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Implication of NBE Directive of Bill Purchase on Performance of
Private Commercial Banks in Ethiopia

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This is to certify that the thesis prepared by Yodit Kassa, entitled: *Implication of NBE Directive of Bill Purchase on Performance of Private Commercial Banks in Ethiopia* and submitted in partial fulfillment of the requirements for the Degree of Masters of Science in Accounting and Finance complies with the regulations of the University and meets the accepted standards with respect to originality and quality.

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Abstract

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The aim of the study is to assess the implication of the NBE's directive of bill purchase on the performance of the private commercial banks. The paper, based on an in-depth interview with official of different banks investigates the premises of the directive or grounds on which the government intervened in the financial sector, the manner in which the directive affects the performance of the banks, related issues with regard to this intervention and measures that are taken by the banks. The results indicate that the directive was issued as a means of increasing the private banks participation in priority sector financing and also to control the inflationary problem. Secondly the directive created two major challenges: liquidity and asset liability mismatch which affect the performance and profitability of the banks in an adverse manner. The banks as such are taking strategic measures, which according to the officials has both positive and negative implications to the sector.

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Acronyms

AIB:	Awash International Bank
ALCO:	Asset Liability Committee
CBE:	Commercial Bank of Ethiopia
DBE:	Development Bank Ethiopia
DC:	Developed Countries
FY:	Fiscal Year
GDP:	Gross Domestic Product
GTP:	Growth and Transformation Plan
IMF:	International Monetary Fund
JDB:	Japans Development Bank
LDC:	Least Developed Countries
NBE:	National Bank of Ethiopia
NIB:	Nib International Bank
NPL:	Non-Performing Loan
OIB:	Oromia International Bank
ROSCAS:	Rotating Saving and Credit Association
SSA:	Sub Sahara Africa

CHAPTER ONE

Introduction

Financial system at best is a set of complex, interconnection of financial institutions¹, financial markets, instruments, services, practices and transactions. The complexity and degree of advancement of any financial system is closely related to the economic development of that specific country (Mishkin & Eakins 2009). As such the financial systems of Developed Countries (DC's) can be characterized by the use of advanced financial instruments, sophisticated financial markets, in general, a more complex systems when compared to that of Least Developed Countries (LDC's). Even with in such complex systems, the most important financial institutions anywhere in the world remain to be the same that is simply banks.

Banks are financial institutions that accept deposits and make loans (Mishkin & Eakins 2009). This means that banks act as intermediaries between those who have excess money and those with shortage of money but viable projects. Hence, banks are one of the major financial institutions through which, transfer of fund takes place. Banks in general engage in different functions like lending money, collecting deposits, transferring money locally and globally as well as other function. Even though the importance of banks is evident everywhere it is even more so in LDC's like Ethiopia where they are major formal financial institutions.

In Ethiopia, the service sector in the FY 2008/09 contributed 45.1% to the total GDP while agriculture and the industry sectors contributed 43.2% and 13.0% to GDP,

¹Financial institutions also referred to as financial intermediaries refers to organizations engaged in the transfer of funds from surplus to deficit units.

respectively. The service sector decomposition shows that the financial sector that is dominated by banks (in Ethiopia's context) has shown the fastest growth. The financial sector in Ethiopia plays a vital role in the development of the economy not only by its intermediary role but also through its disproportionately large tax payments as well as by its role in employment generation².

Currently, the Ethiopian financial sector includes mainly banks, microfinance institutions and insurance companies. The banks can be categorized based on ownership as state owned banks and private banks. A series of financial sector reform had been introduced since 1994 but still the 3 large state-owned banks dominate the financial sector mainly the Commercial Bank of Ethiopia (CBE). The sector is characterized in general by its isolation from the impact of globalization because of its uniqueness, in that it is not open for foreign participants³ (Proclamation No. 592/2008 does not allow non Ethiopian citizens from owning and operating financial institutions in Ethiopia). According to Kiyota et al. (2008), Ethiopia's financial sector remains closed and much less developed than that of its neighbors.

The history of the financial sector in Ethiopia goes to 1905 making it safe to say that the banking industry has about 100 years of experience. The participation of the private actors in the financial sector was reopened in 1994 after the fall of Derge⁴ (Addison & Geda, 2001). In general, there has been a favorable environment for the banking industry and other financial institution to flourish in Ethiopia after the demise of the Derge regime. Following this in the fiscal year 2011/12 there were 17 banks

²Obtained from Access Capital Review of banking sector 2010 (www.accesscapitalsc.com).

³There has been a lot of debate whether the non-participation of foreign banks can be taken as a good thing or not. But there is a clear reservation by the government in allowing foreign investors which is based on a lot of reasons (looking into the working paper of IPC No 29).

⁴1994 marked the establishment of the oldest private bank the Awash International Bank after the demise of the Derge.

(includes both private and state owned banks), with 2 being the most recent additions to the industry (Addis International Bank and Abay Bank). But, still with the increase in banks and their branches, Ethiopia remains as one of the under-banked economies⁵. Financial institutions especially banks are highly regulated not only in Ethiopia but also elsewhere due to several reasons among which few are listed below. Firstly, banks mobilize a large amount of resources in the forms of deposits hence proper allocation of these resources (distribution which is related to the lending process) is very important. Secondly, there is a need to ensure the safety and stability of the banking system. Thirdly and most importantly banks are used as a means for government to implement the monetary policy. These are among the few reasons why these institutions remain as one of the highly regulated entities all over the world (Agu, 1984).

Given the current dynamic global environment, there were many events (like financial crises) that justified the need for regulation in the financial sector and were proof of the consequence that the failure of this industry has on the economy. Apart from market failure (financial crises) the information asymmetry problem has justified the need of government intervention in the allocation of resources (directed credit programs), which might have both positive and also associated cost to the commercial banks as the study by Vittas and Cho (1995) indicated taking the case of Korea. But, the extent of the government's intervention in the sector is still debatable among different researchers (Calomiris et al 1992; Calomiris and Himmelberg 1994a, 1994b 1995).

⁵ By looking at the people to branch ratio of 2008/09 which was estimated to be one bank branch to 126,758 people Ethiopia was said to be one of the under-banked economies even by SSA standards. At the end of 2009/10 this number has not changed significantly being 1: 116,847 people.

In Ethiopia, the regulatory body in charge of supervision and regulation of the banks is the National Bank of Ethiopia (NBE). The NBE was established in 1963 by proclamation No. 206 of 1963 and began operation in January 1964. Prior to this proclamation, the Bank used to carry out dual activities, i.e. commercial banking and central banking. But currently it acts as only the central bank (www.nbe.gov.et). It's worth noting that the financial liberalization index that measures banking security and independence control on a scale of 10 to 100 (100 being, the most liberal) is only 20 for Ethiopia (the lowest in Sub Sahara Africa). This indicates that the Ethiopia financial sector is the most highly regulated (controlled) by the government⁶.

As the main, formal financial intermediaries in Ethiopia, government's intervention of banks for the proper functioning of the financial system and also as a tool for implementation of monetary policy through the issuance of different directives is undeniable⁷.

In this regard the NBE on March 2011 issued a directive which forces the private commercial banks to purchase a bill with a maturity period of 5 years stated as the NBE bill which is different from the normal Treasury bill that banks buy from the NBE. As per the directive the amount of money banks are required to invest in the NBE bills is based on total disbursement of (loans granted by) the banks. Accordingly, private banks have to allocate based on their total loan disbursement 27% to the purchase of the NBE 5 year bill (henceforth stated as the NBE bill) (Appendix-5). To this end the study will explore on the implications of the NBE

⁶Based on IPC working paper series No. 69

⁷To state few example: the directive on the payment of windfall gain tax which was intended to collect the excess profit that banks generated due to the devaluation of Birr, the previous period credit cap which restricted the banks lending capacity are few directives that could be mentioned with regard to the intervention in the financial sector of Ethiopia within 3 years time.

directive with regard to bill purchase has on the performance of private banks in Ethiopia.

1.1 Statement of the problem

Banks are like the heart which pumps blood to any economy of a given country (Iyade, 2006). Banks in Ethiopia play a prominent role in allocation of resources by acting as intermediaries and also help boost the economy by providing employment opportunities. They also contribute directly to the economy through their disproportional large tax payments⁸. Hence, the role-played by banks in the overall economy is substantive. This means that the development or failure of this sector will result in a chain reaction that is expected to either promote or demote the overall growth of the economy. Hence, if banks were to prosper, one major issue would be to regulate as well as to monitor the overall performance of these institutions and the effect they will have on the economy through various mechanisms without over burdensome restrictions that are more likely to be detrimental to their operations.

By looking at the banking sector in Ethiopia it looks somewhat threatened by some unconventional policy intervention⁹ such as lending quotas and heavy tax in the form of windfall gains tax. While having other intentions and purposes (like the reduction of money in circulation/ monetary stability), these policies are more likely to have implication to the banks that are operating in the industry and might also present themselves as additional factor for new banks to enter into the industry.

⁸Obtained from the access capital review which stated the total tax on profit on 2010 from the banks in Ethiopia had been around birr 586million and from other taxes which includes tax on dividend, salaries and tax on value added tax on purchase of fixed assets the industry is estimated to add another 500 million birr which makes the total tax paid over birr 1 billion. This is equivalent to more than 10percent of the birr 8.8 billion in direct income tax revenue collected by the government in previous year.

⁹These policy interventions are also in the form of directives regarding the legal reserve requirement, paid capital requirement for the establishment of new private banks, restrictions regarding the investment options of banks are among the few that could be mentioned.

The current financial crisis around the globe shows the need for proper financial regulation and supervision (government intervention). In Africa unlike previous period the government's involvement in the financial sector have leaned towards a market- friendly role (Kirkpatrick, 2001). This role that is being played by the government is not an easy task because it entails laying the necessary rules without suppressing private initiatives.

The banking industry is clearly one of the crucial sectors for the development of the economy as such the need for prudential regulation is not a controversial issue. Lack of alternatives such as stock markets to raise finance makes the Ethiopian business communities dependent on banks as their major source of finance. The government of Ethiopia realizing the need for these financial institutions has laid down the necessary infrastructures¹⁰ and regulates the banking sector by issuing different directives and regulations. These directives and regulations issued from time to time for the banks are government's intervention in the sector as a broader monetary policy and affect the banks operation.

As such recently the NBE has issued new directive, which requires the private commercial banks to allocate assets amounting to 27% of their total disbursement to the purchase of NBE bill. This bill purchase according to NBE is designated for priority sector financing. Accordingly, the banks are forced to redirect their disbursement to the purchase of the NBE bill which earns 3% interest. Some participants of the banking sector are raising their concern that this will restrict the capacity of banks, which in turn would have its own bearings on their contribution to the development of other sectors and the economy at large. To this end, this study

¹⁰ The necessary infrastructure refers to regulations, skilled labour, proper accounting standards, supervision and the like. But in this context it relates to the regulatory environment.

proposes to assess the implications that the recent directive stated as “*NBE bill purchase directive*” has on the performance of the private commercial banks.

1.2 Objective of the study

The need for well developed, sound and healthy financial institutions is not a luxury that we are able to afford but rather a necessity for a healthy functioning of the economy. The general objective of the study is to investigate the implication the directive (sited, as “Establishment and Operation of National Bank of Ethiopia bills market Directives No MFA/NBEBILLS/001/2011”) has on the performance of the private banks.

1.3 Research questions (RQs)

In order to address the objective stated the study has addressed the following research questions.

- RQ1. Why is the directive necessary? Or what are the grounds and premises for the directive to be imposed on the private commercial banks?
- RQ2. What implication does the directive has on the performance of the private commercial banks? And the consequence of the directive?
- RQ3. What measures are being taken by the banks in order to address the issue?
- RQ4. What does the future look like for the existing and incoming private commercial banks as a result of the directive?

1.4 Scope and limitation of the study

The scope of the study is limited to assessing the implication of the NBE bill purchase directive on the performances of the private banks only and does not include its effect on other stakeholders. In order to address this issue the study was conducted at Addis Ababa in the head offices of selected private banks and totally excludes the stated owned banks, as the directive is not applicable to them.

Besides, researcher believes that, since this directive is a fairly recent one looking into financial data in order to assess the implication of the directive on the performance of the banks will not give the clear picture of the area under study. Hence, the study depends mainly on responses of study participants' that is mainly taken as personal perception.

1.5 Significance of the study

Banks contribute to the growth of a country through the allocation of resource. As such most institutions rely on banks for their day-to-day operation. If these banks are faced with challenges that hinder their role in the economy it creates a problem for the different institutions that rely on them.

One of the challenges that banks face comes in the form of government intervention through directives. These directives although are intended for different purpose like protection of public money, insuring sustainability and the like, they are also used as means through which government executes its monetary and macroeconomic policy and have an implication on performances of the banks.

Identifying the implication of such directive on the performance of the existing banks would help realize the challenges and prospects in the banks. This would help to find means to mitigate the challenges the directive poses and exploit any opportunities it

may entail. It could also help in the bank management by making management aware of the implications of the directive has on different issues with regard to their operation. The study will also be useful to policy makers by identifying the major challenges and prospects of the directive to industry, which eventually make it easy to set the appropriate rules and regulations. In addition to the above points the study can also be used as an input for other researchers for furthering the issue.

1.6 Organization of the Research Report

The research report is organized in to five chapters. Chapter one discussed introduction where background of the study, statement of the problem, research questions and objective of the study, scope, limitation and significance of the study are presented. Chapter two brings review of literature in which theories, empirical evidence and knowledge gap is identified. Chapter three presents methodology. Chapter four presents results and discussions and finally, Chapter five brings to an end the research with conclusions and recommendations.

CHAPTER TWO

2.1 Theoretical foundation

2.1.1 Terms and definitions

When every people talk about financial institution, what come instantly to mind, is bank. “Financial institutions are what makes financial markets work without them, financial markets would not be able to move funds from people who save to people who have productive investment opportunity” (Mishkin & Eakins 2009, p.8). This institutions need to be studied due to the complexity of the financial system¹¹, the nature and impact this institution have and also as a result of financial innovation including managing risk in financial institution. Financial institutions include banks, insurance company’s mutual funds finance companies and investment banks.

Financial intermediaries¹² fall into three categories.

Depository institutions: are financial intermediaries that accept deposits from individuals and institution and make loans. This includes commercial banks, saving and loan associations, mutual saving banks and credit unions.

Contractual saving institutions: that acquires funds at periodic interval on a contractual basis and do not have to worry much as depository institutions about losing funds quickly and a such the liquidity of assets is not as important a consideration as depository institutions. Included here are life insurance companies, pension funds and government retirement funds.

¹¹The financial system relates to the set of financial institutions, financial markets, instruments, practice and transactions.

¹²Financial institution and financial intermediaries are used interchangeably in most literatures and hence are taken as so in the study

Investment intermediaries: include finance companies mutual funds and money market mutual funds (Pilbeam 2005). Pilbeam (2005) also classifies financial intermediaries in to deposit- accepting institutions such as banks and saving institutions and other financial intermediaries such as insurance companies, pension fund and the like.

Despite some resemblance in depository and non-depository institutions depository institutions receive disproportionately huge amount of attention from government regulations both because they play a central role in the economy and because they face unique set of problems. In contrast to their non-depository institutions (Insurance company's pension funds...) banks are unique. Firstly because they hold illiquid assets (assets with long term maturity) and these are backed with liquid liability. This is also the reason for banks fragility, which relates to providing liquidity to customers. Secondly they are linked to one another mainly through interbank loans. Lastly bank failures are contagious which spread from are bank to another (Banks are linked to are another both and their balance sheet and in their customers mind). Among the different deposit-taking institutions the major institutions that make their living pre dominantly by taking deposits (which are liabilities) and loans (which are assets) are banks.

So what is a bank? "The answer to the questions... might seem quite simple. In reality however the answer is complicated one reason is that there is distinction between legal and functional definition of what banks do..." (Gup & Kolari, 2005, p.3). While the functional definition relates to the depository function of banks the legal and regulators definition on the other hand changes over time and across different countries. In Ethiopia the National Bank of Ethiopia (NBE) in charge of regulating and supervision of banking sector defined banks as "a company licensed by

the National Bank to undertake banking business or a bank owned by the government” Banking Business proclamation No.592/2008. Despite their common features there are different types of banks. There are so called universal banks, commerce and retail banks and also merchant banks or investment banks.

2.1.2 Role-played by banks

The financial intermediaries are primarily concerned with the transfer of funds from deficit units to surplus units. In this basic and important role financial intermediaries serve different economic functions. According to Pilbeam (2005) these functions include:

1. The provision of a payment mechanism
2. Maturity transformation
3. Risk transformation
4. Liquidity provision and
5. Reduction of transformation, information and search costs.

2.1.3 Risks associated with banks

According to Gup & Kolari (2005) banking is the management of risk as such it lists nine risks for the purpose of bank supervision: credit risk, interest rate risk, operational risk, liquidity, price, compliance, foreign exchange, strategic and reputation risk. They also stated that bank management must balance risk and return in seeking to maximize shareholders' wealth; however, such decisions are constrained by a number of factors. These constraints may be classified into three separate overlapping areas as *market*, *social* and *legal and regulatory*.

