that foreign banks are likely to “cherry pick” the most profitable and transparent customers, reducing financing to some market segments like small businesses. On the other hand, those in favor of foreign bank entry point to the fact that foreign banks have access to a larger pool of loanable funds that can help them sustain higher levels of lending. Also, proponents of foreign bank participation argue that even if foreign banks focus on the most transparent firms, this process can enhance access to credit by smaller firms by forcing domestic banks to move down the market.<sup>70</sup>

Using data for 61,295 firms with 195,695 loans from 115 different banks in Argentina as of the end of 1998, Berger *et al.* find that smaller and more opaque firms are less likely to secure loans from large or foreign-owned banks.<sup>71</sup> Similarly, Detragiache, Gupta and Tressel, using data for 89 low income and lower middle income countries, find that a larger foreign bank presence is associated lower aggregate credit, higher operating costs, and lower welfare. With shallower credit markets and slower credit growth.<sup>72</sup> Also Main, specifically focusing on the case of Pakistan using a panel of 80,000 loans over 7 years, finds that foreign banks in Pakistan shy away from lending to “soft information” firms such as those that are small, located in rural areas, not affiliated with business groups, or seeking first-time loans and long-term relational financing.<sup>73</sup>

In contrast, certain studies offer some evidence that foreign bank participation may not always be pernicious for access to credit in host developing countries. Large firms benefit more from foreign bank presence but even small companies profit from foreign bank entry since foreign lending stimulates growth in firm sales, assets, and leverage. In general, the evidence on the implications of foreign bank participation for access to credit suggests that foreign banks are generally less inclined to lend to small and opaque borrowers relative to domestic banks. Nevertheless, there is also

---

<sup>70</sup> .Id.p.13

<sup>71</sup> A.Berger, L. Klapper, and G. Udell, “The Ability of Banks to Lend to Informationally Opaque Small Businesses.” *Journal of Banking and Finance* vol.25, (2001)p.2127-2167.

<sup>72</sup> E.Detragiache, P. Gupta, and T. Tressel,“*Foreign Banks in Poor Countries: Theory and Evidence.*” IMF Working Paper No. 06/18. Washington, DC. (2005).

<sup>73</sup> A.Mian, "Distance Constraints: The Limits of Foreign Lending in Poor Economies." *Journal of Finance* vol. 61, (2006) p.1465-1505.

evidence that their presence can have overall positive effects on access to credit, even if foreign banks themselves are not lending to small firms by forcing domestic banks to small businesses.<sup>74</sup>

### **3.2.1.1.3. Foreign bank participation and crises**

Banking crises are common incidents of developing economies. Since the mid-1990s, 77 crises episodes have taken place in 72 developing countries.<sup>75</sup> The costs of dealing with crises (e.g., paying for deposit losses, recapitalizing banks, and building banking systems that are more resilient to shocks) can be very large. Moreover, most crises have macroeconomic roots and take place in environments where governments have already difficult fiscal situations.

The rise in importance of foreign banks in developing countries has led to an intense debate on the pros and cons of foreign bank participation in terms of its impact on stability. Those opposed to foreign bank participation argue that because foreign banks have weaker ties to developing nations and have more alternative business opportunities than domestic banks, they are more likely to be fickle lenders. Moreover, there is also the potential that they could import shocks from their home countries. On the other hand, those advocating greater participation of foreign banks premise their argument on the notion that foreign banks are typically well diversified institutions, with access to many sources of liquidity that will be less affected by shocks.<sup>76</sup>

A larger number of studies have found that foreign banks tend to be more stable lenders than domestic banks, in particular during periods of crisis in developing countries. Investigation of the behavior of banks in Argentina and Mexico during the 1994-95 Tequila crisis showed that foreign banks generally had higher loan growth rates than their domestically owned counterparts, with lower volatility of lending contributing to lower overall volatility of credit.<sup>77</sup> Peek and Rosengren have also arrived similar conclusion after examining direct and cross border foreign bank lending in Argentina, Brazil, and Mexico during 1994-1999.<sup>78</sup>

---

<sup>74</sup> Cull et al, supra note 13, p. 15.

<sup>75</sup> .Id.p.34.

<sup>76</sup>Id.,p.12.

<sup>77</sup> L. Goldberg, B.G. Dages, and D.Kinney, "Foreign and Domestic Bank Participation in Emerging Markets: Lessons from Mexico and Argentina." *Economic Policy Review* vol.6 No.3. Federal Reserve Bank of New York. (2000).

<sup>78</sup> J. Peek and E. Rosengren, "Implications of the Globalization of the Banking Sector: The Latin American Experience." *New England Economic Review*, September/October. Federal Reserve Bank of Boston.( 2000).

De Haas and van Lelyveld investigated how foreign and domestic banks in 10 Central and Eastern Europe Countries (CEEC) reacted to business cycle conditions and host country banking crises from 1993 to 2000 and concluded while during crises domestic banks contracted their credit, foreign banks maintained their credit supply.<sup>79</sup> Discussions about whether foreign banks have behaved opportunistically in response to crises are often inconclusive. Examining the behavior of foreign and domestic banks in Malaysia during the 1997-98 Asian crisis, Detragiache and Gupta find no evidence that foreign banks abandoned the local market during the crisis.<sup>80</sup> Though some studies have found that foreign banks can respond to shocks from their home countries,<sup>81</sup> the evidence available so far is alleged to be supportive of that foreign banks can have a stabilizing influence on credit markets in developing countries, at least where financial sector depth is concerned.

On the other hand, there are indications that financial liberalization may cause financial fragility rather than financial stability. For example, Demirgüç-Kunt and Detragiache (2001) examined the relationship between banking crises and financial liberalization for 53 countries between 1980 and 1995. They found that banking crises were more likely to occur in countries whose financial system was liberalized. This is especially true in developing countries where the institutional environment is weak. However, even in this instance, the negative effect of financial liberalization has been attributed to the liberalization of interest rates, rather than from the entry of foreign banks.<sup>82</sup>

Evidences are also adduced to strengthen the view that participation of foreign banks is not the cause for financial crisis and neither crisis deters further liberalization. Crises are alleged to have prompted developing countries' governments to think differently and creatively about the problems they face.<sup>83</sup> In many developing countries, crises have encouraged governments to deregulate their banking sectors and to allow the entry of foreign banks.

---

<sup>79</sup> R. De Haas, and I. Lelyveld, "Foreign Banks and Credit Stability in Central and Eastern Europe. A Panel Data Analysis." *Journal of Banking and Finance* vol.30 (2006)p.1927-1952.

<sup>80</sup> E. Detragiache and P. Gupta, "Foreign Banks in Emerging Market Crises: Evidence from Malaysia." *Journal of Financial Stability* vol.2 No.3 (2006) p.217-242.

<sup>81</sup> . Cull et al, supra note 13, p. 12.

<sup>82</sup> A. Demirgüç-Kunt, and E. Detragiache, "Financial liberalization and financial fragility." In Caprio, G., Honohan, P., and Stiglitz, J.E. (eds.) *Financial Liberalization: How Far, How Fast?* (Cambridge, UK: Cambridge University Press, 2001),p.96-122.

<sup>83</sup> Id.P.16.

Cull et al have found evidences testifying that countries that have experienced crises tended to be more open subsequently than countries that never experienced a crisis.<sup>84</sup> According to their data, on average, the share of assets held by foreign banks in Eastern Europe and Central Asia increased from 10 to 32 percent within the five year period following crises. In Africa as well, foreign bank participation increased from an average of 32 percent to almost 45 percent five years after crises while in Latin America, the increase was smaller, with foreign bank participation increasing from 28 to 32 percent.<sup>85</sup>

### **3.2.2. Investment Limitation In and By Banks: Separation of Banking and Commerce in General**

Not only that limits are imposed on foreigners' participation but also that restrictions are placed investment of domestic investors in banks and on investment and other activities of banks themselves. Banking laws and regulations in different countries have customarily restricted the level of equity involvement of non-banking entities in banks and prohibited direct engagement of such entities in the activities conventionally acknowledged to be of banking nature. In similar vein, banks have been constrained in their equity participation in non-banking entities and barred from direct involvement in activities claimed to have been outside of legitimate scope of banking activities. These two way restrictions have separated banks from non-banking firms in the commercial or production sector of the economy. This tendency is generally referred to as separation of banking and commerce. Such restrictions have their origin centuries ago and are now prevalent in virtually all nations including Ethiopia.<sup>86</sup>

---

<sup>84</sup>Id.

<sup>85</sup> Id.

<sup>86</sup>Banking Business Percolation No 592/2008, *Fed . Neg. Gaz*, Year 14, No.57 (Hereinafter Proc.592/2008). Art. 22 states that the National Bank of Ethiopia may determine the conditions and limitations on investments of banks. Accordingly, the National Bank has come up with directive SBB /12/1996 regulating the types and limits of investment activities and transactions that banks could engaged in. Pursuant to the directive banks are restricted from engaging directly in certain activities or indirectly by way of equity participation.

### 3.2.2.1. Investment Limitation in Banks: Limitation on Equity Participation in Banks

We have noted that banking business constitutes the most susceptible business for insider abuse and embezzlement by those having substantial influence on the enterprise. Ownership presents itself as the clearest and the most common source of power and control in a bank if not the only.<sup>87</sup> As such limiting ownership goes in line with the regulatory objectives of abetting abuses. The need to avoid mixing sources and uses of funds through combinations with banks so as to prevent its adverse effects has long been felt. A typical legislative response is the 1956 US Bank Holding Company Act (BHCA).<sup>88</sup>

The BHCA defined a bank holding company as “any company which has control over any bank or over any company that is or becomes a bank holding company.”<sup>89</sup> The BHCA specified that “control” of banks occurred when a single “company” such as a non financial business or investment enterprise owned 25% or more stock ownership of voting shares in banks, with significant exceptions.<sup>90</sup> The Change in Bank Control Act of 1978 extended the 25% value to unincorporated

---

<sup>87</sup> Andrew Muscat, *Theliability of Holding Company for the Debts Of Its Insolvent Subsidiaries* (Dartmouth, 1996) P.47. Note that thee are also other indirect sources of control such as being pledge, and usufructuary of share.

<sup>88</sup> William D. Jackson, *Industrial Loan Companies/Banks and the Separation of Banking and Commerce: Legislative and Regulatory Perspectives* (CRS Report for Congress, Updated November 28, 2005).

<sup>89</sup> Normally, “control” of banks occurred when a single “company” such as a nonfinancial business or investment enterprise owned 25% or more stock ownership of voting shares in banks but there are exceptions as well. See 12 U.S.C. § 1841. Definitions

(a)

(1) Except as provided in paragraph (5) of this subsection, “bank holding company” means any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of this chapter.

(2) Any company has control over a bank or over any company if—

(A) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the bank or company;

(B) the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or

(C) The Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.

(3) For the purposes of any proceeding under paragraph (2)(C) of this subsection, there is a presumption that any company which directly or indirectly owns, controls, or has power to vote less than 5 per centum of any class of voting securities of a given bank or company does not have control over that bank or company.

<sup>90</sup> Id. The 25% figure still critically defines the span of prohibited “control” of a bank by a nonfinancial company. Throughout this recent period, the definition of “control” has been a regulatory focal point. In general, control of a firm in an impermissible business is prohibited. Exceptions to general prohibitions and limits are made for investments in publicly-favored areas, e.g., through small business investment companies for low-cost housing and community redevelopment.

firms, individuals, etc.<sup>91</sup> In other words, U.S. law permits firms to acquire voting shares in banks. However, this stake cannot exceed 25 percent of the bank's outstanding equity. Otherwise, the acquiring firm becomes a bank holding company and becomes subject to regulation by the Federal Reserve.

