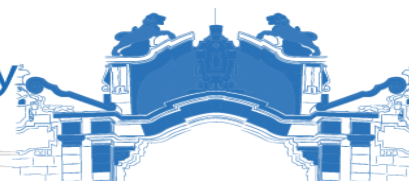




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## **COLLEGE OF LAW AND GOVERNANCE STUDIES**

### **SCHOOL OF LAW**

## **THE NEED TO ESTABLISH DEPOSIT INSURANCE IN ETHIOPIA**

Thesis submitted in partial Fulfillment of the requirements for the Degree of Master of Laws (LLM) business law program at the school of Law, Addis Ababa University

**BY**

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## Contents

ACRONYMS.....	iii
ACKNOWLEDGEMENT .....	iv
ABSTRACT.....	vi
CHAPTER ONE.....	1
INTERODUCTION.....	1
1.1 BACKGROUND OF THE STUDY .....	1
1.2 STATEMENT OF THE PROBLEM .....	4
1.3 RESEARCH QUESTIONS.....	6
1.4 OBJECTIVE OF THE STUDY .....	6
1.5 SCOPE OF THE STUDY .....	7
1.6 SIGNIFICANCE OF THE STUDY.....	7
1.7 LIMITATION OF THE STUDY .....	7
1.8 LITERATURE REVIEW .....	7
1.9 RESEARCH METHODOLOGY.....	10
1.10 ORGANIZATION OF THE STUDY .....	10
CHAPTER TWO .....	11
GENERAL OVERVIEW OF DEPOSIT INSURANCE .....	11
2.1 MEANING AND CONCEPT OF DEPOSIT INSURANE .....	11
2.2. THE NATURE AND TYPE OF DEPOSIT INSURANCE SCHEME.....	12
2.2.1. THE NATURE OF DEPOSIT INSURANCE SCHEME .....	12
2.2.2. TYPES OF DEPOSIT INSURANCE SCHEMES.....	15
2.3 THE OBJECTIVES, MERIT OF AND CHALLENGES TO DEPOSIT INSURANCE .....	16
2.3.1 THE OBJECTIVES OF DEPOSIT INSURANCE SCHEME.....	17
2.3.2 THE MERIT OF DEPOSIT INSURANCE SCHEME.....	18
2.3.3 CHALLENGES TO DEPOSIT INSURANCE .....	20
CHAPTER THREE .....	24
PERFORMANCE ANALYSISOF BANKING SECTOR IN ETHIOPIA AND INTERNATIONAL EXPERIENCE OF SOME COUNTRIES ON DEPOSIT INSURANCE SCHEME .....	24
3.2. PERFORMANCE ANALYSIS OF THE BANKING SECTOR IN ETHIOPIA AFTER 2013.....	24

3.3 THE EXPERIENCE OF SOME COUNTRIES ON DEPOSIT INSURANCE SYSTEM .....	27
3.3.1 WHY COUNTRIES ADOPT DEPOSIT INSURANCE .....	27
CHAPTER FOUR.....	35
THE LEGAL FRAMEWORK OF DEPOSIT INSURANCE SYSTEM IN ETHIOPIA .....	35
EXPLICIT DEPOSIT INSURANCE SCHEME IN ETHIOPIA.....	37
IMPLICIT DEPOSITOR’S PROTECTION SCHEMEIN ETHIOPIA .....	38
CHAPTER FIVE .....	47
CONCLUSION AND RECCOMENDATION.....	47
CONCLUSION.....	47
RECOMMENDATION .....	50
REFERENCE.....	1

## ACRONYMS

IMF	-----	International Monetary Fund
NBE	-----	National Bank of Ethiopia
WTO	-----	World Trade Organization
DIF	-----	Deposit Insurance Fund
DI	-----	Deposit Insurance
PROC.NO.	-----	Proclamation Number
ART.	-----	Article
AfCFTA	-----	African continental Free Trade Area
EDIS	-----	Ethiopian Deposit Insurance Scheme
DIS	-----	Deposit Insurance Scheme
IADI	-----	International Association of Deposit Insurance
FSF	-----	Financial Stability Found
BCBS	-----	Bassel Committee on Banking Supervision
WB	-----	World Bank
EC	-----	European Commission
FSB	-----	Financial Stability Board
SARB	-----	South African Reserve Bank
KDIC	-----	Kenya Deposit Insurance Corporation
EDI	-----	Explicit Deposit Insurance
IDI	-----	Implicit Deposit Insurance
CBE	-----	Commercial Bank of Ethiopia
DBE	-----	Development Bank of Ethiopia

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## ABSTRACT

Modern banking business in Ethiopia has started in 1905 and passed through different legal reforms made through these years. Even though the banking sector is not developed but it shows some progress towards building capacity and the use of some technology. As per the NBE establishment proclamation and the Banking business proclamation, one of the most banking business activities is receiving funds from the public in the form of deposit. Bank depositors put their money in a bank in the form of deposit, believing they can collect at any time they want to withdraw it. On the other hand, banks use the money they collect from depositors to provide loans to their customers and put on different investments. As risk is inevitable in business activity, such loans may not be performed and investments may not succeed and the bank may fail to pay back its depositors the money they deposited.

What banks or the government of Ethiopia do if a single or some banks fail and unable to pay back the fund they have collected in the form of deposit, and the main purpose of this research is to assess the existence of laws, regulation or any directive or circular in relation to the banking business adopted to protect bank depositors in the form of Deposit insurance fund. The finding of the researcher indicates that there is no explicit deposit insurance fund established to protect bank depositors in Ethiopia. The researcher also found the existence of some implicit/indirect kind of protection, which is not enough and adequate to protect depositors. Finally, the researcher reaches NBE officials and law professionals to find whether any progress towards establishing DIF. And the researcher found that the NBE believes in its importance of the establishment and there are some un progressed progress.

That is NBE made some movement in 2010 on studying the issue and in 2014 prepared a draft proposal on its establishment even not posed for discussion then after there is no progress for five years. Looking into the present situation of the banking activity, future possible challenges and other countries experience the researcher recommends that without taking further time the NBE has to establish EDIF to protect bank depositors.

# CHAPTER ONE

## INTERODUCTION

### 1.1 BACKGROUND OF THE STUDY

The history of banking in Ethiopia goes back to the reign of Emperor Menelik II in which the emperor established a bank called Abyssinia bank in 1905 that owned by the Ethiopian government in partnership with the National bank of Egypt then under British rule.<sup>1</sup> After Haile Sellassie, ascend to the throne in 1930, the bank of Abyssinia went in to liquidation and anew institution, the bank of Ethiopia, established in 1931.<sup>2</sup> A well-structured banking system started to evolve starting the 1940s-after the Italian departure.<sup>3</sup> A government owned bank –the state bank of Ethiopia established in 1942, and a number of foreign bank branches and a private bank were operating in competition with the government owned commercial bank until they nationalized and merged in to one government owed mono-bank in 1976.<sup>4</sup>

Following the change of government in 1991, proclamation number 84/94 was issued out to effect the deregulation and liberalization of the financial sector; and a number of private banks were established following the proclamation.<sup>5</sup> In 2008, the economic development of the country forces the lawmaker to issue anew proclamation prc.no.591/2008 (amendment to prc.no.83/1994) to make the power and function of the national bank in conformity with the proportional economic growth in the country.<sup>6</sup> This proclamation gives huge monitoring and supervision power to the national bank. Proclamation.No.84/1994 was replaced by Banking Business Proc.no.592/2008 that clearly stipulate what constitute banking business and provisions to regulate other related issues.

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<sup>1</sup> Prof. Arnaldo Mauri, 'The Short Life of Banking in Ethiopia' [2010] 11

<sup>2</sup> Ibid

<sup>3</sup> Michael Gezae, 'The History of Banking and Other Financial Institutions in Ethiopia' [2014] 9,27

<sup>4</sup> Aderaw Gashayie & Dr. Manjit Singh, 'Development of Financial Sector in Ethiopia' (2016) vol.7 Journal of Economics and Sustainable Development 33

<sup>5</sup> Ibid

<sup>6</sup> The National Bank Establishment (as amended) Proclamation 591/2008,preamble

Banks are the most important financial institutions for - intermediating between savers and borrowers, assessing risks, executing monetary policy, and providing payment services.<sup>7</sup> On the other hand, the configuration of their portfolios' makes them especially vulnerable to illiquidity and insolvency.<sup>8</sup> That is Banks collect money from the public in the form of deposit and they lend it out to their customers and use for investments.<sup>9</sup> Banks play a crucial role in the economy. They create assets to finance apportion of government spending i.e. deficits, and to support private sector expenditure for everything from plant and equipment to consumer durables.<sup>10</sup> Banks serve as repository for savings, providing positive return as well as payment service to liability holders. However, these two functions create instability in the sector.<sup>11</sup> Because illiquid assets financed by liquid liabilities. Banking instability has emerged as a major problem in both developed and developing countries.<sup>12</sup>

To overcome the crucial instability as well as the risks of instability in these sector governments developed varieties of institutional and legal arrangements that tend to promote banking stability.<sup>13</sup> This are designed to assure bank compliance with laws and regulations and to protect banks from unsound banking practice.<sup>14</sup> In addition to this, governments authorized their national bank to shield illiquid banks from having to sell assets with low price in a disorderly market.<sup>15</sup> In doing this central banks play great role in preventing bank liquidity problems. Nonetheless, Depositors and many other liability holders place funds in these institutions fully expecting to be

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<sup>7</sup> Charles Harry, 'Banking Reform in Ethiopia' [2002] 13,27

<sup>8</sup> Alemayehu Geda, 'The Structure and Performance of Ethiopians Financial Sector in the Pre-and Post-Reform Period with A special Focus on Banking' [2006] UN University World Institute for Development Economic Research paper 112/2006, 16 <<http://www.researchgate.net/> accessed on 9 April 2019

<sup>9</sup> Ibid

<sup>10</sup> Tom Keatinge, 'The Role Public and Private Sector Banking in Ethiopia's Future Economic Growth'[2014] (Global Center for Cooperative Security Policy Brief ) 14

<sup>11</sup> AsliDemirguc-Kunt, Edward Kane,and Luc Laeven, 'Deposit Insurance Database' [2014] IMF working paper 2014,31 <<http://www.researchgate.net/> accessed on 7 March 2019

<sup>12</sup> Ibid

<sup>13</sup> Eugene N.White, 'Legacy of Deposit Insurance; The Growth, Spread, and Cost of Insuring Financial Intermediaries' [1997] 112

<sup>14</sup> Ibid

<sup>15</sup> David Archer, 'Roles and Objective of Modern Central Banks' [2012] 18

able to withdraw their deposits whenever they choose. Frequently, their horizon of investment is uncertain and cannot be clearly established at the outset. Accordingly, the financial institution has left in the awkward position of investing in the long –term imperfectly marketable assets funded by liabilities with perceived short, uncertain maturity.<sup>16</sup> On the other hand, investment of banks may not be successful. This vulnerability to the risk of loss becomes a public policy concern than the strictly private concern of an individual depositor.<sup>17</sup> Due to these governments set financial safety net structure to create stability to its funding base and crisis.<sup>18</sup>

Financial safety net is a system of protection for bank customers provided through government legislation.<sup>19</sup> A financial safety net usually includes prudential regulations and supervision, lender of last resort and DI<sup>20</sup>. DIF is one of the main financial safety net mechanisms to protect depositors and to contribute to the financial stability. Banks are highly vulnerable to risk and many countries experienced bank failure and due to these 112 countries in 2014 and 113 as of 2015 adopted EDIF to protect their depositors and to create financial stability.<sup>21</sup> In Ethiopia even though the banking activity is not took a short history, still it is not developed financial sector. With regard to financial safety net it only extended up to the establishment of an implicit kind of depositors protection system rather than adopting EDIS. However in the 21 century, the existing experience has proved that an implicit depositor protection system per se is not enough to guarantee financial stability and depositor’s protection in the sector.<sup>22</sup>

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<sup>16</sup> Ibid

<sup>17</sup> John Marshall, ‘The Financial Crisis in the US: Key Events, Causes and Respond’[2009] research paper 09/34,21 <<http://www.researchgate.net/> accessed on 19 April 2019

<sup>18</sup> Nicola Limodio, Francesco Strobbe, ‘Bank Deposits and Liquidity Regulation: Evidence from Ethiopia’ [2017 ] 21

<sup>19</sup> Julien Bengui, Javier Bianchi, Louphou Coulibaly, ‘Financial Safety Nets’ [2017] 14, 17

<sup>20</sup> Financial Stability Forum , ‘Guidance for Developing Effective Deposit Insurance Systems’ (FSF 2001)