By their very nature banks (the financial systems) are fragile and vulnerable to crises. By and large financial crisis all over the world are really banking crises. Banking crises is not a recent phenomenon the last two centuries are periods of turmoil and failure. Unfortunately when some countries financial system collapses, its economy goes with it and with it economic a crisis comes, violence and revolution. Hence keeping banks open and operating then is as essential to maintaining our way of life as a ready military defense. Because a healthy financial system benefits everyone governments are deeply involved in the way banks and other intermediaries function. As a result the financial sector is subject to voluminous rules and regulations and financial institutions must with stand constant scrutiny by official examiners. The importance of this government oversight in ensuring financial stability is hard to exaggerate.

2.1.4 Government intervention in the financial sector

Governments always have been intervening in the financial sector even though there has been shift to less regulation by many governments, which was recognized as the process of deregulation. It is worth noting “one of the major arguments in favor of regulation is the need for investor’s protection” (Pilbeam 2005). According to Pilbeam (2005) there is a needed for government regulations even though those who oppose regulation say that it increases compliance cost and prevent innovative products. In addition to much investor protection can create moral hazard, which occurs when insuring against an event makes the insured against an event itself more likely to occur.

All in all Cecchetti (2006) states three basic reasons (objectives) why governments interfere in the financial sector.

1. To protect investors
2. To protect bank customers from monopolistic exploration
3. To safe guard the stability of financial system

The degree of regulation and control varies greatly between countries due to different historical cultural, economic and political factors.

The rationale for government intervention “.....is rationalized on the grounds of ‘market failure’ that is left to itself the market would produce sub optimal out comes.

There are instances of market failure in the financial sectors that are frequently cited as requiring government intervention to correct (Pilbeam, 2005, p. 433). These problems are referred as:

- a) *The externality problem*: states that the failure of firms that produce goods and services is less likely to have a devastating effect throughout the entire economy for most countries than the collapse of bank or the financial sector.
- b) *The problem of asymmetric information*: since the information that managers and directors have available to them depends on the soundness of their company and its likely policy. There is need for government to intervene.
- c) *Moral hazard*: relates to the occurrence of an event, which is more likely to occur because the event was insured. This will be even more the case if financial institutions take on more risk than they otherwise would knowing that investors will be protected if the institution encounters problems.
- d) *The principal agent problem*

2.1.5 Types of regulation

In general if governments are able to meet the three objectives, which are listed previously, as well as to address the problems there is a need to regulate the financial sector. Hence regulation can be divided in to three types.

- 1) *Structural regulation*: is about the product, activities and geographical boundaries with in which banks operate.
- 2) *Prudential regulation*: covers the internal management of financial institutions.
- 3) *Investor protection regulation*: covers measures designed to protect investors from mismanagement of funds, malpractice and fraud.

There is a considerable degree of overlap between the three types of regulation and there are also a number of regulations, which fall under these classifications briefly listed below. It includes.

- Licensing regulation: to prevent undesirable individuals who could undermine the confidence of individuals in the financial sector.
- Disclosure requirements: relates to the information requirement.
- Deposit insurance: as a means to forestall runs on deposit is through the authorities setting a deposit insurance scheme which guarantees depositors that they would get their deposit this is also an example for moral hazard.
- Restriction on activities: to prevent banks from taking excessive risk with investor's fund and limit potential conflict of investors.

- Exposure limits: it's about diversified asset portfolio to control its risk exposure. This relates to for example lending to individual customers, which should not be greater than 10% of its capital base.
- Liquidity requirement: is essential about maintaining adequate short-term cash to meet the demand for deposit withdrawals.
- Capital adequacy: to ensure that the institution is regarded as solvent the idea being that shareholders in a bank should make up for losses, not the depositors.
- Regulation of exchanges: that governs the structure and organization of securities exchange.

2.1.6 Statutory versus self-regulation

There has been a constant debate over the merits of self-regulation and statutory regulation. Those in support of self-regulation argue that since regulation is left to market participants/practitioners, it provides flexibility, which makes it a quick to adopt to change in the financial sector. Since it is regulated by market participant and participants who understand and know the business it's more like, to be more effective at spotting breaches of the regulation. The involvement of these participants and professions in return aids the formulation of regulation that led to a higher profession standard. On the down side self regulators get the necessary fund from member firm which leads to the tendency of the regulators in favor of these donor firms instead of the general (Consumer) interest. Statutory regulation is part of the law and usually supervised by the authorities, which relates to governments intervention and regulation. Even though it's usually stated as a time consuming process and is also

often criticized as being behind development in the financial sector, is still vital (Pilbeam2005).

While there may be benefit from regulation we need to recognize that there are numerous costs. Ideally from a societal viewpoint; the marginal benefits from additional regulation should equal with marginal cost imposed by the regulation. Even though there are a number of arguments in favor of government regulation there has also been a strong case made in economics literatures against government regulation. Financial regulations for the most part are viewed as imposing additional cost as well as resulting in loss of some profitable business. Furthermore regulation distorts conduct of financial business by encouraging financial activities in areas favored by government. Excessive licensing requirements can restrict competition and result in excess profits for consumers. Regulations may also mean that financial innovation is reduced or limited to a nature designed to overcome the restrictions imposed by the regulations (Pilbeam2005).

In general the theoretical foundation lies down that there is a basic rationale for governments' intervention in the banking sector in particular and on the financial sector in general. This rationale also shows the problems that are addressed by government regulation. The different regulations listed as structural, prudential and investor protection regulation as stated overlap in certain areas but in general are essential for the healthy functioning of the system. It also states that even though the need for regulation is clear we also need to recognize that there is cost associated with it. At the end it is clear that most regulator bodies need to strike a balance between regulation and the need to allow their financial services industry to develop without over-burdensome restrictions.

2.2 Review of empirical studies

Different researchers like Levine (1997); king & Levine (1993) have studied the role of the development of financial markets and institution for the development of the economy. Using cross-country (cross-sectional data) regression analysis, king & Levine (1993) found that higher level of financial development is significantly and robustly correlated with future rates of economic growth and further stated that finance was a lead to economic growth.

Arestis and Demetriades (1997) showed that the relationship (the causality link) between finance and growth is not as straight forward but rather the result exhibits substantial variation across countries even when the same variables and estimation are used. According to them the use of cross-country regression (like the one used by Levine) is over simplified and may not reflect individual countries circumstance such as institutional structure of the financial system, the policy regime and the degree of government effectiveness which are determinant for the link and a such suggest the use of time-series estimation. Accordingly since they state that cross-country regression is a fragile statistical basis using time series they showed that indeed there is substantial variation across counties among the casual link between financial and economic growth.

But this causality relation shows a wide difference when it is applied for developed and developing (LDC) countries. Jung (1996) showed that there is a clear difference in the casual direction of finance and economic development using annual data of 56 countries out of which 19 are industrialized countries showed that in the LDC's the casual direction runs from financial to economic development while in developed countries it was reverse.

The different researches that are stated above addressed that there is a positive relationship between finance and economic growth. But the causality link between the two is still debatable. While some like King & Levine (1993) state that finance is the lead to economic development others like Jung (1996) stated that these causality links is different and is dependent on countries circumstances.

In general a summary review work of the relationship between finance development and growth can be seen in Demirgüç-Kunt & Levine (2008). The paper is a review of different papers starting from 1993 on the topic of finance and economic development based on individual country, cross country bases and also others. The paper shows the major draw backs in the instruments and variables measures used by different papers. Such as proxies used for financial sector usually focusing on banks and excluding other participants in the financial sector. The paper state that one of the challenges to the finance and economics literature is outlier's in sample for example countries like China. The paper states that china despite its slow progress in the financial sector is one of the fastest growing economies. *In summary, the paper based on different research, stated that despite the weaknesses and qualifications, the accumulation of evidence suggests that financial development is crucial for growth.*

Taking in to account the accumulating evidence that finance affects economic growth researcher have tried to find different variables that are likely to lead to financial crisis, which is usually related to banking crises and has also motivated policymakers to prioritize financial sector policies and devote attention to policy determinants of financial development as a mechanism for promoting growth. The purpose of the different researches conducted was to see (identify) if certain circumstance like financial liberalization, regulation, institutional variables could lead to financial crises, so that it would help policy makers take the necessary measures.

Williamson and Mahar (1998) showed that out of the sample of 34 economies that have undertaken liberalization almost all had experienced some form of financial crisis. According to the paper most countries that have undertaken liberalization in one form or another have had experienced some sort of crises which means there is a high probability that financial liberalization could lead to some sort of financial crises but states that it depends on a lot of factors as well. On the other hand Demirgüç – Kunt and Detragiache (1997) found that banking crisis is highly likely to occur when the macroeconomic environment is weak using annual data of 65 countries.

Demirgüç – Kunt and Detragiache (2005, p.20) in a summarized way stated “the question of how institutional variables such as politics and regulation, influence bank fragility has been a fruitful area of exploration and there are several directions in which this work can continue for example it will be interesting how compliance with bank regulation ... might affect financial stability, particularly in the developing countries....” Accordingly to this paper it also states that with the increased globalization and the quickly reshaping banking system, the study of banks fragility will continue to attract attention.

Demirgüç –Kunt and Detragiache (1998) using a panel data of 53 countries had tested for the relationship between the effectiveness of the regulatory environment, liberalization and banking crises. This paper used alternative proxies to measure the effectiveness of the regulatory environment such as degree to which rule of law is respected, degree of corruption and other. Except one variable the rest were simply taken as a confirmation of the argument that when the quality of the regulatory environment is improved it will minimize (curb) the tendency of liberalized financial markets from developing into a symmetric bank crises. Taking these different facts that could lead to financial crises (market failures) and the importance of the financial

sector to economic growth, the government's involvement in the financial sector has increased.

In this point we could look at Kenney (1997), Are financial markets different? Before the 1960 the prevailing economic orthodoxy was in favor of the government's intervention in the financial markets. The main justification was based on market failure and externalities. But this notion was first broken in 1960 by Ronald Coase's publication "The problem of social cost" which is stated as Coase Theorem. According to Coase as long as the necessary conditions are fulfilled the market forces would ensure an efficient allocation of resources. He stated that market failure is not an automatic justification for government to step in the market. He believed that there is cost in using both the market and the government for regulatory purpose and that there is no reason to believe the cost of regulation is negligible.

On the other hand George Stigler's 1971 "The theory of economic regulation" states that regulation is a valuable commodity that is instituted primarily for the protection and benefit of public at large. He states that as a valuable commodity regulation is actively sought by an industry and as such markets demand intervention. Based on certain characteristics that make financial markets different like imperfect information, the cost of information and systemic disruption of the financial system the need for regulation is there but the notion that such interventions makes government act as an insurer and could led to moral hazard has also be Stigler's question with regard to intervention. While most agree that there is a role for government in the regulation and supervision of financial systems, the extent of this involvement is an issue of active debate.

One rationalization for the interference of government as stated is that information is asymmetric and cost of information. If so then the allocation of credit suffers from the

existence of informational asymmetries, from the costs of monitoring and verification, and from the costs of contract enforcement. Under these conditions, credit is not necessarily allocated to its best use. Asymmetric information problems are further compounded by uncertainty about project returns and by the existence of dynamic externalities. These supports a greater involvement of government in the allocation of credit, although the information problems that inhibit the functioning of markets also constrain the ability of governments and financial institutions to enhance efficiency in the allocation of credit (Calomiris et al 1992; Calomiris and Himmelberg 1994a, 1994b 1995).

In the absence of full information, banks tend to allocate credit to firms with available internal fund or with reliable track record even if they are not the ones with best investment opportunities. Banks tend to favor lending for low risk activities such as self-liquidating short-term working capital and trade finance, or for high risk but more speculative projects with short payback periods, such as real estate development. Commercial banks are generally less willing to finance more risky projects with longer payback periods even if they may have higher overall returns. They are also generally reluctant to finance small firms without adequate collateral, even though such firms may be more innovative and may promise higher returns these pushes government to intervene in the allocation of credit.

As such, one justification for the use of credit programs is as a preferred or superior industrial policy instrument for reaping positive externalities. A second possible motivation for credit programs comes from the comparative advantage the government may enjoy in credit supply. But this doesn't imply that governments will always "do the right thing". Government's involvement in credit allocation often results in rent seeking, corruption, and crowding out, rather than the pursuit of

efficient industrial projects. An important issue in the study of policy-based lending is how governments can prevent rent-seeking behavior from undermining the growth objectives of government policies.

In addition Kohli (1997) states that the purpose of these directives (mainly on directed credit program) from theoretical point is justified based upon both efficiency and equity considerations. In explaining efficiency the paper states that market based allocation of resources would be driven based on expected return private profit (return) which would lead areas with high social return but low private return to be under invested which is accordingly taken as inefficient allocation of resources. The equity argument is upon a redistribution of existing resources. The paper as such states that theoretically there is no basis for assuming that a free market allocation will necessarily be optimal.

According to Vives (1997a, 1997b) Government intervention in financial markets, aimed at channeling credit at concessional terms to government-defined priority sectors, has long been a major policy tool for both developed and developing countries. Despite good intentions, such intervention – especially in developing countries – has generally impeded the development of financial markets while failing to promote the development of priority sectors.

Different countries like Japan, South Korea, China, India etc have undertaken some form of directed credit programs at one or some point in their developmental stage and have used it for promoting developmental programs. In Japan in the mid-1950s, lending areas as a result of directed credit program¹³ diversified into infant industries,

¹³ The researcher found that the directed credit program and policy based lending signify the government's interference in the allocation of credit. Policy based financing relates to the government's involvement in financial markets as part of overall policy to support priority sector with high social returns, sector that are risky to attract private investment without clear government support

such as machinery, and new industries, such as petrochemicals. Japan Development Bank's (JDB) lending to these industries under the directed credit program was important toward guiding private financing.

Taking this to account Horiuchi and Sui (1993), using 477 medium sized firms listed on the Tokyo Stock Exchange in 1965 tried to see the effectiveness directed credit program. Using firm level data they compared the investment behavior of "medium-size" firms receiving JDB assistance with other firms of similar size over the period 1964-1988. They found that the year of initial JDB lending was associated with increased investment and also that within three years firms began to move away from reliance on JDB lending to rely more on private banks.

Calomiris and Himmelberg (1994b) using firm level data collected with the support of the Japan Development Bank examined the effect of policy-based finance over the period 1963-1991 for the machine tool industry, an industry selected for its high potential for spillover effects due to technological innovation and learning. Machine tool producers underwent considerable consolidation during the 1960s and 1970s, which was associated with the introduction of new technologies and the achievement of unusually large economies of scale under the directed credit program. Accordingly the drawback with these two papers was that they covered only surviving firms and excludes firms that exited during the period. This makes the identification of positive effects from policy-based finance more difficult, particularly during the consolidation phase of the 1960s and 1970s when less productive firms exited or were merged with other firms.

and are prone to severe information problem. While the intent is similar the directed credit programs are stricter.

According to Vittas & Cho (1995) Korea's credit policy was quite different from Japan's credit program in that the program heavily involved government owned commercial and development bank. The banks were directed to channel their loan to priority sector. The government took different measures to strengthen the state control over finance, which enabled the government to enhance the scope of its control over the allocation of financial resources. During the period from 1950 up to 1970's the directed credit program for Korea was geared towards different investment areas that were taken as priority for development. For example around 1960's the programs were focused on priority export and around the 1970 the focus was for heavy and chemical industries. Around 1980's the government intended to reduce intervention in the credit market but in practice it did continue to interfere with the emphasis now given to social programs and redistribution of income. Korean credit policy was quite different because of its dependence on the central bank and deposits mobilized by commercial banks instead of fiscal funds obtained from the government. Even though the opportunity cost of financing selective programs cannot be estimated reasonably the paper states that these programs were effective.

It also states that as Korea relied on credit interventions too heavily and for too long as an instrument of industrial policy, the costs were borne heavily by banking institutions and depositors. As a result since commercial banks in Korea were involved so heavily in directed credit programs that they almost functioned as development banks. *In the process their management efficiency and quality of services were sacrificed* (Vittas & Cho, 1995).

Kohli (1997) states, that India has had a consistent policy of targeting 40% of bank credit to priority sector during the post nationalization period. In India this kind of

programs were used to promote agriculture and small-scale industry. The existing evidence of the effect of the program on the Indian economy has both costs and benefits to the financial institutions as well as the performance of the beneficiary sector. The directed credit program in India was aligned with decline in the productivity and efficiency of the financial service. It had adverse consequences for banks income through concessional interest rates and high administrative cost of such loans. Credit to other sectors like trade and large industry has been shrinking because they were not the beneficiary sector. It had adverse impact on profitability and portfolio quality of the banking system. Although no empirical study has been conducted as per the paper high transaction cost associated with small loans and interest sensitivity of profit, as it is the main source of income in India banks had a major effect on profitability. The low interest rate on the government securities was not helping profitability either. Even through the same environment the earning exhibited was different among the public banks but this was dependent on the institutional culture, structure, bank management. There was high default rate exhibited during the period but all the default cannot be attributed to the priority sector only, in addition even though it's not stated as a positive or negative note the paper states that this directive has influenced the lending pattern of the banking system. Since the beneficiary group was sectors which were labor intensive India experienced increased job opportunity as positive externality, it also states that even though it had brought certain positive aspects to the economy it is very difficult to determine all the impact such directives had in the economy. The paper concludes by stating that the successful stories of directed credit program in Japan Korea and most East Asian countries is attributable to a combination of economic and institutional factors. Although it didn't eliminate the moral hazard costs of government

intervention an important element in the success story of East Asian countries was a clearly defined goal, which was based on competitive market policy, monitoring and evaluation (strict performance standards) and high interconnection between the industry, banks and government. The paper notes that although bearing in mind these lessons is important, it should be stressed that replicating the Japanese and Korean experience may be more difficult in today's financial environment.