This Act prohibited a bank holding company from owning a non-bank entity and effectively prohibited BHCs (organizations that controlled two or more banks) from engaging in almost all non-banking activities, as well as restricting their expansion across state lines. The BHCA originally applied only to corporations owning two or more banks that gave a loophole for companies to adjust themselves in to one bank holding companies and operate in any business.<sup>92</sup> In The 1970 the Congress passed several amendments to the BHCA including eliminating the one-bank holding company loophole.

Later on another loophole was identified via limited-service "nonbank banks" (NBBs).<sup>93</sup> NBBs accepted either deposits or made commercial loans, but, critically, not both. Most apparently accepted deposits but made no commercial loans. Hence, NBBs fell outside the strict legal definition of a bank. Thus, their banking operations also fell outside the BHCA's redefinition in 1970.<sup>94</sup> This "nonbank bank loophole" allowed financial conglomerates to offer FDIC-insured banking services. The Competitive Equality Banking Act of 1987 (CEBA) prohibited new NBBs. CEBA broadly defined the terms "demand deposit" and "commercial loan" to cover many variations. Thus, it stopped prospective owners of NBBs from creating more institutions combining banking and commerce across state lines.

In Canada a single investor is not allowed to control more than 10 percent of a bank's shares.<sup>95</sup> Other developed countries have a more permissive approach to banking and commercial affiliations. Most member of the European Union adhere, to the EC Second Banking Directive,<sup>96</sup> which sets limits on the percentage of a bank's capital that can be invested in nonfinancial firms. No limits are set on the actual percentage of a commercial firm that the bank can own. In the reverse direction, outside investors and commercial firms are free to control banks. Commercial firms are

---

<sup>91</sup> .Id.

<sup>92</sup> Many banks converted to one-bank holding companies in order to take advantage of this loophole in the law. The number of one bank holding companies rose from 117 in 1955 to 783 in 1968. a number of large one-bank holding companies started to engage in a wide range of commercial activities such as agriculture, mining and petroleum operations and manufacturing activities. Fischman, supra note 5, p.515.

<sup>93</sup> Jackson , supra note 21.

<sup>94</sup> A redefinition of the term "bank" in the Holding Company Act Amendments of 1970 had opened another loophole. Banks had been redefined in the 1970 legislation as institutions that provided demand deposits and made commercial loans. Beginning in 1980, large conglomerates, securities firms, and insurance companies exploited the loophole by acquiring banks that refrained either from commercial lending or taking demand deposits.

<sup>95</sup> John Krainer, *The Separation of Banking and Commerce*, *FRBSF Economic Review* 2000

<sup>96</sup> Id.

free to buy banks, subject to the approval of the Financial Services Authority. This survey shows how far investment limitations in banks differ and later we will see the Ethiopian scenario.

### **3.2.2.2. Limitation on Activities of Banks: scope of banking powers**

Bank powers,<sup>97</sup> in the sense that what and to what extent banks are permitted to engage in various activities, have been the focal point of banking legislations forming the regulatory regime. Development of modern banking in the form of lending, transferring funds, and accepting deposits had its origin in Mediterranean city states in the thirteenth and fourteenth centuries.<sup>98</sup> They arose out of the activities of “money changers” and merchants.

Bank regulation of various types including those on restrictions on bank activities evolved along with it. Venice, for example, regulated its banks extensively. Beside other regulatory laws,<sup>99</sup> activities were also restricted. In 1374, the Venetian senate prohibited bankers from dealing in copper, tin, iron, lead, saffron, and honey. Nineteenth century scholars suggested that the intent was possibly to keep banks from undertaking risky activities and monopolizing the specified commodities. In 1450, banks were restricted in extending credit to purchase silver, presumably to limit their lending for speculative purposes. From the thirteenth century on in Europe, periodic economic and financial disruptions pertaining to bank failures, currency problems, and “bubbles” focused the attention of public authorities on banking problems and exerted efforts to sort out possible antidotes.<sup>100</sup> Similar trend limiting banking powers has and will have prevailed in banking system despite the difference in scope.

Separation of banking and commerce being a general principle, the magnitude of its application substantially depends on the definitional scope of activities to be performed by banks. The scope of banking business differs from nation to nation as well as from time to time. In general,

---

<sup>97</sup> Global Survey 2000, Institute of International Bankers. September. Pp.1-15. The Institute of International Bankers lists several activities that may be permissible for banking organizations across countries. In 2000 those five powers included: Securities powers (underwriting, dealing and brokering securities, and mutual funds) ; Insurance powers (underwriting and selling insurance as a principal and an agent); real estate (real estate investment, development, and management); bank investments in industrial firms (including through holding company structures) ; industrial firm investments in banks

<sup>98</sup> Bernard Shull, *The Separation of Banking and Commerce in the United States: an Examination of Principal Issues* (Hunter College of the City University of New York,)p.6.

<sup>99</sup> Id. By 1270, Venetian banks were required to hold government bonds as a form of security; various laws passed between 1421 and 1523 gave summary jurisdiction over questions between bankers and depositors to designated public officials; an act in 1467 limited banks to ten ducats in lending to any person upon a single obligation.

<sup>100</sup> Id.p.7. When government’s found regulation unsatisfactory in the sixteenth and seventeenth centuries, there had been cases where they substituted public banks.

banking powers has been delineated either by detail description of possible activities or else at least by general exclusionary clauses that declare banks should not engage in certain activities particularly dealing in merchandize. For instance, in New York prior to the 1825 definition of banking powers, there were simply restrictive clauses declaring that trading or dealings in "stocks" (securities), goods, wares, and merchandise was not within the scope of banking business.<sup>101</sup>

But in 1825, a New York legislation came up with a sort of descriptive definition stating that banks "posses all incidental and necessary powers to carry on the business of banking by discounting bills, notes and other evidence of debt; by receiving deposits; by buying gold and silver, bullion and foreign coins; by buying and selling bills of exchange, and by issuing bills, notes and other evidences of debt. There had been cases where judicial interpretation and legislations have been in flux:<sup>102</sup> at times widening and at other time narrowing banking powers, attesting that demarcating the boundary of banking activities and non-banking activities is not an easy decision.

Banking powers as well differ from country to country. In England, where separation of banking and commerce has its origin in the 17<sup>th</sup> century when the Bank of England was established,<sup>103</sup> a provision was added to the act establishing the bank, restricting its activities. It was declared that ". . . the said corporation . . . shall not at any time . . . deal or trade . . . in the buying or selling of any goods, wares or merchandise whatsoever . . . ." <sup>104</sup> Banking in the United Kingdom today is distinctive in that there are few explicit legal restrictions on the types of business a bank can undertake.<sup>105</sup> As a result, the U.K. is sometimes listed as providing very wide banking powers. In practice, however, such arrangements are not widespread. It has only been since 1987 that commercial banks moved aggressively into securities trading and insurance through subsidiaries.<sup>106</sup> Tradition and moral suasion, exercised by the Bank of England, have effectively constrained the

---

<sup>101</sup> Id.p.13.

<sup>102</sup> Ibid. The 1825 definition was held to be too restrictive in its description of activities and courts had expanded the scope by alleging implicit powers. Notably in 1957 the New York court of Appeal held that the definition did not list all authorized powers and decided that banks had the right to borrow money by issuing bonds. On the other hand, there had been cases where courts displayed a tendency for narrowing banking powers. For instance, in certain litigation it was held that banks could not accept corporate stock as collateral and as payment for debt, could not engage in operation of business even if acquired in satisfaction of a debt. Approaches in legislations as well were contradictory. In 1913 and 1927 there had been expansion and banking powers by legislations among others that authorized real estate loans, trust services, to buy and sell marketable debt obligations. This had been interpreted to empower banks underwrite all debt securities and through their affiliates, underwrite both debt and equity securities. This had enabled banks to get involved much in securities dealings until the Glass Steagall Act came in 1933 that put in to place separation of commercial banking and investment banking activities. In particular commercial banks were restricted in their involvement in securities market.

<sup>103</sup> Eric B. Fischman, "Expanding Bank Ownership: A Necessity for Efficiency and Global Competitiveness of the U.S Banking Industry" in ANNUAL REVIEW OF BANKING LAW (1992) P.510.

<sup>104</sup> Shull, supra note 3 ,p.11

<sup>105</sup> Shull, supra note 3, p.11.

<sup>106</sup> David T. Llewellyn, "Universal Banking and the Public Interest: A British Perspective," Conference on Universal Banking at New York University, Feb. 23-24, (1995) pp.2-3

mixture of banking and commerce. In other words, looking at conglomeration in the U.K., British banks have not taken advantage of the scope of their permissible powers.

In US the scope of banking powers has been in a state of flux. The basis for the US policy on separation of banking and commerce originated in England. Early banks in the United States were patterned after the Bank of England and as such bank activities were restricted.<sup>107</sup> Charters of early U.S. banks were not always specific in their definition of banking, but they typically prohibited banks from dealing in merchandise.<sup>108</sup> Banking powers in the United States were defined for the first time by New York in 1825. The definition indicated that banks would “possess all incidental and necessary powers to carry on the business of banking by discounting bills, notes and other evidences of debt; by receiving deposits; by buying gold and silver, bullion and foreign coins; by buying and selling bills of exchange, and by issuing bills, notes and other evidences of debt; but the said Company shall have and possess no other powers whatever, except such as are expressly granted by this act ....”<sup>109</sup>

However, bank powers, whether explicit or implicit, did not include the power to engage in mercantile enterprises. As late as 1854, banking legislation introduced in the New York state legislature to establish standards for the formation of banking corporations, included the provision that the corporation “shall not, directly or indirectly, deal or trade in buying or selling any goods, wares, merchandise or commodities . . .”<sup>110</sup>

Court interpretation as well served as a check restricting expansion.<sup>111</sup> It was held that National banks were permitted to make loans on "personal security," which in turn was taken to imply that they could not make mortgage loans. More over it was determined that they could not in general invest in real estate; that they could accept corporate stock as collateral and as payment for debt, but could not deal in or purchase stock as an investment; that they could not under any circumstances become a partner in a business in which they could incur unlimited liability; and that they could not engage in the operation of a business, even if it had been acquired in satisfaction of a debt. The national banking system, thus, continued its distinctive legal treatment of commercial banks in restricting their activities.

---

<sup>107</sup> Fischman, supra note 5.

<sup>108</sup> Id. p. 511.

<sup>109</sup> Id.

<sup>110</sup> Id. p. 15.

<sup>111</sup> Id. p. 16

Formal and informal affiliations of investment and commercial banks with securities affiliates constituted the beginnings of a type of “universal banking” in the United States around the turn of the 19<sup>th</sup> century.<sup>112</sup> The spread of mixed commercial/investment banking lessened the distinction between financing an enterprise through credit and controlling it through ownership. The Federal Reserve Act of 1913 provided for a moderate expansion of national banking powers by permitting real estate loans, time and savings deposits, trust services, and foreign branches. Again the 1927 McFadden Act gave national banks explicit authority to buy and sell marketable debt obligations. Based on that it was ruled that national banks could underwrite all debt securities and that their affiliates could underwrite both debt and equities.<sup>113</sup>

This arrangement was demolished by the Banking Act of 1933. The stock market collapse in 1929 reversed the increasing expanding powers of banks. Many critics attributed the Great Depression partly to “financiers,” who abused banks in the service of nonbank business. Specifically some commercial banks’ securities activities were believed to have helped fuel the stock market speculation of the late 1920s prior to the crash. In response to that, the Banking Act of 1933,<sup>114</sup> also known as Glass-Steagall Act revoked the powers that had been granted by the McFadden Act and in particular, required the separation of commercial and investment banking. It divided banking and industry (including securities operations and their corporate investments) into separate businesses after 1933. The Morgan, Rockefeller, and other complex business combinations with financial firms were split into separate banking and “nonbanking” parts.

In the 1980s and early 1990s during the Reagan and Bush administrations, proposals for liberalization of existing limitations on banking activities, including legal and regulatory restrictions on insurance and securities activities were developed. The Gramm–Leach–Bliley Act of 1999 (GLB)<sup>115</sup> reflects a culmination of almost 20 years of debate regarding permissible activities for banking firms. It permits and facilitate the entry of banks into insurance, securities and other activities. It likewise permits and facilitates the entry of other financial organizations into banking.

