



Addis Ababa University

School of Graduate Studies

Collage of Business and Economics

**Department of Public Administration and Development
Management**

**ASSESSING THE IMPLICATIONS OF REGULATORY POLICY
ON THE DEVELOPMENT OF PRIVATE COMMERCIAL
BANKS IN ETHIOPIA: A CASE OF NBE BILLS PURCHASE
DIRECTIVE.**

BY:

SHIBIRU AMSALU HUNDARA

May, 2014

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Advisor: Filmon Hadaro (PhD)

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Approved by Board of Directors:

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Advisor	Signature	Date
Examiners:		
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Internal Examiner	Signature	Date
_____	_____	_____
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Acronyms and Abbreviations

AAU	Addis Ababa University
AB	Abay Bank
ADIB	Addis International Bank
AIB	Awash International Bank
AIDB	Agricultural and Industrial Development Bank
APR	Annual Percentage Rate
BOA	Bank of Abyssinia
CBB	Construction and Business Bank
CBE	Commercial Bank of Ethiopia
CBO	Cooperative Bank of Oromia
CEOs	Chief Executive Officers
DB	Dashen Bank
DGB	Debu Global Bank
E.C	European Calendar
EB	Enat Bank
EBA	Ethiopian Bankers Association
EU	European Union
FDIC	Federal Deposit Insurance Corporation
FSA	Financial Service Authority
HSBE	Housing and Saving Bank of Ethiopia
IMF	International Monetary Fund
ISHOPA	Imperial Savings and Home Ownership Public Association
LIB	Lion International Bank

N.D	Not Dated
NBE	National Bank of Ethiopia
NIB	Nib International Bank
OECD	Organization for Economic Cooperation and Development.
OIB	Oromia International Bank
PCBs	Private Commercial Banks
S.C	Share Company
SME	Small Micro enterprise
U.K	United Kingdom
U.S.A	United States of America
UB	United Bank
UNU	United Nations University
WB	World Bank
WB	Wegagen Bank
WIDER	World Institute of Development Economics Research
WTO	World Trade organization
ZB	Zemen Bank

Abstract

This paper assesses the implications of regulatory policy namely, NBE bills purchase directive, on the development of private commercial banks in Ethiopia. Mixed research approaches and descriptive research type were employed. Accordingly, research questions were approached via research tools like questionnaires, key informant interview and document surveying and analyzed using simple descriptive statistics like ratio, percentage and average. The findings of the research shows that NBE bills purchase directive have negative implications on loanable fund, income and expense, profit, Capital and reserve, and deposit of private commercial banks, whereas positive implications on branch expansion and product development of private commercial banks. According to the finding, the directive affected the loanable fund, income, profit, reserve, and deposit of private commercial banks via reducing them. The implication of the directive implied on expense of private banks via increasing overall expenses. Thus, the NBE bills purchase directive has negative impact on almost all performances of private commercial banks, which further has negative implications on the development of private commercial banks. Finally, respondents forwarded recommendations like lessening the percentage amount of allotment, increasing interest rate paid for the bills and phasing out the directive.

Chapter One

Introduction

1.1 Background

Regardless of their ownership, banking sectors play paramount role in the growth and development of the economies of countries. Numerous scholars witnessed the contribution of financial institution, particularly banking sectors in the growth and development of the economies of countries. Ahunda and Fuentes(2003), for instance, argued that the financial sector and, in particular, the banking industry plays an important role in the allocation of capital resources, management of financial transactions and risks sharing of future flows of finance in an economy. Correspondingly, the banking system is often said to act as the nervous system of the economy and banks play a central role in the allocation of financial resources and manage most financial transactions (Martinez –Diaz, 2007). Ahunda and Fuentes (2003) further argued that, in the long run, a well-functioning banking sector will facilitate increased growth and welfare, and it will smooth business cycles.

Addison and Alemayehu (2001) stated that successful reconstruction and development both require financial institutions capable of mobilizing resources, in particular domestic saving and channeling them into high return investment. Banks are the mainstay of the economic development of the country and they are often regarded as the life giving force of economy, the heart of free market economies (Deloitte, 2012: Shikha and Jain, 2013). They are important in providing external and internal funding sources to a country by issuing loans to individuals and companies and acting as “a safe box” depositors (Deloitte, 2012).

Empirical studies examined whether the level of development of financial intermediation and the degree of state ownership of banks were determinants of economic growth. For example, Levine, Loayza, and Beck (2000) examined the

effects of financial intermediation on economic growth in 74 countries from 1960 to 1995 and found that greater financial intermediation development had a significantly positive impact on economic growth.

A bank in its simplest form has been described as a financial institution that uses money deposited by customers for investment, pay it out when required, and make loans at interest and exchanges currency (Deloitte, 2012). Banks accept deposit from individuals and businesses, and these deposits are made available to the businesses, which make them for productive purposes in the country. Banks have at least the following functions: lending money, depositing others' money, transferring money locally or globally and working as paying agent (Deloitte, 2012). In developing countries, banks are now providing credit for development of agriculture and small-scale industries in rural areas and provide short and medium term loans to entrepreneurs to invest in new enterprises and adopt new methods of production (Shikha and Jain, 2013).

In Ethiopia, the establishment of the Abyssinia Bank in 1905 marked the start of modern banking. Private commercial banks are a recent phenomenon in the Ethiopian economy. They came into existence after the downfall of the Dergue regime. Before the Dergue, in the Imperial regime, private commercial banks used to operate in the economy. But after Dergue came to power, all private commercial banks were nationalized and amalgamated with the state owned banks, then after Ethiopian economy was dominated by state owned banks. Moreover, in the time of the Dergue private banks were not allowed to operate. And not only private banks but also there were discouraging policies for the operation of other private sectors—since the regime pursue a socialist economy. [It was because of], in this period, the NBE was actively involved in the direct Control of all financial institutions by (a) fixing both deposit and lending interest rates, (b) directly controlling the foreign exchange and credit allocation which was done in a discriminatory manner, by favoring the public sector, and (c) directly financing

the government deficit (NBE, 1998 cited in Alemayehu, 2006:20).The sin qua none of such a set-up is the prominent role accorded to the socialized (public and cooperative) sectors by discriminating against the private sector (Alemayehu, 2006:23).

