

*Addis Ababa
University*

(Since 1950)



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

**THE LAW AND THE PRACTICE OF REGULATING BANK
GOVERNANCE IN ETHIOPIA**

**BY
GENENE AZENE**

**A THESIS SUBMITTED IN PARTIAL FULFILLMENT FOR
THE REQUIREMENTS OF MASTER OF DEGREE
OF LAWS /LL.M/**

**ADDIS ABABA
JANUARY 2010**

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

**THE LAW AND PRACTICE OF REGULATING BANK
GOVERNANCE IN ETHIOPIA**

**BY
GENENE AZENE**

Advisor	Signature	Date
Professor Tilahun Teshome	_____	_____
Examiners' Name		
1. _____	_____	_____
2. _____	_____	_____

ACKNOWLEDGMENTS

I am grateful for my advisor, Professor Tilahun Teshome, for his advice and constructive comments.

Table of Contents

	Page
Acknowledgement -----	i
Table of Contents -----	ii
STRUCTURE OF THE PAPER-----	1
<i>CHAPTER ONE</i>	
PROPOSAL OF THE RESEARCH-----	2
1.1. Background of the Research -----	2
1.2. Statement of the Problem -----	6
1.3. Objectives of the Research-----	9
1.4. Significance of the Research -----	9
1.5. Scope of the Research -----	10
1.6. Methodology of the Research -----	10
<i>CHAPTER TWO</i>	
CONCEPTUAL ANALYSIS AND HISTORICAL NARRATION OF BANKS’ GOVERNANCE & REGULATION-----	12
2.1. The Concept of Bank Governance and Regulation -----	12
2.2. Why Regulate Banks -----	15
2.2.1. Depositors’ Protection -----	16
2.2.2. Monetary & Financial Stability -----	17
2.2.3. Service Quality -----	17
2.2.4. Consumer Protection-----	18
2.3. Banks’ Regulatory Agencies in Ethiopia -----	18
2.3.1. Early Development of Banks’ Regulation in Ethiopia -----	18
2.3.2. The NBE as the Principal Banks’ Regulatory Agency -----	20
2.3.3. The NBE’s Methods of ongoing Banking Supervision-----	21
2.3.4. Capability of the NBE -----	23
2.3.5. The Respective Sub-City of Addis Ababa or Region as a Contributory Banks’ Regulatory Agency -----	23

CHAPTER THREE

THE ROLE OF SHAREHOLDERS IN BANK GOVERNANCE-----	25
3.1. Powers of Shareholders -----	25
3.2. The Role of Institutional Shareholders in Bank Governance-----	27
3.3. Regulating Banks’ Shareholders in Ethiopia -----	30
3.4. Protection of Minority Bank Shareholders in Ethiopia -----	35

CHAPTER FOUR

REGULATING BANKS’ DIRECTORS-----	42
4.1. Board and Directors in General -----	43
4.2. Agency Theory as a Theoretical Foundation of Regulation of Bank Governance-----	44
4.3. The Structure of Board of Directors -----	46
4.3.1. The Non-Executive Board -----	46
4.3.2. The Executive Board -----	47
4.3.3. The Two-Tier Board -----	47
4.3.4. The Unitary Board -----	48
4.4. Composition of Board of Directors-----	49
4.5. Directors’ Nomination -----	51
4.6. Directors’ remuneration-----	59
4.7. Removal of Directors, CEO or Senior Executive Officers -----	62
4.8. Duties and Responsibilities of Directors-----	65
4.8.1. Duty of care and skill -----	65
4.8.2. Duty of Loyalty/ Fiduciary-----	66
4.8.3. Duty of Obedience -----	67
4.8.4. Other Duties-----	67
4.9. Conflict of Interests-----	71

CHAPTER FIVE

THE ROLE OF AUDITORS IN BANK GOVERNANCE & THEIR

REGULATION -----79

5.1. Auditors in General -----79

5.2. Regulating Bank Auditors in Ethiopia -----80

5.2.1. Appointment and Revocation of Auditors -----81

5.2.2. Power, Duties and Liabilities of Auditors-----83

5.3. The Contribution of the Audit Committee in Bank Governance-----85

CHAPTER SIX

CONCLUSIONS AND RECOMMENDATIONS -----87

6.1. The Research Questions-----87

6.2. The Conclusions, the Findings and the Recommendations-----87

6.2.1. The Conclusions-----87

6.2.2. The Findings -----88

6.2.3. The Recommendations -----90

REFERENCES-----92

ANNEXES

STRUCTURE OF THE PAPER

The paper is divided into six chapters. Chapter one provides for an introduction to the research. There is a brief discussion of the background, statement of the problem, objectives, significance, scope and methodology of the research.

Chapter two deals with the conceptual analysis of bank governance and historical narration of central bank in Ethiopia. The chapter further provides for bank regulatory agencies in Ethiopia. Justifications for the special treatment of banks will also be discussed with a sufficient detail.

Chapter three describes the desirable attributes and contributions of shareholders in the governance of banks. It also considers the powers of shareholders, the role of institutional shareholders, and minority rights.

Chapter four considers regulation of board of directors of banks. Among others, appointment, remuneration, removal, duties and responsibilities of directors will be discussed.

Chapter five examines regulation of auditors of banks. Therein appointment, duties and responsibilities of external auditors will be discussed.

Chapter six concerns with conclusions and recommendations, that is, findings of the research and possible recommendations will be forwarded in this chapter.

CHAPTER ONE

PROPOSAL OF THE RESEARCH

1.1. Background of the Research

Corporate law is crucial in market economies; it lays down conducive legal environment for the formation, continuing operation of privately owned businesses. Good corporate law is said to be crucial in transition economy countries.¹ It can encourage new investment, and provide investors protection by setting forth clear and objective rules for corporate's ongoing internal governance. It can encourage entrepreneurship by making it easy to start up & register a company. It can also encourage businesses to come out of the under ground economy into the publicly registered, tax paying economy.²

Companies originate from the earliest form of corporate entity, namely sole trader. From the Middle Ages, such traders were regulated by merchant associations, which oversaw a diversity of traders.³ The internationalization of trade, with traders venturing overseas, led gradually to regulate companies arising from the mediaeval guild system.⁴

Although "corporate governance" has become one of the most commonly used phrases in the current global business vocabulary,⁵ the issue of corporate governance came to the forefront surprisingly early. One of the first examples being the formation of the East Indian Company in 1601.⁶ The early governance structures of this company were reminiscent of corporate governance structure and mechanisms in today's companies.⁷

It has to be recalled that corporate governance is a central and dynamic aspect of business.⁸ The term governance originated from the Latin *gubernare* meaning 'to steer', usually applying to

¹ Booz/Allen/Hamilton, (2007) Ethiopian Commercial Law and Institutional Reform and Trade Diagnostic:at 1 (Hereinafter cited as Booz)

² *Ibid*: at 1.

³ Solomon J. & Solomon A. (2004) Corporate Governance and Accountability, Delhi, Wiley India: at 2. (Hereinafter cited as Solomon)

⁴ *Ibid*: at 2.

⁵ *Ibid*: at 11.

⁶ Garratt B. (2003) The Fish Rots from the Head, Profile Books: at 1. (Here in after cited as Garratt)

⁷ The Cadbury Report on UK Corporate Governance (2002): at 12.

⁸ Solomon, *supra note* 3: at 1.

steering of a ship, which implies that corporate governance involves the function of directing rather than control.⁹

Starting from 1601, the formation of East Indian Company, corporate governance has been passing through historical & theoretical developments. Corporate governance has recently received much attention due to Adelphia, Enron, World Com., and other high profile scandals serving as the inputs to employ a strong regulatory mechanism.¹⁰

The separation of ownership & control creates an agency problem. It lets managers to run the firm in their own, rather than the shareholders' interest, choosing the maximization of their own utility over the maximization of the shareholders value.¹¹ This urges shareholders to look for a way out of this so that safeguards investment. On the other side, the government is dragged in to regulate the imperfection of the market.

The globalization of banking markets has raised important issues regarding governance regulation for bank institutions.¹² There are strong reasons for bank regulation. The role of banks is integral to any economy; they provide finance for commercial enterprises, access payment systems, & a variety of retail financial services for the economy at large.¹³ They facilitate the transmission of monetary policy by making credit & liquidity available in difficult market conditions.¹⁴ Furthermore, depositors give up their money to banks, principally believing in the government.

Governance in the banking sector differ from that in non- financial sectors because of the broader risk that banks pose to the economy.¹⁵ As a result, the regulator plays a more active role in establishing standard & rules to make management practices in bank more accountable &

⁹ *Ibid.*

¹⁰ Moshe P. (2006), The Role of Institutional Investors in the Corporate Governance, German Working paper in the Law & Economics, Vol.1: Article 1(Internet source)

¹¹ *Ibid.*

¹² Kern A. (2004), Corporate Governance & Banking Regulation, University of Cambridge: at 1.

¹³ *Ibid.*: at 5.

¹⁴ *Ibid.*

¹⁵ *Ibid.*

efficient. The government also plays a role in enacting regulatory laws, establishing regulatory agencies & empowering them to properly attain their goals.

To this end, Ethiopia has put up basic governance institutions for firms as early as in 1960 by enacting the Commercial Code of Ethiopia. The Code, among others, includes corporate law, disclosure law, auditing, and basic structure, duties and responsibilities of shareholders, board of directors, and managers.

Bank regulation, in its strict sense refers to the frame work of laws and rules under which banks operate.¹⁶ It is asserted that in a market economy, banks are subject to prudential regulation, which includes subjecting them to special licensing, regulation and supervision rules.¹⁷ Banks are treated differently from other enterprises because a safe and sound banking system is indispensable for sustainable economic growth.¹⁸ Besides, the nature of banking activity makes banks and the banking system vulnerable to destructive practices caused by a sudden loss of public confidence.¹⁹

Effective regulation of banking organizations is an essential component of a strong economic environment in that the banking system plays a central role in making payments and mobilizing and distributing savings.²⁰ Effective supervision of banking ensures that banks operate in a safe and sound manner and that they hold capital and reserve sufficient to support the risks that arise in their business.²¹ It has to be noted that, while the cost of banking supervision is indeed high, the cost of poor supervision has proved to be even higher.²²

Governance of banks starts to be regulated right from the commencement of licensing process. In Ethiopia, the National Bank Ethiopia (hereinafter cited as “the NBE”) has been empowered to

¹⁶ Kenneth Spang (2000) Banking Regulation fifth Ed. Federal Reserve Bank of Kansas City; at 5. Foot Note 1.

¹⁷ The World Bank (2001) Principles & Guidelines on Effective Insolvency and Creditors Rights Systems; at 63.

¹⁸ *Ibid.*

¹⁹ *Ibid.*

²⁰ Core Principles of Effective Banking Supervision, Basel Committee on Banking Supervision, Basel, Sep. 1997: at 8. (Hereinafter cited as Basel Committee on Banking Supervision).

²¹ *Ibid.*

²² *Ibid.*

license and supervise banking business. To this end, the NBE has been empowered to set criteria and reset or reject applications for establishments that do not meet the standards set.

The success of a bank has a lot to do with its reputation. Malfunction at governance could be one source of reputation risk. Reputation risk is particularly damaging for banks since the nature of their business requires upholding the confidence of depositors, creditors & the general market.²³

The recent financial crises all over the world has made it clear as to why the issues of transparency and accountability in governance of financial sector are so important to investors' confidence and to overall national economic performance.

Banking Business Proclamation No. 592/2008 (hereinafter cited as “the Proclamation”) has set some regulatory provisions of banking system in Ethiopia in general and governance of banks in particular. The same proclamation has vested in the power to NBE to supervise and regulate banking business issuing directives. Accordingly, NBE has come up with different directives so as to regulate governance of banks in Ethiopia.

In order to carryout its task properly; the NBE must have operational independence, the means and powers to gather information both on and off site, and the authority to enforce its decision. Moreover, it should have the required competent staff and effective regulatory mechanisms.

The licensing process, at a minimum, should consist of an assessment of the banking organization, directors and senior management among others.²⁴ The Proclamation provides for criteria about appointment of directors and employees of a bank²⁵ and to issue directives²⁶ as to the qualification of competency to be fulfilled by directors, minimum number of board's members, the duties, responsibilities and good corporate governance of the board of directors, and the maximum remuneration of directors, among others.

²³ *Ibid*; at 28.

²⁴ *Ibid*; at 15.

²⁵ Bank Business Proclamation, No. 592/2008, Federal Negarit Gazette 11th Year No. 57, Addis Ababa, Art. 14.

²⁶ *Ibid*, Sub-Article 4.

The proclamation further provides for prohibitions put on unqualified persons for directorship.²⁷ Besides, it is provided therein rules of cessation of banking management functions²⁸ and suspension and removal of the same²⁹ by the NBE.

Part six of same proclamation provides for rules on Financial Records and External Audit Inspection. Among others, appointment of Auditors³⁰, Tenure of Auditors³¹ Duties of Auditors³² and Audit reports³³ have got an important place in the proclamation.

The NBE Directors and Chief Executive Officer (hereinafter cited as "CEO") Directives No. 39/2006 provides for selection criteria and appointment of CEO and directors. In addition, approval of appointment of independent auditor of banks has been addressed by Directives enacted by NBE.

1.2. Statement of the Problem

The significance of good governance of banks to the nation's economy in general and to the respective corporation in particular is uncontestable. In this regard, Jim Wolfenson, the then World Bank president, had to offer the following;

*The proper governance of companies (banks) will become as crucial to the world economy as the proper governance of countries.*³⁴

In banking governance, appropriate balance between performance and conformance needs to be made considering the expectations of shareholders reasonable capital growth and the responsibility of considering the interests of other stakeholders of the bank.³⁵ Bank reputation, built up over decades, can be destroyed overnight due to failure around governance.

²⁷ *Ibid*, Art.15.

²⁸ *Ibid*, Art. 16.

²⁹ *Ibid*, Art.17.

³⁰ *Ibid*, Art.24.

³¹ *Ibid*, Art.25.

³² *Ibid*, Art.26.

³³ *Ibid*, Art.27.

³⁴ King's Report, *supra* note 12: at 7.

³⁵ Garratt, *supra* note 6 ; at 117.

Prudential regulation is very crucial in ensuring the sustainability and viability of banks. It also plays a key role in ensuring effective governance. Prudential regulation ensures the solvency and financial soundness of all intermediaries, so as to protect the stability of the country's payment system. It provides shareholders and customers protection scheme against undue risks and losses that may arise from failure, fraud, and unethical conduct of those involved in governance of banks.

Governance of banks particularly boards should not get the chance to mark their own examination paper. Experiences tell us that a few directors and boards are corrupt; others led into bribery and corruption. Unfettered power in the hand of chief executive is an obvious challenge to good bank governance.³⁶

Directors with adequate caliber, capable of running large organization should be attracted to the board. Board should conduct a review of effectiveness of their internal control system and should report this information to shareholders and to the regulator at the same time.³⁷

Banks' control and monitoring procedures need to be sufficient and filled by knowledgeable and experienced officers in the field.³⁸ Laws and Directives enacted by the government or regulatory authority respectively need to be fair, reasonable and able to walk off with the current national and global market demands.

Per the Core Principles of Effective Supervision of Banks established by the Basel Committee, prudential governance of banks regulatory framework criteria and supervision should include:³⁹

- a sound legal framework. Including satisfactory licensing system;
- sound governance structure;
- internal controls that are adequate for the nature and scale of their business;
- management information system;

³⁶ Solomon, *supra note 3*; at 67.

³⁷ *Ibid*; at 49. Also see Ira M. (1995) "the Professional Board", the Business Lawyer Vol. 50, No. 4; at 1414.

³⁸ Ira M. (1995) "the Professional Board", the Business Lawyer Vol. 50, No. 4; at 1414. (Hereinafter cited as Ira M.)

³⁹ Basel Committee on Banking Supervision, *supra note 20*; at 13, 29, 37.

- disclosure norms including publications of annual accounts;⁴⁰ and
- effective banking supervision system.⁴¹

In bank governance regime, three general areas play a significant role, namely; the board of directors; auditing; and the shareholders. But the board of directors is said to be the most important corporate governance mechanism, requiring constant monitoring and assessment.⁴²

It has to be noted that no system of control can completely eliminate the risk of fraud, as human nature cannot be altered through regulation and checks and balance. Regulatory authority, however, has to play momentous role in the well functioning of bank governance.

Nevertheless, governance of banks and regulatory authority in Ethiopia are criticized for various snags, *inter alia*, the following are some of them:

- weak legal and regulatory system;
- poor banking and regulatory practices;
- inefficient oversight by corporate boards and negligible recognition of the rights of minority shareholders;⁴³
- lack of skilled and experienced board members;⁴⁴
- some board members are very busy to spare enough time and contribute to effective governance;⁴⁵
- absence of regular evaluation of the boards and management teams;⁴⁶
- the limited capacity of the regulators to implement the relevant law and the directives; and
- lack of governance code of best practice.⁴⁷

Based on these the study will, *inter alia*, try to address:

⁴⁰ OECD Principles OF Corporate Governance (1999): at 37.

⁴¹ Basel Committee on Banking Supervision, *supra note 20*; at 11.

⁴² Solomon, *supra note 3*; at 49.

⁴³ King's Report, *supra note 12*; at 14.

⁴⁴ Garratt, *Supra note 6*; at 8.

⁴⁵ *Ibid*; at 3.

⁴⁶ *Ibid*; at 109.

⁴⁷ *Ibid*; at 255.

- whether the laws and NBE's Directives governing governance of banks are, fair, adequate, strong enough and are up to the required international standards;
- whether the regulatory institution is in a position or competent enough to enforce the existing legal regime;
- whether there is a conformity between the law and the practice of governance of banks;
- the need to develop governance code of practice and conduct, if so to come up with the proposal of the same.

1.3. Objectives of the Research

The main objective of this study is to explore, investigate and suggest appropriate regulatory policies, laws and practices both the regulator and the regulated could do with pursuing and setting in relation to bank governance.

By scrutinizing the legal, institutional, operational framework; by assessing the practice and investigating experiences and laws of more or less countries similar to Ethiopia; the study recommends working laws, directives and best practices of regulation of governance of banks in Ethiopia.

Last not but least, if appropriate, the study may come up with the proposal of code of practices and conduct for governance of banks in Ethiopia.

1.4. Significance of the Research

Banking institutions and the government (regulatory authority) could be the direct beneficiaries of this research. Thus, the research is expected to benefit the Government in evaluating its Laws, Directives and the practices or in implementing it in relation to banks' governance. Besides, the government may get an opportunity to identify shortcomings of its regulatory institutions and its conscription.

Commercial banks in general and those who are involved in governing them in particular are expected to benefit from this research as it explores into the law and practices of regulation of governance of banks supported and enriched by experiences of similar countries with Ethiopia.

The study will also help as basis and may call the attention of those who would like to carry out further research in the field. Finally, it may help as a reference material in the academic spheres.

1.5. Scope of the Research

It has to be recalled that the whole study is concerned about the law and practice of regulating governance of banks in Ethiopia. Corporate governance in general and bank governance in particular will also be focal point of the study.

The law and practices of governance of banks and their regulation from some selected countries will be examined for the purpose comparisons. Besides, laws and mechanism set to regulating bank governance and their implementation will be dealt with.

Information will be collected from the National Bank of Ethiopia and from some selected or all, if manageable, private commercial banks of Ethiopia.

1.6. Methodology of the Research

The method designed to be employed in this research in order to achieve the required objectives are; reading books, materials, and documents mainly related to laws but also management and accounting. This is because of the fact that minimum understanding of management and accounting underlying principle behind the various provisions of corporate governance law is very helpful to have full understanding of the objectives of the law.

Applications for the establishment of banks and report-documents filed to the NBE will be considered. Concerned officials and individuals will be interviewed. Mainly, the practice of some selected commercial banks, if it is manageable all, in relation to their governance compliance and performance will be scrutinized in a detailed fashion.

Recent legislations and the effort made by the NBE to regulate governance of banks will be looked at. Besides, its legal and institutional, resources and manpower use to run the task of the regulation will be explored.

Experiences of South Africa, UK, US, India, etc as far as regulating bank governance is concerned will be examined for comparisons.

In other words, data will be collected from primary and secondary sources. Primary data will be gathered mainly through interview & questionnaire. The secondary sources will be legislations, documents and foreign literatures related to bank governance and its regulation.

CHAPTER TWO

CONCEPTUAL ANALYSIS AND HISTORICAL NARRATION OF BANKS' GOVERNANCE & REGULATION

Introduction

In the previous chapter, the research proposal of the research has been introduced. In this chapter, we shall discuss the conceptual analysis and historical narration of bank governance and regulation in general and in Ethiopia in particular. The need for regulating banks, history of central bank in Ethiopia and regulatory agencies of banks will be described.

2.1. The Concept of Bank Governance and Regulation

Business would make no sense short of incorporation. It is true that a huge proportion of the world's wealth is generated by corporations. It is reported that the limited liability corporation is said to be "the greatest single discovery of modern times".¹ Huge capital demanding enterprises require an injection of money. This can be achieved by, among others, inviting more people to contribute to the capital sum which the business uses to fund its activity.² People are encouraged investing in to companies by the invention of limited liability. In case the company runs in to bankruptcy; investors will only lose their initial investment. The liability of the company, in other words, may not affect their pocket beyond their investment made to purchase shares.

Bank governance principles were developed; inter *alia*, because investors, in the era of the professional manager, were worried about the excessive concentration of power in the hand of management.³ If there be lack of good bank governance in a market, capital will leave that market with the click of mouth. At this juncture, Arthur Levitt offered the following.

If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are

¹ Koutsias M. & Dine J. (2007) Company Law, 6th edn., Palgrave Macmillan law masters: at 1. (Hereinafter cited as Koutsias)

² *Ibid.*

³ King's Report (2002) King Committee on Corporate Governance: at 8. (Hereinafter cited as King's Report)

*not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere. All enterprises in thatsuffer the consequences....*⁴

Bob Garratt has defined corporate governance as:

*The appropriate board structures, processes and values to cope with the rapidly changing demands of both shareholders and stakeholders*⁵

Bank governance is used in a wide variety of contexts: some people use it to identify all control over bank decision-making (the widest meaning); probably its narrowest meaning is used by accountants and auditors who use it to denote the control that they exercise through financial reporting.⁶

According to OECD principles;

*Corporate governance involves a set of relationships between a company's management, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Corporate governance essentially focuses on the problems that result from the separation of ownership and control, and addresses in particular the principal-agent relationship between shareholders and creditors.*⁷

Accordingly, bank governance is about transparency of the way directors perform their roles of directing a bank. And it is an availability of information on the role played by institutional investors and shareholders right. Besides, bank governance contains shareholders' right and

⁴ *Ibid*: at 9.

⁵ Garratt B. (2003) The Fish Rots from the Head, Profile Books: at 11. (Hereinafter cited as Garratt).

⁶ Koutsias, *supra* note 1: at 141.

⁷ OECD Principles OF Corporate Governance (1999): at 11. (Hereinafter cited as OECD)

democracy. Further, bank governance encompasses modernizing the board of directors' i.e. board composition, directors' remuneration and directors' responsibilities.

Apart from the value added to a bank by good bank governance, interest in such practices has been fuelled by the international financial crises of the 1990s⁸ and the recent worldwide financial and economic turmoil.