Vives (1997a, 1997b) while discussing the necessary conditions for the advisability of policy based finance in Latin America and the Caribbean's stated that government intervention can be justified when there is clear market failure and major externalities associated with certain sectors. To be perceived as successful, however, these intervention programs must demonstrate that they are able to correct for the perceived market failures. Specifically, governments must show that they have access to and are able to effectively use information not available to or not used by the private sector. Intervention programs must also show that they appropriately address the underlying causes of a specific externality, and not just the symptoms of market failure. According to Vives (1997a, 1997b) the more successful experiments in policy based finance clearly worked because the interventions were limited and used market like structure. And that the successful application of the programs is a factor of economic and institutional factors as also stated by Vitas & Cho (1995). He also stated that even though these factors would help in the successful implementation of directed credit programs they are not absolute guarantees. The paper states that under such programs the private financial intermediaries should be responsible for individual lending decisions and investment monitoring, and they should receive the reward or suffer the consequences resulting from their actions. Resources should be allocated at market

rates, to avoid subsidies to the owners of financial intermediaries. Under no conditions should policy-based lending or other directed credit programs be used to substitute for, or to crowd-out, the private financial system.

Vives (1997a) stated that the relatively mild intervention in East Asian credit market when compared with the massive and unsuccessful intervention in Latin America and the Caribbean point towards limited, carefully targeted interventions. While some kind of intervention may result in improved allocation of scarce resources, this doesn't mean that such interventions neither are without cost nor that they will result in positive allocation of resources. At the end even though it is impossible to measure the cost and benefit of such interventions the effectiveness of them will always be an issue and the conclusion that is reached will always depend on the assumptions made, the issues selected and ignored, the conditions under which the program is expected to work or did work, among others. *"The effectiveness and desirability of policy based lending will remain a controversial issue."* (Vives 1997a, p.4)

Barth, J, Caprio, G and Levine, R (2002) conducted a study entitled bank regulation and supervision: what works best? By taking the data of 107 countries the paper tried to show the regulatory and supervisory practice and banking sector development. By taking specific regulatory practice like regulation on capital, restriction on bank activity, restriction on bank entry the paper tried to see the implication they have on development of banking sector. Based on these findings they raise a cautionary flag regarding reform strategies that place excessive reliance on countries adhering to an extensive checklist of regulatory and supervisory practices that involve direct, government oversight of and restrictions on banks. Instead, this paper's findings suggest that regulatory and supervisory practices that (1) force accurate information

disclosure (2) empower private-sector corporate control of banks, and (3) foster incentives for private agents to exert corporate control work best to promote bank performance and stability. The paper doesn't oppose the idea that there is a need for regulation instead states that private-sector monitoring of banks tends to be associated with greater banking-system success than strategies that place excessive emphasis on direct official government oversight and restrictions on banks.

So in general taking into mind the importance of the financial sector and the need for government's intervention in the allocation of resources countries like Japan, Korean and also India including few other have under taken directed credit program at their developmental stage but this intervention has not been without a cost.

2.3 Over view of the financial sector in Ethiopia

The financial sector in Ethiopia consists of Banks, Insurance Companies, pension fund and others. Mainly banks dominate the financial sector in Ethiopia like most developing countries. According to the National Bank of Ethiopia (NBE) the establishment of Bank of Abyssinia in 1905 marked the start of modern banking in Ethiopia. The financial sector at the time was dominated by foreign ownership until the Abyssinian Bank was nationalized and was renamed bank of Ethiopia in 1931, there by becoming the first indigenous bank in Ethiopia and also the first nationally owned bank in Africa (Belay Gedey 1990:83 Befekadu Degfe 1995:234 cited in Geda 2006)

During that period a number of new financial institutions were established. In 1943 the State Bank of Ethiopia was founded despite considerable British opposition. The State Bank of Ethiopia has operated as central and commercial bank until 1963, when the Bank was dissolved and formed the National Bank of Ethiopia (NBE) and the

Commercial Bank of Ethiopia (CBE). During this period the first privately owned Ethiopian bank, Addis Ababa bank Share Company was established together with different financial institutions¹⁴.

But the banking business couldn't go further because of institutionalization of private investment by the socialist regime that came in to power leaving only three government banks; the National Bank of Ethiopia, the Commercial Bank of Ethiopia and Agricultural and Industrial Development Bank (Abrha & Yimam 2005). But in 1991 following the regime change and the liberalization policy in 1992, the financial institutions were reorganized to work to a market oriented policy framework.

After the Derges command policy the country had been left crippled in the economic as well other sectors hence the new government tried to change the fiscal policy so as to reduce the fiscal deficit, make structural reforms and move to a market based system of foreign exchange allocation. As a result in order to change the foreign exchange allocation system the government had indeed began in October 1992 with the devaluation of 140 percent from 2.07 birr to dollar to 5 birr to a dollar. So as to move to a market based foreign exchange allocation. Financial sector reforms began in earnest in 1994 (Addison & Geda, 2001)

It was during this period that the monetary and banking proclamation (No. 83/1994) and licensing and supervision of banking business proclamation (No. 84/1994) which codified the NBE's role in overseeing the commercial banks and the first proclamation which apart from increasing the role of the NBE made illegal any NBE lending other than the government were established. Furthermore two other

¹⁴They were 3 commercial banks (Addis Ababa Bank, Banco di Napoli and Banco di Roma), 13 insurance companies (namely African solidarity, Ethio-Americas life, Blue Nile Ethiopia, General, Imperial, Afro-continental, Pan-African, Union-Ras, and Ethiopia life and Ras) and 2 non-banks. Financial intermediaries (Imperial saving and home ownership public association and the mortgage corporation) were the different financial institution.

proclamations No. 200/1994 and No. 203/1994 renamed and restructured the Agricultural and Industrial Bank as Development Bank of Ethiopia (DBE) and the Housing and Saving Bank into Construction and Saving Bank respectively.

The domestic private sector was permitted to enter the banking and insurance business but till date the foreign financial institutions aren't permitted to invest. With this new reform the dominance of CBE as the leading commercial bank in mobilizing loans and deposits (high market share) was declining as a result of new entrants even though they are relatively small as compared to the public owned CBE. Thus reform has indeed changed the supply and demand side of the loan¹⁵. In addition the need to build the regulatory capacity of the NBE so that it adapts to the market based system and learn the skills to prudential regulation and supervisory from that of a dictatorial was critical but at the same time a challenge throughout its period. In 1996 NBE established a new division to undertake regulation and supervision.

The second phase of the reform started by the authorities concentrated effort on capacity building in the financial sector as well as on other priority areas of economic transition, in particular further liberalization of the foreign exchange system and trade liberalization. But financial liberalization accelerated again when the lending rate was decontrolled in January 1998. Along with the new directives issued at the time for establishing interbank foreign exchange and money market. But this second phase was met by disagreement between the IMF and the government over the financial sector, which has even led to the suspension of IMF fund in October 1997¹⁶Kiyota et al (2008).

¹⁵Prior to the reform the supply side of loan was concentrated to the public enterprise and since the private sector was weak the demand for loan was very weak and was only to the public enterprise or based on the dictatorship of the then government but with the growth of the private sector and upturn in the activity as a result of economy restructure the change was seen from both sides.

¹⁶The disagreement was on two ground

Currently the banking sector in Ethiopia offers different types of services, which include credit facility (lending) deposit services, international banking service, fund transfer and other services. The formal banking in Ethiopia can be divided as the commercial banks and specialized development banks. The commercial banks can be further divided using the type of ownership as state owned banks and private banks. Till date there have been 3 state owned banks and 14 privately owned banks¹⁷. The CBE still continues being the dominant commercial bank. And according to Koyo Kiyota et al (2007) who looked at the performance of the private and public sector states that state owned banks are comparatively inefficient relative to private banks (In terms of performance).

Researchers have had also tried to show the performance as well as the regulation pre and also post the reform period (Addison & Geda, 2001; Geda 2006). According to Geda (2006) who studied the performance of both stated owned and private banks pre and post reform showed that there has been a significant change in the performance of the financial sector but also stated that the stated owned bank mainly CBE continues to be the dominate bank.

According to World Bank Africa is one of the most underdeveloped continents. This characteristics has slowly been changing through years of serious reforms in the economic and financial sector Allen et al (2011)in their review of Africans financial sector stated that Africa still remains as the most under developed continent in terms of finance and specially SSA (which includes Ethiopia). By dividing the continent

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- a) The share of CBE in the market which was very high and
 - b) Pressure to open the market to foreign banks

¹⁷According to access capital banking sector review the private banks they have listed 12 privately owned banks (Abyssinisa, Awash International Bank, Berhan, Buna, CBE, Dashen, Lion International Bank Nib International Bank, Oromia International Bank, United, Wegagen and Zemen) but after the review their were two additions on July 14, 2010 Abay Bank S.c and on January 31, 2011 Addis International Bank S.c making the total number of private banks fourteen.

regionally the paper tried to see (assess) the financial sector, which it states, is dominated by banks. As an indication of high dysfunctionality of banks intermediation in Africa it shows where the banks invest. From this article it was clear that most of the banks invest in government security primarily treasury bill which will shun provision of private credit in favor of a safer government security which is a major and basic phenomena and as such governments are taking due measures. Looking in to central and East Africa the performance of the banks has been Abysmal and financial system can be characterized as having weak financial system and monopolistic nature. The paper concludes that financial system particularly those in sub Saharan Africa are dominated by traditional banking and informal finance¹⁸, mostly they investment in government securities and generally banks don't pursue innovative banking practice.

Kefela (2008) stated the need for a competitive and open financial sector, which plays critical role in financial sector development. Rapid change in the macroeconomic and macro-financial environment, inadequate control and procedure and concentrated pattern of credit or market risk exposure have led most East African countries to experience major problem with in individual banking institutions or the entire banking sector. Given the severity of the problem measures have been taken, but given the dynamic nature of banking industry it can be expected that routine, technical and operational issues will emerge from time to time and concludes by stating the need for prudential regulation and non-distorted macro economic framework for the efficiency of banking system.

¹⁸Kedir et al (2011) in their paper entitled why use rotating and credit saving association (ROSCA) the case of Ethiopia tried justify that the market failures in the development of formal saving and credit mechanisms as the reason for relatively high ROSCAS in developing countries like Ethiopia.

The banking industry is one of the highly regulated industries in Ethiopia. According to the recent review of access capital the industry on the surface was threatened by unconventional policy interventions. The industry also has been scrutinized by the excessive profit it generates, weak lending practice and also by its use of backward technology. Taking into consideration the pivotal role banks play in developmental plan of the country and also the role that banks play to the overall macroeconomic stability in to account, the NBE has issued different directives during different periods.

The recent directive stated as “Establishment and Operation of National Bank of Ethiopia Bills Market Directives No. MFA/NBEBILLS/001/2011” was issued on March 2011. According to this directive the banks have to purchase long-term bill of the NBE having 5 maturity periods. According to the officials is similar to the directed credit programs in other countries like the once mentioned above. Based on this directive the banks should purchase the bill based on their total disbursement of loans and advances. According to the NBE this directive is expected to increase the private sectors participation in the government designated priority sector.(Appendix5)

2.4 Summary

The empirical researchers that are discussed above indicate that financial development is important for economic growth. But even though there is a relationship between financial development and economic development it was difficult to show a clean causality relationship. Recent crises show that banks are fragile and prone to crises and several factors have been listed such as liberalization, macroeconomic environment and weak regulations are few that have been mentioned.

Supporting evidences show that there is a clear need for the intervention of government in the financial sector but the extent of which is still debatable. This intervention of the government through the financial institutions, in the form of directed credit programs have had positive impact on the economic growth of different countries like Japan, Korea but it also had cost. The commercial banks in Korea were involved so heavily in directed credit programs that they almost functioned as development banks. In the process their management efficiency and quality of services were sacrificed. In India the commercial banks profitability as well as asset quality has reduced, the lending to other sectors no stated as beneficiary sectors has decreased. Most of the papers stated above are still inconclusive about the effect of such interventions by the government in the allocation of credit because the programs have had both positive as well as adverse impacts.

The Africa's financial system is characterized by its dysfunctionality, in that most of the banks lend to the public sector. The banking industry is the highly regulated industry but also the most underdeveloped. Even though the failure might be different among countries the main reason in most failures in Africa's financial system is due to lack of control and the dynamic macroeconomic environment. The banks in Ethiopia have under gone reforms under different rules but still the development has been gradual, which has stirred a lot of contention with different international bodies. Theses slow progress of the formal banking sector with its apparent lack of instruments that incorporate the poor people has lead to the development ROSCAs. The sectors major constraint for development has been forwarded as its closed nature, dominance of the state owned bank (mainly CBE) and also the tight control by the government. The NBE is the regulating body in the country and issues different

directives as a means of regulating the financial system and has recently issued the NBE bill purchase directive, which is intended to allocate credit to the priority sectors.

Based on the reviewed literature there have been some papers done in Japan, Korea, china and India on the impact of the government's intervention in the allocation of credit through the directed credit programs and its contribution to the developmental plan of the country. None, to the knowledge of the researcher have tried to see the implication this intervention (directives) has on the private commercial banks except in the case of India and Korea to some extent but they were also inconclusive.

The papers emphasize on the effectiveness, costs and other macroeconomic effects that are a direct result of such intervention in the financial markets but none to the knowledge of the researcher had tried to see the implication this intervention has to the private commercial banks alone. Taking that the context of each intervention is unique to the country in question and taking that such a directive is only recent no research paper has been forwarded in the Ethiopian context.

CHAPTER THREE

Research design and methods

In the preceding chapter, we had tried to see the related literature to the topic. This chapter discusses the research design. Leedy (1989) has stated that research planning (research design) and architectural planning have much in common. Each requires a conceptualization of the overall organization and a detailed plan before work on the project can begin. For successful completion, a building requires plans that are clearly conceived and accurately drawn. A research project should be no less than totally visualized and precisely detailed.

Research approaches all problems through certain methodological channels that are particularly appropriate to the nature and type of data that the investigation of the problem requires (Leedy 1989). In order to address the stated problem well developed design is presented in this chapter and is organized in four sections. The first section 3.1, presents the research question along with the broad purpose of the research. Section 3.2 discusses briefly the research approaches while section 3.3 presents the method adopted in the study.

3.1 Research question and purpose of the study

The recent directive of NBE ¹⁹ is a hot topic in Ethiopians banking sector²⁰. The sector is one, which is categorized as being highly regulated due to several reasons. Mainly and most importantly the sector is heavily regulated because of the key importance it is expected to play to the sustainable economic development of the

¹⁹Directives No MFA/NBEBILLS/001/2001

²⁰Based on a preliminary discussions that the researcher has under taken the researcher has found that these directive is creating a challenge in the sector.

country. As such the governing body from time to time has issued the necessary regulations for the proper functioning of the sector. And the recent directive was also implemented with the same intention but has certain implication on the normal operation of the private banks. As such the general objective of the study is to assess the implication of the new directive has on the performance of the private commercial banks in Ethiopia. In order to address the objective stated this study proposed to address the following research question.

- RQ1. Why is the directive necessary? Or what are the grounds and premises for the directive to be imposed on the private commercial banks?
- RQ2. What implication does the directive has on the performance of the private commercial banks? And the consequence of the directive?
- RQ3. What measures are being taken by the banks in order to address the issue?
- RQ4. What does the future look like for the existing and incoming private commercial banks as a result of the directive?

3.2 Research approaches

Social change begins with inquiry about a topic of interest, which then leads to research. The choice of research methodology has generally been split along the line of two philosophical camps: positivism and constructivism typically associated with traditional quantitative and qualitative methods, respectively (Bergman, 2008 as cited in Baker 2010, Leedy and Ormrod, 2005 as cited in Semu, 2010) with the new addition to the two approaches being the mixed approach.

3.2.1 Quantitative research approach

The quantitative research approach aligns itself to the post positivism philosophical assumption. This approach assumes that “causes determine outcomes”. It involves the generation of data in quantitative or numerical form, which can be subjected to rigorous quantitative analysis in a formal and rigid fashion. Quantitative research approach has *two* strategies of inquiry: survey and experimental design. Using both strategies, we will be able to generalize about the population from the sample which is also taken as the major strength. On the other hand, the weakness of a quantitative research lay in that the researcher knows much about the collective or average experience of study participants but not their individual experiences. Thus, this approach is regarded as closed systems view because the categories and responses of interest are decided up on in advance (Dunn, 1999; Kothari, 2004; Creswell, 2009).

3.2.2 Qualitative research approach

The qualitative approach, on the other hand, is based on a constructivist philosophical assumption. This approach is not concerned with the determination of cause and effect relationship but rather it tries to develop theories from the individual experiences of study participants. The approach operates under the assumption that reality is not easily divided into discrete and measurable variables, hence, data gathered under this approach are not numerical nor are they usually subjected to statistical methods of analysis. Rather they are examined in their raw form (Dunn, 1999). Unlike the quantitative approach which is rigid, the qualitative process is emergent in its nature.

