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Regulation of Liquidity Requirements of Banks in Ethiopia: the Law and the Practice

By:
Geleta Assefa Workineh

Advisor:
Tilahun Teshome (Associate professor)

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By:

Geleta Assefa Workineh

Advisor: Tilahun Teshome _____

Examiners:

1. Zekarias Kenea'a _____
2. Seyoum Yohannes _____

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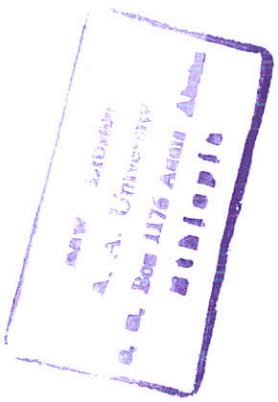

CHAPTER ONE

RESEARCH PROPOSAL

1.1- Introduction

Banking institutions play a significant role in the economic lives of the society. By supplying the basic medium of exchange (cash, checking accounts, and credit cards), they play a key role in the way goods and services are purchased and by accepting deposits from savers and then lending the money to borrowers, they encourage the flow of money from savers to productive use and investments.[1] From this point of view, banks play a paramount role in the overall economic development of a country without which that is very unlikely.

The establishment of the Bank of Abyssinia in 1905 marked the start of modern banking in Ethiopia. Since then until 1943, the banking industry was being principally operated by foreign nationals.[2] In 1943, however, the Bank of Abyssinia was nationalized and renamed the State Bank of Ethiopia and operated both as a commercial bank and central bank until 1963 when it was dissolved to form the central bank; the National Bank of Ethiopia (hereinafter the NBE) and Commercial Bank of Ethiopia.

In the post revolution period, banks operating business in the country were nationalized and consolidated to serve the economic policies of the centralized system guided by socialist ideology and were charged with executing the national economic plan. During this period, the role of the NBE was redefined by law as a developmental organ.[3] With the overthrow of the Derg in 1991, however, Ethiopia began its transition to a market economy and as a result banks operate business in line with this economic policy. Furthermore, the role of the NBE was reformulated accordingly.

Banking business has its own distinctive features in that banks mainly deal with the money of large number of depositors who have hardly any say in the conduct of affairs of

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[1] Vincent P. Polizatto, "Prudential Regulation and Banking Supervision", in Dimitri Vittas (Ed.), Financial Regulation: Changing the Rules of the Game (1992), p.283

[2] Belay Gidey, Money Banking and Insurance in Ethiopia (in Amharic), (1990), p.83

[3] A Proclamation to Provide for the Regulation of the Monetary and Banking System, Negarit Gazeta, Proclamation No 99/1976. Pursuant to Art.6 of the Proclamation, the objective of NBE was to foster balanced and accelerated development of the country.

the companies.[4] Needless to say, deposit of the public constitutes substantial amount of the money under banks' ownership and they can dispose of it in respect of their professional activity. But, they have the obligation to pay what they owe to depositors. They can, however, discharge this obligation if and only if they keep their liquidity intact. The term "liquidity" has special significance in banking business. According to R. S. Sayers, "Liquidity is the word that the banker uses to describe his ability to satisfy demand for cash in exchange for deposit."[5] The banker, therefore, should attach great significance to his obligation to pay his depositors' money on demand or in accordance with the agreement he concluded with the latter, for his inability to do so for any reason whatsoever will lead to disastrous consequences. If a bank fails to honor depositors' claim, the public may lose confidence in it which in turn will create chaos not only on the individual bank but also on the whole financial sector and ultimately on the overall economy of a country.[6] Because of this nature of the banking business, stringent and strict regulatory norms regarding activities of banks in general and of their liquidity in particular need to be set in place.

The ultimate purpose of regulation of liquidity requirements of banks is to protect interest of depositors and thereby promote society's confidence on banking business. This confidence plays a significant role in the monetary stability and the overall economic development of a country. Indeed, the importance of liquidity transcends the individual bank, for a liquidity shortage at a single bank can have system-wide repercussions.[7] For this reason, banks are strictly regulated to ensure that they maintain their liquidity to the level required by law.

In Ethiopia, just like in most other countries, the mission of regulating and supervising the banking business is entrusted to the central bank of the country; the NBE. Created by Order No 30/1963 and reorganized pursuant to the Monetary and Banking Proclamation, the NBE is given the responsibility of regulating and supervising, *inter alia,* banks.[8] Moreover, special rules that govern the banking ventures all the way from their

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[4]P. N. Varshney, Banking Law and Practice (9th Ed., 1982), p.16

[5]Id, p.153

[6]Kenneth Spong, Banking Regulation: Its Purposes, Implementation and Effects (5th Ed., 2000), p.7, available at http://www.kansascityfed.org

[7]Id, p.64

[8]Monetary and Banking Proclamation No 83/1994, Negarit Gazeta (hereinafter Proc. No 83/94), Art.7(4) cum. Art.41

establishment to the services they offer are laid down in a detailed fashion under Licensing and Supervision of Banking Business Proclamation.[9] This shows that stringent rules are set in place to ensure that each and every bank is operating business by keeping its liquidity position as required by law. The research critically analyzes the regulation of liquidity requirements of banks and examines the prevailing practice from a near distance.

1.2- Background of the Study

Just last year at this time, Business Law Department of the LL.M Program of the Law Faculty offered a course entitled "Financial Markets Regulation." The course covered regulation and supervision of banking business, among other things. In the middle of the course, the researcher wanted to know something about "regulation of banks" and went to the library if materials on the subject matter are available. However, the researcher was not able to track even a single material written on the subject and hence was able to understand that there is scarcity of materials on the supervision and regulation of the banking business in general and that of liquidity requirements of banks in particular. It was really a surprise not to get even a single material on the regulation and supervision of liquidity of banks; an area which is really sensitive but not given the attention it deserves. To add insult to injury, there is no material in the archive of the NBE written on the subject matter. Beyond and above this, the researcher witnessed the prevalence of misinterpretation of some of the provisions of Proc. No 83/94 and Proc. No 84/94 and other banking laws among personnel in the NBE regarding regulation of liquidity of banks, which further salivates the researcher to make a study on the law and practice relating to the subject.

1.3- Statement of the Problem

As already stated, the NBE is entrusted with the responsibility of regulating liquidity of banks. It goes without saying that the Bank is expected to fully understand particulars regarding the subject matter as stated in the law to effectively implement the same. The problem in this regard is that the NBE is devoid of the requisite competent and qualified

[9] Licensing Supervisions of Banking Business Proclamation No 84/1994, Negarit Gazeta (hereinafter Proc. No 84/94), Art.36. This Proclamation is expected to be replaced by another proclamation in the near future, for the draft of the new law has already been prepared.

human resource at its disposal to properly discharge its huge responsibilities. Due to this reason, some of the supervisory activities of the NBE are not in line with international banking supervision standards and most importantly with the dictates of the different banking laws applicable in the country.

Moreover, its personnel do not have study material that could provide them with supplementary assistance in solving the hurdles in their regulatory and supervisory role. Therefore, they are so far forced to face their daily task without any assistance from guidelines on how they should handle their tasks.

1.4- Scope of the Study

The government may regulate and supervise the overall activities of banks in general and their liquidity requirements in particular in two different ways; through ownership of banks or through legislations containing rules and regulations that will govern their overall operations. However, this research paper focuses only on the latter type of regulation.

Furthermore, regulation of liquidity requirements of banks aims principally at ensuring that each and every bank that solicits money from the public in the form of deposits has the financial capacity to satisfy at all times claims of depositors. The study does not, therefore, venture on banks such as Development Bank of Ethiopia which normally do not mobilize deposits.

1.5- Research Methodology

The study is conducted by use of a comparative analysis of primary laws on liquidity requirements of banks and directives issued by the NBE concerning the subject matter under consideration, with the data obtained from pertinent personnel in the NBE and other commercial banks through interviews. In some instances, observed data are presented quantitatively while mostly relying on qualitative research methods.

1.6- Sources of Data

Generally, the research hinges on three main sources of data:

The first source of data relates to legal instruments on liquidity requirement of banks currently operational in the country. In this regard, Proc. No 83/94 and Proc. No 84/94 are critically examined. Directives issued on the subject by the NBE at different times are

also thoroughly analyzed. Moreover, books, periodicals and internet sources are consulted to substantiate the study.

The second source of data relates to interpretations of the legal instruments and the directives as interpreted by the NBE during discharging its responsibilities of regulating liquidity requirement of banks. Especially, the different correspondences and reports sent to and from the NBE to other banks on many issues are critically examined.

The third category of source of data is the information obtained from the concerned officials in the NBE and those from other commercial banks. In this regard, interviews and observations are employed as tools for collecting data.

1.7- Objectives of the Study

The study aims at the following objectives:

- to identify the fundamental obligations of banks regarding maintaining their liquidity and liabilities that will follow in case of failure to comply with the law.
- to analyze, among other things, the powers and responsibilities of the NBE in regulating and supervising liquidity requirement of banks.
- to critically examine whether or not laws on liquidity requirement of banks and the prevailing practice are in conformity with each other. This is done with special reference to Proc. No 83/94, Proc. No 84/94 and directives issued at different times by the NBE and application of same.
- to point out areas where there are gaps between the law and the practice and hence to forward possible suggestions and/or recommendations on what measures should be taken with a view to narrow down and to eliminate, if possible, the gap.

1.8- Expected Outcomes of the Research

1- Given the fact that a number of private banks are coming to the banking business due to the economic policy of the country, the interest of depositors could be at stake than ever before if these banks are not to operate in accordance with the dictates of the law and by preserving their liquidity positions intact. Thus, the NBE has to properly discharge its responsibility of regulating liquidity requirement of banks by properly interpreting the law. The study could make

significant contribution in this regard by indicating the proper way of applying the law.

2- Given the scientific nature of the research interms of its methodologies and critical analysis, perhaps the research paper could be employed as a good addition to the scarce resources of materials on the subject matter under consideration.

3- For the research is entirely focusing on the disparity of existing laws on regulation of liquidity *vis-à-vis* the prevailing practice, it could make contributions that cannot be belittled in pointing out area(s) where the NBE has to pay its attention to further its regulatory capacity and thereby properly discharge its responsibilities.

1.9- Discussions Covered in the Research

Rationale behind Regulating Liquidity

Maintenance of liquidity is a cardinal principle of sound banking business. It is crystal clear that the deposits of the public mainly constitute the bulk of banks' funds. The public deposit money in banks believing that they can withdraw same at any time whenever they wish.

Nonetheless, the wish of the public will turn into reality only when banks are financially sound. It, however, they are not financially sound and as a result could not pay back depositors' money whenever the later demand, confidence of depositors on the banking business as a whole will be eroded which will directly affect other banks in the country and finally the overall economy. The government, therefore, interferes with the activities of banks to see to it that they have the financial ability to discharge their obligations towards depositors.

Ways of Maintaining Liquidity

Maintenance of Liquid Assets

Proc. No 84/94 specifies minimum liquid assets to be maintained by banks. Art.16(1)(a) of the Proclamation provides that the NBE may direct every bank of a specified class or classes to maintain liquid assets amounting to not less than a prescribed percentage of the total or specified categories of its deposit and similar liabilities to the public. However, the percentage so prescribed may not exceed thirty five percent of such deposits and similar liabilities. Art.16(2) of the Proclamation prescribes what is meant by liquid assets.

In addition to those that are enumerated as liquid assets under this provision, the NBE issued a directive[10] and specified total and specific requirements that banks are required to maintain with the view to preserve their liquidity.

Reserve Balance

In addition to the obligation of banks to maintain liquid assets as discussed above, Atr.16(5) of Proc. No 84/94 requires them to maintain with the NBE a reserve balance as a percentage of their deposit liabilities as may, from time to time, be determined by the latter. The NBE has issued a directive[11] and determined the percentages of current account deposits, savings deposits and time deposits which every bank is required to maintain with the former.

Legal Reserve Account

With the view to regulate and supervise liquidity requirements of banks, Proc. No 84/94 obliges every banking company operating in Ethiopia to maintain legal reserve account. Accordingly, Art.12(1)(a) provides that, banks should, before declaring dividends, deduct from the annual net profit after tax and credit same to the legal reserve account. Art.12(2)(b) of the same Proclamation also entrusts the NBE with the power to prescribe, by a directive, the method of computing the amount and the form of the legal reserve account.[12]

Limiting Bank Lending and Bank Investment

Banks, especially commercial ones are established principally to make profit. One means of achieving this end is by lending and investing the money they collect from the public. Nonetheless, lending and investment by banks which require money to be spent have the potential of eroding the latter's liquidity. This shows the existence of potential conflict between bank lending and bank investment on the one hand and liquidity on the other hand. Due to this reason, limitations need to be imposed against bank lending and bank

[10] Licensing and Supervision of Banking Business, Liquidity Requirement (3rd Replacement), Directive No SBB/44/2008

[11] Licensing and Supervision of Banking Business, Reserve Requirement (4th Replacement), Directive No SBB/45/2008

[12] Accordingly, the NBE has issued a directive to that end. See Licensing and Supervision of Banking Business, Directive No SBB/4/1995

investment. In line with this, the NBE has issued directives[13] and set limitations on the kind, quality and quantity of loans and investments which banks could make.

Regulatory Modalities

One of the most important indications as to whether or not a system allows for the prudent regulation of liquidity of banks is the kind and form of regulatory modalities set in place. In this regard, Proc. No 84/94 and directives issued by the NBE specify different forms of regulatory modalities which the NBE may employ as tools in regulating liquidity of banks. These regulatory modalities include on-site examination of individual banks and off-site surveillances. Furthermore, banks are required to keep financial records and periodically report information to the NBE. The NBE, therefore, could employ these tools for knowing whether or not banks do comply with the laws.

Consequences of Failure to Maintain Liquidity

The attainment of the objectives discussed hereinbefore lie behind the implementation of the prevailing laws, rules and regulations, and sanctions follow in the event of non compliance. In line with this, Proc. No 83/94, Proc. No 84/94 and the different directives issued by the NBE provide sanctions in case banks go against any of the provisions of banking laws in general and those relating to liquidity requirements in particular. Generally, failure of banks to comply with liquidity requirements as determined by the different banking laws is an offence. The laws and directives specify both penal and/or civil liabilities on those banks which fail to maintain their liquidity requirements or perform acts that have the potential of eroding their liquidity. Moreover, personal liabilities are prescribed against officials of banks who are responsible to manage the affairs of the latter.

[13]Licensing and Supervision of Banking Business, directives on Single Borrower Loan Limit (Directive No SBB/29/2002), Limitation on Loans to Related Parties (Directive No SBB/30/2002), Amendment of Provisions (Directive No SBB/32/2002), Limitation on Investment of Banks (Directive No SBB/12/1996)

CHAPTER TWO

BANKS AND THE REASONS BEHIND THEIR REGULATION

2.1- Banks

2.1.1- Definition

A somewhat simple approach of defining the term "bank" would be to forward a dictionary meaning. Accordingly, Black's Law Dictionary defines the term bank as "... an institution, usually incorporated, whose business is to receive money on deposit, cash checks or drafts, discount commercial paper, make loans, and issue promissory notes payable to bearer, known as bank note."[1] This definition forms an essential attribute of the operation of a bank by enumerating the various activities performed by banks. But, the definition cannot be claimed to be exclusive for there are activities now being performed by banks but not included in the definition.

Other authorities define the term "bank" as an institution authorized to receive deposits of money, to lend money and issue promissory notes or to perform one or more of these functions.[2] Again this definition, somewhat similar with the first one, tries to elaborate what a bank is by enumerating its essential functions, stressing the point that a bank can perform one or more of these functions.

When we come to Proc. No 84/94, the term "bank" is defined in two steps. According to Art.2(1), a bank is a company[3] licensed under the Proclamation to undertake banking business. Art.2(3) of the Proclamation intern defines the term "banking business" by stating in a general manner the essential functions undertaken by a bank.

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[1] H.C. Black, Black's Law Dictionary (6th Ed., 1990)

[2] George S. Gulick, Robert J. Kimbrough (Eds.), American Jurisprudence (2nd Ed., Vol.10, 1963), p.25

[3] A company in turn is defined under Art.1(4) of Proc. No 84/94 as a share company defined under Art.304 of the Commercial Code of the Empire of Ethiopia of 1960, Proclamation No 165/1960, Negarit Gazeta(hereinafter the Comm. C) whose capital is wholly owned by Ethiopians and/ or organizations wholly owned by Ethiopians and registered under the laws and having its head office in Ethiopia. Pursuant to Art.304(1) of the Comm. C, a share company is a company whose capital is fixed in advance and divided into shares and whose liabilities are limited to its assets.

The definition goes:

> *Banking business shall mean any business that consists of the following elements:*
>
> *a. receiving funds from the public through the manner:*
>
> *1. accepting deposits of money payable upon demand or in a fixed period or by notice, or any similar operation involving the sale or placement of shares, certificates, notes, or other securities;*
>
> *2. any other means that the National Bank of Ethiopia has, by published notice, declared to be an authorized manner of receiving funds for the purpose of carrying on banking business;*
>
> *b. using the funds referred to under sub- article 2(a) above, in whole or in part, for the account and at the risk of the person undertaking the banking business*
>
> *1. for loans or investments, or*
>
> *2. for purposes that the National Bank of Ethiopia has, by published notice, declared to be appropriate.*
>
> *c. the buying and selling of gold and silver bullion and foreign exchange.*

From this definition, one may take note of the following salient features:

i. Accepting deposits from the public is one of the essential functions of a bank. It will then utilize this deposited money in investments or extend it in the form of loans or use it for purposes that the National Bank of Ethiopia declares to be appropriate. A bank should invest all or part of the deposited money or give it in the form of loans to those who require it. If, however, the purpose of accepting deposits is not to lend or invest, the business will not be called banking business.[4] To qualify as a banking business, therefore, the purpose of receiving deposits should be to invest or loan the same.

ii. Time and mode of withdrawal of the deposits is important. The deposited money should be repayable to the depositor on demand made by the latter or

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[4] P. N. Varshney, Banking Law and Practice (9th Ed., 1982), p.15

in accordance with the agreement reached between the depositor and the bank or by notice. The depositor may withdraw the deposited money at any time he wants or after giving notice to the bank or at the expiry of the time specified in the agreement reached between the depositor and the bank.

iii. In addition to accepting deposits and investing or loaning same, a bank may also involve in activities such as the sale or placement of share certificates, notes, or other securities and the buying and selling of gold and silver bullion and foreign exchange.

However, it should be born in mind that Art.2(2) of Proc. No 84/94 which enumerates banking businesses has left out some activities which are recognized as banking businesses under the Comm. C.[5] To put it differently, Proc. No 84/94 has left out some banking businesses which are said to be so under the Comm. C. This may create confusion because as Proc. No 84/94 is a recent law, one may be tempted to conclude that it overrides the Comm. C and hence those activities recognized by the Comm. C as banking transactions are no more applicable. Nonetheless, this is not the intention behind the legislature, for Proc. No 84/94 is more of a regulatory law and does not change the rule that banking institutions undertake those banking transactions embodied in the Comm. C.

2.1.2- Requisites to Engage in Banking Business

For banks are share companies, that part of the Comm. C on business organizations in general and that of share companies in particular apply to them. Nonetheless, banks are different from other ordinary share companies in many respects. Thus, there are requirements other than those specified in the Comm. C which a person who intends to undertake banking business has to comply with.

2.1.2.1- Form of Business Organization

According to Art.3(1)(a) cum 2(4) of Proc. No 84/94, a person, in order to undertake banking business in Ethiopia, should be organized in the form of a share company. Despite this, banking business, strictly speaking, is not open to every share company. In

[5]The Comm. C has recognized deposit of securities (Arts.912-918), hiring of safes (Arts.919-924), contracts for current accounts (Arts.925-937), discount (Arts.941-944) as transactions that may be undertaken by banks, but are altogether left out from the ambit of "banking business" as defined under Art.2(2) of Proc. No 84/94.

addition to being a share company, Art.2(4) of Proc. No 84/94 requires the capital of the share company to be wholly owned by Ethiopian nationals and/or organizations wholly owned by Ethiopian nationals and registered under the laws of the land. Moreover, the same provision goes further and specifies that the head office of the company should be situated in Ethiopia.

This, together with Art.4(2) of Proc. No 84/94, make it clear that foreign nationals are prohibited from engaging in banking business in Ethiopia. Thus, it could be argued, is a studious effort on the part of the legislature to totally close the door against foreigners.

The position taken by the legislature, no doubt, cannot be without justification. Had banking business been open for foreigners, domestic banks' interests could have been highly jeopardized and far from this, no domestic bank could have survived to date.[6] Amen to that given the strong financial muscle of foreigners and their experience in banking business which cannot in any way be compared to that of domestic ones. Thus, it is an obvious strategy adopted by the legislature to further the financial stability of the existing domestic banks.

2.1.2.2- Capital Requirements

According to the Comm. C, the minimum capital required to establish a share company is Birr 50,000.[7] Moreover, Art.312(1)(a) and (b) specifies that the total amount of capital of the company must be fully subscribed and at least one quarter of the par value of the shares be deposited in a bank, in the name and to the account of the company. However, as opposed to other ordinary share companies, banks need to be adequately capitalized given their unique nature that will be discussed in the forthcoming sections.

If we take a look at Art.13(1) of Proc. No 84/94, the NBE has reserved the power to determine by a directive the minimum capital required to establish a bank. Accordingly, the NBE has issued a directive and set the minimum capital which a bank has to raise in order to acquire license.[8] According to Art.1.1 of the Directive, a bank should raise a minimum paid up capital of Birr seventy five million which shall be fully paid up in cash

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[6]Solomon Welde, "Profile of the Private Sector in Ethiopia" in Getachew Yoseph, Abdulhamid Bedri Kello(Eds.), The Ethiopian Economy: Problems and Prospects of Private Sector Development, Proceeding of the Tenth Annual Conference on the Ethiopian Economy (1994), p.21

[7]Comm. C, Art.306(1)

[8]See Licensing and Supervisions of Banking Business, Minimum Paid up Capital to be Maintained by Banks, Directive No SBB/24/1999

and deposited in a bank in the name and to the account of the bank under formation. Moreover, as opposed to other ordinary share companies, the total par value of the shares of a bank must be paid up and deposited in a bank as stated under Art.3(1)(C) of Proc. No 84/94.

When compared to the capital required to establish other ordinary share companies, the capital required to establish a bank is much higher; a clear stand that a bank should be adequately capitalized. This emanates from the very nature of banking business. It has been held that, "Lacking adequate capital, the banks' potential for failure is greatly enhanced."[9] Due to this reason, a bank is required under Directive No 24/99 to raise huge amount of capital.

2.1.2.3- Qualifications of Directors and Executive Officers

As will be discussed in the forthcoming sections, not only share holders of a bank, but also depositors and the public at large do have a direct interest in the well-being of banks. In order to preserve their well-being, principally, banks have to be well staffed by those who have the required professional calibre. Specifically and most importantly, banking laws of countries preach that banks should be directed and managed by persons who command respect for their honesty and integrity and professional excellence. For instance, the Banking Act of England requires that every person who is a director or manager of a bank be a fit and proper person to the particular position that he holds.[10] To determine whether or not a particular individual satisfies the 'fit and proper person' test, the Act provides that regard is to be had to his probity, competence and soundness of judgment for fulfilling the responsibilities of that position, to the diligence with which he is fulfilling or is likely to fulfill those responsibilities and to whether the interests of depositors or potential depositors are, or are likely to be, in any way threatened by his holding that position.[11]

A similar approach is employed under Ethiopian banking laws. Proc. No 84/94 specifies qualifications which directors and executive officers of a bank are required to possess.

