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THE PROHIBITION ON REGIONAL GOVERNMENTS' UNDERTAKING OF BANKING BUSINESS

By: Temam Mohammed

Advisor: Tilahun Teshome(Prof.)

**A Thesis Submitted to Addis Ababa University, School of Graduate
Studies, in Partial Fulfillment of the Requirements for the Award of the
Degree of Masters of Laws (LL.M) in Business Law**

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Declaration

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

Declared by:

Temam Mohammed

Signature_____

Date_____

Confirmed by:

Tilahun Teshome(Prof.)

Signature_____

Date_____

Approval Sheet by the Board of Examiners:

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By: Temam Mohammed

Approved by Board of Examiners:

Signature

Advisor:

Tilahun Teshome(Prof.)

Examiners:

1. Mr. Seyoum Yohannes

2. Mr. Yazachew Belew

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ABSTRACT

This research is conducted as an investigation into the complexities of the attempts of the Ethiopian Government to control banking business by applying strict legal framework to ban the units of the federation from owning and operating banks and its legitimacy given the form of government the constitution purports to have set up.

To start with, I accept the argument that banks are unique from other business organizations. This is for they provide the most important contribution to any economy; they uphold the public trust and confidence; they are key players in the payment and settlement system for the government, business sector and households; they mobilize deposits for which they are liable for financial assets are the property of the entire social system which are to be repaid, on demand or on their due date; they play a major role in the allocation of financial resources, acting as an intermediary between depositors of surplus funds and borrowers in need of funds; they are highly leveraged: in comparison to commercial or industrial companies *i.e.* cash flow sensitive to meet repayments.

This unique feature makes banking a risky business whose failure may result in systemic risk and necessitates special and strict regulatory intervention by governments. Among the various regulatory intervention mechanisms is the limitation put on acquisition of shares by persons which stands to be the central theme of this work for there is a blanket ban on regional states as a result of this limitation.

The nature and scope of this limitation is regulated in different countries differently. At the same time, the performance, inclusiveness and stability of banks, *inter alia* depends on how the regulatory regime concerning who owns them and to what extent is fashioned.

The concerns related to protection of infant banking industry against foreign direct investment (hence forth FDI) and the regulator's competency issues should not be relegated. As rapid privatization and liberalization of the economy has been futile elsewhere, the writer appreciates the policy stand in this respect for a lot should be done at home before guests come home with no sense of help but profit.

While the shareholding limit put on national investors began during the transitional period, with the shift in the economic policy, by the law that permitted the private sector operate the banking sector, the Licensing and Supervision of Banking Business Proclamation No. 84/1994, that law did not put any limitation on the then National and Regional Self-Governments for they may hold up to 20% of shares of a bank and even more.

In a stark departure from its predecessor, the new banking business proclamation No. 592/2008 boldly prohibited the regional states of the federation from owning and operating banking business and also reduced the shareholding limit by persons which was 20% under the previous proclamation to 5%. Indeed the 5% restriction itself seems to be too strict because it affects the capital mobilization, competition capacity and efficiency of banks which needs some flexibility. The Ethiopian law has gone contrary to the provisions of the Constitution of the Federal Democratic Republic of Ethiopia (hence forth FDRE Constitution) for the constitution nowhere authorizes the federal government to pass such a law disregarding the power of regions to establish banks of their own as state parastatals. Even worse, the proclamation authorizes the National Bank of Ethiopia (here after the NBE), which is accountable to the Prime Minister, to determine by directive the amount of shares regional governments may hold in a bank transformed from a micro-finance institution putting their autonomy in question. Though reasons pertaining to the regulatory capacity of the NBE and the small financial base of remote unbanked segment of the population may be adduced, nowhere in the minutes of the legislature can one find such rationales. And as such this provision of the proclamation banning the regional governments from owning and operating banks of their own, in the opinion of the writer, cannot be justified by any constitutional principle, but the desire of the federal government to control the sector and even enables the federal government to hold the sector in monopoly violating anti-competition laws in place. The fact of putting the regional states to the mercy of the NBE and the federal government seriously affects the decision making power given to them by the constitution, encroaching upon the very notion of federalism.

As part of a concluding remark, the findings of the research reveal that the banking business proclamation 592/2008 has been ill-considered in that it failed to take note of the state structure established by the constitution the violation of which can be justified by no measurement. Neither the NBE nor the Ethiopian House of Peoples' Representatives (the HPR hence forth) could provide any legitimate cause for the prohibition in an attempt by the writer to look for same. This law would face serious challenges by the regional governments for it goes contrary to their powers under the constitution if federalism, in its true sense, were in place in the country. Based on the result of the study, the writer recommends that policies pertaining to the concern be reconsidered and legislative measures be taken while further research is always commendable.

CHAPTER ONE

INTRODUCTION

1.1. Background of the study

The banking sector in any economy serves as a catalyst for growth and development. Banks are able to perform this role through their crucial functions of financial intermediation, provision of an efficient payments system and facilitating the implementation of monetary policies. It is not therefore surprising that governments across the world attempt to evolve an efficient banking system, not only for the promotion of efficient intermediation, but also for the protection of depositors, encouragement of efficient competition, maintenance of public confidence in the system stability of the system and protection against systemic risk and collapse.

Worldwide, the banking business is highly regulated. This is because of the pivotal position the financial industry occupies in most economies. An efficient system, it is widely accepted, and is a sine qua non for efficient functioning of a nation's economy. Thus, for the industry to be efficient, it must be regulated and supervised in view of the failure of the market system to recognize social rationality and the tendency for market participants to take undue risks which could impair the stability and solvency of their institutions.

Regulation and supervision of banks remain an integral part of the mechanism for ensuring safe and sound banking practice. Banking is one of the strategic economic areas for the state to regulate. It is a sector that is too strategic and too big to fail. It is this feature of the sector that subjects it to regulation. And it is a matter of common knowledge that the banking business has been subject to stricter rules of regulation than other sectors of the business. The fundamental rationales that give rise to such special attention and regulation of banks are basically tied to the unique features that the sector possesses. In the first place, banks carry out their activities by the funds mobilized from depositors while their capital contribution to that effect remains very low when compared to the loans they avail.¹ What is more is that depositors as creditors of a bank are dispersed so that there is little or no chance of scrutiny of the status of their bank.² Second, banks engage in numerous and large transactions with liquid assets which make them vulnerable to insider abuse and embezzlement, *i.e.*, the illiquid

¹ Charles Goodhart, Financial Regulation Why, How and Where Now? (1998) P.10.

² Ibid.

nature of bank assets and the liquid nature of their liabilities.³ Third, given the pivotal role of banks in the payment, settlement and credit system of the economy, failure of a single bank would result in substantial implication than failure of any other business organization in the economy. Unlike other forms of business organizations, banks are susceptible to systemic risk due to the contagious nature of a bank's failure.⁴ Failure of a single bank erodes public confidence in other banks as well and that the failure would spread to other banks due to the unexpected demand for payment from depositors. As the sector is too strategic to fail, the failure of one bank would inevitably lead to the failure of the other thereby failing the economy at large.

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

Regulators found that the identity of shareholders and the amount of shares they hold in banks have important bearing on addressing the special sensitivity and accompanying problems in banks.

In banking regulation, it is understood that regulators maintain limitations on the amount of shares held in banks. These limitations may relate either to the total or partial exclusion of FDI or limitations on the amount of shares to be held by a single shareholder or his/her relatives in a bank both of which are concerns addressed under the Ethiopian proclamation.⁵

With respect to the identity of shareholders, the investment proclamation and the banking business proclamation have made it explicit that foreigners may not take part in the business in any form.⁶

The limitations on the extent of shareholding in banks were introduced for the first time after the country's policy shift following the demise of the derg regime by the law allowing the private sector invest in banks, proclamation No. 84/1994, which allowed persons to hold up to 20% of shares of a bank. This law has been repealed by proclamation No. 592/2008 which reduced the amount of shares a person may hold in a bank to 5%. Though such a restriction

³ G.N. Olson, "Government Intervention: The Inadequacy of Bank Insolvency Resolution-Lesson From The American Experience," In Rosa M. Lastra (ed.), Bank Failures And Bank Insolvency Law In Economies In Transition (1999) P.111

⁴ Charles Goodhart, cited above at note 1 P.10

⁵ Banking Business Proclamation No. 592/2008, Fed. Neg. Gaz., year 14, no. 57 (hereinafter Proclamation No. 592/2008) Arts. 9 and 11

⁶ Investment Proclamation No.769/2012, Fed. Neg. Gaz., year 18, no. 63 (hereinafter Proclamation No.769/2012) Art.7 , Investment Regulation No. 270/2012, Fed. Neg. Gaz., year 19, no. 4 (hereinafter Regulation No. 270/2012) Art. 3(1)(a) and Proclamation No. 592/2008 Art. 9

on the amount of shares held by a person in a bank may be justified, the blanket ban put on regional governments under Ethiopian law stands anathema to the constitution.