<sup>21</sup> AsliDemirguc-kunt, ‘Deposit Insurance Database’ [2014] 41

<sup>22</sup>John Chikura, ‘Types of Deposit Insurance’ [2013] 5,16

## 1.2 STATEMENT OF THE PROBLEM

Even if banking business in Ethiopia started in 1905 and still not well developed, there are progress to expand themselves in terms of asset and branches,<sup>23</sup> As of 2018 there are 16 private banks and 2 government banks (CBE and DBE). From this 18 banks 17 were commercial banks which the number of branches and the amount of deposit mobilization increase from time to time and reached 4757 branches from 2208 in 2013/2014 and deposit liabilities reached birr 730.3 billion from 244.6 billion in 2013/2014.<sup>24</sup> These banks receive money from the public in the form of deposit.<sup>25</sup> The banking sector will not be economically self-sufficient without deposit collection.<sup>26</sup> As depositors play a great role in the banking system, everything about banking business has numerous implications on the interest of depositors. Banks use the money collected from the public for loan and investment and such loans may not be performed and such investments may not succeed and banks may fail. Banks are susceptible to many forms of risk that triggered occasional systemic crises. These include liquidity risk (where many depositors may request withdraws in excess of available funds), credit risk (the chance that those who owe money to the bank will not repay it) and interest rate risk (the possibility that the bank will become unprofitable, if interest rates force it to pay relatively more on its depositors than it receives its loans).<sup>27</sup>

The purpose of such schemes is to assure those depositors that their funds are safe by having the government guarantee and create confidence on them. Therefore, Banks should serve the best interest of its depositors by establishing and employing bank operating policies, practices, rules and procedures to protect depositors.<sup>28</sup> There are financial safety net mechanisms adopted by different jurisdictions to protect their depositors against bank failure.<sup>29</sup> DIF is one form of

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<sup>23</sup> Mekonen Kassahun, Dr. Melesse Asfaw, 'Financial Regulation and Supervision in Ethiopia' [2014] Vol.17  
Journal of Economics and Sustainable Development 47

<sup>24</sup> NBE, Annual Report of 2013/2014 and 2017/2018, (2014, 2018) 49-53

<sup>25</sup> Banking Business Proclamation No. 592/2008 Art. 2(2)a

<sup>26</sup> Narayana Maharana, 'Deposit Collection of Commercial Banks' [2015] 43

<sup>27</sup> James R. Barth, Cidy Lee, and Triphonpumiwasana, 'Deposit Insurance Scheme' [2013] 8

<sup>28</sup> Tom Keatinge, 'The Role of Private Sector Banking in Ethiopian's Future Economic Growth' [2014] (Global Center on Cooperative Society Policy Brief) 17

<sup>29</sup> Nicholas J Ketcha Jr, 'Deposit Insurance System Design and Consideration' [2012] 13

financial safety net mechanisms to protect depositors.<sup>30</sup> Due to the vulnerability of the sector to risk of loss and practical challenges indicate more than two thirds of member countries of IMF have experienced one or more banking crisis in recent years and 113 IMF member countries in the glob choose to adopt EDIF to protect those depositors in case banks fail.<sup>31</sup>

In Ethiopia Despite the existence of implicit form of protection there is no legal as well as institutional framework of EDIF to protect bank depositors against bank failure.<sup>32</sup> Implicit protection is discretionary to the government and uncertain to depositors, as there is no law that force the government to do so and depositors have no knowledge on the extent of reimbursement and also they do not have knowledge whether they are reimbursed or not.<sup>33</sup> Due to this nature of IDIF countries forced to adopt EDIF. Even if the Reports of NBE, shows as the banking system in Ethiopia is profitable and sound. This cannot be a guarantee for tomorrow and all countries in the world established explicit protection not only as they are failed or become insolvent rather it is to make a pre-planned action to respond if loss occurred. First, in the banking sector of Ethiopia, banks opened 4757 branches and mobilized 730.5 billion deposits which is more than a double within five year and their contribution to the GDP is growing fast and this deposit left without guarantee.<sup>34</sup> Managing one branch is not similar with that of more branches and when the number of branches increases more vulnerability to risk will increase.

Secondly, the introduction of technological products that makes banks more vulnerable to risk. Thirdly, progressive liberalization may become effective as Ethiopia signed AfCFTA and on process to join WTO and it is not only this, the market situation in the world also push to make liberalize the domestic oriented investment system. Fourthly, failure to resist even domestic competition may cause bank to fail. These all points necessitate conducting research on the topic. Adopting EDIS help to ensure pre-planned, orderly and efficient provision of protection rather

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<sup>30</sup> Ibid

<sup>31</sup> AsliDemirguc-Kunt,Edward Kane,and Luc Laeven, 'Deposit Insurance Database' [2014] IMF Working Paper 2014,26 <<http://www.researchgate.net/> accessed on 7 March 2019

<sup>32</sup> The NBE establishment Proc. (as amended) 591/2008 Art.5 (18) and Art.25

<sup>33</sup> The World Financial and Policy Center, 'Deposit Insurance System' [2016] Working Paper 2016,53

<sup>34</sup> NBE,Annual Report of 2017/18 (2018) 45-49

than an unprepared scrambling for funds, haphazard policy decisions made under pressure and or disorderly and non-transparent compensation arrangement.<sup>35</sup> It also responds to the crisis or even if the arrangement is weak it can mitigate any excessive loss in the sector. The researcher is convinced that the absence of legal framework and institutional structure of EDIS in the Ethiopian banking sector could be a great risk to the wellbeing of the depositing public in particular and the banking sector and the entire economy in general. As a result the issue has been developed into a researchable problem under a title “The need to establish deposit insurance in Ethiopia.”

### 1.3 RESEARCH QUESTIONS

1. Do the existing banking laws of Ethiopia regulate the issue of DIF?
2. What is the experience of some countries on the establishment of DIF looks like?
3. Is that necessary to establish DIF in Ethiopia in the current situation or in the near future?
4. What looks like the present banking performance in Ethiopia?

### 1.4 OBJECTIVE OF THE STUDY

The **general objective** of this study is to examine the need for the establishment of DIF in Ethiopia.

The **specific objectives** of this study are:

1. To give general overview on DI system through reviewing pertinent literatures.
2. To assess the experience of some countries on deposit insurance system.
3. Assessing the background and performance of banking sector in Ethiopia, and their vulnerability to insolvency.
4. Examine the legal framework of DIS in the banking sector of Ethiopia.
5. To analyze the nature of DIS favorable in Ethiopia.

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<sup>35</sup> Mikhail Frolov, ‘Deposit Insurance and its Design, Literature Review’[2004] Kio University market quality research project 2004,28

## 1.5 SCOPE OF THE STUDY

This research will focus on the need to establish DIF in the banking sector in Ethiopia. It tries to address issues related with DIF in the banking sector. The NBE establishment Proclamation (as amended) Proc.591/2008, Art.2 (2) and (3) jot down the banking business and define banks as companies licensed by the NBE to undertake banking business and banks owned by the government. Therefore, the research only focus on banks undertaking the banking business as defined under the proclamation.

## 1.6 SIGNIFICANCE OF THE STUDY

As the work conducted on the issue of DIS, which is by itself a new area of business law in Ethiopia, it would provide legislative input to organs vested with the power to legislate on deposit insurance system. More over the study would create awareness to all stake holders, especially depositors, the NBE and to other private and public banks. Finally, the study will serve as a reference for further related researches and as an input to conduct different writings in related issues.

## 1.7 LIMITATION OF THE STUDY

This research is limited to study the need to establish deposit insurance in Ethiopia. It addresses issues related with DIF in the banking sector. Even though, international literatures and different journals are available especially in soft copy, there is lack of domestic literatures written with regard to DIF in Ethiopia. In addition to this the NBE unwillingness to give the study and draft proposal made on DIF before seven and five years.

## 1.8 LITERATURE REVIEW

Banks are financial institution that accepts deposits from the public and creates credit.<sup>36</sup> Lending activities can be performed either directly or indirectly through capital markets. Due to their importance in the financial stability of a country, banks are highly regulated in most countries.<sup>37</sup> Deposit insurance is wide spread across the globe and constitutes an integral part of

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<sup>36</sup> Mikhail Frolovo, 'Deposit Insurance and its Design' [2004] 13

<sup>37</sup> [Http://www. Wikipedia .com](http://www.Wikipedia.com) free online legal dictionary >accessed on 21 December 2018

the financial safety net provided to the banking system.<sup>38</sup> Deposit insurance is protection provided usually by a government agency to depositors against risk of loss arising from failure of a bank or other depository institution. However, it covers only affixed amount per account holder also called depository insurance.<sup>39</sup>

Banks are susceptible to many forms of risk that triggered occasional systemic crises.<sup>40</sup> These include liquidity risk (where many depositors may request withdraws in excess of available funds), credit risk (the chance that those who owe money to the bank will not repay it) and interest rate risk (the possibility that the bank well become unprofitable, if interest rates force it to pay relatively more on its depositors than it receives its loans).<sup>41</sup> More than two thirds of member countries of IMF have experienced one or more banking crisis in recent years and the inherent fragility of banks has motivated 50% of the countries in the world to establish deposit insurance scheme.<sup>42</sup> The purpose of such schemes is to assure those depositors that their funds are safe by having the government guarantee and create confidence on them that this can always be withdrawn at full value.

In the absence of deposit insurance, bank runs are an ever present threat owing to the fact that banks typically fund illiquid assets with more liquid liabilities.<sup>43</sup> Due to the above threats and practical challenges suffered by banks in the world, the issue of depositors protection called deposit insurance come in to picture. The history of deposit insurance goes back the great depression resulted in the failure of thousands of banks in 1933, when the FDIC becomes effective in USA<sup>44</sup>. The rationale behind the establishment of FDIC is the financial collapse

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<sup>38</sup> Deniz Anginer, Asli Demirguc, 'Bank Runs and Moral Hazard: A Review of Deposit Insurance' (2018) IMF policy research working paper 8589, 17 > <http://www.ssrn.com> accessed 25 March 2019

<sup>39</sup> [Http:// www. Business Dictionary .com](http://www.BusinessDictionary.com) Free Online Legal Dictionary Accessed 21 March 2018

<sup>40</sup> Sebastian Schich, 'Financial crisis: Deposit Insurance and Related Financial Safety Net Aspects' [2008] p 29

<sup>41</sup> Id

<sup>42</sup> James R. Barth, Cidy Lee, and Triphonpumiwasana, 'Deposit Insurance Scheme' [2013] P 10, 15

<sup>43</sup> Nicholas J Ketcha Jr, 'Deposit Insurance System Design and Considerations' [2014] P 22ff

<sup>44</sup> The FIDIC, Brief History of Deposit Insurance in the United States (first published 1934), 1998 231

between 1930 and 1933 and to provide stability to the economy and to guarantee depositors against bank failure.<sup>45</sup> The number of countries with EDI schemes has continued to increase. Out of 189 IMF member countries covered, 113 countries (or 59 percent) had EDI by year-end of 2014, having increased from 85 countries (or 45%) in 2003.<sup>46</sup> The 2008 global financial crisis contributed to this trend. Unfortunately there are still several countries that have yet to set up DIS especially in Africa, for example only 24% of countries in sub Saharan Africa currently have DI.<sup>47</sup> And in east Africa Kenya deposit Insurance Corporation (KDIC) have best experience and won the 2016 international association of deposit insurers award of DI of the year.<sup>48</sup>

There is no domestic research paper conducted before exactly similar with this topic. However, there is one research paper and Article by Samuel Maireg conducted in 2011 on fundamental consideration of design and institutional framework of DIS. This research only addresses the issues on the design and institutional framework of DI. That is it address issues on if DIF implemented in Ethiopia, what should the membership, premium, extent of coverage and whether it is under government or private agency which is purely doctrinal. The research does not address issues necessitated DIF in Ethiopia. However, this paper on the need to establish DI in Ethiopia brings a new knowledge based on experience of countries, the banking business performance in Ethiopia, financial policies and strategies and it also included interview of NBE officials and legal departments as whether establishing DI is necessary or not and if not established what is the NBE doing on its establishment.

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<sup>45</sup> William M Isaac, 'The Role of Deposit Insurance in the Emerging Financial Service Industry' [1984] Vol.1 YLJ<<http://www.Heinonline.com>>6 March 2019

<sup>46</sup> AsliDemirguc-Kunt,Edward Kane,and Luc Laeven, 'Deposit Insurance Database' [2014] IMF Working Paper 2014,26 <<http://www.researchgate.net/> accessed on 7 March 2019 and available on <http://www.iadi.org/en/core-principles-and-research/publications/glossary/implicit-protection.accessed> on May 26,2019.