Macro economic difficulties could be worsened by systematic malfunction of bank governance, stemming from:

- weak legal and regulatory systems;
- poor banking regulation and practices;
- inconsistent accounting and auditing standards;
- improperly regulated capital markets; and
- inefficient oversight by bank's boards, and scant recognition of the rights of minority shareowners.⁹

There is no single replica of good banks' governance. However, it is not impossible to identify some universal elements that underlie good bank governance.¹⁰ Governments, through their regulatory authorities, have an imperative responsibility for shaping an effective, sufficient, and flexible and conducive market environment. Besides, they should allow market to function effectively and to respond to expectations of shareholders and other stakeholders and the public in general.

For the purpose of this work shortly stated, banks' governance encompasses the collective role of shareholders, board of directors, the role of the management and auditors.

⁸ King's Report, *supra* note 3: at 14.

⁹ *Ibid.*

¹⁰ OECD, *supra* note 7: at 12.

2.2. Why Regulate Banks

Banking business institutions require special treatment. It has long been taken for granted that the banking business should be regulated.¹¹ The bed rock for the necessity of banks regulation is public interest.¹² Though banks operate for profit and bankers are free to make many decisions in their operations, banking is commonly treated as a matter of public interest.¹³

Bank regulation, in its strictest sense, refers to the frame work of laws and rules under which banks operate.¹⁴ It is asserted that in a market economy, banks are subject to prudential regulation, which includes subjecting them to special licensing, regulation and supervision rules.¹⁵

Banks are treated differently from other enterprises because a safe and sound banking system is indispensable for sustainable economic growth.¹⁶ Besides, the nature of banking activity makes banks and the banking system vulnerable to destructive practices caused by a sudden loss of public confidence.¹⁷

Bank regulation at least benefits depositors, businesses and the state by providing safe & stable banking system. Depositors will have a safe and secure place to keep funds. Businesses and individuals will get a dependable framework for conducting money transaction. The state will have a reliable channel to conduct monetary policy.¹⁸

Governance in the banking & financial sector differs from that in the non financial sectors because of the broad risk that banks pose to the economy. That is to say bank clients are either debtors or creditors of the same. Debtors of a bank may have little interest in the fortunes of the bank unless they need further loans. Bank depositors who assume the role of creditors, however,

¹¹ Shelia C. (1960) "Why Banking System should be Regulated", the Economic Journal, vol.106, May: at 692. (Hereinafter cited Shelia)

¹² Kenneth Spong (2001) Banking Regulation, 5th edn., Federal Reserve Bank of Kansas City: at 5. (Hereinafter cited as Kenneth)

¹³ *Ibid.*

¹⁴ *Ibid.*, Foot Note 1.

¹⁵ The World Bank (2001) Principles & Guidelines on Effective Insolvency and Creditors Rights Systems: at 63.

¹⁶ *Ibid.*

¹⁷ *Ibid.*

¹⁸ Myers Foster, (2005) Basics for Bank Directors, Division of Supervision & Risk Management, Federal Reserve Bank of Kansas City: at 6.

become linked with the fortunes of their bank.¹⁹ A mismanaged bank may lead to a bank run or collapse.

Effective regulation of banking organizations is an essential component of a strong economic environment in that the banking system plays a central role in making payments and mobilizing and distributing savings.²⁰ Effective supervision of banking ensure that banks operate in a safe and sound manner and that they hold capital and reserves sufficient to support the risks that arise in their business.²¹ It has to be noted that, while the cost of banking supervision is indeed high, the cost of poor supervision has proved to be even higher.²²

Banking regulation extends to many aspects of banking, including determining those who can open banks, what products can be offered, and how banks can expand.²³ Bank regulation also involves important issues like compliance with laws and regulations and financial soundness,²⁴ ownership, control, service, capital, branch, management etc.²⁵

2.2.1. Depositors' Protection

The basic for regulation of banks is depositors' protection. The public deposits funds in banks in trust of the government. Banks mostly run their activities using such deposits. That makes banking business a risky venture. Government, therefore, through its regulatory agencies, should undertake surveillance over banks than any other venture so as to protect those who relinquish their money to banks trusting it. Note seems to be important that bank depositors may have more difficulty protection their interests than customers of other types of business.²⁶

¹⁹ Kenneth Spong (2000) Banking Regulation; Its Purposes, Implementation, and Effects, 5th edn., Division of Supervision & Risk Management Federal Reserve Bank of Kansas: at 6.

²⁰ **Core Principles of Effective Banking Supervision**, Basel Committee on Banking Supervision, Basel, Sep. 1997; at 8.

²¹ *Ibid.*

²² *Ibid.*

²³ Kenneth Spong, *supra* note 11: at 5.

²⁴ Myers Foster, *supra* note 17: at 3.

²⁵ *Ibid.*: at 5.

²⁶ Kenneth Spong, *supra* note 11: at 6.

2.2.2. Monetary & Financial Stability

Banking regulation must also seek to provide a stable framework for making payments.²⁷ Vast volumes of transactions are conducted every day by individuals and businesses through the medium of banks' product. Thus a safe and acceptable means of payment is highly needed to the health of the economy.²⁸

Banks' supervision should be designed and conducted so as to avoid, if not to mitigate, factors interrupting the flow of transactions across the economy & eroding public confidence in the banking system.²⁹ Reduction in the volume of internal reserves & liquid assets would shake the safety of depositors' fund. Such disruptions in the banking system would further hinder financial transactions & the flow of credit, lending to continued slippages in the over all economy & in depositors' confidence.³⁰

The ways out of these disruptions could be summarized in to two points. Firstly, to providing for a more elastic reserve base & by allowing banks to borrow funds from Reserve Banks to meet depositors' need and credit demands. Secondly, to design deposit insurance scheme to provide further confidence & backup to depositors.³¹

2.2.3. Service Quality

Quality service and competitive prices for customers are said to be another aspect of a good banking system.³² In other words, customers deserve and require getting quality service & competitive prices from their banks.³³ From this it follows that one of the purposes of bank regulation should be to innovate and to put in place a regulatory framework that encourages efficiency & competition. Further, the regulatory package needs to be framed so as to ensure an adequate level of banking service through out the economy.³⁴

²⁷ Shelia C., *supra* note 10: at 7.

²⁸ Kenneth Spong, *supra* note 18: at 7.

²⁹ *Ibid.*

³⁰ *Ibid.*

³¹ *Ibid.*: at 8.

³² *Ibid.*: at 9.

³³ Shelia , *supra* note 10: at 9.

³⁴ Kenneth Spong, *supra* note 18: at 9.

2.2.4. Consumer Protection

Bank regulation is supposed to take in to account in its goal consumers' protection. That is to say, protection of consumers' interests in several of banking relationship is taken to be one more justification of special treatment for banking business.³⁵ Consumers' interest would be protected by requiring financial institutions to provide their customers with a meaningful disclosure of deposit and credit terms. Furthermore, consumers' protection legislations should provide for rules to the effect that to ensure equal treatment and equal access to credit among all financial customers.³⁶

2.3. Banks' Regulatory Agencies in Ethiopia

2.3.1. Early Development of Banks' Regulation in Ethiopia

Banking business was unknown in Ethiopia until the 20th C. History reveals that traditionally persons with surplus cash buried it in the ground.³⁷ Modern banking began in Ethiopia in 1905, when the Bank of Abyssinia was first established.³⁸ The Bank of Abyssinia was established under a 50-year franchise agreement between Emperor Menelik & the then British owned National Bank of Egypt.³⁹ The Bank of Abyssinia was carrying limited business such as keeping government accounts, some export financing & undertaking various tasks for the government.⁴⁰

It is too early to talk about bank regulation at the time of the establishment and its entire operation of the Bank of Abyssinia. This is so because of two facts. Primarily, is that the bank itself was not as such an Ethiopian bank which was established, licensed and regulated by the Ethiopian Government. Secondly, there were no financial institutions in general and bank in particular in Ethiopia to be regulated so that depositors' interests were protected.

The Bank of Ethiopia was the descendant of the Bank of Abyssinia. The Bank of Abyssinia was accused of inefficiency & purely profit motivated activities. That is why the then Ethiopian

³⁵ Shelia , *supra note* 10: at 9.

³⁶ Kenneth Spong, *supra note* 18: at 10.

³⁷ Dr., Richard Pankurst (1967) Primitive Money; Money & Banking in Ethiopia, AA. The Birhanina Selam H.S.I. Printing Press, Nov.: at 47.(Here in after cited as Dr., Richard)

³⁸ Belay Gidey (Sep. 1987) Currency & Banking Ethiopia: at 8. (Hereinafter cited as Belay)

³⁹ *Ibid*: 68-9.

⁴⁰ Dr., Richard, *supra note* 36: at 43.

Government decided to liquidate it & replace it by the Bank of Ethiopia. The Bank of Ethiopia, which was a purely Ethiopian institution, was established by an official decree on August 29, 1931.⁴¹ This bank took over the commercial activities of the Bank of Abyssinia & was authorized to issue dollar notes & coins.⁴²

The Bank of Ethiopia operated until 1935 & ceased to function during the Fascist envision. It was closed by Italians in 1936. During the five years enemy occupation, many branches of Italian Banks were opened & operated.⁴³

Despite the fact that the Bank of Ethiopia was an Ethiopian Bank and acted as a central bank, it is hard to conclude that it acted as a bank regulatory agency. In fact, it acted as a monetary regulatory institution.

The Bank of Ethiopia was followed by the State Bank of Ethiopia. The State Bank of Ethiopia was originally established as a commercial bank by proclamation issued in August 1942. In addition to its commercial banking functions, the bank was entrusted with three basic duties of a central bank. These are controlling the issue of currency; holding the foreign reserves of the country & acting as the fiscal agent of the government.⁴⁴

Under Art. III (11) of the Charter of the State Bank of Ethiopia, the bank was empowered, among other things, to participate in the creation & constitution of all financial & industrial enterprises of interests to Ethiopia.⁴⁵ Thus, the State Bank of Ethiopia had exercised dual functions as a regulatory agency of financial institutions & as a commercial bank.

In July, 1963, the new Ethiopian Monetary & Banking Law came in to force & the State Bank was finally dissolved & split in to the NBE & the Commercial Bank of Ethiopia.⁴⁶ As a consequence, the dual function of central and commercial bank divorced. That is to say, the

⁴¹ Belay, *supra note 37*: at 71.

⁴² Ibid.

⁴³ These were Banco d'Italia, Banco di Roma, Banco di Napoli & Banco Nazionale del Lavoro.

⁴⁴ Teffera Deguefe (1973) A Guide to Service, A.A. Commercial Printing Press; at 12. (Hereinafter cited as Teffera)

⁴⁵ A Proclamation to provide for the Establishment of a State Bank, No.21/1942, Negarit Gazeta, 1st year No.6, 27th August 1962. As quoted in Teffera Deguefe, *supra note 43*.

⁴⁶ Belay, *supra note 37*: at 75.

central bank functions were transferred to the NBE and the commercial activity to the Commercial Bank.

2.3.2. The NBE as the Principal Banks' Regulatory Agency

The NBE proclaimed in the Negarit Gazeta by Proc. No. 206/ 1963, & began operation in January, 1964. The NBE was reestablished under Proc. No.99/1976 with the power to establish, to consolidate or to dissolve banks & other financial institutions.⁴⁷ To protect interest of depositors, banks are required to follow the rules & regulations of NBE. The NBE is, therefore, the major regulatory or supervisory agency of banks.

The NBE Establishment (as amended) Proc. No. 591/2008 has redefined the powers & duties of the NBE. Accordingly, the licensing & supervising power of banks are reconfirmed.⁴⁸ The Proclamation⁴⁹ has provided for rules, among other things, as to licensing & supervision of banking institutions.

Banking business license, to be issued by the NBE, is a prerequisite to transact banking business.⁵⁰ The NBE has no power to register banks. The Proclamation, however, let “the appropriate government organ” to take care of the registration,⁵¹ which is a pre condition for licensing. “The appropriate government organ” is required to secure the NBE’s approval of memorandum & articles of associations before effecting the registration.⁵² Accordingly, eleven private and three government banks have been registered and acquired banking business license, without losing sight on the confusion of registration of banks, until the completion of this work. (To be discussed below).

⁴⁷ *Ibid.*

⁴⁸ The National Bank of Ethiopia Establishment (as amended) Proclamation, No. 591/2008, Federal Negarit Gazette 14th Year No. 50, 11th August Addis Ababa, Art. 5(7).

⁴⁹ Banking Business Proclamation No. 592/2008, Federal Negarit Gazette 14th Year No. 57, 25th August Addis Ababa.(Hereinafter cited as “Banking Business Proclamation.”)

⁵⁰ *Ibid*: Art. 3(1).

⁵¹ *Ibid*: Art. 4(1) (d).

⁵² *Ibid.*

2.3.3. The NBE's Methods of ongoing Banking Supervision

It is reported that an effective banking supervision system consist of some form of both on-site and off-site supervision.⁵³ Supervision requires the collection and analysis of information, which can be done on or off site. In some countries, on-site work is carried out by examiners and in others by qualified external auditors. In still other countries, a mixed system of on-site examinations and collaboration between the supervisors and the external auditors exist.⁵⁴

In Ethiopia, there are three mechanisms of bank ongoing supervision. These are on-site, off-site and sudden examination of banks. The NBE may make or cause to be made an on-site supervision of a bank. The supervision could be periodically, or at any time without notice.⁵⁵ The purpose of the on-site supervision is to determine whether the bank is in a sound condition and the provisions of pertinent proclamations, regulations and directives have been complied with.⁵⁶ Such inspection may be carried out by one or more officers of the NBE or by trusty worthy and qualified persons employed by the same.⁵⁷

Where an inspection of a bank results in a finding that the bank has failed to comply with the relevant laws and directives, or with the terms and conditions of license, or has engaged in a practice detrimental to the interests of depositors or has serious weaknesses in its governance, the NBE may order the dismissal, or suspension of one or more directors or management officers. It may impose fines on such persons.⁵⁸

The supervisory agency needs to establish clear internal guidelines related to the frequency and scope of examinations. Moreover, examination policies and procedures should be developed in order to ensure that examinations are conducted in a thorough and consistent manner with clear objectives.⁵⁹ The NBE has got clear internal guidelines related to the frequency and scope of

⁵³ **Core Principles of Effective Banking Supervision**, Basel Committee on Banking Supervision, Basel, Sep. 1997; at 31.

⁵⁴ *Ibid*, 32.

⁵⁵ The Banking Business Proclamation, *supra note* 49. At Art. 29(1).

⁵⁶ *Ibid*, Sub-Art. 2.

⁵⁷ *Ibid*, Sub-Art. 3. See, **Core Principles of Effective Banking Supervision**, Basel Committee on Banking Supervision, Basel, Sep. 1997; at 33.

⁵⁸ *Ibid*, Art. 31(4).

⁵⁹ **Core Principles of Effective Banking Supervision**, Basel Committee on Banking Supervision, Basel, Sep. 1997; at 33.

examinations. On- site inspection is conducted annually. Minor and grave non-compliances have been identified and recommendations have been offered for their rectification.⁶⁰ But the interviewed officer in NBE declined to disclose what problems were detected, on which bank and what measure taken by the pretext of “confidentiality”.

Off-site supervision refers to collecting, reviewing analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.⁶¹ It has also been suggested that the supervisory agency should also have the ability to obtain information on affiliated non-bank entities.⁶²

Off-site monitoring helps to check adherence to prudential requirements, to identify potential problems, particularly in the interval between on-site inspections, thereby providing early detection and prompting corrective action before problems become more serious.⁶³

In Ethiopia, every bank is required to send to the NBE duly signed financial statements and other reports as prescribed by the NBE. In addition, banks are required to publish in a news paper their balance sheet and profit and loss account.⁶⁴ Furthermore, the NBE may collect any information from banks, as it may deem appropriate, under strict procedure of secrecy.⁶⁵ These could be taken as part of off-site surveillance of NBE. The interviewed official of the NBE refused to disclose problems identified from off-site inspection, the bank that created the problem.⁶⁶ The third method of ongoing bank supervision is sudden inspection of banks on the basis of information obtained from interested organ.⁶⁷ This mechanism of inspection has got no legal ground.

⁶⁰ An Interview with Ato Qurundi Tesgera, Senior Inspector of Banks, Banks Supervision Division of NBE, 09-11-2009.

⁶¹ **Core Principles of Effective Banking Supervision**, Basel Committee on Banking Supervision, Basel, Sep. 1997; at 32.

⁶² *Ibid.*

⁶³ *Ibid*, at 33.

⁶⁴ The Banking Business Proclamation, *supra note* 49, Art. 28(1) (2) (b).

⁶⁵ *Ibid*, Sub-Art, 4 .

⁶⁶ An Interview with Ato Qurundi Tesgera, Senor Inspector of Banks, Banks Supervision Division of NBE, 09-11-2009.

⁶⁷ *Ibid.*

2.3.4. Capability of the NBE

An institution vested with the power of regulating such a sensitive and essential sector is supposed to be manned with competent and experienced persons. In its regulatory role, the NBE is duty bound to understand pertinent laws in operation, its power and duties. Furthermore, the NBE has to issue directives based on the power vested with it to properly discharge its duties. Besides, it needs to investigate and amend directives which do not fit the current circumstances and accommodate national and international happenings.

Laws and or provisions of relevant proclamations and regulations have to be identified and forwarded to the law maker so that they could be amended or repealed and working laws put in place. The NBE should have the capacity to control and regulate banks. This requires the employment of competent and experienced professionals. The regulator if possible should overweigh the regulated if not should go parallel.

What we have in this regard is not promising. The NBE has no sufficient, competent and experienced officials. The salary structure is not in a position to compete with the private financial sectors and employ the required professionals. On the bases the interview with one official⁶⁸ of the NBE, lack of man power in the NBE is the main obstacle in fulfilling the duties of the same. There is endless migration of officials from the NBE to the private sector.

2.3.5. The Respective Sub-City of Addis Ababa or Region as a Contributory Banks' Regulatory Agency

Bank may not engage in any commercial activity unless registered in a commercial register.⁶⁹ Three places of commercial registers are established. The first is a central commercial register which shall be administered by the Ministry of Trade & Industry (simply “the Ministry”). The second is a commercial register, which shall be administered by the Ministry, in which is

⁶⁸ An Interview with Ato Qurundi Tesgera, Senior Inspector of Banks, Banks Supervision Division of NBE, 09-11-2009.

⁶⁹ Commercial Registration & Business Licensing Proclamation No. 67/1997, 3rd year, No. 25, 6th March 1997 Addis Ababa, Art. 5(1) and Art 4(1) (d) of the Banking Business Proclamation, *supra note* 48.

registered any person engaged in those commercial activities for which the Ministry issues license. The last is a commercial register which shall be administered by each Bureau.⁷⁰

Banks shall principally register in the place where his head office is situated.⁷¹ That is to say, if the head office of a given bank is situated at Arada Kifle Ketema, the Arada Kifle Ketema Bureau of Trade and Industry is responsible to register the same. For instance, the Oromia International Bank (S.C.) and the Buna International Bank (S.C.) have got their registration certificate from the above mentioned Bureau.

It has to be stressed that the Bureau which has made registration of a bank shall forward to the Ministry the particulars of registration so that the latter would undertake central registration.⁷² Surprisingly, the practice at registration organs is otherwise. The author's visit on 25th Nov. 2009 to the NBE reveals that eleven commercial private and three government banks are licensed & operating banking activities in Ethiopia. However similar visit to the Ministry shows that no private commercial banks are registered in central register. This absolutely makes difficult access to information about banks. If one needs, for instance, to view their memorandum of association he needs to go to the respective Bureau. The NBE's disinclination to show the memorandum of association of banks has aggravated the problem. In addition banks are not ready to let someone view their non-confidential documents, such as memorandum of association and articles of association. This goes against the right to view of traders documents.

Registration certificate witnesses the birth of a bank. The NBE before issuing banking business license is supposed to make sure that the given bank has got registration certificate.⁷³ However banks have been acquiring business license before registration. For example, Oromia International Bank (S.C.) got business license from NBE on 5/1/2002 (September 15, 2008) and got registration certificate on 26/1/2001(October 6, 2008). This tantamount to issue a business license to a conceived child.

⁷⁰ Ibid: Art. 4.

⁷¹ Ibid: 5 (2).

⁷² Ibid: 7 (2) and (3).

⁷³ See Art. 18(20) of Federal Government Commercial Registration and licensing Council of Ministers Regulations No. 13/1997, Federal Negarit Gazette, 3rd year, No 28, A.A. 8th March 1997.

CHAPTER THREE

THE ROLE OF SHAREHOLDERS IN BANK GOVERNANCE

Introduction

In the previous chapter, we defined bank governance and introduced some theoretical frameworks that have been used to analyze bank governance issues. In addition to this, the reasons why banks should be regulated were briefly described. Furthermore, the previous development & the current bank regulatory agencies in Ethiopia were described. We now provide a discussion of the role of shareholders in bank governance. Powers of shareholders, the role of institutional shareholders in bank governance and protection of minority shareholders rights will be seen.

3.1. Powers of Shareholders

The general principals governing the legal structure of bank governance have never been well articulated. There does exist a more or less standardized well-recognized model of formal bank decision-making which may be called the received legal model.¹ Under this model, the board of directors manages the bank's business and makes business policy. The officers act as agent of the board and execute its decisions. The shareholders elect the board and decide on "major bank actions".² Except the powers vested in the board of directors, the overall powers of controlling the affairs of a bank rest with the shareholders which are exercised in the general meetings of the bank.³

Shareholders obtain their power from the democratic process of voting by which means they can elect or dismiss directors, who carry out the objectives of the bank.⁴ Resolutions at shareholders meetings are passed either by a simple majority or by a special majority (i.e. three-fourth majority). This confirms the fundamental principle of company 'majority share holding must

¹ Eisenberg M. (1976), The Structure of the Corporation: A Legal Analysis, Boston & Toronto, Little, Brown Company: at 1. (Herein after cited as Eisenberg)

² *Ibid.*

³ Jain, D., P. (1991) Company Law, 3rd edn., Konark Publishers, Delhi: at 427. (Here in after cited as Jain).

⁴ King's Report (2002) King Committee on Corporate Governance: at 8. (Hereinafter cited as King's Report).

prevail'.⁵ It has to be noted that corporate law is not bottomed on the democratic principle of one-man-one-vote, but on the proprietary principle of one-share-one-vote. What counts is not shareholders, but shareholdings.⁶ Despite the potential importance of actions taken at shareholders meetings, few shareholders of large corporations actually attend them.⁷ Because few shareholders of public corporations attend the annual meeting, the outcome will generally depend on which group has collected the most "proxies".⁸ Certain powers in the governance are given to shareholders-namely, to vote the management; the right to vote on changes in the bank charter; the right to pass upon certain transactions of general interest.⁹

The Commercial Code of Ethiopia provides for powers of shareholders of a share company in which banks are included. At the close of the formation process of a bank, subscribers are required to verify that the requirements relating to the formation of the bank have been complied with. The Code empowered them to draw up the final text of the Memorandum and Articles of Associations. Subscribers are vested in with the power to approve contribution in kind, if any, and the share in the profits allocated to the founders.¹⁰

The Code safeguards the general interest of shareholders by snatching voting right of founders on the resolution, approving their special share in the profit. The same prohibition extends upon contributors in kind as regards the resolution approving the valuation of their contribution in kind.¹¹

An essential power of shareholders is appointment of directors. There does exist two ways of appointment of directors. The first is when directors are appointed under the Memorandum or Articles of Associations subject to the approval of subscribers' meetings. The second is direct appointment by subscribers in case statutory directors are not confirmed by subscribers.¹² (Under chapter-four appointment of directors will be taken care of).

⁵ Jain, *supra* note 3 at 426.