1.2. Statement of the Problem

In relation to the limitation on the amount of shares held in a bank, regulators and a number of scholars provide numerous premises contending that an independent, impartial and sustainable operation of banking calls for prudent regulatory regime on who and to what extent owns a bank.⁷ There are also arguments otherwise.⁸

Beyond the theoretical discourse, however, there are differences in the practice and implementation of the limitation on ownership of banks among states. While some allowed fewer percentages, others preferred a wider margin.⁹

These theories suggest that the degree of limitation substantially affects the performance and safety of banks. Appropriate level of shareholding limit in banks depends much on the specific context of the country and demands adjustments from time to time depending on the exigencies calling for same.

As the concern is sensitive to this very strategic sector of the economy and the federal state structure established by the constitution, questioning the existing legal regime and showing the hitherto contravention of the federal arrangement is indispensable in the Ethiopian context.

Ethiopia adopted a federal state structure since the promulgation of the 1995 FDRE constitution. The constitution divided government power to the federal and regional governments. And laws enacted after the constitution trace the authority of the law maker to the constitutional provision of art. 55(1) to claim legitimacy. Likewise, proclamation no. 592/2008 was passed by the legislature to regulate banking business from its inception to its end. This proclamation under part three puts limitation on acquisition of shares. Unlike its predecessor, the proclamation reduced the number of shares one may hold in a bank from 20% to 5% and extended the limit in a much stricter fashion on the regional governments for it permits them to hold only less than 2% of the total shares of a bank. This restriction put on regional governments is so severe that it is as good as prohibition. The proclamation even goes further under art. 11(2) and gives the NBE the power to determine the amount of shares

⁷ Mehmet Erdem, "How to Get the Most Out of Foreign Direct Investment in Commercial Banking," Journal of Globalization, Competitiveness & Governability Vol.3 no.1(2009), pp.78-84

⁸ Ibid.

⁹ Ha-Joon Chang, Foreign Investment Regulation in Historical Perspective: Lessons for the Proposed WTO Agreement on Investment (March 2003). p.1.

regional governments may hold in a bank transformed from a micro-finance institution. While the justification given for reducing the shareholding limits with respect to physical/juridical persons other than governments may seem sound, the prohibition provided on regional governments' operation of banking business is rather disputable if not unconstitutional.

The FDRE constitution under art. 51 lists the powers and functions given to the federal government and nowhere therein do we find a provision enabling the federal government to put a close to blanket ban kind of restriction on the regional governments' operation of banking business. Furthermore, the proclamation gives the NBE the power to determine the fate of shareholding limits that may be held by regional governments in banks that are transformed from micro-finance institutions equating them to ordinary persons thereby denying them the status given to them by the constitution. This research, therefore, attempts to look for the legislative rationale for this prohibition and analyze them along relevant constitutional principles and other countries' experience.

1.3. Objectives of the Study

The central concern of this study is to examine the legitimacy of the existing legal regime in Ethiopia with respect to the prohibition on the regional governments' undertaking of banking business and recommend on ways out depending on the finding of the study.

This research encompasses the exposition of the theoretical underpinnings on the pros and cons of the limitation on acquisition of shares in banks by regional governments and the experience of other countries having similar state structure. In particular, the research will examine the nature and extent of the restrictions on acquisition of shares in banks by regional governments as endorsed in the proclamation and evaluate their appropriateness in the Ethiopian context.

1.4. Methodology

The writer employed a combination of several methods. In the process of explicating the theories supporting or negating the prohibition on ownership and operation of banks by regional states, reliance is made on exposition based on literature review. The exposition of the rationale for the prohibition in Ethiopia is made based on analysis of the relevant laws and dialogue with concerned authorities.

The exposition of the theoretical underpinnings, the appraisal of the experience of other countries in their laws and whether their states are allowed to own and operate banks are used

as a framework to evaluate the Ethiopian legal regime and as premises indicative of the shortcomings of the Ethiopian law to enable the writer recommend what changes may be appropriate for the Ethiopian legal regime.

1.5. Significance of the Study

This work, to the best knowledge of its writer, is the first of its kind in the Ethiopian context. It is considered to have its own academic and policy significance. It is hoped that it would initiate further studies on the subject matter. Moreover, it would table a concern before the legislature and other stakeholders as to reconsider the policy direction and evaluate their stance on the law relating to the prohibition on the regional governments' undertaking of banking business.

1.6. Organization of the Paper

In brief, this study would attempt to explore and explain theoretical discourses, the experience of some countries with federal state structure and the Ethiopian legal regime pertaining to the prohibition on regional governments' undertaking of banking business. In so doing, the writer has opted to organize the study into four chapters.

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

The second chapter is devoted to addressing who may operate banking business under Ethiopian law? In an attempt to address this question, it sees the birth, development, and regulation of banking, the prerequisites to undertake banking business under Ethiopian law and the limitations on acquisition of shares (ownership) in banks. It then inquires into the prohibition provided by the law in general and highlights the rationales attaching thereto. It also comprehensively looks into the Ethiopian investment law and displays the prohibitions provided there under.

The Third chapter entertains the limitation on acquisition of shares in banks by regional governments. It exposes the potential gains and possible adverse effects pertaining to the ownership of banks by regional governments. The prohibition of banking ownership and operation by regional governments as explored in relation to the experience of some countries that offers framework for assessing Ethiopian scenario is also dealt with in this chapter.

The fourth chapter is devoted to exploring the Ethiopian legal regime on the limitation on acquisition of shares. It, in particular, focuses on the legitimacy of the prohibition on regional

governments' undertaking of banking business. It starts with the scope of ownership regional governments may have in banks and the cause for the prohibition. This factual exposition is followed by assessment of the legitimacy and potential impacts of the prohibition. Finally, a brief conclusion and recommendation is provided.

CHAPTER TWO

WHO MAY UNDERTAKE BANKING BUSINESS IN ETHIOPIA?

2.1. The Birth, Development, and Regulation of Banking in Ethiopia:

An Overview

The first ever attempt to the establishment of modern banking in Ethiopia is marked by the establishment of the Bank of Abyssinia in 1905. The financial sector was dominated by foreign ownership until this bank was nationalized in 1931 and renamed the Bank of Ethiopia, thereby becoming the first bank to be nationally owned in Africa.¹⁰ Further financial institutions were established during the Italian occupation of the late 1930s. In 1943 the State Bank of Ethiopia was founded.¹¹

The State Bank of Ethiopia operated both as a commercial and central bank until 1963 when it was dissolved to form the central bank, the National Bank of Ethiopia (NBE), and the Commercial Bank of Ethiopia (CBE). A number of other private financial institutions were also established during the 1960s.

All of this changed with the overthrow of the monarchy of Haile Selassie in 1974. Under the Derg government, all privately owned financial institutions including three commercial banks, thirteen insurance companies and two non-bank financial intermediaries were nationalized on 1 January 1975.¹² The NBE continued its functions as a central bank, although the directives of the planning system now circumscribed its activities. The NBE fixed both deposit and loan rates (both of which were set at very low levels), administered the allocation of foreign exchange (all of which had to be surrendered to NBE), and directly financed the fiscal deficit.¹³ NBE's bank supervision and regulation was largely restricted to off-site inspection of a few bank branches.

By allocating credit and foreign exchange in favor of the state sector, NBE constituted a powerful tool for imposing state-led development. Credit to the private sector fell from nearly

¹⁰ Belay Gedey, Money, Banking and Insurance in Ethiopia, (1990) p.83.

¹¹ Befekadu Degefe, "The Development of Money, Monetary Institutions and Monetary Policy in Ethiopia 1941-75," in Shiferaw Bekele (ed.), An Economic History of Ethiopia: The Imperial Era 1941-74 (1995) Vol.1. p.21.

¹² The commercial banks were Addis Ababa Bank, Banco di Napoli and Banco di Roma. The insurance companies were African Solidarity, Ethio-American life, Blue Nile, Ethiopian General, Imperial, Afro-Continental, Pan-African, Union, Ras, and Ethiopian Life and Rasi. The non-bank financial intermediaries were the Imperial Saving and Home Ownership Public Association and the Mortgage Corporation.

¹³ NBE (National Bank of Ethiopia), "Review of the Evolution and Functions of Financial Institutions in Ethiopia," (1996a) Addis Ababa: Memorandum, Economic Research Department, Money and Banking Division.