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[9]Vincent P. Polizatto, "Prudential Regulation and Banking Supervision", in Dimitri Vittas (Ed.), Financial Regulation: Changing the Rules of the Game (1992), p.289.

[10]Banking Act of England of 1987, Schedule 3, Para.1(1)

[11]Id., Para.1(2)

Art.3(1)(e) of the Proclamation provides that directors[12] and principal officers[13] of a bank under formation should have the qualifications prescribed by the NBE. In order to undertake a banking business in Ethiopia, therefore, a bank under formation should satisfy the NBE that directors and principal officers possess the requisite qualifications prescribed by the latter.

The NBE, to discharge its responsibilities in this regard, has issued a directive setting the standards of qualifications expected of "directors" and "principal officers" of a bank.[14] Accordingly, Directive No 39/06 under Art.4.1 states that chief executive officer of a bank should, with due regard to the interests of all stakeholders, have the competence and the ability to understand the technical requirements of banking business, inherent risks and management processes required to conduct banking operations effectively. He/she should hold a minimum of first degree or equivalent from a recognized higher institution of learning and be a person with high honesty, integrity, reputation and diligence.[15] Moreover, pursuant to Art.4.4, he/she is required to have a minimum of ten years experience in banking, of which minimum five years shall be in senior managerial position. Arts.4.7 and 4.8 of the Directive also specify that a chief executive officer should be at least 30 years of age and preferably be married or responsible to a family. However, even if a person fulfills all these requirements and is appointed to the post, the appointment (be it for new or existing bank) should be approved by the NBE, as clearly specified under Art.4.9 of the Directive.

Regarding directors, Directive No 39/06 employs similar parameters. If we see Art.5.1.3(i), it specifies that a director should be a person with honesty, integrity, diligence and reputation to the satisfaction of the NBE. As to qualifications, the Directive says that, "At least seventy five percent of a bank's board members shall hold a minimum of first degree or equivalent from recognized higher learning institution; and the

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[12]According to Art.2(5) of Proc. No 84/94, "'Director' shall mean any person, by whatever title he may be referred to, carrying out or empowered to carry out substantially the same functions in relation to the direction of a bank as those carried out by a director of a share company under the Commercial Code of Ethiopia of 1960".

[13]Art.2(8) of Proc. No 84/94 defines "principal officer" as a manager or other person with whatever title, who is chiefly responsible for the management of the affairs of a bank.

[14]Licensing and Supervision of Banking Business, Amendment for New Bank Licensing and Approval of Directors and CEO, Directives No. SBB/39/2006 (hereinafter Directive No 39/06)

[15]Directive No 39/06, Arts.4.3 and 4.5

remaining board members should, at a minimum, complete general secondary school or its equivalent."[16] In addition to this, the cumulative reading of Arts.5.1.2 and 5.2 of the Directive provides that a director should have adequate experience in business management, preferably in banking business, and/or should take adequate training in banking business management after holding a seat on the board and be a minimum of 30 years of age. Most importantly, a newly appointed director of a new or existing bank should get a blessing of the NBE before assuming office as per Art.5.3.1 of the Directive. As can be seen, the Directive intends to diversify the pool of bank officials and management to ensure that more people acquire banking experience with an eye on continuity. In addition, it is intended to make sure that banks operating business in the country are run by well educated individuals with management experience in order to protect interest of stakeholders especially of depositors. These requirements, in one way or another, are linked with the requirement that the business of banks be conducted in a prudent manner.

This be as it may, Directive No 39/06 specifies prohibitions against directors' possibility of acting in double capacity in a bank and in the same capacity in other financial institutions. It is provided that chairperson of board of directors of a bank may not be chief executive officer of the same bank.[17] Furthermore, Pursuant to Sub (i) of the same provision, director of a bank may not at the same time serve as director in any other financial institution. Obviously, the position taken by the Directive is to avoid the conflict of interest that may occur when a person serves in the board of directors of a bank and other financial institutions simultaneously and in two different capacities of a bank at the same time.

2.1.2.4- License

As a person should hold a license to engage in any business activity, one who wishes to undertake banking business in Ethiopia should secure license from the NBE.[18] Licensing is one means through which the NBE ascertains the fulfillment of the requirements provided by law.

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[16]Directive No 39/06, Art.5.1.1
[17]Directive No 39/06, Art.5.1.4(ii)
[18]Proc. No 84/94, Art.3(1)(d)

No person is allowed to engage in banking business without first obtaining a license. The NBE conducts inspection of the books and issue license if it is satisfied that the person intending to engage in banking business has duly complied with the law concerning application or eligibility for a license [19]

Once the NBE proves that a person has fulfilled all the requirements provided by law, the latter may be issued with a license. The license constitutes final authorization to undertake banking business in Ethiopia. It is clear from this that grant of license depends on the maintenance of satisfactory position by a bank under formation. This is to ensure the continuance and growth only of banks which are established or are operating on sound lines and to discourage those that could not stand firm.[20]

Nonetheless, the fact that a bank is issued with a license does not mean that it will then after be entirely left free to operate business in a way it likes. Rather, its continuing activities will once again be under the strict control of the NBE.

2.2- Relation between Bank and Depositor

As discussed in the previous sections, a bank is an institution undertaking banking business. One of these banking businesses is mobilizing money from depositors[21] for the purpose of lending and/or investing and earning profits from such operations.

The relationship between a bank and a proposed depositor begins with the opening of an account by the former in the name of the latter. This relationship arises out of contract which may be express or implied. Relating to this, it is said:

> *... to create the relation of banker and depositor there must be some contract relation between the proposed depositor and the bank. In the usual case the contract entered into between a depositor and the bank is one that is implied; the depositor delivers to the bank money, funds, or credits constituting the deposit, in return for which the bank assumes the*

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[19] Proc. No 84/94, Art.4(1). The NBE, however, can prescribe additional requirements by a directive which a "bank" should satisfy in order to get license.

[20] Supra note 9

[21] The term "depositor" may be generally defined as one who delivers to, or leaves with, a bank money subject to his order. See William Mack, Donald J. Kiser (Eds.), Corpus Juris Secundum (Vol.9, 1938), p. 544

obligation to pay out on his demand or order a sum equal to the amount deposited...[22]

The relationship being contractual, it is regulated by the general rules of contracts.[23] Speaking generally, the relationship between a bank and a depositor is that of debtor-creditor. Of course, the intention of the parties controls the character of the relation which may be that of bailee and bailor, but it is ordinarily that of debtor and creditor.[24] On the opening of an account, the bank assumes the position of a debtor and the depositor that of a creditor.

Deposits in the Comm. C generally refer to deposit of funds, bank transfers or deposit of securities. Pursuant to Art.896 of the Comm. C, 'deposit of funds' is a contract whereby a bank accepts funds from a depositor with the intention of owning and disposing as its own subject to repayment. Bank transfers[25] and deposit of securities[26] involve other forms of relations. In any ways, once a depositor deposits fund in a bank, ownership right over the funds passes over to the depository bank and thus the latter has the right to dispose of the funds in whatever manner it deems appropriate.[27] However, the owner has the right to demand repayment of the funds although ownership over the funds passes to the bank. Correspondingly, the bank is under an obligation to repay the funds as and when it is required to do so.[28] The depositor, therefore, remains a creditor of his bank so long as his account carries a credit balance.

Broadly speaking, deposit accounts are divided into time deposits, demand deposits (current accounts) and savings accounts. Art.898(1) and (2) of the Comm. C provides that the holder of a deposit account may dispose of the whole or part of the balance at any time or after notice or the expiry of a fixed period. Art.2(2)(a)(1) of Proc. No 84/94, on

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[22]Supra note 2, p.300

[23]Civil Code of the Empire of Ethiopia of 1960, Proc. No. 166/1960, Arts.1675 ff. Pursuant to Art.1675, "A contract is an agreement whereby two or more persons as between themselves create, vary or extinguish obligations of a proprietary nature."

[24]Supra note 21, p.546

[25]Comm. C, Art.903(1). It reads, "A bank transfer is a transaction by which a bank debits the account of a depositor, up on his written instructions, and credits by its entry another account with the same amount."

[26]Comm. C, Art.912 cum Art.913 (1). Deposit of securities requires a bank to ensure the custody of the securities and exercise the rights relating thereto exclusively on behalf of a depositor and act with due care required of a public bailee. For bailee- bailor relationship, see supra note 23, Art.2779.

[27]However, as clearly specified in the second paragraph of Art.896 of Comm. C, the bank may not acquire title or right to dispose of coins or other monetary tokens if there is express agreement that they should be refunded as delivered.

[28]Supra note 4, p.62

its part, recognizes three forms of deposits; demand deposits, time deposits and deposits to be withdrawn at notice.

Time deposits refer to those deposits that can be withdrawn on the expiry of the time specified in the contract concluded between the depositor and the bank. Thus, time deposits are deposits which are subject to notice.[29] The funds are kept for a long period of time and are not subject to regular withdrawal. The deposits are repayable only on the expiry of the specified time fixed in the contract. It follows from this that the depositor withdraws his money after giving notice to the bank.

Demand deposits, as the name indicates, are deposits payable on demand. They are deposits the payment of which may be legally required within a specified number of days.[30] The depositor, therefore, has the option to withdraw his money any time of his own choice and correspondingly, the bank has the obligation to effect payment when demanded.

Deposits to be withdrawn at notice, on the other hand, are those deposits which normally do not have specific maturity date although it could otherwise be specified in the contract concluded between the depositor and the bank.

It should be stressed at this juncture that the distinction between time deposits and deposits withdrawn by notice is some what blurred, for in both cases, an agreement is reached between the banker and the depositor to the effect that the latter will withdraw his deposited money not as he demanded but after the expiry of the time specified in the contract. In both cases, a depositor is required to give notice to a bank before he withdraws his money.

2.3- Reasons behind Regulating Banks

Banking business is subject to high degree of governmental regulation or control in all countries of the world. It is said that banks are indispensable institutions universally recognized as a proper subject of legislative regulation under the police power of the state.[31] Due to their nature, therefore, rigid regulatory laws are laid down with the objective of supervising their activities and operations. Here, it is appropriate to put the query, what are the reasons behind regulating banks?

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[29]Supra note 1
[30]Supra note 2, p.318
[31]Id., pp.35-36

2.3.1- Depositor Protection

Banking business has unique features which distinguish it form other business sectors. Its unique features, as already noted, lie in that banks mobilize huge amount of money from the public in the form of deposits. It is agreed that, "The receipt and payment of deposits constitute a fundamental function of the banking business."[32] People deposit money in banks believing that they could get it back when the need arises.

A bank has the obligation to pay what it owes to depositors. However, it can pay them if and only if the bank is financially sound or if it has enough money at its disposal. Thus, the government interferes with the activities of banks to see to it that they have the financial ability to discharge their obligations towards depositors. One of the objectives behind regulating banks, therefore, is to ensure that their affairs are not being conducted in a manner detrimental to the interests of the depositors.[33] The interest of depositors will be preserved only when the safety of banks is ensured. Regarding this, it has been stated that, "All banking laws are intended to promote the safety of the banks, and such objective cannot be achieved unless the safety of the depositors is the paramount consideration."[34] This clearly shows that protecting the interest of depositors is the major objective behind regulating the banking business.

With this principal objective in mind, many countries lay down rigid requirements which banks should comply with in order to maintain their financial soundness and thus preserve depositors' interest. Thus, the regulatory body is usually keen to ensure capital adequacy, supervise loan quality, set limitations on possible areas of operations, conduct periodic examination of their operations, monitor ownership and management changes and employ such other regulatory modalities.[35]

2.3.2- Creation of Efficient and Competitive Financial System

Another important objective behind regulating banks has something to do with creation of an efficient and competitive financial system. Generally, this objective can be achieved if the competition between and among banks operating in a country is prudently

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[32]Id., p.298

[33]Supra note 9, p.44

[34]Schramm V. Bank of California, quoted in Supra note 21, p.34

[35]For instance, Proc. No 84/94 embodies a number of provisions with the view to enable the NBE to undertake supervisions and control in these areas. The law requires banks to comply with requirements starting from raising adequate capital during formation to maintaining reserve balance with the view to ensure their liquidity and financial soundness.

monitored. Of course, banks like other economic sectors do have the freedom to compete. Nonetheless, the competition is not left alone; rather it is a strictly regulated one.

It is stressed that the financial stability of a country may greatly be explained by referring to the financial system in use.[36] The financial system intern depends on how efficiently banks are functioning. If banks are to function efficiently, there should be competition between them.

Competition among banks has great importance in fostering economic efficiency and consumer welfare. Especially, they play a great role by preserving an unrestrained interaction of competitive forces that will result in numerous benefits for consumers. One writer, observing this, said that competition primarily aims at protecting consumers and bringing about economic efficiency and by encouraging alocative and dynamic efficiency through lowered production costs, technological change and innovation.[37] If, on the contrary, there is no competition, individual banks might attempt to gain higher prices for their services by restricting output or colliding with other banks which is a bad news for consumers.[38] This is because the occurrence of these facts will not urge banks to be innovative and design improved ways of service delivery. Therefore, in order to bring about these numerous benefits, it is a must that the competition runs smoothly.

However, it has to be underlined that competition in the banking sector, though essential in many respects, is undesirable if it becomes unhealthy. One of the main objectives of banking regulation, therefore, is to make sure that this competition is going smoothly. The regulatory agency should create a conducive environment for competition and at the same time avoid practices that stand against it. This can be done through maintaining the required service quality of banks, ensuring that competitive standards are in place, controlling concentration of resources that lead to monopolization of the banking industry and providing rooms for adaptation to changing economic conditions. The following explains it:

> *Competition and efficiency depend on the number of banks operating in a market, the freedom of other banks to enter and*

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[36]Supra note 9

[37]The World Bank Organization for Economic Co-operation and Development (OECD), "A Framework for the Design and Implementation of Competition Law and Policy", (1999), p.3

[38]Kenneth Spong, Banking Regulation: Its Purposes, Implementation and Effects (5th Ed., 2000), p.9, available at http://www.kansascityfed.org

compete, and the availability of banks to achieve an appropriate size for serving their customers.[39]

The point, therefore, is on establishing a system that is conducive for the promotion of competitive environment by regulating anticompetitive practices.[40] But, it should be born in mind that efficient and competitive banking system is a function of many factors. Thus, it requires sorting out factors that could hinder competition and those that contribute to it positively. The regulatory body, therefore, should take these factors into its diary and act accordingly.

Nevertheless, the regulatory body should be armed with Solomonic wisdom and take care not to excessively intervene with banks' affairs, for this could have its own repercussions. Because, unlimited interference with activities of banks will have a negative consequence on operation of banks especially on their ability to serve their customers' financial needs.[41] Thus, intervention with activities of banks to preserve competition and thus their efficiency should be a calculated one.

2.3.3- Monetary and Financial Stability

As has been said earlier, banks hold a unique position in all countries of the world. Given this fact, their weakness as well as strength has a direct impact on the overall monetary and financial stability of a country. For monetary and financial stability to prevail, therefore, regulating the banking sector is not a choice, but a must.

It is held that one fundamental public purpose of governmental regulation of the financial system is the maintenance of system stability.[42] In so far as banks are one of the financial institutions, regulating and supervising their operations will lead to that end.

Of course, monetary and financial stability is the direct reflection of many factors, one of which is confidence of depositors towards the banking sector. As one writer pointed out, the objective of monetary stability in banking regulation has been closely linked with the goal of depositor protection.[43] Obviously, depositors enjoy this protection as long as the bank which they left their money in is financially sound. If depositors' interest is

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[39]Ibid

[40]The Trade Practice Proclamation, for instance is designed to this end. Trade Practice Proclamation No 329/2003, Federal Negarit Gazeta, see the preamble and Art.3(1)

[41]Supra note 38, pp.9-10

[42]Art.6 of Proc. No 83/94 prescribes domestic monetary stability among the primary objectives which the NBE shall endeavor to attain.

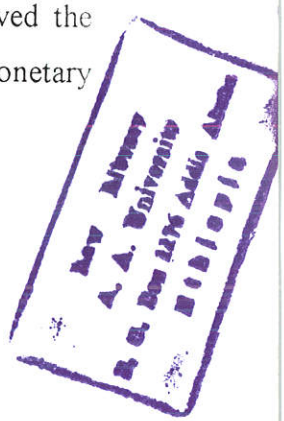
[43]Supra note 38, p.8

protected, the confidence of the public towards banks in general will undoubtedly be high, for they know that the latter will perform the required service as promised. If the confidence of the society towards banks is high, the monetary and financial stability of the country will be in the right track.

As it is known, banks act as intermediaries between savors and borrowers in our society. They accept money in the form of deposits from the general public and extend it in the form of loans to those who need money to meet their short and long term financial needs. In this regard, a vast volume of transactions take place between banks and the public at large. For this transaction to continue smoothly, it is of a paramount importance that the leading actors - the public, should be guaranteed that nothing bad would happen that could affect their interests. This guarantee will have a positive role in maintaining the public confidence towards banks unimpaired, which in turn will further the monetary and financial stability.

If, however, the banking sector is disturbed, confidence of the public will highly be eroded. Such disruption would further hinder financial transactions and the flow of credit that will ultimately result in overall economic shrink.[44] One writer has observed the system wide repercussions that banks' failure will bring about to the overall monetary and financial stability as follows:

> *The failure of a large bank or multiple bank failures may cause a sudden contraction of the money supply, a failure of the payment system, a severe disalocation of the real economy, and real or implicit obligations on the part of the government. The failure of any bank, no matter how small, may lead to contagion and loss of confidence in the system...*[45]



In order to preserve the confidence of the public towards banks and thus maintain the monetary and financial stability, therefore, the banking sector should be supervised and regulated from a near distance.

2.3.4- Consumer Protection

Another objective of regulating the banking industry aims at protecting interest of consumers. The objectives discussed hereinabove aim, in one way or another, at serving the interest of consumers. However, there are also other means that could be availed of to

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[44]Id., p.7

[45]Supra note 9, p.284

protect the interest of consumers. One of such means is to require banks to provide their customers with a meaningful disclosure of deposit and credit terms. Relating to the benefits of such disclosure, the following has been offered:

> *The main intent behind such disclosure is to give consumers a basis for comparing and making informed choices among different institutions and financial instruments. The disclosure also serves to protect borrowers from abusive practices and make them more aware of the costs and commitments in financial instruments.*[46]

Therefore, in order for interest of consumers to be safeguarded, it is believed that minimum disclosure requirements should be imposed on banks. All depositors, investors and creditors of a bank should get reliable and timely information to make informed decisions when transacting business with a bank.[47] If consumers are fed with timely and reliable information, they would arrive at well calculated decisions. If on the contrary, consumers act without timely and reliable information, their decision will finally be regrettable

The other way of assuring consumer protection is generally by promoting financial privacy and preventing problems and abusive practices during credit transactions, debt collections and reporting of personal credit histories and by ensuring equal treatment and access to services among all financial customers.[48] The purpose of these requirements is to enable borrowers and customers to arrive at a well considered transaction with banks. These rules help preserve interest of consumers in their relationship with banks and to enable them enjoy non discriminatory treatment. In order to achieve these merits, it requires strong commitment of the regulatory agency to closely supervise and control day to day operations of banks.

2.4- Organs Entrusted with Power to Regulate Banks

2.4.1- National Bank of Ethiopia

As said time and again, activities of banks are strictly regulated and supervised for a number of pragmatic reasons. Countries entrust the mission of regulating and supervising the banking sector to a central bank though it is known by different names in different

[46]Supra note 38, p.10
[47]Supra note 9, p.294
[48]Supra note 38, p.10

countries. In India, it is called the Reserve Bank of India, in the United Kingdom, the Bank of England, in the United States the Federal Reserve System, in France the Bank of France and in Sweden the Riksbank.[49] In Ethiopia, responsibility for the supervision of banks and banking operations is vested with the NBE.[50]

As evident from Art.6 of Proc. No 83/1994, the general purpose of the NBE is to foster monetary stability and a sound financial system. Because banks are the major financial institutions and play a leading role in fostering monetary stability, the regulation and supervision of banks is the primary target of the NBE. The rules by which banks are controlled and regulated are provided in Proc. 84/94.[51]

Interms of Art.3(1) (d) of Proc. No 84/94, every person is required to hold a license from the NBE to undertake banking business in Ethiopia.[52] The regulatory role of the NBE commences there and then. To ensure that banks in Ethiopia are undertaking business with full compliance with the law, Art.20(1)(a) of Proc. No 84/94 empowers the NBE to make or cause an on-site examination to be made on any bank periodically or at any time without prior notice. Where the examination or inspection reveals that a bank fails to comply with the law or regulations or with the terms and condition of the license, the NBE may take any or all of the actions specified under Art.20(3)(a-i) of Proc. No 84/94. If the worse goes to the worst, the NBE may, as clearly provided under Art.22(1) of Proc. No 84/94, go to the extent of taking over the temporary management of a bank at risk. Banks are also required to submit a number of returns and statements to the NBE on various areas.[53] These returns and statements are inputs to the NBE based on which it will know what is going on in the banking sector. Furthermore, a bank has to secure the prior

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[49]M. L. Jhingan, Money, Banking, International Trade and Public Finance (6th Ed., 2004), p.173

[50]Proc. N0 84/94, Art.7(4) cum. Art.41

[51]The NBE is empowered to issue directives on various areas for the proper implementation of the law and the attainment of its purpose for which it is established. See Proc. No 84/94, Art.36 cum. Proc. No 83/94, Art.61

[52]If, however, a bank is suspected that it is advertising for or soliciting deposits or transacting banking business without having the necessary license or if it fails to comply with the provisions of the law, the NBE will investigate such bank and if need be, may revoke the latter's license. See Proc. No 84/94, Art. 7(1) cum. Art.10(1).

[53]For these returns and statements that every bank is required to submit to the NBE, see Proc. No 84/94, Arts.19(3)(4), 18(1)(6)

approval of the NBE so as to undertake certain activities.[54] A bank can lawfully implement these activities only when the NBE extends approval to that effect.

Generally, the NBE is entrusted with such a Herculean task of closely observing that all banks undertake their business venture in strict compliance with the requisites laid down by the law. But, as stated by one scholar, the attainment of such objectives lie behind the implementation of the prevailing laws, rules and regulations, and sanctions follow in the event of non compliance.[55] In line with this, Proc. No 84/94 embodies important penal provisions that are designed to further the enforcement of banking laws.[56] These serious measures that could be taken against those who fail to comply with the law obviously will play a pivotal role in facilitating the attainment of the purposes which the NBE is established for.

2.4.2- The Court

One can understand from the previous discussions that the lion's share of the responsibility of supervising and regulating the banking business falls on the shoulder of the NBE. However, there are instances whereby the court may be involved in the game. Specifically, the court will have a role in reviewing certain measures taken by the NBE and giving directions that it deems appropriate. A person who is aggrieved by the act of the NBE may take the case to the court and seek judicial review of the act and relief that is appropriate.

As discussed before, the NBE is granted the power to revoke license of a bank if any of the conditions specified under Art.10(1)(a-f) exists. If, however, a bank whose license has been revoked by the NBE thinks that the act of the latter is wrong under the circumstances, it may, according to Art.10(3) of Proc. No 84/94, take the matter to the Central High Court[57] on appeal. On the other hand, where a person undertakes banking business without license and holds money or other property obtained through such act, the NBE, pursuant to Art.9 of Proc. No 84/94, may apply to the Federal High Court for appropriate directions.