The GLB repeals two of the four sections of the Glass-Steagall Act.<sup>116</sup> It repeals Section 20, that prohibited banks from having affiliates principally engaged in dealing in securities, and Section

---

<sup>112</sup> Id.

<sup>113</sup> Id.

<sup>114</sup> William D. Jackson, *Industrial Loan Companies/Banks and the Separation of Banking and Commerce: Legislative and Regulatory Perspectives* (CRS Report for Congress, Updated November 28, 2005).

<sup>115</sup> Bernard Shull, *Financial Modernization Legislation in The United States :Background and Implications*(No. 151, October 2000).p.9.

<sup>116</sup> Id.

32 that prohibited interlocks of directors and officers of securities firms and banks. But it maintained Section 16 of the Glass-Steagall Act, that limits banks that deal in and underwrite securities to specified type C obligations of the Federal government and general obligations of states and political subdivisions. It also affirmed the continuity of Section 21 that prohibits firms dealing in securities from accepting deposits. These sections continue to preclude “universal banking”, in which all investment banking activities may be conducted within the bank itself. The new Act amends Section 4 of the BHCA as well, adding a series of new subsections that permits new activities.<sup>117</sup> A new section is added (4(k)) that permits BHCs that qualify to establish themselves as “financial holding companies” (FHCs). FHCs are permitted to engage in a broader range of activities, including those that are financial in nature, incidental to such activities or, as determined by FRB, complementary” to financial activities. The Section 4(k) list of financial activities includes “lending, exchanging, transferring, investing for others, or safeguarding money or securities, insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing in any State”. It also includes securities underwriting, dealing and market making (without revenue limits), sponsoring all kinds of mutual funds and other investment companies, any activity FRB has found, under 4(c)(8) to be permissible, merchant banking, insurance company portfolio investments, and health insurance. Later we shall see the case in Ethiopia.

### **3.2.2.3. Limitation on Equity Participation of Banks**

The other possible way of mixing of banking and commerce is the equity participation of banks in other firms. Hence countries desiring to maintain separation of banking and commerce set limits on the scope of investment of banks in other firms but again they differ in scope. For example, in Canada banks can own as much as 10 percent of the voting stock of a non-financial firm, with aggregate holdings not to exceed 70 percent of the bank’s capital.<sup>118</sup> This is held to be more permissive approach to banking and commercial affiliations than is in US.<sup>119</sup>

The German banking system has been the prototype of Universal banking.<sup>120</sup> Banks had intimate relationships with the industries they were financing. A simple way of reducing the risks of

---

<sup>117</sup> Ibid. section 4.

<sup>118</sup> John Krainer, The Separation of Banking and Commerce, *FRBSF Economic Review 2000*

<sup>119</sup> John Krainer, The Separation of Banking and Commerce, *FRBSF Economic Review 2000*

<sup>120</sup> Universal banks are typically defined as banks that provide short-term banking credit as well as intermediate and long-term capital through underwriting and investing in equities; a characteristic of a universal banking system is the

what was, in essence, a risky lending operation was to require the borrower to conduct business through one bank (or the lead bank if securities were floated by a syndicate) and bank officials to be appointed to the supervisory board of borrowing firms. These measures gave the banks important information on the borrowing firm's condition and a voice in policy-making. Germany had neither antitrust laws nor restrictions on interlocking directorates. Control of major commercial and industrial firms through direct ownership of stock, proxy rights, and interlocking directors became characteristic of Germany's banking system. Close, long term relationships were nurtured. In 1913, Germany's three largest corporations were universal banks. Today, any bank licensed in Germany may conduct a universal banking business.<sup>121</sup>

Similar banking arrangements can be found on the Continent in Spain, Switzerland, France, and Norway.<sup>122</sup> Most member of the European Union adhere to the EC Second Banking Directive,<sup>123</sup> which, as noted already, sets limits on the percentage of a bank's capital that can be invested in nonfinancial firms. No limits are set on the actual percentage of a commercial firm that the bank can own. In the reverse direction, outside investors and commercial firms are free to control banks. The U.K. also complies with the Second Banking Directive. However, banks that own more than 20 percent of a nonfinancial firm must deduct that investment when calculating their risk-based capital.

In Japan,<sup>124</sup> Japan's antimonopoly law prevents banks from holding more than 5 percent of another firm's shares. However, the postwar Japanese economy has been dominated by loose-knit groups of firms (keiretsu) organized around a lead bank. It is not uncommon for keiretsu members to hold shares in each other. For most of the large keiretsu, such as Mitsubishi and Sumitomo, internal

---

close and long-term relationships, through boards of directors and in other ways, between banks and the commercial/industrial companies to whom they provide credit and in which they have an ownership interest

<sup>121</sup> Shull, supra note 3, p.25.

<sup>122</sup> Shull, supra note 3, p.25.

<sup>123</sup> Id.

<sup>124</sup> Shull, supra note 31

group holdings can account for as much as 25 percent of the total group equity. Thus, it is possible that a bank can informally control a much larger stake than 5 percent through the crossholding structure. In sum, European and Japanese banks have more commercial powers than do U.S. banks.

### **3.2.3. Issues for consideration in Separation of Banking and Commerce**

#### **3.2.3.1. Concerns with Mixing of Banking and Commerce**

A number of concerns have been forwarded of which the following are the main ones:

##### **3.2.3.1.1. Conflict of Interest**

The possibility for multiple conflicts of interest when a bank is controlled by or is an owner of the company to whom it is lending, or to whom it provides other services, raise issues that have a long history.

Shareholders' meeting is the ultimate decision maker.<sup>125</sup> Moreover they are not precluded from stretching their invisible hand to the board of directors and even down to the executive manager and his fellows.<sup>126</sup> They can shape the overall activity of the bank by appointing more cooperative and amenable directors and removing those resisting their dictation.<sup>127</sup> Armed with such patent and latent controlling power, unlimited ownership and company voting power of some shareholders might bring substantial risks of abuse and unfairness to the overall sustainability of the bank given the special vulnerability of banks.

In the first place, a bank may be used as a "captive source of finance" for such influential shareholders.<sup>128</sup> Some regulators envision that a conflict of interest might arise when a bank's influential shareholder needs a loan of a size or type that the bank would not normally make. There was a potential danger that commercial corporations will buy banks and then use bank resources to finance their other potentially risky ventures.<sup>129</sup> Banks may feel pressure to extend loan without interest or below market rates.<sup>130</sup> Influential shareholders may also drain the assets of a bank by engaging in different dealing at less than arm's length.<sup>131</sup> It involves the transfer or use of the bank's resource without offsetting consideration.<sup>132</sup>

---

<sup>125</sup> Andrew Muscat, P. 47-48

<sup>126</sup> Ibid

<sup>127</sup> Ibid

<sup>128</sup> Id, P.79

<sup>129</sup> Fischman, Supra Note 18, P. 519

<sup>130</sup> Ibid

<sup>131</sup> Ibid.

<sup>132</sup> Muscat, Supra Note 56, P. 76-77

From the other vantage point as well, there is a natural temptation that out of the wish to make its affiliate more successful a bank would make its credit facilities more freely available to its affiliate, independent of its creditworthiness.<sup>133</sup> A bank may come to the rescue of a failing company by moving bad assets from its subsidiary or affiliate to the bank.<sup>134</sup> Still more, a bank may obtain substantial amounts of inside information that it might use to the detriment of outsiders.<sup>135</sup>

In defense of this it has been contended that mixing banking and commerce may give rise to advantageous convergence of interest. Equity holders receive high returns if a high-risk, high-return project pays off and have limited down side risk due to limited liability.<sup>136</sup> Banks as creditors do not enjoy the upside of such projects since their return is limited to the agreed-upon interest rate. Banks might proffer to shut down a distressed enterprise to ensure loan repayment while shareholders would prefer to continue operation in the hope that it will turn around.<sup>137</sup> They might evaluate the business differently. One suggested solution to such problem is to allow a creditor bank also take an equity stake. The bank will take account of the interest of both shareholders and creditors. Equity participation by a bank can mitigate conflicts by aligning its interests with those of equity holders.<sup>138</sup>

### **3.2.3.1.2. Portfolio Risk**

The other long standing justification for separation of banking and commerce has been the belief that widening the scope of involvement of commercial firms in banks has the propensity to increase volatility in bank returns. And that the involvement of banks in non-banking activities including equity and real estate investment were perceived to be too risky than debts have been.<sup>139</sup> However, recent developments tend to imply that equity and other types of assets could offer potential gains by their diversifying effect on risk. This advantage has been claimed to offer benefits particularly for smaller regional and local banks with limited investment opportunities.<sup>140</sup> But still regulatory frameworks to that effect are held to be indispensable owing to the fact that banks may venture on too speculative and risk businesses.

---

<sup>133</sup> Michael P. Malloy, *The Regulation of Banking: Cases And Materials On Depository Institutions And Other Regulators* (Anderson Publishing Co., 1992) P.614-642

<sup>134</sup> *Ibid.*

<sup>135</sup> Shull, p.41.

<sup>136</sup> Rawndall S. kroszneer, the separation of banking and commerce continues in the Grham-Leach Billey, available at [www.mineapolisted.org/purlictions-papers/pub-display.cfm?id=3518](http://www.mineapolisted.org/purlictions-papers/pub-display.cfm?id=3518). accessed on 5/8/2009.

<sup>137</sup> *Ibid.*

<sup>138</sup> *Ibid.*

<sup>139</sup> Shull, p.35.

<sup>140</sup> *Id.*p.36.

### **3.2.3.1.3. Concentration and Competition**

Regulators fear that lack of control over investment in and by banks will lead to greater concentration of money in the hands of a few institutions.<sup>141</sup> Such institutions will control more money and, therefore, bear more influence over the broader aspects of the economy, such as monetary policy.<sup>142</sup> Second concerns in relation to competition have been voiced.<sup>143</sup> In case a bank has substantial market power in commercial loans, it can cause harm by inducing unbalanced competition among commercial firms such as by denying credit to rivals of its commercial affiliate, or it may raise credit costs of rivals of its commercial affiliates. For banks' function as an impartial source of credit not to be impaired, there has to be some bounds on the degree of relation a bank may establish with other non-banking entities.

Of course, some say that the competition concern should not be taken as a serious problem unique to banking business. Though we cannot say that there can never be legitimate foreclosure concerns arising from the vertical merger of a bank and a commercial firm, foreclosure concerns are not limited to the banking industry. "The relevant question is," one scholar stated, "whether the risk of vertical foreclosure is especially acute in banking, so much more so than in other industries as to trump antitrust review and warrant a blanket prohibition on the mixing of banking and commerce. The answer is "no". In comparison with many other industries, banking appears neither exceptionally concentrated nor unusually susceptible to foreclosure risks."<sup>144</sup>

### **3.2.3.1.4. Systemic Risk**

While universal banking pledges to provide some level of averting distress, systemic problems arising from risks that cannot be diversified away could pose more threat in universal banking system. This is so because the combination constitutes a larger share of financial and entire economic activity whose exposure might be devastating.<sup>145</sup> Affiliation may also invite systemic risk from a different angle. Where a bank and its affiliate are closely associated in the public mind, there would be a risk that if the affiliate fare badly, public confidence in such bank may be impaired.<sup>146</sup>

---

<sup>141</sup> Fishcman, P. 517-518

<sup>142</sup> Ibid

<sup>143</sup> Alexander Raskovich, Should Banking Be Kept Separate from Commerce (Economic Analysis Group, Discussion Paper, August 2008).

<sup>144</sup> Ibid.

<sup>145</sup> Shull, pp.52-53.

<sup>146</sup> Michael P. Malloy, P.614-642

And since public confidence is essential to solvency of a bank, there might be a tendency to bailout the affiliate through unsound loan or aid, or else the bank itself might fall into distress, which in either ways is risky.