100 per cent of total bank credit under the monarchy to only 40 per cent under the Derg.¹⁴ The Agriculture and Industrial Development Bank (known today as the Development Bank of Ethiopia) allocated 68 per cent of its resources to State farms.¹⁵ State banks undertook little in the way of any financial or economic analysis of prospective projects. Since loan collateral was not required from state-owned enterprises and the government implicitly covered losses by fiscal subventions, state banks developed very little capacity to appraise the riskiness of their balance sheets.

Thus under the Derg government, financial institutions were basically executing the economic plans outlined by the central planning organ. In that period, regulation and supervision were not critical since the national plan was believed to regulate and direct the activities of the financial institutions. Furthermore, financial institutions were directed to finance some public projects that may not pass proper financial appraisal simply based on either ideological ground or ‘merit wants’ argument.¹⁶

Following the demise of the Derg government in 1991, the post-1991 economic policy witnessed a marked departure from the previous “Socialist’ System”. Its main difference lies on openly adopting a market-oriented economic policy. In fact much of the policies adopted by the new government in 1991 had been already proposed by the defunct Derg government virtually at the end of its reign. This new change in policy brought about a significant change in the functioning of the financial sector. As a result private sector investment, which hitherto had been demonized, was allowed following which new private financial institutions emerged. Equally the role of the Ethiopia’s central bank, the NBE, was also reformulated. Thus, financial sector reconstruction was the top item in the government’s agenda.

In undertaking this task the Ethiopian government adopted a strategy of (a) gradualism: gradual opening up of private banks and insurance companies alongside the public ones, gradual liberalization of the foreign exchange market, etc and (b) strengthening domestic competitive capacity before full liberalization *i.e.*, restrict the sector to domestic investors, strengthening the regulatory and supervision capacity of the NBE, providing autonomy to banks as well as opening up inter-bank money market etc). In line with this strategy various proclamations and regulations were passed since 1992.¹⁷

¹⁴ M. Di Antonio, “The Excess Liquidity of Commercial Banking in Ethiopia,” African Review of Money, Finance and Banking, Vol. 12 (1) (1988) pp 71-101.

¹⁵ Ibid.

¹⁶ Alemayehu Geda, “The Structure and Performance of Ethiopia’s Financial Sector in the Pre- and Post-Reform Period with a Special Focus on Banking,” United Nations University: World Institute for Development Economics Research Research Paper No. 2006/112, October 2006 P.23.

¹⁷ Ibid.

2.2. Ownership and Operation of Banking Business in Ethiopia

While Ethiopia's banking evolution with the change in political regimes resembles what has been discussed above, ownership and operation of banking business following the downfall of the Derg government will be considered. This period is divided into two: the transitional period (1991-1995) and the period following the promulgation of the FDRE constitution (since 1995). This division is predicated on the progresses the country witnessed under Ethiopian People's Revolutionary Democratic Front (hence forth EPRDF) rule to the establishment of a federal state structure that culminated in the enactment of the FDRE constitution of 1995.

2.2.1. The Transitional Period

This is the period following the downfall of the Derg government. It was during this time that market oriented economic policy started to take root overturning the socialist ideology of the previous government. This policy change fundamentally affected the financial sector. Reversing the nationalizing policy of the socialist military government, the transitional government decided to allow private domestic banks to be reestablished through the instrumentality of Proclamation No. 84/1994,¹⁸ which allowed the private sector to engage in the banking business. This decision marked the beginning of a new era in Ethiopian banking. Following this proclamation, Ethiopia witnessed a proliferation of domestic private banks.

This proclamation enabled the private sector engage in the banking sector. As the government adopted the strategy of gradualism in its task of reconstructing the sector, it did not privatize the banks under state ownership for strengthening domestic competitive capacity and strengthening the regulatory and supervisory capacity of the NBE was a prelude.

During the period of transition, it was the Transitional Charter No.1 of July 1991 that served as the supreme law. This charter, under article 13, recognized the establishment of National/Regional Self-Governments. Accordingly, Proclamation No. 7/1992 established National/Regional Self-Governments and defined their powers. Though these National/Regional Self-Governments were made subordinate to the central government¹⁹, nowhere in this proclamation are they banned from owning and operating banks.

In perfect congruence with the charter and the proclamation, the Licensing and Supervision of Banking Business Proclamation No. 84/1994 has not put prohibition on National/Regional

¹⁸ The Licensing and Supervision of Banking Business Proclamation No. 84/1994, Neg. Gaz. of the Transitional Government of Ethiopia, year 53, no.44.

¹⁹ National/Regional Self-Governments Establishment Proclamation No. 7/1992, Neg. Gaz. of the Transitional Government of Ethiopia, year 51, no.2.

Self-Governments. The proclamation under article 13(2) fixes the shares a person may hold in a bank at 20%. As the provision stands, the then National/Regional Self-Governments may also hold shares of a bank up to the fixed limit. Though this limit seems to also apply on them; and even if it does is a positive development until the country gets into full fledged federal polity, the proclamation has not prohibited acquisition of shares more than the prescribed maximum as it authorizes the NBE to approve shareholdings exceeding 20%.²⁰ The then National/Regional Self- Governments could have reaped immense benefits had they established banks of their own through the instrumentality of this provision without even being limited to the 20% shareholding they could have had with no further formalities. There attaches no formality on the acquisition of shares in banks to the allowed maximum. The prerequisites under articles 3 and 5 of the proclamation are applicable to all persons who wish to undertake banking business, including the then National/Regional Self-Governments.

2.2.2. The Period Following the Promulgation of the FDRE Constitution

Ethiopia has adopted a new constitution in 1995; in fact, the constitution was adopted in the constituent assembly on the 8th of December 1994. It came into full force and effect as of the 21st of August 1995.²¹ And for more than two decades now, the country has been and is a “Federal Democratic Republic”.²² The constitution made Ethiopia a federal polity with nine states forming the federation.²³ It has fairly regulated the relationships between the federal government and the states. While explicitly listing the federal powers, the state powers, and concurrent powers, the constitution leaves residual powers to the states.²⁴

In exercising its legislative powers under the constitution, the HPR has passed laws governing different matters. With respect to banking business the licensing and supervision of banking proclamation No. 84/1994 which was enacted during the transitional period remained in force until it was repealed in 2008. Unlike the proclamation enacted during the transitional period, the new proclamation, passed long after the country has evolved to a fully fledged federal system, encroached upon the power of the states in a blatant disregard of the constitution. This proclamation, cited as the Banking Business Proclamation No. 592/2008, denied the states the right to own and operate banks of their own. Even worse, it authorized the NBE to determine by directive the amount of shares states may hold in a bank

²⁰ Article 27 of Proclamation No. 84/1994.

²¹ See the Proclamation issued to pronounce the Coming into Effect of the Constitution of the Federal Democratic Republic of Ethiopia, Proclamation No. 1/ 1995, *Fed. Neg. Gaz.*, year 1, no.1.

²² Article 1 of the constitution.

²³ Article 47 of the constitution.

²⁴ Articles 50-52 of the constitution.

transformed from micro-finance institution.²⁵ It has also made changes on the amount of shares one may hold in a bank from 20% to 5%.²⁶ Accordingly, while only the federal government is allowed to own more than 5% of shares in a bank, regional governments may only hold less than 2% of shares of a bank if at all they so wish to hold any. This study, therefore, is an attempt at examining the constitutionality or otherwise of this prohibition.

2.3. Shareholding Limitations from Investment Law Perspective in General

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

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

Investment limitations based on economic sectors are probably the most common forms of limitations. Based on the governments' economic policy, some investment areas are totally closed to private investment either domestic or foreign. Investment laws often determine areas reserved for the government, domestic investors and foreign investors as well as areas in which they might participate only in joint venture. The basic considerations in making

²⁵ Article 11(2) of proclamation no. 591/2008. As per. 3(4) of proclamation no. 591/2008, the National Bank of Ethiopia (NBE) is accountable to the Prime Minister. And as such the proclamation, in a back handed way, is empowering the Prime Minister to determine how much share a state may hold, which by far exceeds the power he/she is given under the constitution. Nothing can justify subjecting the states' fate of how much to hold to the federal government other than the ever centralizing character of the federal government in power.

²⁶ Art 11(1) of the proclamation no. 592/2008.

such decision include: national security, protection of strategic industries and the need to control the commanding heights of the economy.²⁷

The total exclusion of any private investment, whether of foreign or domestic origin, applies mostly in relation to certain key sectors of the economy that are regulated predominantly for the public benefits and strategic consideration. In Zambia, for instance, areas where only government investment is allowed include: arms and ammunitions, public utilities, power, water, telecommunication, and wholesale outlets for general goods.²⁸

A distinction is also made between domestic investors and foreign investors in relation to sectors of investment in which they can engage. There are, of course, sound economic reasons for excluding foreign investors from certain industries including the need to retain that basic industries which could easily be undertaken by local entrepreneurs, the desire to prevent vital public services from falling under foreign control and some countries pre-occupied with national security in case of engaging in production of war materials and other related areas.²⁹ In this regard the limitations range from absolute exclusion or limiting the scope of involvement of FDI in all or certain sectors of the economy or allowing participation on stringent conditions than it is the case for domestic investors.