⁶ Eisenberg, *supra* note 1 at 44.

⁷ Klein W. and Ramsefer I. , (1991) Business Associations, Agency, Partnerships, and Corporations the Foundation Press, Inc, 438. (hereinafter cited as Klein and Ramsefer)

⁸ *Ibid* 438.

⁹ *Ibid*.

¹⁰ Commercial Code of the Empire of Ethiopia, No. 3 of 1963, Negarit Gazeta-Extraordinary Issue 19th year, No. 3, Addis Ababa, article 321(1-4). (Hereinafter cited as the Commercial Code of Ethiopia)

¹¹ *Ibid*, Sub-Article 3 of Article 322.

¹² *Ibid*, Sub-Article 1 of Article 350.

Shareholders, unless otherwise specified by the Memorandum of Associations, shall decide the number of directors to be appointed.¹³ Besides, shareholders have the power to elect the chairman of the board.¹⁴ What's more, shareholders fix the remuneration of directors.¹⁵

Shareholders are not only empowered to elect directors but also to remove them.¹⁶ It seems settled that the body of shareholders has the inherent power to remove a director for causes, even where such power was not conferred on that body.¹⁷ A survey conducted in seven banks¹⁸ couldn't show the existence of an event where shareholders dismissed a director.

Any dealings made directly or indirectly between a bank and a director shall finally be approved by the shareholders.¹⁹ Any proceedings to be instituted against the directors shall be based on resolution of a general meeting.²⁰ Shareholders elect auditors²¹ and may at any time revoke the appointment of any auditor.²² The remuneration of auditors shall be fixed by the general meeting.²³

3.2. The Role of Institutional Shareholders in Bank Governance

Bank governance should not only depend on the banks and the effectiveness of their boards of directors but also should be played by responsible shareholders, especially institutional investors.²⁴ Institutional investors are entities with millions of Birr invested in the shares of large companies, such as banks.²⁵

¹³ *Ibid*, See Sub-Article 3 of Article 347.

¹⁴ *Ibid*, See Sub-Article 1 of Article 348.

¹⁵ *Ibid*, See Sub-Article 1 of Article 353.

¹⁶ *Ibid*, Article 354.

¹⁷ Eisenberg, *supra* note 1 at 86.

¹⁸ Anbessa Bank S.C., Bank of Abyssinia (An Interview with an officer of the bank who requested his name to be kept anonymous), Awash Int. Bank S.C., Wegagen Bank S.C. (An Interview with Ato Gebbisa Teresa, Legal Expert of the Bank), Oromia International Bank S.C., Zemen Bank S.C., Dashen Bank S.C., Cooperative Bank of Oromia. An official Data requested from NIB Int. Bank S.C., United Bank S.C., Bank of Abyssinia, Buna International Bank S.C., and Wegagen Bank S.C., were refused.

¹⁹ See Sub-Article 1-2 of Article 356 of the Commercial Code *supra* note 10.

²⁰ *Ibid*, See Sub-Article 1 of Article 365.

²¹ *Ibid*, Article 368(1).

²² *Ibid*, Article 371.

²³ *Ibid*, Article 372.

²⁴ Solomon J. & Solomon A. (2004) Corporate Governance and Accountability, New Delhi, Wiley India: at 96. (herein after cited as Solomon)

²⁵ *Ibid*, 91.

Generally, institutional investors have been growing so large and influential.²⁶ Given the weight of their votes, that institutional investors use their power to influence the standards of bank governance is of fundamental importance.²⁷ Institutional investors are gaining significant ownership concentrations. Ownership concentration is believed as an important mechanism which controls agency problem and improves investors' protection.²⁸

Institutional investors can play a significant role in monitoring bank management.²⁹ In this regard, Stapledon commented that "... monitoring by institutional investors fits within a broad tapestry of devices and market forces which operate to reduce the divergence between the interests of managers and shareholders."³⁰ Furthermore, institutional shareholders help to align the interests of management with those of their shareholders.³¹

Ownership concentration may result in adverse effect such as, their access to privileged information, which creates an information asymmetry between themselves and smaller shareholders.³² In this regard, Eisenberg stated that:

*Some concern has been expressed over whether the concentration of shareholdings in institutional hands is consonant with sound public policy. Certainly, these shareholdings pose serious problems, since the managers of financial institutions are often subject to severe conflict-of-interests problems resulting from their ties to portfolio corporations through other capacities, as in the case of commercial banks, which are lenders and pension-fund trustees as well as shareholders.*³³

²⁶ Shleifer, A. and Vishny, R.W. (1997) 'A survey of Corporate Governance' Journal of Finance, 52(2), June: at 739. (Hereinafter cited as Shlifer).

²⁷ The Cadbury Report, 1992:at 50.

²⁸ Shleifer, A. *Supra note*, 26 at 739.

²⁹ Solomon, *Supra note*, 24 at 90.

³⁰ Stapledon, G.P. (1996) Institutional shareholders and Corporate Governance, Clarendon press, Oxford: 17. (Here in after cited as Stapledon).

³¹ Solomon, *supra note*, 24 at 92.

³² The Hamper Report, 1998: 92.

³³ Eisenberg, *Supra note* 1 at 61.

There have been warnings to avoid excessive “interference” by institutions in the day-to-day running of business.³⁴

From this follows that, institutional investors represent both the cause and the solution of the agency problem. Their presence as shareholders creates a divorce of ownership and control, whereas their increasing involvement in banks and concentration of ownership provides a means of controlling management and actually solving agency problem.

One problem with institutional shareholders as monitors of banks management is that, they are not actually the shareholders. It is said that, “their relationship with the investee bank and with the true shareholders involves a complicated web of ownership and accountability”.³⁵

If the institutional investors manager does not ensure that the investee bank pursue shareholder wealth maximization the shareholders dividend will not be maximized.³⁶ Therefore, from the agency theory perspective there is an added agency problem. The shareholders of institutional investors do not only worry about the possibly divergent objectives of investee bank management but also they have to worry about the activities of their institution’s manager. Therefore, one can safely conclude that the existence of intermediaries (institutional investors) can obscure the bank governance monitoring function.

Institutional investors should encourage regular one-to-one meetings with directors of their investee banks (as the process referred to as “engagement and dialogue”). They should make positive use of their voting rights and should pay attention to the composition of the board of directors in their investee bank.³⁷

Institutional shareholders should establish their own voting policies. One research revealed that there were two types of agents of institutional investors who voted on all issues. The first type is known as “box tickers” because they are simply voting for the sake of voting not reflecting on the

³⁴ The Hamper Report, 1998:at 92.

³⁵ Solomon, *supra note* 24 at 92.

³⁶ Short, H et.al. (1998) ‘Corporate Governance Accountability and Enterprise’, Corporate Governance. An International Review; 6(3): at 165.

³⁷ **Combined Code on Corporate Governance**, July 2003 Par. E3. UK. Also see Solomon, *supra note* 24 at 97.

impact of their votes. The second group did consider their votes carefully and decided in each case whether or not to vote with the incumbent management.³⁸ The former group could hardly be considered effective from bank governance perspective. The later, whereas, is a more responsible approach from bank governance perspective and is likely to result in far more effective monitoring of bank management.

3.3. Regulating Banks' Shareholders in Ethiopia

The NBE is vested with the power to license and undertake surveillance of banking business. Shareholders, as part of bank governance, need to be regulated. The need to regulate shareholders is, among others, to protect depositors, creditors and minority shareholders interests.

The Proclamation precludes the holding of shares beyond five percent of a bank's total shares. The prohibition does not concern the Federal Government.³⁹ The Federal Government is the sole institutional investor that is allowed to hold more than five percent of bank's total shares. However, there is a possibility that regional governments share the privilege given to the Federal Government if two conditions are met. First, the bank must be a bank transformed from a micro-finance institution. Second, the NBE should grant such shareholding by directives.⁴⁰ But no directive to this end is enacted by the NBE until this work. An interview conducted with an official of the NBE⁴¹ revealed that the reasons given for the delay of the passing of directives are lack of man power and time constraint.

Shareholders who have acquired more than 5% of the capital of the bank before the coming in to force of the Proclamation are required to reduce accordingly within the period of time to be determined by the directives to be issued by the NBE. Survey conducted in four previous banks, show that it is allowed to hold up to 20% of the total shares of the bank.⁴² For instance, in Dashen Bank S.C., there are shareholders who hold 20% of the bank's share.⁴³ Moplaco Trading

³⁸ Solomon, *supra* note 24 at 105.

³⁹ See Banking Business Proclamation No., 592/2008, Federal Negarit Gazeta, 14th year, No., 57, 5th August, Addis Ababa: at Article 11(1, 6). (Hereinafter cited as The Bank Business Proclamation)

⁴⁰ *Ibid*, Sub-Article 2.

⁴¹ An Interview with Ato Qurundi Tesgera, Senior Inspector of Banks, Banks Supervision Division of NBE, 09-11-2009.

⁴² See A/ of Association of Awash Int. Bank S.C., Wegagen Bank S.C., Bank of Abyssinia S.C., United Bank S.C., Note has to be taken that banks did not develop an experience of annexing any amendment to their memorandum or articles of association. So, this information may not necessarily represent their current status.

⁴³ One officer of the Bank who does not want his name being disclosed.

Co. Ltd. And NIB Insurance Co. S.C. held 5.6% and 7.3% of NIB Int. Bank S.C.'s share capital respectively.⁴⁴ The NBE's failure to issue such directives, makes the limitation of 5% unpractical in relation to banks established prior to the enactment of the Proclamation at least until the issuance of the directives. It has to be noted that, in a country having no organized stock market it seems difficult to force shareholders to sale out their superfluous shares within a short period of time. However, the NBE needs to enact such directive at least for one very important ground. That is, there is a situation in which major shareholders are highly influencing the management of a bank top to down. A frequent change of directors and presidents (now 7th President) in the Bank of Abyssinia⁴⁵ is said to be due to undue influence from such shareholders. To weaken their muscles, it has to be admitted that, their shareholding needs to be below 5% of the bank's total shares. The NBE is not ignorant about the problem of governance attributed to major shareholders. But it opted to keep silent. Does the influence of major shareholders go to the extent to influence the regulator itself?

The general rule states that, to establish a share company five shareholders and Birr 50,000 capital are prerequisites.⁴⁶ These requirements, however, do not work with regard to banks. The NBE Directives No. SBB/24/99 sets the minimum paid up capital to be maintained by banks. No. 1.1. of the Directives requires banks to obtain a banking business license to have Birr Seventy Five Million. The Proclamation on the other hand prohibits holding more than 5% of a bank's total share.⁴⁷ Five percent of Birr Seventy Five Million is Birr 3,750,000. $\text{Birr } 75,000,000 / \text{Birr } 3,750,000 = 20$ shareholders. Accordingly, at least 20 shareholders are required to meet Birr Seventy Five Million minimum requirement. The minimum five shareholders requirement among founders provided for in the Commercial Code has been amended with regard to banks. Save the case of the Federal Government involving as a shareholder, which is allowed to hold more than 5%.

Shareholders classified as "influential" are subjected to special surveillance. A person who holds directly or indirectly two to five percent of the total subscribed capital of a bank is called

⁴⁴ NIB Int. Bank S.C., Annual Report July 2008-June 2009, at 28. Note that the NIB Insurance Co. S.C. is director of the bank.

⁴⁵ An Interview held with one shareholder of the bank (who requested his name to be kept anonymous), on 10-12-2009.

⁴⁶ Commercial Code of Ethiopia, *supra note* 10; at Arts. 306, 307(1).

⁴⁷ The Bank Business Proclamation, *supra note* 39; at Article 11(1).

“influential shareholder.”⁴⁸ Banks’ supervisor needs to have the power to control transfer of significant ownership.⁴⁹ Accordingly, the NBE is required to approve any transfer of share that makes any person influential shareholder.⁵⁰ Another limitation imposed on influential shareholders is that once they have classified as “influential shareholders” in any bank, they may not acquire shares in other banks.⁵¹ The later may limit investment of wealthy persons in more banks which may discourage the development of banks.

Influential shareholders are required to meet the fitness and propriety criteria to be prescribed by the NBE.⁵² The NBE may suspend the voting right of influential shareholder where such person fails to fulfill the prescribed ethical and propriety requirements.⁵³ Nevertheless, such criteria are not yet prescribed. It is not clear as to the importance of providing such criteria. This as well may limit investment of wealthy persons, who fail to meet the criteria, in banks which may discourage the development of banks.

The effort of the writer to assess the role and/or the influence of influential shareholders in bank governance was troublesome due to the refusal of disclosure of information by banks and the NBE. One officer, who requests to be kept anonymous, in the Bank of Abyssinia, told the writer that the influence of influential and institutional shareholders is a visible problem in relation to getting loan facility with favorable terms. The chairman of the board, directors and the president of the bank were removed or resigned and replaced by others. But the specific ground for their removal or resignation is mysterious. For instance, while the writer writing this paper, four directors have resigned. One director had made a speech to the shareholders general assembly that, the main ground for the resignation is the majority of board members are acting as a rubberstamp of major shareholders acting with their invisible hands.⁵⁴

⁴⁸ *Ibid*, Articles 2(11) and 11(1).

⁴⁹ **Consultative Document: Core Principles of Effective Banking Supervision**, Bases Committee on Bank Supervision, April, 2006:112. (Hereinafter cited as Consultative Document).

⁵⁰ The Banking Business Proclamation *supra note* 39 Article 10(3). Also see Consultative Document *supra note* 49 at 12 criterion 2.

⁵¹ *Ibid*, Article 11 (4).

⁵² *Ibid*, Article 5(1) (h).

⁵³ *Ibid*, Article 11(3). See also Consultative Document; *supra note* 49 at 13, Principle 5.

⁵⁴ An Interview held with one shareholder of the bank (who requested his name to be kept anonymous), on 10-12-2009.

Major shareholders in Ethiopia, do not want to be seen in the board room. But, using whatever means, they struggle the majority seat in the board to be taken by their pupate directors and lead the boat to the direction they want. Their goal is not the remuneration of directors but to get loan to them or to their associates with favorable terms.

Although there are some civil and criminal cases in this relation, the writer unable to get access to these cases as they are pending. Due to loan without or with insufficient collateral, makes a bank to suffer a lot. Even court remedies may subject a bank to incur court fee and ultimately the bank may be left with unexecuted judgments as the judgment debtors might have no sufficient property to satisfy the claim.

The NBE is required to determine the amount of shares that may be held in a bank by institutional investor, which is partially or fully owned by persons who have share in the bank.⁵⁵ But the NBE has not yet enacted directives to this effect.

The NBE may assign observers to attend any general shareholders' meeting of a bank. Moreover, where it finds necessary to safeguard the purpose of bank regulation, call a general shareholders' meeting of a bank.⁵⁶ Although the effect of attending general meetings is not provided, one official⁵⁷ in the NBE told the writer that if irregularities are shown the NBE can take appropriate measure on the spot. But this power of the NBE's act seems to be an ultra virus as it does not have legal ground. The NBE may limit the number of votes by proxy in any meetings of shareholders and voting right of a holder, who borrowed money from the bank.⁵⁸

The effort of the writer to get the practice in relation to the role of institutional shareholders was burdensome because the surveyed banks⁵⁹ are not ready to disclose list of shareholders with their shareholdings by the guise of "confidentiality". The NBE⁶⁰ itself reused to show the writer the memorandum of association and articles of association of banks. However, these organs are

⁵⁵ Banking Business Proclamation *supra* note 39, Article 12 (1) (a, b).

⁵⁶ *Ibid*, Article 13(1) (a, b)

⁵⁷ An Interview with Ato Qurundi Tesgera, Senior Inspector of Banks, Banks Supervision Division of NBE, 09-11-2009.

⁵⁸ Banking Business Proclamation *supra* note 39 Article 13(2).

⁵⁹ Bank of Abyssinia, Wegagen Bank S.C., Oromia International Bank S.C., Dashen Bank S.C., Nib Bank S.C., United Bank S.C., Awash International Bank S.C., Cooperative Bank of Oromia S.C.

⁶⁰ Supervision Division of the National Bank of Ethiopia.

legally obliged to make available the books containing the names of shareholders.⁶¹ This obligation is well understood by the FDRE Ministry of Justice Documents Authentication & Registration Office, which make available to the writer the Memorandum & A/ of Association of each bank.

Accordingly, the writer saw no problem with regard to banks established post the Proclamation with regard to the potential influence as shareholding beyond 5% of the bank's capital is not allowed.⁶² As far as those banks established prior to the enactment of the Proclamations are concerned, memorandum of association and articles of association the writer got from the Office of Documents Authentication and Registration helps a little as they show not the current status of banks but their status during the formation process. For example, Dashen Bank S.C. 's capital was Birr 50,000,000 but now it reached Birr 1,000,000,000⁶³, Bank of Abyssinia S.C., 's capital was Birr 50,000,000 but now it reached Birr 313,141,425,⁶⁴ United Bank S.C. capital was Birr 100,000,000 but now Birr 355,202,724.⁶⁵ This deviation holds the same to all aspect of the banks' information.

It can, however, be said that at present the role of institutional shareholders in bank governance in Ethiopia seems to be insignificant as there are no more than two directors⁶⁶ in the board representing institutional investors. Unlike shareholders' general meetings, the vote in board room is one-man-one-vote. To control the board, therefore, institutional share holders need to take 50+1 seat in the board. There was one situation in which out of the seven seats six seats in the board were taken by institutional shareholders.⁶⁷ This shows a clear control of the bank by institutional shareholders. In the shareholders general meetings things are different. From the consented surveyed three banks, one bank's 65% (Cooperative Bank of Oromia) and above 60%

⁶¹ The Commercial Code, *supra note 10*, Art.221 (4).

⁶² See Art. 5 (5) of Buna Int. Bank S.C.'s A/ of Associations, Art. 5 of Birhan Int. Bank S.C.'s A/ of Associations, and Art. 5 (8) of Zemen Bank S.C.'s A/ of Associations.

⁶³ See Art. 5(1) of the Bank's Memorandum of Association and the 2009 Bank's Annual Report, at 33.

⁶⁴ See the Bank's Memorandum of Association and its annual report of 2009 at 24.

⁶⁵ See Art. 4 of the Bank's memorandum of association and its 2009 Annual Report, at 34.

⁶⁶ Two in Bank of Abyssinia S.C, One in Zemen Bank S.C., previous four now two in NIB Int. Bank S.C., None in Dashen Bank S.C., two in Cooperative Bank of Oromia S.C., one in United Bank S.C., one in Awash Int. Bank S.C., two in Oromia Int. Bank S.C.

⁶⁷ The first directors of Wegagen Bank S.C., see the memorandum association of the bank.

(wegagen Bank) of total votes are occupied by institutional investors.⁶⁸ One should not lose sight that there could be a possibility of a board overwhelmed by institutional shareholders as there is no limitation of membership to institutional shareholders.

3.4. Protection of Minority Bank Shareholders in Ethiopia

The basic rule of corporate law is majority holdings must prevail.⁶⁹ It is only members who hold the majority of the shares can control each and every resolutions of a corporate. Such power in the hands of majority can be misused to exploit the minority shareholders. If the majority are rogues and are not acting bona fide in the interest of the bank as a whole minority rights will be endangered.⁷⁰ Hence, legal & institutional protection of minority shareholders is in order.

Certain exceptions have, therefore, been admitted in the interest of justice to the rule of majority. Palmer has rightly observed in this regard that "...a proper balance of rights of majority and minority shareholders is essential for the smooth functioning of a corporate".⁷¹ A cardinal requirement in corporate governance is that of ensuring that mechanisms that can be built in for protecting minority shareholders.⁷²

At least three different reasons justifying minority protection come to mind. First, if the given country's legal system does not provide for adequate protection of minority shareholders compared to others: foreign investment may not invest in that country. That country's investors look out where proper protection is available. Domestic investors would also be discouraged.⁷³ Second, weak protection of minority shareholders increases the average cost of capital for a company, putting it at a comparative disadvantage with foreign companies. A final reason seems to be no good reason why it should be considered fair & equitable to disproportionately disadvantage minority shareholders compared with large shareholders, only on the grounds that

⁶⁸ Dashen Bank S.C. 25.1% of its total votes are occupied by institutional shareholders, Lion Int. Bank S.C.0.0535% of its total votes are occupied by institutional shareholders and 65.027% total votes of Cooperative Bank of Oromia S.C. are occupied by institutional shareholders (this is due to the nature of the bank which is established mainly by cooperatives) and previously above 60% of Wegagen bank's capital was pulled from institutional shareholders.

⁶⁹ Jain, *supra* note 3; at 427. Also see Case Toss VS. Harbottle (1843) 2 Hare 461.

⁷⁰ *Ibid*, at 429.

⁷¹ *Ibid*.

⁷² Emirates Bank Group (2004) Protecting of Minority Shareholders: 1, Internet source.

⁷³ Timmeman & A. Doorman (2002) "Rights_of Minority Shareholders in the Netherlands", Vol. 6.4, Electronic Journal of Comparative Law: at 2.(Hereinafter cited as Timmerman & A. Doorman)

they hold fewer shares. All shareholders, large or small, should receive adequate protection from the law.⁷⁴

In the majority of jurisdictions, there is no general definition of “minority shareholders”. However, even absent a specific definition, the concept of “minority shareholders” is frequently understood to mean a shareholder that does not exercise a substantial degree of control or influence over the company’s affairs. For instance, in Turkey, the term “minority shareholders” is defined as a shareholder or a group of shareholders holding less than 10% of the company’s capital.⁷⁵ In Thailand, “small or ordinary shareholders” are defined in the shareholders distribution rule to mean ordinary shareholders that do not “take part in management”.⁷⁶

Timmerman & A. Doorman would like to define minority shareholders as those shareholders who, irrespective of the amount of capital they provide, are unable to exercise any significant form of control within the company.⁷⁷ In Ethiopia, neither the Commercial Code nor the Banking Business Proclamation defines who “minority shareholders” are. However, shareholders who hold two percent or more of the total subscribed capital of the bank are influential shareholders.⁷⁸

Minority Rights

Minority rights can be categorized as positive, negative, or normalizing rights. By positive rights we mean the ability to initiate policies by the company that would not have been pursued without the initiative. By contrast, negative rights refer to the possibility for a minority shareholder or a group of minority shareholders to block a resolution that is desired by the majority. The so-called normalizing minority rights refer to the minority shareholders rights to force the company to comply with statutory provisions or the articles of association.⁷⁹

⁷⁴ *Ibid.*

⁷⁵ **Protection of Minority Shareholders in Listed Issuers**, Technical Committee of the International Organization of Securities Commission in Consultation with the OECD, June 2009: at 6.

⁷⁶ *Ibid.*

⁷⁷ Timmerman & A. Doorman, *supra note 73*; at 3.

⁷⁸ The Banking Business Proclamation, *supra note 39*; at Art., 2(11).

⁷⁹ Timmerman & A. Doorman, *supra note 73*; at 3.

1. Access to Information

It is noted that a strong disclosure regime that promotes transparency is integral to shareholders' ability to exercise their ownership rights on an informed bases. Disclosure conceived as a powerful tool for influencing the behavior of banks and protecting investors.⁸⁰ The right of access to information is not without limitation. Disclosure requirements are not intended to place unreasonable administrative or cost burdens on the bank, unless the information is material. Material information can be understood as information whose omission or misstatement could influence the economic decisions made by users of that information.⁸¹

A survey conducted in eighteen countries,⁸² revealed that in all jurisdictions minority shareholders have a right of timely access to the financial statements, books and/or records of a bank.⁸³

In Ethiopia, the Commercial Code provides for rights to inspect documents. Every shareholder (including minority shareholders) may at all times, at the head office, inspect and take copies of the following documents. Balance sheets and profit and loss accounts; reports submitted by the directors and by the auditors to general meetings related to the three preceding financial years; and minutes and attendance sheets of these meetings.⁸⁴

Shareholders who have been denied such rights may appeal to the Ministry of Trade and Industry to enforce the same.⁸⁵ Given the current regulatory responsibility of the NBE, appeal seems to be proper to the NBE rather than the Ministry of Trade & Industry. Furthermore, any shareholder may, during the fifteen days which precede annual ordinary general meetings, inspect and take copies at the head office of the balance sheet and the profit and loss account.