### **3.2.3.1.5. Small business lending**

Critics of mixing of banking and commerce for long held that close association between banks and commercial firms could give rise to potential marginalization of small and new businesses in relation to access to credit. This view has been reflected both in US and Japan,<sup>147</sup> and there is some evidence in support of the view that larger and more complex banks do not provide as much credit to small business. The counter argument holds that larger banking organizations should not be an issue in that respect larger banks means adequate credit where by at least smaller banks would be pushed to that direction.<sup>148</sup>

Beyond the concern to small businesses, the need for keeping banks as source of liquid finance has been sound reason to restrict investment activities of banks. Providing money for other businesses and individuals represented the primary function of banks.<sup>149</sup> If a bank extensively invested its funds in long term ventures, the money would not be available for other businesses or for emergencies such as recessions. Hence, bank assets should be liquid compared to their liabilities so as to enable payment of demand deposits and provide other financial services to customers.

### **3.2.3.1.6. Financial Markets Development**

It has been suggested that in countries where banks have substantial role in both equity provision and long-term as well as short-term credit, financial market development could be negatively affected. The experience of Germany is cited as exemplary in that banks being there to provide fiancé in any form, commercial paper, bonds and other financial instruments and overall capital markets may not develop to their full-fledged level.<sup>150</sup> This is so because their circulation as a means of financial transaction would be reduced because banks can do that directly using their affiliation.

---

<sup>147</sup> Shull, p.59.

<sup>148</sup> Ibid.

<sup>149</sup> Fischman, P.511

<sup>150</sup> Goodman et al., product line Regulations for Financial Institutions, "proceedings of a conference on bank structure and competition, Federal Reserve Bank of Chicago, April 23-25,1984, pp.79-108) p.90

### **3.2.3.2. Potential benefits of mixing banking and commerce**

The preceding section highlighted the possible downsides mixing banking and commerce. On the other hand there are arguments favoring the mixing.

#### **3.2.3.2.1 Economies of Scale and Scope**

Economies of scale<sup>151</sup> and economies of scope<sup>152</sup> are likely to be achieved by eliminating barriers between banking and commerce. Economies of scale reduces average cost when the scale of production of a certain product increases and similarly economies of scope lowers average cost by enabling different products to share inputs within one organization.<sup>153</sup>

Based on this logic, allowing mixing between banking and commerce gives rise to bigger organizations and high degree of diversification that could increase scale and scope if products of the combining firms were enough alike to share some production process. This in turn would enable banks to maintain competitive advantage by reducing cost and thereby prices paid by customers. This argument has been persuasive in US that progressive liberalization has been achieved.<sup>154</sup> Combining banking and commerce might also manifest its impact on innovation capacity of both banking and industry. The mixing would give rise to large firms having the capacity to support research and innovation.

#### **3.2.3.2.2. Reduction in Transaction Cost of monitoring creditworthiness**

Banks in their business relation with commercial firms, particularly loan extension, demand appropriate information in evaluating prospects and risk associated with their customer. This information ascertaining difficulty and associated cost would be minimized if a bank is already in possession of sizable equity in the borrowing customer. From the customers perspective as well, many bank products are complementary and their combined purchase may reduce transaction costs of information-searching and shopping and provide convenience. It has been shown that small

---

<sup>151</sup> Economies of scale refer to the case for full utilization of industry's production capacity of a firm on a certain product.

<sup>152</sup> Economies of scope refers to the advantage of producing various products sharing common inputs in a firm.

<sup>153</sup> Shull, p.37.

<sup>154</sup> Id. pp. 39-40.

business borrowers with longer banking relationships tend to pay lower interest rates and are less likely to pledge collateral.<sup>155</sup>

### **3.2.3.2.3 Enhances stability?**

In contrast to the allegation that mixing fuels up bank failures and systemic risk, it is proposed that commercial corporations should be allowed to have substantial investment in banks. They hold that such investors would contribute to the stable continuity of the banking industry. They allege that many banks have failed in the past several years and others suffered from poor financial health. Government support or other mechanisms like the deposit insurance fund were not found to be adequate to bailout failing banks.<sup>156</sup> If large industrial companies own banks, they will infuse money, assets and other sources of financial strength into the banking system at the necessary levels to relive it. An investor having a substantial investment in a failing bank would not worry what to lose its large investment in commercial bank if it could inject capital and save it from going bankrupt.<sup>157</sup>

The other view holds that sometimes investors with substantial investment could be a source of power to the bank by disciplining abusive or unfair acts of company agents (board of directors and other officers). In modern structure of corporate governance, ownership and power of control are divorced. This has given rise to what is commonly referred to as agency problem<sup>158</sup> that the agent may not always act in the best interest of the principal absent some sort of control from the principal. Shareholders exercise oversight over managerial opportunism. In doing so, they have to incur monitoring costs such as to become informed about the operation of the firm; to communicate among themselves and make decisions, bring their decision to bear on the firm's management, etc.<sup>159</sup>

Shareholders with substantial investment are more willing to undertake monitoring efforts because the cost is spread over a larger investment and unlikely to outweigh the benefits.<sup>160</sup> Thus especially in banks where depositors are unsophisticated and dispersed, where the assets are more vulnerable to insider abuse and embezzlement, shareholders with substantial investment would be an asset to the bank.

---

<sup>155</sup>Alexander Raskovich,

<sup>156</sup>Fischman, P. 529

<sup>157</sup>Ibid.

<sup>158</sup>Roberta Romano, Foundation of Corporate Law (Oxford University Press,993)P. 78

<sup>159</sup>Id, P.19

<sup>160</sup>Id, P. 155

#### **3.2.3.2.4 Global Competition**

Just as a generalization from the preceding discussion, it seems that narrowing or eliminating the separation of banking and commerce will have moderate effect on the performance and competitive advantage of banks at global level. It has been suggested that banks in country where separation of banking and commerce is absolute or stringent would be at competitive disadvantage in global competition. The experience of US where foreign banks, from countries with loose separation of banking and commerce grow rapidly than US banks in the 1980s, has been cited to offer some evidence if not conclusive.<sup>161</sup>

---

<sup>161</sup> Shull, p.43.

## CHAPTER FOUR

### INVESTMENT LIMITATIONS IN AND BY BANKS IN ETHIOPIA

The Ethiopian legal regime in banking has comparable provisions on investment restrictions to that of what we have discussed already. It has come up with some limitations which typically take the form of who can invest and to what extent in the banking sector. Some of the limitations apply to other sectors as well while some are unique to the banking sector. The typical forms of limitations in relation to investment in banks are: the nationality requirement restriction, the restriction on maximum amount of investment (shares) to be held by a single investor/related investors, and the prohibition of an investor having allegedly substantial investment in one bank (influential shareholder) from investing in any other bank. On the other hand Ethiopian law has delineated the scope of banking activities and it has also limited the scope equity participation of banks in other firms.

#### **4.1. The Ban on Participation of Foreign Investment in Banks: The Nationality Requirement**

The Ethiopian banking sector has remained blocked to foreign investors. We have already seen that the banking sector is among areas of investment exclusively reserved to Ethiopian nationals. Moreover Art. 9 of the banking business proclamation No. 592/2008 reasserts the exclusion of foreigner investors and other domestic investors by stating that “foreign nationals or organizations fully or partially owned by foreign nationals may not be allowed to open banks or branch offices or subsidiaries of foreign banks in Ethiopia or acquire the shares of Ethiopian banks.”<sup>162</sup>

This pervasive provision asserts the continuation of banking business as exclusive domain of Ethiopian nationals and their own business entities. While the usual form of foreign participation in the banking sector is via opening branches or subsidiaries of foreign banks, the law does not give any loophole for foreign participation even by way of equity holdings. Foreign nationals including

---

<sup>162</sup> Banking Business Proclamation No 592/2008, *Fed . Neg. Gaz.*, Year 14, No.57 (Hereinafter Proc.592/2008) Art. 9.

any entity in which they have shares regardless of how insignificant their shareholding may be relative to equity holdings of Ethiopians are pushed away from the banking sector.

As noted earlier, in spite of the increasing liberalization trend, in Ethiopia foreign participation in the banking sector is absolutely prohibited. The customary justification for exclusion of foreign participation holds that banks are naturally trust and fiduciary institution for which reason nationals are preferred.<sup>163</sup> Some also argue that banks are lucrative businesses to be enjoyed by nationals only.<sup>164</sup> There is also a contention that, in case of participation of foreign banks in developing countries, foreign banks could potentially import shocks from their home countries,<sup>165</sup> while the majority argues that foreign banks are well diversified institutions, with access to many sources of liquidity that will be less affected by shocks.<sup>166</sup> Other justifications for allowing participation of foreigners include capital flow thereby providing greater credit access.<sup>167</sup>

Governments liberalize their banking markets in order to attract new capital and to promote the restructuring of their often rather inefficient banking systems. One possible channel for how foreign banks may foster such a restructuring process is spillover effects from foreign to domestic banks, another possible channel could be the increase in competition. However, the opening up of banking markets can also entail large risks since domestic banks need to undertake huge investments to become competitive with foreign banks.<sup>168</sup>

Various advantages and disadvantages of FDI in banking are pointed out. At any rate in the context of Ethiopian law, the balance of pros and cons of foreign participation in banking has gone in favor of exclusion of foreigners. As summarized by Kozo Kiyota et al, in their study on Ethiopian financial sector, Ethiopian Government and other stakeholders, including the leadership of the private banks and the Ethiopian Bankers' Association, have five main concerns:<sup>169</sup>

- The government believes that the development of a viable domestic banking sector will be threatened by foreign banks, because they have more capital, more experience, and

---

<sup>163</sup> Eric B. Fischman, Expanding Bank Ownership: A Necessity for Efficiency and Global Competitiveness of the U.S Banking Industry” in **ANNUAL REVIEW OF BANKING LAW** (1992) P.518.

<sup>164</sup> Ibid.

<sup>165</sup> Cull et al, supra note 13, P.12

<sup>166</sup> Ibid

<sup>167</sup> Ibid P. 10-13

<sup>168</sup> .Maria Lehner&Monika Schnitzer, Entry of Foreign Banks and their Impact on Host Countries (University of Munich, Department of Economics, Discussion paper September 2006)p.1.

<sup>169</sup> Kozo Kiyota, Barbara Peitsch, and Robert M. Stern, The Benefits of Financial Sector Liberalization for Developing Countries: A Case Study of Ethiopia (INTERNATIONAL POLICY CENTER /IPC/ Working Paper Series Number 69, Gerald R. Ford School of Public Policy University of Michigan, June 27, 2008),p.15-18.

better reputations. They argue that the Ethiopian financial sector is too young and inexperienced to compete (the infant industry argument).

- Ethiopian government officials also believe that entry by foreign banks will further skew credit allocation towards large-scale industrial, real estate and service enterprises(including trade) and away from agriculture, small-scale and cottage/micro enterprises (sectors which are the priorities for the government’s development strategy). They contend that foreign banks will concentrate lending in major urban centers using foreign funds, contributing little towards the development of rural banking. Furthermore, they contend that foreign banks will “cherry pick” the best companies and sectors.
- Domestic savings mobilization has been identified as an area of concern to Ethiopian officials, who have suggested that foreign banks would lend in their home or other foreign currencies and would not be interested in mobilizing domestic savings.
- There is concern that foreign banks may serve as conduits for the inward and outward flows of capital (e.g., through capital and money-market transactions; credit operations; personal capital movements; etc.). This may cause foreign exchange and/or liquidity shortages, with potentially adverse effects on the country’s capital account. The concern becomes more pronounced in view of the limited regulatory capacity of the central bank.
- Finally, it is strongly believed that the authorities will be unable at present to regulate and supervise foreign banks effectively.