Qualitative research approach has five common strategies of inquiry. The strategies include case study, ethnography, phenomenological study, grounded theory and

content analysis (Leedy and Ormrod, 2005 as cited in Semu, 2010). The approach makes considerable use of inductive reasoning. And the findings may be so specific to phenomena under certain context that making generalization will not be possible about the same phenomena under different context which is taken as the major weakness of the approach. On the other hand, the qualitative approach represents an open systems view, which is the main benefit when it comes to developing a theory in the early stage of investigating a topic (Dunn, 1999).

3.2.3 Mixed research approach

The mixed research approach uses a pragmatic view to how knowledge is acquired. Whether quantitative or qualitative, most methods have inherent weaknesses and/or biases that limit their usefulness and potentially skew the interpretation of the results. However, by utilizing a mixed methods approach in which the different quantitative and qualitative methods compliment with each other's strengths and weaknesses, these biases can be equalized, resulting in an enhanced solution that better explains the problem under study (Creswell & Plano Clark, 2007; Singleton & Straits, 2005 as cited in Baker 2010). This approach some of quantitative and qualitative strategies stated above in a complementary manner. As such it is mainly applied when the data obtained using one of the methods alone is not expected to address the problem in depth.

3.3 Methods adopted.

As can be seen from the research problem, this research is more of exploratory with regard to the stated phenomenon hence; the researcher believed that using qualitative research design is more appropriate.

3.3.1 Reasons for choosing qualitative research

The researcher believed that the qualitative research method, which is used to acquire detailed conceptual and rich ideas, should be used in the current study because of the reasons stated below. Firstly the topic is very recent. Secondly developing a relationship (analyzing potential impact on a variable) between the directive and the potentially affected variables requires an already stated knowledge (developed theory) about the topic. Hence, the researcher believed that this clearly depicts a need to prepare an exploratory research with regard to the topic which could be properly addressed using qualitative research approach.

Thirdly the quantitative research, which is mainly applied to determine cause and effect relationship cannot be used because of the nature of the data that is required in order to use the quantitative approach and the available data in conducting the research are quite different (the data was more of qualitative in nature). The major concern of the researcher with this regard is that since the collected information in qualitative research are too much in most cases; this would bring forth the constraint of time.

In conclusion the researcher took a qualitative research approach mainly for two reasons: the nature of the research and type of data available. In addition to the stated reasons the researcher did also take the philosophical stance of the different approaches in to consideration and strongly believed that the qualitative research approach is the best suit for the study.

3.3.2 Data collection instruments

For the purpose of data collection, the researcher used in-depth interview. In depth interviewing is a qualitative research technique that involves conducting intensive

interviews with a small number of respondents to explore their perspective on a particular idea, program, or situation. The researcher choose this data collection instrument not only because it is the most commonly used data collection instrument in qualitative research but also because of the nature of the data that the researcher is trying to look into.

The researcher took field notes and recorded the interview using audio recorders with the permission of each interviewee, which were then summarized, in great detail. The researcher will avail the field notes up on demand for further investigation.

3.3.3 Sample and Sample selection

There are currently 14 private commercial banks operating in Ethiopia (www.nbe.gov.et). Almost all have their head offices located in the capital city, Addis Ababa. Based on their market share and other financial measures, the banks are classified as the “large 6”²¹ which are dominate in the sector and the remaining as “small 8”²² (Appendix 1-A). The researcher, therefore took, 3 banks from the large ones, namely, Dashen, Awash International Bank (AIB) and Nib International Bank (NIB) and also 3 other ones from the small banks, namely Oromia International Bank (OIB), Zemen and Abay. Before determining the sample size and its composition, the researcher conducted two preliminary interviews with conveniently selected respondents (not included in the current sample) and clearly saw that the implication the directive has on the large and small (most of them recent entrants to the industry) banks is quiet different because of the number of years they have been in operation,

²¹ Refers to Dashen, Awash International Bank, Nib International Bank, Abyssinia, United and Wegagen bank

²² Refers to the remaining 8 private commercial banks

their resource base and the market share they have in the industry. Hence, the researcher took samples from the two groups.

The interviews were conducted with the officials selected purposively from the head office of sample banks. As the directive is first sent to the head office of the banks and then communicated throughout the branches, the researcher believed it to be suitable to address only the officials at the head office level. Based on a preliminary interview that was conducted with two bank officials and also the nature of the directive, the researcher obtained that the directive affects every activity (department) of the banks, but most significantly the credit department. Hence, most of the interviews that were conducted were with top-level officials from credit department. In addition to the credit department, the research had also interviewed officials from other departments including corporate planning and marketing department, finance and treasury and accounts and finance in order to solicit different point of views²³. In general, the banks and also the interviewed officials were all selected using purposive sampling. But, the major hurdle that was expected and faced by the researcher in conducting the interview is that since the interviews can only be conducted with top level managers of different banks it was very time demanding.

²³The researcher believed that the different departments would be able to see the topic from different angles and give a rich insight about the topic.

CHAPTER FOUR

Results and Discussions

The previous chapters presented the introduction, the literature review and also the methods and techniques implemented in the study. This chapter presents the results and discussions. As described in the previous chapter the study aims at examining the implication the recent NBE bill directive has on performance of the private commercial banks in Ethiopia.

Before conducting the interview for the research, the officials were all given a letter that states the topic being studied, that the interview conducted would be used for academic purpose and any data that was sensitive would be kept confidential (Appendix-4). Besides in the process of collecting the data the researcher has initially explained the purpose of conducting the study and has taken the necessary ethical measures to insure that the data collected was unbiased to the best of the researcher's knowledge.

In order to keep the information obtained and the official's identity confidential the researcher gave code to the officials. All of the officials from the big six banks that were selected were given code A and assigned numbers 1,2 and 3 hence code A1 represents the first official from the large six banks. These officials are all from the credit department. The selected officials from small 8 were assigned code B; and except the official from one bank the rest two are from the credit department. They were assigned 1, 2 and 3 hence code B1 would represent the first official from the 8 small banks. The officials from different departments were given code C but it doesn't signify whether it is from the large six or from the small 8 banks. Instead code C1 is assigned for official working as Director for corporate planning and marketing

department, code C2 is assigned for official working as manager of accounts and finance department and code C3 is assigned for official working as head of finance and treasury. In addition based on the emerging themes the researcher has assigned codes. For example with regard to the expectancy of the banks which is the second theme the researcher has assigned code B hence if the responses are from the selected officials from the large six who are already assigned code A then the code would be AB in the appendix. And if it is from the officials selected from the small banks then the code would be BB the first letter signifying the officials and the second the response obtained with regard to the theme. (Appendix-3)

Information about the officials

The officials that are included in the research are all currently working as top-level managers of their respective banks with in different departments. The officials have been working in the industry for many years. In addition to their designated departments they are currently serving their banks through different committees. Most of the officials are members of asset liability committee (ALCO members) with in their respective banks. The researcher believes that the participation of the officials within these different committees added with their years of experience, have created the opportunity for them to look in to general operation of the business and give accounts from different viewpoints.

4.1 Basic understanding about the regulation

The researcher asked few introductory questions in order to obtain basic understanding of respondents and the readiness of the banks with regard to the current directives. As the directive was imposed on the private banks the researcher wanted to see if the banks had been ready in terms of operational management to handle the

directive or if it was an unanticipated directive that came as a surprise to the officials. The response obtained is summarized in the following to sub sections.

A. The likely motive behind the implementation of the directive

The objective behind this section is to have an understanding (idea) about the motive (premises) for the introduction of this directive from the official's point of view:

“Even though stated as increasing participation of banks in priority sector financing... Still I believe that it is due to inflationary pressure and hence it's a means of reducing banks participation in the circulation of money” and also

“In addition the government as much as possible is trying to reduce the amount of money it borrows from the central bank and finance its projects as well.” (A1- Appendix 2)

“As stated in the directive it's intended to increase the private banks participation in government priority sector projects.” (A2- Appendix 2)

“On the one hand it could be to reduce circulation of money by controlling outflow from banks. But as it is explicitly stated it is intended for financing priority sector.” (A3-Appendix2)

“Those²⁴ banks are directed by the NBE as to which sector they should finance and which sector they shouldn't finance. Hence this directive has that same intention” (B2 – Appendix 2)

“In order to meet the growth and transformation plan (GTP²⁵) the government needs to finance those projects that are expected to realize the GTP plan” (B2 – Appendix 2)

²⁴ Those banks in this case refer to the government banks.

“The basic reason as stated in the GTP is that the government is undertaking huge programs and since the government alone won’t be able to finance these programs; it requires the participation of the private sector.” (B3 – Appendix2) and also

“It is more so to control inflation. The correct reason really might be inflation”

The officials from the other two departments stated that the motive behind the direction was to obtain the necessary finance to the priority sectors (C1 and C2 - Appendix 2). In addition one of the bank officials also stated that this directive could have motive for inflationary control as well (C2-Appendix 2). According to most of the officials two views are mainly seen as the motive and also the basic reason for the directive, which are: *priority sector financing* and *inflationary control* (macroeconomic stability) (code AA, BA and CA- Appendix 2).

According to the officials the government requires huge finance to meet its GTP plan and achieve those projects that are stated as priority sector without increasing the amount of money it borrows from central bank (A1-Appendix 2). Hence, the government taking into consideration the need for finance decided to collect the amount needed by using the NBE bill purchase directive. According to the officials they are financing those priority sectors and there was no need for the directive. Based on the stated GTP plan the officials stated that they are financing the priority sector (included in the plan as priority sector are the manufacturing and agricultural sectors) and stated that we need only to look at the private sectors loan portfolio (Appendix1-B) to verify that they indeed are financing those sectors.

By looking into the loan portfolio if as stated under the GTP priority sectors imply those sectors (agriculture and manufacturing sectors) then it clear that the banks do

²⁵The plan states the governments plan for the coming five years and is available at the Ministry of Finance and Economic Development website (www.mofed.gov.et).

indeed finance these sectors. But in this regard one bank official had quite a different opinion. He believed that the private banks were not financing priority sectors.

"No we are not financing private sector ... because as stated through different medias priority sector doesn't mean to imply the manufacturing, agriculture sector what government states as priority sector includes specific projects like construction of dams, sugar factory and other huge projects"(Official A3). So from the officials view the direct finance collected from the private banks will help to finance such huge investment project.

With regard to the inflationary control since the circulation of money is now restricted (because the directive directly restricts the banks capacity of lending) it could help to minimize inflationary problems, which in turn could lead to macroeconomic stability. The officials in this regard were a little inconclusive. Because if as they stated the case is for inflationary control and if the government after collecting the money from the banks, directly injects it to the economy by financing the different project, then there will be no reduction in the circulation of money. As such the researcher after discussing this with the officials gathered that: one of the main functions that are performed by banks is the circulation of money in the economy through there intermediary role, since these bill purchase directive affects the bank's lending capacity thereby reducing the role banks play in the circulation of money, it could help to reduce the inflationary pressure which could be a plausible idea.

B. The expectancy of the banks to the directive

As financial intermediaries it is part of their main duty to manage different types of risks associated with their operations. Banks face different types of risks that constrain their general operations among which are government regulations. Hence,

the objective of this section is to show whether the banks had expected the directive to surface. According to the officials

“We have expected some sort of regulation in the sector and we have received a signal that even though there will be change, that there will be restrictions. But we don’t expect it to be in this form.” (A1-Appendix 2)

“There were some rumors that there was some sort of directive to be issued when the credit cap²⁶ was lifted. But no one has anticipated such kind of a directive.” (A2-Appendix 2)

“No it was not expected.” (A3-appendix 2)

“....suddenly they imposed this directive and went to the implementation.”(B2-Appendix 2)

“Some few years back there was a credit cap which was basically for inflationary purpose... as soon as this was lifted we were faced with this new directive which was not expected.”(B3-Appendix 2) The bank officials from different departments didn’t have different views with regard to the point raised (C1, C2 and C3-Appendix2).

From the above statements it’s clear to see that *the bank officials did not anticipate the directive* and that the bank didn’t have enough time to adjust to the change. According to the bank officials the directive was quite sudden and that they have expected some sort of regulation but absolutely not in this form (code AB, BB and CB- Appendix2). The officials also believe that it has an instant effect of cooling the banks activity.

“We didn’t expect it to highly and instantly cool the banking sector we had expected some time within which the banks would adjust.”(Official A1)

²⁶The credit cap, which was imposed on the banks some three years ago was direct monetary policy instrument to curb the higher level of inflation at the time and thereby helps bring macroeconomic stability. The directive states certain credit ceiling above which the banks cannot give loan.

“It’s like what I have mentioned early if we had known that this was coming do you think we would have even given short term loans²⁷ like we did?”(Official A2)

Table 1: Summary for basic understanding

No.	Views that are forwarded by the officials with regard to grounds for the directive.
1.	Governments need to finance those projects, which are said to be priority sector in order to meet it GTP plan.
2.	In order to increase the private banks participation in priority sector financing.
3.	To control inflation by reducing the role played by the banks in circulation of money (reduce circulation) and hence bring forth macroeconomic stability.
4.	To directly direct the private banks like the public banks.
5.	The directive according to the official was not expected which instantly cooled the banks performance. This directive affected the bank’s performance in terms of profitability by reducing the lending capacity of the banks, the low interest income, the high cost associated with the directive which will be discussed in subsequent parts.

Source: interview

²⁷This according to the official was because of the nature of the loans and because of the effect the directive has on such type of short term loan which is explained later section.

As reflected by the officials when the directive was issued they were very much surprised by the way in which it affected the banks. Previously the officials stated that the credit cap directive was in place which was clearly a direct monetary policy instrument to curb inflation. This directive was opposed by the officials because of the effect it has on the credit capacity of the banks but considering the recent NBE bill directive the officials stated that they would take the credit cap any time. As will be explained later the recent directive affects the bank's lending pattern as well as capacity which do have its own bearing in the profitability of the banks.

4.2 The implication the directive has on the performance of the banks

The directive is recent and its impact couldn't be seen directly from the financial statements of the banks. Thus, in order to see if the directive would have an impact on the bank's performance the researcher asked respondents whether the directive really affects performance of their respective banks and in what ways it is affecting them.

C. Does the directive affect the bank's profitability?²⁸

And if so

D. In what manner?

The researcher in this regard didn't have to go further because the answers obtained were unanimous in the sense that almost all respondents focused on the effect of the directive on profitability of the banks as shown below.

"Yes, it affects profit... and it was a huge impact." (A1-Appendix-2)

"There is no question that it would have on adverse impact on profitability." (A2-Appendix2)

²⁸The researcher in this case would like to clarify that even though performance could be measured through different means the manner in which the officials addressed how the directive affects their performance is primarily through its adverse implication on the profitability of the banks and hence the theme "banks profitability" is obtained from the different officials as means of performance measure.

“It would decrease the gap on profitability.”²⁹ (A3-Appendix-2)

“The bill has many impacts.” (B2- appendix-2)

All that officials stated the same thing with regard to the directive. They all stated that *it will have impact on profitability and that this impact will most certainly be in an adverse manner.* (Code AC and AD, BC and BD, CC and CD- Appendix -2). They stated that the directive is affecting profitability of the banks in different ways as stated below.

E. How will the directive affect profit?

“We have invested 27% of our disbursement on a loan(refers to the NBE bill) which is generating only 3% on which we pay 5% if it’s saving³⁰ and 7% if its fixed deposit.”(Official A1)

“We obtain the fund by 7% and they take it by 3% interest from us.” (Official A2)

“On average we used to lend this money at 11.5-12%.... but what we earn is 3% based on the directive.”(Official A3)

“It increases the banks cost of fund but on the other hand we collect 3% on the bill which is not easily accessible.”(Official B2)

“The interest rate on the bill is worth mentioning an average we might pay 6% on the deposit but we are earning 3% on the bill.”(Official B3)

²⁹The gap from the respondents point is the difference between the interest income from investing in the NBE bill and the interest expense the banks pay to depositors. Thus, the directive has the effect of decreasing the margin (referred as profit gap by the officials)

³⁰We have three main accounts (deposits) in Ethiopia the saving account and also fixed (time) deposit on which the banks do pay an interest and the current account also referred to as demand account (used interchangeably in this study) which is noninterest bearing. These rates are slightly different from bank to bank but do not show significant difference.

Almost all of the officials stated two main effects of the directive namely: *low interest income* and *increasing cost* that is directly or indirectly the result of the directive. (Code AE, BE and CE – Appendix 2). The officials raised the following important points to elaborate the effect of the directive in low interest income and increasing cost.

a) With regard to the low interest income;

The officials all reflected that the low interest income that they generate is directly attributable to the directive itself, which fixed a 3% return (i.e. interest income) on investment in the bill. According to the officials, taking the composition of deposit into account and also the interest paid on these sources of fund it is not justifiable to charge 3% interest on the bill because it doesn't cover even the cost of fund. According to the officials the only account on which they do not pay interest on is current account. But looking into the deposit composition saving and fixed deposits together constitute the largest share of deposit (Appendix-1C) on which there is interest paid (cost). The officials also stated that such accounts are highly volatile that they should not be invested in a long term maturing loan.

"....current accounts as such are not stable accounts hence they should not be taken as a stable means to finance long term investment."(Official B3)

Hence from the officials view the 3% interest income that they generate on the bill not only isn't justifiable taking the composition of the different accounts into consideration but it is also unwise move to place them in long term maturing investment such as the NBE bill.

b) With regard to the increasing cost;

The officials also pointed out that this directive will affect performance which they described in terms of profit, because it directly or indirectly increasing cost to the

banks. As shown below, the officials stated *liquidity challenge as the basic reason* leading to unnecessary cost.