<sup>47</sup> Marlon Rolston Rawlins, 'Building Deposit Insurance System in Developing Countries'[2017] P 43,47

<sup>48</sup> IADI, report of the year 2016

## 1.9 RESEARCH METHODOLOGY

The research methodology applicable for this research is doctrinal research method. The researcher has used applicable banking finance laws as primary sources to assess the legal framework of DIF in Ethiopia. The researcher also uses Books, literatures, journals, related researches written on the topic and reports as secondary sources in order to give an Overview on the concept, form, experience of countries and issues related to DIS. The researcher takes use of raw data and annual reports of the NBE which is important to conduct a situational analysis on the present situation of banking performance in Ethiopia. In addition to the literature review and using primary sources,

In addition to the above points in order to know what the NBE is doing with regard the issue at hand, the researcher conducted interview with concerned NBE officials and legal departments. Even if the research is more of doctrinal, this make the research a little bit mixed that is doctrinal and empirical. As NBE establishment proclamation ( as amended) Proc.no.591/2008 Art.5(18) give the power and duty to establish and manage DIF to the NBE, the interview help to understand practically what the NBE is doing with regard to the establishment of DIF.

## 1.10 ORGANIZATION OF THE STUDY

This study attempt to assess the need to establish deposit insurance in Ethiopia and it is organized as follows. The study contain five chapters, i.e. Chapter one of the study contains the Introduction part of the paper, Chapter two of the study contains General overview on deposit insurance, chapter three of the study contains background and performance of the banking sector in Ethiopia and other countries experience, chapter four contains the legal frame work of Deposit insurance scheme in Ethiopia and chapter five contains conclusion and recommendation part.

## CHAPTER TWO

### GENERAL OVERVIEW OF DEPOSIT INSURANCE

#### 2.1 MEANING AND CONCEPT OF DEPOSIT INSURANCE

Before addressing the issues related with the role of deposit insurance in a banking safety net, it is important to briefly discuss what is meant by financial safety net and why such nets have been established for banking system in general and deposit insurance in particular.

Financial safety net is a system of protection for bank customers provided through government legislation.<sup>49</sup> Safety net is a multi-dimensional policy scheme that is alleged to balance the costs and benefits generated by protecting bank customers from being blindsided by bank insolvencies, limiting aggressive risk taking by banks, preventing and controlling damage from bank runs, detecting and resolving insolvent banks and allocating across society whatever losses occur when an insolvent bank is closed.<sup>50</sup> A financial safety net usually include prudential regulations and supervision, lender of last resort, failure resolution and deposit insurance<sup>51</sup> As discussed before deposit insurance is one of financial safety net mechanism that different countries adopt to protect depositors in the banking system.<sup>52</sup> Before we embark on the definition of deposit insurance, it is important to give a short clue on the concept of deposit and insurance in the eyes of the banking system. For the purpose of the banking system, Bank Deposit consists of money placed in to banking institutions for safe keeping. These deposit accounts can be in the form such as savings accounts, checking accounts and money market accounts. The account holder has the right to withdraw deposited funds, as set forth in the terms and conditions governing the account agreement.<sup>53</sup> The deposit itself is a liability owned by the bank to the depositor. When someone opens a bank account and makes cash deposit, he surrenders legal title to the cash, and it becomes an asset of the bank. In turn, the account is a liability to the bank.<sup>54</sup>

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<sup>49</sup> Julien Bengui, Javier Bianchi, Louphou Coulibaly, 'Financial Safety Nets' [2017] p 14-17

<sup>50</sup> Ibid

<sup>51</sup> FSF, Guidance for Developing Effective Deposit Insurance Systems' [2001] <http://www.idi.org.com> March 27 2019

<sup>52</sup> Julien Bengui, Javier Bianchi, Louphou Coulibaly, 'Financial Safety Nets' [2017] P 11

<sup>53</sup> Julia Kagan, 'Bank Deposits' [2018] p 29

<sup>54</sup> Ibid

On the other hand, insurance means an undertaking by an insurer to indemnify another person, in exchange for consideration called premium against damage, distraction, loss or liability in respect of certain risk or peril to which the object of the insurance may exposed to depending up on the happening of a certain event.<sup>55</sup>So Deposit insurance in banking terminology ,it refers to a type of protection for funds held in a measure implemented in many countries to protect bank depositors ,in full or in part ,from losses caused by a banks in ability to pay its debts when due.<sup>56</sup>The principal objectives for deposit insurance are to contribute to the stability of the financial system and to protect less financially sophisticated depositors.<sup>57</sup>

Generally, deposit insurance is a system implemented in the banking system as banking safety net mechanism, to safeguard specially those depositors of the bank. The concept of deposit insurance come in to picture in 1933, which is the history of deposit insurance goes back the great depression resulted in the failure of thousands of banks in 1933, when the FDIC becomes effective in USA<sup>58</sup>. FDICs purpose was to provide stability to the economy and the failing banking system.

## **2.2. THE NATURE AND TYPE OF DEPOSIT INSURANCE SCHEME**

### **2.2.1. THE NATURE OF DEPOSIT INSURANCE SCHEME**

#### **2.2.1.1. GOVERNMENT AND PRIVATE AGENCIES DEPOSIT INSURANCE SCHEME**

The issue of deposit insurance and financial sector crisis is both the concern of the public policy and private individual interest. Banking system crisis or any loss and insolvency affect both the

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<sup>55</sup> Insurance Business Proclamation No.746 of 2012 Art.2 (16)

<sup>56</sup> DR yusufsani Abubakar ,Drlukman Olorogun, Dr.Ahmad faosi, ‘Concept of Deposit Insurance;-Comparative Between Conventional System and Shariah’[2016] <<http://www.idi.org.com> > 24 January 2019

<sup>57</sup> Mikhail Frolov, ‘Deposit Insurance and its Design, Literature Rewiew’ [2004] Kio University market quality research project 2004 28

<sup>58</sup> The FIDIC, Brief History of Deposit Insurance in the United States (first published 1934),1998 231

economy of a country as well as depositors of a bank as the bank fails to pay back the money received from its customers which is payable upon the request of payments. Due to this, the issue of depositor's protection and financial crisis become public policy concern in different countries around the world. DI institutions are for the most part of government run or established, may or may not be part of a country's central part, while some are private entities with government backing and completely private entities.<sup>59</sup> Government provision of a financial safety net for banks and other financial institutions has been a key element of the policy response to the current financial crisis.<sup>60</sup>

As mentioned above deposit insurance institutions can be established by government or by private independent agencies. That is the government itself may establish deposit insurance institutions under its control and management to safeguard bank depositors as an insurance company. On the other hand, it can be established by private entities. DIS commonly managed whether by a government agency or in a public private partnership. With the exception of few countries, that arrangement is totally under private agencies like countries Switzerland, Germany and Argentina.<sup>61</sup> With regard to membership to those agencies, countries also have no uniform form of membership requirement.<sup>62</sup>

#### 2.2.1.2. FULL AND LIMITED COVERAGE SCHEME OF DEPOSIT INSURANCE

EDI measures implemented in many countries to protect bank depositors from losses partially or fully due to the inability of a bank to pay its debt<sup>63</sup>. Countries differ significantly on the amount

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<sup>59</sup> Sebastian Schich, 'Financial Crisis :-Deposit Insurance and Related Financial Safety Net Aspects' (2008)

<<http://www.iadi.org.com> > 21 May 2019

<sup>60</sup> Ibid

<sup>61</sup> Asli Demirguc-Kunt and Edward J.Kane, 'Deposit Insurance around the Globe: Where Does it Work?'(2001) <http://www.researchgate.net> 18 May 2019

<sup>62</sup> Spyridon Repousis, 'Regulatory Framework and Deposit –Investment Guarantee Fund in Greece and Switzerland'[2015] Vol.23 No.1 Journal of Financial Regulation and Compliance <http://www.emeraldinsight.com> 22 May 2019

<sup>63</sup> DR Yusufani Abubakar, Dr. Lukman Olorogun, Dr. Ahmad Faosi, 'Concept of Deposit Insurance;-Comparative Between Conventional System and Shariah'[2016] <http://www.iadi.org.com> 24 January 2019

of protection their deposit insurance provides. Most developed countries have a smaller ratio of coverage that is limited as their per capita GDP than developing countries with undeveloped banking system. Generally, there is no uniformity between countries in the world in adopting deposit insurance system. For instance, countries like Mexico, Turkey and Japan promise hundred Percent depositor coverage, on the other hand, Chile, Switzerland and UK-cover only an amount of deposits that is actually less than their per capita GDP.<sup>64</sup> By reducing the likelihood that a ‘problem’ bank will be pushed in to a serious liquidity squeeze through a run by large depositors who withdraw funds, 100% deposit insurance would decrease the probability that manageable problems will suddenly become unmanageable and lead to bank failure or insolvency”.<sup>65</sup>

On the other hand, economists like Garcia, Thakor and Greenbaum ,Demirguc-kunt, and Detragiache argue that “full coverage application is the moral hazard problem that makes depositors careless initially in the selection of their bank and, later discourages them from insured bank. knowing that runs are unlikely ,may take on additional risk on their asset portfolios, reduce the amount of capital and liquid reserves they hold to enable them to weather shocks”. As data’s show in many countries, deposit insurance coverage is limited to some extent.<sup>66</sup> During the 2008 financial crisis, the Limited DI coverage system adopted in USA it deemed insufficient to guarantee the stability of the payment system. And the FDIC implemented the Transaction Account Guarantee (TAG) program that fully insured noninterest bearing transaction deposit accounts.<sup>67</sup> Moreover, interest-bearing accounts kept subject to the limited

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<sup>64</sup> Edward J.Kane and AsliDemirguc-Kunt, Deposit Insurance around the Globe [ 2001] P 23,41

<sup>65</sup> Humphrey Leon, ‘Deposit Insurance Coverage’[1976] p 97

<sup>66</sup> Oz Shy,RuneStenbacka,VladimirYankov, ‘Limited Deposit Insurance Coverage and Bank Competition, During the 2008 Financial Crisis’[ 2014] <http://www.independent.academicia.edu>10 April 2019

<sup>67</sup> Ibid

deposit insurance.<sup>68</sup> These shows as countries choose the extent of deposit insurance based on their financial policy, performance and economic analysis.

## 2.2.2. TYPES OF DEPOSIT INSURANCE SCHEMES

### A.EXPLICIT DEPOSIT INSURANCE

Explicit deposit insurance is a type of deposit insurance protection system in which countries clearly and expressly state on their legal documents. EDI protection system has laws that expressly provide for bank deposit guarantees and establish basic aspects of DIS. It contain coverage limits, how the system to be funded, the way depositors are to be paid in the event of bank failure, types of institution eligible for protection, and whether membership is compulsory or voluntary.<sup>69</sup> EDI is contractual obligation between the insured and the insurer to pay back the money deposited during bank failure while implicit coverage is only conjectural and it depend on government willingness and to the extent of political incentive.<sup>70</sup>

The World Bank survey on regulation and supervision conducted in 2010 indicate that in1974, only 12 countries adopt explicit deposit insurance system and as of 31 January, 2014, 113 countries adopted it.<sup>71</sup> The 2008 global financial crisis has contributed to the increasing of adopting explicit deposit insurance in which five countries adopt in the year 2008 alone. EDI has the merit of limiting the discretionary decision, build public confidence, impose obligation on insurers and it is predictable.<sup>72</sup>

### B.IMPLICIT DEPOSIT INSURANCE

In Implicit deposit insurance system government depositors protection is discretionary.<sup>73</sup>This system does not have formal laws or regulations that explicitly state the reimbursement amount and the form of protection which is based on adhoc decision solely made by the government and

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<sup>68</sup> Ibid

<sup>69</sup> Ibid

<sup>70</sup> Kunt and Kane, 'Depositors Protection' [2002] P 74

<sup>71</sup> AsliDemirguc-kunt, 'Deposit Insurance Database'[2014] <http://www.academics.net> 3 December 2018

<sup>72</sup> John Chikura, 'Types of Deposit Insurance'[2013 ] p 13

<sup>73</sup> Ibid

is responsible for the financing of depositors.<sup>74</sup> There are no statutory rules regarding the eligibility of financial institution liability, the level of protection provided and the form of reimbursement. The government offer such protection, not because it is obliged to do so by law, but because it believes that such action will achieve certain public policy goals, because it may feel at least partly responsible for the losses that must be absorb, or because it may consider it to be cheaper in the long run to do so.<sup>75</sup> On the other hand, it creates uncertainty about how and when depositors compensated and funding depends on the ability of government to access funds.<sup>76</sup>

### 2.3 THE OBJECTIVES, MERIT OF AND CHALLENGES TO DEPOSIT INSURANCE

There are different lines of argument on the need of deposit insurance system. Establishing deposit insurance system in the banking sector is necessary, and they try to support his argument as, DI is important to safeguard depositors from baking panic.<sup>77</sup> Because depositors put their money on bank in believing that, they will be repaid up on request for payment .Even if their motive is to make profit it is not always true that they are always profitable because they may suffer loss due to unsound business practice because risk is inevitable in business activity.<sup>78</sup>

Maybe similar scenarios happen to banks. Banks collect money in the form of deposit from customers then invest deposits to earn revenue, which explains how banks pays interest for saving, time and demand deposits including other products. These investments include providing loan to customers and other more complex investments. If banks investment loses too much the institution may be unable to satisfy the demand of customers who want to use their money that they have deposited in the bank. When this happen to a bank then we can say that the bank fails.<sup>79</sup> If the bank becomes insolvent, depositors ought to have to get his money that they put under the trust ship of such bank. So in case when the bank become not in a position to pay back the money under its control due to insolvency, the insurance will pay the money they deposited

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<sup>74</sup> Ibid

<sup>75</sup> The World Financial and Policy Center, Working Paper 132 ,2016 <http://www.researchgate.net>

<sup>76</sup> Ibid

<sup>77</sup> Nicholas J Ketcha Jr, 'Deposit Insurance System Design and Considerations'[ 2012] p 32

<sup>78</sup> Ibid

<sup>79</sup> Ibid, <[https:// www.fdic.gov/deposit/deposits/your insured deposits .com](https://www.fdic.gov/deposit/deposits/your%20insured%20deposits.com) 3 March 2019.

in the insolvent bank in extent of the amount insured. Marlowe Neal added that in his writing “The Role of deposit insurance in financial crisis resolution”, deposit insurance is to contribute to financial stability. That he adds, deposit protections reduce the financial uncertainty and this will promote financial intermediation and enhance economic and financial stability.