Kozo Kiyota et al, admit that these are legitimate concerns on the part of the government but still they believe that total exclusion of foreign banks is not the right approach.<sup>170</sup> They argue that there are compelling reasons to liberalizing the financial sector. One of their grounds for liberalization is the need to improve efficiency. On this point it pointed out that not only foreign banks should be allowed to enter into Ethiopia but also that liberalization should begin with privatization of government owned banks.

---

<sup>170</sup> Id. P. 17-20

During the period 1998-2006<sup>171</sup>, state owned banks have absolute dominance in Ethiopian banking sector. Bank concentration, defined as the asset share of the three largest State owned Banks (Commercial Bank of Ethiopia, Development Bank of Ethiopia, Construction and Business Bank), was 87.9 percent in Ethiopia, which is the highest in East Africa. Indeed, the Ethiopian banking sector is dominated by one large state-owned bank, the Commercial Bank of Ethiopia (CBE). The asset share of the CBE was 66.3 percent, while the share of all three state-owned banks was nearly 80 percent. Though some private banks are opened after 2006, this does seem to have significant effect on the share of state banks to private banks given the dominant state control of the Ethiopian banking sector.

This large asset share of state-owned banks could have important implications. Several studies such as La Porta et al. have found that the performance of private banks is typically better than state-owned banks.<sup>172</sup> Similarly, Kozo Kiyota et al have shown that state-owned banks of Ethiopia underperform relative to private banks.<sup>173</sup> They categorized their findings into three. First, the costs of state-owned banks are significantly higher (1.6 percentage points) than those of private banks. Second, the return on assets (ROA) of state-owned banks is 1.7 percentage points lower than private banks. These findings imply that state-owned banks are less efficient than private banks. Third, the interest spread is 1.5 percentage points smaller for state-owned banks than private banks. Moreover, they concluded that the overall situation of the banking transactions<sup>174</sup> suggest that the banking sector reflects a non-competitive market structure, even among private banks, although the market share of private banks is still small.

As a part of financial sector liberalization, they recommended, the privatization of state-owned banks may be another important issue to consider in promoting competition in the banking sector. Also it is contended that the entry of foreign banks through financial liberalization may improve bank supervision through regulatory spillover. According to Goldberg<sup>175</sup> the participation of foreign banks that are healthier than domestic banks in emerging markets implicitly allows a country to import stronger prudential regulation and increase the soundness of the local banking sector. And as such similar step is recommended to Ethiopia as well. In fact, there are factors and facts pointing that the financial structure in Ethiopia would no longer remain as it is. For one thing Ethiopia is acceding to the World Trade Organization within that process some concession is expected. And in

---

<sup>171</sup> Id. P. 10.

<sup>172</sup> R. La Porta et al., "Government ownership of banks." *Journal of Finance*, Vol.57 No.1 (2002): p.265-301.

<sup>173</sup> Kozo Kiyota et al., *supra* note 49, p. 13.

<sup>174</sup> Id. P.

<sup>175</sup> L.S. Goldberg, "Financial sector, FDI and host countries: New and old lessons." *FRBNY Economic Policy Review*, Vol.13No.1 (2007), p. 10.

advance of that some foreign banks such as Citi Bank and Commerz Bank are already on the way to open offices which is a signpost that there is some lee way for liberalization though they cannot engage in the banking business as the laws stand now.

#### **4.2. Limitations on Investment in Banks: Limitation on Equity Participation in Banks**

The tradition of separation of banking and commerce has also been transplanted to the Ethiopian legal system. Legislations here and there signify the intent to maintain a degree of independence between banking and commerce. The legislations on separation of banking and commerce could be considered from two perspectives: first the laws limiting the involvement of non-banking entities and other investors in banks; and, in the second place laws regulating the involvement of banks in economic activities and their equity participation in non-banking entities.

Limiting ownership helps for controlling insider abuse and embezzlement by those having substantial influence on the enterprise. As shown in the preceding discussion, in other legal systems the ownership structure and accompanying or otherwise arising control in banking is a subject of extensive literature and legislative focus.<sup>176</sup> Such problems are at climax where commercial firms acquire substantial equity holdings in a bank and often the problem is addressed via the regulation of what they call bank holding companies.<sup>177</sup>

In Ethiopia, the rules on holding companies and their subsidiaries have not been well developed though the commercial code makes some references here and there about holding companies and subsidiaries.<sup>178</sup> In the banking sector, the concerns are generally addressed under the heading control of influential shareholders and other relevant provisions. Under Ethiopian law, persons holding allegedly substantial investment in banks are named influential shareholders. As per Art.2 (1) of proc.592/2008, influential shareholder is defined as “a person who holds directly or indirectly two percent or more of the total subscribed capital of a bank.”<sup>179</sup> The maximum limit is, with government holding exceptions, set at five percent of a bank’s shares.”<sup>180</sup>

---

<sup>176</sup> See For Instance Muscat, Supra Note 16; See Also P.A Schott, **Federal Regulation Of Banking: Bank Holding Companies** (Warren, Groham And Lamont, 1988)

<sup>177</sup> See 12 U.S.C. § 1841.

<sup>178</sup> See for instance, Art. 384 And 451 of the Commercial Code of the Empire of Ethiopia Proclamation No. 166/196, **Neg. Gaz.**, Year 19, No.3.

<sup>179</sup> Proc.No.592/2008, Art. 2(1).

<sup>180</sup> Proc. No 592/2008, Art 11(1).this provision states that “[n]o person, other than the Federal Government of Ethiopia, may hold more than five percent of a bank’s shares either on his own

An influential shareholder is thus one who holds directly or indirectly 2 up to 5 percent of the subscribed capital. Accordingly, the definitional elements are person, and amount of equity held directly or indirectly. The term person does not invite much investigation. It should be understood to imply the ordinary meaning it has in legal parlance i.e. including both physical and juridical person. The second element demands close examination. What does it mean by to hold/holding? What does it mean by direct or indirect holding? Is it restricted to ownership or does it extends to other forms of right such as usufruct, pledge, etc that would vest power of control in the company? As given in the definition, holding is attached to the subscribed capital. Thus, a straightforward interpretation suggests ownership. An influential shareholder is thus one who owns directly or indirectly 2 up to 5 percent of the subscribed capital.

If holding stands to ownership, it might be contended that the definition of influential shareholders in terms of ownership is somehow narrow and a bit illogical when seen in light of the very purpose of regulating persons who do have the potential to influence the operation of the bank. For the purpose of regulating person with significant influence most jurisdictions prefer to use the term ‘control’ or a combination of control, ownership and related terms. Consider, for instance, the following definitional extract “...principal shareholder of a member bank means any person... that, directly or indirectly, owns, controls, or has power to vote more than 10 percent of any class of voting securities of the member bank.”<sup>181</sup> Compare also the definition bank holding company in US law mentioned earlier.<sup>182</sup>

When compared to the definition in Ethiopian law, these definitions are fairly broad and ensure accommodation of concern surrounding regulation of influential persons. Ownership is the most common but only one of the forms of control. A shareholder may have the power to influence the operation of a bank even if it does not own the percentage of share that makes it an influential shareholder (2% threshold). The instrument of influence lies in the power to vote. A person can have the power to vote on shares at the banks shareholders meeting without being an owner of such shares. For instance, Art 329 of the commercials code,<sup>183</sup> to which a bank as a share company is subject to in the absence of special legislation,<sup>184</sup> provides that “[w]here a share is pledged or subject

---

or jointly with his spouse or with a person who is below the age of 18 related to him by consanguinity to the first degree”

<sup>181</sup> [File://c:/Regulation](#) O-Loans by member Banks to their executive officers, Directors, browsed on 12/19/2008

<sup>182</sup> See 12 U.S.C. § 1841,

<sup>183</sup> Commercial code, Art. 329

<sup>184</sup> Proc.592/2008, Art. 48.

to a usufruct, the right to vote at meetings shall, unless otherwise agreed, be exercised by the pledgee or usufructuary.”

Therefore, the term holding in Art. 2(11) should be broadly interpreted to embrace such other forms of control other than ownership encompassing instances of usufruct and pledge that would vest a shareholder acting through others the opportunity to exercise influence in so far as there are no separate legislations addressing such concerns. (As of this day) To date there is no such legislation. Hence, the writer argues that specifically the phrase”... who holds...indirectly...” the definition of influential shareholders could be availed in support of this construction. We noted that the phrase ‘...who holds directly or indirectly...’ is part of the definitional element. The term directly may not be difficult to understand. It envisages instances where the shareholder himself has ownership of shares. On the other hand, the word indirectly seems to be a legislative art to address concerns where a shareholder, without apparently holding 2 percent or more of them by himself, may have the opportunity to influence the operation of the bank acting through others such as usufruct and pledge.

Of course, it might be contended that the term ‘indirectly’ is used to address the subtle exercise of influence availing one’s close relationship with other persons. For instance, a physical person may indirectly exercise a controlling influence over the management policies of the bank if his spouse or close relatives do have shares in the same bank. Accordingly, as noted above, Ethiopian law has limited not only the maximum amount of shares that a person himself owns but also the sum total of shares to be owned by him and his spouse or with a person relative by consanguinity to the first degree and who is below the age of 18 to be limited to 5%.<sup>185</sup> Hence, one might be persuaded to conceive that the word “indirectly” is used to address such concerns. Nevertheless the writer does not believe that particularly concerning physical persons Art. 2 (11) has intended a person and his spouse each owning single share to be subject of rules governing influential shareholders. Nor can we legitimately say that one indirectly holds the others' share since there is no dismemberment of right of ownership.

By the same token, a juridical person may exercise similar indirect influences via its subsidiaries. Thus, using the above logic we would arrive at the conclusion that if the holdings of a parent company plus the holdings of one or more of its subsidiaries count at least 2 percent of the capital of the bank, the parent company and its subsidiaries would qualify to assume the status of influential

---

<sup>185</sup> Proc.592/2008 Art. 11(1)

shareholders. This does not appear to be the intention of the legislature .Art. 11(3) Proc.592/2008 verifies this by stating that “[t]he amount of shares that may be held in a bank by a company, which is partially or fully owned by persons who have shares in the bank, shall be determined by the National Bank” which makes clear that indirect holding in the definition of influential shareholders does not envisage aggregate holdings by affiliated firms.

The above explanation seems to be the plausible notion of influential shareholders under Ethiopian law. Influential shareholders are subject to special regulations than other shareholders,<sup>186</sup> which somehow gives the impression that Ethiopian law follows the analogous trend of regulation of bank holding companies in other legal systems such as US. The underlying rationales in both the US and Ethiopian legal regimes are similar- principally the need to limit the undue influence of shareholders in that very sensitive and critical banking business sector. But in substance the two differ substantially.

US law does not strictly set prohibition on the amount of shares to be held by non-bank firms rather it warns them that they shall be treated as bank holding companies if they fall within the “control”<sup>187</sup> definition and shall be subject to regulations concerning bank holding companies among which the principal one is limitation of activities that such companies could carry out. Bank holding companies are required to limit their activities to those which are "of a financial, fiduciary, or insurance nature" and "so closely related to *the business of banking* or managing or controlling banks as to be a proper incident thereto,” which are later expanded by amendment.<sup>188</sup> In effect only banks and other financial institutions whose activities fall within the above specification can freely invest in banks.

Whereas in Ethiopia, instead of letting investors in banking to invest whatever amount they like and attempting to regulate their behavior, Ethiopian law has preferred to limit their influence by imposing limitation on ownership of their share, setting the maximum at five percent with its notable

---

<sup>186</sup> See Proc. 592/2008, Art. 22(1) and Art. 2.6 of the National Bank Directive No. SBB /30/2002 on conditions and limitations to influential shareholders; And see also art. 4(1)(h) of proc. 592/2008 on the fitness and propriety requirement to be an influential shareholder to hold two or more percentage of shares.

<sup>187</sup> For comprehensive notion of control see 12 U.S.C. § 1841. supra note 42.