⁸⁰ Protection of Minority Shareholders, *supra note* 75 at 15. Also see OECD Principles on Corporate Governance (2004) Principle V, and the OECD Methodology for Assessing the Implementation of the OECD Principles of Corporate Governance (2006).

⁸¹ Protection of Minority Shareholders, *supra note* 75; at 15.

⁸² Australia, Brazil, Canada, Germany, Hong-Kong, Israel, Italy, Japan, Mexico, the Netherlands, Poland, Portugal, Spain, Switzerland, Thailand, Turkey, UK, and USA. In Hong-Kong, shareholders holding 2.5% shares total paid up capital of HK\$100,000 can seek a court order authorizing them to inspect a bank's records. In Brazil, shareholders holding 5% of shares may seek a court order to gain access to the issuer's books if they suspect any irregularities. In Japan, shareholders holding 3/100 of the votes or more may request from the issuer account books or material used in preparation of account books.

⁸³ *Ibid.*

⁸⁴ Commercial Code of Ethiopia, *supra note* 10; at Art., 406(1) (a-c).

⁸⁵ *Ibid.*, at Art., 404(2).

In addition to these rights as provided for in the Commercial Code, bank shareholders have the following rights. Such rights could be exercised where banks properly discharge duties imposed upon them by the Banking Business Proclamation. Thus, every bank is duty bound to exhibit at every places of its business including its branches, in a conspicuous place throughout the year a copy of the last audited balance sheet and profit and loss account in respect of all of its operations. Besides, every bank has to cause such balance sheet and profit and loss account, together with the notes thereto, to be published in a newspaper of wide circulation.⁸⁶

2. *Shareholders' Meetings*

There is no corporate law that fails to recognize shareholders right to participate in the annual general meetings and to vote per their investment. Attending meetings per se does not warrant minority shareholders right to influence decisions in the meetings. Information in relation to the meeting is indispensable to pass resolutions in the meetings.

In this regard, OECD Principle II.C.1.states:

*Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.*⁸⁷

A survey conducted in eighteen countries⁸⁸, shows that companies are required to hold an annual shareholders' meeting and to provide advance notice of such meetings to all registered shareholders. Certain jurisdictions surveyed also require that the notice be published in newspapers of wide circulation.⁸⁹ In all surveyed jurisdictions, shareholders, including minority shareholders, have a right to require the board to call shareholders' meetings through the minimum shareholdings required to exercise that right varies among jurisdictions.⁹⁰

In Ethiopia, manner of calling general meetings has to be determined by the articles of association and the same is required to be published in a newspaper circulating in the area where

⁸⁶ Bank Business Proclamation, *supra* note 39; at Art., 28 (2) (a-b).

⁸⁷ OECD Principles on Corporate Governance (2004), at Principle II.C.1.

⁸⁸ See, Australia et al., *supra* note 82.

⁸⁹ Protection of Minority Shareholders Rights, *supra* note 75; at 17.

⁹⁰ *Ibid.*

the head office is situate.⁹¹ Such notice in the newspaper shall not apply where all the shareholders are registered and are notified of meetings by registered letter at the company's expense.⁹² Any resisted shareholder has a right to require the company to notify him of meetings by registered letter at his own expense.⁹³

Shareholders representing at least 20% can able their own auditor force auditors to call a general meeting.⁹⁴ This right could be exercised both by minority & majority shareholders. But it has a paramount importance for the former. In Awash Bank S.C. the auditor of the bank called general meeting based on the request submitted by shareholders representing 20% of the Bank's share.⁹⁵ This episode became hot court litigation. (A detailed analysis of the case will be provided under chapter five).

General meetings' resolutions adopted contrary to the law, the memorandum or articles of associations are challengeable. Any shareholder within three months from the entry of the resolution in the commercial register can apply to the court to set aside the resolution.⁹⁶ Even if no specific provision is provided for, there will be no ground to deny a shareholder whose personal rights are infringed to bring the case to the court. In addition, minority shareholders may apply to the court where a fraud is committed to their rights.

3. *Nomination and Appointment of Board Members and Auditors*

The right to elect directors is an important shareholder right. Mechanisms have been adopted that allow minority shareholders to nominate a director or directors. For example, in Germany, employees are entitled to elect a certain number of directors to the supervisory board. In Israel, approval of external directors requires one-third of the votes of shareholders who are not controlling shareholders. In Italy, at least one board member must be elected by minority shareholders.⁹⁷

⁹¹ The Commercial Code of Ethiopia, *supra* note 10; at Art., 392(1).

⁹² *Ibid*, at Art., 392(2).

⁹³ *Ibid*, at Art., 392(3).

⁹⁴ *Ibid*, at Art., 377(2).

⁹⁵ See, Hambissa et.al. v. A.A. Beromhead & Co. Chartered Accountant; The Federal High Court; Appeal Civil File No.58624; Tikimt 15, 2000. (Annexed).

⁹⁶ See, Art., 416(2-6) of The Commercial Code of Ethiopia, *supra* note 10.

⁹⁷ Protection of Minority Shareholders, *supra* note 75; at, 28.

In fifteen jurisdictions, among the surveyed countries,⁹⁸ there are means by which a sub-group of shareholders can elect a director, or directors to the board. In thirteen jurisdictions, there are requirements that limit the level of representation of substantial or controlling shareholders on an issuer's board or board committees.⁹⁹ In five jurisdictions, a substantial or controlling shareholder owes a fiduciary or other duty directly to minority shareholders.¹⁰⁰ In Ethiopia, the Commercial Code provides for some rights of minority shareholders in this regard. Where there are several groups of shareholders with a different legal status, the article of association shall provide for each group to elect at least one representative on the board of directors.¹⁰¹ A survey conducted in eight banks, revealed that in all banks the Articles of Association does not have such rights.¹⁰² If there are such classes of shareholders in a bank, no need to include the right of the same to be represented in the board of directors.

4. Other Rights

Generally, the Commercial Code and the Banking Business Proclamation provide for some rights of minority shareholders. A resolution of a general meeting to modify the rights of a class of shareholders becomes effective only when confirmed by a special meeting of the shareholders in the class concerned.¹⁰³ Two-third majority is required for a resolution to be adopted in an extraordinary meeting.¹⁰⁴ It is only extraordinary meeting that can amend the memorandum or articles of associations.¹⁰⁵ Resolutions to change the nationality or require shareholder to increase their investment in the company have to be adopted where the holders of all shares having voting rights are present or represented and the vote is unanimous.¹⁰⁶

Shareholders representing 20% of the capital can appoint their own auditor.¹⁰⁷ Minority shareholders representing at least 20% of the capital may require the auditors to call a general meeting.¹⁰⁸ Minority shareholders representing one-tenth of the share capital may require the

⁹⁸ See Australia et al., *supra* note 82.

⁹⁹ *Ibid.*

¹⁰⁰ *Ibid.*

¹⁰¹ The Commercial Code of Ethiopia, *supra* note 10; at Art., 352.

¹⁰² Buna Int. Bank S.C., Zemen Bank S.C., Oromia Int. Bank S.C., Bank of Abyssinia S.C., United Bank S.C., Dashen Bank S.C., Wgagen Bank S.C., Awash Int. Bank S.C.

¹⁰³ The Commercial Code of Ethiopia, *supra* note 10; at Art 426.

¹⁰⁴ *Ibid*, at Art., 425(1).

¹⁰⁵ *Ibid*, at Art., 423.

¹⁰⁶ *Ibid*, at Art., 425(2).

¹⁰⁷ *Ibid*, at Art., 366(2).

¹⁰⁸ *Ibid*, at Art., 377(2).

court to appoint an officer and call a general meeting.¹⁰⁹ The Ministry of Trade and Industry has got a regulatory role by reducing the remuneration of directors where it considers it excessive on the request of shareholders representing not less than 10% of the capital,¹¹⁰ although this does not concern banks.

Under the Proclamation surveillance put on influential shareholders, among others, protects the rights of minority shareholders. Any transfer of share that makes any person influential shareholder is invalid unless approved by the NBE.¹¹¹ The limitation imposed on the getting hold of shares more than five percent of bank's total share could be taking as guard of minority shareholders.

¹⁰⁹ *Ibid*, at Art.,391(2).

¹¹⁰ *Ibid*, Article 353(7).

¹¹¹ Banking Business Proclamation, *supra note* 39; at Art. 10 (3).

CHAPTER FOUR

REGULATING BANKS' DIRECTORS

Introduction

The success of any bank depends upon its proper governance. The separation of ownership from control has endangered a situation where the true owners of banks, shareholders, had little influence over bank management.¹ In the case of sole proprietorship, partnership & private limited company, there is no as such separation of management from ownership.² Because the organizations are small and it is practicable for the owners to manage the affairs of the business themselves. In the case of share companies, however, this is neither practicable nor feasible. There is a divorce of ownership & control that has led to the notorious agency problem.³

Similar to other business organizations, a bank, being a factitious person, is not liable to manage its affairs. It must act through human agency. Now the question is who should manage the affairs of the company? Even if the true owners of a bank are its shareholders and it is their duty to manage its affairs; it is not possible for all shareholders to run the day-to-day business of the bank due to the following main reasons. Firstly, the number of shareholders in a bank in most cases is very large⁴; therefore, it is not possible for all the shareholders to participate in the management of the bank. Secondly, the shareholders are scattered over a very wide area and cannot come together to formulate the policies & strategies of the bank. Lastly, the ownership of shares, as a rule, is freely transferable.⁵

It is, therefore, decided that the management of banks must be entrusted to some elected representatives of the shareholders known as “directors”. Banks are expected to exercise management oversight through their boards. Where banks oversight is strong, problems

¹ Solomon J. & Solomon A.(2004) Corporate Governance and Accountability, New Delhi, Wiley India: at 4. (Hereinafter cited as Solomon)

² Jain, D. (1991) Company Law, 3rd edn., Konark Publishers, Delhi: at 274. (Here in after cited as Jain).

³ Solomon, *supra note 1*; at 17.

⁴ For instance, Buna International Bank S.C. has over 11,000 shareholders.

⁵ Jain, *supra note 2*; at 2.

addressed and corrected easily otherwise problems remain uncorrected,⁶ probably resulting in bank failure.

Weaknesses in the banking system of a country, can threaten financial stability.⁷ This obliged the government via its regulatory agencies to undertake surveillance over, particularly, banks' directors. This chapter, therefore, addresses major issues of governing directors' of banks.

4.1. Board and Directors in General

A company is an abstract entity which can act only through individuals. Worth noting that, one of the advantages of incorporation is to form a legal being separate from its owners which could operate at a distance from those members.⁸ Used properly, this enables banks to be run by specialists. Every bank should be headed by an effective board, which is ultimately accountable and responsible for the performance and affair of the bank⁹ and collectively responsible for its success.

There are two ideas about the specific duty of directors. Kinney argues that a board is responsible to manage the business and affairs of the bank. Eisenberg in contrast argues that the board does not manage the bank's affairs in the ordinary meaning of the term. He went on to say that, rather the function is vested in the executives. He added, directors do not and cannot manage banks. He concluded the board does make business policy.¹⁰ The duty of the board should go beyond mere policy formulation since the responsibility put up on it by innocent shareholders is not as such easy.

For a bank to be successful, it must be well governed. It is said that well-functioning and effective board of directors is "the holy grain sought by every ambitious company".¹¹ Board of a

⁶ *Ibid.*

⁷ **Core Principles for Effective Banking Supervision**, Basel Committee of Banking Supervision, Basel, Sep., 1997; at 1. (Hereinafter cited as Core Principles 1997)

⁸ Koutsias M. & Dine J. (2007) Company Law, 6th ed., palgrave Macmillan: at 149. (Hereinafter cited as Koutsias M. & Dine J.).

⁹ Mervyne King (2002) king Report on Corporate Governance for South Africa, Institute of Directors in South Africa: at 21 (Hereinafter cited as King's Report 2002).

¹⁰ Eisenberg M. (1976) the Structure of the Corporation; A Legal analysis, Boston and Toronto, Little, Brown and Company; at 139-40.(Hereinafter cited as Eisenberg).

¹¹Solomon, *supra note 1*; at 65.

bank is its heart and as a heart it needs to be healthy, fit and carefully nurtured for the bank to run effectively.

The board is expected to give strategic direction to the bank and responsible to retain full and effective control over the bank. Added, the board should make sure the bank complies with all pertinent laws, regulations and code of business practice. In addition to these, the board should have unrestricted access to all bank information, records, documents and property.¹²

There are two kinds of directors: executive and non- executive. Executive or inside directors are persons who are full-time member of the management staff. Non- executive / independent/ outside directors are people who have no association with the management of the bank.¹³ They are part-time directors drawn from many walks of life, but lawyers, accountants, and men whose names have some prominence in the commercial community. They are usually chosen on account of some special skill or knowledge which they are able to contribute for the benefit of bank.¹⁴ It is said that, part-time or full-time directors are directors of twenty four hours of the day and their responsibilities as a member of the board are no less than those of any other member.¹⁵

4.2. Agency Theory as a Theoretical Foundation of Regulation of Bank Governance

A number of different theoretical frameworks have evolved to explain and analyze bank governance. Though there are market differences among the various theoretical frameworks, as they each attempt to analyze the same problem but from different perspectives, they do share significant communalities.¹⁶

Under this section, the agency theory will be discussed as it is revealed very pertinent to the rationale of regulating governance & the ways of controlling management.

¹² King's Report, *supra note 9*; at 21.

¹³ N.A. (N.Y.) the Law & Practice Relating to Directors Liability, at 73 .(Hereinafter cited as N.A.).

¹⁴ *Ibid.*

¹⁵ *Ibid.*

¹⁶ Solomon, *supra note 1*; at 16.

Two important events had a dramatic impact on the way in which companies were controlled: the introduction of limited liability & the opening of corporate ownership to the general public through share ownership.¹⁷ As it has been indicated under section 4.1., shareholders of banks are not in position to control the bank. They delegate the running of the bank to its management. Thus, separation of ownership and control created the issue of agency problem.¹⁸

The managers of the company were defined as “agents” and shareholders as “principals”.¹⁹ The problem that arises as a result of agent-principal relation is that managers and directors do not necessarily make decisions in the best interest of the principal.²⁰ The agency theory takes assumptions that the goals of the principal and agent conflict. Managers may pursue their own personal objectives, such as aiming to gain the highest bonus possible i.e. tendency of egoism.²¹ Another important basic assumption of agency theory is that it is expensive and difficult for the principal to verify what the agent is doing.²² Thus, managers prefer to focus on project and corporate investments that provide high short run profits (where managers’ pay related to this variable) rather than the maximization of the long-term shareholder wealth through investment, in projects that are long-term in nature.²³

This agency problem presents shareholders with a need to control company management. An important question is; therefore, ‘how can shareholders control over company management?’. The way out of agency problem can be summarized as follows. First, via their voting at Annual General Meeting (simply, GM) shareholders have the right to influence the way in which the company is run.²⁴ Voting by shareholders constitutes “shareholders activism”. Second, connected to shareholders voting rights is the takeover mechanism, which represents another means of controlling company management.²⁵ If shareholders are dissatisfied with a company’s

¹⁷ *Ibid*, at 17.

¹⁸ *Ibid*.

¹⁹ Rose, S., (1973) “the Economic Theory of Agency: the Principal’s Problem” American Economic Review: at 137.

²⁰ Solomon, *supra note 1*; at 17.

²¹ Boatright J.R. (1999) Ethics in Finance, Blackwell, Oxford; at 80.

²² Eisenhardt K. (1989) “ Agency Theory: An Assessment & Review”, Academy of Management Review; at 59

²³ Demiang, T. & Tylecote, A. (1992) “The Effects of Organizational Culture, Structure & Market Expectations on Technological Enovation: A Hypothesis”, British Journal of Management: at 19.

²⁴ Solomon, *supra note 1*: at 19.

²⁵ *Ibid*.

management, they may resort to the takeover mechanism. The threat of takeover would be effective as managers are unlikely to want to lose their jobs.²⁶

Third, shareholders may attempt to control managers through passing of shareholder resolutions, where a group of shareholders collectively lobby the company on issues with which they are dissatisfied. Shareholders also have the option of selling their shares. Should companies lose major shareholders, the market loses confidence in the company; more shareholders sell their shares price plummets. Without financial support the company will fail.²⁷

Another way out of agency problem is the engagement of government via its regulatory agencies. Since the market mechanism and shareholders' ability are not enough to monitor and control management behavior, some sort of regulation is needed. Governments are, therefore, intervening by producing policy documents and codes of corporate governance best practice.²⁸

4.3. The Structure of Board of Directors

There are four structures of board across the world. These are the non-executive (also called as a single board comprised wholly of independent directors), the executive directors, the two-tier board or the senate board, and the unitary board.

4.3.1. The Non-Executive Board

Here, the board wholly embraces non- executive directors who decide policy and strategy decision- giving responsibilities. Non-executive board has both advantages and disadvantages. To begin with the advantages, given the board's principal function is to monitor management's performance, their independence make them an ideal candidate.²⁹ The main drawback attached to this type of board is that it often distances the board from the realities of operations, particularly when the CEO is not a full member of the board. Jack Welch describes such board as '...an organization which its faces towards the Chief Executive Office and its ass towards the

²⁶ *Ibid.*

²⁷ *Ibid*, at 20.

²⁸ Solomon, *supra* note 1; at 20-21.

²⁹ Eisenberg, *supra* note 10; at 172.

customers'.³⁰ This board is common in USA. In Ethiopia, the Oromia International Bank S.C.'s board structure is one of non-executive board, which has no executive director.³¹

4.3.2. The Executive Board

Directors of this board are individuals who are involved in the day-to-day management and/or are in full time salaried employment of the company.³² Even if strong on knowing what is going on inside the business the chance of delivering their fiduciary duty, through independent and open, is low. In addition to this, this kind of board suffers from critical review of proposals to the board. Thus, it is usually weak on monitoring the outside world. It also suffers from lack of diversity, criticism, and debate in the board meetings.³³ There is no such kind of banks' board structure in Ethiopia even if no law prohibits the same.

4.3.3. The Two-Tier Board

This board is commonly seen in such countries as German, Netherlands, Indonesia and France.³⁴ Under this structure the functions supposedly performed by the single board are distributed between two organs, one entrusted with management and the other with supervision.³⁵ It consists of an upper or supervisory board which deals with the policy and strategic issues and a lower or operational board which represents the different interests in the company. The operational board, also known as managing board is composed of executive directors³⁶ The supervisory board is charged informing the operational board of its intentions in the medium and long term and receiving the performance figures from the operational board.³⁷ In Ethiopia, there is no two-tier board structure. But each bank has the so called executive management body which mainly performs duties of the operational board.

³⁰ Solomon, *supra* note 1; at 20-21.

³¹ The Bank tries to minimize the disadvantage of non-executive board structure by making manager of the Legal Department, who is member of the management, secretary of the board.

³² King's Report, *supra* note 9 at 24.

³³ Garratt B. (2003) The Fish Rots from the Head, Profile Books: at 40.(Hereinafter cited as Garratt B.).

³⁴ *Ibid*, 41.

³⁵ . Eisenberg, *supra* note 10; at 177.

³⁶ Roth, (1973) Supervision of the Corporate Management; the "outside" Directors and the German Experience, at 69.

³⁷ Garratt B., *supra* note 33; at 42.

4.3.4. The Unitary Board

This is the classic board found across the UK and mainly parts of the Commonwealth. The board encompasses two kinds of directors; the non-executive³⁸ and the executive directors. This board assumes that all directors are equal and must accept the same responsibilities and liabilities for the performance of the company.³⁹

The non-executive directors add value by forming policy and ensuring accountability whilst helping the board debate with, and criticize constructively, the executives' actions and performance. The executive directors are responsible for delivering the supervision of the operational side of the business and for agreeing and executing the strategies.⁴⁰

Despite the advantage of a rule mandating complete independence, a rule requiring that only a clear majority of the board be independent would be preferable.⁴¹

Executive directors have the advantage of greater knowledge of the actual business operation of the company. Outside directors are scarcely in position to make decision based on direct knowledge of business operation⁴². However, should they are competent and understanding, and keep themselves properly informed; the judgments they make should be impartial and sound.⁴³

The unitary board said to be with the best potential for being self-correcting⁴⁴ and is advantageous in its positive interaction and diversity of views that take place between individuals of different skills, experience and background.⁴⁵

A balance board, one consisting of both outside and inside directors is probably, in most instances a desirable compromise.⁴⁶ Although there is no specific provision that clearly shows the

³⁸ Non executive directors are individuals not involved in to day-to-day management and not a full-time salaried employee of the company or of subsidiaries. See King's Report at 24.

³⁹ Garratt B. *Supra* note 33; at 43.

⁴⁰ *Ibid.*

⁴¹ Eisenberg, *supra* note 10; at 175.

⁴² N.A. *supra* note 13; at 74.

⁴³ *Ibid.*

⁴⁴ Garratt B. *supra* note 33; at 43.

⁴⁵ King's Report, *supra* note 9; at 21.

board composition being followed by Ethiopian banks,⁴⁷ it is not difficult to conclude unitary board system seems to be followed, though not mandatory. It is stated that the NBE should determine the maximum number of employees of a bank who may be elected and⁴⁸ serve as members in the board of directors of the bank.⁴⁹ Thus, employees of a bank acting as director most likely, but not necessarily,⁵⁰ are executive directors. While currently board of directors of banks in Ethiopia are dominated by external directors essential to put the maximum number of internal directors in a board to keep the board out of the reach of the management. The writer recommends that the mixed directors with the dominance of external directors should be adopted so that the board benefits the virtues of both inside and outside directors.

4.4. Composition of Board of Directors

It goes without saying that banks should be headed by an effective board that can lead and control the same.⁵¹ Board service places increase demands on directors to understand the complexities of the bank and its industries.⁵² The skill, experience and personality of the individual directors nominated should complement each other so that the board can discharge its duties effectively.⁵³ That is why the Basel Committee requires bank regulator, during licensing process, to assess and evaluate the competence, integrity, and qualifications of proposed management, including the board of directors.⁵⁴ Thus, bank directors should consist of leaders who are intelligent, energetic, curious, and caliber.

⁴⁶ A clear majority rule would be effective if the definition of independent is rigorous. Any persons, for example, close relatives of CEO and influential executives must be treated as not independent. See Wharton (1962) School of Finance and Commerce Study of Manual Funds: at 462.

⁴⁷ The following banks have unitary board structure; Zemen Bank S.C., Dashen Bank S.C., Awash Int. Bank S.C., Bank of Abyssinia, United Bank S.C., NIB Int. Bank S.C., Lion Int. Bank S.C., Cooperative Bank of Oromia S.C.

⁴⁸ Banking Business Proclamation, No. 592/2008, Federal Negarit Gazette 11th Year No. 57, Addis Ababa, Art. 14(4)(f).