On the other hand, others argue, as Deposit insurance is not necessary because it is subsidy by the government due to unsound practice by a bank. This kind of arrangement may encourage recklessness and mindless risk taking on the part of managers of banking institutions. That is by insuring market participant’s costs of pursuing riskier strategies reduced, and excessive risk taking might be incentivized. Anthony M.Santomero, show on his writing on Deposit insurance (1997),That is this kind of arrangement may encourage risk taking by insured institutions in a sense that with government guarantee or deposit insurance agencies guarantee some or all depositors are insured so the does not care about the asset it hold or their likely hood of failure.

### 2.3.1 THE OBJECTIVES OF DEPOSIT INSURANCE SCHEME

From its name, we can see that deposit insurance is all about insuring the money deposited by bank depositors. Therefore, the first, and the main objective of DIS is to ensure this depositors that they will not loss their savings and deposits held with bank if the bank become insolvent.<sup>80</sup> Depositors put their money in banks up on their choice only based on the trust they build on the bank, it is a trust-based relationship. Even majority of depositors may not know the actual performance of such bank and they only put their money on the bank in believing that they can access their money when they need to withdraw it. Any profit making business companies undertake their business activity to gain profit. However, even if their motive is to make profit it is not always true that they are always profitable because they may suffer loss due to unsound business practice because risk is inevitable in business activity. Similar scenarios may happen to banks. So the main point is that if such a bank become insolvent and not in a position to pay back depositors money, what is the fate of customers/depositors?, that is there should be a back up or

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<sup>80</sup> Nicholas J Ketcha Jr, ‘Deposit Insurance System Design and Considerations’ [2012] P 16

guarantee a kind of financial safety net called depositors protection insurance. The second, objective of deposit insurance is to contribute to financial stability.<sup>81</sup>

Financial stability is the sum up of different sound financial practices. If there is unsound practice by a single financial sector like a bank, it may cause financial loss, that may affect not only the bank itself but also it may affect financial activity and the GDP of a country. Insolvency of a bank largely affects large depositors of a bank and this may cause financial instability. Generally, its main objective is safeguarding depositors whether they are large or small, individuals or companies having deposited their money and doing so will contribute to financial stability of a country.

### 2.3.2 THE MERIT OF DEPOSIT INSURANCE SCHEME

Different countries in the world including developed as well as countries with underdeveloped banking system are adopting the deposit insurance scheme as they are convinced as it have a great contribution to the banking system as well as to the financial sector in general. The following are some of the advantage of adopting deposit insurance scheme specially that of explicit deposit insurance.

#### **1. To protect depositors**

Depositors only put their money in banks in believing that they can access their money when they need to withdraw it. Risk or loss is inevitable in business activity and we can understand that banking business is a type of business that need strong administrative measure, due to the nature of banking business its insolvency affect not only itself but also it may have adverse effect on the rest of the financial activity and GDP of a country. It is the peace of mind for depositors as they know their money has ensured and they can access their money even the bank becomes illiquid or insolvent.<sup>82</sup> These in turn support the stability and smooth operation of the economy. This make people to put their money in banks and banks well access more funds that enable

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<sup>81</sup> Marlowe Neal, 'The Role of Deposit Insurance in Financial Crisis Resolution' [2010 ] Central Bank of Belize Financial Sector Supervision Department working paper p 54

<sup>82</sup> George J Pennacchii, Deposit Insurance'[2009] P 29

them to lend that lower interest rate. Because of the aforementioned points the first and for most purpose of deposit insurance is to ensure depositors that they will not lose their savings and deposits held with bank if the bank becomes insolvent.<sup>83</sup>

## **2. It contribute to financial stability**

Insuring depositors will create confidence in the banking system. Deposit protections reduce the financial uncertainty and this will promote financial intermediation and enhance economic and financial stability.<sup>84</sup> Unsound banking business operation by a single financial sector like a bank may cause financial loss which may adversely affect not only the bank itself but also the whole financial activity and the GDP of a country. Therefore, we can say that protecting depositors have its own contribution in financial stability.

In addition to this besides providing deposits, banks have the role of lending money to “opaque” firms and individuals in which whose creditworthiness is needed to be evaluated and monitored in order to decrease excessive loss.<sup>85</sup> Diamond and Dybvig argue that deposit insurance eliminate the incentive to start a bank run and thereby avoid the excessive liquidation of bank loans. This well helps to save banks from excessive loss and contribute to financial stability.

## **3. It contribute in promoting sound business practice**

Deposit insurance companies may contribute in monitoring and supervising risk contributory institutions for safety and soundness via unsound management. That is many countries experience show as deposit insurance companies are not there only to give coverage then when damage happen they try to reimburse depositors rather they have the mandate to follow up those insured institutions whether they are doing their job according to the market discipline or its soundness. Therefore, this kind of arrangement will help to promote sound risk management practices, good corporate governance, and customer protection.<sup>86</sup>

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<sup>83</sup> KaluUbere Ume, OlikeChioma, Alice ChinweObasikene, ‘Deposit Insurance and Moral hazard: A theoretical discourse’ [2018] Vol. 03 The Economic <[http:// www.ecoblog.org](http://www.ecoblog.org) 22 February 2019. Protecting depositors fund means protecting depositors and contributory institutions from risk and create financial stability that may lead to economic growth.

<sup>84</sup> George J Pennacchii, ‘Deposit Insurance’[2009 ] <[http:// www.dpcorp.co.zw](http://www.dpcorp.co.zw) 11 April,2019

<sup>85</sup> Ibid

<sup>86</sup> Ibid

#### **4. Protecting against government funds**

As we can see from past experience for instance from the 1930s great depression and the recent phenomena of the 2008 banking crisis countries try to manage the crisis through the way they believe they can get out it. One of the mechanisms they implemented is that, it is government incentive to those banks in the crisis. Giving incentive is not an easy task especially for those developing states. Because governments need to have, more funds that can make them to revive and to do so these developing states may collect the funds from outside through lending or support from developed once. First, it is not an easy task to get the fund second; such funds implemented for incentive may do for other activity of the government in the country.so we can argue that deposit insurance is important to avoid this up and down.

#### **5. Enhancing competition between the banking sectors**

If banks has been mandated to adopt deposit insurance scheme, this will create more trust on the mind of bank users and enable them to choose any bank they went to be a customer and this will enhance competition between the banking sectors. Offering deposit protection to every bank including small banks make depositor of such bank to feel safe and protected,<sup>87</sup> and this will enhance competition in the sector. Deposit insurance can level the playing field and allow small banks to attract depositors and thus foster greater competition in the system. It can also help private banks to compete against state owned banks.<sup>88</sup> Especially in countries with undeveloped awareness on using and how to choose their banks, the society has more trust to government banks like ours.

### **2.3.3 CHALLENGES TO DEPOSIT INSURANCE**

Even though deposit insurance has tremendous advantages in the banking system, if it has not properly managed, it will cause financial crisis by itself. The following points show as some of the drawbacks of deposit insurance.

#### **1. The moral hazard problem**

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<sup>87</sup> Ibid

<sup>88</sup> Denize Anginer, Asli Demirguc-kunt 'Bank Runs and Moral Hazard A Review of Deposit Insurance' World Bank Group policy research working paper [2018] <[http:// www.researchgate.net](http://www.researchgate.net) > 17 February 2018

Governments and financial sector regulators favor deposit insurance since they want to ensure financial stability and protect depositors against bank failure.<sup>89</sup> However, it has believed that this kind of arrangement may encourage recklessness and mindless risk taking on the part of managers of banking institutions. That is by insuring market participant's costs of pursuing riskier strategies reduced, and excessive risk taking might be incentivized.<sup>90</sup> That is this kind of arrangement may encourage risk taking by insured institutions in a sense that with government guarantee or deposit insurance agencies guarantee some or all depositors are insured so the does not care about the asset it hold or their likely hood of failure.<sup>91</sup> In its nature the banking sector need due diligence in management failing to do so will cause failure. As stated before supervision and monitoring insured institution is essential in order to control moral hazard and risk taking thereby ensure financial stability and protect depositors. DI arrangement will remove market discipline, encourage excess risk taking and depositors even have no longer to choose as to who or who not to deposit money with.

## **2. It makes depositors to have little incentive to monitor bank risk taking**

As stated before like moral hazard on banks, depositors may become negligent when they decide to choice to which bank they deposit their money in believing that such banks are insured.<sup>92</sup> Therefore, if any failure happened they know they can get their money back. We can say that it will also create moral hazard on depositors. An intended drawback of DI is the reduction in the incentive of depositors to monitor banks, which lead to excessive risk taking.

## **3. Intervention by regulatory agencies**

Especially when the insurance agency is government agency there is the issue of government intervention.<sup>93</sup> That is government come with programs in every sectors of the country and there may be some programs prioritized due to other public interest or state security. Moreover, this force the government or rather than managing the problem the government may abuse its responsibility to underprice the program. Generally in government agency non-economic factors affect economic decision these influences adversely affect the economy and the sector being

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<sup>89</sup> KaluUbereUme,OlikaChioma,AliceChinweObasikene, 'Deposit Insurance and Moral Hazard: A theoretical Discourse' [2018] Vol. 03 , IMF law journal <[http:// www. iadi.net](http://www.iadi.net) > 15 February 2018

<sup>90</sup> Nicholas J.Ketcha Jr, 'Deposit Insurance System Design and Considerations'[2012] P 1,5

<sup>91</sup> Anthony M.Santomero, 'Deposit Insurance: Do we Need It and Why' [1997] P 34 <http://www.Africa journal.net>

<sup>92</sup> Ibid

<sup>93</sup> Ibid

manipulated.<sup>94</sup> For instance, the USA Federal deposit insurance protects small and unsophisticated depositors. However, governments constrained in their assessment of banks risk, and they usually priced unfairly and administered ineffectively.<sup>95</sup> These generally show that regulatory agencies may intervene improperly on the sector through their over and over changing regulations.