Approaches towards foreign direct investment have been controversial both in theory and in practice. There are theories developed on this concern: neoclassical economic theory³⁰ propounds that FDI contributes positively to the economic development of the host country alleging that foreign investors usually bring capital into the host country, thereby influencing the quality and quantity of capital formation in the host country; ensures that domestic capital available for use could be redirected to other uses;³¹ reduces the balance of payments constraints of the host country, and increases government revenue via tax and other payments. On the contrary, dependency theory³² takes the view that foreign investment does not bring any meaningful economic development to the host country.³³

²⁷ Jeswald.W.Salacuse, “Direct Foreign Investment and the Law in Developing Countries”, Foreign Investment Journal Vol.15,No. 2,2000),p.378.

²⁸ Kamuwanga Mwangala, Negotiating Investment Contracts: Investment Law in the Context of Development(1989),p.4

²⁹ Wolfgang Friedmann, Legal Aspects of Foreign Investment(1959),p.747.

³⁰ The definition of neoclassical economics is not perfectly clear. It has had a variety of technical meanings as to its central problem: the mechanics of utility, price determination or operation of price mechanism, the working of free enterprise system, the operation of pure markets, the mechanics of the pure theory or logic of choice, constrained maximization decision making and the like. See Sherif H.Seid, Global Regulation of Foreign Direct Investment(Ashgate, 2002),p.9

³¹ M.Sornarajah, The International Law on Foreign on Investment, (1994), p. 38.

³² Roughly understood, the dependency theory claims that development in a certain region is dependent on the underdevelopment of a certain region i.e. they are two aspects of a single global process. Should a country

The post-war period was the period where FDI was regarded most favorably in the developed as well as the developing world alike while in the 1960s and 1970s attitudes towards FDI in most host countries, particularly developing countries, were hostile or skeptical. However, these attitudes have changed since then and countries are becoming increasingly appreciative of the benefits that can be gained from FDI. It now appears that there is an emerging broad consensus among both developing and developed countries that FDI can hasten economic growth and that any possible adverse effects can be controlled.³⁴

Generally, economic sectors either wholly or partially closed to foreign investors include defense, utilities, transportation, communications (including media), banking, insurance, and other financial institutions, certain natural resources, and farm and ranch land.³⁵

The other category of limitations pertains to the issue of requirement of compliance with certain conditions so as to invest in the jurisdiction of a certain state. In other words, in cases where the sectors are open to investors the state uses its regulatory power to make such investment contingent upon certain conditions. In this regard as well distinction may be made among the different category of investors.

2.4. Shareholding Limitations under Ethiopian Investment Law

Investment limitations in different countries might take different forms and might even discriminate among investors based on different parameters and often against foreign investors as the concerned country deems appropriate. This trend similarly applies to the Ethiopian scenario as well and a cursory review of the basic limitations is in order. In the past decades, the legal framework for investment in Ethiopia has undergone through recurrent

develop, the theory alleges, it is necessary to dissociate itself from the world market and strive for national self reliance.

³³ J.M. Rothbeeb, "Investment Dependence and Political Conflicts in Developing Countries: A Comparative Regional Analysis" in S.Chan (ed), FDI in a Changing Global Political Economy (1995) P. 189. The theory argues that growth is supposedly slowed for several reasons: FDI is mostly made by multinational corporations (MNCs) that normally devise global policies in the interest of developed countries in which they have their headquarters and shareholders in the home countries; as much as there is an initial inflow of capital, there is subsequent repatriation of capital and profits from the host country which according to some studies, twice as the capital they brought in. It is claimed that FDI creates a foreign dominated local high income-group or elite who formulate policies and enact laws that protect foreign interests and ignore the needs of the people. It is said that the technology that is brought into the developing host country is usually outdated or capital intensive, thus not satisfying their needs. FDI is also blamed for increasing unemployment or not generating significant employment by using capital-intensive techniques designed for developed economies, rather than labor-intensive techniques believed to be more appropriate for developing countries. Indeed, if the proper regulatory systems are not in place, FDI may cause considerable environmental damage.

³⁴ C.R.Kennedy, Relation between Multinational Corporations and Host Countries: A Look to the Future (1992) p.69.

³⁵ Earl H.Fry, The Politics of International Investment (1983) p.133.

amendments with a view to improve investment opportunities in the country.³⁶ The principal legislation currently governing investment is Proclamation on Investment No.769/2012. This proclamation classifies investors as domestic investors and foreign investors.³⁷ Nevertheless, based on the treatment they receive we can categorize them into the Government itself,³⁸ domestic investors³⁹ and foreign investors.⁴⁰ Or looking from the other perspective, under Ethiopian law, economic sectors are categorized into the following groups based on the investors that might participate in them. These are: areas exclusively reserved for the government; areas reserved for joint venture with the government; areas exclusively reserved for domestic investors.⁴¹

The Ethiopian government is the most privileged investor followed by domestic investors and foreign investors taking the threshold favorable treatment. There are three areas of investment that are exclusively reserved for the government. The first one is transmission and supply of electric energy through the Integrated National Grid system.⁴²

This implies that the production of electric energy is open for private investors in general and there by foreign investors in so far as it does not constitute transmission and supply of electric energy through the Integrated National Grid system. But there is a concern for private investors that the government may control them for all purposes (for example, fixing of fee) since the government is in charge of transmitting and supplying it. The second area is postal services with the exception of courier services.⁴³ For strategic considerations, ordinary postal service is not open to private investors while courier service is. The third is air transport service using aircraft with seating capacity of more than fifty passengers.⁴⁴

Some sectors are reserved for investment only in partnership with the government. Under the current Ethiopian law, investment areas that are to be undertaken only in joint venture with

³⁶ The policy shift of the transitional government of Ethiopia to market oriented economic system necessitated the enactment of laws on investment. Accordingly, we had various laws on investment until we finally reached Proclamation No. 769/2012 which is currently in force.

³⁷ Investment Proclamation No.769/2012, Fed. Neg. Gaz., year 18, no. 63 (hereinafter Proclamation No.769/2012) Art.2(4).

³⁸ The term government includes both the Federal Government of Ethiopia as well as any of the Regional Governments in Ethiopia. See Proclamation No.769/2012, Art.2(12).

³⁹ Domestic investor is defined broadly as “an Ethiopian or a foreign national treated as a domestic investor as per the relevant law, and includes the Government, public enterprises as well as cooperative societies established as per the relevant law.” See Proclamation No.769/2012, Art. 2(5).

⁴⁰ Foreign investor is defined as a foreign national or an enterprise wholly owned by foreign nationals, having invested foreign capital in Ethiopia, or a foreigner or an Ethiopian incorporated enterprise owned by foreign nationals jointly investing with a domestic investor, and includes an Ethiopian permanently residing abroad and preferring treatment as a foreign investor. See proclamation No.769, Art.2(6).

⁴¹ Articles 6-8 of Proclamation No.769/2012.

⁴² Article 6(1)(a) of Proclamation No.769/2012.

⁴³ Article 6(1)(b) of Proclamation No.769/2012.

⁴⁴ Article 6(1)(c) of Proclamation No. 769/2012.

the government are manufacturing of weapons and ammunitions, and telecommunication services.⁴⁵

Next to the Government, Ethiopian nationals constitute second category of privileged investors. Ethiopian nationals have got some investment areas exclusively reserved for them from which other domestic investors and foreign investors are excluded. The following areas of investment are exclusively reserved for Ethiopian nationals:⁴⁶ banking, insurance and micro credit and saving services; travel and shipping agency services; broadcasting services; and air transport services using aircraft with a seating capacity of up to 50 passengers.

Domestic investors (including the Government and Ethiopian nationals and others) constitute the third preferred investors to whose advantage foreign investors are excluded from a number of economic sectors.

Somehow broad areas are closed to foreign investors. There are sound economic reasons for excluding foreign investors from certain industries including the need to retain basic industries which could easily be undertaken by local entrepreneurs, the desire to prevent vital public services from falling under foreign control and others. Indeed, even the developed countries maintain limitations or even prohibitions on foreign investment participation as discussed in the preceding section.