“The directives immediate impact was on liquidity. It drained the banks liquidity because not only was it 27% and based on total disbursement it was also retroactive³¹.”(Official B2)

“The directive by itself is putting us in to liquidity problem.”(Official A2)

“Even though we are allowed to lend as much as we want to whenever we lend the directive will drain our liquidity.”(Official B3)

The directive simply states the amount to be invested in the NBE bill should be calculated based on total disbursement of each banks. From the officials point neither the amount (27%³²) nor the method is helping the liquidity challenge they face. As stated by official A1:

“Since the directive states that we should purchase for the preceding 8 months, and we were expected to pay the amount immediately we had no chance in which we were able to manage our cash and hence this led the banks to liquidity challenge.”

All of the officials had stated that they are certainly faced with liquidity challenge. The officials, in explain the liquidity challenge, stated that the amount of money they lend is mainly obtained from the deposits they mobilize and from the repayment of the loans they gave out. Since the directive states that it should be calculated out of total disbursement, whenever a loan is issued they have to buy NBE bill and when it's repaid and lent out again they also have to buy another round of NBE bill which has a *compounding effect*. According to the directive, the bill has 5 year maturity period and

³¹The directive when first introduced was applied on previous 8 months disbursement making it retroactive.

³²For better explanation read the directive in the appendices (appendices-5)

as such ties these resources of the banks in the NBE bill which in turn creates liquidity problem. This could be explained with the following example.

Assume that a bank gives a 1 million birr³³ term loan that matures within 2 or 3 months. This money that the bank gave in the form of term loan was collected from different types of deposit that are all payable upon demand. When the loan was given initially the bank had to purchase a bill, which amounts to 27% of the total disbursement, in this case 27% of 1 million birr. According to the directive if bank were to lend it again after it is collected within 3 months, then the bank has to buy another round of bill. On average if this 1 million birr turns over say 3 times in a year, the bank would buy 27% of the 1 million 3 times ($0.27 \times 1 \text{ million} \times 3$) which comes around 810,000 birr. So, roughly the bank would have to raise around 2 million birr deposit (because of other stipulation that may exist) to be able to give the same amount of loan to that specific customer. These will push banks to mobilize huge resources. In addition, the 810,000 birr would be held by NBE for 5 years at 3% interest and is out of the reach of the banks. (Assuming that all else remains the same).

From the above stated example and the officials' view, we can see that the directive doesn't take into consideration the type of loan³⁴ in calculating the amount to be invested in the NBE bill, which aggravates the liquidity problem of the banks and resulting costs. As the officials put it, loans especially with shorter maturity period (as they call them revolving nature loans) aggravate the problem: As stated by official A2:

³³The Ethiopian local currency

³⁴As per the directive the only calculation which is different is for overdraft loan which is calculated based on the incremental amount instead of the total disbursement.

“Many of the revolving nature loans make us susceptible to more bill purchase which put us in asset liability mismatch and also liquidity problem.”

The asset-liability mismatch is further explained by respondents in connection with the fact that the directive forces the banks to move their assets with short-term maturity to those with long-term maturity. In explaining this, the officials stated that when we look at the loan (asset) side of the balance sheet of a particular bank, it normally consists of assets with short term maturity. This is to match the liability side which constitutes mainly deposits that are paid on demand (short term maturing). After the directive was issued, lending on short-term basis, such as export loans, advances against imports and merchandize loans, pushes the amount banks invest in NBE bill upward due to the high turnover of short-term loans and the amount of investment in NBE bill is based on total disbursement. According to the officials, the purchase of bill on such loans not only increases the amount of bill purchased (which means low interest income) but also pushes the asset side of the balance sheet to long-term maturity which would led the banks to *asset liability mismatch* and also aggravate the liquidity problem (because of the revolving nature of the loans). This challenge is further noted by the statements from official B2:

“Our liability is short term maturity and usually paid back on demand and when we look at the assets (loans) of almost all banks, around 78% of them are financed from deposits (liability). The deposits are of three types. For they are frequently drawn accounts, they are not dependable sources of funds to the banks and to meet drawings we do not prefer lending for long period... but due to the NBE bill directive while we are still mobilizing short term maturing deposits we are forced to finance long term projects or investments... this is one way we can express the challenge.”

From what has been explained above, we can conclude that the banks are facing two major challenges, namely, *liquidity* and *asset liability mismatch* which are highly related. To maintain liquidity and avoid asset-liability mismatch, the banks are incurring cost. This cost, accordingly to the officials, is a direct result of the banks attempt to mitigate the above stated challenges posed by the directive as shown below:

"We are incurring cost due to liquidity." (Official A1)

"Since we are not liquid we are paying up to 8% on time deposit but previously we would pay 5 to 6%." And *"It increases our operating cost"*. (Official A3)

"....the first effect is on liquidity and that impact will hinder us from doing our job properly" (Official B3)

In explaining the above statement, all the bank officials' state that the liquidity challenge that they are facing will be mitigated if they are able to mobilize huge deposits. As can be seen even from the above example it would require additional 810,000 birr to even give the same loan to customers. These means not only to mitigate the liquidity problem but also to be able to give loans the required resources mobilization is very high due to the directive. This from the officials view will lead to competition for mobilizing huge deposits as such the banks will take mainly two steps as means of competing:

- a) *Opening branches aggressively* (except Zemen³⁵) and or

³⁵Even though Zemen bank is one of the young banks in the industry the strategic focus of this bank is quite different from the industry in two main reasons: a) the bank operates in a niche market and hence focuses on corporate customers and b) it uses one branch system. Therefore Zemen's strategy for mobilization of resources doesn't include branch opening, which is stated as one reason for increased cost. Instead like all the other banks in the industry Zemen focuses on increasing interest on deposit for mobilizing deposits. Although Zemen doesn't use branches it use window shops which they call "kiosks" for collecting deposit which are very few in number and as per the officials of the bank require a very limited resources. (www.zemenbank.com)

- b) *Increase the interest paid on deposit (specially fixed deposits), which will increase operating cost and cost of fund respectively.*

The operating cost according to the officials is associated with the new branches that would require the necessary human and internal resources, which would increase cost (especially rental cost is mentioned by most of the officials as the major cost for new branch openings). As already stated this form of operating cost wouldn't be an issue for Zemen bank. But like all the officials from different banks stated Zemen bank also competes through interest in order to obtain deposits, which is true for all banks in the industry. The officials from the small and young banks excluding Zemen, also stated that they would incur higher operating cost than the large banks because they are at their initial stage of operation as stated by officials B2 and A3 respectively below:

"Banks at initial stage have higher operating expenses than revenue... if we take us specifically within few months in which we started operation... we have to expand our branches at higher rate."

"The impact is going to be great to small banks; they will be highly affected by the directive."

According to the officials, since these banks are young and new to the industry they will incur cost of establishment. These includes all the requirement for establishment laid by the government, the necessary office needed for running the business with all the cost incurred for staffing, furniture and set up. The officials added that this, in addition to the cost the small banks incur due to the directive like every bank in the industry, increases the operating cost for the young banks more than so for older ones which have been in the industry for a very long period of time. Hence, the effect the directive has on profitability is expected to be more severe for those young banks.

In summary, most of the officials stated two basic reasons as to why they believe that the recent directive on NBE bill purchase would adversely affect the profitability of the banks. This includes *low interest collected on the bill (3%)* and *high cost of fund* that they incur in order to mitigate the major *liquidity challenge* they are facing due to the directive (Code AE, BE and CE – Appendix 2).

F. Sustainability of the banks

Taking the ideas forwarded by the officials, the researcher asked the officials their opinion with regard to sustainability. Taking into consideration the challenges that they are facing with (as stated by the officials) the researcher wanted to see if all things remain the same and there would be no modification/change to the directive would the banks be able to generate sustainable income and sustain in the finance sector. The researchers believed that this would show the viability of the banks. Accordingly, the researcher obtained the following response from the officials.

“Yes we can be sustainable because sustainability is an issue of managing liquidity.”

(A1-Appendix2) As per the official, sustainability wouldn't be an issue. As far as the banks are able to mobilize sufficient resource (deposit) and be able to manage liquidity challenge, they could be sustainable. Additionally, the official stated that since the banks are highly regulated (because they mobilize public funds) the chance of failure is very minimal. Other officials have also supported these ideas as shown below:

“The magnitude is quite different.... If it continues like this the impact is so clear. I am not saying it wouldn't hurt the bank. It's a challenge... but if things continue I don't believe we would incur loss because it depends on our deposit mobilization.”

(A2-Appendix2)

“I don't think sustainability would be an issue.” (A3-Appendix2)

“You might not see the same growth rate but we can’t say with certainty that we will not be profitable” (B3-Appendix2)

In conclusion most of the official stated that the banks would be able to generate sustainable income and sustain in the sector as long as they are able to mobilize huge deposits. Still the banks will be faced with challenging times and the *growth rate (for profit) will be decreasing*. (Code AF, BF, and CF-Appendix2). From the size and the capacity of the banks it is clear that the officials from the large banks were optimist about the ability of the banks to generate sustainable income. From what the researcher has obtained on the field the small banks except few are very pessimist with regard to the future but due to sensitivity of the subject and also the likely signals that it gives to potential customers and stakeholders, the officials were reluctant to addressee the point. This ability to sustain in the sector is directly related to the banks resources, years of experience and in general the bank’s ability to absorb such shocks.

Table 2: Implication on profitability

1.	Does the directive affect the bank’s profitability?	The response gathered from the officials was “yes” it does affect the bank’s profitability.
2.	Is the effect that the directive has on profitability positive or adverse?	The officials all stated that the directive has an adverse impact on profitability.
3.	When asked in what manner?	The officials stated that the directive decreases the interest income because the interest collected from

		the bill is only 3%. But on the other hand it increases the cost that the bank incurs.
4.	How does it increase cost?	The officials explained that the directive leads the banks to two major challenges: <i>liquidity challenge</i> and <i>asset liability mismatch</i> . In order to overcome this challenge, which is a direct attribute of the directive, the officials stated that there is a need to mobilize resources. The resources are mobilized (collected through) basically through two means: i) by opening branches which increases operating cost and or ii) by competing through increasing deposit rates which would increase the cost of fund thereby increasing the cost the banks incur.
5.	In comparing the impact the directive will have on the young and old banks	Some of the officials addressed that the directive will have severe impact on the profitability of the young banks when compared to the old banks given that they are still in the initial stage of establishment.
6.	If things don't change in the future would the banks sustain?	The officials stated that the road is going to be challenging but the banks would be able to sustain in the sector if they are able to manage the liquidity challenge.

Source: interview

G. The directives preferential treatment and the consequence on the private commercial banks (Code AG, BG and CG Appendix-2)

The directive clearly states that the private banks are to purchase the bill but leaves out all state owned banks including the largest state owned bank (CBE). In relation to the fact that the directive does not cover state banks and its consequences, the officials stated:

"... those customers that we are not able to give the required finance (loan) will go elsewhere... and are going to CBE... in addition we are not only losing our credit customer but also the... whole package... hence we would loss our customers." (A1-Appendix2)

"It's absolutely partisan; because it's not applicable to the CBE and DBE." (A2-Appendix2) In explaining the consequence of the fact that the directive is partisan, one the official used export loans as an example and stated the following:

"...Export loans are mainly seasonal and also are repaid with in short period. But whenever this loans are returned and we want to lend it again we have to buy another round bill hence we are forced to reduce such loans as a result the customer would shift to another who is able to finance their loan request."

"We can't retain our customers." (A3-Appendix2)

"The directive focuses on the private banks." As a result

"The directive is making the public loss their confidence on the private banks and shifting them to the public bank." And that

"In the long run there will be a challenge in retaining existing customers would create a challenge in retaining existing market share." (B2-Appendix2)

"Yes, the regulation is partisan and the fact that the public banks are excluded from the directive makes it so." And because of these directive

“Our corporate customers are... going to banks who could service their loans.” (B3-Appendix2)

As per the officials B1, C3 and C1 have also stated that the regulation is partisan and hence leads to *“shift of customers”* from the private banks state-owned ones.

Therefore, according to the officials the directive is partisan and due to this preferential treatment, particularly, the *CBE is increasing its strong hold in the market*. In explaining this, these officials stated that due to this directive they are not able to service (give loans to) their credit customers because if they would even want to lend the same amount of money to an individual they need to mobilize huge deposit so as not to be in a liquidity problem. Especially those customers who are in need of short-term loans would not be able to get the loan easily because of the impact this is going to have on the banks liquidity if the banks were to provide such loan. As such most of their customers would be forced to look for credit elsewhere. Since all private commercial banks are in the same situation these customers would go to especially CBE which is not covered by the directive as a result has the ability to service the request. The officials state that this would ultimately increase the market share of the CBE, which already has the largest market share in the industry. As stated by official B2, after the directives both the credit cap and now the bill purchase directive *“the CBE is showing a sharp increase in market share.”*

In addition, two officials stated that this directive not only reduces the capacity of the existing banks it would also be a barrier to new entrants in the sector as follows:

“How can new entrants come to the market if you are shrinking the existing banks through such regulation?” (A1-Appendix2)

“From the private banks point it seems that this was deliberately done as a challenge to the private sector... in some way it will shrink the private banks” (B2-Appendix2)

According to the above stated officials, such directives which have effects of shrinking the existing private banks can also be a discouragement to the new entrant and could be seen *as a barrier to new entrants*. Besides, almost all of the officials stated that the directive is clearly partisan and therefore will lead to shift of customers from the private banks to the state owned bank specifically to the CBE. With regard to this official, A3 also pointed out the fact that they (the private banks) also need to see that the CBE being a state owned bank bears a lot of burden. For example, the CBE is directed to finance such projects like housing projects (for building of condominium house), hydroelectric power and the like which are not and also cannot be financed by the private sector. The official stated that

“Looking at it from outside it might seem as if it is given favorable treatment but when we see it deeply we could also see that it shoulders a lot of burden.” So, official A3 pointed out, even though this directive clearly excludes the CBE and as such is partisan with all its implications that they should take in mind that CBE also takes other burdens that are directly forwarded in the form of policy to the CBE only. This from the official point of view doesn't mean that the directive of bill purchase is not partisan, just a point to consider in consideration to the CBE.

H. Competition among banks (Code AH, BH and CH Appendix-2)

Official A1 stated that: (A1- Appedix2)

The directive creates *“unfair competition”* among private and state-owned banks. This is due to the nature of the directive, which excludes the state-owned banks. The official stated that since we are competing for the same resource the competition from both private and state owned bank is for deposit. The official also stated that we have ample credit request hence there wouldn't be that much competition for credit customers. But in order to give any kind of loan, without increasing the liquidity

challenge there is a need to aggressively mobilize deposits. Therefore the main competition is for deposit. The official stated that the manner in which we compete would be different from bank to bank and that it will depend on the management style, risk appetite and other factors.

“Yes, there will be competition. But how we would compete differs from bank to bank depending on the stated facts.”

These means that even though increasing interest rate would be the means to compete for deposit it would also increase cost; as such official A1 stated that it would be wise to take slow steps before rushing to measures such as increasing interest rate. The official also stated that such measures are influenced by the management style, culture and other internal factors.

Official A2 also stated that:

“There is competition both from private and also government banks if we ask in what manner it is simple through deposit... since credit demand is there these is not an issue... but the competition for deposit is going to be cut throat.”(A2- Appedix2)

In addition to the above comment the official also stated that this competition is further aggravated through the bond market. The official stated that currently as is observed through different media individuals and households are purchasing the 5 year bond issued by the DBE which is reducing the amount of money that individuals are saving these increases the competition for deposit.

OfficialA3 stated that:

The competition is for deposit from both the private and also state owned bank. In order to compete for the deposit the official stated that they could *use service delivery* instead of increasing deposit rate. In explaining this official stated that by increasing the efficiency of our work through improved service delivery we would be able to

satisfy our customers and be able to create loyal customer, which would also help in reducing cost.(A3- Appedix2)

OfficialB2 stated that:

It creates unfair competition among private and state owned banks these competition as per the official is for deposit (resources) that is highly in demand due to the directive for the sustainability of the banks. As per the official the major means through which they could compete for the deposit is based on price (interest on deposit). (B2-Appendix2)

“Currently what we are doing is competing based on price on deposits.” and also stated

“We could also compete based on service by diversifying our products.”(B3-Appendix2)

Officials B1, C1, C2 and C3: also stated that the competition is for deposit. According to the officials as a means of competition they could use interest rate and according to official C3, by focusing on product (service delivery) the banks could also compete for deposit.

The major role of banks is to collect resources and allocate to scarce areas. The banks competition for resources has been based on market demand and supply. Since the directive has been issued the banks need to aggressively mobilize resources and the exclusion of the stated owned banks has created unfair competition, which is not based on the market demand and supply. The banks competition for resources is using interest rate or it could also be using service delivery. This competition on the good side pushes the private banks to improve their service delivery and product diversity as a means of product diversity.

Table 3: Consequences of the directives partisan nature

1.	The directive is applicable only to the private banks, which makes it highly partisan.
2.	Because the directive excludes the state owned bank specifically the CBE ³⁶ the private banks are directly losing their customers to the CBE.
3.	The directive is shrinking the existing private banks market share and on the other hand it is increasing the CBE market share.
4.	As a result of the preferential treatment the competition for resources is unfair among the private and state owned banks.