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[54]Proc. No 84/94, Arts.5(1), 27

[55]Supra note 9, p.45

[56]See, for instance, Proc. No 84/94, Arts.7(2), 8, 21(1-2)

[57]The Central High Court is later re-organized as the Federal High Court. See Constitution of the Federal Democratic Republic of Ethiopia, Federal Nagarit Gazeta, Proclamation No 1/1995, Art.78(2)

The court has also a role in the regulation of banking business by reviewing decisions reached by the NBE to takeover the temporary management of a bank. Pursuant to Art.23(1) of Proc. No 84/94, a bank which thinks that the decision of the NBE in taking over the management of the former is unjustifiable, may appeal to the court against that decision.

Generally, with the view to make sure that the NBE acts only in accordance with the law and thereby protect citizens from unauthorized power, the court reviews decisions rendered by the former and register decisions which it deems appropriate under the circumstances. The court will either approve or reverse the decision of the NBE, obviously after considering as to whether or not the act of the latter is justifiable in the given situations.

2.4.3- Ministry of Trade and Industry

Banking business is one of those activities which are regarded as acts of trade under Art.5(20) of the Comm. C. A person, therefore, is deemed to be a trader if he professionally and for gain carries on banking business. Due to this reason, those requirements which are applicable on traders are equally applicable on banking companies, without prejudice to the applicability of other additional norms relevant to the latter due to their unique nature.

Because banking business is an act of trade, it is under the strict regulation of the Ministry of Trade and Industry which has the power, *inter alia*, of regulating and supervising activities of traders. In addition to NBE and the court, therefore, Ministry of Trade and Industry involves in the regulation and supervision of banks as traders. According to Commercial Registration and Business Licensing Proclamation, a bank can engage in banking business only when it is entered in the commercial register.[58] More specifically, every bank is required to get registered principally in the place where its head office is situate and in addition be summarily registered in regional states where it operates its branch offices. This is what can be gathered from Art.5(2) cum. Art.5(4) of Proclamation No 67/1997.

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[58]Commercial Registration and Business Licensing Proclamation, Federal Negarit Gazeta, Proclamation No 67/1997, Arts.2(3) and 5(1)

CHAPTER THREE

LIQUIDITY REQUIREMENTS OF BANKS

3.1- What is Liquidity?

Black's Law Dictionary defines the term liquidity as "the status or condition of a person or a business interms of his or its ability to convert assets into cash. The degree at which an asset can be acquired or disposed of without danger or intervening loss in nominal value."[1] The Basel Committee, on its part, defines "liquidity" as the ability to fund increases and meet obligations as they come due.[2] Thus, liquidity is the ability or the capacity to increase money and timely meet obligations at their due date. Liquidity of a bank, therefore, describes its ability to increase its financial position and discharge its obligations at the moment they become due.

When we come to the directive issued by the NBE, the term "liquidity" is defined in a similar way as the above definitions. Liquidity, according to the Directive, refers to the possession of liquid assets including cash and financial assets which can readily be converted into cash.[3]

From the above definitions, one can understand that the term "liquidity" carries two inter-related concepts. First, liquidity refers to the ability of a bank to fund increases than what it already has, or the status or condition of a bank to convert an asset into cash without loss of actual or real value of the asset. In order to say a given bank is liquid, it should have at its disposal assets that could be converted into cash or some liquid form without loss of nominal or actual value.

Secondly, liquidity means the ability of a bank to meet its obligations when they fall due. When we combine these two meanings, liquidity will mean ability of a bank to quickly convert assets into cash without loss of their nominal value and to meet customers' demand as they become due.

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[1]H. C. Black, Black's Law Dictionary (6th Ed., 1990)
[2]Edmstero O. Robert, Financial Institutions, Markets and Management (2nd Ed., 1996), p.161
[3]Discount Window Facility for Commercial Banks, Directive No ERMPD/004/2006 (hereinafter Directive No 004/06), Art.1(5)

3.2- Significance of Liquidity in Banking

As has been pointed out in the previous chapter, banks act as intermediaries between depositors and investors. They solicit and accept money from the general public in the form of deposits and loan same to those who are in need of money and employ part of it in different investment opportunities. However, for banks to discharge their responsibilities as depository and as lender or investor, they have to retain their proper liquidity position. Therefore, one of the most important considerations in bank operations is liquidity position.

The need for liquidity can arise from a number of sources whose effects can vary in magnitude. Deposit flows and loan demands are subject to a high degree of uncertainty with respect to their direction, magnitude and timing.[4] Given this fact, it is absolutely essential that a bank has enough liquidity to satisfy loan demands, answer claims of depositors together with interests and meet other expenses. Thus, banks in all countries have the obligation to have backup sources of liquidity to meet their legal and social responsibilities as depository and lender.

Because a bank attracts large amounts of savings from depositors, it can give loans to different customers in various amounts and for various maturities period. Furthermore, it can invest part of the deposited money in many investment sectors to generate profit for its shareholders and operate other services necessary for its survival. But, all these hopes will be turned to reality if a bank can keep its depositors' trust intact. That is why it is usually said that a bank's duty is primarily to its depositors.

Deposit liabilities of banks are money (demand deposits) or near money (time deposits). Thus, a bank has the obligation to pay back depositors' money on the latter's demand or after the expiry of a certain period (as per the terms of deposits) or after notice.[5] Given this fact, it is a must that a bank must stand ready to pay out currency on demand or at a short notice. Nonetheless, it can do that only when it is financially sound especially when its liquidity is kept intact. To this end, many statutes lay down requirements for minimum amount of liquid assets that banks must maintain and set out basic principles for effectively managing liquidity.

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[4]John R. Brick, Commercial Banking: Text and Readings, p.289

[5]George N. Halm, Economics of Money and Banking (Revised Edition, 1961), p.145

If a bank is not liquid, it could not live up to its expectations and satisfy depositors' demand. A bank that cannot satisfy depositors' demand is said to have encountered liquidity risk.

Liquidity risk is the risk to a bank's earnings and capital arising from its inability to meet obligations in full when they become due without incurring unacceptable losses.[6] If a bank has encountered liquidity risk or becomes illiquid, it cannot meet deposit withdrawals, which in turn will pose a number of challenges.

First, liquidity problems will pose challenges on the ability of a bank to answer to depositors' claims which in turn will bring about financial crisis. If a bank is unable to satisfy claims, let us say, of some depositors, other depositors will think that it is better to withdraw their whole money before the worse goes to the worst. Such concerns about a bank's viability raised among the public could shake depositors' confidence in the safety of their deposits and trigger a bank run and large withdrawals from other banks as well. Relating to this, it is stated that:

> *Once rumors that bank X is in trouble emerge, depositors may withdraw funds from it very quickly, in part because the existence of a bank run increases each depositor's incentive to withdraw his or her funds. Since it is hard for depositors to assess the viability of individual banks, fears about bank X could also quickly spread to other banks.*[7]

This says that, loss of public confidence on a particular bank can quickly snowball into runs on otherwise healthy banks that may ultimately bring down the entire banking system. Thus, importance of liquidity transcends an individual bank, since a liquidity shortfall at a single institution can have system wide repercussions. Prudential supervision and regulation of banks, therefore, is essentially driven by the need to avoid panics and by concern for the safety of public savings deposited with them.

Of course, as pointed out by one commentator, it may seem unrealistic for a bank to expect that all depositors will demand payment on the same day for their entire savings account balances nor will all holders of time deposit instruments seek payment at the

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[6]Comptroller of the Currency Administrator of National Banks, Liquidity Comptroller's Handbook, (February 2001), p.1

[7]Discussion Paper 07/7, Financial Service Authority, Review of the Liquidity Requirements for Banks and Building Societies (December 2007), p.18, available at http://www.fsa.gov.uk

same time.[8] This is very unlikely if not totally impossible. Despite this fact, a bank should maintain its liquidity and be prepared just for such an eventuality. This requires every bank to set in place different methodologies and lay down a variety of possible future unhealthy developments.[9] Thus, liquidity requirement not only targets ability of a bank to meet its obligations under normal circumstance, but also in adverse conditions.

Second, liquidity requirements of banks could be employed by the regulatory agency as a supervisory tool in its effort to discharge its responsibilities; one of which is ensuring the effective functioning of the banking system. The banking sector will function effectively and efficiently when the money circulation in a market is optimal. To achieve this end, the regulatory body needs to avoid large swings in the volume of available cash that would undermine the implementation of monetary policy.[10] The regulatory agency will fix the amount of liquidity which a bank has to maintain depending on its assessment of the economic atmosphere, inflationary or deflationary booms.

Third, liquidity of a bank is also significant from another perspective. It is crystal clear that the credit function of banks is an integral part of banking business. Obviously, long standing customers with good credit relationship with a bank would expect the latter to make funds available to them when they need. A bank must be prepared to accommodate customers who have a legitimate claim on it, and the amount needed for an increase in loans represents the portion of liquidity requirement.[11] Therefore, liquidity of a bank will help the latter to smoothly continue its relationship with customers, for it enables the bank to accommodate even sudden and unexpected changes in loan demands.

Because bank liquidity has numerous significances as discussed hereinabove, international institutions such as the International Monetary Fund (IMF) and the World Bank (WB) have developed extensive checklists of "best practice" recommendations that they urge all countries to adopt.[12] It can be said that the Basel Committee on Bank Supervision is the result of such an effort.

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[8]Eric N. Compton, Inside Commercial Banking (2nd Ed., 1983), p.80

[9]For instance, Principle Six of the Basel Accord provides that, "A bank should analyze liquidity utilizing a variety of what if scenarios."

[10]Frazer, Reserve Bank of New Zealand. Bulletin (Vol. 67, No. 4), p.16

[11]Supra note 8, p.81

[12]Ross Levine, NBER Reporter, Bank Regulation and Supervision, Research Summary Fall (2005), p.4 , available at http://www.nber.org/reporter

3.3- Ways of Maintaining Liquidity

3.3.1- Maintaining Liquid Assets

3.3.1.1- Scope of Application of Liquid assets

Maintenance of adequate liquid assets is a cardinal principle of sound banking. As a result, every bank operating business in Ethiopia is required to hold liquid assets to supplement liquidity from depositors and other liabilities. The different banking laws and regulations, though do not define the term 'liquid assets', address the type and quality of assets banks should hold to satisfy their liquidity demand.[13] As has been said in the previous chapter, in order to say a given asset is liquid, it should have the quality of being converted into cash or some liquid form without loss of nominal value.

Proc. No 84/94 authorizes the NBE to direct every bank of a specified class or classes to maintain liquid assets amounting to not less than a prescribed percentage of the total or specified categories of its deposit and similar liabilities.[14] The Proclamation specifies the nature of assets which are deemed to be liquid. According to Art.16(2), 'liquid assets' means freely transferable assets, unencumbered by any charge or lien whatsoever that consists of classes of assets specified under Sub (a) and (b) of the same provision. In its definition of liquid assets, Proc. No 83/94, on its part, include among other things, cash, deposits by banks approved by the NBE, readily convertible assets expressed and payable in foreign currency as are approved by the NBE, and other assets that the NBE may from time to time declare acceptable.[15] Thus, Proc. No 83/94 defines what is meant by 'liquid assets' by enumerating assets which are said to be liquid. From this, one may take note of the following important points:

First, the NBE is entrusted with the power to order banks to maintain liquid assets. If we take a close look at Art.16(1)(a) of Proc. No 84/94, it gives the discretion to the NBE to order banks to maintain liquid assets. This is evident from the wordings of the provision which goes, "The National Bank of Ethiopia may ... direct that every bank of a specified class or classes shall maintain liquid assets..." (Emphasis added). Strict interpretation of this provision reveals that the NBE has the discretion to order banks to maintain liquid

[13]Black's Law Dictionary defines the term 'liquid assets' as assets that can readily be converted into cash, See supra note 1

[14]Proc. No 84/94, Art.16(1)(a)

[15]Proc. No.83/94, Art.2(13)(a-d)

assets as it prescribes. Thus, if the NBE is satisfied that directing a bank(s) to maintain liquid assets is not feasible under the circumstances, it may exempt the latter from such an obligation. Moreover, it could be interpreted that the NBE is not obliged to direct all banks to maintain liquid assets. Therefore, it may direct 'bank X' to maintain liquid assets as it prescribes but exempt 'bank Y' from the obligation. The following adds to such interpretation:

> *As a principle, every bank has the obligation to hold liquid assets as prescribed by the NBE. However, there may be situations whereby a bank could be relieved from this obligation. The NBE may relieve, for instance, Development Bank of Ethiopia from the obligation for the latter normally does not mobilize deposits. Moreover, there could be a situation which justifies exemption of a bank from the obligation. If, for instance, a bank comes to the market very recently and is not financially strong, it could be relieved from the obligation of maintaining liquid assets.*[16]

But, this kind of interpretation may provoke debate. Moreover, the researcher argues that such interpretation is not in line with the very purpose of the law. As said before, the rationale behind the requirement of banks to maintain liquid assets is to ensure that every bank has the ability to answer to depositors' claims when they become due. Its target, therefore, is protection of interest of depositors. Because one of the most important functions of banks is accepting deposits, it is a must that all of them should have the ability to meet depositors' claims at all times. (Development Bank of Ethiopia is an exception, for it does not normally accept deposits). Two banks accepting deposits are on the same footing, i.e., both should have the ability to satisfy claims of their respective depositors. There is no reason to require 'bank X' to maintain liquid assets and thereby meet depositors' claim but exempt 'bank Y' from such an obligation. The debate will even be hot given the law's failure to provide guidelines on when and how the NBE may relieve a bank from this obligation.

Second, assets which are said to be liquid are specified both under Art.2(13)(a-d) of Proc. No 83/94 and Art.16(2) of Proc. No 84/94. According to the latter, liquid assets should be

[16]Interview with Ato Kurene Tesgera. Banking Supervision Department of National Bank of Ethiopia, February 1, 2008.

freely transferable. The law's requirement in this regard is to ensure that a bank can dispose of the assets within a very short period of time when the need arises. When an asset is freely transferable, a bank holding same can easily convert it into cash as it wishes. This will guarantee interest of depositors. According to the same provision, the liquid assets to be maintained by a bank should also be unencumbered by any charge or lien whatsoever. This requires that any third party should not have any kind of claim or interest, direct or indirect, on the assets to be maintained by banks to satisfy their liquidity requirements. A similar approach is propagated through Art.16(1)(c) of Proc. No 84/94 which says that the NBE may disallow the use of any particular asset of a type referred to in Sub(2) of Art.16 of the same Proclamation if it believes that the asset is not a *bona fide* asset of a bank. This obviously is designed for the best interest of depositors. Relating to this, it is said:

> *A liquid asset will serve a bank by providing liquidity when there is cash shortage. But, if an asset is not freely transferable or if somebody else has got a right on an asset, or if an asset is not a bona fide asset of a bank, an obstacle will stand against the bank's move to convert same to cash easily and satisfy its cash needs. Thus, even if a bank has some kind of entitlements other than ownership rights over an asset, the NBE may reject this asset to be considered liquid. This is to maximize interest of depositors.*[17]

Third, the kinds of assets which are said to be liquid are enumerated under Art.16(2) of Proc. No 84/94 and Art.13(2) of Proc. No 83/94. Furthermore, the NBE is empowered to prescribe assets other than those specified under the two proclamations as liquid assets and order banks to maintain such assets to comply with their liquidity requirements. This is what is provided under Art.16(2)(b)(6) of Proc. No 84/94 and Art.2(13)(d) of Proc. No 83/94 which say that the NBE may from time to time approve other assets to be liquid. Thus, the NBE could declare an asset to be liquid by taking a number of factors into consideration. If the NBE believes that other sets of assets other than those specified under Proc. No 83/94 and Proc. No 84/94 should be declared liquid due to different

[17] Ibid

considerations, it can issue a directive and specify the kind of additional asset(s) banks could maintain.

One may also infer from those provisions that the NBE could declare an asset to be liquid at one point of time and illiquid at another time and vice versa. This implies that due to a number of factors, the liquid nature of assets varies from time to time. Thus, in order to suit the prevailing situations, it is necessary that the NBE should from time to time update the list of liquid assets. Hence, valuation of liquid assets needs to be regularly adjusted to reflect market conditions. The position taken by the law is clear in that liquidity of an asset is dependant upon many factors such as economic development and technology. Regarding this, it has been pointed out that:

> *The scope of liquid assets may vary from time to time depending upon many factors such as economic development. For instance, net balances and money denominated in currencies and located in such countries approved by the NBE are considered to be liquid assets as per Art.16(2)(b)(3) of Proc. No 84/94. However, liquidity of currency of a given country is directly related to its economic development. If the economic development of a country is booming, the currency of such country will be liquid though it was not some years before. So, it is the responsibility of the NBE to regularly revise the list of liquid assets provided in the law.*[18]

From this, one can understand that the NBE will determine the assets to be maintained as liquid assets depending upon a number of factors. At any rate, the most important point is the quality of an asset. How well a particular asset serves in this capacity depends upon its marketability and quality of the asset to be converted into cash within a short period of time. Assets that can be sold at a very short period of time without any appreciable loss to a bank are ideal candidates for meeting unexpected liquidity demands and thus will be taken as liquid assets. Thus, assets to be declared liquid by the NBE need to be of high quality and readily marketable to ensure that they can be realized as required without significant loss.

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[18]Interview with Ato Getahun Nana. Banking Supervision Department of National Bank of Ethiopia (Manager), February 1, 2008

The other point worth mentioning at this juncture is that the NBE is authorized to prescribe different percentages of liquid assets for the total or specified categories of banks' deposit and similar liabilities. Thus, the NBE may either prescribe the same percentage of liquid assets which banks should maintain for all demand deposits, time deposits and deposits at notice or other liabilities, or different percentages of liquid assets for different deposit liabilities. Because the maturity dates of deposits are different, the ability of banks to satisfy claims of these classes of deposits is different. Thus, higher percentages of liquid assets could be prescribed for demand deposits for they are payable on demand and relatively lower percentages for time deposits and deposits at notice depending upon their respective maturity dates. However, if the NBE found that not feasible, it may prescribe the same percentage of liquid assets for all deposit liabilities irrespective of their maturity dates.

Pursuant to Art.16(1)(b) of Proc. No 84/94, the distribution of the total amount required to be held for various classes or subclasses of liquid assets is left to the discretion of each bank unless the NBE directs otherwise. However, there is a discrepancy between the English version and the Amharic one. The English version talks about the distribution of the amount of the various liquid assets, while its Amharic counterpart is about the kind of liquid assets to be maintained by banks.[19] However, now, banks are not free to determine the kind of assets they should maintain, for the NBE has issued a directive regarding the kind of liquid assets to be maintained. The details will be discussed in the forthcoming sections.

For the researcher, the NBE's move to determine the kind of liquid assets to be maintained by banks by issuing a directive is the right approach. This is because, if a bank is free to determine itself what assets to maintain, it could opt for less liquid assets. In this case, interest of depositors could have been jeopardized for the degree of liquidity of assets differs depending upon their kind and nature.

3.3.1.2- Amount of Liquid Assets to be Maintained

Pursuant to Art.16(1)(a) of Proc. No 84/94, the NBE has the prerogative to direct every bank to maintain liquid assets amounting to not less than a prescribed percentage of the total or specified categories of the latter's deposit and similar liabilities. From this part of

[19]But, it is the Amharic version which is acceptable according to the NBE official cited in Supra note 16

the Proclamation, it is clear that the amount of liquid assets to be maintained by banks is to be determined by the NBE. The NBE, therefore, can vary the amount by taking a number of factors into consideration, especially by considering interest of depositors. Its important target is to ensure that banks have enough assets to meet their liabilities in different time-bands on a maturity ladder.

However, the jurisdiction of the NBE in fixing the amount of liquid assets is not without limit. Proc. No 84/94 reveals that the amount of liquid assets to be maintained by a bank as a percentage of the total or specified categories of its deposit and similar liabilities, as the case may be, cannot exceed thirty five percent of such deposits and similar liabilities.[20] Within this limit, the NBE will fix a certain percentage which it believes is reasonable under the circumstances. What parameters does the NBE employ when it fixes the percentage?

> *During fixing the percentage, interest of depositors and banks' ability to satisfy their cash needs will principally be taken into account. A certain percentage will be fixed if it will maximize interest of depositors. The NBE will basically employ as a parameter internationally accepted principles called 'prudent banking principles' when it fixes the amount of liquid assets.*[21]

This indicates that the NBE will not fix the percentage arbitrarily. It will rather fix a percentage which is reasonable under the given situations. For instance, even within the limit permitted by the law, the NBE cannot fix an excessive percentage under the pretext of protecting interest of depositors and creditors. True, if banks are obliged to maintain higher percentage of liquid assets, interest of depositors and creditors will be protected more than with lower ones. Nonetheless, it could significantly hamper banks' overall performance. Because, when higher percentages are fixed, banks will be obliged to hold a lot of funds in the form of liquid assets and as a result will remain with little money to invest and lend. This intern will decrease the amount of profits they will make from investments and/or loans. This is because highly liquid assets carry a lower yield and represent a diversion of resource away from the banks' main business of lending and

[20] Proc. No 84/94, Art.16(1)(a)
[21] Supra note 16

investment to their customers. So, imposing liquidity requirements that are too high unjustifiably raises all banks' costs. This undoubtedly will affect them for they are principally established for profit. When the NBE fixes the percentage of liquid assets, therefore, a balance should be struck between interest of depositors and banks' principal objective- profit.

As authorized by Proc. No 84/94, the NBE has issued a directive and fixed the percentage of liquid assets to be maintained by banks.[22] As evident from Art.3 of Directive No 44/08, the NBE has fixed a total requirement. It says, "Any licensed bank shall maintain liquid assets of not less than 25% (twenty five percent) of its total current liabilities." This means, if a bank, for instance, has Birr 1 million current liabilities, it should maintain at least Birr 250,000 in the form of liquid assets. The NBE issued Directive No 44/08 very recently and increased the percentage of liquid assets to be maintained by banks with a view of controlling the money supply and thereby curbing the inflation that prevails in the country.

Art.4.1 cum. Art.4.2 of Directive No 44/08, on the other hand, prescribes specific requirements. It is provided that, for the purpose of meeting liquidity requirements, each bank has the obligation to maintain at least twenty percent and five percent of the current liabilities in the form of primary reserve assets and secondary reserve assets respectively.[23] This seems apportionment of the twenty five percent rate between primary and secondary reserve assets. If this is so, the researcher does not see any reason why the Directive provides the total requirement given these specific requirements.

Here, it is appropriate to raise one point. What does the term 'current liabilities' refer to? The term 'current liabilities' is defined under Art.2.2 of Directive No 44/08 as the sum of demand (current) deposits, savings deposits and time deposits and similar liabilities with less than one month maturity period. Thus, demand deposits, savings deposits and time deposits and similar liabilities having less than one month maturity period are included under current liabilities. If this is so, what kinds of liabilities are excluded from the ambit of 'current liabilities' as defined in the Directive?

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[22] Licensing and Supervision of Banking Business, Liquidity Requirement(3rd Replacement), Directive No SBB/44/2008 (hereinafter Directive No 44/08)

[23] Art.16(2)(a) and (b) of Proc. No 84/94 respectively define the terms 'primary reserve assets' and 'secondary reserve assets'. Details will be presented in the forthcoming sections.