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<sup>94</sup> Stiglitz Chen and Kane, 'Deposit Insurance and its Effect' [1981,2002] P 20 ,37

<sup>95</sup>George G. Pennacchii, 'Deposit Insurance' [2009] p 71



## CHAPTER THREE

### PERFORMANCE ANALYSIS OF BANKING SECTOR IN ETHIOPIA AND INTERNATIONAL EXPERIENCE OF SOME COUNTRIES ON DEPOSIT INSURANCE SCHEME

#### 3.2. PERFORMANCE ANALYSIS OF THE BANKING SECTOR IN ETHIOPIA AFTER 2013

As important financial institutions, banks have a unique function in an economy by bridging saving and investment activities. Compared to most countries, Ethiopia has taken cautious approach towards the liberalization of its banking sector and still the sector has closed for foreign investment with underdeveloped banking system.<sup>96</sup> The dominance of the CBE certainly restricts the financial intermediation and economic growth.<sup>97</sup> Recent data shows that commercial bank mobilizes more than 60% of total bank deposits, bank loans and foreign exchange<sup>98</sup>. Under the growth and transformation plane II (GTP II), the NBE increased minimum capital for banks to operate to 2 billion birr (\$90 million) and all sixteen private banks are required to increase their paid-up capital to that amount by 2020. The banking sector was not allowed to foreign investment but currently, Ethiopia has allowed some foreign banks to open liaison offices in Addis to facilitate credit to companies from their countries of origins.<sup>99</sup> The 2013/2014 annual report of the NBE indicates that Commercial banks opened 480 new branches, which increased the total number of branch to 2208 from 1728 last year. Moreover, this increased their total deposit mobilization reached 244.6 billion birr. Their non-performing loan is within the required ceiling of 5%.<sup>100</sup> Generally, the report shows that the financial sector was remained safe, sound and well capitalized profitable. The 2014 /2015 annual report of the national bank of Ethiopia on the banking sector performance shows that in this fiscal year, the number of banks stood 19 of

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<sup>96</sup> Tom Keatinge, 'The Role of Private Sector Banking in Ethiopian's Future Economic Growth'[2014] (Global Center on Cooperative Society Policy Brief) 17

<sup>97</sup> Ibid

<sup>98</sup> [https://www.export.gov-Ethiopia-Banking Systems/export.gov.com](https://www.export.gov-Ethiopia-Banking_Systems/export.gov.com) published by U.S Embassies Abroad 2 February 2011

<sup>99</sup> Ibid, Chinese, Germany, Kenya, Turkish and South African banks have opened liaison offices in Ethiopia.

<sup>100</sup> The NBE, Annual Report of 2016/2017 ,P 45-49

which 16 were private commercial banks and three states owned. Commercial banks opened 485 new branches, which increased their total to 2693 up from 2208 in 2013/2014.

They stepped up their deposit mobilization, which 25.5 % of annual growth. Their loan collection exhibited a 16.0 percent increase and new loan disbursement about 26% expansions.<sup>101</sup> More over all indicators show that commercial banks are well capitalized and their returns on equity and assets were well above the required level, and their non-performing loan was kept within the prudential requirement. The report added that, saving and time deposit went up 32.3 percent and reached birr 216.6 billion in line with the increased capacity of banks in deposit mobilization and opening of new branches. Commercial banks and the development bank of Ethiopia disbursed birr 75.5 billion in new loans to different economic sectors this shows 25.9 annual increase in line with higher deposit mobilization and collection of loans.<sup>102</sup> From the total new loans, 44.5% was by private banks.<sup>103</sup>

2015/2016 annual report of the NBE indicates that Commercial banks opened all commercial banks scaled up their deposit mobilization by opening 694 new branches and their total deposit mobilization reached 378.6 billion birr. Loan disbursements are 5.9 percent and the report shows that the non-performing loan is within the required ceiling of 5%. Generally, the report shows that the financial sector was remained safe, sound and well capitalized profitable. The 2016/2017 annual report of the national bank of Ethiopia indicates that Commercial banks opened 956 new branches, which increased the total number of branch to 4257 from 3301 in 2015/2016. Moreover, this increased their deposit mobilization to 29.8 %, loan collection 25.9 percent and loan disbursement to 23.8 percent and non-performing loan is within the required ceiling of

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<sup>101</sup> The NBE, Annual Report of 2014/2015 ,P 46, <[http://www. Financial dictionary.com](http://www.Financial dictionary.com) > 12 March, 2019.

*time deposits* are deposited in bank for a fixed period of time whereas *demand deposits* are deposits payable upon request i.e. there is no fixed time period involved in case of demand deposit. Saving account and current accounts are an example of demand deposits and saving deposits are customer deposits money for any non-immediate use.

<sup>102</sup> The NBE, Annual Report of 2014/2015 , P 46

<sup>103</sup> *Ibid*

5%.<sup>104</sup> Generally, the report shows that the financial sector was remained safe, sound and well capitalized profitable. Saving and time deposit went up 33.7 percent and reached birr 356.6 billion in the close of the fiscal year and demand deposit rose to 27.6 percent

The 2017/2018 annual report of the national bank of Ethiopia indicates that Commercial banks opened 500 new branches, which increased the total number of branch to 4757 from 4257 in 2016/2017.<sup>105</sup> Moreover, this increased their deposit mobilization to 23.6%, loan collection 14.9 percent and loan disbursement to 5.9 percent and the report shows that the non-performing loan is within the required ceiling of 5%. Generally, the report shows that the financial sector was remained safe, sound and well capitalized profitable. Saving and time deposit went up 28.8 percent and reached birr 459.5 billion in the close of the fiscal year and demand deposit rose to 36.3, due to the rise of demand in money for transaction purpose.

Generally, the annual reports of the National Bank of Ethiopia shows, domestic actors only dominate the banking sector. As of May 2019 there are 18 banks, 16 private and 2 state banks (Development bank of Ethiopia and the commercial bank of Ethiopia).from 17 commercial banks, commercial bank of Ethiopia still dominated the market over the private banks with almost 60% of the total bank deposits, bank loans and foreign exchange. The whole report from 2014/2015 up to 2017/2018 shows that deposit mobilization of banks are increasing through time and the number of branches increased to 4757. The reports in each fiscal year show that the banking sector is still profitable and sound.

The report of the NBE from 2013/2014 up to 2017/2018 shows that banks are expanding themselves in terms of number in opening dramatic number of branch each fiscal year, I increasing their amount of deposit mobilization in billions per year. And banks are competing highly to make more branches to make themselves accessible and to increase their number of customers. These activities of banks still show sound and profitable business in the country. As per the National bank establishment proclamation No.591/2008, the NBE has given huge power to regulate banks and monitoring and supervisory role. Banks are mandated to report their

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<sup>104</sup> The NBE, Annual Report of 2016/2017 P 45

<sup>105</sup> The NBE, Annual Report of 2017/2018 P 38,39

activity to the supervision department of the national bank.<sup>106</sup>NBE monitor and supervise their activity audit there business, Follow up whether business activity is in a sound business practice or not, which have a great contribution to the soundness of the sector.

### 3.3 THE EXPERIENCE OF SOME COUNTRIES ON DEPOSIT INSURANCE SYSTEM

#### 3.3.1 WHY COUNTRIES ADOPT DEPOSIT INSURANCE

Deposit insurance is widely adopted across the world and different countries make it part of their financial safety net program in the banking sector<sup>107</sup>.Out of 189 countries covered, 112 countries (or 59 percent) had explicit DI by year-end of 2013, having increased from 84 countries (or 44%) in 2003.<sup>108</sup> The 2008 global financial crisis contributed to this trend. Unfortunately, there are still several countries that have yet to set up DIS especially in Africa, for example, only 24% of countries in sub Saharan Africa currently have DI scheme.<sup>109</sup>Specially after the global financial crisis, number of countries which have no deposit insurance arrangement introduced new deposit insurance schemes or countries that already adopted the scheme were extended the scope of coverage and review the design, type(explicit and implicit) and structure of their deposit insurance scheme.

#### **Economic rational of deposit insurance**

Someone can ask that why countries adopt deposit insurance system in the banking sector and the economic rationale for deposit insurance ,Deposit insurance in itself need investments and so when countries adopt the arrangement it is obvious as they incur cost but no one pay for nothing

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<sup>106</sup> The Licensing and Supervision of Banking Business Directive, No. SBB/21/96 Manner of reporting financial information

<sup>107</sup> Denize Anginer, AsliDemirguc-kunt, 'Bank Runs and Moral Hazard A Review of Deposit Insurance' [2018] World Bank Group policy research working paper 8816 P 65

<sup>108</sup> AsliDemirguc-Kunt, Edward Kane,and Luc Laeven, 'Deposit Insurance Database' [2014] IMF working paper 2014,31 <http://www.researchgate.net/> 7 March 2019

<sup>109</sup> Marlon Rolston Rawlins, 'Building Deposit Insurance System in Developing Countries' [2017] P 37

rather than some economic rational. That is deposit insurance have its own economic rational in the banking sector and in the stability of financial sector of a country. One of the important functions of the banking system is to transform short-term deposits in to long-term loans. However when savers face income uncertainty and they strongly want their money for consumption or something for another purpose, they are reluctant to invest in long term illiquid assets.<sup>110</sup>

For instance demand deposits are short term and have seniority over other claims like that of saving and time deposit, and if substantial portion of depositors withdraw their money the same time ,banks' ability to invest in long term as well as to create liquid deposits in transaction will be down.<sup>111</sup> Economic projects however, need long term investment and these projects can result in significant economic losses if they have to be liquidated before being completed. Then banks can pool savings to minimize the amount reserves that need to be set aside to meet the needs of savers when they realize a liquidity or consumption shock.<sup>112</sup>

Generally, the rational why countries adopt deposit insurance system in their banking system is because first, it is to protect depositors against bank loss in a way that it will arrange reimbursement mechanism when banks failed to pay the money deposited by its customers called depositors. secondly, still the issue correlate with the first one that is building the confidence of depositors .The third point is that it create financial stability because failure of a bank may not only affect such bank rather it many become a cause for failure of another bank due to the existence of interbank lending mechanism.Different papers written on the issue shows us some governments established deposit insurance system after their financial sector suffer financial crisis. Moreover, others adopt as precautionary measure before happening of any financial crisis. However a number of countries adopt or expand their deposit arrangement during crises, For instance countries like Thailand, Malaysia and Korea adopt after their recent crises.<sup>113</sup>

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<sup>110</sup> Denize Anginer, AsliDemirguc-kunt, 'Bank Runs and Moral Hazard A Review of Deposit Insurance' [2018] World Bank Group policy research working paper 8816 P 65

<sup>111</sup> Ibid

<sup>112</sup> Ibid

<sup>113</sup> Ibid

There is no uniformity between countries in the world in adopting deposit insurance system. For instance, countries like Mexico, Turkey and Japan promise hundred percent depositor coverage, on the other hand, Chile, Switzerland and UK-cover only an amount of deposits that is actually less than their per capita GDP.<sup>114</sup> Deposit Insurance scheme commonly managed whether by a government agencies or in a public private partnership. With the exception of few countries, that arrangement is totally under private agencies like countries Switzerland, Germany and Argentina.<sup>115</sup> With regard to membership to those agencies, countries also have no uniform form of membership requirement. However, almost all countries make membership compulsory with the exception of Switzerland that later on joined the compulsory membership requirement.<sup>116</sup>

There are core principles for effective deposit insurance system that are jointly issued by the Basel committee on banking supervision (BCBS) and the international Association of Deposit insurers IADI on June 2009 ,<sup>117</sup> Together with the IMF, WB, the European Commission(EC) and the European Forum of Deposit Insurers. Then the financial stability board accepts them. Those principles generally contain 18 principles that categorized in to 10 groups. These are setting objectives(principle 1 to 2), setting mandates and powers(3 to 4), Governance(5), Relationships with other safety net participants cross border issues(6 to 7), Membership and coverage (8 to 10), funding(11), public awareness(12), selected legal issues(13-14), failure resolutions (15 to 16); and reimbursing depositors and recoveries(17 to 18).

Different countries which are member to the FSB expected to consider in the sense of obligation and non-members apply this principle these principles voluntarily only because of their importance.<sup>118</sup> There are many countries in the world with good experience in adopting and managing deposit insurance to protect their depositors and their banking system. However, it is impossible to discuss the whole countries experience and I have chosen four countries two from

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<sup>114</sup> Edward J. Kane and Asli Demirguc-Kunt, 'Deposit Insurance around the Globe: Where Does it Work?' [ 2001] P 48

<sup>115</sup> Ibid

<sup>116</sup> Ibid

<sup>117</sup> FSB, 'Thematic Review on Deposit Insurance System' [2012] P 9,15-19

<sup>118</sup> Ibid

countries with developed financial system with long time experience that is the USA and Switzerland deposit insurance scheme. These countries experienced for long time and they have well developed deposit insurance system.

More over Switzerland's legal system is similar with our sit is civil law country. Moreover, two from African countries with best experience of implementing deposit insurance that can be lesson for newly emerged deposit insurance system. These are Kenya and South Africa. Kenya is one of the fastest growing African countries and its Deposit Insurance Corporation is the winner of the 2016 best deposit insurance corporation. Therefore, it is better to see the experience of a country with best Deposit Insurance Corporation.