<sup>188</sup> .Shull, supra note 3, p.19. The Gramm–Leach–Bliley Act of 1999 amended the 1956 BHCA and permitted BHCs that qualify to establish themselves as “financial holding companies” (FHCs) to engage in a broader range of activities, including those that are financial in nature, incidental to such activities or, as determined by federal reserve board (FRB), “complementary” to financial activities. A bank holding company may become an FHC by notifying FRB provided that all of its subsidiary banks must be “well capitalized” and “well managed”, as defined by the Federal bank regulatory agencies. Any bank holding company electing to become an FHC must also have satisfactory or better CRA ratings on its most recent examinations for all insured depository institution subsidiaries.

provision that reads as “[n]o person, other than the Federal Government of Ethiopia, may hold more than five percent of a bank’s 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 consanguinity to the first degree”.<sup>189</sup> The law strives to curb not only the apparent control an individual would exercise but also the subtle exercise of influence by availing one’s close relationship with others. And perhaps its logical extension might lead us to conclude that the aggregate share of a company and its subsidiaries should not exceed 5 percent of shares in a bank.

The principal forms of regulation of influential shareholders include restrictions pertaining to loan to influential shareholders, fitness and propriety requirements, the restriction that an influential shareholder of a bank may not invest in another bank.

Loan from a bank constitutes the most typical source of abuse for influential shareholders and demands clear legislative intervention. Art 22(1) of proc.592/2008 grants general authority for the National Bank of Ethiopia to issue directives to determine the conditions and limitations of loan,<sup>190</sup> among others. Accordingly, the National Bank issued directive No. SBB/30/2002 regulating conditions and limitations of loan to related parties,<sup>191</sup> which includes influential shareholders.<sup>192</sup>

Thus Art 4 of the directive provides that:<sup>193</sup>

- 4.1. Banks shall not extend loans to related parties on preferential terms with respect to conditions, interest rate, and repayment periods other than the terms and conditions normally applied to other persons.
- 4.2. The aggregate sum of loans extended or permitted to be outstanding directly or indirectly to one related party at any one time shall not exceed 15% (fifteen percent) of the total amount of capital of the bank.
- 4.3. The aggregate sum of loans extended or permitted to be outstanding directly or indirectly to all related parties at any time shall not exceed 35% (thirty five percent) of the total capital of the bank.

---

<sup>189</sup> Proc. No 592/2008, Art 11(1).

<sup>190</sup> Proc. 592/2008, Art. 22(1)

<sup>191</sup> Art. 2.6 of national bank directive No. SBB/30/2002 defines related parties as "a shareholder, a director or principal officer of that bank and/or the spouse or relation in the first degree of consanguinity or affinity of such shareholders, director or principal officer, business enterprises in which such persons have direct interest are also assimilated to related parties.

<sup>192</sup> Directive No. SBB/30/2002, Art. 2.6 cumulatively with Art. 3

<sup>193</sup> Directive No. SBB/30/2002, Art. 4

The provision requires loans to influential shareholders and other related parties to be at arms-length basis. It has reduced maximum amount of loan to individual influential shareholder to 15 percent in contrast to the single borrower limit which is fixed at 25% of total capital of a bank.<sup>194</sup> The aggregate loan to all related parties is also fixed at 35%. This evidences the special suspicion and concern that a bank may be used as captive source of finance to influential shareholder and other insiders.

The other controlling mechanism employed in our law is setting fitness and propriety requirement (qualification standards) for those who are going to assume the status of influential shareholders. Not only that a person may not own more than 5% (five percent) of shares of any bank but also that he may not own even two percent unless he meets some qualification standards.

Art 4(1) (h) of proclamation No. 592/2008 asserts that "influential shareholders of the bank shall meet the fitness and propriety criteria prescribed by the national bank..."<sup>195</sup> The criteria are not yet issued. What could be the content of such criteria? The Basel committee recommended that the supervising agencies should assess and review "... the controlling shareholders' past banking and non-banking business ventures and their integrity and standing in the business community, as well as the financial strength and of all major shareholders and their ability to provide further financial support should it be needed. As part of the process of checking integrity and standing, the supervisor should determine the source of the initial capital to be invested."<sup>196</sup>

The personal history of a person, for instance whether convicted or pending cases exist particularly related to his business engagement as well as his material endowment matters for eligibility. Art 11(5) of Proc. 592/2008 clearly asserts that a person may not acquire bank shares using bank loans and advances even without achieving status of influential shareholder. Thus ethical standards pertain to the personal integrity, financial endowment and past and current business carried out might affect one's eligibility for status of being influential shareholders.

With a view to ensure that such fitness and property requirements are fulfilled, Art 10(3) subjects any transfer (by contractual arrangements, donation, succession) shall be subject to prior approval of national bank. Again where a person fails to adhere to the criteria, voting right be suspended as short run sanction pursuant to Art.13(2).

---

<sup>194</sup> National Bank of Ethiopia, Directive No. SBB/29/2002, Art. 4 and 6.

<sup>195</sup> Proc. 592/02008, Art. 4(1)(h)

<sup>196</sup> Basel committee on banking supervision: core principles for effective banking supervision (Basel, September 1997)

Furthermore, an influential shareholder of any bank may not acquire shares in other banks.<sup>197</sup> What concerns motivated the legislature to come up with such provision? The rationale may be the concern that an influential shareholder may abuse his power to create undue connivance among two or more banks. The collusion may manifest its implication by way of anti-competitive arrangements transfer pricing for tax evasion purpose and so on. Moreover, given the contagious nature of bank failures, allowing a person to be influential shareholder in more than one bank may aggravate the problem of systemic risk. However, once again coupled with the severe limitation of maximum holding at five percent, the rationality of this prohibition may be questioned. It could have been better if rules addressing the concerns of collusion are provided and offer investors the option to participate in more than one bank.

In sum, in Ethiopia the maximum holding in banking free of interference (without assuming the status of influential share holder) is less than 2 % of bank's shares while in US treatment as bank holding company normally commences when one controls 25 % voting shares and exceptionally at 5%.<sup>198</sup> Moreover, Ethiopian law does not differentiate between holding voting shares and non-voting shares while US law explicitly use the term 'voting shares' in determination of control. Overall, the regulation in Ethiopia tends to be strict.

In relation to limitation on equity ownership in banks, given the opposing justifications against and in favor of mixing banking and commerce, how much is the optimum that maximizes social welfare? On the one hand, we need to control the risks of abuse. On the other hand, stringent separation rules on separation of banking and commerce might hinder banks from achieving efficiency and would be at competitive disadvantage. Determining the optimum demands complex economic analysis of the tradeoffs between gains from relaxing the rules and loses from risks of abuse by influential shareholders.

Others may focus on the need to arrest abuse by shareholders. An inspector in the supervision department of National Bank of Ethiopia stressed that the reduction of the earlier maximum 20% to 5% was necessary.<sup>199</sup> There was, he added, a clear potential for abuse reminding that there had been shareholders, particularly insurance companies holding up to 20% of shares of a bank. He amplified

---

<sup>197</sup> Proc.No.592/2008, Art 11(4)

<sup>198</sup> .Commercial firms are allowed to own, with "control" as its focal point for prohibition, up to 25 per cent of the total equity of any company without aggregate limit and without being treated and regulated as bank holding company though under some circumstances the treatment of a company as a bank holding company begins when it controls 5% or more of the shares of a company. See supra note 42.

<sup>199</sup> Interview with Ato Semer Wolde, inspector in the supervision department of National Bank of Ethiopia, held on April15, 2008

his concern stating that given such scenario the fate of a certain bank and consequently the financial system in general would fall into the hands of three or more shareholders acting in concert.

The issue invites further investigation and consideration from constitutional perspective. Regulatory power of government is circumscribed with the doctrine of Vested right's<sup>200</sup>-bundle of claims that can be subsumed under the general right to own and acquire property. The doctrine of vested rights not only precluded infringements on the present accumulation of capital (such as expropriation of land without just compensation) but also that it is extended to restraining government from damaging interference with future property interests.<sup>201</sup> Surrounding such private considerations are vital public interests that vests the state inherent power to legislate for the public health, safety and welfare.<sup>202</sup> The conflict between private interests and public interest becomes acute when the form of government is a democracy.<sup>203</sup>

Art.40(1) of the FDRE Constitution affirms that “every Ethiopian citizen has the right to the ownership of private property. Unless prescribed otherwise by laws on account of public interest, this right shall include the right to acquire, to use and, in a manner compatible with the rights of other citizens, to dispose of such property by sale or bequest or to transfer it otherwise.”<sup>204</sup>

With a view to control influential shareholders, Ethiopian banking law has come up with a number of restrictions on investment of capital in the banking sector. To recall our earlier discussion a person may not own more than 5% of a bank's capital. Nor can an influential share holder of one bank invest in another bank. Even to acquire 2% of a banks share a person is subject to qualification standards.

It might be contended that these actions of the government constitutes damaging interference with future property interests which is protected by the doctrine of vested rights. Of course government is not totally precluded from intervening into private property rights but it should not be arbitrary and unreasonable.<sup>205</sup> The validity or other wise of governments action depends much on whether the interference is on account of public interest or not. Ethiopian Constitution as well endorses similar justification for interference by using the clause “unless prescribed otherwise by laws on account of public interest....” The problem, however, is that it is impossible to define and measure with any degree of certainty what constitutes public interest.<sup>206</sup>

---

<sup>200</sup> Crair R. Ducat, *Constitutional Interpretation* (West Publishing Company, 6<sup>th</sup> ed., 1996) p.491

<sup>201</sup> Ibid.

<sup>202</sup> Ibid.

<sup>203</sup> Ibid.

<sup>204</sup> The Constitution of the Federal Democratic Republic of Ethiopia Proclamation No. 1/1995, *Fed. Neg. Gaz.*, Year 1, No. 1., Art 40(1)

<sup>205</sup> Ducat, *Supra* note 40.

<sup>206</sup> Ibid., p. 516

Yet in the above measures taken by the government, yes of course there is public interest to control influential shareholders and maintain the confidence of the depositors and other creditors. The government is duty bound to maintain systemic stability for healthy economy. The problem is how to balance compromise of private interest and protection of public interest. This tension poses the difficulty of assessing constitutionally whether the exercise of the police power (power to regulate economic activities) in a given instance remains within the legitimate interests to regulate or whether the state has crossed the line.<sup>207</sup>

Advocates of greater economic freedom turned their attention from the traditionally conceived procedural due process (deprivation will occur by means that are regularly applied, not arbitrarily) to substantive due process- they sought to keep government from enacting policies that regulate the economy.<sup>208</sup> This might suggest the extreme case. But it provides the basis to question the content of the law itself. Thus the content of the above rules restricting investment in banking sector may be constitutionally challenged.

### **4.3. The scope of banking business in Ethiopia**

The scope of banking business differs from nation to nation as well as from time to time. In general, banking powers has been delineated either by detail description of possible activities or else at least by general exclusionary clauses that declare banks should not engage in certain activities particularly dealing in merchandize.<sup>209</sup>

Demarcating the precise boundary of banking activities and non-banking activities is not an easy decision. At any rate, some general definition of banking activities offers some guidance. The Ethiopian law also did that. The banking business proc. 592/2008 in its relevant provision holds that, having 'bank' defined as a company licensed to undertake banking business, banking business is any business that consists of activities listed here in under:<sup>210</sup>

- a) receiving funds from the public through means that the National Bank (of Ethiopia)(hereinafter NBE) has declared to be an authorized manner of receiving funds;

---

<sup>207</sup> Ibid., p.492.

<sup>208</sup> Ibid, p.514.

<sup>209</sup> Id.p.13.

<sup>210</sup> Proc. 592/2008, Art. (1)&(2).