The answer seems simple. *Acontrario* reading of Art.2.2 of the Directive reveals that demand (current) deposits, savings deposits, time deposits and similar liabilities having more than one month maturity period fall outside the ambit of current liabilities. As said earlier, demand deposits are payable on demand and hence cannot fall outside the ambit of current liabilities. Moreover, savings deposits can be withdrawn any time or after short notice, may be at less than thirty days time. So, savings deposits also cannot outrightly be excluded from the domain of current liabilities unless, of course, they have more than one month maturity period. However, in case of time deposits, they can be reclaimed at less than one month or after one month depending upon the agreement reached between depositors and a bank. Hence, some time deposits may fall outside the ambit of current liabilities.

The other point to be raised at this juncture is the phrase 'similar liabilities' mentioned under Art.2.2 of Directive No 44/08. The phrase 'similar liabilities' is not defined under the Directive. Nonetheless, it is said to refer to liabilities of banks such as tax liabilities and other debts with less than one month maturity period.[24]

When we see the liquidity position of commercial banks doing business in Ethiopia in the years 2005 and 2006, it can be said that they are operating in the right track. For instance, the liquidity position of commercial banks in September, October and November 2005 was beyond the level required by law. In these three months, the excess liquidity figures read Birr (in millions) 19,080.90, 19,654.24 and 18,378.95 respectively.[25] In September, October and November 2006, on the other hand, the excess liquidity position of banks was Birr (in millions) 20,327.46, 20,089.26 and 20,042.47 respectively.[26] The statistics also show that all commercial banks operating business in the country keep liquidity positions in excess of the limit provided by law. From these figures, it could be said that the law regarding liquidity requirements of banks is being complied with.

Having considered these figures, some are heard saying that the problem with Ethiopian banks is not that of illiquidity, rather it is the opposite. However, what is being heard

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[24]Supra note 16

[25]National Bank of Ethiopia, Reserve and Liquidity Position of Commercial Banks as at November 30, 2006, available at http://www.nbe.gov.et

[26]Ibid. However, the researcher is not able to get the liquidity position of commercial banks after November 2006 for the statistics is said to be confidential until some time in the future.

from private banks operating business in the country is entirely different. According to them:

> *The assertion that 'banks operating business in Ethiopia are excessively liquid' is misleading and hence should be qualified. As can be seen, the aggregate excess liquidity position of banks is very insignificant. This is a strong indication that banks in Ethiopia are being strongly hit by liquidity shortage. Just last year at this time, for instance, private banks had totally ceased to extend loans due to liquidity shortage. But, they use to comply with the law and regularly maintain their liquidity position to the level required by law, not because they do have excess money at their disposal, but it is because they do not have other options. Therefore, the assertion that 'Ethiopian banks are excessively liquid' is true only regarding Commercial Bank of Ethiopia which really is excessively liquid.*[27]

From this point of view, one can understand that the regular compliance by commercial banks with the law does not necessarily indicate that these banks are over liquid and hold excess money at their disposal.

3.3.1.3- Nature of Liquid Assets

Proc. No 84/94 and Directive No 44/08 divided liquid assets into primary and secondary reserve assets. Why the division and what parameters are employed to put a certain asset in the one category not in the other?

3.3.1.3.1- Primary Reserve Assets

Art.16(2)(a) of Proc. No 84/94 specifies that primary reserve assets are one of the components of liquid assets recognized under the Proclamation. Of course, the Proclamation does not define what the phrase 'primary reserve assets' means rather, it simply lists assets which are said to be so. According to literatures, the term 'primary reserve assets' refers to those liquid assets which are the most liquid in their very nature when compared with other assets.[28]

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[27] Interview with Ato Asfaw Alemu, Corporate Planning and Development Department (Manager), Dashen Bank S. Co., February 11, 2008

[28] Supra note 4, p.291

When we see the listing under Art.16(2)(a) of Proc. No 84/94, it is not difficult to observe that assets under the category of primary reserve assets are those liquid assets which are the most liquid. Due to their very nature, therefore, primary reserve assets are used to meet the day to day liquidity demands of banks. In some jurisdictions, for instance in America, the term 'primary reserve assets' refers to those liquid assets that will serve as the first line of defense against a deposit or currency outflow and include currency and coin in a bank called vault cash, reserve with the Federal Reserve Bank and demand deposits with other banks.[29] Generally, primary reserve assets are cash (the most liquid asset) or cash equivalents which are ideal sources of liquidity for banks.

When we come to our law, assets which are said to be primary reserve assets are enumerated under Art.16(2)(a) of Proc. No 84/94. The first class of these assets consists of notes and coins that are legal tenders in Ethiopia.[30] These assets, as one can see, are the most liquid in their very nature and as a result a bank can make use of them in a moment's time as it wants. This is because they are actually in the hands of banks and require no further conversion before they are put into use. The parameter employed in categorizing a particular asset in the class of primary reserve assets, therefore, is the ease a bank can make use of it and the degree at which an asset can be made use of within a very short period of time.

Balance held with the NBE is the other class of assets which are said to be primary reserve assets.[31] Of course, what is meant by 'balance held with the NBE' is not clear in the Proclamation. But, it is not difficult to suggest that the term 'balance held with the NBE' refers to money which banks deposited or reserved with the NBE. This balance cannot be other than the balance under Art.16(5) of Proc. No 84/94 which banks maintain with the NBE as a percentage of their deposit liabilities. Thus, reserve balance held with the NBE is regarded as primary reserve asset and serves in the same capacity as cash money, for a bank can make use of it in a moment's time.

However, one has to bear in mind that assets which are regarded as primary reserve assets are not exhaustively enumerated under Art.16(2)(a) of Proc. No 84/94. Therefore, there

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[29]Thomas Mayer, James S. Duesenberry, Robert Z. Alber, Money, Banking and the Economy (4th Ed., 1981), p.111

[30]Proc. No 84/94, Art.16(2)(a)(1). Most Commercial banks in Ethiopia hold these assets as liquid assets as explained by bank officials. See Supra note 27

[31]Proc. No 84/94, Art.16(2)(a)(2)

may be assets other than those mentioned under this article that could be categorized as primary reserve assets. Here, one has to raise the query, what other possible assets could be included in the list of primary reserve assets?

> *The assets that could be included in the list of primary reserve assets are those assets which display similar characteristics as those which already are declared to be primary reserve assets under the law. Before the NBE declares an asset to be included in the category of primary reserve assets, therefore, it has to prove to that effect. But, it is not possible to enumerate these assets before hand.*[32]

Thus, the NBE will determine other assets to be considered as primary reserve assets generally by evaluating their nature and quality.

3.3.1.3.2- Secondary Reserve Assets

In addition to primary reserve assets, banks can also satisfy their liquidity requirements by means of other sets of assets. These assets are called secondary reserve assets. However, the term 'secondary reserve assets' once again is not defined under Proc. No 84/94 or other laws. According to scholars, secondary reserve assets are assets which are not quite as liquid as and safe as primary reserve assets.[33] Actually, secondary reserve assets, like primary reserve ones, still are liquid although they are less liquid than the latter. Even if it cannot be denied that secondary reserve assets do have the advantage of contributing to liquidity, there is, however, a slightly higher degree of risk involved in them. Due to this reason, secondary reserve assets provide only a second line of defense if the primary reserve assets are not sufficient. Art.16(2)(b) of Proc. No 84/94 enumerates the assets which are regarded as secondary reserve assets.

Pursuant to Art.16(2)(b)(1) of Proc. No 84/94, net balances that could be withdrawn on demand and money at call at the NBE or at any licensed bank in Ethiopia are said to be secondary reserve assets. Thus, if a bank deposits money at the NBE or any other bank, it can employ same as a secondary reserve asset and may withdraw and satisfy its liquidity shortage. However, it is not every deposit at the NBE or other banks that is considered to be liquid. For a deposit or money in the NBE or other banks to be considered liquid, it

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[32]Supra note 18
[33]Supra note 29

should be withdrawable on demand and at call. Therefore, balances which are not withdrawable on demand and money not at call are not considered to be secondary reserve assets. For instance, time deposits of a bank kept in another bank is not considered to be secondary reserve asset for such money is not withdrawable on demand and at call. This is because a bank cannot employ such assets to satisfy its immediate cash needs.

Treasury bills[34] and other securities[35] are regarded as secondary reserve assets as per Art.16(2)(b)(2) of Proc. No 84/94. But, every treasury bill or security is not declared to be secondary reserve asset. For treasury bills and other securities to be considered so, they should be issued by the government and should have a maturity period of less than three hundred seventy days. Treasury bills and other securities that do not display these characters are not considered to be secondary reserve assets. Currently, private banks hold very little amount of treasury bills as liquid assets, for the government issues limited amount and even if it issues, it is the Commercial Bank of Ethiopia which entirely subscribes to them.[36]

Usually banks operating in Ethiopia, for various pragmatic reasons, could deposit money in a bank operating in another country. These kinds of deposits, if they fulfill some conditions prescribed by law, could be considered as liquid assets. Pursuant to Art.16(2)(b)(3) of Proc. No 84/94, net balances withdrawable on demand and money at call or at not more than thirty one days notice at such banks, denominated in such currencies, and located in such countries and available in accordance with such terms as the NBE approves are considered to be secondary reserve assets. This shows that in order for banks to hold such assets as secondary reserve assets, the NBE should approve the denomination of their currency, the bank in which they are kept and the country in which the bank is located at. Moreover, the assets should be available in accordance with the terms as approved by the NBE. Obviously, the NBE is expected to approve such assets as

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[34]Black's Law Dictionary defines the term 'treasury bill' as short term obligations of the government. See supra note 1

[35]A security is any interest or instrument relating to finances including a note, stock, treasury stock, bond debenture, trust certificate and c. See Ibid

[36]Interview with Ato Sisay Molla, Finance and Accounts Department (A/Manager), United Bank S. Co., February 11, 2008.

liquid assets only when it believes that they are really liquid and that banks can withdraw same as they want or at short notice.

The other assets which can be maintained by banks as secondary reserve assets, according to Art.16(2)(b)(4) of Proc. No 84/94, are negotiable instruments.[37] But, all negotiable instruments will not be taken as secondary reserve assets. For negotiable instruments to be considered as secondary reserve assets, they should be of a type and drawn and denominated in currencies approved by the NBE. Moreover, they should be payable within a period of one hundred eighty six days. Negotiable instruments which do not satisfy these conditions are not considered to be secondary reserve assets. But as things stand now, Ethiopian banks do not hold negotiable instruments as liquid assets due to the absence of capital market.[38]

Treasury notes or bills issued in other countries could also serve as secondary reserve assets. However, all kinds of such treasury notes will not serve as secondary reserve assets. Pursuant to Art.16(2)(b)(5) of Proc. No 84/94, in order for treasury bills to serve as secondary reserve assets, they should have such qualities that they should be issued by the government of a country and denominated in a currency approved by the NBE. Furthermore, their maturity period should be within three hundred seventy days.

In addition to the above assets which are considered to be secondary reserve assets, Art.16(2)(b)(6) of Proc. No 84/94 authorizes the NBE to approve, from time to time, other assets to be secondary reserve assets. Thus, the NBE may approve other assets not included in the list under Art 16(2) (b) to be regarded as secondary reserve assets. However, the law fails to give a clue as to what is meant by other assets. In spite of this fact, one can say that the other assets that will be approved by the NBE as secondary reserve assets should have similar qualities with the other assets enumerated in the law and most importantly, should be readily convertible into cash.

This be as it may, based on its power given to it by law, the NBE has added other assets to the listing of secondary reserve assets enumerated under Art.16(2)(b) of Proc. No 84/94. Regarding this, Art.2.1 of Directive No 44/08 states:

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[37] Black's Law Dictionary defines the term 'negotiable instruments' as, "A written and signed unconditional promise or order to pay a specified sum of money on demand or at a definite time payable to order or bearer." See Supra note 1

[38] Supra note 36

For the purpose of liquidity requirement 'liquid assets', in addition to what has been provided for under 16(2) of Proclamation No 84/1994, include deposits held in Organization for economic Cooperation and Development(OECD) member countries currencies and payable by banks of OECD countries and in such other currencies as may be approved by the National Bank of Ethiopia as well as securities issued by OECD countries denominated in currencies of such countries with tenures as indicated under article 16(2)(b) of Licensing and Supervision of Banking Business Proclamation No. 84/1994.

Thus, the NBE approves deposits held in OECD[39] countries to be included in the assets of secondary reserve assets and, therefore, banks can hold these assets to satisfy their liquidity requirements.

Before winding up the discussion of this section, it is important to pose a question. Can a bank satisfy its entire deposit liabilities by holding only primary reserve assets or only secondary reserve assets? Directive No 44/08 has an answer to this question. Art.4.1 of the Directive requires at least twenty percent of the current liabilities to be in the form of primary reserve assets. However, if a bank opts to hold only primary assets to satisfy its entire liquidity requirement, that is fine for such assets are the most liquid assets one can imagine. On the contrary, a bank cannot satisfy its entire deposit liabilities by holding only secondary reserve assets. Pursuant to Art.4.2, a bank can maintain to the extent only of five percent of its current liabilities in the form of secondary reserve assets. Had this not been the case, banks would have inclined to hold only secondary reserve assets and consequently interest of depositors would have been at risk, for as discussed earlier, secondary reserve assets are less liquid and more risky than primary reserve ones.

3.3.2- Reserve Balance

3.3.2.1- Nature

Since the credit function of banks and bank investments are the most important banking businesses, deposits almost immediately go out into the market as loans and investments. Thus, a bank faced with a sudden demand for withdrawals would obviously face a serious

[39]Organization for Economic Cooperation and Development (OECD) has 30 member nations including the United States, Canada, Japan, Germany, France, The United Kingdom, South Korea and Australia.

liquidity problem in the absence of reserves. In order to tackle such problems, banks are required to maintain reserve balance with the NBE.

Black's Law Dictionary defines the term 'legal reserve' or 'reserve balance' as the minimum amount of liquid assets that a bank must maintain by law to meet depositors' or claimants' demands.[40] Reserve requirement, therefore, refers to the amount of liquid assets or funds that a bank must hold in reserve against specified deposit liabilities.

Many jurisdictions require banks to deposit with the central bank a certain amount of money in respect of their deposit liabilities. Theoretically, reserve balance operates as a cushion against sudden demands for withdrawals of deposits.[41] During serious banking and economic problems, reserves could be quickly exhausted and depositors could be paid what they demand. Thus, every bank is required to keep reserves as a precaution against adverse withdrawals of deposits.

Just like in other countries, reserve balance is another mechanism employed by Proc. No 84/94 to ensure that banks operate by preserving their liquidity position.[42] Pursuant to Art.16(5) of Proc. No 84/94, every bank operating business in Ethiopia is required to maintain with the NBE a reserve balance as a percentage of its total deposit liabilities. At least theoretically, a bank will withdraw the reserve it kept with the NBE when the former encounters fund shortage. Thus, reserve balance is to be maintained by banks to make sure that they do have the ability to answer depositors' claims.

The minimum legal reserve with the NBE maintained by banks as a proportion of deposits may be considered as reserve liquidity held as protection against an eventuality of a run on banks, but in actual fact, it represents a permanently frozen pool of funds kept in a blocked account. This is because banks in principle cannot withdraw money from the legal reserve balance and satisfy their cash shortage. In this regard, Directive No 42/07, under Art.2.1(b) provides in black and white that the reserve balance cannot be

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[40] Supra note 1

[41] However, this is not the only purpose of reserve requirements at the present time. Today, reserve requirements indirectly serve a broader public policy purpose, namely, monetary control. By raising or lowering the percentage of deposits to be reserved, the central bank in a country could affect the availability of money in the credit market. See Michael P. Malloy, The Regulation of Banking: Cases and Materials on Depositary Institutions and their Regulations (1992), p.436

[42] According to the preamble of the directive on reserve requirement, statutory reserve requirement is one of the important monetary policy instruments and prudential regulatory tools. See Licensing and Supervision of Banking Business, Reserve Requirement (4th Replacement), Directive No SBB/45/2008 (hereinafter Directive No 45/08)

withdrawn except with the prior approval of the Banking Supervision Department of the NBE. A bank, therefore, can withdraw money from the reserve balance only when the NBE allows to that effect. This implies that the NBE may allow one bank to withdraw money from its reserve balance but disallow another which presents the same request. However, the Directive fails to provide the situations as to when the NBE allows or disallows withdrawal of money from the legal reserve balance. Despite this fact, the following has been offered by officials in the NBE concerning the issue at hand:

> *It may happen that a sudden withdrawal of funds leaves a bank unable to cover its liquidity requirements. A bank must try to cover the shortfall with available cash if there is any. If no available cash, it will move to free up reserves with the NBE and the latter will allow that. But, a bank should employ this reserve balance only and only to satisfy its liquidity shortage. Thus, a bank will not be allowed to withdraw money from the legal reserve balance simply because it wants the money for a certain purpose. The NBE will not permit the withdrawal of money from the reserve balance if it believes that the money so withdrawn will be for a purpose other than satisfying claims of depositors.*[43]

So, it all depends upon evaluation of individual cases by the NBE. From this, one can understand that the NBE is armed with wide discretionary power in allowing or disallowing withdrawal of funds from reserve balance. In addition to this, Directive No 45/08 does not provide guidelines as to when and how the NBE will allow or disallow withdrawal. For the researcher, it could have been better had there been indications that could serve the NBE as guidelines during exercise of its discretion. The absence of any guideline may open the door for abuse of power and favoritism.

Pursuant to Art.16(5) of Proc. No 84/94, the minimum reserve requirement is expressed as a percentage of the total deposit liabilities. The NBE, pursuant to the same provision, is authorized to determine from time to time the percentage of the reserve requirement. The same is provided for under Art.31(2) of Proc. No 83/94 which says that the NBE may, from time to time require banks to maintain with it a proportion of their deposit liabilities as prescribed by it. Thus, the NBE is entrusted with the power to vary the

[43] Supra note 18

amount of reserve balance to be maintained by banks. The primary purpose of the law that enables the NBE to vary the minimum reserve ratio is to influence the level of liquidity which each bank has to enjoy in a given period of time.[44] It will also enable the NBE to influence the volume of credit by contracting or expanding the cash basis of credit at the disposal of banking institutions. Obviously, in discharging its responsibilities in this regard, the NBE will asses the economic atmosphere; inflationary or deflationary booms. At a time of inflation, the NBE requires banks to maintain a high percentage of reserve balance with a view to controlling the money supply and conversely, at a time of deflation, it lowers the reserve requirements to enable banks to have more cash at hand for lending purposes.[45] However, according to Art.16(5) of Proc. No 84/94, the percentage of legal reserve to be prescribed by the NBE may not exceed twenty percent of the total deposit liabilities of banks. So, the NBE can play the game only within this limit.

The reserve requirement is expressed as a percentage of designated liabilities. According to Art.31(2) of Proc. No 83/94, the NBE may prescribe percentage of reserve requirements for different types of liabilities. Similarly, Art.16(5) of Proc. No 84/94 says that the NBE may prescribe different percentages for demand, savings and time deposits. These provisions made it clear that the NBE has the discretion to prescribe the ratio of legal reserve to different deposit liabilities. This part of the law enables the NBE to prescribe the percentage as it wants. Thus, the minimum ratio of reserves to liabilities could be expressed either as a fixed percentage or as a range of percentages within which the minimum may be varied by the decision of the NBE. Even where a percentage range is prescribed, the same percentage may apply to all classes of liabilities, or different percentages may be prescribed for different classes of liabilities. It is up to the NBE to choose.

Although these options are available, the NBE opted to prescribe the same percentage of reserves to all demand, savings and time deposits. Art.3 of Directive No 45/08 provides that every bank operating in Ethiopia has the obligation to maintain, at all times, its reserve requirements fifteen percent of all Birr and foreign currency deposit liabilities

[44]Supra note 16
[45]Ibid

held in the form of demand (current) deposits, savings deposits and time deposits. This percentage applies starting from April 2008 before which it was only ten percent. The percentage of the reserve balance is increased to curb the inflation that has prevailed in the country since some months before, as can be inferred from the preamble of Directive No 45/08.

Even if the law says that the reserve will be maintained in the form of either demand deposits, savings deposits or time deposits, it should not be interpreted as authorizing banks to withdraw at will the assets that constitute, in whole or in part, the legal minimum requirements. Of course, Banks could withdraw temporarily certain marginal amounts of their legal minimum reserves with the understanding that the average weekly minimum reserve ratios are not thereby affected.[46] When a certain bank has more reserves than the required level, it can withdraw it and use for any purpose it wants.

Each commercial bank operating in Ethiopia has a reserve account with the NBE and maintains with it the reserve balance required by law. As things stand now, all banks do comply with the legal reserve requirement and maintain the amount of legal reserve balance as is provided under the Directive. Statistics kept by the NBE speak to that effect. For instance, if we take a look at the reserve position of commercial banks of some months in the years 2005 and 2006, it is above the level required by law. In September, October and November 2005, banks kept excess reserve balance of Birr (in millions) 11,298.29, Birr 11,840.29 and Birr 11,141.85 respectively in excess of the level required by law.[47] On the other hand, the excess of the reserve balance of banks in September, October and November 2006 reads Birr (in millions) 6,358.67, Birr 6,179.04 and Birr 7,424.19 respectively.[48] As could be observed from these figures and the statistics kept by the NBE, each commercial bank undertaking business in Ethiopia has reserve balance in excess of the limit provided by law.

These figures show that commercial banks operating in Ethiopia enjoy reserve balance in excess of the required limit. But, as in the case of liquid assets, the insignificant excess of reserve balance of commercial banks is a manifestation of their illiquidity. It is remarked

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[46]Supra note 18. But, what is being heard from private banks is just the opposite. They say, the NBE will not allow withdrawal of the excess amount. Supra note 36

[47]Supra note 25

[48]Ibid. However, the researcher is not able to get the level of reserve balance of commercial banks after November 2006, for the statistics is said to be confidential until some times in the future.

that all private banks comply with the reserve requirement not because they have excess money, it is rather due to fear of the consequences.[49] If it is heard that a certain bank has failed to fulfill its reserve requirement, the image of that bank will undoubtedly be damaged whose consequence is very devastating.

In addition to the reserve balance indicated under Art.16(5) of Proc. No 83/94, banks are required to maintain special reserve account for provision for loss due to negligence or dishonesty. Proc. No 84/94 specifies that every bank shall either maintain a special reserve account that is, in the opinion of the NBE, adequate and exclusively reserved for the purpose of making good any loss resulting from the negligence or dishonesty of any director, manager, principal officer, or any other officer or employee of the bank, or ensure itself against such loss, to an amount and on terms that the NBE deems adequate.[50] The purpose of this special reserve or insurance scheme is to avoid a possible risk or loss that could arise due to negligence or dishonesty of bank officers at different levels. This intern could somehow protect interest of depositors, among other things. This is because, even if a bank's liquidity has been drained due to negligence or dishonesty of these individuals, the loss will be made good from the special reserve or insurance scheme.

3.3.2.2- Computation

Directive No 45/08 prescribes ways of computing reserve balance. Computation of the reserve balance will determine the amount of reserve balance that should be maintained and the deductions to be made before fixing the amount of the legal reserve balance. Pursuant to Art.4.1 of Directive No 45/08, cash items in the process of collection will not be considered during calculation of the amount of the legal reserve balance. It says, "Cash items in the process of collection, if included under deposits, shall be deducted therefrom in computing the balance of total deposits for reserve purposes." Therefore, in case cash items in the process of collection are included in the deposits or even if they form part of the deposits, they will be deducted. They do not form part of deposits for the purpose of reserve balance and thus deposits will be considered only after these items are deducted. Deposits are taken as deposits less these items.