⁴⁹ *Ibid.*

⁵⁰ There are so called full-time Directors who are individuals employee of the bank on a full-time basis, but differ from executives in that they do not have operational responsibilities. See Eisenberg M. *supra note,10*; at 152.

⁵¹ King's Report *supra note 9*: at 2.2.1.

⁵² Ira M. (1995) "The Professional Board" The Business Lawyer, American Bar Association, University of Mary and School of law,(Vol. 50, No. 4), August; at 1427 (Hereinafter cited as, Ira).

⁵³ Noyes E. and Robert H. (1976) "The Outside Directors of the Publicly Held Corporation" the Business Lawyer, (Vol. 31, No.4), July: at 1807. (Hereinafter cited as Noyes).

⁵⁴ Basel Committee 1997, *supra note 7*; at 17.

As stated supra, the board should comprise the mix of inside & outside directors with a higher proportion of the outside directors.⁵⁵ Both inside and outside directors are essential ingredient for an effective board, as;

*The inside directors provide valuable information about the firm's activities, while outside directors may contribute both expertise and objectivity in evaluating the managers' decisions. The corporate board, with its mix of expertise, independence, and legal power, is a potential powerful governance mechanism.*⁵⁶

The majority of non-executive directors should be independent of management so that shareholders' interests can be protected.⁵⁷

The benefit of a board dominated by outside directors can be gained only by guaranteeing that the outsider is truly independent.⁵⁸ However, to trace independence of a non-executive director will not be easy to attain.

William attempted to put a boundary upon outside independent directors. It described them as those persons who are not involved in the daily operations of the bank. And those persons who are not for a specific number of years officers or employees of the bank, and who do not have a close family relationship to any of its officers.⁵⁹

The propositions that "...outside directors are believed to be guard against many of the abuses those insiders have the power to perpetrate"⁶⁰ is highly questionable. Mace in contrary, argued that "... most inside directors continue to be relatively complaisance, giving inside management a

⁵⁵ Noyes, *supra note* 53; at 1828-29.

⁵⁶ Byrd, J and Hickman, K. (1992) 'Do Outside Directors Monitor Managers?' A Journal of Financial Economics, 196. As quoted in Solomon *supra note* 1; at 69.

⁵⁷ King Report, *Supra note* 9; at. 2.2.1. Also see William J., Feis (1976) "Is shareholder Democracy Attainable?" The Business Lawyer, Vol. 31 No. 2: at 624 (Hereinafter cited as William).

⁵⁸ Noyes, *supra note*, 53; at 1830.

⁵⁹ William J. (1976) "Is shareholder Democracy Attainable?" The Business Lawyer, Vol. 31 No. 2: at 624 (Hereinafter cited as William).

⁶⁰ *Ibid.*

free hand except in the rare instances when a serious management makes decisive action inescapable.”⁶¹

The independence of non-executive directors could be eroded given that most of them, if not now, will have future dealings with the bank, as service provider or seeker, therein the current management (CEO) continues to exist and control the dealings.⁶² The independence of outside directors should be taken seriously as the Enron scandal has underlined the dangers of an ineffective group of non-executive directors and the severe problems that can arise when their independence is compromised through conflict of interest.⁶³

As mentioned earlier, the board composition being followed by Ethiopia seems to encompass both executive and non-executive directors.⁶⁴ However, the number of executive directors is not limited. Even if the Proclamation refers the NBE to issue directives to this end the later did not enact. With regard to the independence of non-executive directors, the Proclamation provides for no rule or standard. A stand seems to be taken non-executive per se warrants independence.

4.5. Directors' Nomination

As a practical matter a bank cannot be managed by shareholder referendum.⁶⁵ Thus, Shareholders nominate directors to direct, conduct, manage or supervise the affairs of the bank.⁶⁶ Every shareholder has a voice in the selection of management. However, in most cases inside management, sometimes with the backing of a control group, selects directors. Management tends to avoid choosing persons who are unlikely to support them. Thus, the directors serve at the pleasure of inside management. This confirms the assertion “... shareholders democracy is a fiction in most public corporations.”⁶⁷

⁶¹ Mace (1971) *Directors; Myth and Reality*: at 47 (Hereinafter cited as Mace). Also see Noyes, *supra note*- at 1831.

⁶² William, *supra note* 59; at, 625.

⁶³ Solomon, *supra note* 1; at 70.

⁶⁴ The Banking Business Proclamation, *supra note* 48; Art. 14 (4) (f).

⁶⁵ **OECD Principles of corporate Governance** (1999) Paris, OECD Publications Service: at 27. (Hereinafter cited as OECD Principles)

⁶⁶ Jain *Supra note* 2; at 274.

⁶⁷ William, *Supra note* 59; at 621.

In some jurisdictions, no body corporate can be appointed as a director of a bank, but an individual.⁶⁸ In contrary, the Commercial Code of Ethiopia grants bodies corporate to be directors, but the Chairman of the board of directors shall be a person.⁶⁹ But there is a bank whose board is chaired by body corporate.⁷⁰ This shows the weakness of the NBE. Only shareholders of a bank are eligible to be elected as director of the bank.⁷¹

It has been suggested that mechanisms need to be in place to enable shareholders to select members of the board.⁷² In the nomination process, the participation of minority shareholders should be taken in to account. Hence, the cumulative voting procedure makes it more feasible for minority shareholders to obtain representation on the board.⁷³ Cumulative voting is said to be a significant force for good. Others criticize that it is disruptive and does not furnish any real power to the minority.⁷⁴ Mattes argues that cumulative voting may actually be counterproductive to the interest of minority shareholders. It went on to reason out that it encourages each director to represent his own particular consistency. It concluded that where there is no cumulative voting each director has a more obvious duty to represent the interest of all the shareholders.⁷⁵ Note is important that non-existence of cumulative voting per se can hardly warrant the conclusion that directors' actions represent the interest of the entire shareholder.

Directors in bank may be appointed in the following ways: (1) by the memorandum or articles of associations;(2) by signatories of the memorandum;(3) by GM;(4) by the directors; (4) by third parties;(5) by proportional representation; and (6) by the government.⁷⁶

In Ethiopia, there are two mechanisms by which directors are appointed. The first is, during the formation of a bank, under the memorandum of association or articles of association subject to

⁶⁸ *Ibid*, at 275

⁶⁹ Commercial Code of Ethiopia, No. 3 of 1960, Negarit Gazeta-Extraordinary Issue, 19th year, No.3 Addis Ababa, Sub-Article 4 of Article 347 (Hereinafter cited as the Commercial Code)

⁷⁰ Endowment Fund for the Rehabilitation of Tigray (EFERT) is the current board chairperson of Wegagen Bank S.C.

⁷¹ Commercial Code of Ethiopia, *supra note* 69; Sub-Article 1 of Article 347.

⁷² William, *Supra note*, 59; at 622-623.

⁷³ *Ibid*, at 623.

⁷⁴ Noyes, *supra note* 53; at 550.

⁷⁵ William, *supra note* 59;at 623.

⁷⁶ Jain, *supra note* 2; at 279-80.

subsequent approval of subscribers. The second is directly by subscribers or by shareholders as the case may be.⁷⁷

It goes without saying that there should be a formal, rigorous and transparent procedure for the appointment of directors to the board.⁷⁸ The appointment of directors must be made on the basis of good experience of industry and experience in life. They must have the self-confidence to stand up to others.⁷⁹ A director, that lacks the business sense to properly understand and appreciate the bank's affairs serves only to give incumbent management an extra vote on every issue.⁸⁰

The crucial aspect of the licensing process is an evaluation of the proposed management including the board of directors. The licensing organ should check the proposed directors' collectively and individually their banking experience, personal integrity and relevant skill.⁸¹ The

⁷⁷ The Commercial Code of Ethiopia, *supra note 69*; Art.,350 (1,2)

⁷⁸ Many proposals are being aired about the nomination process of directors. Among the ideas that have been advanced are:

1. Creation of a roster of eligible and suitable independent directors, perhaps compiled by the regulator, from which banks would be required to select one or more directors who would represent the public interest. See Moscon (1972) "The Independent Director" the Business Lawyer, Vol. 28, No.9, at 12.
2. Election of "Professional Director" Whose Principal occupation and orientation would be to serve on boards of public corporations. (Eisenberg (1975) "Legal Models of Management Structure in the Modern Corporation: Officers, Directors and Accountants" California Law Review, Vol. 63, No. 4; at 388.
3. Election of full-time outside directors, who would be appropriately compensated and would devote their time and efforts to continuous review supervision and direction of management and policy. See William, *supra note 57*; at 637.
4. Allocation of some board representation to government, industry other factions. See Vagts (1966) "Reforming the "Modern" Corporation: Perspectives for the German," Harvard Law Review:
5. Employment of a full staff to serve the outside directors, including, accounting, legal, financial and technical express. See William, *supra note 57*; at 637.
6. Nationwide popular election of directors of the Bank. See William, *supra note 57*; at 638.

⁷⁹ Garratt B., *Supra note 33*; at 226.

⁸⁰ William, *supra note, 59*; at 629.

⁸¹ Basel, 1997, *Supra note 7*; 17.

Basel document recommends that the regulator should set fit & proper criteria such as skill, expertise, integrity & no record of criminal activities.⁸²

Neither the Proclamation nor the pertinent directives provides for procedures of appointment of directors of banks except saying, “directors shall be appointed by shareholders’ GM”. The experience of banks shows that there is no as such formal procedure of appointment of directors. Given the sensitivity of the overall banking business and the involved public interest the law should have come up with provisions regulating selection procedures of directors. On the part of the NBE, a position seems to be taken that appointment procedure should be left to the shareholders as they will not let their interest being compromised.⁸³ However, this seems evading the problem rather than facing.

In some jurisdictions the so called ‘nomination committee’ is made responsible to come up with potential directors. It is used as a means of formalizing the procedures whereby shareholders may participate in the directors’ selection process.⁸⁴ This bank governance structure provides a working-sized group to whom shareholders may submit their recommendation for nominations to the board of directors. In Ethiopia, some banks have been experiencing directors’ nomination committee.⁸⁵

There is a struggle among major shareholders to get membership in the board due to, as per the interviewed NBE official;⁸⁶ the exorbitant directors’ remuneration. The writer believes that nomination committee may play a role in smoothing the appointment procedure and makes up shareholders participation. Besides, the law must set clear and objective directors’ appointment rules and procedures.

⁸² **Core Principles Methodology**, Basel Committee on Banking Supervision, Basel, Oct., 1999; at 16.

⁸³ An interview with Ato Semere Welde, Bank Inspector, Supervision Division of NBE, April 19, 2009.

⁸⁴ Corporate Directors Guidebook: “Comments Submitted by the American Society of Corporate Secretaries” the Business Lawyer’s Vol. 33 No. 1, November 1977; at 332.

⁸⁵ Zemen Bank S.C., Awash Int. Bank S.C., and Lion Int. Bank S.C., have directors’ nomination committee Bank of Abyssinia, as per an interview conducted with Ato Nigatu Tesfaye Head, legal Dept. of the Bank, has adhoc directors’ nomination committee.

⁸⁶ An Interview with Ato Kurundi Tesgera, Senior Bank Inspector, Supervision Division NBE, 25,Nov., 2009.

Banks' directors may not serve on a board for more than six consecutive years. However, re-election for one more term is possible provided that the number of board members so re-elected shall be limited to a maximum of one-third of the outgoing board members.⁸⁷ However, the Com. Code provides no limitation on the reelection of directors.

In this regard, it is interesting to note a case brought to the Federal 1st Instance and appealed to the Federal High Court.⁸⁸ The plaintiffs asked the court to cancel Art. 5.1.4 and Art. 5.1.5 of Licensing and Supervision of Banking and Approval of Directors and CEO Directives No. SBB\39\2006. The ground was these provisions contradict with Arts. 347(1) & 350 (3, 4) of the Com. Code. The Commercial Code⁸⁹ states that directors may not be appointed for more than three years, save the case of reelection. It, however, prohibited simultaneous re-election of two directors. The Code does not limit the rate or frequency of re-election, save contrary indication in the memorandum or articles of association. But some articles in the directive prohibit some rights provided in the Code. They read;

5.1.4. Prohibition

- i. A board member of a bank shall not, at the same time, serve as a board member of any other financial institution;*
- ii. Chairperson of board of directors of a bank shall not be chief executive officer of the same bank.*

5.1.5. Rotation

- i. A director shall not serve on a board of a director for more than six consecutive years; however, he/she may be re-elected after a lapse of six years.*
- ii. Notwithstanding provisions of article 5.1.5.(I) herein above, if the shareholders of a bank wish to maintain continuity in the board and re-elect some of the existing board members, they may re-elected such board members*

⁸⁷ Licensing and Supervision of Banking and Approval of Directors and CEO Directives No. SBB\39\2006,5.1.5.

⁸⁸ Hibret Insurance S.C. et al v the National Bank of Ethiopia, Federal 1st Instance Court, File No. 93620. & Federal High Court Appeal File NO. 64552. See annex 1.

⁸⁹ Commercial Code, *supra note* 69 ; Art. 350 (3, 4, and 5).

for only one more term. The number of board members so re-elected shall, however, be limited to a maximum of 1/3 of the outgoing board members.

Both the lower & the higher courts decided that the NBE has no power to enact directives with such articles amending the above stated articles of the Com. Code. Thus, the articles contested were cancelled. Note that, Arts. 14(2) & 15(3) of the Proclamation has resumed the prohibition which was provided under Art. 5.1.4 of the Directives. Art. 14(4) (d) of the Proclamation lets the NBE to issue directives on the maximum number of years a director may serve in any bank & the conditions for his re-election. But this does not mean that the abrogated articles under the above case resume.

The NBE is believed to make sure that each and every act and measures taken by it are within the scope of its power and in with the relevant law.

Licensing and Supervision of Banking and Approval of Directors and CEO Directives, No. SBB\39\2006 sets for rules for appointment of Directors and Selection Criteria. Educational criteria may comprise two qualifications. Accordingly, at least seventy five percent of a board's members shall hold a minimum of first degree or equivalent from recognized higher learning institution. And the remaining board members should at minimum complete general secondary school or its equivalent.⁹⁰ Members of Board of Directors shall have adequate managerial experience, preferably in banking business, and \or should take adequate training in banking business management after holding a seat on the board.⁹¹ This may perhaps help the board discharge its responsibilities properly; without losing sight that further relevant training is indispensable to cope up with changing circumstances. Having in mind the complexity of bank business & the interest involved, minimum educational requirement seems to be inadequate. To this end, the minimum educational requirement for directorship should be first degree.

The Directives further states that each nominee director shall be a person with honesty, integrity, diligence and reputation to the satisfaction of the bank.⁹² In determining propriety the NBE has

⁹⁰ Directives No. SBB\39\2006, *supra* note 87; Art.5.1.1.

⁹¹ *Ibid*, 5.1.2.

⁹² *Ibid*, 5.1.3.

provided some leading considerations.⁹³ Thus, the board member is required to answer to some questions related to criminal and disciplinary records, unfortunate business and managerial history, among others.

A director shall not sit on the board of a bank if he or a business entity in which he served or is serving as director or CEO:

- Has filed for bankruptcy, been adjudged bankrupt, had assets sequestered, or been involved in court proceedings related to any default on credit repayments or tax payment;
- Carries non-performing loans as defined in the Bank's relevant directives from any bank.⁹⁴

Appointment of members of a board of directors for a bank shall be subject to approval by NBE.⁹⁵ To this end, banks are required to submit to the NBE written request for such approval along with completed propriety test questionnaire and other relevant document necessary to process the approval.⁹⁶ The NBE rejected the appointment of two directors of a bank one due to unable to meet appropriateness test, the other was serving as a board member in an Insurance company.⁹⁷ Besides, the NBE rejected one bank's⁹⁸ director on ground he has double nationality. The law requires shareholders to be nationals that it does not prohibit double nationality. That as it may, had the NBE undertook a glance examination of the memorandum of association nationality would have not been the issue during approval of directors.

In relation to appointment of CEO (president) of banks, the Commercial Code and the NBE's Directives No. 39/2006 confirms that their appointment has to be carried out by directors. The board of a bank is required to take in to account at the time of the appointment of CEO the following considerations;⁹⁹

- whether the person has ever been diagnosed as being mentally ill or unstable;

⁹³ *Ibid*, Annex 1.

⁹⁴ *Ibid*, at 5.1.6.

⁹⁵ The Banking Business Proclamation, *supra* note 48; at Art., 14(2) and NBE Directives, *supra* note 88; at, 5.1.4., 5.3.1.

⁹⁶ NBE Directives, *supra* note 88; at 5.3.2.

⁹⁷ Zemen Bank S.C.

⁹⁸ Wegagen Bank S.C.

⁹⁹ Directives No. 39/2006, *supra* note 88; at 4.2 and the Com. Code, *supra* note 69; Art. 348(3).

- whether the person has ever been fined, suspended, removed, or his professional license revoked by a professional, trade or regulatory body because of incompetence, fraud, negligence, or violation of laws, rules, regulations and professional code of conduct;
- whether the person has ever been fined, demoted, dismissed or requested to resign from any position or office for incompetence or mismanagement by his employer;
- whether the person has been convicted of crime involving a breach of trust or a fraud; (a point should be made in relation to this requirement. The very purpose of punishment is to rehabilitate the criminal and join the society with a clean mind. Punishing a person denying any level of job in the bank will contradict the purpose of punishment.)
- whether the person holds a minimum of first degree or equivalent from a recognized higher institution of learning;
- whether the person has a minimum of 10 years experience in banking, of which at a minimum, five years shall be in senior managerial position; extra.

In this relation, the NBE rejected one bank's¹⁰⁰ president on ground lack of a minimum of 10 years experience in banking.

The NBE regulates appointment of directors primarily, by setting qualification of competency to be fulfilled by nominee-directors (without losing a sight on the applicable directive was enacted to enforce the repealed proclamation). Secondly, the NBE regulates appointment of directors by fixing the minimum number of directors in the membership of the board of directors of a bank. Thirdly, the NBE fixes the maximum number of years a director may serve in any bank and the conditions for his re-election.¹⁰¹

It deserves mention here that what parameter uses to select where the director is a body corporate. There are many bodies of corporate acting as a director.¹⁰² There is no legal ground (or impossible) to measure the competency of bodies corporate to act as a director unless the

¹⁰⁰ Wegagen Bank S.C. An Interview with Ato Gebisa Teresa, Legal Expert at Wegagen Bank S.C., 27th Nov. 2009.

¹⁰¹ Banking Business Proclamation, *supra* note 48; at Art., 14(4) (a-d).

¹⁰² Two in Bank of Abyssinia S.C, One in Zemen Bank S.C., previous four now two in Nib Int. Bank S.C., None in Dashen Bank S.C., two in Cooperative Bank of Oromia S.C., one in United Bank S.C., one in Awash Int. Bank S.C., two in Oromia Int. Bank S.C.

competency of the agent representing these bodies in the board. The NBE investigates the competency of the person representing the body corporate.¹⁰³

Such regulatory scheme should have been managed by issuing directives. However, following the enactment of the Proclamation such regulatory tools are not yet addressed by directives. Fragmented and sometimes contradicting previous directives are left to govern post Proclamation period.

Note that the applicable Directives is enacted not to implement the current proclamation but to make effective the already repealed proclamation. This may raise the issue of legality of the directives as its mother proclamation is no more in operation.

4.6. Directors' Remuneration

Levels of remuneration should be sufficient to attract, retain and motivate executives of the quality required by the board to run the bank successfully.¹⁰⁴ Though offering salaries that are high enough to attract directors of adequate caliber, capable of running large organizations, it is vital to establishing a balance between detectors' salaries and their competency and performance. So, bank should avoid paying more than necessary for this purpose.¹⁰⁵

There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.¹⁰⁶ This helps to avoid conflicts of interests. Banks are recommended to set a remuneration committee consisting entirely or mainly of independent persons, to make recommendations to the GM about specific remuneration packages for directors.¹⁰⁷ A survey conducted in nine, one refused to respond, banks in Ethiopia shows that

¹⁰³ An Interview with Ato Kurundi Tesgera, Senior Bank Inspector, Supervision Division NBE, 25th ,Nov., 2009.

¹⁰⁴ King's Report, *supra note 9*; at 258, and Solomon, *Supra note 1*; at 258.

¹⁰⁵ Solomon J., *supra note 1*; at 258.

¹⁰⁶ *Ibid.*

¹⁰⁷ King's Report, *supra note 9*; at 25.

none of them has a remuneration committee.¹⁰⁸ The board itself or the shareholders should determine the remuneration of directors.¹⁰⁹

The Ethiopian Commercial Code states that the amount of directors' remuneration shall be fixed by shareholders general meeting. The articles of association may provide for that the directors may receive a specified share in the net profits, not exceeding 10%, of a financial year.¹¹⁰ It is interesting to note that 10% of the annual net profit of banks is not a simple payment given the high profitability of the same. Interestingly, the Ministry of Commerce is called up on to reduce the remuneration of the directors where it considers it excessive on the petition of shareholders representing not less than 10% of the capital.¹¹¹ But this power can hardly be exercised by the Ministry of Trade & Industry in relation to banks as banks' regulation is given to the NBE.

The Proclamation directs the NBE to issue directives on the maximum remuneration of directors of a bank.¹¹² As it has been pointed out above, remuneration of directors beyond attracting knowledgeable and experienced persons to the board puts the bank in risk. This power of the NBE gives it a green light to amend the 10% maximum requirement of the Commercial Code. It is a big backlash against the general principle of law making process and hierarchy of laws. Because a proclamation made by the parliament is allowed to be amended by directives to be issued by an executive organ.

There has been a growing reaction and support from banks¹¹³ against the power vested in the NBE, which limits the maximum remuneration of directors. The former argued that none of the business of the NBE to fix the maximum payment of directors. Their grounds are, first, the payment is from the net profit of the bank. Second, since the legal reserve and sufficient amount

¹⁰⁸ Awash International Bank (S.C.), Dashen Bank (S.C.), Wegagen Bank (S.C.), Bank of Abyssinia (S.C.), United Bank (S.C.), Cooperative Bank of Oromia (S.C.), Lion International Bank (S.C.), Zemen Bank (S.C.), Oromia International Bank (S.C.), Nib International Bank S.C. refused to respond.

¹⁰⁹ Solomon Jill, *supra note 1*; at 260.

¹¹⁰ The Commercial Code of Ethiopia, *supra note 69*; at Art., 353(1, 2).

¹¹¹ *Ibid*, sub 7.

¹¹² Banking Business Proclamation, *supra note 48*; at Art., 14(4) (e).

¹¹³ Among the surveyed eight banks; banks 12.5% has objected and 87.5% has supported. Also see A commentary Document on the Draft Banking Business Proclamation Prepared by Private Banks' Association.

for various risks have been deposited and so long as the shareholders have granted it observing the limit put by the Commercial Code there in no public or state interest to be protected. Further, they went on to say that it is against the ownership right of shareholders limiting their right to decide on their property. The later however argues given the huge profit of banks makes the remuneration exorbitant. Furthermore, the contribution of directors to a bank is not commensurate the level of payment. Ato Kurundi Tesgera, Senior Bank Inspector at NBE says for three reasons, at least, the NBE assumes such power. First, “banks are not only the property of shareholders but also the property of depositors who have deposited Millions of Birr”. So the NBE is responsible to protect depositors’ interest. Second, “uniformity of payment for directors should be secured among banks”. Third, the high amount of payment has created “gangsters” in the bank who assume directorship by whatever means at the expense of the interest of the bank.¹¹⁴ However, the writer suspects that fixing the maximum remuneration of directors would avoid “gangsters”, protect the interest of depositors and maintain uniformity of payments among banks. Because, manipulation of election has to be controlled by formulating working system or procedure for the election not by fixing payments. Uniformity would have been maintained had the Proclamation given power to the NBE to set clear-cut payment for directors. Lastly, it is not clear that in what ways depositors’ interests are protected by curbing excessive board fees because the reduced amount rather goes to shareholders dividend.