Investment in banking and insurance is an area reserved for Ethiopian nationals. Non-nationals are not allowed to take part in banking business. The justification for this prohibition can be implied from the strategy of gradualism the government adopted during the transitional period in its decision to reconstruct the sector. In perfect congruence with the investment proclamation, the banking business proclamation has put a blanket ban on foreign nationals from taking part in the sector in any form.⁴⁷

Though there is no clear provision in the investment proclamation that allows/disallows the government to engage in banking business, it is apparent that the federal government is even a monopoly in the sector.⁴⁸ This is so for the fact that the federal government owns whatever

⁴⁵ Article 6(2) of Proclamation No.769/2012. As per Art.9 of Proclamation No.769/2012, the privatization and public enterprises supervising agency takes the mandate to receive investment proposal from any private investor intending to invest in jointly with the government and submit same to ministry of industry for decision and designate the public enterprise to invest as partner in the joint investment.

⁴⁶ Article 7 of Proclamation No.769/2012 and Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation No. 270/2012, Fed. Neg. Gaz. year 19. no. 4 (hence forth regulation no. 270/2012), art 3.

⁴⁷ See article 7 of proclamation no. 769/2012, art 3(1)(a) of regulation. no 270/2012 and art 9 of proclamation no. 592/2008.

⁴⁸ Following the nationalization of the financial sector by the derg, it appeared that the then privately owned operators of the sector were taken over by the state. This government, too, continued with its ownership of the huge operators of the sector as taken over by its predecessor.

amount of shares of a bank, implements its development program attracting huge savings through these banks, and compels government employees of all levels to use its bank. The banking business proclamation allows the federal government of Ethiopia to own banks. The investment law does not proscribe regional governments from engaging in banking business. The banking business proclamation, however, puts a close to prohibition provision by restricting the amount of shares states may hold in a bank to less than 2%. This severe restriction put by law on the shareholding limit by regional governments does not seem to have taken note of the federal system established by the constitution.⁴⁹

⁴⁹ The banking business proclamation no. 592/2008 under article 11 puts the limit on acquisition of shares. This provision of the proclamation permits only the federal government of Ethiopia to hold more than 5% of shares of a bank. While persons other than regional governments may become influential shareholders in banks owning 2-5% shares of a bank, regional governments may not become influential shareholders let alone operate banks fully owned by them. This is for the qualifying requirement imposed on influential shareholders which in no way can be met by governments. Furthermore, the proclamation puts the fate of amount of shares that may be owned by regional governments in banks transformed from micro finance institutions to the mercy of the federal government, even then, that would only be less than 2% though no micro finance institution owned by a regional government is reported to have transformed to a bank until this work is written.

CHAPTER THREE

STRUCTURAL FEATURES OF THE BANKING SECTOR

There are many causes justifying the fact that the banking sector should be regulated in a relatively stricter manner than other business engagements. As a legislative response to these causes, special rules in relation to shareholding structure in banks are enacted.

3.1. The Special Features of Banking Sector

The basic cause for the special treatment of banks in several aspects including shareholding structure is among others attributed to the following considerations: that the nature of bank contract is especially in the nature of trust;⁵⁰ that banking business is peculiarly susceptible to insider abuse and embezzlement;⁵¹ and that banks are especially susceptible to systemic risk.⁵²

To begin with, banks conduct most of their business with funds drawn from depositors while their capital contribution to that effect remains very low. Furthermore, depositors as creditors are too dispersed and unsophisticated so that there is little or no way by which they know the status of their bank. Thus deposits are more of in the nature of trust. Therefore, there exists a legitimate cause for regulatory intervention to protect those depositors as creditors.

The second reason that calls for special regulatory regime in general and in respect of share holding limit in banks in particular is that banking business is believed to be especially susceptible to insider abuses. In view of this, Good Hart noted that: "... banking is a business that is peculiarly subject to fraud. Banks engage in numerous, liquid, and large transactions which are ready subjects of forgery and embezzlement schemes...".⁵³ Owing to their exposure to fraud, it would be justifiable to put cap on the amount of shares held in bank with a view to control the inevitably attending power of investors with substantial equity holdings.

The third reason for having a different approach on bank regulation pertains to the need to maintain stability of the financial system and avoid systemic risk. Given the pivotal role of banks in the payment and credit system of the economy, failure of a single bank would have substantial implications than failure of most other enterprises.⁵⁴ What is worse is that in the banking sector, disruption in a bank would not be limited to that particular bank. It generally erodes public confidence in the overall banking sector. Given the fact that banks would be

⁵⁰ Charles Goodhart, cited above at note 1, P.10

⁵¹ Olson, cited above at note 3, P.111

⁵² Charles Goodhart, cited above at note 1 P.10

⁵³ Olson, cited above at note 3, P.10

⁵⁴ Id. P.113.

expected to pay their depositors on demand, and if depositors fear that their bank would be insolvent, it is expected that they all would demand payment. On the other hand, most bank assets are often in illiquid form while their liabilities are always liquid.⁵⁵ Banks would, therefore, be forced to liquidate their illiquid assets below actual market value to meet their obligations. This complex relationship, referred to as systemic risk,⁵⁶ might generally lead to disruption of the overall financial system thereby causing economic crisis. Therefore, putting limit on how much one owns in a bank is imperative.

3.2. Shareholding Structure in Banks in General

While the general regulation of trading activity apply to the banking sector as well,⁵⁷ the special nature of banking business as outlined in the preceding section makes the regulation of shareholding structure all the more important. In particular, prohibitions on shareholdings by foreigners through FDI⁵⁸ and limitations on acquisition of shares in banks are worth considering and this section will be devoted to the examination and analysis of the theoretical discourses of these restrictions and the realities in the Ethiopian context.

3.2.1. Prohibitions on Shareholdings by Foreign Nationals

In many countries and for years the banking sector has either been closed to foreigners or permitted under strict terms and conditions. For instance, in the US, the sector was discriminated against foreign firms when it was a capital-importing country. It demanded all directors of national banks to be citizens, and deprived foreign shareholders of voting rights with respect to federally-chartered banks. At the state level, there were even more restrictions. Some states imposed more strict capital base requirements on foreign financial institutions, while states like New York⁵⁹ even totally prohibited entry into certain financial industries.

Canada did not allow foreign banks to establish branches on its territory until 1999. Instead, foreign investors had to establish separate subsidiaries that draw on the capital of the parent

⁵⁵ Lawrence S. Ritter, *Principles of Money, Banking, And Financial Market* (10th ed., 2000) P.293.

⁵⁶ Olson, cited above at note 3, P.110

⁵⁷ Com. C., Art. 5(20). Operating banking business is a trading activity subjected to the general regulatory rules under the commercial code.

⁵⁸ Mehmet Erdem, cited above at note 7, pp.78-84

⁵⁹ Ha-Joon Chang, cited above at note 9, p.1

company.⁶⁰ In Niger, foreigners are not allowed to invest in banking and other financial sectors.⁶¹

In Ethiopia, too, the sector is reserved to nationals and the federal government. Non-nationals may not become shareholders in Ethiopian banks in any form.⁶² This policy direction has in mind the protection of local operators with small capital, limited skilled man power and poor technological base from foreign investors that may awash them. The institutional and regulatory framework of the sector is also too nascent to open it to foreign participation.⁶³

3.2.2. Limitation on Acquisition of Shares in Banks

It has been noted that banking is the most susceptible business for insider abuse and embezzlement by those having substantial influence on the enterprise, if left unregulated. Shareholding is one of the most common sources of power and control in a bank.⁶⁴ Hence the regulatory rule on limiting amount of shares one owns in a bank goes in line with the regulatory objective of protecting depositors. In an attempt to realize this objective, the banking business proclamation has put cap on amount of shares held in a bank.⁶⁵

Ethiopia is a federal polity with nine states forming the federation. Unlike the case in other jurisdictions with similar state structure, it is only the federal government that is allowed to hold more than 5% of shares of a bank.

There are three principal laws that regulate the establishment of banks in Nigeria.⁶⁶ The Companies and Allied Matters Act deals with incorporation of a bank as a body corporate, while, the Banks and Other Financial Institutions Act is concerned with application and issuance of banking license, and the Central Bank of Nigeria Act deals with the authority to issue banking license.⁶⁷

In Nigeria, all bank licensing applications pass through the Central Bank of Nigeria (the CBN). Any interested person may make a formal application for the grant of a license to carry on the business of banking in Nigeria and address the request to the Director of Banking

⁶⁰ "Foreign Bank Regulation in Canada: Barriers to Competition," Submission of Norwest Financial, Inc. and Trans Canada Credit Corporation to the Task Force on the Future of the Canadian Financial Services Sector, October 31, 1997.

⁶¹ Jeswald.W.Salacuse, cited above at note 18, pp.389-390.