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[49]Supra note 27

[50]Proc. No 84/94, Art.28

Cash items could be collected through the NBE and can be included in the reserve. However, it is not all these items that can be accepted as legal reserves. For these items to be included in the reserves, they have to be credited to the reserve account as per Art.4.2 of Directive No 45/08.[51] Cash items collected through the NBE will be acceptable as reserves only when they are credited to the reserve account.

As said earlier, a legal reserve is deposited with the NBE in proportion to deposit liabilities of a bank. But, the percentage will be calculated to the proportion of net deposit balances. Art.4.3 of Directive No 45/08 provides that the reserve required shall be computed on the net deposit balance. The same provision explains what the term 'net profit balance' refers to. Net profit balance is the deposit balance obtained by excluding cash items in the process of collection shown at the end of each reporting week. The reserve required, therefore, will be computed on the net profit balance, not on the gross profit balance.

3.3.2.3- Reserve Deficiencies

One of the legal consequences of non compliance with minimum reserve requirements is civil liability on the part of the defaulting bank. Art.5.1 of Directive No 45/08 specifies that "Deficiencies in reserve balance are subject to a penalty." The Directive determines how the penalty should be assessed and prescribes a special interest rate to be paid by a bank which fails to comply with the reserve requirement. This interest rate is expressed as a percentage of the difference between the required and the actual reserve level. The details will be discussed in the forthcoming sections.

3.3.3- Legal Reserve Account

3.3.3.1- Meaning and Significance

Reserve is defined as funds set aside to cover future expenses, losses, claims or liabilities which may arise from indefinite contingencies.[52] It is, therefore, a monetary account required by law to be established by banks as protection against losses. The Commercial Code of Ethiopia provides that share companies are required to establish, *inter alia*, legal reserve account required by law and transfer funds from the net profits shown in the

[51] Art.2.1 of Directive No 45/08 provides that banks operating in Ethiopia have the obligation to open two separate Birr accounts one of which, pursuant to Sub (a), is a reserve account that will exclusively be used to maintain the reserve balance.

[52] Supra note 1

profit and loss account.[53] More specifically, Art.454(1) of the Comm. C provides that, a certain amount of the net profits shall be transferred each year to the legal reserve fund. Because banks are share companies, they have similar obligation though the amount to be transferred to the legal reserve account differs from other ordinary share companies.

Proc. No 84/94, under Art.12(2)(a), provides that every bank has the obligation to maintain a legal reserve account. The Proclamation further says that a bank, before declaring dividend, deduct from the annual net profit after tax and transfer same to its legal reserve account.[54] This obligation of a bank will continue until the legal reserve account equals its capital as can be deduced from Art.13(4).

However, the NBE upon good cause may exempt a bank from this obligation for a period not exceeding twelve months, provided an agreement has been reached between the NBE and the concerned bank on a scheduling specifying the progressive application of the obligation.[55] Thus, if a bank can show 'good cause' to the NBE that it is not in a position to comply with the requirement, the latter has the discretion to exempt the former from the obligation. The problem in this regard is, Proc. No 84/94 does not specify what constitutes 'good cause'. However, officials of the NBE say that the term 'good cause' should be interpreted as a situation, for instance, a decrease in capital of a bank which could bring about undesirable consequences on its overall financial condition.[56] When such situations occur, they are good reasons to exempt a bank from the obligation of transferring a part of its net profit to the legal reserve account. However, since the absence of legal reserve could make a bank vulnerable to financial distress, the exemption to be granted by the NBE should end somewhere. Thus, Art.12(3) of Proc. No 84/94 urged the NBE to reach an agreement with the concerned bank on a schedule specifying the progressive application or restoration of the obligation.

One important significance of legal reserve account lies in that it will be employed to cover losses that a bank could encounter in due course of time. With the view to ensure that banks minimize losses, Proc. No 84/94 requires the former to make provisions for the items enumerated under the Proclamation in making the calculations necessary to

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[53]Comm. C, Art.453(1) cum. (2)(a)
[54]Proc. No 84/94, Art.12(2)(a) cum. Art.13(4)
[55]Proc. No 84/94, Art.12(3) cum. Art.13(4)
[56]Supra note 16

ascertain that a bank is complying with the provisions concerning the requirements of legal reserve.[57] Thus, the legal reserve account is used to recover the losses and liabilities incurred by a bank that arose from various contingencies as specified in the Proclamation. By doing so, the law tries to protect interest of depositors and ensure macro-economic stability.

As a matter of principle, the legal reserve account can neither be reduced nor attached as clearly specified under Art.12(2)(c) of Proc. No 84/94. Hence, once a bank transferred money to the legal reserve account, it will not have the chance to make use of it. However, there are exceptional situations whereby a bank may utilize the money found in its legal reserve account. In this regard, Art.12(2)(c)(1) of Proc. No 84/94 states that the NBE may permit the reduction of legal reserve account for the purpose of increasing the capital. If, therefore, a bank satisfies the NBE that it intends to increase its capital by transferring money from the legal reserve account, the latter has the discretion either to approve or reject the request. The same provision further states that the NBE may issue a directive and specify circumstances in which the legal reserve account could be reduced. As we can see, the permission of the reduction is not an outright one. Rather, the Proclamation opted to grant the power to the NBE to issue directives and permit the reduction of the legal reserve account. Hence, the NBE has the discretion to permit the reduction of the legal reserve account under two scenarios.

First, the NBE may permit the reduction of the legal reserve account when the purpose of the reduction is to increase the capital of a bank.[58] Thus, if a bank can show that it intends to increase its capital by transferring thereto money from its legal reserve account, the NBE may allow that. The NBE once again is armed with huge discretionary power. It can allow a certain bank to increase its capital by decreasing the reserve account but prohibit another from doing that.

Second, the NBE may issue directives and specify circumstances in which the legal reserve account may be reduced. A close look at this provision reveals that there may be situations other than the one discussed hereinabove which could push the NBE to allow

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[57] Proc. No 84/94, Art.15(1) provides the list of assets from (a-e) against which provisions should be made to the satisfaction of the NBE.

[58] Similarly, pursuant to Art.482 of the Comm. C, a share company could increase its capital by transferring thereto the whole or part of its reserve account.

the reduction of the legal reserve account. However, the Proclamation is silent as to the kind of situations based on which the NBE could issue directives and specify circumstances in which the legal reserve account may be reduced. According to persons close to the issue at hand, the NBE will issue directives and allow the reduction of the legal reserve account when it is satisfied that banks encounter a financial distress or liquidity problem.[59]

However, it should be borne in mind that interest of depositors may be endangered when the legal reserve account is reduced. The fact that the legal reserve account is reduced means that a bank will not have back up sources of defense in case something bad happens in the meantime. This obviously will endanger interest of depositors, among other things. Recognizing this fact, the Comm. C urges the substitution of the taken out money from the legal reserve account prior to distribution of profits to the share holders. The last limb of Art.482 of the Comm. C specifies that no distribution of profits should be made to share holders before the legal reserve is restored to its former position.[60] This part of the law intends to keep the *status quo.*

As a general principle, the legal reserve account may not in any way be attached. However, under exceptional situations, the NBE may allow for its attachment. In the words of Art.12(2)(2) of Proc. No 84/94:

> *The National Bank of Ethiopia shall permit an attachment of the legal reserve account when it is the only means of preventing a reduction or attachment of the paid up capital, provided an agreement has been reached on the period within which the deficiency has been made good. (Emphasis added)*

As we can see, this part of the Proclamation is mandatory and, therefore, the NBE has the obligation to permit the attachment of the legal reserve account when it is convinced that this is the only option to prevent a reduction or attachment of the paid up capital of a bank. However, because the attachment or the reduction of the legal reserve account will once again make a bank vulnerable to a sudden financial crisis, it should be restored to its former position within a reasonable period of time. Having recognized this fact, the law

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[59]Supra note 16

[60]Pursuant to Art.458(2) of the Comm. C, dividends distributed contrary to this rule are considered fictitious dividends.

requires an agreement to be reached between the NBE and the concerned bank about the period within which the deficiency is to be made good.

3.3.3.2- Amount

The amount of legal reserve account which banks are required to maintain is calculated based on the net profit which a bank makes in a financial year. Pursuant to Art.13(4) of Proc. No 84/94 every bank should, at the end of each financial year, transfer to its legal reserve account at least twenty five percent of its net profit. But, when the legal reserve account equals the capital, the amount of the net profit to be transferred to the legal reserve account shall be determined by the NBE.[61] From this, one can discern that the NBE is granted with the power to issue directives not on the amount of the net profit to be transferred each year to the legal reserve account. That is already fixed by Proc. No 84/94. Rather, the power of the NBE is limited to fixing the amount of the net profit which a bank has to transfer to the legal reserve account after it equals the capital of the bank.

This be as it may, the NBE has issued a directive on the amount of legal reserve account to be maintained by every bank.[62] Pursuant to Art.2.1 of Directive No 4/95, every bank is required to transfer annually twenty five percent of its net profit to its legal reserve account. This obligation will continue until the legal reserve account equals the capital. But, Art.2.2 of the Directive made it clear that once the legal reserve equals the capital of a bank, the amount of the obligation will be reduced to ten percent of the net profit.

At this point, it is important to raise one issue. Is a bank obliged to transfer ten percent of the net profit to the legal reserve account throughout its life? Or, for how many years does the transfer continue? Nothing is provided either under Proc. No 84/94 or under Directive No 4/95. However, according to officials in the NBE, every bank is obliged to continue to transfer ten percent of the net profit to the legal reserve account even after the latter equals its capital as long as it continues operational.[63] This is an acceptable interpretation of the law in the absence of any clue to the contrary.

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[61] Art.13(1) of Proc. No 84/94 specifies that the NBE will determine the amount in accordance with internationally accepted guidelines.

[62] Licensing and Supervision of Banking Business, Legal Reserve, Directive No SBB/4/1995 (hereinafter Directive No 4/95)

[63] Supra note 16

3.3.3.3- Computation of Legal Reserve

As discussed above, the law prescribes the minimum amount of legal reserve account which every bank is required to maintain. Moreover, using the power granted to it by law, the NBE has issued Directive No 4/95 and prescribed the amount of net profit to be transferred to the legal reserve account once it equals the capital of a bank. Art.12(2)(b) of Proc. No 84/94 further empowers the NBE to prescribe, from time to time, the method of computing the amount and form of the legal reserve account. Thus, the NBE will vary from time to time the method of computing the amount and form of the legal reserve account obviously depending upon existing situations.

However, there is one important limitation imposed upon the NBE's power of prescribing the method of computing the amount and form of the legal reserve account. The second limb of Art.12(2)(b) of Proc. No 84/94 provides that the NBE, in prescribing the method of computing the amount and the form of the legal reserve account, should take into account the method employed by the Ministry of Finance. According to the NBE, there is a method which the Ministry of Finance employs in computing amount and form of an account of financial nature and the former employs this method during calculation of legal reserve account.[64]

3.3.4- Limitation on Bank Lending and Bank Investment

3.3.4.1- Rationale behind Limiting Bank Lending and Bank Investment

Deposits are usually interest bearing which is an expense for banks. This expense takes place in the form of interests to be paid to depositors and has to be compensated in one way or another. Furthermore, banks, especially commercial ones engage in banking business with the principal objective of securing profits out of their operations and distribute same to shareholders. In order to generate profits, banks have to employ their funds in high income yielding opportunities. After collecting money from the public, therefore, banks will employ part of the depositors' money in various investment

[64]Ibid

opportunities. The money invested will generate profit that is crucial to their stay in the business. Relating to this, it has been observed:

> *It is obvious that a savings bank, if it is to pay interest to its depositors and to earn profits for its stakeholders, if any, must have the power to invest the funds held by it which are not needed by it in its ordinary course of business or which are in excess of its required or necessary cash reserves, and, indeed, it is the duty of a savings bank to invest such funds.*[65]

In addition to employing funds of depositors in various investment opportunities, banks also can give or lend money at their disposal in the form of loans to those who need it. Loans constitute a majority of banks' assets and interest earned on loans is an important source of banks' revenues.[66] Because banks target profits, they could realize this by lending their money to borrowers. Lending of funds to the constituents, mainly traders, business and industrial enterprises constitutes the main business of a banking company and accordingly the major portion of banks' funds is employed by way of loans which is the most profitable employment of its funds.[67]

Though lending and investment by banks are integral parts of their operations, these investments and loans have to be limited to a certain extent, as they could negatively affect liquidity of banks. As said earlier, liquidity requirements primarily call for keeping sufficient amount of assets and other back up sources to meet short-term cash needs. Loans and investments, on the contrary, require banks to spend money. These facts show that there is a clear incompatibility between liquidity of banks on the one hand and investment and lending on the other hand.

Because of this, restrictions are usually set in place regarding the amount, quality and areas where banks may lend their money and employ in investment opportunities. If limitations are not set against the amount of investments and loans, the sector in which they may lend and invest, the quality of investments and loans, there may appear practices that could significantly endanger the liquidity position of banks. With this

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[65]William Mack, Donald J. Kiser (Eds.), Corpus Juris Secundum (Vol.9, 1938), pp.1432-3

[66]Forest E. Myers, Basics for Bank Directors, Division Supervision and Risk Management, Federal Reserve Bank of Kansas City, (April 2005), p.39, available at http://www.kansascityfed.org

[67]P. N. Varshney, Banking Law and Practice (9th Ed., 1982), p.16

principal objective, banking regimes set limitations on investments and lending practices of banking institutions.

3.3.4.2- Limitation on Bank Lending

3.3.4.2.1- Limitation on Accommodation

Proc. No 84/94 embodies a number of rules and principles on limitations on specified operations and activities of banks. Art.17 of the Proclamation specifies how a bank may grant loans or advances to certain group of individuals or entities. Pursuant to Sub (1)(a-c), the NBE is empowered to issue directives and determine the conditions and limitations on accommodations[68] directly or indirectly granted to directors of a bank, jointly or severally or with any other person, business organizations in which a bank or one or more directors of the bank participate as owner, shareholders, directors, partners, managers or agents or members, persons to whom the bank or one or more directors of the bank are guarantors. Accordingly, the NBE has issued a directive and prescribed the conditions and limitations on accommodations to be granted to the group of borrowers specified under Proc. No 84/94.[69]

As a principle, a bank can grant or permit to be outstanding unsecured loans, advances or credit facilities to its directors, whether severally or jointly with any other person, or to any person of whom or of which it or any one or more of its directors is a guarantor. However, pursuant to Arts.3.1 and 3.2 of Directive No 10/95, a bank cannot as of right grant or permit to be outstanding such loans, advances or credit facilities to such group of individuals in excess of Birr thirty thousand. A bank can grant such loans and advances in excess of Birr thirty thousand only with the prior written approval of the NBE. When will The NBE approve such loans and when will it disapprove?

> *The NBE will approve a loan in excess of the limit prescribed by law when the loan has a significant impact on the overall development of the country. If, for instance, a certain borrower intends to utilize the loan for fertilizer purchase, electrification, telecommunication service provision and similar purposes, a bank could be allowed to extend loan*

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[68]The term 'accommodation' is defined under Art.17(3) of Proc. No 84/94 as a loan, advance or other credit facility, financial guarantee, or other liability given or incurred by a bank to or on behalf of any person

[69]Licensing and Supervision of Banking Business, Limitation on Accommodation, Directive No SBB/10/1995 (hereinafter Directive No 10/95)

to such borrowers in excess of Birr 30,000, for these areas are directly related to the overall development of the country. Nonetheless, the NBE will not approve a loan in excess of the limit prescribed by law simply because a bank wants to lend to a certain Mr. X.[70]

The law limits the amount of loans and advances a bank could grant to its directors or to persons of which any of its directors is a guarantor for a purpose. Speaking generally, because conflict of interest could involve in such kind of loans, such loans are more risky than other ordinary loans. When a certain loan is risky, the money lent will not be repaid as agreed. This obviously will negatively affect the liquidity position of a bank. Thus, in order to avoid such undesirable effects, a limit is set against loans and advances to some group of individuals.

3.3.4.2.2- Limitation on Loans to Related Parties

In addition to the above restriction, banks are usually subject to restrictions on loans and extensions of credit to related parties. Generally speaking, granting loans to insiders is always regarded as problematic. It is said that loans granted to bank insiders and to individuals or firms connected through ownership or with the ability to exert control, whether direct or indirect, has its own risks.[71] More specifically, a bank's close linkage with such group of parties will result in compromise on some lending terms. It is underlined that:

The basic reason for insider lending restrictions is to prevent those in charge of a bank from using their positions to obtain credit on preferential terms and outside normal credit underwriting standards. Such restrictions help ensure that a bank's lending is in the best interest of depositors and the community.[72]

With this objective in mind, the NBE has issued a directive and provided the nature of limitations imposed on loans to related parties.[73] As a principle, a bank can make loans to

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[70]Supra note 16

[71]Vincent P. Polizatto, "Prudential Regulation and Banking Supervision", in Dimitri Vittas (Ed.), Financial Regulation: Changing the Rules of the Game (1992), p.291

[72]Kenneth Spong, Banking Regulation: Its Purposes, Implementation and Effects (5th Ed., 2000), p.77, available at http://www.kansascityfed.org

[73]Licensing and Supervision of Banking Business, Amendment of Loans to Related Parties, Directive No SBB/30/2002 (hereinafter Directive No 30/02)

related parties although there are some limitations. Pursuant to Art.4.1 of Directive No 30/02, a bank is not allowed to extend loans to related parties (as defined under Art.2.6) on preferential terms with respect to conditions, interest rates and repayment periods other than the terms and conditions normally applied to other borrowers.

As we can see, banks are not outrightly prohibited from lending money to related parties. However, they should treat related parties in the same way they treat other borrowers. Because loans to related parties may not meet the same standards as that extended to non related parties, this kind of limitations is always considered to be justifiable. The purpose of this provision is, therefore, to prohibit banks not to favor affiliated parties on a number of conditions such as on interest rates and repayment periods. It is observable that banks usually tend to prop up or support related parties that are in trouble rather than recognizing them as problem borrowers.[74] This kind of thinking, however, could impose problems on liquidity of a bank. Due to this reason, limitations on conditions of borrowing power of banks to related parties need to be imposed.

Of course, a bank can make loans to related parties so long as the loan is not made on preferential terms. However, even the amount of loans to be extended to related parties in non preferential terms is not without limit. According to Art.4.2 of Directive No 30/02, the aggregate sum of loans extended directly or indirectly to one related party at any one time shall not exceed fifteen percent of the total capital of a bank.[75] Thus, a bank cannot in any way make loans to one related party at a time more than fifteen percent of its total capital, even if the loan is to be made on the same terms as loans to other borrowers. In addition to this, Directive No 30/02 prescribes the total amount of loans a bank can make to all related parties. Pursuant to Art.4.3, "The aggregate sum of loans extended or permitted to be outstanding directly or indirectly to all related parties at any one time shall not exceed 35% (thirty five percent) of the total capital of the bank." Here again, a bank cannot extend loans beyond thirty five percent of its total capital to all related parties even if the loan is made on the same terms as other borrowings. Here, the amount will be calculated on all related parties, not on a single related party.

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[74] Supra note 16

[75] The term 'total capital' is defined under Art.2.7 of Directive No 30/02 as the paid up capital, legal reserve and any other unencumbered reserve held by a bank that is acceptable to the NBE.

At this time, one may argue that, there is no reason to prescribe limitation on the amount of loans to be granted to related party/ies so long as the loan is made on the same terms as loans to other borrowers. However, this is not the case as can be understood from the following view:

> *Even if a loan is granted to related parties on the same terms as other borrowers, the kind of risk involved in the two scenarios is entirely different. Loans to related parties are potentially risky in their very nature for inter-related interests are involved. A risk that affects a borrower will directly affect a bank, for these two parties have inter-related interests. Thus, so as to minimize such interrelated risks and thereby ensure liquidity of banks, the limitation on the amount of loans to related parties is justifiable.*[76]

However, there are exceptions to these rules. Even if a loan is to be made to related parties on preferential terms or in excess of the limit prescribed by law, there are situations whereby the loan could be acceptable. Pursuant to Art.5(i) and (ii) of Directive No 30/02, loans to related parties which are fully secured by cash collateral[77] and cash substitutes[78] are not subject to limitations specified thereunder. The stand of the Directive is said to be acceptable for the following reasons:

> *So long as loans to related parties are fully secured by cash collaterals or cash substitutes, there will not be any kind of risk a bank will assume. This is because even if the related parties who borrowed the money fail to comply with the terms and conditions of the loan contract they signed with a bank, the latter could resort to the cash collaterals or cash substitutes within a moment's time without any problem. Due to this reason, a bank*

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[76] Supra note 16

[77] The phrase 'cash collateral' is defined under Art.2.2 of Directive No 30/02 as "credit balances on accounts in the books of the lending bank over which customers have given the lending bank a formal letter of cession and which the bank at its discretion has transferred from the customer's account(s) to a specific or general cash collateral account(s) or blocked."

[78] Art.2.3 of Directive No 30/02 defines 'cash substitutes' as a security issued by the Federal Government of Ethiopia(Art.2.3.1), an unconditional obligation or guarantee issued in writing by the Federal Government of Ethiopia or non affiliated domestic financial institution, where the beneficiary bank maintains a current written and well documented evaluation evidencing that the non affiliated financial institution is financially sound (Art.2.3.2) and an unconditional obligation or guarantee issued by a foreign bank with an a or above rating.(Art.2.3.3)

can even lend money to related parties up to its entire capital so long as the latter furnish cash collaterals or cash substitutes as security.[79]

As correctly pointed out, since there is no risk involved in such kind of loans, a bank is safe even if it lends to related parties in excess of the limit provided by law. However, it is not difficult to appreciate that a person will very rarely borrow cash from a bank by furnishing as a security cash or cash substitutes.

3.3.4.2.3- Single Borrower Loan Limit

Safeguarding against excessive concentration of risk is one of the areas through which liquidity of banks could be enhanced. Banks could increase their returns and reduce their risks or generally achieve a better combination of risk and return by diversifying their loan partners or by limiting the amount of loan to be extended to an individual or group of individuals. Extending loans to a single person only, to group of individuals or to a particular sector often increases the exposure of banks to particular risks.[80] Unless the amount of loan to be extended to a single borrower is limited, just one large problem borrower can render a bank illiquid if a borrower's loan becomes uncollectable for various reasons. Thus, since concentration in funding sources potentially increases liquidity risk, the risk should be minimized by diversifying loans.

Recognizing this fact, the NBE has prescribed limitations on the amount of loans or extensions of credit to a single borrower by issuing a directive.[81] According to Art.4 of Directive No 29/02, the aggregate loan or extension of credit by a bank to any one borrower shall at no time exceed twenty five percent of the total capital of the former.[82] Thus, a bank can lawfully lend to a single borrower to the extent only of twenty five percent of its total capital. The limit is inspired by same rational as the above one. If a bank lends a large portion of its capital to a single borrower, its interest could be highly affected in case something bad happens to the borrower. Such occurrences will significantly erode the liquidity of the bank. So, in order to avoid such kind of evil consequences, banks are not allowed to lend to a single borrower beyond twenty five

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[79] Supra note 16

[80] Supra note 71, p.290

[81] Licensing and Supervision of Banking Business , Amendment of Single Borrower Loan Limit, Directive No SBB/29/2002 (hereinafter Directive No 29/02)

[82] Art.2.6 of Directive No 29/02 defines 'total capital' as the paid up capital, legal reserve and any other unencumbered reserve held by a bank and acceptable to the NBE.

percent of their capital. At this time, even the NBE does not have the power to permit a bank to grant loans to a single borrower above the limit provided by law.