Source: interview

4.3 Other issues related to the banks

In preceding part we would be looking into the issues through which the directive affects the performance of the banks apart from decreasing the bank's profitability.

I. Deposit and structure of the deposits (Code AI, BI and CI Appendix-2)

As stated by officials most of the accounts that make up the deposit structure are of short-term maturity. These accounts as such are normally invested in short term maturing assets (loan) in order to control asset liability mismatch. As was explained previously the asset side of the bank's balance sheet since the directive was issued shows an increase in long term maturing loan. By forwarding some ideas the

³⁶Because as commercial banks they have to compete mainly with the CBE which is stated owned commercial bank in the country the other stated owned banks are not instituted for commercial purpose but with specific reason. For more we can look at the banking history in chapter two of the paper.

researcher wanted to see if the directive has affected the deposit structures and obtained the following information from the officials.

Official A1 stated: (A1-Appendix2)

"Yes, we can make certain modification with the structure but making huge changes has its own consequence."

The official stated that the deposit structure has been showing some kind of change. This change although not drastic nonetheless pushes the banks to move to more of fixed (time) deposit. As per the official since we have high liquidity challenge the need to mobilize huge resource (deposit) is not questionable. In this urgent need to collect deposits the banks are forced to compete for fixed deposit, which is also expensive in relation to other deposits.

"In a matter of few months our time deposit has highly increased" (A2-Appendix2)

"Our time deposit portfolio is increasing." (A3-Appendix2)

"It might not have a very big change on deposit and structure but in the near future we expect that it would increase time deposit." (B3-Appendix2)

Officials from the different departments also stated that after the recent directive the deposit structure of the bank is more of fixed deposits. (B1, C2 and C3-Appendix2 respectively)

Gathered from the officials is that: even though all the accounts are paid on demand considering the deposits and their nature; fixed and saving deposits are more stable as to current (demand) deposit. In this regard since banks require huge amount of deposit, which is also stable, there is a tendency to shift to fixed deposit. But in order to obtain this fund the cost is very high which according to some of the officials could led to *price war*.

In addition the officials stated the deposit structure of the banks is currently not showing a drastic change not only because of the cost but also because there is a need to maintain the optimal mix of deposits from the banks side but the tendency in the market is showing a steady increase in time deposit.

J. Loans and advances (AJ, BJ and CJ-Appendix2)

“With regards to loans and advances the temptation in the market is to shift to medium and long term loans but we are not immediately reacting due to the regulation.” (A1-Appendix2)

“There is tendency in the industry recently to shift to medium and long term loans... here again there cannot be a drastic change.” (A2-Appendix2)

“Even now our long term loans have jumped from 10% to 20%.” (A3-Appendix2)
according to the official this tendency of shifting from short term to long-term loans is also the concern of the supervisor authorities.

Officials B1, B2, C1, C2 and C3 all stated that there is a tendency to shift to long term and medium term maturing loans.

All of the officials except official from the Zemen bank³⁷ stated that the directive is directly pushing us to shift to long term and medium term maturity loans. In explaining this the officials stated that the shift from short term maturing to long term maturing loan is not only because the NBE bill has a 5-year term maturity, which increases the long-term loan that the banks hold. But from the banks point it is taken as a strategic move. According to the officials they are focusing on such loans because the directive has high impact when the maturity of the loan is short term. As explained earlier the calculation of the directive is stated on total disbursement which

³⁷Zemen bank official stated that the directive affects those loans which have revolving nature like overdraft facility and in this regard since Zemen bank does not give any such loans the effect is minimal which means the shift from short term to long and medium term loans would not be an issue.

means when the turn over increases it will increase the bill purchase. In order to avoid this banks are going for loans, which have low turnover in other words, loans with long term and medium term maturity.

Stated by the official B2 *"in relation to term loans since the calculation is connected with disbursement... and as such the impact will be minimal when you give long-term loans instead of short-term loans."*

In general, the officials stated that the directive *pushes the banks to long and medium term maturity loans.*

K. Stress test indicator tests³⁸ (code AK, BK and CK- Appendix2)

From what the officials have discussed with regard to the directive the researcher gathered that this directive although recent has had a major implication on liquidity challenge that they are faced with at present. In this regard the researcher wanted to see if the banks had made tests such as stress test in order to assess the likely implication that the directive would have and obtained the following:

Official A1 stated that:

He himself does not perform such test and also indicated that he doesn't know if such tests are even preformed. But the official stated that if we are going to assume that the directive will continue the impact it will have on liquidity is clear. The official stated *"But even without such test the impact that it will have on liquidity and profitability is very clear."* (A1-Appendix2)

Official A3 stated: (A3-Appendix2)

³⁸According to the preliminary discussion made with an official in the industry the researcher gathered that banks would undertake certain tests in order to see if under certain assumption the bank would be faced with problems and also be able to assess the magnitude of the problem and one such test done by the banks is "stress tests" after looking into certain documents the researcher wanted to see if the banks do perform such tests and if so what are the likely signals due to the directive.

That they do perform some tests and that the work they do with this regard is not very detailed. But with regard to the directive he stated that the signal is showing a future environment faced with many challenges. But he also underlined that the liquidity problem would most certainly be the biggest treat of all.

Official B2 stated: (B2-Appendix2) that such tests are not given that much emphasis. The official also stated that without such tests it is clear that banks will be faced with liquidity challenge.

Official B3 stated: (B3-Appendix2) that there is a signal of liquidity challenge ahead of the banks. But official B3 didn't state whether they performed any such tests or not in determining the above signal.

Officials C1 and C3 stated: that there is no test needed to see the stress the bank is facing in terms of liquidity directly related to this directive(C1and C3-Appendix2). But apart from few banks officials most of them didn't clearly state whether this analysis was obtained through such tests like stress test. Most of the officials simply stated that it's clear from the environment where the banks are heading due to the directive.

L. Work out plan (code AL, BL and CL-Appendix2)

After the bank officials stated that due to the directive the banks are shifting to long and medium term loans the researcher based on preliminary discussions wanted to see how these directive affects the work out plan of the banks.

Banks perform different type of measures to either correct or minimize the impact of problem loans. In this case one way in which banks carry out their work out plan is through the means of injecting additional (working capital) money. After carrying out the necessary precaution so as not to send "*good money after bad money*" if it is believed that the best possible means that would help to collect the principal amount

lent and also the interest is through such means then the bank would inject additional money to solve these problem loans before they become NPLs³⁹. Because once they are classified as nonperforming loans these type of workout plan through the injection of additional money is restricted by the NBE (as a protection of public money).

This type of work out plan (injecting additional working capital money to solve problem loans) by their very nature is assumed to be a short-term loan, which means it's considered in the bill calculation. The objective was since the banks are showing a tendency to move to medium and long term maturity loans how this directive would affect workout plan of banks which are short term maturing loans.

Official A1 stated: That currently they are in a tight situation due to the directive and there is a challenge of giving loan. It would require a large amount of deposit than they normally need if they are to service loans. So the officials stated that whether it's for workout or for new loans our capacity will be affected as a result of the directive. In other word *"the issue about loan capacity is their whether it's a new loan or not."*

(A1-Appendix2)

"It would affect workout plan." (A2-Appendix2) official A2 also stated that taking into consideration the amount of problem loans into consideration it wouldn't be pressing issue. In explaining the official stated the amount of problem loan in banks is very small due to the stringent regulation of the authorities with regard to credit. As such the amount problem loan is very immaterial which makes such workout plans very rare.

³⁹According to the official this is not included in NPL once classified as NPL then it's illegal to take such measure according the regulation.

“Its not as such a big issue because we haven’t experienced it so far. But I am not saying that it won’t have an effect.” (A3-Appendix2)

“Even though it has not happened yet we can be certain to expect such a problem in the future.” (B2-Appendix2)

“It might not be as such difficult... we don’t face that much problem in relation to work out plan.” (B3-Appendix2)

Officials B1, C1 and C3 all stated that even though the effect is not exhibited currently the directive would affect the banks workout plan. The officials stated that this was due to the nature of such workout plan and also stated that since the amount of problem loan is very minimal, due to the stringent policy of the NBE the effect of such workout plan on the banks in general would be immaterial.

Table 4: Other issues related to the banks

1.	In an attempt to mobilize huge resources the deposit structure of most of the banks is shifting to fixed deposits. Although not volatile as the current accounts nonetheless these accounts are highly costly.
2.	Since the directive doesn’t take into consideration the nature of the loan and this result in aggravated liquidity problem when the banks service those loan requests with short term maturity, it pushes the banks to shift to loans with long and medium term maturity.
3.	Only some of the official clearly stated that they do perform stress test. But according to most of the officials even without such test the signal from the current situation is that the future will be faced with many challenges but most specifically liquidity challenge is very severe.

4.	The effect the directive will have on work out plan is minimal. According to the officials the stringent policy of the authorities with regard to credit reduces the amount of problem loans they have. But these doesn't mean that it won't be affected by the directive because it is short term loan by its very nature
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Source: interview

4.4 Measures taken:

M. Revision of lending and deposit rates (Code AM, BM and CM Appendix2)

The officials stated that there is a very high competition for deposit mainly because of liquidity challenge they are faced with. In this regard the means of competing for deposit as stated is through service (product delivery) and interest rate. In addition since the cost of the banks is increasing due to mainly cost of fund the researcher started to ask if the directive implies a revision of lending and deposit rates and obtained the following.

Official A1 stated: Since we are in need of deposit we could directly increase the deposit interest rate for competition purpose, which would increase our cost of fund. If this is the case then obviously there is also a need to adjust our lending rate in order to get the required net margin. The official also stated that even though the bill would require us to adjust the deposit and also the lending rate we would still need to be cautious because our main competitor CBE. The official stated if we do increase the lending rate and the CBE doesn't take the same move then we would be losing more customer than we already are. Therefore the official stated that although it might be required we wouldn't be taking drastic measures that further aggravate the problem.

Official A2 stated: *“Absolutely it requires revision of lending and deposit rates.”* (A2-Appendix2)

The official also stated *“we have already increased our lending rate.”* And with regard to deposit rates *“we pay around 7-7.5% up to 8% for time deposit. Hence as a means to compete we have to increase deposit rate.”*

Official A3 stated *“Yes it requires revision of lending and deposit rates.”* (A3-Appendix2) the official also stated that the changes wouldn't be drastic mainly because of the biggest competitor that is the CBE.

“We can see deposit rates are already changing... its already happening and some banks have already increased their lending rate by 1%.” (B3-Appendix2)

Official B2 and C1 also stated that this would require revision of lend and deposit rates. In general most of the officials agree on the point that due to this directive the banks are revising their deposit as well as lending rate.

With this regard official A3 also stated that *“small depositors are not as such price sensitive”*. As such the increase in deposit rate as can be seen from the market is based on fixed deposit. As stated by the official those that deposit in fixed saving account are “institutional depositors⁴⁰” who are price sensitive. Apart from this the officials also mentioned that even though there is a tendency to revise both deposit and lending rate. Unless the CBE takes the first move no private bank would take the lead and take a bold move knowing the strong hold CBE has within the market.

⁴⁰ Among such institutional customers the official mentioned as an example Ethiopian Insurance Corporation.

N. Strategic measures taken by the banks (Code AN, BN and CN -Appendix2)

According to the officials the directive has an adverse impact on the banks performance. Since regulation is outside the banks control the banks would take some strategic measures, which are within the banks capacity in order to minimize the effect that the directive will have on performance of the banks. This includes:

Official A1 stated:

- *“Immediate focus is now in how to increase our deposit and to maintain a stable growth on deposit mobilization”*
- *“Based on the resource that we have invested on huge computer servers (technology) we could utilize those and get out of traditional banking and focus on contemporary banking”*
- *“Increasing the type of products”*(A1-Appendix2)

Official A2 stated:

“Aggressive branch opening in order to mobilize deposit”

“Changing our loan structure to long term and medium term maturity loans”

The official also stated increasing lending rate would also be one means through which the bank would be able to mitigate the impact. (A2-Appendix2)

Officials B1, C1, C2 and C3 also stated that if the banks are to be able to continue in the sector then the basic thing would be strong mobilization of resource through different means like branch opening and also the use of IT infrastructure. Official C1 and C3 also stated that there would be shift to long term and medium term maturity loans. And as per most of the officials the banks focus on traditional banking has to change. (B1, C1, C2 and C3 -Appendix2)

Official B2 stated:

“Increasing our resource base,” this according to the official means mobilization of deposit.

“Increasing interest rate on credit” the official also stated that the lending structure would change to *“bank need based”* lending instead of *“customer based lending.”* In explaining this the official from OIB stated that those short term maturity loans aggravate the problem of liquidity as such even though there is a short term loan request we would now be inclined to focus on those loan request which have longer maturity period this means that the bank will be focusing on its need instead of the customers.(B2-Appedix2)

Official B3 stated:

“First thing is first we should decrease those loans with short term maturity.” He also stated *“We should also need to work on deposit mobilization.”*(B3-Appendix2)

In general almost all of the officials agree on two basic things as strategic move:

- a) The need to mobilize large deposit and,
- b) The need to change the structure of loan to long-term maturity loans.

Table 5: measures taken to mitigate the effect of the directive

1.	According to the officials the directive requires the revision of the bank’s lending and deposit rates and accordingly few banks have already revised their rates. The officials state that considering the CBE has the largest market share in the industry it seems like the private banks are scared of taking strong measures.
2.	Mobilization of resources through the means of price, product diversity and others.

3.	The need to focus on long term maturing loans instead of short term maturing loans which would help reduce the liquidity challenge
4.	Focusing on contemporary banking instead of tradition banking. Meaning instead of becoming interest based becoming fee based. These would decrease the dependence on loan which would minimize the risk associated which such source of income.

Source: interview

Expectation about the future and further notes

If the directive is not modified and these persists for long period of time the officials as stated above believe that it would affect the bank's profitability but where reserved to state whether the banks would be able to sustain in the market or not expect few who were confident to say so. With regard to the future and what we can expect some of the officials stated:

- a) Ultimately the problem that we face is the problem for the stakeholders (the public) and if this doesn't change these participants are going to face a lot of problems. (Official C1)
- b) If all remains the same in the future *"it's going to be a difficult environment."* (Official B3)
- c) *"In general if the return on investment decreases then entrepreneurs will not be willing to invest... in the short run we might not see the effect on the sector but in the long run the sector might not be a promising sector."* (Official B2)

d) *“Yes, I believe that we would be in a very difficult situation but I wouldn’t expect us to fail.”* (Official A1)

As per the officials the future would be a challenging environment. From what the researcher has gathered future expectation of the banks will also depend on the capacity. For most of the new banks the challenge that they are going to face would be strong when compared to the large banks that seem to have strong asset base and also a wide range of investments that would help them to navigate the challenge easily. Hence there will be a difference in the magnitude of the problem among small and large private banks in the industry.

Official A1:

Stated that if as it is described the issue is for private sector financing then the authorities could directly state for which sector they would want the banks to finance. If not the calculation of the bill should be modified from simply total disbursement to taking 27% on the *incremental*⁴¹ amount so that it would not have a compounding effect and drain the banks liquidity.

On a positive note: the official stated that the directive pushes banks to *non-traditional banking*. The official explained that since government regulation is one of the risks to the banks in order to be able to avoid such risk the banks would have to be *creative and innovative*. In this regard focusing on nontraditional bank, which isn’t highly dependent on income generated from loan could be one means by which banks

⁴¹The official stated that if we lend 8 million birr for a specific period (on which we paid 27%) and assume that this doesn’t increase then whenever it is repaid and lent again we should not be forced to purchase additional bill because clearly these has compounding effect and will drain the banks liquidity. So according to the official instead once we paid 27% on the 8 million birr if the total disbursement increases say by ½ million to 8.5 million we should only buy the bill for the incremental amount which is 27% of ½ a million.

can avoid such risk that is directly associated with the traditional banking (which depends on income generated mainly from interest). In addition it pushes the banks to be alert about deposit mobilization.

Official A2:

Official A2 Stated the same thing with regard to the calculation of the NBE bill as that of official A1. In addition to the bill calculation the official stated that since the directive was issued the NBE bills constituted the largest portion of loan. This makes government the largest borrower and as a single borrower has associated risk with it and also stated this “*will decrease private lending.*”(Appendix 1-D)

The official also stated that it would lead to *misbehavior of participants* in the financial sector. In explaining, the official stated that: according to the calculation of the regulation it would have a huge impact when maturity of the loan is short-term as such the banks are opting for long-term loans. But this also has associated risk with it and if we look at the borrowers point of view since the directive will make *them loss confidence on the banks* ability to lend this would ultimately push the borrowers to unnecessary measures like defaulting of payment which emanated from the loss of confidences on the bank ability to service their loan request in the future as such increased default risk.

Official A3:

Stated that this directive has both negative and positive implication and starting with the positive note: the officials listed few things.

a) “*This directive has pushed us to think about a lot of things such as liquidity management, stress test, about product development and many more.*”

b) “*If we are to stay in the market we now know that we need to be creative.*”

c) *“Instead of being interest based becoming fee based.”*

In general the official stated that the directive has pushed them to stand back and look at things more consciously. In addition the official stated that they are now becoming more cost conscious. On the other hand the official stated that this could also lead to *price war and unnecessary cost to the economy*. The official stated that due to the aggressive need to mobilize resource we are now paying up to 9% on fixed time deposit and this need might lead to price war.