- b) Using the funds referred to under paragraph (a) of this sub-article, in whole or in part, for the account and at the risk of the person undertaking banking business, for loans or investment in a manner acceptable by the National bank;
- c) the buying and selling of gold and silver bullion and foreign exchange;
- d) the transfer of funds to other local and foreign persons on behalf of the banks themselves or their customers;
- e) the discounting and negotiation of promissory notes, drafts, bills of exchange and other evidence of debt;
- f) any other activity recognized as customary banking business, which a bank engaged in the activities described from (a) to (e) of this sub-article may be authorized to undertake by the National Bank.

This definition of scope of banking activities in Ethiopia is narrow as it mentioned limited and common activities that banks carryout. Interestingly, it seems by way of admitting the limitation in this listing, it paves the way for necessary accommodation by granting power to the NBE to authorize other activities. At the same time it warns the NBE to adhere to customary activities of banks and once again vesting NBE substantial discretion to avail the less clear phrase ‘customary banking businesses’.

Again another lee way is opened in Art. 22 of the banking business proclamation whereby the NBE is empowered to determine the conditions and limitations on investments of banks, and a loan, advance or other credit facility, financial guarantee or any other commitment or contracts given by a bank, directly or indirectly to a person. Following that a directive<sup>211</sup> has been issued and the power of banks in investment has been determined.

The directive supplements the proclamation by setting forth that a bank may not directly engage in insurance business or other non-banking businesses such as agriculture, industry, and commerce.<sup>212</sup> By way of exception, some level of direct engagement in non-banking business may be carried out but only in two specified sectors: <sup>213</sup> in the sphere of real estate acquisition and development; and securities. The NBE has determined that a bank enjoys the liberty to invest up to 20% of its net worth in the sphere of real estate acquisition and development, excluding investment for own business premises. And in the securities sector, a bank may invest up to a maximum of 10% of its net worth, excluding investment by way of equity participation in securities firms.

---

<sup>211</sup> National Bank of Ethiopia Licensing and Supervision of Banking Business: Limitation on Investment of Banks, Directive No. SBB/12 /1996. (Hereinafter Directive No.sbb/12/96).

<sup>212</sup> Directive No. SBB/12 /1996, Arts 1 And 2.

<sup>213</sup> Directive No. SBB/12/1996 Arts. 5&6.

Apart from these two exceptions (in real estate and securities), direct engagement in non-banking business would be violation of the regulatory regime. In line with the accepted principle that banks and commerce should be kept apart, banks in Ethiopia are not allowed to engage in trading or manufacturing or other typical areas of commerce featuring separation of banking and commerce in Ethiopian context. However, some venting room has also been created for banks to engage in indirectly in the sphere of commerce-by way of equity participation of banks in non-banking entities.

#### **4.4. Limitation on Equity Participation of Banks**

Involvement of banks in commerce by way of equity participation has been recognized and applied more flexibly than direct engagement though with varying scope in different countries. Unlike the sector specific permissions as stated above, banks could purchase shares of any company but only up to a certain limit.

But still sector differentiation is maintained by the level of investment permitted. In the area of insurance business, a bank may acquire up to 20% of the shares of that insurance company but the total investment in that insurance company could not exceed 10% of the investing bank's equity capital.<sup>214</sup> In securities firms, a bank may hold only shares amounting up to 10% of its equity capital.<sup>215</sup>

In other companies engaged in any other business, the equity participation of a bank may go up to 20% of the company's shares without exceeding 10% of the bank's net worth.<sup>216</sup> In any manner, the aggregate sum of all investments at any one time (excluding investment in government sureties) may not exceed 50% of the bank's net worth.<sup>217</sup> However, this rigidity may be relaxed with prior approval of NBE.<sup>218</sup> Investment in government security is excluded in calculating this aggregate possibly due to the conventional creditworthiness of the government such investment carry little or no risk at all.

Ethiopian law on the level of restrictions on investment of banks takes a moderate position. For instance, the regulatory regime in Indonesia tends to be stricter: equity participation by banks works only in financial companies;<sup>219</sup> equity participation is saddled with numerous

---

<sup>214</sup> Directive No. SBB/12/1996 , Art. 1.

<sup>215</sup> Directive No. SBB/12/1996 , Art.1.

<sup>216</sup> Directive No. SBB/12/1996, Art 3.

<sup>217</sup> Directive No. SBB/12/1996 , Art 6

<sup>218</sup> Directive No. SBB/12/1996.

<sup>219</sup> The Governor Of Bank Of Indonesia, Bank Of Indonesia Regulation No 5/10/Pbi/2003, Concerning Prudential Principles In Equity Participation, The Elucidation Part On The Said Equation, Available At [Http://Www.Bigo.Id/Biweb/Utama/Peraturan/Pbi\\_51003\\_eng.Pdf](http://www.bigo.id/biweb/utama/Peraturan/Pbi_51003_eng.Pdf) (Hereinaster Bank of Indonesia Regulation)

preconditions;<sup>220</sup> the total equity participation portfolio shall not exceed 25% of Bank capital.<sup>221</sup> On the other hand, the law in the republic of Moldova permits relaxed equity participation of banks; while investment in real estate might account up to 50% of bank's capital, the aggregate equity participation may go up to 100% of bank's capital.<sup>222</sup> Also, in Albania,<sup>223</sup> a bank may acquire 10% of capital of a commercial company without any precondition and up to 50% on approval, provided that each investment in companies does not exceed 15% of capital of investing bank without approval and up to 25 of its capital up on approval. The aggregate is bound at 60% of capital of the bank. Equity participation by a bank in another bank or any non-bank financial institution is absolutely free from any restriction.

---

<sup>220</sup> Bank Of Indonesia Regulation Art.3

<sup>221</sup> Bank Of Indonesia Regulation Art.5(20).

<sup>222</sup> National Bank Of Modoua, Minutes No. 384, December 23, 1999, Regulation On Investment Of Bank In Real Estate, Arts 4 And 5.

<sup>223</sup> See generally the Supervisory Council of the Bank of Albania, Decision No.42/2001, Regulation on the Banks Investments in the Equity of Commercial Companies.

## **CHAPTER FIVE**

### **CONCLUSION AND RECOMMENDATION**

This research has provided a fair exposition of theoretical discourses, the experience of some countries and the Ethiopian legal regime as they pertain to issues of investment limitations in and by banks. The discussion on FDI in the banking sector displays that scholars differ in their views as to the impact of FDI in a country's banking system and its overall economy. Thus, it is no wonder that theories on FDI have generally been contradictory even in other sectors of the economy that country let alone in a sensitive sector such as banking.

From the point of view of the experience of countries, the investment policy of almost all of them showed that the banking sector is among the most sensitive sectors next to electricity, transport and telecommunication sectors in which nations put a cap on the level of equity to be held by foreigners or even prohibit any foreign ownership. Moreover, not only policies on FDI are widely at variance but also changed from time to time in a given nation. However, the trend generally showed that at early stage of development, even developed countries used to be restrictive in this sector.

The current trend is that developing nations in different corners of the globe are showing progressive and faster rate of liberalization, partly due to the change at the international regime specially the WTO that calls for time and again for liberalization of any sector. So far, the experience of developing countries supports that liberalization of banking so as to allow FDI in the sector may not present the risks advanced at theoretical level by opponents of FDI in the sector. This fact helped the continuity of progressive openness in banking sector that began in the past decade.

Regardless of these trends and political pressures, the Ethiopian Government has insisted on absolute exclusion of foreigners. Let alone FDI by foreign banks in their own stand, no foreigner or an entity in which a foreigner has equity interest, regardless of whether that entity is incorporated in Ethiopian law can participate in the banking business. The recurrent formulations and amendments of investment policy and laws left the banking sector and some others unaffected. It is very doubtful how long the government will cope with and endure political pressures and developments at international legal regime while the country is in the eve of accession to the WTO.

Apart from this external factor, there appears to be a reason to make some adjustments. The critical issue in FDI constitutes adverse implications of competition from foreign banks that can easily wipe out infant domestic banks. In order to avail perceived benefits of transfer of skill and infusion of capital from FDI, it seems unreasonable to exclude any investor with foreign element from having any equity interest in banking. Competition concerns crop up only where foreign banks engage independently delivering banking services via branch or subsidiary. Should foreign banks be allowed to take this option in the future, their competition power may be controlled by adopting different treatment between foreign and domestic banks. Hence, the beginning of transition period seems to be somehow a bit late.

The exposition on equity investment limitations in the banking business showed that there is a strong justification for controlling investors having controlling interest (ownership shareholding) in business. Banking is a business peculiarly susceptible to insider abuse and embezzlement. Theoretical discussions admit and testify that the need to control investors with controlling interest in this vulnerable sector is valid. However, the experiences of nations are widely at variance. Germany and some other countries do not put any formal limit on the equity control of investors in banks; Canada sets the maximum limit at 10% of a bank's capital; in the US, an investor having more than 25% of a bank's voting shares is subject to the strict rules on bank holding companies and on a case by case determination the rules on bank holding companies apply to an investor owning at least 5% of a bank's capital if accompanied by other mechanisms that vests the investor control over a bank.

The Ethiopian law with regard to banking business, by setting the initial at 2% and limiting the maximum 5%, well represents to be as one of the strictest legal regimes. Legal regimes like the Ethiopian law hinder the banks' capital mobilization opportunity and affect their efficiency. At any rate, the current limitation of a maximum on the holdings of an investor of a bank's capital at such a lower level of 5% might have clinching effect on investment in the banking sector particularly in view of the fact that investment in banking is totally reserved to nationals of Ethiopia alone.

Moreover, though the writer may not claim to be in a better position to propose different arithmetic figure, it seems that fixing the maximum share at five percent and prohibiting an influential shareholder not to invest in another bank might raise issues of undue limitation against constitutional right of individuals to acquire property. As propounded by advocates of greater economic freedom, governments' regulatory power should be subject not only to the traditionally conceived procedural due process (deprivation will occur by means that are regularly applied, not arbitrarily) but also to substantive due process- a theory that seeks to restrain government from

enacting policies that regulate the economy in so far as it affects the interest of individuals.<sup>224</sup> This might suggest the extreme case. But it provides the basis to question the content of the law itself. Thus, the content of the above rules restricting investment in banking sector may, constitutionally be challenged.

The restrictions could also be challenged from the public interest aspect itself. Coupled with the fact that investment in banking is reserved for Ethiopians alone, it would stifle investment in banking sector beyond the concern for individuals' right to acquire property. The threat of influential shareholders is taken to a hypothetical degree and idealized that the regulation in this regard may backfire against the public's interest for expanded banking sector which is the basis of each and every economic activity in the country. It might lead to what Goodhart & Others stated as the dangers of overregulation that the "end result is worse than the unregulated starting point."<sup>225</sup>

Furthermore, in addressing control, Ethiopian law simply sticks to ownership of a bank's equity while other persons like a pledgee and usufructory left uncontrolled. On the other hand, Ethiopian law does not differentiate voting and non-voting shares. In view of all these facts, it seems, therefore, appropriate to open a window for capital mobilization at least by recognizing ownership of nonvoting shares. Even the limit on voting shares is the stringent one when compared to the survey of countries assessed in this regard and thus requires reconsideration.

In relation to the scope of banking powers, the scope of banking business has become broad even in countries like the US that have been expanding and shrinking the scope in their historical roots. Countries like Germany are known for their universal banking system in history. Wide banking powers improves efficiency of banks via economies of scope while banks in countries with narrow banking powers may be defeated at global competition. Ethiopian law lists limited banking powers but with important clause for expansion. All said and discussed in this regard, the law is not limitative but it actually tries to protect them lest most banking services are not yet developed in Ethiopia and thus deprives them of economies of scope.

With respect to equity investment of banks in other firms, both theory and practice (experience) put a cap on the interdependence between a bank and other firms. In Canada, a bank can own up to 10% of a commercial firm's equity capital with aggregate holdings not to exceed 70% of the bank's capital. Even European countries that set no limit on single investor in a bank admit a limit the percentage of a bank's capital that can be invested in non-financial firms as stipulated in EC second Banking Directive.