⁶² Article 9 of proclamation no. 592/2008.

⁶³ Explanation given by Ato Teklewold Atnafu, Governor of the NBE, on the discussion held with experts on the draft proclamation on Sene 06/2000 E.C.

⁶⁴ Andrew Muscat, The Liability of Holding Company for the Debts of Its Insolvent Subsidiaries (1996) P.47. Note that there are also other indirect sources of control such as being pledgee and usufructuary of share.

⁶⁵ While only the federal government is allowed to hold more than 5% of shares of a bank, units of the federation may only hold less than 2%. Other persons may hold up to 5% of shares of a bank.

⁶⁶ Okojie-Ibiayo,M.I., Elements of Banking: Accountancy Approach,(2004) p. 16.

⁶⁷ Ibid.

Supervision Department, CBN with the necessary documents.⁶⁸ With varying regulatory requirements, commercial banks in Nigeria may be regional, national or international depending on their authorization. And the units of the federation in Nigeria may undertake banking business within their territory.⁶⁹ The banking sector currently comprises 20 local banks and foreign banks. The top four banks are: First Bank of Nigeria, Guaranty Trust Bank, Zenith Bank and UBA and they account for 44% and 42% of industry assets and deposits respectively.⁷⁰ Hindrances in the current environment include decline in middle income class, poor risk management, high operating costs, lack of credit information and a lack of accessible consolidated financial sector data. Opportunities in the current environment include finance of small and medium enterprises, untapped agriculture finance and the high number of unbanked citizens. Three of the banks currently operating in Nigeria are state owned. Government ownership was brought about by the inability of the banks to recapitalize after the expiration of the deadline given by the CBN.

The South African constitution establishes three distinctive, interdependent and interrelated spheres of government.⁷¹ These spheres of government are constitutionally autonomous national, provincial and local governments.⁷² South Africa has a well-developed and sophisticated banking sector, regulated by the South African Reserve Bank.⁷³ There are around 18 registered local and foreign banks, as well as a large number of branches and representative offices of foreign banks operating in South Africa. The sector is dominated by 4 large full service banks, with significant branch footprints, and a number of others operating in niche markets. The sector is extremely competitive, both at a wholesale and retail level. While the requirements with respect to the prerequisites for license are almost

⁶⁸ KPMG, Africa Banking Survey (2012), pp. 46-49.

⁶⁹ Ibid.

⁷⁰ Ibid.

⁷¹ Section 40(1) of the Constitution of the Republic of South Africa, 1996. Unlike the FDRE constitution, that clearly established a federal state structure in the nomenclature of the state, the South African constitution shy away from employing the term federal in its name and nowhere in the constitution can one find the term federalism despite the fact that the state reflects many of the characteristics of a federal state. And this fact of not employing the term federalism was the major bone of contention among the makers of the constitution as it was seen as a system that would introduce apartheid through the backdoor. Finally it was agreed to drop the term and emphasize on an appropriate system of constitutional government that provides for good and effective government. Therefore, the institutional realities of the state, which incorporate important federal features, are not reflected in the name of the state. See Yonatan Tesfaye Fessha, Institutional Recognition and Accommodation of Ethnic Diversity: Federalism in South Africa and Ethiopia, a PhD dissertation submitted to the University of the Western Cape, pp. 220-21.

⁷² KMPG, cited above at note 68, pp. 46-49.

⁷³ Ibid.

similar to that under the Ethiopian banking proclamation, there is no prohibition on the provinces in South Africa from owning and operating banking business.⁷⁴

The other federal polity that allows federating units to own and operate banks of their own is India. In India, banks dominate the financial system.⁷⁵ Within the banking system, public sector banks, which are owned by the federal government and the states, (PSB) continue to dominate with 73% of market share of assets and 83% of branches.⁷⁶ Rural and urban cooperatives banks have a relatively small share in the banking system.⁷⁷ However, given their geographic and demographic outreach, they play a key role in providing access to financial services to low and middle income households in both rural and urban areas.⁷⁸ Similarly, Regional Rural Banks, the ownership of which is of states, play a key role in promoting financial inclusion. The Government is pursuing branch expansion and capital infusion plans for the Regional Rural Banks.⁷⁹ In the United States, too, the states are allowed to undertake banking business.⁸⁰ The Ethiopian law, in this regard stands in stark contrast to the case in other federations. The author doubts whether this peculiarity has led to a better institutional design making the policy credible and based on sound economic reasoning, if not legal, as opposed to politics.

3.3. Points for Consideration in the Hitherto Disregarded Ownership and Operation of Banks by Regional Governments in Ethiopia

Over the past decade, Ethiopia has achieved economic growth averaging close to 11 percent annually.⁸¹ The development of a vibrant and active banking system that complements existing public sector work is considered important to Ethiopia's economic progress by a range of experts, including the World Bank, the African Development Bank (AfDB), and the International Monetary Fund (IMF). These bodies view the expansion of the banking system in a prudent and controlled manner as key to the success of Ethiopia's development plans.

Compared to most countries, Ethiopia has taken a cautious approach toward the liberalization of its banking industry. For all intents and purposes, its industry is closed and generally less

⁷⁴ Ibid.

⁷⁵ Duvvuri Subbarao, Banking Structure in India Looking Ahead by Looking Back, p.3. Taken from speaking notes of Dr. Duvvuri Subbarao, Governor, Reserve Bank of India, at the FICCI-IBA Annual Banking Conference in Mumbai on August 13, 2013.

⁷⁶ Ibid.

⁷⁷ Id. P. 4.

⁷⁸ Ibid.

⁷⁹ Ibid.

⁸⁰ Seth Kincaid Jolly, Jeffersonian Federalism: State Rights and Federal Power, pp.7-9.

⁸¹ World Bank, Ethiopia Economic Update II: Laying the Foundation for Achieving Middle Income Status, 18 June 2013, p. XI.

developed. The industry comprises banks owned by the federal government and privately owned banks. While the room opened to the private sector to the ownership and operation of banking is applauded, the ban on regional governments is upheld for no constitutional legitimacy can be attached thereto. Despite the country's entry to a fully fledged federal polity after the promulgation of its constitution, the law passed then after, with no constitutional basis, opted to unify the banking system. This not only encroaches upon the power of the regional states but also restricts financial intermediation and economic growth.⁸² The lack of domestic savings opportunities provided by banks owned by regional states and the limited available access to bank credit for small businesses located in remote areas dramatically restricts economic growth potential.⁸³ Public sector banks will inevitably lead investment in key developmental projects such as those involving infrastructure, but broad-based development is required in order to create sustainable economic growth, and in the opinion of the writer, this investment typically comes, in the Ethiopian context, from banks owned by the states as their deposit base grows. Development projects designed by regional governments can be financed by their banks the absence of which has inhibited the implementation of balanced and sustainable development initiatives in the regions.⁸⁴ And as such expanding the banking system will create greater savings opportunities that will in turn boost funding via savings. The alternative is a country's heavy reliance on external sources, private or official value transfers such as remittances, and external borrowing which hardly benefit the people in far remote areas. And none of these approaches is within a nation's control, and thus all are unreliable. In contrast, a developed domestic savings market can be controlled and managed within a country and create a much more stable base from which investment can be made, and development of an inclusive and accessible banking system will be key to maintaining this national advantage.

Microfinance plays an important role in Ethiopia, and the NBE has sought to encourage this segment via the instrumentality of Micro-Financing Business Proclamation No. 626/2009,⁸⁵ which provides guidance on the licensing and supervision of microfinance institutions.

⁸² Ethiopian banks are concentrated in urban centres and the segment of the population found in the peripheries remains unbanked and with little or no banking habit, which in the opinion of the writer, hugely the economy.

⁸³ It is evident that the more accessible and inclusive banks are the better the level of saving and investment. The experience of states that have enabled their federating units own and operate banks of their own can be considered to prove this assertion.

⁸⁴ It is apparent from the housing policy designed by the federal government of Ethiopia that residents of the city of Addis Ababa are made to make regular deposits to the commercial bank of Ethiopia from which source the government realizes its project. For the units of the Ethiopian federation have no bank of their own, there cannot be such a shared means of realizing their projects if at all they wish to have one.

⁸⁵ Micro-Financing Business Proclamation No. 626/2009, *Fed. Neg. Gaz.* year 15, no. 33.

Despite these efforts, development of this segment has been slow because provision by microfinance institutions of the type of financial services that can be delivered by a full-fledged bank remains restricted by capacity and penetration. As a result, a large percentage of the population remains unbanked. And still regional states are not allowed to undertake banking business.