However, Directive No 29/02 under Art.5 provides exceptions, in the words of the Directive-exclusions. Pursuant to Art.5(i) and (ii), loans or extensions of credit fully secured by cash collateral and cash substitutes[83] are not subject to the credit limit prescribed by the Directive. As said before, these kinds of loans are riskless and thus a bank can lend even to the extent of hundred percent of its capital to a single borrower so long as the latter furnishes cash collaterals or cash substitutes as security. Here again, failure of such borrower to comply with the terms and conditions of the loan contract it signed with a bank will pose no potential threat on the latter, for it will proceed to the collaterals within a very short period of time without any kind of problem.

3.3.4.3- Limitation on Bank Investment

Proc. No 84/94, under Art.2(2)(b)(1), categorizes bank investment as one of banking businesses. Banks always spend part of the money they accept from depositors in various investment opportunities so as to generate profit. However, they once again are not free to invest their money as they want. With the view particularly of protecting interest of depositors, a limitation is always imposed against the amount, kind and areas where banks should invest in. As correctly pointed out by one writer, because banks invest the borrowed funds or depositors' money, their prime concern is the safety of the funds invested.[84] Therefore, it is of a paramount importance that investment by banks should not go to the extent of eroding their liquidity and thereby endangering interest of depositors. To this end, the NBE has issued a directive which sets limitations on bank investment.[85]

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[83]The terms 'cash collateral' and 'cash substitutes' are defined respectively under Arts.2.2 and 2.3 of Directive No in the same way as what is provided under supra notes 77 and 78 above.

[84]Supra note 67, p.157

[85]Licensing and Supervision of Banking Business, Limitation on Investment of Banks, Directive No SBB/12/1996 (hereinafter Directive No 12/96)

3.3.4.3.1- Types of Bank Investment

3.3.4.3.1.1- Intra-sector Investment

Intra-sector investment refers to investment by banks in other banks or other financial institutions. As a principle, a bank can invest in other banks and financial institutions. But these investment opportunities are not open to them as of right.

Banks are allowed to invest in another bank by raising equity contribution or by buying shares. Nonetheless, as clearly spelt out under Para.4 of Directive No 12/96, a bank's equity participation in another bank is subject to the prior authorization of the NBE. From this we can infer that there may be situations whereby the NBE may not allow a bank to invest in another bank. However, the Directive does not provide guidelines as to when and how the NBE may prohibit a bank from investing in another bank. The following information has been secured relating to the conditions when the NBE will prohibit or allow such investments:

> *Of course, Directive No 12/96 simply authorizes the NBE to permit or disallow a bank to or not to invest in another bank without providing guidelines. Despite this fact, the NBE will authorize or prohibit request of investment in another bank by taking a number of things into consideration. If, for instance, investment by a bank in another bank has a potential threat on its liquidity, the NBE will not grant the authorization since doing so will highly affect interest of depositors. These situations are to be judged on a case by case basis. However, when the NBE is satisfied that a bank's investment in another bank has no potential threat on its liquidity position, there is no reason for the NBE to prohibit such investment.*[86]

The other intra-sector investment in which banks may invest is insurance business. A bank may invest its funds by having equity interest in insurance companies, for instance, by subscribing to shares. But, this may lead banks to involve in business other than banking. As a result of this, investing in insurance business is usually considered to be non recommendable.

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[86]Supra note 16

Due to this reason, the law sets some limitations on investment of banks in insurance business. Paragraph 1 of Directive No 12/96 provides that no bank can engage in insurance business. In fact, it is not that clear what this means. But, it could be argued that the Directive prohibits a bank from establishing an insurance company as one of the founders. The intention of the Directive is to protect interest of creditors, because if a bank establishes an insurance company as one of the founders, it will be jointly and severally liable.[87] This joint and several liability will be highly prejudicial to interest of depositors of a bank because if it is a founder, the bank may be individually obliged to satisfy the whole claims of creditors of the insurance company in case the latter fails to discharge its debts.

Save this prohibition, the same paragraph allows banks to hold shares in an insurance company as an ordinary shareholder, although the extent of shares which they may hold is limited. Para 1 of Directive No 12/96 states that a bank may invest in an insurance company to the extent only of twenty percent of the shares of the latter. Beyond and above this, Para 1 of the Directive states that a bank may hold shares in an insurance company to the extent only of ten percent of the equity capital of the former. Generally, a bank is allowed to invest in insurance business subject to the limitations provided under Directive No 12/96. It can invest in an insurance company to the extent of twenty percent of the total shares of the insurance company. If a bank holds shares amounting only to twenty percent of the shares of an insurance company, but has committed more than ten percent of its equity capital, that will be against what the Directive says. Conversely, even if a bank purchases shares of an insurance company by committing less than ten percent of its equity capital, the total number of shares should not be greater than twenty percent of the shares of the insurance company. Thus, a bank should invest in an insurance business by observing both of the limitations at the same time.

These prohibitions and limitations again are motivated by protection of interest of depositors. If a bank commits more than ten percent of its equity capital in another insurance company or if it purchases more than twenty percent of the shares of an

[87]Comm. C, Art.308(1). It says that founders of a share company are jointly and severally liable to third parties in respect of commitments entered into for the formation of the company.

insurance company, that may be prejudicial to interest of the former. Failure of the insurance company for a reason whatsoever will directly affect the bank and consequently it may encounter liquidity risk.[88] In order to avoid such risk, therefore, the Directive sets limitation on investment in another insurance company.

The other area where banks may invest is in securities. Generally a bank can invest in securities. But, there is a limitation on the amount a bank can invest in securities. Within the wordings of Para 6 of Directive No 12/96, a bank is not allowed to invest more than ten percent of its net worth in other securities.[89] Here, unlike bank investment in insurance companies, the limit is to be calculated on the net-worth of a bank, not on equity capital.

Beyond and above this, the Directive prescribes another limitation against bank investment in securities. It determines how banks could invest in securities. According to Para 8 of Directive No 12/96, a bank may deal with securities only through a limited liability subsidiary company.[90] However, Para 8 of the Directive clearly provides that the holding of a bank in a subsidiary company cannot exceed ten percent of its equity capital. Here, the Directive prescribes two sets of limitations.

The first limitation has something to do with the equity share of a bank in a subsidiary company. The holding of a bank in a subsidiary company should not be more than ten percent of the former's equity capital. Thus, a bank can deal with securities through subsidiary companies when its holding in a subsidiary company is not greater than ten percent of its equity capital. It seems that even the NBE does not have the power to permit a bank to invest in securities by committing more than ten percent of its net-worth.

The second limitation is on the way of dealing with securities. Even if a bank is allowed to invest in securities, it cannot, however, do it by its own or directly by itself. Rather, it is allowed to deal with securities only through subsidiary companies. The Commercial Bank of Ethiopia and Construction and Business Bank, for instance, deal with shares

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[88]Supra note 16

[89]Directive No 12/96 does not define what 'net worth' means. But, Black's Law Dictionary defines the term 'net-worth' as the excess of total assets over total liabilities. See supra note 1

[90]Directive No 12/96 does not, however, define what subsidiary company refers to. But, it seems that the term 'subsidiary companies' refers to companies related to a bank and owned some shares in it.

through a subsidiary company called 'Commercial Nominees' which they jointly established.[91]

3.3.4.3.1.2- Inter-sector Investment

By inter-sector investment is meant investment of banks outside the financial sector. As a general principle, a bank may engage in non banking and non financial undertaking. But, before engaging in these businesses, a bank needs to secure the prior approval of the NBE.[92] Thus, Directive No 12/96 some what changed the stand of Proc. No 84/94. According to the Directive, it is exceptionally (not as a rule as specified in the Proclamation) that banks could engage in non banking business.

According to Para 2 of Directive No 12/96, banks are prohibited from engaging directly in non banking business. Of course, what is meant by non banking business is not clear in the Directive except that it specifies agriculture, industry, and commerce as representatives of non banking business. According to officials from the NBE, 'non banking business' refers to businesses of banks which are not included in their objectives as specified in their memorandum of association or in their respective establishing statutes in case of government owned banks.[93] Hence, the door is slum shut against engagements in some non banking businesses both as founder and shareholder.

A critical look of this provision reveals that it is the direct engagement of banks in non banking business which is prohibited. This implies that banks are allowed to indirectly invest in non banking business such as agriculture, industry and commerce. Actually, the Directive does not define what the term 'directly' refers to. Moreover, it is very difficult to determine what direct and indirect engagements are. This being the case, while direct engagement of banks in non banking business such as agriculture, industry and commerce is totally prohibited, the indirect one is allowed.

Although a bank is allowed to indirectly invest in non banking business, the law prescribes a limitation on the amount of the investment. Pursuant to Para 3 of Directive No 12/96, a bank can hold shares in a single non banking business to the extent only of twenty percent of the share capital of the latter. The same provision further provides that the total holdings in such business shall not exceed ten percent of the net-worth of a bank.

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[91] Supra note 16
[92] Proc. No 84/94, Art.27(3)
[93] Supra note 16

In this regard, even the NBE is not authorized to permit a bank to invest in non banking business beyond these limits.

The other investment area which banks could engage in is real estate investment.[94] As a general rule, a bank is allowed to engage in real estate investments. However, there is once again a limitation. According to Para 5 of Directive No 12/96, no bank may commit more than twenty percent of its net-worth in real estate acquisition and development without the prior approval of the NBE. This shows that a bank is free to engage in real estate acquisitions and investment so long as the investment amounts only to twenty percent or less of its net-worth. However, if the investment amounts to greater than twenty percent of its net-worth, the prior approval of the NBE has to be secured. But, this limitation does not apply to investments of banks in their own business premises. Thus, a bank can invest in its own business premises even by committing more than twenty percent of its net-worth without the need to secure the prior approval of the NBE. Banks are allowed to invest in own business premises without any limit due to the minimum risk involved in the investment.[95]

As we can understand from the above discussions, banks could invest in a number of investment opportunities at the same time subject to the prohibitions and restrictions of individual cases. However, Directive No 12/96 came up with another form of limitation. Even if a bank may invest in various investment areas, the aggregate sum of all investments at a time may not exceed fifty percent of its net-worth. If investing in various investment areas involves more than fifty percent of the net-worth of a bank, prior permission of the NBE is necessary. The prior approval of the NBE, therefore, is not a requirement if the aggregate sum of all investments at a time is fifty percent and less than fifty percent of a bank's net-worth. However, the amount of money involved in government securities will not be considered in the calculation. The exclusion of investment in government securities from the calculation stems from their very nature. Investing in government securities is relatively safe and there is no danger in them.[96] Due

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[94]Black's Law Dictionary defines the term 'real estate' as land and any thing permanently affixed to the land, such as buildings, fences and those things attached to the buildings. See Supra note 1.

[95]Supra note 16

[96] Ibid

to this reason, it is not found feasible to consider investment in securities in the calculation.

CHAPTER FOUR

REGULATORY MODALITIES AND CONSEQUENCES OF FAILURE TO COMPLY WITH LIQUIDITY REQUIREMENTS

4.1- Introduction

As said earlier, the NBE is designated by law as the primary organ entrusted with the power to regulate liquidity of banks. The law specifies regulatory modalities which the NBE may employ in discharging its responsibility. Moreover, the attainment of these objectives lies behind the implementation of the prevailing laws, rules and regulations and sanctions follow in the event of non compliance. With this principal objective in mind, the banking laws prescribe liabilities and sanctions that will arise when a certain bank fails to observe and comply with banking laws in general and those relating to liquidity requirements in particular. This chapter is devoted to these and other related issues.

4.2- Regulatory Modalities

4.2.1- Off-site Surveillance

While grant or denial of a license is the initial means of enforcing the requirement of the law, continuous enforcement of it is sought by a number of mechanisms; one of which is off-site surveillance. Off-site surveillance involves the receipt, review and analysis by the NBE of financial statements and statistical returns submitted to it by each and every bank. Presently it is widely accepted that off-site surveillance provides an important element to supervise and regulate activity of banks in general and of their liquidity requirement in particular. It serves as a complement to an on-site examination (which will be discussed in the forthcoming section) by providing early warning of actual or potential problems and a means for monitoring and comparing financial performance.

NBE requests information from banks primarily for the purpose of verifying, *inter alia*, their liquidity or financial stability. Pursuant to Art.19(3) of Proc. No 84/94, every bank shall, within twenty days from the end of each month, send to the NBE a duly signed

balance sheet showing the position on the last working day of the preceding month and a semi-annual profit and loss account within the month following the preceding six months. According to this part of the Proclamation, every bank has two primary obligations. First, it should, within twenty days from the end of each month, send to the NBE a duly signed balance sheet that shows the position on the last working day of the preceding month. This is a monthly report. This report will enable the NBE to evaluate the performance of a bank in every month. Second, every bank has the obligation to send to the NBE a semi-annual profit and loss account within the month following the preceding six month period. This is a semi-annual obligation/report. From the semi-annual data submitted to it by different banks, the NBE will have a clear picture about the credit and deposit position of each bank in the previous six months.

Banks still have other obligations. According to Art.19(4) of Proc. No 84/94, every bank has the obligation, within one month from the closing of each financial year, to send to the NBE a duly signed balance sheet and profit and loss statement for the preceding year. This is an annual obligation that gives the NBE information on the overall financial condition of banks in a given financial year. These reports will serve as the basis on which banks will be judged for financial soundness.[1] The NBE will employ the reports as input to reach a decision to take or propose to be taken such measures which it deems are appropriate.

In addition to these periodic obligations, Proc. No 84/94 entrusts further power to the NBE to require banks whatever information it wants. It is stated that, "The National Bank of Ethiopia may require each bank carrying on business in Ethiopia to furnish to it, periodically or upon request, such information as it considers necessary to fulfill its functions..."[2] This provision, as can be seen, gives huge powers to the NBE to require information of any nature from any bank at any time.

Apart from the rules governing the various kinds of information to be submitted by banks to the NBE either from time to time or in response to a particular request, the law requires banks to publish information that will display their status. Art.19(6)(b)of Proc. No 84/94, for instance, provides that every bank has the obligation to cause balance sheet and profit

[1]Interview with Ato Kurene Tesgera, Banking Supervision Department of National Bank of Ethiopia, February 7, 2008

[2]Proc. No 84/94, Art.19(8)

and loss account to be published in a daily news paper circulating in Ethiopia. The purpose of the publication is to give the public generally and investors and customers particularly information about a bank's operations and performances.[3] Obviously, this information will enable these bank stakeholders to protect their financial interests.

Banks have also the obligation to make some financial records available to the public for inspection. Pursuant to Art.19(6)(a) of Proc. No 84/94, every bank has to exhibit at every one of its place of business, including branches, in a conspicuous place throughout a year a copy of the last audited balance sheet and profit and loss account in respect of all of its operations. The documents posted will contain details about the overall performance of a bank including its liquidity position.

However, the NBE does not watch over whether or not each and every bank complies with this obligation. It is said that even though the NBE does not check the observance of the requirement, it knows that banks comply with this obligation.[4] However, this is not what has been expected from an organ which is in the forefront to check whether or not the law is being complied with. As said time and again, banking business by its very nature demands the close supervision of the market actors. In line with this, the NBE is given the mission to watch over the unconditional observance of banking laws. However, if the NBE fails to discharge its responsibilities by assuming that banks will not go against the requirement of the law, problems will appear which will bring about a lot of undesirable consequences.

There are also situations where banks should notify the NBE about the happening of a fact which could endanger interest of depositors and other creditors. Pursuant to Art.19(7)(a) cum(b) of Proc. No 84/94, a bank has to forthwith notify the NBE the full facts of a situation and provide such other information as the NBE may request. The obligation rips when it appears that a bank is likely that it cannot meet its obligations to depositors or other creditors or that it may have to suspend payments to them. Based on the information submitted to it by such banks, the NBE will proceed to take measures appropriate under the circumstances.

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[3]Supra note 1
[4]Ibid

Beyond and above these requirements, banks also have other reporting obligations on a number of matters provided in different directives issued by the NBE. The reports will be submitted to the NBE within twenty days after the end of the period for which the data are reported in the form and manner attached with the directive.[5]

In addition to these general reporting requirements, banks are also required to submit to the NBE various reports on various matters. For instance, they have the obligation to report to the NBE their reserve balance. Art.6 of Directive No 45/08 states:

> *For the purpose of determining strict compliance with the reserve requirement stated under article 2 of these Directives, properly checked and signed reports, showing balances as of each Wednesday, shall be submitted to the Supervision Department of the National Bank of Ethiopia. The reports shall be submitted not latter than Tuesday of the following week and shall show the balance of each type of deposit under article 2 hereinabove, reserve balance with National Bank of Ethiopia and the excess/shortfall in reserves.*

These reports are weekly reports and should be prepared and be submitted to the NBE in a form called 'Form SD 3'. The report is required to show the balance of each demand/current deposits, savings deposits and time deposits. Moreover, the reserve balance with the NBE and the excess or shortfall in reserves should be clearly indicated in the report. Based on the report, the NBE will evaluate the reserve position of each and every bank.

Art.5 of Directive No 44/08, on it part, obliges every bank to submit to the NBE properly certified weekly liquidity positions showing the end-of-week balances of each Wednesday not later than Tuesday of the following week. Moreover, banks need to submit their weekly liquidity position to the NBE. As to the manner of reporting, a bank should use a form called 'Form SD 3'. In the report, the kinds of deposits (demand, savings, time), liquidity requirement (excess/deficiency of reserve), current liabilities, liquid assets etc should be clearly shown. The report reveals about the liquidity position

[5]Licensing and Supervision of Banking Business, Manner of Reporting Financial Information, Directive No SBB/21/1996 (hereinafter Directive No 21/96)

of a bank and will serve as a legal basis to the NBE to ensure the quality of liquid assets held by each and every bank.

In addition, banks are required to submit to the NBE key financial data such as the composition of lending and the scale of non performing loans on a regular basis in order to identify all the risks which each bank is exposed to.[6] Art.11 of Directive No 32/02 provides that banks shall submit to the supervision department of the NBE a quarterly report on loan classification and provisioning. Banks will report the status of non-performing loans/advances and provisions using 'Form SD 4'.

Banks are also required to file a number of reports concerning their lending activities. Accordingly, every bank shall file reports showing month-end exposures to each related party within twenty days after the end of the period for which the data are reported.[7] It is a monthly return on related parties. The report is to be prepared in 'Form SD 7' and is required to display clearly the list of twenty largest borrowers.

Moreover, Pursuant to Art.6 of Directive No 29/02, banks have the obligation to file, within twenty days after the end of the period for which the data are reported, information showing month-end exposures to every single borrower which exceeds ten percent of the total capital of a bank. The reports shall be submitted in accordance with a form called 'Form SD 6'. The form requires banks to report credit concentration by listing loans in excess of ten percent of their respective capital. Moreover, they are required to clearly prepare and submit to the NBE credit concentration by listing ten largest borrowers.

As we can see, the law prescribes stiff reporting requirements concerning various activities and operations of banks. According to some, the stiff reporting requirements are clear indications that the NBE mostly relies on off-site surveillance to control and supervise activities of banks. It is said:

> *The NBE undertakes most of bank supervision through the various periodic reports submitted to it by banks. This is due to NBE's incapacity to employ on-site examination as a regulatory tool. Due to this fact, the NBE in effect tries to substitute on-site examination for off-site surveillance. In most of the cases, it is not the NBE that goes to each*

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[6]Supra note 1

[7]Directive No 30/02, Art.7

and every bank and inspects their activities, but it is the opposite which is happening.[8]

This be as it may, these various information the NBE collects from its off-site surveillance is used to score a bank on its performance-ranging from 1 (unsatisfactory) to (strong) and the results are reported to the governor and to its board.[9] If from the reports submitted to it on various issues, the NBE believes that further inspection or examination should be arranged to get full-fledged information on the overall performance or on a specific area, it will physically go to banks and undertake the inspection or examination.

4.2.2- On-site Examination

As has been discussed in the previous section, the NBE can supervise the liquidity requirements of banks through periodic reports of banks. Periodic reports or off-site surveillance, though a very important supervisory tool, may not be enough to fully control activities and operation of banks. Thus, information collected through off-site surveillance alone should not be used to judge the financial soundness or liquidity position of a certain bank and hence, it would be inappropriate to rely on periodic reports as more than a complement to on-site examination. Thus, information gathered off-site should be affirmed by on- site examination.

Extensive powers relating to the inspection of banks is conferred upon the NBE. Thus, on top of the off-site surveillance discussed above, the NBE does physically go to banks and collect information on various areas. Proc. No 84/94 defines the scope of the inspecting power of the NBE very broadly. Art.20(1)(a) provides that the NBE can periodically or at any time make or cause on-site inspection to be made of any bank. The same provision further says that the inspection could be made with or without prior notice and the NBE determines the scope and form of the on-site examination. What does this mean?

On-site examination undertaken by the NBE or other bodies on its behalf can take different forms. It could be full scale, where all main risks and operations of a bank are examined. In this case every operation and document of a bank will be examined. The on-site examination could also

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Interview with Ato Assamenew Berega, Legal Services (Head), Wogagen Bank S. Co., February 13, 2008
Supra note 1

be special which is limited in its scope where the examination covers only certain areas of risk, for example, asset quality and specific area of bank operation.[10]

The purpose of on-site examination is to ensure that banks operating in the country are complying with rules and regulations including those relating to liquidity requirements. Through on-site examination, the NBE will collect on the spot information that will indicate the current financial conditions of banks and their compliance with applicable laws and regulations. Specifically, the NBE will asses a number of things including their financial position, soundness of operation, documentation and recording systems, organization, the quality of loans, investments and other assets, loan management procedures, verification of various returns (reports) filed to it at different times.[11] Especially, different banking operations that have a direct or indirect bearing on the liquidity of banks are to be inspected. This is crucial to overcome some of the shortcomings of off-site surveillance such as unreliable or misguided reports.

The NBE could undertake the examination by its own or through other bodies or organs. According to Art.20(1)(a) of Proc. No 84/94, the examination could be carried out by trust worthy and qualified persons or firms employed by the NBE for this purpose. The inspecting power of the NBE covers the right to inspect the books and accounts of banking institutions. Particularly, the examination could include the right to examine all documents, paper, or records which enable the examiners to ascertain the true condition of a bank being examined.

Some banks operating business in Ethiopia have many branch offices. For instance, Commercial Bank of Ethiopia alone has more than one hundred and ninety branches throughout the country. It does not, however, mean that all these branches will be examined on-site by the NBE. Rather, on-site examination will be done on a sample basis and based on a possible problem gathered off-site. The examination will start from the most dominant branches (owing to their important impact) and then to known problems of a bank and to those branches that have not been examined for long periods.[12] Then, the

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[10]Ibid

[11]Interview with Ato Getahun Nana, Banking Supervision Department of National Bank of Ethiopia (Manager), February 1, 2008

[12]Ibid

results obtained will be analyzed in a way to reflect not only the financial position of the examined bank branch alone, but also of all branches which have not been actually examined.