A survey conducted shows that the maximum payment of directors is 5% of annual net profit of the bank.¹¹⁵ No bank has crossed the maximum limit set by the Commercial Code and set directors’ remuneration. So, no bank should be blamed in this regard. The blame, if any, goes to the Commercial Code. The author would like to argue that the Proclamations should have not given such power to the NBE rather it could have amend and reduce the 10% upper edge of the Commercial Code to certain amount (perhaps 5%) so that different interests are accommodated. Though no bank has paid over five percent, it seems fair enough to reduce the ten percent to five

¹¹⁴ An Interview with Ato Kurundi Tesgera, Senior Bank Inspector, Supervision Division NBE, 25th, Nov., 2009.

¹¹⁵ Nib Int. Bank S.C., 5%- for example in 2009 the bank has paid Birr 352,829.75 for each director, Awash Int. Bank S.C., 5%-Oromia. Int. Bank S.C., 3%, Bank of Abyssinia, if the annual profit is up to Birr 100,000,000 they will get 3%, if the profit is more than Birr 100,000,000 they will get 5%- for example in 2009 the bank has paid Birr 199,613 for each director, United Bank S.C., 5%- for example in 2009 the bank has paid Birr 389,937.33 for each director, Cooperative Bank of Oromia S.C., none except some fixed payment, Wegagen Bank S.C. 5% - for example in 2009 the bank has paid total 4,495,435 Birr for all director. Note has to be taken that directors fee is liable to 35% income tax.

percent. Five percent of the annual profit is not as such excessive because if banks earned no profit directors go un-paid. For instance, per 2008/9 Annual Report of Bank of Abyssinia in 2008 each director was paid 309 Birr (35 % taxed). Moreover, we should not forget that directors are the heart of the bank thus they are supposed to do their level best for the healthy management and profitability of the bank. Furthermore, they may be subjected to civil and/or criminal liability if something goes wrong. Besides, they are responsible to conduct directorial business reading bulk reports and pass risky decisions. Hence, it is reasonable where shareholders pay reasonable directors' fee out of their dividends as they earned at the expense of the later, among others.

4.7. Removal of Directors, CEO or Senior Executive Officers

In Ethiopia, banks' as any forms of Share Company, directors, CEO or senior executive officers of a bank may be removed at any time by general meetings of shareholders¹¹⁶ and by the NBE¹¹⁷ with sufficient reason. Note that share companies' directors may not be removed by the NBE except banks. A director, CEO or senior executive officer removed from directorship by general meeting of shareholders without good cause may claim compensation. Though it is not provided in the Proclamation, a director, CEO or senior executive officer removed short of sufficient reason by the NBE should request reinstatement and/or claim compensation from the NBE.

Although the Commercial Code provides nothing as to what things constitute "good cause" the Proclamation provides for the following.¹¹⁸

- Acting as a director, CEO or senior executive officer having criminal records of breach of trust or a fraud;
- Acting as a director, CEO or senior executive officer by a person who had been director or senior executive officer of any bank that wound up without prior approval of the NBE,
- Assuming double directorship of bank and a financial institution;
- Acting as a director, CEO or senior executive officer by an employee of a bank chairperson of the board of directors of that bank or a director of any other bank;

¹¹⁶ The Commercial Code of Ethiopia, *supra* note 69; at Art., 354.

¹¹⁷ The Banking Business Proclamation, *supra* note 48; at Art., 17(1).

¹¹⁸ *Ibid*, sub 2.

- Acting as a director, CEO or senior executive officer in a bank having ten percent or more equity interest in a business entity or a company;
- Acting as a director, CEO or senior executive officer in another bank by bank's employee;
- To be a chairperson of board by an employee of that bank;
- If the director, CEO or senior executive officer of a bank or a company in which he is a director, CEO or senior executive officer has instituted bankruptcy proceedings or declared bankrupt, or his or the company's assets have been sequestrated because of bankruptcy or been foreclosed by a bank because of failure to repay a loan granted by the bank failed to resign;
- Acting as a director, CEO or senior executive officer having been convicted of default on repayments of bank's or other credits or tax payment;
- Acting as a director, CEO or senior executive officer while he or the company in which he is a director or executive officer carries non-performing loans;
- Acting as a director, CEO or senior executive officer while he fails to fulfill any of the qualification of competency requirements set by the NBE; and
- Any action by the director detrimental to the stability or soundness of the financial sector, the economy or the general public interest.

It is quite striking to note the point as to why and on what ground the Proclamation has given the power of removal of directors, CEO and senior executive officer of a bank to the NBE. Basically appointment and removal of directors, CEO, and senior executive officer should be carried out by shareholders' GM, board and CEO respectively. It is to this end that banks are strongly objected the power of the NBE to remove directors, CEO and senior executive officer. As to them the NBE should submit to the respective bank if it deems necessary the removal of officials. If the NBE is allowed to do this by itself, it encroaches to the freedom of banks and shareholders right.¹¹⁹

¹¹⁹ A Commentary Document on the Draft Banking Business Proclamation, un pub., prepared by Private Banks' Association; Tahisas 4, 2000; at 7.

The writer more worries not on the power of the NBE to remove officers of a bank but the ground of removal. One of grounds of removal is, if the officer acted as director, CEO or senior officer of any bank that wound up. Though a bank highly involves public interest in it, it should not be forgotten the fact that it is a business organization created by shareholders' volition. Any time it may be wind up by shareholders' agreement securing the consent of the NBE. From this it follows that an officer of a bank wind up by shareholders' agreement and the consent of the NBE may be removed from directorship, CEO or senior executive officer in other bank. This is unwarranted and unreasonable. Even if the bank wound up due to insolvency, the contribution of the given director to the bankruptcy of the bank should be investigated to be taken as a ground of its removal.

Another ground of removal is "...any action detrimental, **in the opinion of the NBE**, to the stability or soundness of the financial sector, the economy or the general public interest..." ¹²⁰ [Emphases mine]. This ground is more of subjective, incalculable and unpredictable that may be ill-treated by the NBE. In addition, the right to be heard of the removed or suspended officer has not been put in place.

Where the NBE removes directors of a bank and as a result of the removal the number of directors reduces below the minimum¹²¹ it shall immediately assume the powers of board of directors. The NBE, within 30 days, shall call a meeting of shareholders for directors to be elected to replace the removed directors.¹²² The Commercial Code has got clear remedy in case the number of directors falls below the minimum required by law. The surviving directors or auditors can take care of the problem. So, there is no concrete and convincing ground that the NBE takes the power of the board of that bank but it may erodes public confidence resulting in irreversible injures on the bank. A survey conducted in eight banks,¹²³ show that there is no director removed from office before term save the case of resignation.

¹²⁰ The Banking Business Proclamation, *supra note* 48; Art. 17(2) (b).

¹²¹ Even if the NBE is required to fix the minimum number of directors in a board no directives has been so far enacted. The Commercial Code however states that "A company shall have no less than three no more than twelve directors who shall form a board of directors". The Commercial Code of Ethiopia, *supra note* 67; at Art., 347(2).

¹²² *Ibid*, sub 3.

¹²³ See *supra note* 113.

4.8. Duties and Responsibilities of Directors

Effective control over banks' entire business helps for the attainment of bank regulation goals. Effective control over banks' can hardly be achieved should there be weak or no framework of directors' duties and responsibilities. The Basel Document for Supervision of Bank states that laws, regulation or the regulator should establish the responsibilities of directors and senior management with respect to corporate governance to ensure that there is effective control over banks.¹²⁴

Delegation of directors' authority and responsibility for running the bank on a daily basis to officers may not relieve directors from assuming ultimate accountability to shareholders.¹²⁵ Directors owe their duty to the bank rather than to shareholders or to potential shareholders. This however does not mean that directors have no liability to the shareholders, they do but indirectly.¹²⁶ In other words, directors owe duty directly to the bank and indirectly to the shareholders. This is particularly significant where the enforcement of those duties is in question, because the general rule is that directors' duties can only be enforced by the bank suing directors. It is difficult however to separate the interests of the bank from those of shareholders, because companies' interests are defined primarily in terms of what benefits the shareholders.¹²⁷

Directors owe the bank three duties; (1) duty of care ;(2) duty of loyalty; and (3) duty of obedience.¹²⁸

4.8.1. Duty of care and skill

Directors may be liable to the bank if they do not exercise the proper degree of care in the performance of their duties. Duty of care refers to the situation in which directors devote time, exercise ordinary diligences and use reasonable judgment to ensure the bank is run prudentially

¹²⁴ Consultative Document: Core Principles for Effective Banking Supervision, Basel Committee on Banking Supervision, April, 2006: at Principle 17, criterion 1.

¹²⁵ Forest E. (2005), Basics for Directors, Division of Supervision & Risk Management, Federal Reserve Bank of Kansas City; at 53. (Hereinafter cited as Forest)

¹²⁶ Alexander K.(2004) Corporate Governance & Banking Regulation, University of Cambridge; at 14.(Hereinafter cited as Alexander)

¹²⁷ *Ibid.*

¹²⁸ Forest, *supra note* 126; at 53.

and with due regard for the bank's shareholders.¹²⁹ A director must display merely the degree of skill that may reasonably be expected of a person of his skill & experience.¹³⁰

The test of what constitutes due care and skill has been stated in several ways.¹³¹ Some argue that 'reasonable person' test would not be applied whereas others argue that 'reasonable person' test should apply to directors.¹³²

Modern English company law would set forth three important standards regarding the duty of care and skill for directors. First, a director is not required to demonstrate degree that would exceed what would be expected of a person with the directors' actual level of skill and knowledge. Second, a director is not concerned himself on a continuous basis with the affairs of the company, as his or her involvement will be periodic & will be focused mainly at board meetings and at other meetings at which he is in attendance, and he is not required to attend all meetings, nor to be liable for decisions that are made in his absence. Third, a director may properly rely on company officers to perform any day-to-day affairs of the business while not being liable for any wrongdoing of those officers in the absence grounds for suspension.¹³³

4.8.2. Duty of Loyalty/ Fiduciary

Duty of loyalty means a director will not engage in activities or make use of information obtained as a director that benefits him/ her at the expense of the bank.¹³⁴ It is also understood as acting *bona fide* to the interests of the bank.¹³⁵ A fiduciary is one who acts primarily for the benefits of another in the fulfillment of undertakings.¹³⁶ Investors, who buy shares place trust and confidence in the directors and officers of the bank that issue them, expecting them to manage and work for the bank to make it profitable.¹³⁷

¹²⁹ *Ibid.*

¹³⁰ Keeling D. (2002) Corporate Finance: Public Companies & the City, Britain, Hobbs the printer Ltd of Southampton, at 16. (Hereinafter cited as Keeling)

¹³¹ Reitzel D. et.al. (1990) Contemporary Business Law: Principles & Case, 4th ed., McGRAW-HILL Pub. Company, at 871.

¹³² Alexander, *supra note 127*; at 14,15.

¹³³ *Ibid*, 15.

¹³⁴ Forest, *supra note 126*; at 53.

¹³⁵ *Ibid*, 15.

¹³⁶ Kapla S. (1997) "Fiduciary Responsibility in the Management of the Corporation", The Business Lawyer, Special Issue, Vol. 31, Feb., at 88.

¹³⁷ Reitzel D. et.al. (1990) Contemporary Business Law: Principles & Case, 4th ed., McGRAW-HILL Pub. Company;

Directors owe a bank duty to act in good faith and in the interest of the bank. They must not make a secret profit. They must exercise their powers only for the purpose for which they were given. And they must seek to avoid putting themselves in a position where their interests conflict with those of the bank.¹³⁸

In UK, the fiduciary duties of directors fall into the following categories: the directors may act only within the course and scope of duties conferred up on them by the bank memorandum or articles of association, and they must act in good faith in respect to the best interest of the bank. Moreover, a director who finds himself or herself in the position of having a conflict of interest will be required to take corrective measures.¹³⁹ Besides, duty of fiduciary of directors contains to devote reasonable time and effort to the performance of the directorial duties and to investigate suspicious circumstances.¹⁴⁰

4.8.3. Duty of Obedience

Duty of obedience means directors will obey applicable laws in their personal dealings with the bank & ensure their bank is complied with laws & regulations.¹⁴¹

4.8.4. Other Duties

Though, beyond these basic duties there is no definitive list provides for basic responsibilities, it is not impossible to highlight some additional duties of directors. Directors hold various responsibilities to the bank they direct. Firstly, they are responsible to provide the bank with competent management. Providing capable and working management is the responsibility of directors. If management is poor all area of the bank's operations suffers.¹⁴²

Directors should prepare plan for the bank. Long term direction and goals for a bank is important to make sure there is an ordinary transaction from where the bank is today to where it will be

at 873.

¹³⁸ Keeling, *supra* note 131; at 16.

¹³⁹ Alexander, *supra* note 127; at 15.

¹⁴⁰ Kapla S. *supra* note 137; at 88.b

¹⁴¹ Forest, *supra* note 126; at 53.

¹⁴² *Ibid* at 54.

tomorrow.¹⁴³ Another key responsibility of directors is to establish written operating policies covering various aspects of the bank's operations.¹⁴⁴ In addition to these, directors are responsible to establish the necessary internal control to provide feedback on compliance & adequacy of policies put in place. Moreover, directors are responsible to take cognizance where the bank stands. That is to say, to be effective directors should remain knowledgeable about the bank's financial condition and adequacy of its internal audit.¹⁴⁵ To remain knowledgeable about the bank's affairs, directors are responsible to attend regular and special board and committee meetings. Attending meetings per se does not suffice rather directors need to participate in the deliberations.¹⁴⁶ Directors may not come to meetings to act as a rubberstamp for internal management or major shareholders.

Another essential responsibility of bank directors is evaluating bank management. Forest rightly observed that:

*[It is an] inescapable responsibility of directors to see that management is doing its job. The wise choice of capable management and the removal of management that fails the responsibility are true central and culminating responsibilities of the board.*¹⁴⁷

To elect the competent bank officers per se does not warrant the proper running of the bank but directors need to advise them, approve their actions, & audit their performance¹⁴⁸ and if that is necessary to remove failed officers. Evaluating the management requires directors to assess financial statements, internal/external reviews conducted or commissioned by the board, and supervisory examination reports.¹⁴⁹

In Ethiopia, the Proclamation calls upon the NBE to issue directives with regard to the duties and responsibilities of banks' directors.¹⁵⁰ Banks are against such power of the NBE. They argue that so long as the duties and responsibilities of directors' are provided for in the memorandum and

¹⁴³ *Ibid.*

¹⁴⁴ *Ibid.*, at 55.

¹⁴⁵ *Ibid.*

¹⁴⁶ *Ibid.*, at 56.

¹⁴⁷ *Ibid.*, 58.

¹⁴⁸ Ray G. et. al., (1966) "Duties & Liabilities of Corporate Directors", the Business Lawyer, Vol. 22., No. 1, at. 31.

¹⁴⁹ Forest, *supra* note 126; at 58.

¹⁵⁰ Banking Business Proclamation, *supra* note 48; at Art., 14(3 (c)).

articles of association and in laws no need for the NBE to come up with the same.¹⁵¹ It appears to be important, they added, the Proclamation could address it rather than giving the power to the NBE to set it by directives.¹⁵² The writer believes the regulator should have such power as it is important to set a clear duties, responsibilities and good corporate governance of board of directors of banks. What are provided under the respective banks' memorandum and articles of associations are not adequate.

The NBE is in default to enact the directives. At this juncture, one thing deserve attention, the NBE shows big hesitation in enacting very essential directives which highly affect its regulatory task. A regulator which is responsible to supervise banks' directors can hardly carry its duties without setting out the basic responsibilities for the board of directors and its members.

Duties and liabilities of directors provided for under the Commercial Code¹⁵³ do not suffice to regulate the current state of affairs of companies in general and banks directors in particular. It is important to note that the 50 years old Code can hardly fit the current development in all aspects. Put otherwise, relying on a code enacted 50 years ago to regulate a highly sensitive sector involving public interest and the nation's economy is absolutely badly chosen. Next we shall discuss the relevant provisions of the Com. Code in relation to duties and responsibilities of directors.

¹⁵¹ A Commentary Document on the Draft Banking Business Proclamation, un pub., prepared by Private Banks' Association; Tahisas 4, 2000; at 10.

¹⁵² *Ibid.*

¹⁵³ Articles 362 & 364 of the Commercial Code provides for the following duties & liabilities of directors. Keeping regular records of the management & of meetings, keeping accounts and books, submitting the accounts to the auditors & annual reports of the company's operations including a financial statement to the meetings and convening meetings as provided in the articles of association. Setting up the reserve funds required by law or the article of association and applying to the court where the company stops payments. Directors shall be responsible for exercising the duties imposed on them by law, the memorandum or articles of association and resolution of meetings, they shall be jointly and severally liable to the company for damaged coursed by failure to carry out their duties and when they fail to take all steps within their power to prevent or to mitigate acts prejudicial to the company which are within their knowledge. Furthermore, directors shall be responsible for showing that they have exercised due care and diligence.

For any damage, or loss that may happen to the company, acts or omissions of directors, the directors are jointly and severally liable to the bank.¹⁵⁴ Thus, each of the directors is responsible for faults and failure of the other. Where liability emerges out because of decisions passed by the directors, a director contending no fault on his part has to prove that he has exerted due care and diligence. Thus, the burden of proof falls on the director. If any one of the directors fails to prove or if the evidence adduced is not acceptable, the director(s) concerned may be liable for the loss that happened to the bank. If a particular director did not take part in a particular action he shall not be liable provided that he has caused a minute dissenting from the action which has been taken by the board.¹⁵⁵

Per Art. 365 of the Code, there shall be a resolution to bring a legal action against the directors. Shareholders desiring action to be taken against directors have to petition for a meeting or ask the directors to call a meeting. The meeting of the members may pass a resolution to institute a case against the director or not to proceed.

If the directors have committed fault or fraud on the creditors, the creditor can bring action against the directors. The only security of the creditors is capital of the bank. If the directors have misused the property and as a result the bank failed to pay its debt, the creditors can sue the directors for the loss. In such a case, if the petition of the creditors is granted directors may be compelled to pay from their personal property.

Shareholders in their personal capacity may also bring action against the directors. This is the situation in which their personal rights are infringed by the directors. This right is also available to a third party. If a certain director causes personal harm to the third party using his power, the third party can sue the director.¹⁵⁶

It is quite striking to note that among the surveyed eight banks only three of them do have directors' code of conduct and disciplinary rules.¹⁵⁷ Not only the NBE but also most banks have no code of conduct to control directors.

¹⁵⁴ Commercial Code of Ethiopia, *supra* note 69; at Art. 364.

¹⁵⁵ *Ibid.*

¹⁵⁶ *Ibid.*, Art., 367.

¹⁵⁷ Zemen Bank S.C., Lion Int. Bank S.C., and Oromia Int. Bank S.C.

4.9. Conflict of Interests

It is inevitable that a bank faces actual and potential conflicts of interest periodically. A bank's policy is to take all reasonable steps to maintain and operate effective organizational and administrative arrangements to identify and manage relevant conflicts.¹⁵⁸

Recent scandals in the financial industry in the United States have raised the question whether the market can adequately control conflicts of interests. The policy responses to these recent corporate scandals suggest that markets are relatively ineffective and imply that new regulation is needed to prevent any further loss of investors' confidence in the financial system.¹⁵⁹

Asset management services for clients may be required to manage a variety of actual or potential conflicts of interests. Conflict of interests would be understood as any circumstance where the interests of different parties, such as the interests of related parties on the one hand & client and those of the bank on the other are inconsistent or divergent.¹⁶⁰

Related parties can be perceived as board members, CEO, and their parents, wife, children, and other persons or entities that would reasonably be considered or perceived to be related to the board member. It also includes companies controlled by the board member or by the board members family or employee or its associates and any companies connected with those companies.¹⁶¹

The common law rule against conflicts of interest is a natural incident of the fiduciary nature of a director's role. Essentially, it requires that a director avoids situations in which there is a real and sensible possibility of conflict between the director's personal interests and the bank's interests.¹⁶² Insider transactions require considerable disclosure & prudence in handling. Loans to

¹⁵⁸ **Global Conflicts of Interest**, A Passion to Perform, Deutsche Bank, August, 16, 2007; at 1.

¹⁵⁹ Eugene N. (2004), Can the Market Control Conflict in the Financial Industry, Department of Economics Rutgers University; at 1.

¹⁶⁰ Statement of Policies Respecting Conflicts of Interests, **National Bank Trust (Canada)**, N.Y.; at 1. (Hereinafter cited as National Bank Trust).

¹⁶¹ ADCB Directors Conflict of Interest Policy, May, 2, 2009; at 1. (Hereinafter cited as ADCB Directors Conflict of Interest Policy).

¹⁶² *Ibid.*

directors, executive officers, and their related interests are permitted, but certain procedures and limitation must be followed. Loans for relatives or business partners of directors would require a director to abstain from voting. Ideally, the director will physically leave the room when voting occurs on these loans.¹⁶³

Bank should develop policies and procedures to ensure that such dealings are monitored and restricted. Banks should also establish systems to avoid them.

The overriding principles of directors in relation to conflict of interest are the following. Firstly, board members must not use their position, or confidential information obtained by them relating to the bank or its customers, in order to achieve a benefit for him or a related party.¹⁶⁴ Secondly, no board member should allow his outside activities to interfere with his work for the bank, allow any conflict between his duties to the bank & his outside interests to affect his ability to act appropriately as a board member.¹⁶⁵ Thirdly, a board member need not be troublesome to affect its reputation.¹⁶⁶ Fourthly, board members need to be aware of potential conflicts between the bank, its shareholders & other related parties & should remain aware that their overriding duty is to act in best interest of the bank.¹⁶⁷

A bank is a financial institution which grants loan in the ordinary course of its business. Loan to the board members & their related parties raise potential conflict of interests. The bank should adopt a policy whereby loan will only be granted to board members and their related parties on arm's length terms. In addition there must be maximum limits of loan set by a regulator.¹⁶⁸ Member of the board & managers should be required to disclose any material interests in transactions or matters affecting the bank.¹⁶⁹

In Ethiopia, regulating conflicting interest in the governance of bank is governed by the Commercial Code, the Proclamation, NBE's Directives and by the NBE. The Commercial Code

¹⁶³ The Director's Primer, **A guide to Management Oversight & Bank Regulation**, 3rd edn., 2002; at 31.

¹⁶⁴ ADCB Directors Conflict of Interest Policy, *supra note* 162; at 2.

¹⁶⁵ *Ibid.*

¹⁶⁶ *Ibid*

¹⁶⁷ *Ibid*

¹⁶⁸ *Ibid*, at 2.