Legitimate economic concerns can be raised on lifting the ban imposed on the regional governments' undertaking of banking business in Ethiopia. This measure could result in destabilizing disruption caused by "hot money" flows and skewed allocation of credit toward more-attractive borrowers, such as larger industrial companies that already have access to bank lending, rather than smaller-scale enterprises and farmers having no access to banks (so-called cherry picking).⁸⁶

Hence, lifting the prohibition on ownership and operation of banks by the federating units in Ethiopia, can deliver meaningful economic benefits. These benefits may include improvements in the overall efficiency of the sector, the accessibility and inclusiveness of the sector, and greater, stable and reliable financial base for regional states to finance their development as well as employment and tax benefits, among others.

Although the country went through the implementation of the Growth and Transformation Plan (GTP) in the years 2010 to 2015, it cannot claim to have fully realized same for no shift in its development is witnessed. The author believes that, in seeking to attain the goals set by the GTP II, regional states should be allowed to undertake banking business to reach the unbanked segment of the population and finance their functions. With the CBE still being a quasi-monopoly in the sector, the health of the Ethiopian economy is closely correlated with the performance of this bank. It would serve Ethiopia well to improve its economy through a legislative response enabling the regional states' undertaking of banks for it enables competitiveness.

Ethiopia would also gain security benefits in addition to economic benefits from this legislative measure. The current foreign exchange control regime means that illicit finance, such as the proceeds of smuggling or currency brought into the country by immigrant workers, most likely uses transference channels that are outside the regulated banking system. With these money flows occurring outside the narrow banking system, it is more difficult for Ethiopian authorities to regulate and disrupt these flows because the criminals are using

⁸⁶ Availability of credit facilities to small local entrepreneurs is pivotal to the creation of a vibrant and inclusive economy from which a nation would take advantage. The writer believes that this, in the Ethiopian context can best be realized through the instrumentality of banks owned by the regional governments.

methods that are inevitably more opaque than those that are closely and transparently regulated in the formal banking industry. Although the Ethiopian government is believed to have shut down some networks that were operating illegally, monitoring their usage would be challenging for any government.⁸⁷

By enabling regional governments to undertake banking in conjunction with the relaxation of the current foreign exchange control regime and the continued rise of anti-money laundering and countering the financing of terrorism AML/CFT compliance standards driven by the Financial Intelligence Centre (FIC), the government would likely improve the extent to which the financial system can be used to combat money laundering, terrorism financing, and other forms of illicit finance.⁸⁸

⁸⁷ The Financial Action Task Force (FATF) pays particular attention to the prevalence and control of informal finance networks. FATF, International Standards on Combating Money Laundering and Financing of Terrorism and Proliferation: The FATF Recommendations, http://www.fatfgafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf visited on 21st April 2015, (Recommendations 14 and 16); FATF, The Role of Hawala and Other Similar Service Providers in Money Laundering and Terrorist Financing, <http://www.fatfgafi.org/media/fatf/documents/reports/Role-of-hawala-and-similar-in-ml-tf.pdf>, visited on 21st April 2015.

⁸⁸ Ibid.

CHAPTER FOUR
THE LEGITIMACY OF THE PROHIBITION ON REGIONAL GOVERNMENTS’
UNDERTAKING OF BANKING BUSINESS

The Ethiopian banking business proclamation has come up with some limitations of which the identity of shareholders⁸⁹ and the amount of shares they hold in a bank⁹⁰ is the central concern of this chapter. In a bid to demonstrate how much a regional state may invest in a bank, the provision of the law putting shareholding limit will be appraised. In this regard, only the federal government is allowed to hold more than 5% of shares of a bank while the units of the federation are belittled for they may, if they so wish, hold less than 2% of shares of a bank. The other forms of limitations are: the nationality requirement restriction,⁹¹ the restriction on maximum amount of shares to be held by a single shareholder/related shareholders⁹², and the prohibition of a shareholder having allegedly substantial share in one bank (an influential shareholder) from being a shareholder in any other bank.⁹³ The scope of ownership of regional governments and the cause for the cap in banks as well as the legitimacy and potential impacts of the prohibition would be the points for consideration under this chapter.

4.1. The Scope of Ownership and the Cause for the Cap on the Shares Held By Regional Governments

In Ethiopia, instead of letting the amount of shares one may hold in a bank to the determination of the shareholder and attempting to regulate the attending consequence, the law has preferred to begin with imposing limitation on the amount of shares, setting the maximum at five percent with its infamous provision that reads as “[n]o person, other than the Federal Government of Ethiopia, may hold more than five percent of a bank’s shares either on his own or jointly with his spouse or with a person who is below the age of 18 related to him by consanguinity to the first degree”.⁹⁴ While the law, in fixing the shareholding limit, strives to curb not only the apparent control an individual would exercise but also the subtle exercise of influence by availing one’s close relationship with others, the justification for the prohibition put on regional governments is rather unclear.

⁸⁹ Art. 9 and 11(1) of proc. 592/2008.

⁹⁰ Art. 11(1) of proc.592/2008.

⁹¹ Art. 9 of proc. 592/2008.

⁹² Art. 11 of proc. 592/2008.

⁹³ Art. 11(4) of proc 592/2008.

⁹⁴ Art 11(1) of proc 592/2008.

The proclamation, having reduced the amount of shares one may hold in a bank from 20% to 5%, has identified those holding from 2% to 5% of shares of a bank as influential shareholders to subject them to further regulations.⁹⁵ The principal forms of regulation of influential shareholders include restrictions pertaining to loan availed to influential shareholders, the fitness and propriety requirements, the restriction that an influential shareholder of a bank may not invest in another bank.⁹⁶

What then is the scope of ownership of regional governments? Article 11(1) of the banking business proclamation is clear in its wording-that only the federal government may hold more than 5% of shares of a bank. The perusal of this provision does not seem to have totally prohibited regional governments from being influential shareholders. But going through the provisions aimed at putting regulatory guidelines on influential shareholders would prove otherwise. Art 4(1) (h) of proclamation No. 592/2008 asserts that “influential shareholders of the bank shall meet the fitness and propriety criteria prescribed by the national bank...”⁹⁷ The criteria as set by the directive on Requirements for Persons With Significant Influence in a Bank Directives No. SBB/54/2012 of the NBE puts integrity and financial soundness as a prerequisite and ongoing test and notification procedure is set to ensure that it is complied with.⁹⁸ The Basel committee, too, recommended that the supervising agencies should assess and review “... the controlling shareholders' past banking and non-banking business ventures and their integrity and standing in the business community, as well as the financial strength and of all major shareholders and their ability to provide further financial support should it be needed. As part of the process of checking integrity and standing, the supervisor should determine the source of the initial capital to be invested.”⁹⁹ These criteria may only be applicable on physical persons and juridical persons other than governments.

With respect to the history of a person be it physical or juridical, for instance whether convicted or pending cases exist particularly in relation to his/its business engagement as well as his/its material endowment matters for eligibility. Art 11(5) of Proclamation No. 592/2008 clearly asserts that a person may not acquire bank shares using bank loans and advances even without achieving status of influential shareholder. Thus ethical standards pertain to the

⁹⁵ Article 2(11) of proclamation no. 592/2008.

⁹⁶ Basel committee on banking supervision: core principles for effective banking supervision (Basel, September 1997). See also Requirements for Persons with significant influence in a bank Directives No. SBB/54/2012, arts. 5-8.

⁹⁷ Proc. 592/2008, Art. 4(1)(h).

⁹⁸ Requirements for Persons with significant influence in a bank Directives No. SBB/54/2012, arts. 5-8.

⁹⁹ Basel committee on banking supervision: core principles for effective banking supervision (Basel, September 1997).

personal integrity, financial endowment and past and current business carried out might affect one's eligibility for status of being influential shareholders.

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

How would regional states be expected to prove these fitness and propriety criteria? The inability to answer this question would show that regional governments of the Ethiopian federation are banned from undertaking banking business in any capacity, if not for holding less than 2% of shares of a bank.¹⁰⁰

The cause for the prohibition on regional governments' undertaking of banking business is unclear. The Licensing and Supervision of Banking Proclamation passed during the transitional period when the country was on its way to establishing a federal polity did not put such a limitation on the then national/regional self governments.¹⁰¹ However, the law passed after the promulgation of the constitution banned regional governments from banking business in disregard of the power they are given by the constitution. In an attempt to look for the justification for this prohibition, the writer went through the minutes of the legislature but the issue was not even a concern during the entire process of the enactment of the proclamation. The writer went further in an effort to find the rationales for the blanket ban, and contacted the Bank Licensing and Supervision Directorate within the NBE but could get no justifications.¹⁰² The fact that the constitution established a federal state structure and the

¹⁰⁰ Given the fact that a clear provision allowing only the federal government of Ethiopia to hold more than 5% of shares of a bank is injected to the Banking Business Proclamation no. 592/2008, and at the same time authorized the NBE to determine by directive the amount of shares that may be owned by regional governments in a bank transformed from a micro-finance institution, one can easily infer the fact that regional states of the Ethiopian federation are not allowed to hold the amount of shares of a bank to the extent the federal government owns, *i.e.*, more than 5%. Moreover, the qualifying requirement imposed by the directive issued by the NBE on influential shareholders cannot be met by governments owing to their nature. The directive requires integrity, financial soundness, past banking and non-banking experience and ongoing test and notification requirement under the pain of suspension of voting right. Though one may contend that these requirements may be presumed with respect to regional states, the clear wordings of article 11(1) and (2) of the proclamation do not support the contention. And the writer believes that the provisions of the proclamation and the directive deny units of the Ethiopian federation to even become influential shareholders of a bank let alone own banks of their own. This relegates their status under the constitution belittling them to even less other persons.