As a general principle, the NBE will undertake on-site examination at its own motion. However, it is also possible that depositors may push the NBE to examine a certain bank. In this regard, Art.20(1)(b) of Proc. No 84/94 specifies that the NBE shall examine a bank if one-fifth of the total number of depositors or of depositors holding one-third of the liabilities of a bank made an application to that effect and produce evidences. Therefore, if either of these situations happens and that the applicants submit evidences showing that such examination is justified under the circumstances, the NBE has the obligation to undertake inspection or examination or cause a bank to be examined. Of course, the law does not come up with a clue as to the kind of evidence the depositors should produce to the NBE so that the latter will undertake the examination or inspection. But, the personnel in the NBE say that if the depositors show that a certain bank is operating not in accordance with banking rules and regulations, or that it is following unsafe or illegal banking practices, or there is fraud, that can serve as evidence for the NBE to inspect the said bank.[13]

In addition to the power to examine the books and accounts of a bank, the NBE has broad authority to request from personnel of a bank under inspection or examination such information or explanation of the records or transactions when that is found to be necessary for the proper discharge of its responsibilities. In particular, the NBE is authorized, as per Art.20(2)(b) of Proc. No 84/94, to require personnel of a bank to furnish information and explanations relating to the nature of any record or transaction. The NBE will request explanation obviously when things as expressed in the different documents are not clear and thus require further explanation or when they are contradictory to each other. In such situations, the NBE can require explanation to comprehend the genuine content of a document. Correspondingly, the personnel of a bank under inspection or examination have the duty to cooperate with the NBE by giving the required information or explanation.

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[13]Supra note 1

Once information is collected through on-site examination, it will be analyzed and processed to arrive at a conclusion. Then the NBE, pursuant to Art.20(2)(c) of Proc. No 84/94 will communicate its findings to the bank concerned so as to allow time for remedial actions to be taken to correct unsafe and unsound practices and violations of laws, rules and regulations and other problems, if there are any. If, for instance, results of the inspection or examination reveal that there is liquidity risk or that a bank is operating not in accordance with laws and regulations relating to liquidity requirements, the results and corrective actions should be outlined and communicated to the examined bank. According to Art.20(3) of Proc. No 84/94, where inspection or examination of a bank results in a finding by the NBE that the inspected or examined bank has failed to comply with applicable laws or regulations or with terms and conditions of the license, the NBE may, with due regard to interest of creditors of the inspected or examined bank, take appropriate steps

If, let us say, a certain bank is operating business by violating laws or regulations on liquidity requirements, the NBE may take any or all of the measures enumerated under Art.20(3)(a-i).[14] But, the NBE is required to take a measure by considering interest of depositors. Most importantly, as per Sub(c), it may suggest in writing corrective actions to be taken by the inspected or examined bank. This should be underlined, for the principal purpose of examination is to provide early detections of adverse trends and problems, which, if continued, might result in deterioration in the financial conditions and eventual failure of a bank.

On-site examination, therefore, is one of the most important supervisory tools which the NBE could employ to discharge its responsibility of regulating liquidity requirements of banks. But, commentators note that effective supervision and regulation of banks especially on-site examination needs considerable human capital. Needless to say, adequate staffing for bank supervision both in terms of quality and skill levels is a must.[15] Relating to the issue at hand, one question has to be raised here. Does the NBE have the

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[14]These measures include requiring the examined bank to call a meeting of its board of directors, deputing officers to watch the proceeding at any meeting of the board of directors, suggesting corrective actions to be taken, imposing a fine, prohibiting the inspected bank from accepting new deposits, ordering dismissal of directors or officers, directing the inspected bank to temporarily suspend business, revoking the bank's license and initiating a liquidation procedure.

[15]Caperio, G. Jur., 'Bank Regulation: The Case of the Missing Models', Policy Research Working Paper 1574, Washington DC: World Bank (1996), p.4

requisite experienced and skilled human resource at its disposal to effectively discharge such a Herculean task? The researcher requested reaction from the personnel in the NBE regarding the point at hand and was able to secure the following:

> *It is crystal clear that on-site examination of bank operations in general and of liquidity requirements in particular is very technical that demands a well staffed and skillful supervisory organ. Nonetheless, it is an open secret that the NBE is devoid of the necessary human resource at its disposal. More specifically, it does not have experienced and well trained staff. The problem is partly due to the age of the Banking Supervision Department of the NBE which was established only in 1996. Due to these and other related problems, some aspect of the NBE supervision is not in line with internationally accepted standards.*[16]

This is not a good news to the Ethiopian banking system. Especially, the problem will be acute given the current banking environment in the country. The number of banks operating in the country is increasing from time to time.[17] The growing number of banks obviously will pose additional burden on the scarce human resources of the NBE. As the number of banks increases, the capacity of the NBE should correspondingly increase so as to respond to the situation that will be created following the licensing of many banks. However, this is not what is happening in the premises of the NBE. As things stand now, the NBE is suffering from skilled human resource constraint to effectively examine on-site all the banks which are operating business in Ethiopia. The problem will obviously get momentum in the future when many more banks will come into the market.

In order to alleviate the human resource constrain, training and capacity building of the staff should be made use of. It is argued that inadequacies in training and development affect the supervisor's ability to build a skilled, knowledgeable and competent staff and hence, training programs should ensure that each supervisor receives not less than two

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[16] Supra note 1

[17] Currently, there are two government owned commercial banks and one development bank and eight private banks. Other banks are on their way to the market.

weeks training per year.[18] Thus, the NBE could at least minimize the problem by arranging short term and long term trainings to its staff. Relating to this, it is said:

> *The staff of the NBE has been taking periodic training especially seminars on international bank supervision in different countries. Actually, it is the higher level officials who have been participating in the trainings once in a year. Others will take trainings as there is the chance. Particularly, if the training is for free and if we are invited, we participate in the trainings. However, if the hosts of the training ask us for money, we will not participate, for the NBE cannot afford that.*[19]

This fact has chained the NBE not to work as it should have. Had the NBE been well staffed, it could have discharged its responsibilities effectively and consequently, the performance of banks could have been improved significantly. This is what can be learnt from the experience of Commercial Bank of Ethiopia (CBE). Since NBE's 1997 examination of CBE, non performing loans have been reduced to twenty four percent of the total loans, and some relate this improvement to NBE's examination.[20] This is a living evidence that shows, effective regulation of banks could significantly improve their overall performance. But, NBE's weakness interms of skilled manpower becomes an obstacle not to effectively discharge its responsibilities.

Given this fact, it is better to find a way out like what is being done in other countries. In England and Germany, for instance, on-site examination or inspection is delegated to external auditors by strengthening the reporting requirements of banks' auditors to central banks.[21] Therefore, until such time that the NBE raises the experience and skill of its staff to the required level, this is an option which it can avail itself of.

4.2.3- Keeping Records

In addition to the regulatory tools discussed hereinabove which the NBE could make use of to regulate liquidity of banks, every bank in Ethiopia has the obligation to keep records of its overall operations. Pursuant to Art.19(1) of Proc. No 84/94, every bank is obliged

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[18] Vincent P. Polizatto, "Prudential Regulation and Banking Supervision", in Dimitri Vittas (Ed.), Financial Regulation: Changing the Rules of the Game (1992), p.311

[19] Supra note 1

[20] GOE-IMF, Government of Ethiopia and the International Monetary Fund (1998), p.2, available at http://www.imf.org

[21] Supra note 18, p.299

to keep records to exhibit clearly and correctly the state of its affairs and to explain its transaction and financial position. The purpose of keeping records is to enable the NBE to determine whether or not banks comply with the law. The NBE will get information, in addition to interviews conducted during on-site examination, from the records kept by each bank. Thus, the financial records kept by banks will serve as information source for the NBE and based on the information it will deduce how a bank is doing.

In addition to the obligation to keep records showing their overall affairs, Art.19(2) of Proc. No 84/94 obliges banks to register and keep documents for each type of accommodation. Therefore, every history of the accommodation i.e. the borrower, advance receiver, amount of the accommodation, all these facts should be clearly indicated in a special document. Thus, the NBE could at any time inspect these documents and judge the financial condition of banks and compliance of laws, rules and regulations regarding liquidity of banks. Relating to the form and required entries of the documents, Art.19(2) of entrusts the NBE with the responsibility to prescribe.

4.2.4- Issuing Directives

One of the most important tools which the law arms the NBE with is the power to issue directives. Speaking generally, Art.61 of Proc. No 83/94 empowers the NBE to issue directives. Accordingly, the NBE may issue directives which are necessary for the attainment of the purpose for which it is established and for the proper implementation of Proc. No 83/94. Art.36 of Proc. No 84/94 on its part says that the NBE may issue directives that are necessary for the proper implementation of the Proclamation. This provision entrusts the NBE with the power to issue directives on any matter at any time. Here, we have to consider two points. First, the NBE may issue directives which are necessary for the attainment of the purpose for which it is established. The purpose of the bank as provided in the law is to foster monetary stability and a sound financial system, among other things.[22] These purposes are interrelated in that in order to achieve one or the other, regulating liquidity of banks is a must. Therefore, if the NBE thinks that issuing a directive is necessary to regulate liquidity requirements of banks, it can do it. Particularly, the NBE is expected to play active role by issuing new rules that are necessary for adopting markets to changing conditions and for controlling and assessing

[22]Proc. No 83/94, Art.6

the implementation of these rules. The huge power granted to the NBE in this regard is said to be justifiable for the following reasons:

> *The banking sector by its very nature is different from others in a number of points. What is a fact today may change tomorrow and as a result rules and regulations in response to the changing environment need to be laid down. Moreover, banks operating in the country should be closely watched over, absence of which will greatly affect interest of depositors and the overall economy at large. Thus, the power will enable the NBE to effectively lay rules and regulations on matters that suit the prevailing reality. This is very crucial to create, inter alia, a liquid banking industry in the country.*[23]

Second, there are also specific instances where the NBE is authorized to issue directives. For instance, Art.31(1) of Proc. No 83/94 says that the NBE may from time to time require banks to maintain in cash and in other forms of liquid assets a proportion of their deposit liabilities as prescribed by it. (Emphasis added) Similarly, within the meaning of Proc. No 84/94, it can issue directives from time to time concerning the kind and amount of liquid assets to be maintained by banks. Art.16(2)(6) of the Proclamation, on its part, says that the NBE may issue directive and approve other assets to be held by banks to satisfy their liquidity requirements. It is clear from these provisions that the NBE is authorized to determine the amount of cash and other forms of liquid assets which banks have to maintain to fulfill their liquidity requirements.

Beyond and above the power to issue directives in these areas, the NBE is also entrusted with the power to issue directives on reserve balance. According to the cumulative reading of Art.31(2) of Proc. No 83/94 and Art.16(5) of Proc. No 84/94, it has the power to prescribe, by a directive, reserve requirements as a percentage of deposit liabilities of banks. Thus, after fully comprehending the overall banking and economic environment, the NBE may decide to issue a directive to make the percentage of reserve requirements in line with the existing situation.

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[23]Supra note 11

However, it has to be born in mind that the NBE will issue directives always with the view to further interest of banks' depositors and other creditors. Relating to this, it has been held that:

> *Depending upon the prevailing conditions and interest of depositors, the NBE till now has been issuing a number of directives and determined the amount of reserve balance, kind of liquid assets a bank has to hold to satisfy its liquidity requirements and other rules related directly or indirectly to liquidity requirements of banks. Similarly, if the current situations and conditions will change after some years in the future and consequently issuance of new directives is necessary to protect interest of depositors, the NBE will do it.*[24]

However, arguments forwarded from the other end of the relationship appeal that the NBE is unduly employing its power of issuing directives to excessively control each and every activity of banks, which is not intended by the different banking laws of the country:

> *One cannot deny that the NBE should be armed with powers given its huge responsibilities. The problem is on its scope. The power given to the NBE by law is so broad that it is using it to oppress the infant banks under the pretext of regulating their activities. Moreover, the NBE is using its power to discriminate between government owned banks and private ones. To cite some instances, the current president of the Commercial Bank of Ethiopia assumed power in a way contrary to the directives issued by the NBE. When this fact happened, the NBE opted to sit folding its hands together. But, it rejected the appointment of one 'director' of Wogagen Bank by saying the appointment is not in line with the NBE directives. Moreover, when Commercial Bank of Ethiopia extended loans to six regional states against directives, the NBE said*

[24] Ibid

nothing. All these are living evidences which show NBE directives are not being equally applied on private and government owned banks.[25]

The NBE, to these allegations, gives diplomatic answers. According to officials in the NBE, the law is not a 'bible' and thus could be applied differently in different circumstances. CBE may grant loans beyond the limit provided by law because it is a government owned bank and the government will guarantee the loan which in effect renders it riskless.[26]

But, the researcher would say that the NBE's practice cannot in any way be justifiable. The same law cannot apply differently on different banks. For whatever justification, law is law and should be respected. There cannot be a justification to breach the law. If the NBE does not ensure the observance of the law by all banks, one can safely conclude that it does not have the ability or capacity to indiscriminately and effectively implement its own directives.

There are also instances that appealed to NBE's discriminatory treatment of government owned banks and private ones. The NBE, for instance, has issued a directive relating to trade with China and prescribed that any one who exports products to China should employ the L/C facility only of Commercial Bank of Ethiopia (CBE).[27] Regarding this, officials in the NBE say that CBE is selected to this for it mobilizes foreign exchange more than other private banks.[28] However, this is very difficult to accept for the foreign exchange which banks mobilize should have been left to the market. Thus, this cannot in any way serve as a reason to go to the extent of determining by a directive which bank's L/C facility should a person make use of for products he exports. This, the researcher believes, is an undue benefit accorded to CBE which adds to the resentment of private banks over the activities of the NBE.

4.3- Lender of Last Resort Facility

Despite the fact that a number of regulatory norms are laid down to ensure liquidity of banks as discussed hereinabove, they could, for a number of reasons, encounter liquidity

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[25]Interview with Ato Sisay Molla, Finance and Accounts Department (A/Manager), United Bank S. Co., February 11, 2008.

[26]Supra note 1

[27]National Bank of Ethiopia, Directive No ባቢሥዩ/097/99

[28]Interview with W/o Martha H/Mariam, Reserve Management Department of National Bank of Ethiopia, March 12, 2008

crises. Under such scenarios, banks still have a chance to meet liquidity demand by borrowing money form central banks. This is called facility of lender of last resort or sometimes called emergency liquidity funding.

Facility of lender of last resort or emergency liquidity funding takes the form of loans from, or guarantees by, central banks that is designed to assist one or more commercial banks that are either undergoing a run on deposits as a result of concerns about safety and soundness or that are experiencing a systemic financial crisis.[29] By extending short term credit to banks that encountered unexpected deposit drains or other problems, central banks could help the former avoid more drastic steps, such as a hurried liquidation of loans.[30] This facility is widely practiced in many jurisdictions. In America, for instance, the Federal Reserve Bank could lend money to banks that face chronic financial crises.[31] A bank, therefore, could avail it self of this facility and satisfy its cash shortage.

In Ethiopia too, a bank may resort to the NBE and borrow money from the latter when it faces financial crisis. This will ensure the survival of a certain bank in business under some difficulties and most importantly, it will answer depositors' claims by borrowing money from the NBE. To this end, a directive has been issued concerning how a bank could borrow money from the NBE through lender of last resort facility.[32] The preamble of this Directive says that the NBE as lender of last resort should provide credit to commercial banks when they face short term liquidity shortage arising from seasonal or excess payments over receipts. If, therefore, a bank encounters a financial distress, it will employ the discount window facility established by the NBE and borrow money from the latter and quench its money needs. Lender of last resort facility has got a lot of objectives. Regarding this, the following has been offered:

> *Strict regulatory norms are laid down with the view to ensure the financial soundness of each bank. Despite this, a bank could encounter liquidity shortage due to a number of reasons. In this case, the NBE will provide loans to a bank which is in trouble. This will help a bank to curb*

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[29]Ross S. Delston and Andrew Campbell, IMF Legal Department and IMF Institute Seminar on Current Developments in Monetary and Financial Law, Emergency Liquidity Financing by Central Banks: Systemic Protection or Bank Bailout? (May 7 - 17, 2002), p.3, available at http://www.imf.org

[30]Kenneth Spong, Banking Regulation: Its Purposes, Implementation and Effects (5th Ed., 2000), p.107, available at http://www.kansascityfed.org

[31]Supra note 18, p.354

[32]See Directive No 004/06

its liquidity shortage and most importantly to satisfy depositors' claims. The NBE will provide the facility not to help banks as such, but it is to ensure the financial stability and thereby the economy of the country. Failure of a single bank has a domino effect in that it will affect the whole financial sector and in the end the entire economy of the country.[33]

But, the NBE's discount window facility is not open to every commercial bank. For a bank to be eligible for the NBE's discount window facility, it has to fulfill the criteria specified under Art.2 of Directive No 004/06.[34] This is to ensure the prudent utilization of the credit facility in light of its very purpose.

Despite the presence of this facility, no bank has to date made use of it in the Ethiopian banking history. According to officials in the NBE, this is because no bank has ever encountered a liquidity crisis which shows that the Ethiopian banking industry is relatively stable.[35]

4.4- Consequences of Failure to Comply with Liquidity Requirements

4.4.1- Civil Liability

4.4.1.1- Corporate Liability

Pursuant to Art.210(2) of the Comm. C, share companies are legal persons. Banks, which are share companies, therefore, have their own legal personality distinct from shareholders establishing them. Thus, a bank will be civilly liable if it fails to comply with the dictates of banking laws and regulations in general and those relating to liquidity requirements in particular.

During on-site examination, the NBE may come up with a finding which shows failure of the inspected or examined bank to comply with applicable laws and regulations. Let us

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[33] Supra note 1

[34] According to Arts.2.1-2.5 of the Directive, a bank has to present evidence showing that it has encountered liquidity shortage, has exhausted all alternative sources of credit and has no excess reserves, discountable or re-discountable securities. Moreover, there should be *prima facie* evidence showing that the liquidity shortage is not due to basic problems associated with poor credit risk appraisal, incompetent financial and non-financial resources management or to fraudulent practices. Most importantly, it has to be proved that a bank is ready to comply strictly with the provisions of the Directive and with all other applicable rules and regulations of the NBE.

[35] Supra note 1

assume that a bank has failed to comply with laws and regulations on liquidity requirements. In this case, the NBE has the power, with due regard to the interest of creditors, to impose on the inspected or examined bank any or all of the measures specified under Art.20(3) of Proc. No 84/94. For instance, pursuant to Art.20(3)(d), from among the different measures the NBE could take, it may impose a fine as prescribed by directives issued by it.

Based on this power, the NBE has issued a directive and prescribed penalties that will be imposed on banks that fail to comply with the different directives.[36] Thus, two sets of liabilities are prescribed. Those banks that violet any of the directives issued by the NBE are liable to the penalties specified under Directive No 35/04. On the other hand, those banks that violate the different banking laws other than NBE directives will be answerable to the liabilities specified in the respective laws.

Proc. No 84/94 specifies a number of civil liabilities which the NBE may impose on banks which go against applicable laws or regulations. Among these penalties, it may prohibit the inspected bank from accepting new deposits and publish a notice of such prohibition in newspapers of general distribution, direct the inspected bank to temporarily suspend business in whole or in part, revoke a bank's license, or initiate a liquidation procedure.[37] The NBE has the power to take any or all of these measures. The only limit put against this power is to ensure that a measure it is going to take is in the best interest of creditors. So long as the NBE proves this, it can, depending upon the circumstances, take one or two or all of the measures. Which measure first and which next?

> *In fact, the law in black and white authorizes the NBE to take any one or more of the measures provided under Proc. No 84/94. But, these measures are, as clearly indicated in the Proclamation, to be taken with due regard to interest of creditors. If taking only a certain measure is enough to curb a particular problem and at the same time is in line with interest of creditors, that will be enough. As to the order, the NBE will start from the easiest (as provided in the Proclamation) to try to remedy*

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[36]Licensing and Supervision of Banking Business, Amendment of Penalty for Non-compliance with the Directives of the National Bank of Ethiopia Directive No SBB/20/96, Directive No SBB/35/2004 (hereinafter Directive No 35/04)

[37]Proc. No 84/94, Art.20(3)(e), (g), (h), (i)

the situation and the worst of the measures will be initiated as a last resort.[38]

As has been stated time and again, the NBE is conferred with power to issue directives from time to time to discharge its responsibilities. Every bank operating business in Ethiopia has the obligation to comply with directives issued by the NBE. Art.2.1 of Directive No 35/04 provides that, any bank that fails to comply with the requirements of any of the directives of the NBE will be subject to Birr 10,000 penalty for each violation. Hence irrespective of the gravity of the violation, a bank that fails to comply with any of the directives we discussed earlier will be liable to Birr 10,000 fine.

There are also situations whereby a bank may be subject to additional penalties than what is discussed hereinabove. According to Art.2.2 of Directive No 35/04, the NBE is entrusted with the power to take any measure it considers necessary other than that prescribed under Art.2.1 of the same Directive. Here again the NBE enjoys wide discretionary powers. The Directive did not leave a clue as to the kind of the 'other measures' the NBE could take. At this point, one has to pose the question, what possible measures can the NBE take in addition to that provided by law? Can the NBE take, for instance, more serious measures than the penalty provide under Art.2.1 of the Directive? The following has been forwarded in response to the question:

> *Directive No 35/04 unequivocally gives power to the NBE to take other measures, without any limit. So, the NBE can take even more serious measures than the 10,000 Birr penalty, for the Directive does not say the NBE cannot take more serious measures than the 10,000 Birr penalty. The only thing the NBE has to do is to make sure that 'the other measure' it is going to take is necessary under the circumstances.*[39]

The researcher, however, does not agree with such interpretation. The Phrase 'other measures' needs to be construed narrowly. Directive No 35/04 some how limited the extent of penalties that the NBE can impose on a bank that does not comply with directives issued by the former. The NBE can, in addition to the civil penalty, take other

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[38]Supra note 1
[39]Ibid

measures that are appropriate. However, it cannot take more serious measures than what is provided under Directive No 35/04. As a principle, a person cannot be liable to more serious measure than what is provided in the law. So, the 'other measure' which the NBE could take relates to other conservatory measures that ensure the well-being of the concerned bank.

The Directive in the same provision (Art.2.1) says that the penalty specified thereunder does not concern Directive No SBB/14/96 (which is amended three times by Directive No SBB/37/2004, Directive No 42/2007 and Directive No 45/08). This shows that failure to comply with reserve requirements will bring about a different set of penalties.

As a general rule, deficiencies in reserve balance are subject to a penalty.[40] Regarding the assessment of the penalty, Art.5.2 of Directive No 45/08 provides, "The penalty shall be assessed at a rate twice the current average rate of interest on loans and advances charged by banks computed on the amount of the deficiency in reserve and multiplied by the number of days over which the reserve account remained deficient." Therefore, the amount of the penalty is not pre-determined. Rather it goes with the number of days the reserve remained below the level prescribed by law and will be calculated based on the rate of interest charged by banks on loans and advances. It will be computed on the amount of the deficiency in reserve and multiplied by the number of days over which the reserve account remained deficient. If, for instance, banks charge 9.75% interest rate on loans and advances and a bank's reserve level is less by Birr 50,000 than the required amount and the reserve account remained deficient, let us say, for a month, the bank will be penalized two times 9.75% on Birr 50,000 and multiplied by thirty.