¹⁶⁹ OECD principles, *supra note* 65; at 34. Also see ADCB Directors Conflict of Interest Policy, *supra note* 162; at 3.

provides for two articles as far as managing conflict of interest of directors with the bank or clients are concerned. Directors are prohibited, unless otherwise approved by the GM, from being a partner with joint and several liability in rival companies nor compete against the bank either on their own behalf or on behalf of third parties.¹⁷⁰

Another area that the Code addresses is dealings between a company and its directors. Any dealings made directly or indirectly between a bank and a director shall receive the prior approval of the board of directors and notice shall be given to the auditors. Board's approval is a requirement in respect of any dealings made between a bank and another concern where one of the directors of the bank is owner, partner, agent, director or manager of such concern. Dealings not approved shall remain in force but the director concerned shall be liable for damages arising from fraud and if he fails to meet his liability the board of directors shall be liable. The GM assumes the ultimate power based on the report to be submitted to it by the auditors.¹⁷¹

The Proclamation does not provide for a provision about conflicts of interest between directors or senior management and a bank. However, based on the power vested with it by the Proclamation, the NBE addressed the issue as an insider trading or as related parties¹⁷² by enacting directives.¹⁷³

This directive defines related parties categorizing in to two groups. The first category includes:

*A shareholder, [shareholders with holdings of 5% or more of a banks subscribed capital] a director or a principal officer of that bank and/ or the spouse or relation in the first degree of consanguinity or affinity of such shareholder director or principal officer.*¹⁷⁴

¹⁷⁰ The Commercial Code of Ethiopia, *supra* note 69; Art., 355.

¹⁷¹ *Ibid*; Art., 356(1-5).

¹⁷² It has to be noted that, the term "insiders" is interchangeably used with the term "related parties". For instance, the directive opts to use the term "related parties" instead of using the term "insiders".

¹⁷³ Banking Business Proclamation, *supra* note 48; Art., 22 (1) And 59(2).

¹⁷⁴ National Bank of Ethiopia Directive on Limitation on Loan to Related Parties, Directive No.30/2002, Art.2.6 First Paragraph. (Hereinafter cited as NBE Directives No. 30/2002).

Accordingly, the most important insiders are the ones listed out in the first category. This is because the second category insiders or related persons are business organizations in which the first category insiders have direct interest.¹⁷⁵

Insider lending or otherwise called as connected lending simply refers to the loan advanced by a bank to “insider parties that are connected to the bank through ownership or ability to control” same in one or another way.¹⁷⁶ Insider lending under Ethiopian law, thus, refers to loans extended by a bank to shareholders, directors or principal officers like top managers of the bank, persons to whom these parties are related by marriage or blood in first degree or to businesses in which these persons have an interest as share holder, director, principal officer, owner or officer.¹⁷⁷

One may wonder as to why the law imposes restrictions on insiders in taking loans from the banks in which they are closely linked in one or more of the above relations. It is worth mentioning that the banking system will be small and its ability to finance consumption and investment will be reduced unless individual and business enterprises deposit their wealth in banks.¹⁷⁸ Once customers deposit their wealth, they relinquish control over it to bank insiders who can abuse it by lending in an imprudent manner.¹⁷⁹ Depositors will not deploy their wealth so long as they feel not confident that insiders will behave prudently or unless they can be convinced their wealth is not at risk.¹⁸⁰

Moreover, unless there is a restriction on their power of lending, insiders will get opportunity to abuse their power by, for instance, receiving loans at favorable terms which in turn adversely affect the interest of many stakeholders.¹⁸¹ Insider lending with favorable terms and conditions, may include: extension or renewal of loan after date of payment, an insider loan made in violation of law that exposes the lending bank to risk, loan against the lending bank’s loan

¹⁷⁵ *Ibid.*

¹⁷⁶ *Ibid.*, at 3.

¹⁷⁷ NBE Directive No. 30/2002, *supra note 175*, V , Art,2(6)

¹⁷⁸ Stephen H. (2005) Banking with and without Insurance: Mexico’s Banking Experiments, at 2.

¹⁷⁹ *Ibid*

¹⁸⁰ *Ibid*

¹⁸¹ Luc L. (2001) “Insider Lending and Bank Ownership”, *Journal of Comparative Economics*, Washington Dc, June. at 3. (Hereinafter cited as Luc L.)

policies, insider loans with special or extra- ordinary terms or conditions which are not available for ordinary borrowers.¹⁸²

Insiders may use various ways to secure loans with favorable terms and conditions. For instance, insiders may exert undue influence so that a bank manager extends loan at a subsidized rates and other favorable terms. Bank managers may also be threatened that they may be fired or demoted unless they extend loans with favorable terms.¹⁸³ Furthermore, insider lending is more susceptible to bribe than lending to outsiders. Insiders may easily convince the managers by, for instance, sharing the proceeds of the loan. Hence regulator needs to put a gaze at on to them.

The NBE Directives No. 30/2002 provides for the following restrictions on insider lending.

- 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 apply to other borrowers.*
- 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 capital of the bank.*
- 4.3. The aggregate sum of loads extended or permitted to be outstanding directly or indirectly to all related parties at any one time shall not exceed 35% (thirty five percent) of the total capital of the bank.*

Accordingly, it strictly prohibits loans to insiders with favorable conditions in terms of the condition of lending, interest rates and repayment period which is not available for ordinary borrowers. Secondly, it is not allowed for an insider to borrow at one time an aggregate sum exceeding 15% of the total capital of the bank. Thirdly, the sum total loan of all insiders cannot exceed 35% of the total capital of the bank.

These restrictions, however, are not without exceptions. The restriction does not extend to cover loans or extensions of credit fully secured by cash collateral and loans fully secured by cash

¹⁸² Stephen B., (2002) *Prohibition In Regulation Against Loans With “Unfavorable Features”*, May 2002, at 6.
¹⁸³ Luc L., *supra note 182*; at 6.

substitutes.¹⁸⁴ If the loan is secured by cash collateral or cash substitutes, the law does not put limitations on the lending right of insiders.¹⁸⁵ The rationale for this holding seems the security attached to the loan which is believed to avoid the risk of repayment.

However, these exceptions should not be extended to the limitation provided under art 4.1. of the directives. Because the existence of security does not guaranty that the loan is free from preferential terms, favorable conditions in relation to the conditions of the loan, interest rate and repayment period.

Regulating Conflict of Interests

Insiders lending with favorable condition saddles the banks with large amount of overdue debt. Hence, such preferential loans need to be drastically reduced.¹⁸⁶ The directives on limitation on loans to related parties provides for mechanisms of enforcement of the limitations. It requires each bank to submit a report to the Supervision Department of the NBE.¹⁸⁷ The report has to be filed within twenty days after the end of the period for which the data are reported.¹⁸⁸ Each bank is expected to include in the report month-end exposures to each related party.¹⁸⁹

To this end, the NBE has prepared a formal table for effecting the report. The table requires inclusion of borrowers' name and all facilities extended to them such as over drafts, term loans, merchandise loans, letter of credit facilities, guarantees, etc.¹⁹⁰ Besides, in case the collateral is financial guarantee bond, the report should indicate whether it is issued by affiliated or non-affiliated financial institution.

184 NBE Directives No. 03/2002, Art 5.

185 NBE Directives 30/2002, Art. 2(2)-Cash Collateral Art. 2(3)- Cash Substitute . *These articles provide for the meaning of cash collateral and cash substitute. accordingly, cash collateral refers to credit balances on accounts in the books of the lending bank over which customers have given the lending bank a formal letter of cession and which the bank at its discretion has transferred from the customer's account(s) or blocked. cash substitute on the other hand refers to a security issued by the federal government of Ethiopia; an unconditional obligation or guaranty issued in writing by the Federal Government of Ethiopia or a non affiliated domestic financial institution, where the beneficiary bank maintains a current written and well documented evaluation evidencing that the non-affiliated financial institution is financially sound and capable of honoring the guaranty on demand with respect to repayment of both principal and interest, or a specific amount, and the lending bank has not been advised of any determination by the guarantor to deny payment under the terms of the obligation or guaranty; and an unconditional obligation or guaranty issued in writing by a foreign bank with an a or above rating by standard and poor's corporation and / or by moody's investor services in their latest rating.*

186 Luc L., *supra* note 182; at 5.

187 NBE Directive No. 30/2002, *supra* not 175, Art.7.

188 *Ibid.*

189 *Ibid.*

190 *Ibid.*, Report Table on Monthly return on Loans to Related Parties.

The roles each bank is required to play in relation to insider lending mainly include identification of insider parties.¹⁹¹ In addition, it is expected that it devises internal controlling mechanism to ensure that loan facilities to insiders are given in accordance with the limitations provided in the directive. Further, the bank is duty bound to provide necessary and timely information in report form so that the NBE would be in a position to carry out its regulatory functions.¹⁹²

The further issue is what if a bank fails to report or violates the limitations imposed by the directive. It has been stipulated that non-compliance with the requirements of any of the directives of the NBE entails a penalty of Birr 10,000 for each violation.¹⁹³ On top of such penalty, the NBE may take any other measure it considers necessary.¹⁹⁴ This may lead the NBE to abuse its power as such power is not predictable. Moreover, if any director or management personnel intentionally produced any false or misleading information or omits to include any information in any book, account, report or statement, the law imposes penalty of Birr 50,000 to 100,000 and rigorous imprisonment of 10-15 years.¹⁹⁵

The consequence of this is that it triggers the criminal machinery of justice in to motion. The effect of this is it pulls the organs of criminal justice into the fore. Thus, the police, the court and the public prosecutor form part of the regulatory organs of insider lending.

In exceptional situation, if the bank intentionally violated any of the limitations imposed, the NBE may even snatch the administration power from the bank and appoint a receiver on its place.¹⁹⁶

The calamity in the Bank of Abyssinia has been contributed largely by loan to related parties or major shareholders with insufficient collateral and/or with favorable terms. Major shareholders' arms stretch not only to the board but also to the management and loan committee.¹⁹⁷

191 *Ibid*, Art 6.

192 *Ibid*, Art. 7.

193 NBE, Penalty for Non-Compliance with the Directives of the NBE, Directive No. SBB/35/2004, Art. 2.

194 *Ibid*.

195 Banking Business Proclamation, *supra note* 48, Art. 58(6) (B). See Also the NBE Establishment Proclamation No. 591/2008, (As Amended) *Federal Negarit. Gazeta*, 11th Year No. 50, 11th August 2008, Art. 6(2) (A).

196 Banking Business Proclamation, *supra note* 45, Art. 33(1)(E).

197 An Interview with one shareholder who wants his name to be kept anonymous, 8-12-20009.

CHAPTER FIVE

THE ROLE OF AUDITORS IN BANK GOVERNANCE & THEIR REGULATION

Introduction

In the previous chapter, discussion was held about bank directors. This chapter examines the role of auditors in bank governance and their regulations. The auditing function is shown to play an essential role in good bank (corporate) governance, emphasizing the importance of corporate transparency and communication with shareholders and other stakeholders. Transparency is an essential ingredient for a sound system of bank governance. If accounting is not reliable and fraudulent confidence in the bank decline and may end up with bank collapse. Given the regulatory responsibility upon the NBE and the role of audit in good bank governance, this chapter focuses on the audit system of banks in Ethiopia.

5.1. Auditors in General

Audit represents the most indispensable bank governance; checks and balances that help to monitor bank management's activities, thereby increasing transparency.¹ It goes without saying that transparency is an essential ingredient for a sound system of bank governance.² Auditors are regarded as a watching dog of shareholders. They watch for irregularities and report the same to the general body of shareholders and regulators.

In this relation, the Cadbury Report emphasized that:

*The annual audit is one of the cornerstones of corporate governance
The audit provides an external and objective check on the way in which
the financial systems have been prepared and presented.*³

¹ Solomon J. & Solomon A. (2004) Corporate Governance and Accountability, New Delhi, Wiley India: at 137. (Hereinafter cited as Solomon).

² *Ibid*, at 36.

³ Cadbury Report, 1992, p.36, para.5.1.

From an agency theory perspective, the audit function helps shareholders in their monitoring and controlling of bank management. The audit of a bank's financial statements makes disclosure more credible, thereby instilling confidence in bank's transparency. Failure in the audit system contributes for the collapse of a bank. For example, failure of the audit function was one of the principal factors that contributed to Enron's downfall.⁴

Audit is an independent, objective assurance and consulting activity to add value and improve a bank's operations.⁵ Conflicts of interests are frequent problem in the audit profession. Independent appointment of bank's audit by the bank's shareholders is frequently replaced by subjective appointment by bank's bosses, where the audit is all too often obliged to the bank's senior management.⁶ In Ethiopia, in some banks the general assembly appoints the board to select external auditors by bid and submit for final approval to the former.⁷

Audit firms are supposed to be ethical and realistic. If they go contrary to this, they become not only the cause for the failure of the bank they audit but also their own. For example, in America Arthur Andersen, one of the Big Five audit firms, involved in Enron's fraudulent accounting and auditing by hiding company's liabilities and off- balance sheet so that the financial statements look much better than they really are.⁸ Thus, Enron collapsed, which was the biggest corporate collapse ever and the downfall of Arthur Andersen the most significant and shame full death of an accounting firm ever.⁹

5.2. Regulating Bank Auditors in Ethiopia

A bank in Ethiopia may have two kinds of auditors. These are internal auditors and external auditors. Under this chapter we shall discuss the case of external auditor.

⁴ *Ibid*,37.

⁵ Mervyne King (2002) king Report on Corporate Governance for South Africa, Institute of Directors in South Africa: at 33 (Hereinafter cited as King's Report).

⁶ Solomon, *supra note* 1; at 38.

⁷ For example in Wegagen bank S.C., Zemen Bank S.C., Dashen Bank S.C., Bank of Abyssinia(un official Interview), Awash Int Bank S.C.,

⁸ Solomon, *supra note* 1, at 36.

⁹ *Ibid*, at 38.

52.1. Appointment and Revocation of Auditors

The Proclamation obligates any bank to appoint external auditors. The appointment of such auditors shall be approved by the NBE. It has to be noted that the NBE has no formal & legal minimum professional experience and knowledge requirement to measure the appointment of external auditors though the Proclamation¹⁰ empowers it to set the same. If a bank fails to appoint an external auditor the appointment of auditor of such bank shall be made by the NBE.¹¹ An auditor who has been appointed accordingly shall hold office until the next annual general meetings of the shareholders of the bank.¹²

The Commercial Code states that auditors shall be appointed by meeting of subscribers and by the general meeting subsequently. The maximum term of external auditor is three years.¹³ There is a bank which does not change its external auditor since its establishment (1987).¹⁴ Though the rate of reelection of auditors is not limited, such long time tenure may minimize the independence of auditors as there could be a possibility of creation of strong relationship with the management of the bank.

Shareholders representing not less than 20% of the capital may appoint an auditor selected by them. From the surveyed eight banks¹⁵ there are no auditors appointed by shareholders representing 20% of the capital. Where there is more than one auditor, they may exercise their duties jointly or separately.¹⁶ Auditors who have been elected by subscribers shall hold office until the first general annual meeting. Auditors elected at an annual general meeting may hold office for three years.¹⁷

¹⁰ The Banking Business Proclamation, No. 592/2008, Federal Negarit Gazetta 11th Year No. 57, Addis Ababa, at Art. 25(1). (Hereinafter cited as the Banking Business Proclamation).

¹¹ Bank Business Proclamation, *supra* note 10; Art., 24(1), (4).

¹² *Ibid*, Art. 25(2)

¹³ Commercial Code of the Empire of Ethiopia, No. 3 of 1963, Negarit Gazeta-Extraordinary Issue 19th year, No. 3, Addis Ababa, article 369. (Hereinafter cited as the Commercial Code of Ethiopia)

¹⁴ A.A. Bromhead & Co. Chartered Accountants UK Registered Auditor, Auditors of Awash Int. Bank S.C., An Interview with Ato Desta Dinka, Attorney at Awash Int. Bank S.C., 10th of Nov, 2009.

¹⁵ Zemen Bank S.C., Awash Int. Bank S.C., Dashen Bank S.C., Oromia Int. Bank S.C., Cooperative Bank of Oromia S.C., Lion Int. Bank S.C., Bank of Abyssinia S.C. (unofficial interview), Wegagen Bank S.C.,(Interview). The status of Buna International Bank S.C., Nib International Bank S.C., & United Bank S.C., in this regard is not clear as they refused to fill the questionnaire disturbed for the purpose of this paper.

¹⁶ The Commercial Code of Ethiopia, *supra* note 13, Art., 368(1-3).

¹⁷ *Ibid*, Art., 369.

Founders, contributors in kind, beneficiaries holding special benefits, directors of the bank or of one of its subsidiaries or of its holding company are not eligible to assume auditors' office. Besides, spouses or relatives by consanguinity or affinity to the first degree inclusive, of such persons are not competent to be elected as auditors. Persons who receive from the persons mentioned above a salary or periodical remuneration in connection with duties other than those of an auditor may not be elected as auditors. Audit firm of which any partner or a staff member falls with the categories provided here above.¹⁸ The ground for the exclusion is to keep the audit office independent and neutral which is crucial for the effective functioning of auditors.

Auditors may not be appointed directors or managers of the bank which they audit nor of one of its subsidiaries or its holding companies within three years from the date of the termination of their functions.¹⁹

The remuneration of auditors shall be fixed by the general meeting. Where a general meeting fails to agree on the remuneration, the Ministry of Commerce and Industry may be called upon to fix the remuneration.²⁰ It has to be recalled that given the supervisory role of the NBE on banks, the Power given to the Ministry of Commerce and Industry seems to be exercised by the former. Revocation of auditors can be made at any time by a general meeting. But auditors' right to any claim for wrong full dismissal will not be affected.²¹ Any bank the external auditor of which terminates its service before its term office is required to notify forthwith such fact to the NBE.²² Dissimilar to directors, CEO and senior executive officer, the NBE has no power to remove auditor of a bank. But the NBE if not satisfied with the external audit report requires the prompt appointment of a new auditor.²³

¹⁸ Commercial Code of Ethiopia, *supra note 13*, Art., 370. Also see the Bank Business Proclamation, *supra note 10*; Art. 24 (2) (a-c).

¹⁹ *Ibid*, Art. 370(2)

²⁰ *Ibid*, Art. 372.

²¹ *Ibid*, 371.

²² The Banking Business Proclamation, *supra note 10*; Art. 25 (3).

²³ *Ibid*, Art. 27(3).

5.2.2. Power, Duties and Liabilities of Auditors

As that of directors, auditors have to discharge their official and ethical responsibilities. In order to discharge their duties properly auditors should keep their independence. Auditor's independence could be compromised due to the close relationship that is inevitable between auditors and bank managers and due to auditor's wish to develop a constructive relationship with their clients for future selection.²⁴ It is crucial to ensure that an appropriate relationship exists between the auditors and the management whose financial statements they are auditing.²⁵ The possibility of establishing compulsory rotation of auditors as this could be a means of avoiding cozy auditor-client relationships.²⁶

The role and duties of auditor should be clearly identified. In this regard, Solomon has rightly stated the proper role of auditor as follows:

...the auditor's role is not to prepare the financial statements; nor to provide absolute assurance that the figures in the financial statements are correct, nor to provide a guarantee that the company will continue as a going concern, but the auditor has to state in a annual report that the financial statements show 'a' true and fair view rather than 'the' true and faire view.²⁷

Thus, the role of directors and external auditors has to be demarcated. Directors are responsible for preparing the financial statements per the applicable laws, regulations and Generally Accepted Accounting Principles. Auditors, on their part audit the financial statement in accordance with relevant legal & regulatory requirements and Generally Accepted Auditing Standards and to express an opinion on these financial statements based on their audit and whether the financial statements are properly prepared per the relevant laws.²⁸

²⁴ Solomon, *supra* note 1; at 139.

²⁵ Cadbury Report (1992) at 38, para.5.7.

²⁶ Solomon, *supra* note 1; at 141.

²⁷ *Ibid*, at 139.

²⁸ United Bank S.C., Annual Report June 30, 2009; at 22. Almost all external auditors who have audited banks aware of such duties see each bank's annual report 2007-2009.

The Commercial Code provides for duties of auditors. Auditors have to maintain professional secrecy. Auditors are responsible to audit books and securities of the bank, to verify the correctness and accuracy of the inventories, balance sheets and profit and loss account. Moreover, auditors are duty bound to certify that the report of the board of directors reflects the correct state of the bank's affairs.²⁹

The auditors, in the absence of directors, may manage the affairs of the bank, this; however, is very exceptional. Sometimes, it may happen that all the directors may resign or leave the office for any reason. In such a case, until new directors are appointed, the auditors may manage the bank on behalf of the board.³⁰ Hence, auditors beyond their inherent duties may involve in the managing of the affairs of a bank.

If auditors breach any of the duties spelled out in the Commercial Code or article of association, they may be liable. They may be civilly liable for fault that brought loss to the bank and third parties depending upon the effect of the fault. Where the auditors have conspired with the directors and committed crime, they may be subject to criminal liability.³¹

In addition to what is provided in other laws, external auditors are duty bound to report their audit findings and conclusions to the shareholders of the bank and the NBE. A person appointed as an auditor of a bank may not operate an account with, or be granted any type of loan, advance or facility from, the bank except in the normal course of business and at arm's length basis.³²

External auditors are required to report to the NBE and concerned organ if they come up with a serious breach of or non-compliance with laws, a crime involving fraud or other dishonesty and losses have been occurred which reduce the total capital of the bank by 25% or more. Besides, if they get serious irregularities that may jeopardize the bank's ability to continue conducting its business or the security of its depositors or creditors, auditors shall immediately report the matter to the NBE.³³

²⁹ Commercial Code of Ethiopia, *supra* note 13; at Art. 374.

³⁰ *Ibid* Art., 351 (4,5).

³¹ *Ibid*, Art., 380 (2).

³² The Banking Business Proclamation, *supra* note 10; Art., 26.

³³ *Ibid*, Art., 27 (4).

One controversial duty of auditors is the consequence of to calling general meetings where shareholders representing at least 20% of the capital so request.³⁴ Issues such as; when should such shareholders exercise this right, what possible decisions could be taken by the meeting is not yet clear.

Hot litigation³⁵ was conducted in relation to the duty provided for under Art. 377(2) of the Com. Code. Under this case, on Miyazia 13, 1999 E.C. shareholders GM of Awash Int. Bank S.C. appointed directors. Shareholders representing 20% of the total share of the Bank were disappointed by the appointment and requested the auditor (AA Beromhead & Co. Chartered Accountant) to call a general meeting per Art. 377(2) of the Com. Code. The auditor called the meeting and prepared agenda to reelect the directors. The elected board members instituted a suit against the act of the auditor to the Federal 1st Instance court Lideta Chilot. The court, recognizing the legality of the call of the GM rejected the agenda prepared by the Auditor.

The Auditor appealed to the Federal High Court objecting the decision of the 1st Instance Court. The Federal High Court revised and decided the Auditor can, short of knowledge of the board, call GM meetings per Art. 377(2), it is possible to change the resolution of the previous meeting and the auditor can prepare agenda for the meeting. Hence, the external auditor based on Art.377 (2) can call the GM and change the resolution, selection of directors, passed by previous GM meeting. Accordingly, the meeting had changed some directors. The result of the meeting witnessed the deceitfulness of the previous election. This is so because a director who had been removed by previous meeting had got first place in the meeting conducted by the Auditor.³⁶

Although shareholders have the right to challenge the resolution of the GM before the court per Art. 416, there is no obligation to go to the court rather than to request the auditor to call GM so that previous resolutions be revised. The court of appellate, in the opinion of the writer, was right.

5.3. The Contribution of the Audit Committee in Bank Governance

Typically the audit committee is appointed by and reports to the full board of directors.³⁷ The primary function of audit committee is to assist the board of directors in fulfilling their fiduciary

³⁴ Commercial Code of Ethiopia, *supra note* 14; at Art., 377 (2).

³⁵ See, Hambissa et.al. v. Beromhedina & his Company Charter Accountant; The Federal High Court; Appeal Civil File No.58624; Tikimt 15, 2000. See Annex 1 to view the decision.