### **The USA Deposit Insurance Scheme**

The first country in this regard is the US Deposit insurance system that has established as a formal deposit insurance guarantor with a long experience since 1933. In USA, the implementation of state sponsored insurance of financial system safety net goes back to 1829, the opening of a safety fund for banks which started to operate in New York. However, it failed to provide protection during the panic of the 1837.<sup>119</sup> This safety net program expanded to other eight states, of the eight, all but the Texas guarantee fund left depositors with uninsured losses. The great depression resulted with the failure of thousands of banks that lead to the establishment of the Federal Deposit Insurance Corporation (FDIC) in 1933.<sup>120</sup> The FDIC is a government agency designed to protect consumers and the US financial system.<sup>121</sup> When an insured bank fail or run out of money, the corporation steps in and pays any fund due only on checking and saving accounts, time deposits official payments issued by covered banks like money orders and market accounts.<sup>122</sup> The FDIC generally covers up to \$250,000 per account holder per institution and depending on account entitlement it may be possible to have more than \$250,000 in one institution.<sup>123</sup> We can see from the above points FDIC is government agency,

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<sup>119</sup> Ibid

<sup>120</sup> Ibid

<sup>121</sup> FDIC, 'Division of Research and Statistics, A brief History of Deposit Insurance in the United States [1998] <http://www.iadi.com> 28 April 2019

<sup>122</sup> [https://www.fdic.gov/deposit/deposits/your insured deposits](https://www.fdic.gov/deposit/deposits/your%20insured%20deposits) updated on 2019, 17 March 2019

<sup>123</sup> Ibid

give limited coverage ,it is explicit, membership to insured banks is not compulsory and it is established due to the happening of the great financial crisis of 1930s.

In addition to depositors protection FDIC has the role of overseeing the general activity of banks to promote a safe banking environment that it monitor banks that too make sure that they are working in line with consumer friendly laws.<sup>124</sup>As of 2014, out of 189 countries covered 112 countries or 59% had explicit deposit insurance having increased from 84 countries in 2013. In its effort to build a banking union, the European commission adopted European deposit insurance scheme (EDIS).Since 1994 the European union enact a directive that require all member countries to have a deposit guarantee scheme for at least 90% deposited amount and the extent of coverage increased through time. This more importantly forces 96% of European countries to establish deposit insurance system. In Africa only 24 % of countries adopted explicit deposit insurance.<sup>125</sup>From October 2008, many EU countries increased the amount covered by their deposit insurance schemes due to the then financial crisis.

### **The Swiss Government Deposit insurance scheme**

The Swiss government adopt mandatory rule to Swiss Banks called the Swiss Banking Act in 2005 that stipulate all banks and security dealers must have depositors protected by Depositor protection Associations,<sup>126</sup>Established explicit deposit insurance system for its banking system. The arrangement is privately operated deposit insurance system called deposit protection of Swiss Banks and Securities dealers, which regulated by the Swiss financial Market Supervisory Authority (FINMA).<sup>127</sup> Membership is compulsory and the extent of coverage is up to 100,000 CHF per bank customer,<sup>128</sup>

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<sup>124</sup> Ibid

<sup>125</sup> Asli Demirguc-kunt, 'Deposit Insurance Database' [2014] P 14

<sup>126</sup> <<https://www.bcp-bank.com>> 16 May 2019

<sup>127</sup> Spyridon Repousis, 'Regulatory Frame work and Deposit –Investment Guarantee Fund in Greece and Switzerland' [2015] Vol.23 Journal of financial regulation and compliance 27

<sup>128</sup> Ibid

And member institutions are expected to pay premium based on risk assessments. Swiss Deposit Insurance Scheme covered three banks failed in 1993, 2007 and in 2008, clients of this three banks received the payment up to 30,000 CHF per customer.<sup>129</sup> This dictates us deposit insurance play a great role in protecting depositors in case of bank failure.

### **Kenya Deposit Insurance system**

Few countries across Africa have established explicit deposit insurance protection systems that follow the core principles outlined by the Basel Committee on Banking Supervision.<sup>130</sup> Kenya Deposit Insurance Corporation (KDIC) is Kenya Government Corporation providing deposit insurance to depositors in Kenyan banks and deposit taking microfinance institutions.<sup>131</sup> It was established by the parliament Act in 2012, as part of the central bank of Kenya and however in 2014, it was separated from the central bank.<sup>132</sup> It was established with the aim of protecting depositors against the loss of their insured deposits. Its main characteristics is that First, membership is compulsory,<sup>133</sup> Second, the corporation collect flat rate fee and additional premium adjusted based on risk. Thirdly, the extent of coverage is limited it is not full coverage and KDIC is only mandated up to 100,000.00 Kenyan shilling (Kshs) to each depositor of member institution and fourthly Kenya Adopt explicit deposit insurance scheme.<sup>134</sup> When we see the rationale behind the establishment of Kenya Deposit Insurance Corporation, it is established a happening of financial crisis to protect depositors and to create banking stability before the happening of any loss. KDIC has also the role of administering the deposit insurance system .and, provide incentive for sound risk management in financial institution, promote, and

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<sup>129</sup> Asli Demirguc-Kunt, Edward Kane, Luc Laeven, 'Deposit Insurance Data Base' [2014] the World Bank Development Group Working paper 7211 p 41

<sup>130</sup> Boyed, John H. and Gianni De Nicolo, 'The theory of Bank Risk Taking and Competition Revisited' [2005] Vol.60, issue 3 Journal of Finance 34 and Eugene Bempong Nyantakyi, 'The Banking System in Africa :Main Facts and Challenges' [2015] Vol.6 issue 5 Journal of African Banking System 43

<sup>131</sup> <http://www.Kdic.go.ke> December 2018

<sup>132</sup> Ibid

<sup>133</sup> Ibid and Kenya Deposit Insurance Act Section 24 Chapter 487c

<sup>134</sup> Ibid

contribute to the stability of the Kenyan financial system.<sup>135</sup>As the banking history of Kenya show that the period 1984-1996, twenty-nine banks are closed due to under capitalization and non-performing loans and because of other reasons.<sup>136</sup>Moreover, this happen in the banking sector before Kenya joined the world trade organization in 1995 and the establishment and implementation of deposit Insurance Corporation.<sup>137</sup>However, after the establishment of the Kenya Deposit Insurance Corporation there is no recorded loss in the banking sector.<sup>138</sup>

### **South African Deposit insurance system**

South Africa has relatively strong banking sector, which is well regulated, numerous banks have failed in the last three decades.<sup>139</sup>Moreover, recent failures have again brought the idea of deposit insurance in to picture. Currently there is no explicit arrangement to protect depositors rather in the last time bank failures the government compensated depositors case-by-case and not all are compensated.<sup>140</sup> Government ability and willingness to pay for the cost is diminished, and this create uncertainty about which depositors are to be compensated and which are not and the amount of compensation and the source of the fund.<sup>141</sup> Due to a complicated problem happened in the past bank failure now the government of south Africa want to establish a comprehensive regulatory frame work to protect depositors.<sup>142</sup> The south African Reserve Bank (SARB) and National Treasury are currently reviewing a deposit insurance scheme to bring the country in line with international best practice.<sup>143</sup>Generally, the above points dictate that especially the first three countries established deposit insurance arrangement after experiencing many bank failing

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<sup>135</sup> ShambeM. ‘An Investigation in to the Role of Deposit Insurance in Kenya’s Banking Sector Stability’ [2003] research project in university of Nairobi 74 <http://www.Kdic.go> 4 May 2019

<sup>136</sup> Ibid

<sup>137</sup> AMB Nelson Ndiragu, Presentation on Kenya’s experience at the WTO, [2017]

<sup>138</sup> Ibid

<sup>139</sup> Charles C.Okeahalam, ‘Deposit Insurance Design and Bank Regulation in South Africa’ [2013] Vol.9 Issue 2 Journal of Financial Regulation and Compliance P 53

<sup>140</sup> Ibid

<sup>141</sup> Ibid

<sup>142</sup> South African Reserve Bank, financial stability department, [2017] <http://www.sarb.go> 11 May 2019

<sup>143</sup> Ibid

and then after they adopt Explicit deposit insurance system and they are implementing it to protect their depositors and financial stability of the banking sector. The last country South Africa with the largest economy and relatively developed banking has not adopted explicit deposit Insurance system rather it have implicit one without formal arrangement. Moreover, writings show that with in recent three decades three banks failed and depositors left without reimbursement. This pushes the government to prepare proposal for establishment.

## CHAPTER FOUR

### THE LEGAL FRAMEWORK OF DEPOSIT INSURANCE SYSTEM IN ETHIOPIA

In order to achieve its objective to create healthy financial system the government of Ethiopia through its law making organ and the national bank issued different proclamations, regulations ,directives, manuals and guidelines to regulate and supervise the activity of the banking system. As per the NBE establishment, proclamation the banking sector in Ethiopia is an investment only opened for investor with Ethiopian nationals.<sup>144</sup> That is foreign investors are not allowed to invest in the sector. Even if the banking sector is still undeveloped, there are some progress in developing the sector in terms of number, branches and capital. In the banking sector of Ethiopia as of May, 2019 there are 16 private banks and 2 state owned banks. From these banks, 17 are commercial banks with total branch of 4757 as of 2017/2018. The 2017/2018 NBE report show that Saving and time deposit went up 28.8 percent and reached birr 459.5 billion in the close of the fiscal year and due to the rise of demand in money for transaction purpose demand deposit rose to 36.3percent and deposit liabilities of the banking system increased to 730.3 billion birr in 2017/ 2018.<sup>145</sup>

NBE establishment proclamation (as amended) proc.no.591/2008 Art.2 (3) defines banks as they are companies licensed by the NBE to undertake banking business and banks owned by the government. Then the next question come to our mind is what is banking business activity consists of, to know the banking business activities it is important to see in to the banking business proclamation number 592/2008 Art.2(2). That is banking business consists of receiving funds from the public and using the received funds in whole or in part for loans or investments on their risk in a manner compatible with loan regulating rules by the NBE. As provided under the NBE's Monetary Policy framework of 2009, one of the objectives of the Ethiopian monetary policy is to encourage the mobilization of savings and their efficient allocation for productive

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<sup>144</sup> The Banking Business Proclamation No.592 / 2008 Art.9

<sup>145</sup> [Http:// www.newbusinessethiopia.com](http://www.newbusinessethiopia.com) up dated on April 23,2019 accessed on 28 May ,2019

economic activities. Through deposit mobilization, banks plan to increase their number of customers and amount of money deposited in a bank and Banks play an intermediary role of mobilizing funds from savers and then subsequently lend for investors.

In addition to the policy framework, the NBE has come up with the National Financial inclusion strategy in 2017. This strategy in its statement on the current state of financial inclusion analysis; it states that the existence of a sound financial consumer protection framework is fundamental to increasing access while maintaining trust in the system. According to the analysis made in the strategy the legal framework with regard to financial consumer, protection needs to be improved for fair treatment of consumers and insurance claim settlements. This shows that financial consumer protection laws are inadequate and there should be a legal framework to protect financial consumers. Due to the inadequate legal framework for consumer protection, it is necessary to build a legal framework that provides effective consumer protection regulation and supervision of financial services providers.<sup>146</sup>

The main point here is that the above points show that the NBE set as a policy objective and a strategic plan as well as individual banks does their best effort to mobilize deposits. More over the five-year consecutive annual report of the NBE as stated in the last chapter shows that bank deposits are increasing frequently from one fiscal year to the other fiscal year. On the other hand, this huge money deposited on a bank has to have a system of protection. Because banks use the money deposited for loan and for other investments and we cannot conclude that all investments can be effective and all loans can be performed on Maturity. Therefore, if the bank failed due to non-performing loans, failed investments, and other external or internal factors what will be the fit of those depositors who are the owners of the money they deposited in such a failed bank who have also the right to withdraw their money when they need it?

This chapter will try to assess laws that provide financial safety net mechanism for depositor's protection. As we have seen in the last chapter the experience of different countries, show that different countries adopt financial safety net program called Deposit Insurance system to protect depositors. Deposit insurance system can be established in the form of implicit or explicit. Before we move to assessing the implicit laws on bank depositor's protection, first we have to

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<sup>146</sup> The NBE, Financial Inclusion Strategy of 2017, Strategy No.3

assess the existence of explicit laws to protect depositors through the establishment of deposit insurance in the banking sector of Ethiopia.