However, Directive No 45/08 under Art.5.3 gives discretion to the NBE to waive the penalty on grounds it considers reasonable. Once again, the NBE is entrusted with wide discretionary power. To make matters a bit complicated, the Directive does not come up with guidelines as to when the NBE can waive the penalty. But, the following is forwarded by the NBE regarding the issue at hand:

> *The NBE will waive the penalty when it is satisfied that doing so is justifiable under the circumstances. For instance, if it believes that the reserve balance of a bank was less than the required amount due to*

[40]Directive No 45/08, Art.5.1

misunderstanding between the concerned bank and the NBE, for instance, if the bank debits but if the NBE fails to credit the balance to the legal reserve account of the former, or if a bank is a newly established one and thus does not know the technical aspect of the obligation or short of money, the penalty may be waived.[41]

For the researcher, this is a very wide discretionary power that may push the NBE to abuse its power. Of course, it is very necessary that the NBE should exercise discretionary power and it is ok that the Directive is flexible. But, so as to minimize abuse of power and favoritism, it would have been better to provide guidelines the NBE should consider when it exercises its discretion.

4.4.1.2- Personal Liability

As a general principle, shareholders of a share company (including of a bank) are liable only to the extent of their contribution.[42] Share holders are insulated behind a corporate veil that separates them from their bank. However, there are exceptional situations whereby the corporate veil will be pierced and thereby individual shareholders will be held personally liable for debts of their bank. One of these situations is provided under Art.20(3)(f) of Proc. No 84/94. According to this provision, if a bank fails to comply with applicable laws and directives, the NBE can, with due regard to interest of the concerned bank, order dismissal of one or more directors or officers of the bank. When we say a bank has failed to comply with applicable rules and regulations, the fault will obviously be committed by physical persons who manage the bank. Therefore, the corporate veil which the law created will no more stand for them and consequently they will be liable personally.

In addition to these liabilities incorporated under Proc. No 84/94, the Comm. C prescribes joint and several liability on directors for any fault they commit. Pursuant to Art.364(2) of the Comm. C, directors will be jointly and severally liable for damage they cause due to failure to carry out their duties. If a bank becomes illiquid, for instance, due to loss of liquid assets, reserve balance, loss due to loans and investment beyond the statutory limit or due to the illegal, fraudulent acts or any other act, directors at fault will be jointly and

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[41] Supra note 1
[42] Comm. C, Art.304(2)

severally liable. As expressly specified under Art.364(5) and (6) of Comm. C, a director could escape from such liabilities only when it is proved that he/she/it has exercised due care and diligence or that he/she/it was not at fault. By prescribing such penalties, the law encourages greater involvement of directors in closely supervising the affairs of a bank and to guard against potential abuses prejudicial to interest of depositors, other creditors and of course shareholders.

4.4.2- Criminal Liability

4.4.2.1- Corporate Liability

In addition to civil liabilities discussed above, banks are criminally liable when they fail to comply with banking laws and regulations in general and with liquidity requirements in particular. The *raison d'eter* behind such rules, in one way or another, is to preserve liquidity of banks and thereby protect interest of depositors.

As said earlier, every bank is obliged to maintain liquid assets as prescribed by the NBE. The NBE, through Art.3 of Directive No 44/08 made it clear that every bank has to maintain liquid assets of not less than twenty five percent of its total current liabilities of which at least twenty percent in the form of primary reserve assets and five percent in the form of secondary reserve assets. A bank is guilty of an offence, if for whatever reasons, it allows its holding of liquid assets to be less than these limits. In such cases, a bank will be liable on conviction to a fine not exceeding Birr ten thousand for each day during which it permits its liquid assets to be less than these limits.[43]

A bank is also guilty of an offence and will be liable on conviction to a fine not exceeding Birr ten thousand for each day when it fails to furnish, within a reasonable time as prescribed by the NBE, any information required by same to satisfy itself that it is observing the requirements of minimum liquid assets.[44]

As said earlier, banks are not allowed to grant or permit increases in advance or overdrafts without the prior approval of the NBE when at any time its liquid assets are less than that prescribed by law. Failure to comply with this is an offence. Art.16(3)(c) cum Art.16(4)(c) of Proc. No 84/94 made it clear that a bank will be liable on conviction to a fine not exceeding Birr ten thousand. This shows that when the level of liquidity of a

[43]Proc. No 84/94, Art.16(3)(b) cum Art.16(4)(b)
[44]Proc. No 84/94, Art.16(3)(a) cum Art.16(4)(a)

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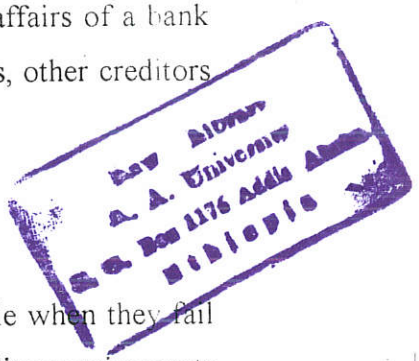

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[43]Proc. No 84/94, Art.16(3)(b) cum Art.16(4)(b)
[44]Proc. No 84/94, Art.16(3)(a) cum Art.16(4)(a)

bank is below the level prescribed by law, it should not perform activities that could worsen the situation by granting or permitting increase in advances or overdrafts.[45]

Pursuant to Art.29(1) of Proc. No 84/94, a bank is prohibited from accepting deposits while it is insolvent. If, however, a bank receives any deposit while insolvent, it is guilty of an offence and will be liable on conviction to a fine not exceeding Birr 50,000 as per the same provision. If a bank solicits and receives deposits while it is insolvent, obviously, interest of depositors will be prejudiced for the bank will not pay their money when demanded. So, the law prescribes penal liabilities to deter such practices.

4.4.2.2- Personal Liability

In the discussion we just saw, a bank is guilty of an offence when it commits any of the faults under Art.16(3)(a-c) and consequently will on conviction be liable to a fine not exceeding Birr 10,000 and imprisonment of three to five years.[46] (Emphasis added) Here, a close look at the provision reveals that the main reference is about criminal liability of a bank, a corporate entity. However, when the law imposes liability of imprisonment on a bank, obviously it is not saying that a bank (a corporate entity) will be imprisoned. It is the physical persons who are in the forefront of the management of a bank that are going to be imprisoned.

The law also imposes personal liability on those who run a bank by violating what the law says. Pursuant to Art.21(a) and (b) of Proc. No 84/94, any director, manager, principal officer, or any other officer, employee, or any other agent of a bank who obstructs the proper performance by an auditor of his duties or who obstructs a lawful inspection or examination by an inspector or examiner duly authorized by the NBE is guilty of an offence and consequently is liable on conviction to a fine not less than Birr 10,000 and to rigorous imprisonment of not less than five years.[47]

Similarly, pursuant to Art.21(2) of the Proclamation, these persons are guilty of an offence and consequently are liable to the same penalty when they, with the intent to deceive, make false or misleading statements or make entry in or omits any statement that should have been made in any book, account, report, or statement of such bank. The purpose is to deter these officials from performing acts that could prevent the NBE from

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[45]Supra note 1
[46]See Proc. No 84/94, Art.16(4)(a-c)
[47]Proc. No 84/94, Art.21(1)(a) and (b)

discovering in the books of a bank an account of its true condition. Here, intent to deceive the officials of the NBE or other specified persons is an essential element of the offence; negligent acts are not punishable.

There are also persons in a bank who will be liable when they fail to prevent acceptance of deposits while the bank is insolvent. Regarding this, Art.29(2) of Proc. No 84/94 goes:

> *A director, manager, principal officer, or other officer or employee of a bank who knows or ought to know of the insolvency of such bank, who receives, causes, authorizes or permits the acceptance of a deposit shall be guilty of an offence and liable on conviction to a fine of Birr 10,000 (ten thousand) and imprisonment of five (5) years.*

Thus, if depositors honestly leave their money in banks without knowing the financial position of the same, persons who could have prevented this should be answerable to their act or negligence. This clearly reveals the strong commitment of the law in safeguarding interest of depositors.

4.4.3- Temporary Management, Dissolution and Winding up

The NBE, starting from their establishment, regulates the liquidity of commercial banks operating in Ethiopia to see to it that they have the financial soundness to satisfy claims of depositors. To this end, a number of rules and regulations are laid down concerning liquidity requirements of banks, regulatory modalities available to the NBE and consequences of failure to maintain the appropriate liquidity position. All these requirements, in one way or another, are designed principally to ensure liquidity of banks and thus further interest of depositors.

Despite all these efforts, a bank may encounter liquidity shortage due to a number of reasons. Under such situations, the NBE will intervene in the affairs of such bank to prevent further ill consequences. When such situations occur, the NBE can serve notice announcing its intention of temporarily managing a bank from such date and time as specified in the notice.[48] Especially, the NBE may take over the temporary management of a bank if paid up capital of the latter becomes less than the amount prescribed by law, its business is being conducted in an unlawful and imprudent manner or in unsound condition or when the continuation of its activities is not in the best interest of its

[48]Proc. No 84/94, Art.22

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[48]Proc. No 84/94, Art.22

depositors.[49] In providing these rules, the law aims, in one way or another, at ensuring liquidity of banks and interest of depositors.

Fortunately, no bank has ever been subjected to temporary management of the NBE due to liquidity risk. This is an indication that the Ethiopian banking industry is relatively stable. Is it because of the effective supervision of the NBE?

> *Absolutely not. The main reason for the stable banking environment in Ethiopia is due to absence of stiff competition between and among banks in terms of product and service. Moreover, banks in Ethiopia are still undertaking only traditional banking services which by their very nature are riskless. Beyond and above these, there is rigorous entry barrier that could filter out 'weak banks' from entering the market.*[50]

A bank could encounter liquidity crisis due to various reasons. When the NBE believes that it will be devastating to interest of depositors if a bank which encountered liquidity crisis continues business, it may decide to take the temporary management of the latter. In this case, the NBE will be vested with full and exclusive powers of management and control over the bank as per Art.22(3) of Proc. No 84/94. If that is found to be necessary, the NBE may also decide to continue or discontinue the bank's operations, stop or limit the payment of obligations of the latter and perform other activities that are essential under the given circumstances. Regarding the nature of the temporary management, the following has been forwarded:

> *If a bank encounters financial crisis, the NBE will propose measures which it thinks are appropriate to tackle same. If things are going better, that is fine. Rather than improvement, if, however, things are becoming worse than before, the NBE will not sit folding its hands together, but will take the temporary management of the bank. The purpose of temporary management is to help a bank rehabilitate if that is possible, or to safeguard interest of depositors from being highly affected. Some thing is*

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[49]Proc. No 84/94, Art.22(1)(a-c)

[50]Interview with Ato Asfaw Alemu, Corporate Planning and Development Department (Manager), Dashen Bank S. Co., February 11, 2008. Officials from the NBE also agree with such an assertion, Supra note 1

better than nothing and hence the NBE will manage the bank to save this 'something' to depositors.[51]

Within sixty days from the date specified in the notice served to a bank or such longer period as may be permitted by the Federal High Court, the NBE has to perform any of the conditions specified under Art.24 of Proc. No 84/94. After the temporary management, things could be improved. If that happens, the NBE will restore the bank to its board of management or owners.[52] If, however, no improvement has been seen, the NBE will petition the Federal High Court for winding up of the bank as per Art.24(2). On the other hand, if it believes that compromise or arrangements between the bank and its creditors or reconstruction of the bank is feasible under the circumstances, the NBE can propose to that effect as per Art.24(3). From these available options, the NBE has to take a measure which safeguards interest of depositors.

[51] Supra note 1
[52] Proc. No 84/94, Art.24(1)

Conclusion and Recommendations

Successful economic development in a country requires financial institutions especially banks that are capable of mobilizing resources, in particular domestic savings, and channeling them into high return investments. Because of their central role in the economy, therefore, the day to day activities of each and every bank operating in a country are closely supervised and regulated by the government more than any other business sector. This is to ensure their well-being and thereby enable them discharge their roles in the economy.

Banking business has unique features which distinguish it form other sectors in that banks mobilize huge amount of money from the public in the form of deposits. Due to this reason, it is necessary that their activities be controlled from a near distance. In line with this, banking institutions operating business in Ethiopia are regulated from the moment they enter into the market. A person intending to engage in banking business in Ethiopia, for instance, should fulfill certain requirements. It should be organized in the form of a share company in which its capital is wholly owned by Ethiopian nationals. Moreover, it should have a minimum paid up capital of Birr seventy five million, should be directed and managed by trust-worthy and qualified personnel and most importantly, should secure license from the NBE before commencing banking business. After a bank enters into the market, once again it will be subject to continuing duties while conducting business.

Banks and their day to day activities are regulated for a number of reasons. Monetary stability, efficient and competitive banking system, consumer protection and depositor protection are the *raison d'être* behind regulating and supervising the day to day activities of banks in general and of their liquidity in particular. Most importantly, regulation and supervision of banking business principally registers protection of interest of depositors as the main objective. In line with this objective, it has to be guaranteed that each and every bank is liquid and hence, has the ability to fund all its contractual obligations, notably deposit withdrawals.

Liquidity is one of the essential requirements for the effective functioning of the banking system. This liquidity is crucial to a bank's reputation and even to its continued existence.

A bank with adequate liquidity is able to pay creditors, meet unforeseen deposit run-offs, accommodate sudden and unexpected changes in loan demand, and fund normal loan growth. On the contrary, a bank with poor liquidity cannot maintain or generate sufficient cash resources to meet its payment obligations in full as they fall due. Failure of a bank to satisfy particularly depositors' claims for a reason whatsoever will push the public to lose confidence on the individual bank. This loss of confidence in one bank will have a knock-on effect and wider systemic repercussions on other banks and other financial institutions and finally on the overall economy of the country. To ensure that its liabilities can be met as they fall due, therefore, a bank must at all times maintain overall liquidity resources which are adequate both as to amount and quality.

The principal responsibility in regulating activities of banks in general and their liquidity in particular is entrusted to the NBE. In fact, as Ethiopia's central bank, the NBE has the responsibility for the implementation of monetary policy and the promotion of a sound and efficient banking system. As part of its responsibilities in these areas, the Bank has an active role in managing and regulating liquidity of all the banks operating business in Ethiopia.

Proc. No 83/94, Proc. No 84/94 and the different directives issued by the NBE at different times lay down a number of regulations and rules with the view to ensure liquidity of banks at all times. The law authorizes the NBE to direct every bank of a specified class or classes to maintain liquid assets amounting to not less than a prescribed percentage of the total or specified categories of its deposit and similar liabilities. Based on this power, the NBE has issued Directive No 44/08 and prescribed that every bank operating business in Ethiopia is required to maintain liquid assets amounting to not less than twenty five percent of its total current liabilities. Liquid assets to be maintained by banks are enumerated by law and are by their very nature capable of being turned into cash immediately when the need arises. Moreover, they are required to be freely transferable assets, unencumbered by any charge or lien whatsoever. Due to their nature, a bank which encountered liquidity shortage could resort to these liquid assets and satisfy claims of depositors within a short period of time.

In addition to liquid assets, every bank is also required to maintain at all times in its reserve account a reserve balance of fifteen percent of all Birr and foreign currency

deposit liabilities held in the form of demand deposits, savings deposits and time deposits. Theoretically, reserve balance operates as a cushion against sudden demands for withdrawals of deposits. Thus, these reserves could be quickly exhausted and depositors could be paid what they demand.

Beyond and above these, every bank is required to transfer to its legal reserve account a certain amount of its annual net profit. This legal reserve account will help a bank cover future expenses, losses, claims or liabilities which may arise from indefinite contingencies. Restrictions and prohibitions are also imposed on the amount and quality of bank lending and bank investment, as unlimited and unrestricted lending and bank investments could negatively affect liquidity of banks. Banks, therefore, could lend and invest subject to these prohibitions and restrictions. The main goal of all these rules is to provide banks with the liquidity they need to meet their settlement obligations and consequently to enable them to plan for their survival at any time including during adverse occurrences.

The responsibility of ensuring observance of these rules and regulations falls on the shoulder of the NBE. With the view to enable it effectively discharge this Herculean task, the NBE is conferred upon regulatory tools like on-site examination, off-site surveillance and the power to issue directives. Thus, the NBE may physically go to banks and examine the different operations and documents of any nature or may from time to time demand from same relevant information of whatever nature. Apart from being obliged to comply with such requests for information, banks are also required by law to furnish periodic returns on their different activities and to keep records of their day to day operations so that the NBE will employ same to judge their financial soundness. More importantly, the NBE is entrusted with the power to issue from time to time directives on a number of areas. Through these set of regulatory tools, the NBE will assess the effectiveness of a bank's liquidity management system, the reliability of the reports submitted to it by each and every bank, diversification of assets and liabilities, the adequacy of liquid assts holding and generally the strict compliance by each and every bank of the rules and regulations having a direct and indirect bearing on its financial soundness.

Failure of banks to observe the different banking laws in general and those relating to liquidity requirements in particular will bring about civil and/or criminal liabilities. The liability could be corporate in its nature directed towards banks themselves or it could be personal to those physical persons who are at the top level of decision making, and on ordinary employees under special circumstances. If, on the other hand, it is shown that a bank does not meet the established legal requirements, the NBE may take the temporary management of the bank and take charge of or carry on the business of the banking institution. All these rules, in one way or another, are designed to ensure liquidity of each and every bank operating in the country.

As things stand now, the NBE is trying to discharge its obligations to its best and fortunately, the banking sector is relatively stable. However, this should not lead one to conclude that the NBE is efficient and effective in regulating banks. The truth is just the opposite. The Ethiopian banking industry is relatively stable for two main reasons. Firstly, there is no as such stiff competition between and among the market actors and this fact contributed a lot to the stable banking environment. Secondly and most importantly, all banks in Ethiopia still are operating traditional banking businesses (intermediary services) which by their very nature are relatively riskless.

Nonetheless, this fact does not guarantee that things will continue as they are now. For the banking sector by its nature is volatile, there may come times when things will turn otherwise. Particularly, the increasing number of banks coming into the market from time to time and the intense competition that may exist following this will pose additional challenge on the NBE. These facts call for further measures to be taken to keep the sector in the right truck. Hence, the researcher forwards the following recommendations:

- It is observable that the NBE is charged with huge responsibilities of regulating and supervising activities of banks in general and their liquidity requirements in particular. No doubt, this demands skilled man power. However, existing facts appeal that the NBE does not have the requisite experienced and competent stuff at its disposal to effectively discharge these huge responsibilities. Hence, some of the activities of the NBE are not in line with international banking supervision standards and most importantly with the dictates of the different banking laws of the country. For instance, the NBE mostly relies on off-site surveillance, but very

rarely employs on-site examination as a tool to regulate liquidity of banks. This is not because the latter is less effective than the former, but it is due to skilled human resource constraint on the part of the NBE which severely hampers on-site examination of all the banks. This is a living evidence which shows that NBE's weakness interms of skilled man power has firmly chained it not to discharge its responsibilities in line with international banking practices. Thus, in order to tackle this problem, capacity building in the Bank's Supervision Department should be a high priority. This could be achieved partly by arranging regular periodic seminars on bank supervisions.

- The NBE should apply its regulations equally and indiscriminately in different circumstances especially on private banks and government owned ones. There should not be different interpretation of the same rules in different circumstances. The laws should not be interpreted in one way concerning private banks and in another way regarding government owned banks. There cannot be a reason for the NBE to strictly enforce the law against private banks, but to become lenient when it comes to government owned ones. Nothing could serve as a justification for government owned banks to violate the law and more importantly for the NBE not to react against such practices when they occur.
- There are facts which show NBE's practices in excess of its mandate given to it by the law. Regarding trade with China, for instance, the NBE has issued a directive and prescribed that a person who exports products to this country should make use of the L/C facility only of the Commercial Bank of Ethiopia. Such a practice, which pushed private banks completely out of the game, is totally against its role as an impartial regulator and thus cannot in any way be acceptable. The NBE should not go to the extent of prescribing by a directive which bank's L/C facility should a person make use of for products he exports abroad. The L/C market of whatever nature should be left to the market alone and thus the NBE should retreat from such practices which show its bias towards private banks.
- The different banking laws in the country entrust the NBE with very wide discretionary powers. True, the NBE should enjoy discretionary powers given the nature of its responsibilities. Nonetheless, absence of any guidelines as to how the

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- The different banking laws in the country entrust the NBE with very wide discretionary powers. True, the NBE should enjoy discretionary powers given the nature of its responsibilities. Nonetheless, absence of any guidelines as to how the

NBE exercises its powers may lead to abuse of powers and favoritism. Thus, it would be better to prescribe some kind of rules which the NBE will employ as guidelines during exercise of its discretionary powers.

- All banks without any kind distinction have the obligation to maintain liquid assets so long as they mobilize deposits. Therefore, the stand of officials in the NBE that 'some banks which mobilize deposits could be exempted from the obligation of maintaining liquid assets' is not in line with the very purpose of the law. Development Bank of Ethiopia could be exempted from the obligation of maintaining liquid assets since it does not normally mobilize deposits. Except this, there is no reason to require a certain bank to maintain liquid assets but exempt another from such an obligation. The law targets protection of depositors of all banks and it is when they maintain liquid assets that this could be achieved. Thus, the law should be interpreted in such a way that all banks have to maintain liquid assets so long as they solicit and deposit public money.
- Art.19(6)(a) of Proc. No 84/94 clearly provides that every bank has to put, in a conspicuous place throughout a year, a copy of the last audited balance sheet and profit and loss account in respect of all of its operations. This rule is designed to make some financial records available to the public for inspection and it is through this mechanism that the public especially depositors get information regarding the financial soundness of banks. However, the NBE does not check whether or not banks do comply with this obligation. This is wrong and, therefore, the NBE should check whether or not banks discharge this obligation. Failure to do this by assuming that 'banks will not go contrary to the law' is not what is expected from the NBE which is in the forefront to ensure observance of the law.

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  - Limitation on Investment of Banks, Directive No SBB/12/96
  - Liquidity Requirement (3rd Replacement), Directive No SBB/44/2008
  - Manner of Reporting Financial Information, Directive No SBB/21/96
  - Reserve Requirement(4th Replacement), Directive No SBB/45/2008
  - Amendment of Penalty for Non Compliance with the Directives of the National Bank of Ethiopia Directive No SBB/20/96, Directive No SBB/35/2004
  - Limitation on Accommodation, Directive No SBB/10/95
  - Amendment of Loans to Related Parties, Directive No SBB/30/2002
  - Amendment of Single Borrower Loan Limit, Directive No SBB/29/2002
  - Discount Window Facility for Commercial Banks, Directive No ERMPD/004/2006

III- Interviewees

- Ato Getahun Nana, Banking Supervision Department of National Bank of Ethiopia (Manager), February 1, 2008
- Ato Assamenew Berega, Legal Services (Head), Wogagen Bank S. Co., February 13, 2008
- Ato Kurene Tesgera, Banking Supervision Department of National Bank of Ethiopia, February 1 and 7, 2008
- Ato Asfaw Alemu, Corporate Planning and Development Department (Manager), Dashen Bank S. Co., February 11, 2008
- Ato Sisay Molla, Finance and Accounts Department (A/Manager), United Bank S. Co., February 11, 2008
- W/o Martha H/Mariam, Reserve Management Department of National Bank of Ethiopia, March 12, 2008

Declaration

he undersigned, declare that the thesis is my original work and has not been presented for a ;ree in any other university and that all sources of materials used in the thesis have been duly nowledged.

Declared by:

Geleta Assefa

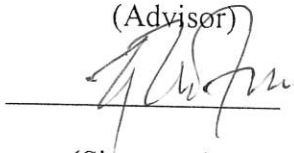
(Signature)

31 March, 2008

ıfirmed by:

Tilahun Teshome (Associate Professor)

(Advisor)



(Signature)

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