---

<sup>224</sup> Ibid, p.514.

<sup>225</sup> Goodhart, Supra note 1, p.2

In Indonesia, a bank can participate only in equity of financial firms and aggregate investment should not exceed 25% of banks capital. In Albania a banks can acquire 10% of a firm's capital and with approval up to 50% and aggregate equity investment is bound at 60% of a capital of the investing bank.

In this regard, there arises a concern in limiting risks inherent in investment on the one hand. And investment augments revenue of banks on the other hand. In the face of so much divergence in other countries, therefore, Ethiopian law that allows 20% equity holding without exceeding 10% of banks capital in, and equity investment in different firms up to the aggregate 50% of banks capital can be said a moderate one. No tangible reason can be forwarded for a change in either direction. Flexible mixing reduces information costs of leading banks but affects its function as an impartial source of credits.

All in all, strict regulation including in the area of investment in and by banks puts banks at disadvantage while loose regulations offer competitive advantage. This has been confirmed and exemplified by the case of the US whereby in the 1980s US banks tied with rules on separation of banking and commerce were over-whelmed by German banks that enjoyed universal banking in their home country. On the other hand, risks associated with loose regulation and implications in this very essential and sensitive sector are commending. In sum, the country's policy should be reviewed so as to minimize restrictions and address adverse concerns by scaling up its regulatory capacity.

## BIBLIOGRAPHY

### Books

- Chang, Ha-Joon, *Foreign Investment Regulation in Historical Perspective: Lessons for the Proposed WTO Agreement on Investment* (University of Cambridge, Faculty of Economics and Politics, March 2003).
- Demirgüç-Kunt, A., and E. Detragiache, “*Financial liberalization and financial fragility.*” In G. Caprio, P.Honohan, and J.E. Stiglitz, (eds.) *Financial Liberalization: How Far, How Fast?* (Cambridge, UK: Cambridge University Press, 2001).
- Ducat, Crair R., *Constitutional Interpretation* (West Publishing Company, 6<sup>th</sup> ed., 1996).
- Friedmann, Wolfgang, *Legal Aspects of Foreign Investment* (1959).
- Fry, Earl H., *the Politics of International Investment* (McGraw-Hill Book Company, 1983).
- Goodhart, Charles et al, *Financial Regulation Why, How And Were Now?* Routledped (1998).
- Haber, S. and A. Musacchio, “*Contract Rights and Risk Aversion: Foreign Banks and the Mexican Economy, 1997-2000.*” Stanford University. Mimeo. (2005).
- Kamuwanga, Mwangala, *Negotiating Investment Contracts: Investment Law in the Context of Development*(1989)
- Kennedy, C.R., *Relation between Multinational Corporations and Host Countries: A Look to the Future* (1992).
- Malloy, Michael P., *the Regulation of Banking: Cases and Materials On Depository Institutions And Other Regulators* (Anderson Publishing Co., 1992).
- Muscat, Andrew, *The Liability of Holding Company for the Debts Of Its Insolvent Subsidiaries* (Dartmouth, 1996).

- Nwogugu, E.I., *The Legal Problem of Foreign Investment in Developing Countries* (1956).
- Ritter, Lawrence S. et al, *Principles of Money, Banking, and Financial Market* (Addison-Wesley, 10<sup>th</sup> Ed., 2000).
- Roberta Romano, *Foundation of Corporate Law* (Oxford University Press, 1993).
- Rothbeeb, J.M.,” *Investment Dependence And Political Conflicts in Developing Countries: A Comparative Regional Analysis*” in S. Chan (ed.), *FDI in a Changing Global Political Economy* (St.Martin’s Press, 1995).
- Schott, P.A, *Federal Regulation of Banking: Bank Holding Companies* (Warren, Groham And Lamont, 1988).
- Seid, Sheriff H., *Global Regulation of Foreign Direct Investment* (Ashgate Publishing Limited, Gower House, 2002).
- Shull, Bernard, *Financial Modernization Legislation in The United States: Background and Implications* (October 2000).
- Shull, Bernard, *The Separation of Banking and Commerce in the United States: an Examination of Principal Issues* (Hunter College of the City University of New York,).
- Sornarajah, M., *The International Law on Foreign Investment* (Grotius Publications, 1994).
- *Survey of Best Practice in Investment Practice* (United Nations Conference on Trade Development Division on Investment, Technology and Enterprise, UN, New York, Geneva, 1997).

## **Journals**

- Ahooja, Krishna, "Investment Legislation in Africa", *Journal of World Trade Law* Vol.2, No.5 (1968).
- Berger, A., L. Klapper, and G. Udell, "The Ability of Banks to Lend to Informationally Opaque Small Businesses." *Journal of Banking and Finance* vol.25, (2001)
- Claessens, S., A. Demirguc-Kunt, and H. Huizinga, "How Does Foreign Entry Affect Domestic Banking Markets?" *Journal of Banking and Finance*, Vol. 25 (2001).
- De Hass, R., and I. Lelyveld, "Foreign Banks and Credit Stability in Central and Eastern Europe. A Panel Data Analysis." *Journal of Banking and Finance* vol.30 (2006).
- Detragiache, E. and P. Gupta, "Foreign Banks in Emerging Market Crises: Evidence from Malaysia." *Journal of Financial Stability* vol.2 No.3 (2006) .
- Erdem, Mehmet, How to Get the Most Out of Foreign Direct Investment in Commercial Banking, journal of globalization , competitiveness& governability Vol. 3 No.1 (Georgetown University – UNIVERSIA, 2009).
- Fischman, Eric B., "Expanding Bank Ownership: A Necessity for Efficiency and Global Competitiveness of the U.S Banking Industry" in *ANNUAL REVIEW OF BANKING LAW* (1992).
- Goldberg, L., B.G. Dages, and D.Kinney, "Foreign and Domestic Bank Participation in Emerging Markets: Lessons from Mexico and Argentina." *Economic Policy Review* vol.6 No.3. Federal Reserve Bank of New York. (2000).
- Goldberg, L.S., "Financial sector, FDI and host countries: New and old lessons." *FRBNY Economic Policy Review*, Vol.13No.1 (2007).
- Krainer, John, The Separation of Banking and Commerce, *FRBSF Economic Review* 2000.
- La Porta, R. et al., "Government ownership of banks." *Journal of Finance*, Vol.57 No.1(2002).

- Mian, A., "Distance Constraints: The Limits of Foreign Lending in Poor Economies." *Journal of Finance* vol. 61, (2006).
- Peek, J. and E. Rosengren, "Implications of the Globalization of the Banking Sector: The Latin American Experience." *New England Economic Review*, September/October. Federal Reserve Bank of Boston.( 2000).
- Salacuse, Jeswald.W., "Direct foreign investment and the law in Developing Countries", *Foreign Investment Journal* (Vol.15,No. 2,2000).
- Yeyati, E. Levy and A. Micco, "Concentration and Foreign Penetration in Latin American Banking Sectors: Impact on Competition and Risk." *Journal of Banking and Finance* ( 2007).

### **Other Materials**

- Basel Committee on Banking Supervision: Core Principles for Effective Banking Supervision (Basel, September 1997).
- Cull, Robert et al, (Finance and Private Sector Development Research Group, The World Bank), Foreign Bank Participation and Crises in Developing Countries: World Bank Policy Research Working Paper 4128, February 2007.
- Detragiache, E., P. Gupta, and T. Tressel, "Foreign Banks in Poor Countries: Theory and Evidence." IMF Working Paper No. 06/18. Washington, DC. (2005).
- Foreign Bank Regulation in Canada: Barriers to Competition," Submission of Norwest Financial, Inc. and Trans Canada Credit Corporation, Task Force on the Future of the Canadian Financial Services Sector, October 31, 1997.
- Global Survey, Institute of International Bankers. September 2000.
- Goodman et al., Product Line Regulations for Financial Institutions, "proceedings of a conference on bank structure and competition, Federal Reserve Bank of Chicago, April 23-25,1984.

- Interview with Ato Semer Wolde, inspector in the supervision department of National Bank of Ethiopia, held on April 15, 2008.
- Jabbarov, Mikayil and Scott Horton, Foreign Participation in the Azerbaijani Banking Sector, At <http://ourworld.compuserve.com/HOMEPAGES/USAZERB/424htm>. Accessed On 5/8/2009.
- Jackson, William D., Industrial Loan Companies/Banks and the Separation of Banking and Commerce: Legislative and Regulatory Perspectives (CRS Report for Congress, Updated November 28, 2005).
- Kiyota, Kozo, Barbara Peitsch, and Robert M. Stern, The Benefits of Financial Sector Liberalization for Developing Countries: A Case Study of Ethiopia (International Policy Center /IPC/ Working Paper Series Number 69, Gerald R. Ford School of Public Policy University of Michigan, June 27, 2008).
- Kroszner, Randall S., the separation of banking and commerce continues in the Gramm-Leach Bliley, available at [www.mineapolisted.org/purlictions-papers/pub-display.cfm?id-3518](http://www.mineapolisted.org/purlictions-papers/pub-display.cfm?id-3518), accessed on 5/8/2009.
- Lehner, Maria & Schnitzer, Monika, Entry of Foreign Banks and their Impact on Host Countries (University of Munich, Department of Economics, Discussion paper September 2006).
- Lehner, Maria & Monika Schnitzer, Entry of Foreign Banks and their Impact on Host Countries (University of Munich, Department of Economics, Discussion paper September 2006).
- Llewellyn, David T., Universal Banking and the Public Interest: A British Perspective,” Conference on Universal Banking at New York University, Feb. 23-24, (1995).
- Olson, G.N., “Government Intervention: The Inadequacy of Bank Insolvency Resolution-Lesson From The American Experiences” In Rosa M. Lastra (Ed.), Bank Failures And Bank Insolvency Law In Economies In Transition (Kluwer Law International, 1999).

- Papi, Luca and Debora Revoltella, Foreign direct investment in the banking sector: A Transitional Economy Perspective,(University of Oxford, Queen Elizabeth House, Development Studies Working Papers, Noember1999).
- Raskovich, Alexander, Should Banking Be Kept Separate from Commerce (Economic Analysis Group, Discussion Paper, August 2008).
- Ritter, Lawrence S. *et al*, Principles of Money, Banking, and Financial Market (Addison-Wesley, 10<sup>th</sup> Ed., 2000).
- Schulz, H., “Foreign Banks in Mexico: New Conquistadors or Agents of Change?” The Wharton School, Financial Institutions Center, Working Paper No. 06-11. University of Pennsylvania,( 2006).
- Survey of Best Practice in Investment Practice (United Nations Conference on Trade Development Division on Investment, Technology and Enterprise, UN, New York, Geneva, 1997).

## **Laws**

- Banking Business Proclamation No 592/2008, Fed . Neg. Gaz, Year 14, No.57 (Hereinafter Proc.592/2008).
- Council of Ministers Regulation No.84/2003.
- Investment Proclamation No.280/2002, Fed., Neg. Gaz., Year 8,No. 27 (hereinafter Proc.No.280/2002).
- Investment Proclamation No.37/1996, Fed.Neg.Gaz.,Year 2,No.25.
- National Bank of Ethiopia Licensing and Supervision of Banking Business: Limitation on Investment of Banks, Directive No. SBB/12 /1996.
- National Bank of Ethiopia, Directive No. SBB/29/2002.
- National Bank Of Moldova, Minutes No. 384, December 23, 1999, Regulation On Investment Of Bank In Real Estate.

- The Commercial Code of the Empire of Ethiopia Proclamation No. 166/196, Neg. Gaz., Year 19, No.3.
- The Constitution of the Federal Democratic Republic of Ethiopia Proclamation No. 1/1995, Fed. Neg. Gaz., Year 1, No. 1.
- The National Bank of Ethiopia, Directive No. SBB /30/2002.
- The Supervisory Council of the Bank of Albania, Decision No.42/2001, Regulation on the Banks Investments in the Equity of Commercial Companies.