## EXPLICIT DEPOSIT INSURANCE SCHEME IN ETHIOPIA

Explicit deposit insurance system is one of the most practiced forms of financial safety net program, which explicitly or expressly establish basic aspects of deposit insurance system. Deposit Insurance system contains laws explicitly governing Such as, coverage limits, how the system to be funded, the way depositors are to be paid in the event of bank failure, types of institution eligible for protection, and whether membership is compulsory or voluntary.<sup>147</sup> When we see the banking system in Ethiopia, the NBE was established by the amendment proclamation No.591/2008 with the objective to foster healthy financial system.<sup>148</sup> The power to regulate and supervise the financial sector in general and the banking sector in particular was given to the NBE.<sup>149</sup>

Under the same proclamation, the NBE has the mandate to establish and manage deposit insurance fund and the council of ministers may issue regulation on the establishment and regulation of deposit insurance fund.<sup>150</sup> However, there is no proclamation, regulation, directive or any circular or guidelines that expressly established deposit insurance fund in the banking system of Ethiopia. The researcher concluded this on the ground that i tried to find and see banking laws enacted by the parliament as well as regulations by the NBE and nowhere they established and regulate deposit insurance fund to protect depositors. In addition to searching such regulations on deposit insurance system, the researcher tried to go to the NBE to ask the existence of any legal document specially those concerned department's bank supervision directorate, risk management directorate, the legal department, the change management and chief executive office as to the existence of any legal document to establish DIF to protect depositors. However, they confirmed as to then on-existence of legal document to establish DIF by the NBE. Generally, from the above data we can conclude that there is no explicitly established deposit insurance fund in Ethiopia to protect bank depositors.

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<sup>147</sup> John Chikura, 'Types of Deposit Insurance' [2013] <http://www.Heinonline.com> 13 October 2018

<sup>148</sup> The NBE establishment Proclamation (as amended) Proc. No.591/ 2008 Art.4

<sup>149</sup> Ibid, Art.5

<sup>150</sup> Ibid, Art.5(18) and Art.25

## IMPLICIT DEPOSITOR'S PROTECTION SCHEME IN ETHIOPIA

As we can see its concept from chapter two of the thesis, this type of deposit insurance system that does not have formal laws or regulation that explicitly state the reimbursement amount and the form of protection.<sup>151</sup> The government offer such protection, not because it is obliged to do so by law, but because it believes that such action will achieve certain public policy goals, because it may feel at least partly responsible for the losses that must be absorb, or because it may consider it to be cheaper in the long run to do so.<sup>152</sup> Before moving to the Ethiopian banking laws with regard to the existence of implicit deposit insurance, the researcher tried to see, what kind of regulations could be considered as implicit depositors protection.

Implicit protection is, by definition, never formally specified. There are no statutory rules regarding the eligibility of financial institution liabilities, the level of protection provided or the form which reimbursement will take, rather it is an expectation that some form of government protection would be provided in the event of a financial institution failure.<sup>153</sup> Therefore, we can say that implicit deposit protection is an indirect depositor's protection provided to depositors by the government through strong regulation of the banking business. The government of Ethiopia through its law-making organ and the NBE has adopted different laws to regulate the banking system. In this banking laws there are some provisions here and there that indirectly indicate this laws are protecting depositors. The following points are some indicators of indirect protection.

**1. Priority rights in asset distribution:**-the principle of depositor's protection is reflected in the provision governing the liquidation of banks. Article 45 of the banking business proclamation regulates in which order claims have to be paid in the time of bank liquidation. Under this Provision depositors are ranked in the fourth position as per sub article 1(d) even prior to government taxes.

**2. Special depositor's right**

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<sup>151</sup> John Chikura, 'Types of Deposit Insurance' [2013] P 17

<sup>152</sup> The World Financial and Policy Center, [2016] working paper 312/2016 <http://www.researchgate.com>

<sup>153</sup> <http://www.iadi.org/en/core-principles-and-research/publications/glossary/implicit-protection>.accessed 26 May 2019.

As per article 29 of the banking business proclamation, in addition to the NBE on sight inspection of banks, one –fifth of the total number of depositors or the holders of 1/3 of the total deposit up on some evidence can ask for examination of the bank affair on its soundness. This is a strong right only given to depositors rather than shareholders and this is another main indicator of depositor’s protection in the center of attention of the legislator.

**3. Legal reserve:-**under Article 19 of the banking business proclamation 592/2008 impose as an obligation to maintain legal reserve not less than 25% from their net profit. The rationale behind the legal reserve is to make reserved money that can be used when banks face financial crisis and if such crisis is manageable they use the money in the reserve account to make the banking activity good and if it to be liquidated it will used to reduce the extent of loss. Therefore, this can reduce further big loss in the sector as well as serve to reimburse depositors money.

**4. Lender of the last resort: -** In case banks encounter financial difficulty or are considered highly risky or near collapse that can endanger the interest of depositors at large, the NBE serve as lender of the last resort. Article 13(2) indicates this kind of arrangement by the NBE.

**5. Appointment of receiver:-**as stipulated under article 2(16) of banking business proclamation no.592/2008 receiver is the NBE or a person appointed by the NBE for the purpose to take control of a bank having problem to restructure or to terminate its existence. This can be taken as one mechanism of depositor’s protection because if a bank is in problem depositor’s money can be endangered. Therefore the receiver may fix the problem or if it is unmanageable risk it hands over the bank and terminate its existence and can mitigate the loss through properly managed termination. This will help depositors to get some money and this can be taken as one indicator for depositor’s protection.

**6. Limitation on loans and Advances:-**With the objective to minimize losses because of failure of single or related counterparty to repay loans the NBE issued directive to regulate the loan distribution of banks to related and non related parties.<sup>154</sup>In addition to this the NBE has the power to prohibit them not to extend any loan or advance to any person. All loans extended to related parties should not exceed 35% of its paid up capital and banks cannot offer any preferential terms for this related parties other than other borrowers. Controlling the mechanism

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<sup>154</sup> Licensing and Supervision of Banking Business Directives SBB/53/2012 Art.5 and 6 Related parties is defined under article 3/3.7.i.e persons that have relation with the bank, whether company or other organization or a shareholder having relation with the bank.

to distribute loan is one of an important mechanism of controlling bank failure and indirectly protecting depositors.

**7. Bank supervision and risk assessments:**-under the NBE establishment proclamation no.591/2008 the power and duty to license, supervise, monitor and regulate banks was given to the NBE. In addition to the above points NBE through its Proc. And directives put requirements such as Liquidity requirements (cash reserve) and capital requirement. The NBE examines the soundness of the banking activity through banking supervision. When I go to conduct interview in the office of the NBE I got the chance to see the so called Banking supervision directorate. This is a highly organized department with the mandate to inspect and supervise the banking activity of banks. The NBE makes off sight inspection through reporting mechanism. It is not only quarterly and annual report it also started day to day, weekly, monthly liquidity and risk assessment reports. In addition off sight inspection the NBE also under take on sight supervision. In addition to this, even the licensing procedure is strict and even the NBE study extra profile of members outside the requirement set in the regulation.<sup>155</sup> This all supervisory and regulatory mechanisms are implemented with the aim of protecting the soundness of the sector that indirectly set to protect depositors.

The aforementioned points shows that the existence of an implicit or indirect protection of depositors. Moreover, it can be taken as a measure by the government to protect bank depositors. However, the next question come to our mind is that, is that these implicit protections are enough to protect depositors in the present situation and in the near future in Ethiopia? In chapter two of the paper, we have seen the natures of DIF. The chapter discussed both the benefits and drawbacks of adopting explicit and implicit DIF. literatures that discussed in this regard shows that in case of implicit DIF reimbursement by the government is discretionary and the government is not obliged to do so by the law.

Generally this kind of arrangement is discretionary to the government and uncertain to depositors, as there is no law that force the government to do so and depositors have no knowledge on the extent of reimbursement and also they do not have knowledge whether they

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<sup>155</sup>Interview with Mr.Gobena Werena, Vice Director, Bank Supervision Directorate, NBE and Mr.Epherem Baraki, Senior Legal Officer , NBE (NBE, Addis Ababa, 20 May,2019 )

are reimbursed or not.<sup>156</sup>In addition to this, these kinds of arrangement fail to respond to the present banking crisis. Practically if we see the experience of South Africa, relatively strong banking sector and like ours, there is central bank called South African reserve bank established in 1921with the mandate to formulate and implement financial policies, which can be said, it is well regulated.<sup>157</sup> However, it still has no explicit deposit insurance arrangement and numerous banks have failed in the last three decades.<sup>158</sup>

Moreover, recent failures have again brought the idea of deposit insurance in to picture. In the last time bank failures, the government of South Africa compensated depositor's case-by-case and not all are compensated.<sup>159</sup> This case-by-case compensation mechanism in South Africa can be taken as a good example of the impact of implicit deposit insurance. In case when there is no explicitly stated right and obligation, it is up on the good will of the government to be reimbursed. This is unquestionable that it strongly affect the interest of depositors specially those un sophisticated and small depositors. In addition to the South African experience, as we have seen in chapter the US experience, the implementation of state sponsored safety fund for banks which failed to provide protection during the panic of the 1837 were established to protect bank users.<sup>160</sup>

Even though this safety net program expanded to other eight states, of the eight, all but the Texas guarantee fund left depositors with uninsured losses.

As discussed in chapter three of this paper, Our neighbor Kenya has experienced similar problem during the period 1984-1996,in which twenty-nine banks are closed due to under capitalization and non-performing loans that left some depositors without reimbursement. The overall experience of this countries and the nature of IDI shows that IDIS is not enough to protect bank depositors. We have seen above some indicators of the existence of implicit

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<sup>156</sup> The World Financial and Policy Center [2016] working paper 312/2016 [http://www. researchgate.com](http://www.researchgate.com)

<sup>157</sup>[www.Africanjournal. com](http://www.Africanjournal.com), on Banking Business, accessed on 1April, 2019

<sup>158</sup> Charles C. Okeahalam, 'Deposit Insurance Design and Bank Regulation in South Africa' [2013] Vol.9 Issue 2 Journal of Financial regulation and compliance 33

<sup>159</sup> Ibid

<sup>160</sup> FSB, 'Thematic Review on Deposit Insurance System' [2012] P 9,15-19

depositor's protection laws in Ethiopia through interpretation. On the other hand, we have seen the nature and features of IDIF and experiences of other countries then we have concluded, as IDIF is not enough to protect depositors. For similar reasons implicit depositors protection is not enough to protect bank depositors in Ethiopia.

Therefore, if implicit protection is not enough to protect bank depositors in Ethiopia, is that not necessary to establish EDIF Should be the next point to be addressed. Literatures discussed in this paper shows as it is important to have EDIF to protect depositors than implicit protection. When we come to the case of Ethiopia as we have discussed before we have concluded that there is no explicit protection rather it is only implicit one, which is not enough to protect depositors of a bank. The 2009 monetary policy and the 2017 financial inclusion strategy of the NBE set strategic plane on deposit mobilization and consumer protection.

Looking in to the annual report of the NBE on banking performance from 2014-2018 the first strategic plan (deposit mobilization) seems successful. Because the reports show that, the extent of deposit is increasing each fiscal year and deposit liabilities of the banking system increased to 730.3 billion birr in 2017/ 2018.<sup>161</sup> However, with regard to the second plan nothing has been done on it. That is with regard to depositor's protection following the monetary policy or the financial inclusion strategy the government or the NBE does not adopt laws to protect depositors. Even though the reports of the NBE on bank performance from 2014-2018 shows that the overall financial sector in the country is sound and profitable, it does not make as to set in silence. Because different literatures and writings discussed before show that Adopting explicit deposit insurance help to ensure pre-planned, orderly and efficient provision of protection rather than an unprepared scrambling for funds, haphazard policy decisions made under pressure and or disorderly and non-transparent compensation arrangement. Moreover, they reason out that if DI adopted before happening of any crisis in the banking sector, it will respond to the crisis or even if the arrangement is weak it can mitigate any excessive loss in the sector. Therefore, when the government or the NBE plan to mobilize deposits it also has to plan the way it protects depositors. Strong control by the NBE is not enough to protect depositors because if we see

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<sup>161</sup> [http:// www.newbusinessethiopia.com](http://www.newbusinessethiopia.com) up dated on April 23,2019 accessed on 28 May,2019

countries experienced bank failure, like Kenya, South Africa, Switzerland and USA they do have central banks to work on the monetary policy of the country and to oversee and supervise the soundness of the banking activity. However, nothing protects them from failure. The main purpose of adopting regulations is not only to regulate the way banks undertake their activity rather it is also necessary to regulate what if their activity causes danger to the interest of depositors. There should be certain and predictable DIS to protect the interest of depositors. Establishing DIS is important not only to respond for the risks during bank failure but also it is important to contribute banking stability.