¹⁰¹ Article 13 of proclamation no. 84/1994 puts cap to shareholding and fixes it at 20%. But there is no limitation imposed on national/regional-self governments, unlike proclamation no. 592/2008 that hardly allows regional governments undertake banking business. Proclamation no. 84/1994 under article 27 authorizes the National Bank to decide shareholdings exceeding the 20% limit through the instrumentality of which the then national/regional self-governments could have owned banks of their own.

¹⁰² In a dialogue with Ato Solomon Tadesse, Director of the Bank Licensing and Supervision Directorate on 19 August 2015, the writer was informed that the director did not know the reason behind the prohibition but guessed that the reason could be the financial base required to undertake banking business which regional states

legislature passed law disregarding the constitutional arrangement and division of power constitutes a clear violation. Even further, the law's subjection of the fate of banks transformed from micro-finance institutions to the mercy of the NBE which is accountable to the Prime Minister goes contrary to the notion of federalism which the constitution has established.¹⁰³ In the opinion of the writer, nothing can be advanced to justify this blatant disregard of the constitution than the desire of the federal government to control the sector and stay in monopoly-contrary to the anti-competition laws in place.

4.2. The Legitimacy and Potential Impacts of the Prohibition

Ethiopia is a country of devolutionary federalism with nine member states.¹⁰⁴ Accordingly, the constitution has fairly regulated the intergovernmental relations (*i.e.*, the relationships between the federal government and the states). The constitution explicitly lists down the federal powers, the state powers, concurrent powers, and leaves residual powers to the states.¹⁰⁵

The principle of mutual respect between the federal and state governments is clearly stated. Mutual non-interference in one another's affairs, and thus in matters that are exclusively under the jurisdictional competency of each other, is recognized.¹⁰⁶ The fact that the states have legislative, executive, and judicial competence is readily recognized.¹⁰⁷ But because there is no explicit recognition of the principle of federal supremacy with regard to laws, the status of laws passed by the federal law making organ in the states is rather difficult to tell with any precision.

As the power to formulate and implement monetary and financial policies as well as the administration of the National Bank fall within the competence of the federal government, it sounds perfect for the federal government to come up with laws on these domains. But taking away the ownership and operation of banks by the states denies them their status under the constitution. The enactment of such a law putting blanket ban on the undertaking of banking business by the states would bear no positive fruits than creating a fertile ground for banks owned by the federal government to monopolize the sector with insignificant competition

may not satisfy. But, in the opinion of the writer, the fact of putting such a prohibition under the guise of the presumed absence of the required financial base is unsound.

¹⁰³ Art. 11(2) of proc. 592/2008.

¹⁰⁴ Art. 47 of the constitution.

¹⁰⁵ Arts. 51 and 52 of the constitution.

¹⁰⁶ Art. 50(8) of the constitution.

¹⁰⁷ Art. 50(2) of the constitution.

from their counterparts. Furthermore, it restricts the revenue sources states would have to finance their projects and aggravates their dependency on federal governments' grant.

This is caused, in the opinion of the author for the delicate balance that has to be maintained between state autonomy and federal union is far from being completely established in Ethiopia. The fact that an ever centralizing government is in power at the federal level¹⁰⁸ and the fact that the states, owing to their low level of economic development coupled with their reigning political parties' ties with the dominant coalition of ethnic parties ruling the country, depend much on the resources of the federal government has made it unclear as to how far the federalism has managed to strike a fair balance between state autonomy and the need to preserve unity of the polity.

In view of this, the prohibition and subjection to the federal government imposed on regional governments of the Ethiopian federation by the banking business proclamation is just a slice of the ever increasing assumption of power by the federal government in complete disregard of the constitution. This not only poses threat to the right to self-determination in all its forms of states but also demonstrates that the Ethiopian federalism, as established by the constitution, is not more than a textual fact.

The issue invites further investigation and consideration from constitutional law perspective.

CONCLUSION AND RECOMMENDATIONS

Banks play key role in an economy in terms of enhancing both allocative and productive efficiency. An efficient banking industry will make the largest contribution to economic growth. Conversely, when a banking system does not work well or when there is instability, there will be substantial economic costs. Thus, like in other industries, competition is important in a banking industry to enhance social welfare, optimizing efficiency and stability. It could be possible for banking efficiency to be benefited from both competition and size.

In the Ethiopian context, banks are owned by the federal government, and privately owned by Ethiopian nationals. While the former may hold 100% of shares of a bank, a shareholder in a bank may only hold up to 5% of its shares.

The member states of the federation may not undertake banking business; save the less than 2% of shares of a bank they may hold if they so wish. This goes contrary to the demand of the overall size of the economy and renders the Ethiopian economy under-banked compared

¹⁰⁸ The listing of federal law making powers under article 55 of the constitution apart, the incumbent federal government of Ethiopia has passed laws on matters not falling within its competence. No constitutional principle would justify such a manipulation of the constitution.

to its size and population. The level of competition in the Ethiopian banking industry is at infancy, with the CBE still seizing quasi-monopoly power. In terms of contestability, the Ethiopian banking industry can be characterized as incontestable as entry in the industry is prohibited for the states that could have reached the unbanked segment of the population and offer a choice on banking services.

It can be witnessed that the Ethiopian banking system is not able to offer adequate and competitive services on the scale required. This is so for the federal government uses its bank and compels states to use same leaving no chance of choice. And many development schemes designed for the benefit of the public are run through the bank owned by the federal government and this undermines competition and may have the effect of kicking other banks out of the game. Had the ownership and operation of banking business been permitted to the states, these concerns would have been significantly addressed, supporting their regions' sustainable development and contributing to the country's economic growth.

The country, as a federal polity, has not been able to provide any reason for the ban on banking business undertaking it imposed on members of the federation. Neither the NBE nor the HPR are able to justify their decision, rendering the ill considered law they came up with unconstitutional.

Were it not for the current arrangement within the ruling ethnic coalition party (the EPRDF) that passes decisions binding all in disregard of the state structure established by the constitution, the banking business proclamation and the insurance business proclamation would remain mere draft. The increasing acquisitive and ever centralizing character of the federal government is the cause for the preclusion put on the member states of the federation from undertaking banking business.

The writer thus recommends that legislative response to lift the ban put on regional governments' undertaking of banking business should be made as the existing law goes contrary to the spirits of the constitution and limits the financial competence of the states.

Therefore, legislative correction should be made to enable regional states undertake banking business so that the national savings rate increases dramatically. And investment in businesses within the states and the broader economy can be undertaken from this base of funding stability rather than through the release of foreign exchange reserves or the use of international borrowing which would make the states expectants of the federal government to carry out their activities.

And, considering that branch networks are heavily concentrated in urban areas, letting the states engage in banking would foster inclusion and develop banking habits among the rural

public. It would also give the authorities greater oversight of the financial flows within the country and improve AML/CFT security.

The unleashing of banking by the states would bring significant benefits: greater savings, increased supply of credit to businesses, and support for start-up activity. It will also bring secondary benefits, such as greater exports and an increased tax base, which will create a virtuous cycle of economic growth and employment.

Furthermore, the operation of banking business by states will bring security benefits as a greater proportion of the country's financial flows are brought into the regulated system, it enhances the authorities' ability to manage and oversee financial flows consistent with the Financial Action Task Force requirement for the country to maintain firm control of informal value transfer systems.

As a final note, the writer recommends that all the concerned bodies including the NBE need to understand that the prohibition has not only gone contrary to the constitution in denying their status by telling them what business to undertake and what not to, it has also affected the competition level of banking industry for states are compelled to use banks owned by the federal government which also benefits from other policy directions of the government. It is also imperative to take a lesson from other countries with similar polity and take their experiences and important practices to enable the financial sector in general and the banking sector in particular advance to a better level.

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