³⁶ An Interview with Ato Desta Dinka, Attorney in Awash Int. Bank S.C., on 10th, Nov., 2009.

³⁷ Richard J. Farrell (1972) " The Audit Committee-A Lawyer's View" the Business Lawyer, Vol. 28, No. 4; at 1090. (Hereinafter cited as Richard & Farrell)

responsibilities by overseeing the bank's financial reporting and public disclosure activities.³⁸ The members of audit committee shall be elected by the Board and shall be comprised of independent directors.³⁹

Two factors make audit committee a necessity. The first is the investing public lacks confidence in reporting financial information. The second is the responsibilities of directors for, and may incur liability as a result of, misleading financial statements.⁴⁰

A properly functioning audit committee of the board of directors might rectify, in part, the failings of the board. The audit committee may serve as a forum for designated outside directors to deliberate as unit out of the view of the executive directors, in certain potentially sensitive matters, before reporting their findings to the full board.⁴¹ This is so because members of such committee are non-executive directors.

The major functions of audit committee could be summarized as follows. The first is to review the financial statement prior to recommending approval by the full board. The second is to inquire the effectiveness of the bank's financial & accounting functions, organization, operations & management through discussion with an independent and internal auditors & officer of the bank especially those using the information. The third is to inquire into effectiveness of the bank's internal auditing methods and procedure; and to report to the board on the committee's activities and recommendations.⁴²

In Ethiopia, the law does not make the audit committee structure of banks' governance. But the practice of banks revealed that due to the importance of audit committee NBE has been playing a role to convince banks to include audit committee in their governance structure and thus, almost all banks have set audit committee.⁴³

³⁸ **Audit Committee Charter**, TFC Financial Corporation Board of Directors, January 23, 2006; at 1.

³⁹ United Community Banks, INC. Audit Committee of the Board of Directors, (NY.); at 1.

⁴⁰ Richard & Farrell, *supra note 37*; at 1089.

⁴¹ Falk Bernard & Greene Edward,(1998) "The Audit Committee A measured Contribution to Corporate Governance: A Realistic Approach of its Objectives and Function", The Business Lawyer, Vol. 34, No. 1, November; at 1229.(Herein after cited as Falk Bernard & Greene Edward).

⁴² Rechar & Farrell, *supra note 37*; at 1091.

⁴³ An Interview with Ato Semere Wolde, Bank Inspector, Supervision Division of NBE, April 19, 2009.

CHAPTER SIX

CONCLUSIONS AND RECOMMENDATIONS

In this concluding chapter we sum up the findings and attempts to draw some overall conclusions and forward some recommendations. First we recapitulate the research questions which we formulated at the beginning of this study. Next we present the conclusions & findings of the research. Finally, we provide some recommendations based on the findings.

6.1. The Research Questions

The main question addressed in this study was how best to regulate bank governance in Ethiopia and to describe how the existing regulatory system has fared in this regard. To be a little bit specific, the study has, *inter alia*, addressed the following research questions:

- whether the laws and the NBE's Directives governing governance of banks are, fair, adequate, strong enough and are up to the required international standards;
- whether the regulatory institution is in a position or competent enough to enforce the existing legal regime;
- whether there is a conformity between the law and the practice of governance of banks;
- the need to develop governance code of practice and conduct, if so to come up with the proposal of the same.

6.2. The Conclusions, the Findings and the Recommendations

6.2.1. The Conclusions

The first chapter concerned with the research proposal. In the second chapter we discussed the conceptual analysis and historical narration of bank governance and regulation in general and in Ethiopia in particular. The need for regulating banks, history of central bank in Ethiopia and regulatory agencies of banks have been described. Moreover, the competency of the NBE to regulate the banking sector and the methods of ongoing bank supervision has been investigated. Chapter three studied the role of shareholders in bank governance. Powers of shareholders, the role of institutional and major shareholders in bank governance has been discussed. How the law and regulatory agency are regulating major shareholders has been dealt with. Besides, the issues of protection of minority shareholders rights were investigated.

In the fourth chapter we discussed major issues of bank directors. The theoretical framework of board of directors' has been discussed. Appointment and remuneration of directors', among other, continuous to be the most disputed points in bank governance. The chapter, therefore, has given broad coverage for appointment and remuneration of directors in Ethiopia. Furthermore, the chapter dealt with removal of directors, management of conflict of interests and duties & responsibilities of directors.

The fifth chapter is devoted to the role of auditors in bank governance and their regulations. The auditing function is shown to play an essential role in good bank (corporate) governance, emphasizing the importance of corporate transparency and communication with shareholders and other stakeholders. Audit represents the most indispensable bank governance; checks and balances that help to monitor bank management's activities, thereby increasing transparency. The audit of a bank's financial statements makes disclosure more credible, thereby instilling confidence in bank's transparency. Failure in the audit system contributes for the collapse of a bank.

6.2.2. The Findings

We found that the main challenge with regard to the licensing process of banks is lack or dearth of coordination between the Ministry of Trade and Industry, the respective bureaus and the NBE. The other main challenge to the regulatory role of the NBE is lack of competent and experienced man power in the department of bank supervision and failure to identify confidential and non-confidential information. Other point is the NBE to some extent lacks a clear cut knowhow of its power specifically given to it by laws.

We found that the main challenge in connection with regulating shareholders in bank governance is the undue influence of major shareholders top-to-down so that getting loan facility with inadequate collateral and/or with favorable terms. Besides, failure of the NBE to issue directives to control such major shareholders, that is, to make them comply with the maximum shareholding limitation set in the Proclamation.

It has to be recalled that, in chapter four we explored the various provisions dealing with directors and assessed the practice. Thus, the NBE failed to fix the maximum number of executive directors in a board. Even if there is no board dominated by insiders, the current fact may not guaranty the future unless addressed by laws. With regard to the independence of non-executive directors, the Proclamation provides for no rule or standard.

In Ethiopia, most banks have no directors' nomination committee. There is no remuneration committee and remuneration policy to evaluate and formulate directors' remuneration. Most banks believe that directors' remuneration is a bone of contention in General Meetings. With regard to educational qualification of directors, given the sophistication of banking business and the heavy responsibilities of directors the minimum educational requirement for directorship appears to be insufficient. Moreover, there is no limitation on proxy in Ethiopia.

In relation to grounds of removal of directors and senior officers the NBE may remove them if the bank they are involved as such winds-up. A bank as any business entity may any time wind up by shareholders' agreement securing the consent of the NBE. So, this ground is unreasonable. The Proclamations has given the NBE to revise the maximum limit of directors' remuneration set under the Com. Code. This goes against the general principle of hierarchy of laws & law making process. The NBE is called up on to issue directives with regard to the duties and responsibilities of banks' directors. The NBE however failed to issue such directives.

Regulation of loan to related parties or major shareholders is found to be insufficient. There are banks which are highly suffering from loans to related/major shareholders.

We found that the NBE has no formal & legal minimum professional experience and knowledge requirement to measure the appointment of external auditors though the Proclamation empowers it to set the same. Short of this requirement the NBE is approving the appointment of external auditors of banks. We found a tendency of external auditors fully appointed by managements and brought to the shareholders meeting for mere approval. There is a bank which does not change its external auditor since its establishment (1987). Though the rate of reelection of auditors is not yet limited, such long time tenure may compromise the independence of auditors as there could be a possibility of creation of strong relationship with the management of the bank. We found that

audit committee plays a vital role in bank governance and supposed to be part of the governance structure under the board.

6.2.3. The Recommendations

Based on the research findings, we recommend the following points to be considered by the concerned organs.

- The NBE should confine itself to methods of on-going bank supervision only provided for in the law.
- Banks shall principally register in the place where (sub-city) his head office is situated. The Bureau which has made registration of a bank should forward to the Ministry of Trade & Industry the particulars of registration so that the latter would undertake central registration. This would make smooth access to information about banks. Registration certificate witnesses the birth of a bank. Before issuing banking business license, the NBE should make sure that the given bank has got registration certificate from concerned bureau.
- The NBE needs design salary structure and other benefits so as to compete with the private financial sectors and employ the required professionals.
- Per Art. 11(6) of the Proclamation, the NBE needs to issue directives to the effect that those shareholders holding more than 5% of the total share of the bank reduce their holdings so as to comply with the 5% total share maximum limitation.
- The NBE is supposed to revise its mechanism of controlling loan provisions to insiders.
- Banks should at least annually report to the NBE the updated status of holdings of shares by shareholders.
- Given the sensitivity of the overall banking business and the involved public interest, the law needs to address selection procedures of directors by setting clear and objective directors' appointment rules and procedures. The present, if any, is insufficient.
- Standards need to be set to measure the independence of external directors.
- To set directors' nomination committee or to delegate external auditors to act as directors' nomination committee.
- The minimum educational requirement for directorship should be first degree.

- To revise the provision addressing the case of proxy rights of shareholders, for instance, one person should be prohibited not to represent more than one shareholder in GM to keep fair directors election and other material resolutions of a bank.
- Revising Art. 14(4) (e) of the Proclamation to make it consistent with the rules of law making process and hierarchy of law makers. The Proclamation should not have given the power of fixing the maximum remuneration of directors to the NBE rather it could have amend and reduce the 10% upper edge of the Commercial Code so that different interests are accommodated. To this effect, Art. 60 of the Proclamation should be amended and the following new sub-article (3) should be added.

“3/ sub- article 3 of article 373 of the Commercial Code is not applicable to banks.”

On behalf of Article 14(4) (e) of the Proclamation, new article has to be included which ties banks not to cross a certain amount (perhaps 5%) of the annual profit of the bank.

- Revising Art. 15(2) of the Proclamation excluding the possibility of wind-up of a bank not attributable to the director and subjective unpredictable standards.
- In accordance with Art. 14(4) of the Proclamation, the NBE needs to issue directives on;
 1. Qualification of competency to be fulfilled by directors;
 2. The maximum number internal directors in the board;
 3. The duties, responsibilities and good corporate of the boards of directors or code of best practice; and
 4. The maximum number of years a director may serve in any bank and the conditions for his reelection.
- The possibility of establishing compulsory rotation of external auditors as this could be a means of avoiding cozy auditor-management relationship.
- There must be procedure of appointment of external audit independent of the management.
- The NBE should have yardstick and competency criteria to measure and approve the appointment of external auditors. And hence, Per Art. 24(3) of the Proclamation, the NBE needs to issue directives on the minimum professional experience & knowledge required of external of banks.
- Given its importance, the audit committee needs to be legally included in the governance structure of banks.

BIBILOGRAPY

Books

1. Booz/Allen/Hamilton, (2007) *Ethiopian Commercial Law and Institutional Reform and Trade Diagnostic*,
2. Solomon, J. & Solomon, A. (2004) *Corporate Governance and Accountability*, Delhi, Wiley India.
3. Garratt, B. (2003) *The Fish Rots from the Head*, Profile Books.
4. *The Cadbury Report on UK Corporate Governance* (2002).
5. Kern, A. (2004), *Corporate Governance & Banking Regulation*, University of Cambridge.
6. Kenneth, S. (2000) *Banking Regulation*, 5th Ed., Federal Reserve Bank of Kansas City.
7. The World Bank (2001) *Principles & Guidelines on Effective Insolvency and Creditors Rights Systems*.
8. *OECD Principles OF Corporate Governance* (1999).
9. Koutsias, M. & Dine, J. (2007) *Company Law*, 6th edn., Pal grave Macmillan law masters.
10. Kenneth, S. (2001) *Banking Regulation*, 5th edn., Federal Reserve Bank of Kansas City.
11. Myers, F. (2005) *Basics for Bank Directors*, Division of Supervision & Risk Management, Federal Reserve Bank of Kansas City.
12. *Core Principles of Effective Banking Supervision*, Basel Committee on Banking Supervision, Basel, Sep. 1997.
13. Dr. Richard, P. (1967) *Primitive Money; Money & Banking in Ethiopia*, AA. The Birhanina Selam H.S.I. Printing Press.
14. Belay Gidey (Sep. 1987) *Currency & Banking Ethiopia*.
15. Teffera Deguefe (1973) *A Guide to Service*, A.A. Commercial Printing Press.
16. Jain, D., P. (1991) *Company Law*, 3rd edn., Konark Publishers, Delhi.
17. Klein, W. and Ramsefer, I. (1991) *Business Associations, Agency, Partnerships, and Corporations* the Foundation Press, Inc.
18. Stapledon, G. (1996) *Institutional shareholders and Corporate Governance*, Clarendon press, Oxford.
19. *Consultative Document: Core Principles of Effective Banking Supervision*, Basel Committee on Bank Supervision, April, 2006.

20. Emirates Bank Group (2004) *Protecting of Minority Shareholders*.
21. *Protection of Minority Shareholders in Listed Issuers*, Technical Committee of the International Organization of Securities Commission in Consultation with the OECD, June 2009: at 6.
22. OECD Principles on Corporate Governance (2004) Principle V, and the OECD Methodology for Assessing the Implementation of the OECD Principles of Corporate Governance (2006).
23. King, M. (2002) *king Report on Corporate Governance for South Africa*, Institute of Directors in South Africa.
24. Eisenberg, M. (1976) *the Structure of the Corporation; A Legal analysis*, Boston and Toronto, Little, Brown and Company.
25. N.A. (N.Y.) *the Law & Practice Relating to Directors Liability*.
26. Boatright, J. (1999) *Ethics in Finance*.
27. Roth, (1973) *Supervision of the Corporate Management; the “outside” Directors and the German Experience*.
28. *Consultative Document: Core Principles for Effective Banking Supervision*, Basel Committee on Banking Supervision, April, 2006.
29. Alexander,, K. (2004) *Corporate Governance & Banking Regulation*, University of Cambridge.
30. Keeling, D. (2002) *Corporate Finance: Public Companies & the City*, Britain, Hobbs the printer Ltd of Southampton.
31. Reitzel, D. et.al. (1990) *Contemporary Business Law: Principles & Case*, 4th ed., McGRAW-HILL Pub. Company.
32. *Global Conflicts of Interest*, A Passion to Perform, Deutsche Bank, August, 16, 2007.
33. Eugene, N. White (2004), *Can the Market Control Conflict in the Financial Industry*, Department of Economics Rutgers University.
34. Statement of Policies Respecting Conflicts of Interests, *National Bank Trust (Canada)*, (N.Y.)
35. ADCB Directors Conflict of Interest Policy, May, 2, 2009.
36. Conflict of Interest; Changing Control Can Cause Conflicts, *Australian Institute of Company Directors*, 2007.

37. The Director's Primer, *A guide to Management Oversight & Bank Regulation*, 3rd edn., 2002.
38. Stephen, H. (2005) *Banking with and without Insurance*: Mexico's Banking Experiments.
39. Stephen, B. Woodrogh, (2002) *Prohibition In Regulation Against Loans With "Unfavorable Features"*.

Journals,

1. Luc, L. (2001) "Insider Lending and Bank Ownership", *Journal of Comparative Economics*, Washington Dc, June.
2. Ray, G. et. al., (1966) "Duties & Liabilities of Corporate Directors", *the Business Lawyer*, (Vol. 22., No. 1).
3. Kapla, S. (1997) "Fiduciary Responsibility in the Management of the Corporation", *The Business Lawyer*, Special Issue, (Vol. 31, Feb).
4. Ira, M. (1995) "The Professional Board" *The Business Lawyer*, American Bar Association, University of Mary and School of law, (Vol. 50, No. 4,) August.
5. Noyes, E. and Robert, H. (1976) "The Outside Directors of the Publicly Held Corporation" *the Business Lawyer*, (Vol. 31, No.4), July.
6. William, J.(1976) "Is shareholder Democracy Attainable?" *The Business Lawyer*, (Vol. 31 No. 2).
7. *Corporate Directors Guidebook: "Comments Submitted by the American Society of Corporate Secretaries"* *the Business Lawyer's* (Vol. 33 No. 1) November 1977.
8. Eisenhardt, K. (1989) " Agency Theory: An Assessment & Review", *Academy of Management Review*.
9. Demiang, T. & Tylecote, A. (1992) "The Effects of Organizational Culture, Structure & Market Expectations on Technological Enovation: A Hypothesis", *British Journal of Management*.
10. Timmeman & A., Doorman (2002) "Rights_of Minority Shareholders in the Netherlands", *Electronic Journal of Comparative Law*, (Vol. 6.No.4)
11. Moshe, Puto (2006), "The Role of Institutional Investors in the Corporate Governance", *German Working paper in the Law & Economics*, (Vol.No.1).

12. Shelia, C. (1960) “Why Banking System should be Regulated”, the Economic Journal, (vol.106,) May.
13. Rose, S., (1973) “the Economic Theory of Agency: the Principal’s Problem” American Economic Review.
14. Shleifer, A. and Vishny, R. (1997) “A survey of Corporate Governance”, Journal of Finance, (Vol.52 No.2), June.
15. Short, H. et.al. (1998) “Corporate Governance Accountability and Enterprise”, Corporate Governance. An International Review.

Laws

1. Bank Business Proclamation, No. 592/2008, *Federal Negarit Gazette* 11th Year No. 57, Addis Ababa.
2. A Proclamation to provide for the Establishment of a State Bank, No.21/1942, *Negarit Gazette*, 1st year No.6, 27th August 1962.
3. The National Bank of Ethiopia Establishment (as amended) Proclamation, No. 591/2008, *Federal Negarit Gazette* 14th Year No. 50, 11th August Addis Ababa.
4. Commercial Code of the Empire of Ethiopia, No. 3 of 1963, *Negarit Gazette-Extraordinary Issue* 19th year, No. 3, Addis Ababa.
5. National Bank of Ethiopia Directive on Limitation on Loan to Related Parties, Directive No.30/2002.
6. Licensing and Supervision of Banking and Approval of Directors and CEO Directives No. SBB\39\2006.
7. NBE, Penalty for Non-Compliance with the Directives of the NBE, Directive No. SBB/35/2004.

Cases

1. Hambissa et.al. v. Beromhedina & his Company Charter Accountant; The Federal High Court; Appeal Civil File No.58624; Tikimt 15, 2000.
2. Hibret Insurance S.C. et al v the National Bank of Ethiopia, Federal 1st Instance Court, File No. 93620. & Federal High Court Appeal File NO. 64552.

Reports

1. Lion International Bank S.C., Annual Report, Oct. 2009.
2. United Bank S.C., Annual Report, June, 2009.
3. Bank of Abyssinia S.C., Annual Report, Nov. 2009.
4. Dashen Bank S.C. , Annual Report, Oct. 2009.
5. Wegagen Bank S.C., Annual Report, Oct. 2007/8.
6. NIB International Bank S.C., Annual Report, July 2008-June 2009.

Interviews

1. Ato Nigatu Tesfaye, Manager, Legal Dept. of Bank of Abyssinia, 16th , Nov. 2009.
2. An interview with Ato Semere Welde, Bank Inspector, Supervision Division of NBE, 19th, April, 2009.
3. An Interview with Ato Kurundi Tesgera, Senior Bank Inspector, Supervision Division NBE, 25th ,Nov., 2009.
4. An Interview with Gebisa Teresa, Legal Expert at Wegagen Bank S.C., 27th Nov. 2009.
5. An Interview with Ato Desta Dinka, Attorney in Awash Int. Bank S.C., on 10th, Nov., 2009.

DECLARATION

I, the under signed, declare that this Thesis is my original work and all source of materials used for the Thesis have been duly acknowledged.

Researcher Name

Name: GENENE AZENE

Signature: _____

Date: _____

Advisor

Name: PROFESSOR TILAHUN TESHOME

Signature: _____

Date: _____

QUESTIONNAIRE

AAU, Faculty of Law Graduate Studies

LL.M. Thesis (research) Questionnaire

This Questionnaire is designed to be filled by banks' Managers/ Officers to make surveying assessment on the Law and Practice of Regulating Bank Governance in Ethiopia.

The objectives of the Questionnaire are to investigate the effectiveness of;

- regulatory laws and mechanisms;
- regulatory institutions;
- the compliance to laws and directives; and
- the role of shareholders in bank governance.

The Questionnaire has two parts. The first part is about information of the bank. The second part is about the information sought by the researcher.

I hereby kindly request you to complete this Questionnaire responsibly and maturely. I would like to thank you in advance for your time.

Instructions

- ❖ No need to write your name.
- ❖ Circle the alternative you selected.
- ❖ Write your opinion in the space provided. If the place provided is not enough to complete your view, you can attach and use other papers.

Part One

I. Information about your Bank

1. The name of the bank _____
2. Capital _____
3. Number of shareholders _____
4. Number of shares _____
5. The par value/price of a share _____
6. The position of the person who filled this questionnaire (**not mandatory**) _____

Part Two

II. Questions

1. How many shares of your bank are held by institutional investors (entities)?

2. How many shares of your bank are held by individuals (human beings)?

3. Institutional shareholders are actively participating in the management of the bank.
Yes **No**

If your answer is “Yes” please write some activities played by them.

- _____
4. Institutional shareholders are passively participating in the management of the bank.
Yes **No**
 5. If the answer to the above question is “Yes” please write some limitations that make them passive.

6. The influence of institutional shareholders in the bank’s management is

- A. Strong
 - B. Medium
 - C. Weak
 - D. No
-

7. Is there directors' nomination committee in the bank?

Yes

No

8. If your answer to the above question is "No", how did directors of the board were nominated?(who brought them to the nominees' list)

9. Does bank have directors' selection criteria?

Yes

No

10. How many directors are there?

11. How many of the board members are from members of the management?

12. How many of the board members are representing institutional shareholders?

13. Who decided the maximum numbers of directors?

14. Was there any director removed by shareholders or other organ before its term?

Yes

No

15. If you answer to the above question is "Yes" what was the reason?

16. Was there any auditor removed by shareholders before its term?

Yes

No

17. If your answer to the above question is "Yes" what was the reason?

18. Did the National bank of Ethiopia reject any appointment of directors?

Yes

No

19. If your answer to the above question is “Yes” what was the refusal ground?

20. Did the National bank of Ethiopia dismiss any appointed director?

Yes

No

21. If your answer to the above question is “Yes” what was the dismissal ground?

22. Does the bank have ethical code of conduct for directors?

Yes

No

23. Does the bank have disciplinary rules for directors?

Yes

No

24. Were there directors that have been punished violating the ethical code of conduct or other laws?

Yes

No

25. If your answer to the above question is “Yes” mention the specific violation and the kind of punishment passed.

26. Does the bank have directors’ remuneration committee?

Yes

No

27. If your answer to the above question in “No”, how your bank did fix the remuneration of directors?

28. As per Art. 14(4) (e) of Proc. No. 592/2008, the National Bank of Ethiopia has been empowered to set the maximum payment for banks’ directors.

I agree

I do not agree

Why/ why not?

29. Does the bank have bonus /pension payment arrangements for directors?

Yes

No

30. Does the bank have a remuneration policy?

Yes

No

31. Is there any auditors appointed by shareholders holding 20% capital of the bank, [Commercial Code of Ethiopia, Art. 368(1-30).

Yes

No

32. How was the appointment of external auditors?

33. Is there a situation that auditors of the bank took the power of directors and called shareholders General Meeting?

Yes

No

34. If your answer to the above question if “Yes”, what was the reason how it was solved?

About the National Bank of Ethiopia

1. Mention the good side of NBE in relation to regulation of governance (directors, managers, auditors, influential shareholders) of the bank.

2. Mention the weak side of NBE in relation to regulation of governance (directors, managers, auditors, influential shareholders) of the bank.

My contact

+251911736323 /+251910881549 genene20000@yahoo.com

Thank you so much!