In explaining the unnecessary cost to the economy the official listed some examples:

1) If an importer brings goods (import product) before the directive was issued, since the banks had ability to finance these importers, a letter of credit would be opened and the goods would be at the ports. If the expected cash by the importer were not collected then the bank would settle payment on behalf of the importer and obtain the goods from the port. But now there are a lot of goods at ports due to demurrage cost. Because loans of such nature are of short-term maturing we wouldn't finance such loans. Which means the availability of the product would decrease and hence the products price in the market is ultimately going to increase.

2) There are projects, which have stopped because we could not finance them.

Above all the official stated that even though liquidity is now only a challenge if it materializes and banks are not able to service their depositors, *the problem of single bank run would be contagious and hence uncontrollable*.

Official B1 Stated:

That this directive would lead participants to misbehave special with regards to loans and advances just like official A2 has stated. In additional note the official also stated that due to aggressive move for deposit mobilization *though branch opening the*

financial sector is creating job opportunity to the economy. Even though it increase cost to the bank.

Official B2:

Also stated three points which are already stated above:

- a) The calculation of 27% being on total disbursement has compound effect and that the rate by itself is very high.
- b) It would lead participant to misbehave.
- c) The need to look more closely at the liquidity challenge they are faced with because of its contagious nature.

Official B3:

Also fears that the competition for deposit would be so aggressive that it would lead to price war among banks. The official also addressed that we should be careful as how we look at this banks. According to the official currently the biggest challenge is liquidity. If you look at the banks they might be showing high profitability, which is partly because they are leveraged institution but still if faced with liquidity problem there is a high probability they would fail.

Official C1 stated:

That this kind of interference, which excludes the state owned banks, is only increasing the CBE strong hold in the sector, while becoming a *huge barrier to new entrant*. The official also stated that it *creates unfair competition* between the already existing private and state-owned banks (special CBE). In general from what is stated above from the different officials including official C2 and C3, the directive will clearly have both positive as well as negative implication. But the discussion above also depict that the directive has clear adverse implication for the banks in term of performance.

Table 6: Expectation about the future and further notes

1.	The officials believe that there is going to a challenging future ahead of the banks if all remains the same.
2.	If the objective truly was priority sector financing then they believe that they could directly finance the sector instead of being forced to purchase the NBE bill.
3.	The banks focus with traditional banking is increasing the risk associated with the main source of fund which is interest income so in order to reduce the risk the banks should focus more on fee based banking (conventional banking).
4.	The implementation of the directive which takes total disbursement as a base for calculation is leading the banks to a problem and hence needs to be reconsidered.
5.	Even though it brings forth a challenge to the banks on the upside it will create job opportunity through the branch opening.
6.	Might create misbehavior of market participants.
7.	Decrease private lending and increases the government amount of loan in the private banks.
8.	Creates unnecessary cost to the economy.
9.	Creates price war and unfair competition.
10.	Pushes the banks to be creative and also innovative.

11.	Presents itself as a challenge to the existing banks and also as barrier to new entrants.
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Source: interview

In general the implication of such directives (interventions) by the government in the allocation of credit as in other countries like Korea, Japan, china and few others is to finance government defined priority sectors (Vives, 1997a, 1997b) and from the response gathered the intention of the recent NBE bill purchase directive has the same intention. Just like the different countries this intervention does have associated costs and benefits. Most banks in Ethiopia as stated by the officials tend to allocate credit to short term liquidating investment opportunitiesthis according to the officials is so that they won't be faced with asset liability mismatch. This is similar to other commercial banks as stated by different researchers (Calomiris et al 1992; Calomiris and Himmelberg 1994a, 1994b 1995).

Every country has unique financial system as such the situation that is applicable under one circumstance might not necessarily be applicable under different circumstances. From what the officials have discussed about the implication it would have on the performance of private banks in Ethiopia the situation most closely resembles the experience of India (Kholi 1997) with regard to the implication of such interventions. According to the officials the intervention affects: the bank's profitability adversely and the impact for the banks will depend on the capacity of the banks, the lending pattern of the banks, reduces the lending for none beneficiary

sectors (private lending) and could potentially increase the job opportunity in the economy⁴² which is consistent to the experience stated by Kholi (1997).

As can be seen from the literature the success or failure of such intervention doesn't mean that such intervention could be replicated in other countries. Hence apart from assessing and discussing the implication under different cases so that necessary measures could be taken we cannot be able to confer or differ from the implications obtained under different circumstance.

⁴² A point to remember is that the banks in Ethiopia are directly creating job opportunity through branch opening while in India the increased job opportunity arise from the financed sector which are mainly small scale industries that do require huge labor.

CHAPTER FIVE

Conclusion and recommendation

Conclusion

The previous chapters presented the results and discussions with regard to implication of the NBE bill purchase directive while this chapter attempts to show the conclusion and recommendations.

The researcher based on the stated objective of the paper assessed the implications the directive of the NBE bill purchase has on the private commercial banks using qualitative research approach (from the view of the study participants). The results obtained shows that according to the perception of the officials and the related documents the likely motive of the NBE bill is to increase the private sectors participation in priority sector financing and also bring macroeconomic stability by controlling inflation through reducing the role that banks play in the circulation of money in the economy.

As per the respondents the directive was sudden and didn't give them enough time to adjust therefore when it was imposed it instantly cooled the sector. The directive affects the bank's profitability in an adverse manner. The directive which forces the banks to purchase NBE bill with 5-year maturity is creating liquidity challenge for the banks. The directive states that banks should purchase 27% based on their total disbursement with disregard to the nature of loan. As such those loans, which have revolving nature and are also short term, would aggravate the liquidity problem. But taking into consideration the deposit structure of the banks in to account if the banks shift to long term maturing loans in order to avoid the aggravated problem of liquidity with such revolving loans the banks would be faced with asset liability mismatch.

In order to mitigate the implication the directive has on their performance the banks, they are incurring huge amount of cost so as to mobilize the resource through means such as branch opening, which would in fact affect the profitability of the banks adversely. The magnitude of the problem is severe when it comes to young banks that have recently joined the sector due the small market share they have in the industry (simply because they are at initial stage they incur high operating costs compared to the older banks).

The directive as can be seen excludes the state owned banks which create an unfair ground for competition between the private and state owned bank specifically the CBE. The directives preferential treatment hence, resulted in the shift of customers from the private banks to public banks as a result reduce the private banks market share in the industry while increasing the already strong market share of the CBE. In addition the directive is also a barrier to new entrants. Even though it's early to state whether it creates unhealthy competition or not, the officials believe that it's certainly creating price war among the banks.

The directive is also pushing the private banks to change both their deposit as well as loan structure. The banks currently are paying higher amount for fixed deposit and this type of deposit is now increasing in the banks deposit structure. When it comes to the loans and advances in an attempt to mitigate the directives effect on liquidity the banks are now shifting to medium and long term maturing loans which will also led the banks to asset liability mismatch including the associated risks with it.

In order to mitigate the challenges they are faced with the banks are currently working on huge resource mobilization through different means. These include branch openings, revision of deposit and loan rates, aggressive marketing strategy and use of technology are some of the main means stated.

The directive on a positive note has pushed the banks to be creative and innovative. It pushes them to think about product development, liquidity management, contemporary banking (now the system is traditional) and in addition is creating job opportunity to the economy. On the negative side these directive affects the growth of the industry from the private banks side. In addition it creates unnecessary cost to the economy, decreases private lending and could led the market participants to misbehave. In general the future ahead of the private commercial banks in Ethiopia is faced with challenging environment with regard to the NBE bill purchase directive.

The government's intervention in the financial sector has been a topic for debate for a very long period. The paper in this regard only addressed the implication of these intervention has on the private commercial banks but didn't cover in-depth the implication of such intervention of the different participant in the economy like the business community, those sectors which are not financed by such interventions and hence further research is needed in these regard.

This study tried to meet the gap between the existing literatures but it also has its own limitations and other researchers can address those limitations in the future.

Recommendation

- The stringent monetary policy of the NBE with regard to bill purchase is pushing the commercial banks to unanticipated liquidity challenge. Taking total disbursement as a base for calculation and the 27% as the amount to be deducted is aggravating the liquidity challenge. Hence in order for the banks to mitigate this challenge of liquidity the NBE should consider a) reducing the percentage that is stated as the amount to be deducted b) take other bases for calculating the bill purchase amount. For instance instead of total disbursement as a base for calculation, the outstanding balance could be used which would also reduce the

compounding effect.

- Considering the directives effect on short term revolving loans the directive should be modified so that it considers asset composition in to account and therefore certain modification to the calculation is necessary.
- There has been a profound emphasis in the need for establishing secondary markets (capital markets) in Ethiopia and there have also been moves by the NBE to establish secondary markets. So far the steps that are taken are gradual and don't seem to take into consideration the urgent need for this markets. Since one of the problems is that the banks have to hold these bills till maturity, which creates asset liability mismatch the authorities should be able to facilitate such markets through which the banks are able to resale the bills which would help them to mitigate this challenge.
- The directive clearly affects the performance of the banks by adversely affecting profitability. The commercial banks in Ethiopia currently focus on traditional banking which is highly dependent on income generated from lending (interest income). Interest income is becoming risky source of income due to such interventions as the recent bill purchase directive. Therefore the banks taking into consideration the risk associated with such traditional source of income need to work on contemporary banking which is focused on fee based income instead of interest income as the major source. This would reduce the implication of such regulatory interventions on the major source of the banks income.
- In the future when such interventions are to be implemented it would be advisable to give grace period through which the banks are able to adjust to such intervention.

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APPENDICES

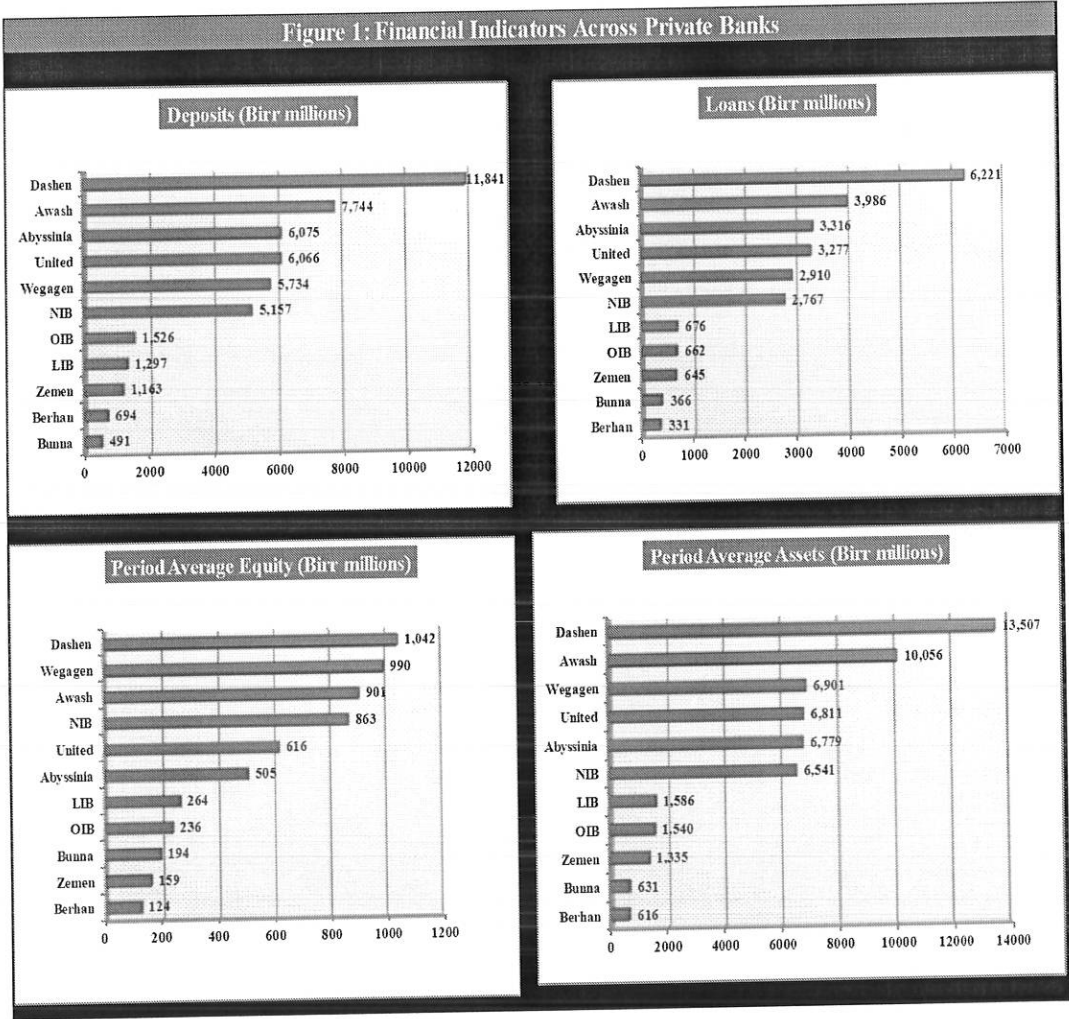
Appendix1: financial indicators of private banks for the fiscal year 2010/11

A. Market share and financial indicators across private banks

Market share of...	Top 1 Banks	Top 2 Banks	Large 6 Banks	Small 8 Banks
Total Assets	22.5%	39.6%	86%	14%
Foreign Asset	28.1%	43.2%	86%	14%
Loans	24.0%	39.4%	87%	13%
Deposits	23.8%	39.3%	86%	14%
Capital, year-average	17.7%	33.0%	83%	17%
Capital, year-end (Birr millions)	16.3%	31.0%	78%	22%
Gross income	19.6%	37.4%	88%	12%
Of which: Net interest	19.5%	32.4%	91%	9%
Of which: other	19.7%	39.3%	87%	13%
Expenses	20.9%	34.9%	85%	15%
Of which: Salaries and benefits	19.4%	35.7%	88%	12%
Net profit before tax	21.9%	39.5%	88%	12%
Net profit after tax	22.0%	39.6%	87%	13%

Source: Access capital banking sector review. Top 1 Bank refers to Dashen Bank; Top 2 Banks refer to Dashen and Awash Banks, Large 6 Banks are Dashen, Awash,

Abyssinia, NIB, United and Wegagen Banks; Small 8 Banks are Abay, Addis International, Berhan, Bunna, CBO, LIB, OIB and Zemen Banks.



Source: access capital banking sector review.

B. Loan Portfolio of private banks based on sector

Share of Loans by Sector	Abys sinia	Awas h	Berha n	Bunn a	Dashe n	LIB	NIB	OIB	Unite d	Wega gen	Zeme n
Agriculture	0.2%	2.2%	0.5%	0.0%	2.0%	3.0%	4.5%	2.2%	0.0%	0.5%	0.4%
Manufacturin g	9.3%	5.8%	10.2%	3.3%	22.8%	2.6%	25.7%	4.7%	16.7%	13.7%	17.4%
DTS	38.7 %	26.4%	30.1%	32.4%	31.8%	56.0%	19.4%	51.1%	21.0%	23.2%	21.9%
Export	14.5 %	21.1%	14.5%	7.8%	6.1%	4.3%	14.2%	15.4%	15.1%	10.7%	23.4%
Import	13.1 %	14.2%	7.3%	19.3%	8.8%	24.7%	13.9%	4.0%	21.1%	20.6%	10.3%
Constructio n	15.9 %	18.7%	17.8%	17.6%	16.2%	8.0%	18.5%	9.1%	12.7%	9.3%	11.6%
Transport	3.5%	7.1%	19.3%	15.2%	7.0%	0.0%	3.0%	11.1%	6.6%	10.4%	9.0%
Personal	1.2%	0.9%	0.3%	0.7%	1.0%	1.4%	0.7%	1.3%	2.7%	5.7%	3.9%
Loan in Legal Department	2.0%	3.7%	0.0%	0.1%	0.9%	0.0%	0.0%	0.9%	2.0%	1.8%	0.0%
Advance in LC	1.3%	0.0%	0.0%	3.6%	3.5%	0.0%	0.0%	0.0%	2.1%	4.2%	0.0%
Others	0.3%	0.0%	0.0%	0.0%		0.0%	0.0%	0.1%	0.0%	0.0%	2.2%
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

C. Deposit structure of all the private banks

	Time Deposits	Saving Deposits	Checking Deposits
<i>Abyssinia</i>	1%	73%	26%
<i>Awash</i>	1%	73%	26%
<i>Berhan</i>	42%	31%	27%
<i>Bunna</i>	28%	48%	24%
<i>Dashen</i>	5%	66%	29%
<i>LIB</i>	2%	56%	41%
<i>NIB</i>	4%	61%	35%
<i>OIB</i>	19%	42%	39%
<i>United</i>	7%	59%	34%
<i>Wegagen</i>	2%	44%	54%
<i>Zemen</i>	15%	63%	22%

Source: Access capital review

D. NBE bill holdings as of June 2011

NBE Bill Holdings			NBE Bills to Total Loans		
(In Birr millions)			(In Percent)		
1	Awash	1,589	1	OIB	44%
2	Dashen	971	2	Awash	41%
3	Wegagen	900	3	Zemen	34%
4	Abyssinia	817	4	Wegagen	32%
5	United	807	5	United	25%
6	NIB	563	6	LIB	25%
7	OIB	290	7	NIB	21%
8	Zemen	216	8	Abyssinia	20%
9	LIB	165	9	Dashen	16%
10	Berhan	27	10	Berhan	8%
11	Bunna	11	11	Bunna	3%
Total		6,357	Average		25%