That is to mean DI corporations or agencies for instance established in Kenya, Switzerland and USA play an important role not only reimbursing depositors during bank failure rather they also play a great role in supervising, monitoring and supporting banks to their soundness before failure.<sup>162</sup> Even after bank failure, they are not there only to reimburse. For instance years 2008 through 2013, 489 FDIC insured banks were failed and FDIC's bank examiners and supervisors made significant efforts, employees with substantial experience and loan review specialists were hired to assist failed banks.<sup>163</sup> Electronic banking has different benefits in facilitating the banking transaction. However, implementing such a system also brings risk of loss to the bank especially in a country that has underdeveloped technology, understanding society, low level of technology penetrations and poorly developed telecommunication infrastructure like Ethiopia even which lacks suitable legal and regulatory framework for e-commerce and e-payment.<sup>164</sup>

These situations have the capacity to make the business activity more sophisticated and complex and increase their vulnerability to risk. In addition to the present situations that make banks vulnerable to risk, in the future things may become more complex in the sector. As we know our country applied to join the WTO in 2003. Since then we are on progress to join the system, this

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<sup>162</sup> Kenya Deposit Insurance Act, Section 24, 2012 and available at <http://www.Kdic.go.ke>, FDIC Division of Research and Statistics, A brief History of Deposit Insurance in the United States (1998)

<sup>163</sup> [https://www.fdic.gov/deposit/deposits/your insured deposits](https://www.fdic.gov/deposit/deposits/your%20insured%20deposits) updated on 2019, accessed on 13 March 2019

<sup>164</sup> Gardachew Worku, 'Electronic Banking in Ethiopia Practices, Opportunities and Challenges' [2016] Vol.3 Journal of internet banking and commerce 9

may force Ethiopia to open its financial sector to foreign investments. The entrance of these foreign banks may endanger the life of domestic banks and they may make them out of market. Unlike ours, foreign banks are strong whether in terms of capital or advanced technology and skilled labor.

In the future, this can make the banking sector more vulnerable to risk and we have to prepare ourselves to the new era of business by building the capacity of our banks and increasing the confidence of depositors through giving genuine protection to them. In addition to WTO, Ethiopia has signed in 21<sup>st</sup> day of March 2018 the biggest trade agreement next to WTO called African Continent Free Trade Area (AfCFTA). The general objective of this agreement is to create a liberalized market for goods and services through successive rounds of negotiations and with a specific objective of progressively liberalize trade in service.<sup>165</sup> Ethiopia has ratified the agreement through its parliament on March 21, 2019.

First of all this is an agreement, that gives right as well as impose obligation to act accordingly. Following its signatory membership, our country has ratified the agreement through its parliament that make the agreement part of the laws of the country. Therefore, our country is expected to make progressive liberalization in the service area that includes the financial sector in general and the banking sector in particular. This is the other indicative for liberalization of the sector in the near future that can even make African countries banks will come to join the sector. This will make the banking system more vulnerable to risk.

When business become broader and subject to international transaction, it is not only need the skill and capacity of management as needed for domestic market. Unless domestic banks give protection to their depositors, it is unquestionable that these depositors may rush to withdraw their money from those uninsured domestic banks to the newcomer-insured banks. Even though the NBE establishment proclamation gives the mandate to establish DIF, still it does not establish such an arrangement. Due to this the researcher want to know the opinion of NBE on its

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<sup>165</sup> African Continent Free Trade Area Agreement of 2018, Article 3 and 4. This agreement was signed by 49 countries of 55 AU member countries.

establishment and if any progress made to establish DIF. According to interview conducted with Mr.Gobena Werena, vice director of bank supervision directorate of NBE and Mr.Sintayehu Desalegn, principal bank examiner of NBE, there is no explicit law that create insurance arrangement to protect bank depositors because the NBE can control each and every activity of unsound banking activity.<sup>166</sup>

They added now a day's things going on different, recently banks are opening many branches, mobilizing a huge amount of deposits, their capacity to distribute loan and their contribution to the GDP is growing fast and the supervision by NBE is not enough to protect depositors and we need to establish DIF to protect bank depositors. Mr.Sintayehu added that especially after the coming of the new Prime Minister Dr.Abey Ahemed, they focus on liberalizing or promote privatization and previously state owned organizations are started to privatized. This will have indirect impact on the banking activity because if liberalizing is not made progressively and managed by law, state owned huge companies may not be profitable as before after they transferred to private business.

Therefore, if such businesses fail banks may not get back the loan distributed and it has adverse effect on the banking activity. He also added that Liberalization in the near future is inevitable and capital increment of banks by the NBE is to build the capacity of banks to overtake strong competition. In addition to Mr.Sintayehu and Mr. Gobena, i conducted interview with Mr. Getu Mola, senior bank examiner of the NBE and he stated that establishing DIS in Ethiopia is important to protect depositors.<sup>167</sup> He added that the NBE controlling mechanism does not give guarantee to depositors and today's profitability cannot be a guarantee for tomorrow sound banking activity. When the number of banks increases the business become more sophisticated and progressive liberalization can expose banks to risk.

Generally, all the above-mentioned interviewed individuals agree on the need to establish DIS in Ethiopia. Moreover I asked them that if they believe as it is necessary to establish now why the

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<sup>166</sup> Interview with Mr. Gobena Werena, vice director, Bank Supervision Directorate, NBE and Mr. Sintayehu Desalegn, Principal Bank Examiner, NBE (NBE, Addis Ababa ,20 May 2019)

<sup>167</sup> Interview with Mr.Getu Mola, Senior Bank Examiner , NBE, (NBE, Addis Ababa,22 May 2019)

NBE keeps silent since 2008 and to tell me if there is a progress to establish DIF. They explained in 2010 IMF and the Bassel committee personnel give training on DIS to some officials and employees of NBE. Then after in 2012 the NBE gives the mandate to make an assessments report on its importance for foreigner from IMF. Moreover, as the assessment report is not a formal research they use it as internal document and specially they have discussed on the document with high officials of NBE, and concerned departments of the NBE.

In addition, they reach on consensus on its importance and establishment. After that in 2014, NBE prepared draft proposal to establish DIS in Ethiopia. Moreover, especially Mr.Sintayehu is one of the members the committee to prepare the draft proposal and after they finish the proposal they have submitted to the then governor of NBE. Then after, there is no progress since 2014 in preparing public and further discussion with commercial banks due to change in governors and lack of giving attention. As Mr. Sintayehu explained the draft proposal contain limited coverage up to 100,000 birr, the agency to be established is government DI agency, membership is compulsory and premium is based on extent of deposit.

As a researcher have tried to access the assessment report and the draft proposal but they are not willing to give and they reason out as the issue as well as the documents are not officials it only serve as internal document. Therefore, we can conclude from this that the NBE believes in the importance and establishment of DIF. However, its silence after 2014 without any progress made to establish DIF shows that still the NBE does not give attention to protect bank depositors in the country. To sum up because of the aforementioned reasons it is important and it is the time to establish DIF in Ethiopia in order to protect bank depositors and financial stability in the country.

## CHAPTER FIVE

### CONCLUSION AND RECCOMENDATION

#### CONCLUSION

The history of banking business in Ethiopia is last for 114 year. Even if compared to the westerns it is still in infant stage, there is a progress towards developing the sector. As of May 2019 there are 18 banks from which 16 are private and 2 government owned. From those 18 banks 17 were commercial banks and one development bank. The sector is growing in terms of both volume and its role of contribution to the country's entire GDP. These 17 commercial banks in 2014 /2015 increased their branch to 2693 up from 2208 in 2013/2014 and in 2019 the total number of branch to 4757. And their deposit liability increased to 730.5 billion in 2018/2019 from birr 216.6 billion in 2014/2015. Deposit mobilization through increasing the number of branches is one of the monetary policy and strategy set by the NBE in 2009 and 2017 of financial inclusion strategy. When we see the number of branches opened in 2014/2015 is increased almost by double in 2017/2018. the amount of deposit mobilized within five year increased by more than double. Bank depositors put their money in bank and they will withdraw their money on terms of deposit.

That is the deposits can be made in the form of demand, time or saving depositors in which such depositors can ask the bank for withdrawal at any time. Deposit and loan operations are one of the main sources of revenue for commercial banks. Banks collect money in the form of deposit from customers then invest deposits to earn revenue. These investments include providing loan to customers and other more complex investments. In order to function well, a bank has to collect their loans and make profit on the investment they make by the money collected in the form of deposit. However this may not be the case at all time, in business activity risk is inevitable. If bank investments lose too much and non-performing loan increase, such banks may become unable to satisfy the demand of customers who want to use their money that they have deposited. When this happen to a bank then we can say that the bank fails.

Banking instability has emerged as a major problem in both developed and developing countries financial sector. Due to the banking system instability different governments in different

jurisdictions are taking strong action in to restore their banking system to health and work in on strengthening on their regulation. And those countries which do not face such banking system instability are alarmed by others instability and continued to take measures through adopting different legal and institutional financial safety net called DIF to protect their depositors and the financial instability. DI is a fund devoted to insuring the depositors of individuals covered by the insuring agency set aside to pay back the money lost due to insured bank failure.

DIF can be in the form of explicit or implicit protection, with full or limited coverage, under government or private arrangement and on compulsory or voluntary membership. Establishing DIF has more advantage than its disadvantage. According to IADI as of January 2014,113 countries instituted EDI and 41 countries are considering the implementation to protect their depositors. From these countries some adopted before and others after crisis and they make explicit protection as implicit protection failure to properly respond of the bank failure.

In Ethiopia there is no EDI arrangement to protect bank depositors as of May, 2019. Even though the NBE establishment Prc.No.591/2008 art.5 (18) gives the mandate to establish DIF to the NBE, still the NBE does not establish such kind of arrangement. Strategies by the NBE also focus on deposit mobilization and Deposit liability of commercial banks increased to 730.5 billion birr as of March,2019.Rather than focusing to collect depositors money and use the deposit to build their asset through high interest loan and investments the government looks like does not care for owners of those deposits.

Because these 730.5 billion birr bank deposits have no insurance and if the banks fail there is no legal framework that expressly responds to such crisis and reimburses depositors money. Even if the findings in this research show the NBE started to study about DIF and some progress on preparing drat proposal to establish DIF in 2014, since then there is no progress on establishment for 5 years. Reading through some provisions under prc.No.591/2008 proc, No.592/2008 and directives by the NBE there are some indications as to the existence of implicit protection. Those indicators are Priority rights in asset distribution, asking for examination of the bank affair on its soundness, Legal reserve, Lender of the last resort, Appointments of receiver, Limitation on loans and Advances, Limitation on loans and Advances and other rules and procedures on bank supervision and risk management undertaken towards making the banking system more sound. However this implicit protection is not enough to protect depositors to get reimbursement during

bank failure. The first reason is that such kinds of regulations are there principally to regulate the overall activity of the sector not to protect depositors against bank failure. Secondly, we take them as implicit protection not they are clear to indicate such protection rather it is through interpretation. Thirdly, this type of DIS does not expressly state the reimbursement amount and the form of protection and it is discretionary to the government no law to force to reimburse depositors money. The experience of other countries dictates the some scenarios that they make the arrangement explicit rather than adopting implicit protection.

Even if the Reports of NBE, shows as the banking system is profitable and sound. This cannot be a guarantee for tomorrow and all countries in the world established explicit protection not as they are failed or become insolvent rather it is to make a pre-planned action to respond if loss occurred. First, in the banking sector of Ethiopia, banks opened 4757 branches and mobilized 730.5 billion deposits which is more than a double within five year and their contribution to the GDP is growing fast.

As managing one branch is not similar with that of more branches and when the number of branches increases more vulnerability to risk will increase. Secondly, the introduction of technology and banks with new products like ATM and Mobil banking. Thirdly, progressive liberalization may become effective as Ethiopia signed AfCFTA and on process to join WTO and it is not only this, the market situation in the world also push to make liberalize the domestic oriented investment system. Fourthly, through competition there may also failure due to failure to resist the competition.

These all points necessitate conducting research on the topic. So Literatures and different writings show that Adopting EDIS help to ensure pre-planned, orderly and efficient provision of protection rather than an unprepared scrambling for funds, haphazard policy decisions made under pressure and or disorderly and non-transparent compensation arrangement. It also responds to the crisis or even if the arrangement is weak it can mitigate any excessive loss in the sector. The above points and literatures show that it is necessary to establish DIF in Ethiopia.

## RECOMMENDATION

Based on the above discussions and findings, which inferred from the research work the researcher gives the following recommendation:-

1. The NBE which has given the power and responsibility to establish deposit insurance fund as per art.5 (18) of NBE establishment proclamation no.591/2008 but it does not established such an arrangement. On the other hand the experience of other countries shows that banks are vulnerable to risk and faced banking crisis in different time. In Order to give protection to bank depositors and to protect financial instability has to establish explicit deposit insurance fund.
2. Such explicit insurance fund has to be clear as to extent of coverage limits, how the system to be funded, the way depositors are to be paid in the event of bank failure, types of institution eligible for protection, whether membership is compulsory or voluntary and the arrangement of the insurance agency.
3. When enacting laws that establish the Deposit insurance agency such law should be formulated in a way to make the agency to work with banks in cooperation as to take proactive measure on risk management before any loss happened to banks. This is important not only to protect depositors but also to keep financial stability in the country.

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