Source: Access capital review

Appendix 2: interview results in data table

A. Interview with the large three banks officials from credit department

No.	Question	A1	A2	A3	Code
1.	Basic understanding of the regulation				
A	What do you think is the likely motive for introducing the directive?	Mainly Inflationary control and priority sector financing, reduce borrowing from central bank	Priority sector financing and macroeconomic stability	Priority sector financing and inflationary control	AA
B.	Was the directive expected	We expected a regulation but not this kind.	We expected a regulation but not this kind.	No	AB
2.	Banks performance				
C.	Does the directive affect banks profit	Yes	Yes	Yes	AC
D.	Does it affect profit in positive or adverse manner	Adversely	Adversely	Adversely	AD
E.	How?	Low interest collected on the bill and high cost of fund.	Low interest collected on the bill and high cost of fund.	Low interest collected on the bill and high cost of fund.	AE

F.	Assuming that the directive doesn't change would the bank be sustainable	Yes, it's a matter of managing liquidity challenge	Yes it depends on the deposit we mobilize	Yes because of the capacity of the bank we can absorb such shocks	AF
G.	Is the regulation partisan? And the consequence?	Yes, shift of customer and a barrier to new entrants	Yes, shift of customer	Yes, shift of customer	AG
H.	Competition among banks, for what and in what manner	Creates unfair competition for deposit but the manner will depend	Creates unfair competition for deposit and the competition is based on interest	Creates unfair competition for deposit and the competition is based on interest and on service (by products)	AH
3.	Other issue related to the banks				
I.	Deposit and structure	Leads to fixed (time) deposit which is costly source of fund	Leads to fixed (time) deposit which is costly source of fund	Leads to fixed (time) deposit	AI
J.	Loans and advances	Tendency of shifting to long and medium term loans	Tendency of shifting to long and medium term loans	Our long term loan has increased	AJ

K.	Stress test signals	There is a signal of liquidity challenge	There is a signal of liquidity challenge	There is a signal of liquidity challenge	AK
L.	Does it affect workout plan?	Yes our loan capacity is restricted whether it is for workout or not	Yes	It might in the future but currently not a big issue	AL
4.	Measures taken				
M.	Does it imply revision of lending and deposit rate?	Yes, but we cannot take drastic measures	Yes	Yes, but we cannot take drastic measures	AM
N.	Strategic measures	• Deposit mobilization • Conventional banking • Increase product diversity	• Deposit mobilization • Focusing on long term loans • Increasing lending rate	NA	AN

Source: interview

B. Interview with the three small bank officials from credit department

No.	Question	B1 *	B2	B3	Code
1.	Basic understanding of the regulation				
A.	What do you think is the likely motive for introducing the directive?	Inflationary control and to finance the priority sectors as well.	Priority sector finance, direct the banks like the government banks and governments inefficiency	To finance priority sector and inflationary control	BA
B.	Was the directive expected?	No not in this manner	It was imposed suddenly	No	BB
2.	Banks performance				
C.	Does the directive affect banks profit	Yes	Yes	Yes	BC
D.	Does it affect profit in positive or adverse manner	Adversely	Adversely	Adversely	BD
E.	How?	Low interest collected on the bill and high cost of fund.	Low interest collected on the bill and high cost of fund.	Low interest collected on the bill and high cost of fund.	BE
F.	Assuming that the directive doesn't change	Yes but it a challenge	It would be challenging	Yes but we would expect a declining	BF

	would the bank be sustainable			growth rate	
G.	Is the regulation partisan? And the consequence?	Yes, shift of customer and barrier to entry and also increase market share of public banks.	Yes, shift of customer and decrease the market share of the banks and barrier to new entrants.	Yes, shift of customer	BG
H.	Competition among banks, for what and in what manner	Creates unfair competition for deposit	Creates unfair competition for deposit and the competition is based on interest	Creates unfair competition for deposit and the competition is based on interest and on service (by products)	BH
3.	Other issue related to the banks				
I.	Deposit and structure	Leads to fixed (time) deposit	Leads to fixed (time) deposit	Leads to fixed (time) deposit but we also need to maintain the optimal level of deposit.	BI
J.	Loans and advances	Tendency of shifting to long and medium term	Tendency of shifting to long and medium term	Doesn't have that much impact	BJ

		loans	loans		
K.	Stress test signals	There is a signal of liquidity challenge	NA	There is a signal of liquidity challenge	BK
L.	Does it affect workout plan?	Yes	It might in the future but currently not a big issue	Yes, but it might not be huge	BL
4.	Measures taken				
M.	Does it imply revision of lending and deposit rate?	NA	Yes	Yes its already happening	BM
N.	Strategic measures	• Deposit mobilization	• Deposit mobilization • “<i>Bank need based lending</i>” • Increasing lending rate	• Deposit mobilization • Focusing on long term loans	BN

Source: interview

*The researcher had to take a member of Asset Liability committee instead of the credit manager because the researcher was not able to meet the intended target at the allotted time

C. Interview with other officials from different department

No.	Question	C1 Official from corporate planning and marketing department	C2 Official from Accounts and finance department	C3 Official from finance and treasury	Code
1.	Basic understanding of the regulation				
A.	What do you think is the likely motive for introducing the directive?	Priority sector financing	Priority sector financing and inflationary control	Didn't clearly state the reason (disagrees on both likely motives)	CA
B.	Was the directive expected?	No not expected	No not expected	No not expected	CB
2.	Banks performance				
C.	Does the directive affect banks profit	Yes	Yes	Yes	CC
D.	Does it affect profit in positive or adverse manner	Adversely	Adversely	Adversely	CD
E.	How?	Low interest collected on the bill and high cost of fund.	Low interest collected on the bill and high cost of fund.	Low interest collected on the bill and high cost of fund.	CE
F.	Assuming that the directive doesn't change	It's a challenge	Yes	We would expect a challenging	CF

	would the bank be sustainable			environment.	
G.	Is the regulation partisan? And the consequence?	Yes, shift of customer	Yes, shift of customer	Yes, shift of customer	CG
H.	Competition among banks, for what and in what manner	Creates unfair competition for deposit and the competition is based on interest	Creates competition based on deposit	Creates unfair competition for deposit and the competition is based on interest and on service (by products)	CH
3. Other issue related to the banks					
I.	Deposit and structure	Leads to fixed (time) deposit which is costly source of fund	Leads to fixed (time) deposit	Leads to fixed (time) deposit	CI
J.	Loans and advances	Tendency of shifting to long and medium term loans	Tendency of shifting to long and medium term loans	Tendency of shifting to long and medium term loans	CJ
K.	Stress test signals	No test needed to identify liquidity challenge	NA	Signals liquidity challenge	CK
L.	Does it affect workout plan?	Yes	NA	Yes	CL
4. Measures taken					

M.	Does it imply revision of lending and deposit rate?	Yes, but we cannot take drastic measures	Yes	NA	CM
N.	Strategic measures	• Deposit mobilization • Focusing on long term loans	• Deposit mobilization • Focusing on conventional banking	• Deposit mobilization • Focusing on long term loans	CN

Source: interview

Appendix 3: Understanding table

A. Interview with the three large banks officials from credit department A1. First official from large bank A2. Second official from large bank A3. Third official from large bank	C. Interview with other officials from different department C1. Official from corporate planning and marketing C2. Official from accounts and finance C3. Official from finance and treasury
B. Interview with the three small bank officials from credit department A1. First official from small bank A2. Second official from small bank A3. Third official from small bank	

The first letter of the codes would signify whether it's from the large or small banks. The second letter addresses specific theme in the research. For example: code AA signifies from the large three banks and with regard to the motive for the directive.

Appendix 4: Sample of the request form and interview guiding questions

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Addis Ababa University
College of Business and Economics
Department of Accounting & Finance

Date:

To:

Addis Ababa

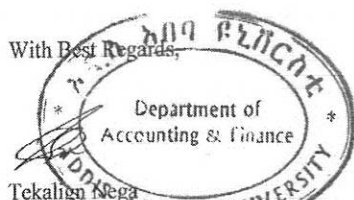
Student, *Yodit Kassa*, is undertaking project entitled, "*The implication of the NBE directive of bill purchase on private commercial banks in Ethiopia*". She is taking this opportunity of project study in partial fulfillment of a project paper for MSc degree in Accounting and Finance.

We believe that the result of this project would have practical application and be of value to you, to us, and to the business community at large. Hence, we would be very grateful if your organization could support us in this endeavor.

Besides, we promise you that all data will be kept confidential and used for academic purposes only. Further, we can send to you all the summary results and findings, when the undertaking is completed.

Thank you for the anticipated cooperation

With Best Regards,



Tekalign Isaga
Chairman, Department of Accounting & Finance
School of Business and Public Administration
Addis Ababa University



251-011- 1223787

Email: infoacct@acct.aau.edu.et



5563

Guiding interview question

1. Background information about respondents.
2. Basic understanding about the regulation. What do you think are the premises (grounds) of this regulation? What do you think is the likely motive of NBE in introducing this directive?
3. Was this directive expected by your bank to surface?
4. Do you think that it will have impact on performance? What are the likely implications on banks' performance? Positive or otherwise? And in what manner?
5. Assuming that this directive will persist in the coming years do you believe it affects the bank's ability to generate sustainable income and also sustainability? How?
6. Is the regulation partisan? Which banks are treated preferentially? And what are the likely consequences of this change on the banks apart from profit?
7. Does it affect competition among of banks?
 - Private to private
 - Private to government? In what area? How and in what manner?
8. Identify the areas of immediate impact the regulation is going to create on
 - Deposits and their structure
 - Loan & advances
9. After the introduction of the directive what have the *stress test indicators* been signaling?
10. Do you think this will have an impact on the workout plan of banks? Why or why not? In what manners will this affect the bank and other related parties in the work out plan?
11. Does the regulation imply revision of lending and deposit rates? Why?
12. What is the bank currently doing to address this problem? The necessary measures in other word what *strategic reactions* are expected from banks to cope with this regulation?
13. If this situation doesn't change what can we expect in the future?
14. Further note with regard to the directive?

Appendix 5: NBE bill purchase directive

Establishment and Operation of National Bank of Ethiopia (NBE) Bills Market Directives No. MFA/NBEBILLS/001/2011

Whereas, fostering monetary, credit and financial conditions conducive to orderly, balanced and sustained economic growth and development is the principal objective of the National Bank of Ethiopia (NBE);

Whereas, all banks should participate in the financing of priority sector projects to bring sustainable economic development;

Whereas, the purchase and sale of NBE bills constitute a key part in achieving the objective;

NOW, THEREFORE, in accordance with powers vested on it by articles 5(3,4) and 27(2) of the National Bank of Ethiopia Establishment Proclamation No. 591/2008, the National Bank of Ethiopia, (hereafter the NBE), has issued these directives.

Article 1

Short Title

These Directives may be cited as "Establishment and Operation of National Bank of Ethiopia Bills Market Directives No. MFA/NBEBILLS/001/2011".

Article 2

Definitions

For the purpose of these Directives, unless the context provides otherwise:-

1. "NBE bills" mean long-term obligation of the National Bank of Ethiopia having a maturity period of 5 (five) years and sold to all banks.



2. "Banks" mean all the banks operating in Ethiopia except the Commercial Bank of Ethiopia and Development Bank of Ethiopia.
3. "Allotment" means the determination or the decision as to what amount of bills a bank should buy.
4. "Loans and advances" mean any financial assets of a bank as defined by Article 4.6 of NBE Directive No. SBB/43/2008.
5. "Disbursement of loans and advances" means new extension of loans and advances including overdraft facilities during a specified period of time by a bank to all economic sectors except the Federal Government.
6. "Overdraft disbursement" mean average of every Tuesday's overdraft outstanding balance over a given period of time, say a month, a quarter or a year.
7. "Face value" means apparent worth, or the nominal value that appears on the face of a bills.
8. "Maturity date" means period over NBE bills are completed or become due. If maturities fall on weekend and/or holidays NBE bills shall be redeemed on the next working day.
9. "Issue date" means the date on which the bills are issued.
10. "Settlement" means completion of the transaction by delivering the required bills and/or funds.
11. "Settlement date" means the deadline by which a purchaser of the bills must pay for what has been bought and the seller must deliver the certificate for the bills that has been sold.
12. "Fiscal year" means the period from July 1 of a year to June 30 of the following year.
13. "Rollover" means the bills renewal request to be made before maturity date.

Article 3

Supply of NBE Bills and Eligibility Criteria

1. Banks shall buy the bills allotted to them as per Article 4 of these Directives.
2. The volume of bills to be supplied shall depend solely on the amount of new loans and advances disbursed by banks during the fiscal year and shall be calculated as per Article 4(2) of these Directives.



3. In case of overdraft disbursements, the allotment shall be computed on the difference of two consecutive months balances.
4. The bills shall only be purchased by banks operating in Ethiopia.

Article 4

How to Purchase NBE Bills

1. Every month each bank shall notify NBE in writing its own respective allotment amount using the report format in **Annex 1** of these Directives within 15 days after the end of the reference month.
2. Each bank shall calculate its own allotment based on monthly plan of loans and advances disbursement. The applicable ratio for the allotment shall be 27 percent of such disbursements. However, the ratio may be revised by the National Bank of Ethiopia when necessary.
3. The settlement date for the purchase of the bills shall be 3 (three) days after the end of the transaction date. If the settlement date falls on weekends or holidays settlement shall be effected on the next working day.
4. If the actual disbursement during a month is higher (or lower) than the planned disbursement, the difference in allotment shall be considered in deciding the allotment for the next month.
5. Banks shall submit a letter of authorization permitting the National Bank of Ethiopia to debit their Payment and Settlement Account for the balance of the purchased bills by them.

Article 5

Notification

1. The NBE shall notify banks in a predesigned format about its deduction of the allotment amount from their Payment and Settlement Account within 3 (three) days after their account is debited.
2. NBE shall notify payment of interest rate accrued on the bills and credit their payment and settlement account on annual basis within 5 (five) days after effecting the payment.



Article 6

Tenure of the Bills

1. The NBE bills shall have a maturity period of five years.
2. The interest rate for each bills shall be 3.0 percent per annum.
3. The NBE shall pay the interest accrued on the bills on annual basis.

Article 7

Issue and Transferability of the Bills

1. NBE bills shall be issued to banks pursuant to Article 3.2 and Article 4.2 of these Directives.
2. The bills shall be issued to each bank on monthly basis.
3. Notwithstanding Article 7(2) NBE bills to be issued for fiscal year 2010/2011 shall retroactively apply on the previous eight months starting July 1, 2010.
4. A bank may transfer its bills to another bank by endorsement on the back of the bills itself.
5. A bank may use the bills as collateral for any agreement to be made with domestic banks including NBE.
6. A bank may arrange with NBE to hold the bills in safe custody on its behalf.

Article 8

Redemption

1. On the maturity date as specified on the bills itself, the bills shall be redeemed and credited to the Payment and Settlement account at NBE.
2. The NBE shall verify the bills before redemption.
3. Holders other than those who have previously lodged their bills with the NBE at the time of issue in accordance with Article 7(5) shall present their bills for verification to the NBE two days before the date of maturity.



4. Maturing bills so presented shall be signed with the authorized signature(s) of the last holder and clearly endorsed with the name and other particulars of the Payment and Settlement Account into which the redemption money shall be credited.

Article 9

Rollover Instruction

1. Banks may authorize the NBE to rollover their bills at the maturity date.
2. Pursuant to **Article 9(1)** of these Directives, the NBE may issue new bills within two days upon receiving rollover instruction from banks.
3. The principal amount of the bills shall be paid at the end of the maturity period if no rollover instruction is obtained within 10 (ten) days before the maturity date of the bills.

Article 10

Loss of the Bills

1. In the event of an NBE bills being stolen, lost, mislaid, defaced or damaged, the holder shall inform the NBE in writing with a full statement of the circumstances immediately after the loss is discovered. If theft or malpractice is known or suspected, it shall also inform the police immediately.
2. No duplicate of such NBE bills shall be issued. But where the NBE is satisfied, after due enquiry and (in its sole discretion) the deposit with it of sworn statements and/or a suitable and acceptable form of indemnity against any other person establishing a claim to be the rightful holder of the bills, it may pay (on or after the maturity date) the redemption money due on the bills to the commercial bank whom it considers, after such enquiry, to be the rightful holder.



Article 11

Loans and Advances Facilities by NBE

NBE bills held by banks may be used as collateral for loans and advances from the NBE subject to the policies, rules, terms and conditions laid down for such facilities from time to time by the NBE.

Article 12

Penalty

Any bank engaging in any fraudulent activities when reporting the fresh loan disbursement amount or the allotment amount or in transferring the bills or any other activities against these Directives shall be punishable in accordance with the circumstance of the case in Article 26 of NBE Establishment Proclamation No. 591/2008.

Article 13

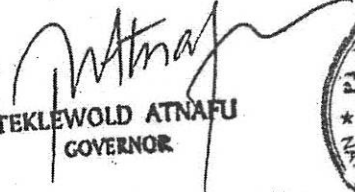
Inapplicable Laws

Any directive which contravenes with these Directives shall have no legal force on matters provided for in these directives

Article 14

Effective Date

These Directives shall enter into force as of the 4th day of April 2011.


TEKLEWOLD ATNAFU
GOVERNOR