In order to accelerate the economic growth process, the current government of Ethiopia has embarked on a number of reforms to improve the efficiency and competitiveness of the banking sector (Admassu and Asayehgn, 2014). Reform measures undertaken by government to date include addressing the wide-spread problem of non-performing loans experienced by state owned banks; reconstituting both the Development Bank of Ethiopia and the Construction and Business Bank as Commercial banks; opening up the banking sector to private domestic investment; and introducing a new banking act to give more autonomy to the National Bank of Ethiopia (ibid).

Although the banking sector has grown somewhat since 1994 when the above stated reform measures were implemented, thus far the banking sector still remains monopolistic , inefficient, and is incapable of improving the intermediation of private saving sectors(Admassu and Asayehgn, 2014). As a consequence, the contribution of the banking system to facilitating the economic growth of Ethiopia is marginal. One of the basic reasons that contribute to immaterial contribution of banking sector to the economic growth is that government's implementation of misguided policies that negatively impact the performances of private banks and weaken them. The NBE bills purchase directive is one of the repressive policies of government issued and implemented so far. The National Bank issued this directive on April 6, 2011 ordering private commercial banks to buy government bond worth of 27 percent of the fresh loan disbursement. This policy set to earn 3 percent interest while deposit rates set by National Bank stands at 5 percent.

The impact of this policy (directive) has been pinpointed on various reports. Access Capital Research report for instance stated that the NBE bills Purchase

directive is having an increasingly material impact on private banks (Access Capital, 2012). The report stated the impact of the directive as follows,

Looking at the stock of NBE Bills, an equivalent of 38 not just 27 percent as is commonly assumed is now held in the form of such low-yielding government paper. More strikingly, an amount equal to 61 percent of all new private bank deposits mobilized this past year has gone towards buying new NBE Bills Birr 10 billion of new deposits were collected in FY 2011/12 while an extra Birr 6 billion in new NBE Bills was purchased during the same period. Seen differently, although in place for just 16 months, the accumulated stock of NBE Bills bought by private banks (Birr 12.6 billion) has now effectively absorbed the entire pool of new deposits (Birr 10 billion) that was collected by private banks in the just completed fiscal year.

Moreover, the IMF report(2012) uncovered the impact of NBE bills purchase directive on private banks by stating that NBE bills purchase directive introduced in April is having tangible impacts on banking sector, including maturity mismatch and less profitability. This implies NBE bills purchase directive has a sizable implication (impact) on the development of private commercial banks. Thus, this study aims at assessing the implications of NBE bills purchase Directive on the development of private commercial banks in Ethiopia.

1.2 Statement of the problem

After the new government seized power in 1991 demising the Derg regime, several private commercial banks started banking business in the country. Proclamation No 84/1994 that allowed the private sector to engage in the banking business marked the beginning of new era in Ethiopian banking (Admassu and Asayehgn, 2014). Following this proclamation Ethiopia witnessed a Proliferation of domestic private banks governed by National Bank of Ethiopia. At present, there are sixteen private commercial banks with more than 860 branches which have been contributing to the growth and development of Ethiopian economy in various aspects. Their relative contribution to economy in terms of employment creation, resources mobilization, increasing government incomes, improving banking

services of the country, strengthening the competition and efficiency and channeling fund to various economic sectors in the country is undeniable. As of 2012/13, for instance, all 16 private commercial banks managed to mobilize resources (deposits) of birr 76.1 billion from the general public and channeled resources amounted of birr 44.6 billion to various sectors of the economy. Moreover, they play paramount role in creating employment opportunity for 22,358 people during the same period.

However, despite these impressive performances and somewhat contribution to the economy of the country, private commercial banks have been facing challenges from the misguided policies of government regulatory organ (National Bank of Ethiopia). National Bank of Ethiopia, since its empowerment to license and supervise banking business, has been issued various policies (directives) that particularly focus on how to operate the private commercial banks. NBE bills purchase directive was one of such directive issued so far by National Bank of Ethiopia three years ago. The regulatory organ (National Bank of Ethiopia) designed this directive in order to finance priority sector projects via mobilizing funds from banks (NBE, 2013).

Even though it was apt mechanism for government to finance priority sector projects, the directive has sizable impact on the private banking sector. The report written by the IMF in 2012, for example, claimed the directive as having tangible impacts on the banking sector including maturity mismatch and less profitability and calls government to phase out the bill on private commercial banks. Moreover, the Ethiopian Bankers Association (EBA) has appealed to National Bank of Ethiopia to revise requirement for purchasing NBE bills by pinpointing its implication on the sustainability of developments in the private commercial banks (Mahlet, 2011). This implies that the policy (directive) has implications on the development of private commercial banks. Hence, what are the wide range implications of the directive on the performances and resulted development of

private commercial banks? This is the underlying reason of this study that instigates the researcher to undertake.

Furthermore, there were no prior undertaken academic studies to assess the implications of regulatory policies specifically this aforementioned policy on the development of private commercial banks in Ethiopia. Hence, this study was conducted to fill these observed empirical gaps. The study gave particular focus on NBE Bills purchase directive, which requires all private commercial banks to purchase National bank of Ethiopia bills to the value of 27 percent each loan disbursements.

1.3 Objective of the research

The main objective of the research was to assess the implications of NBE bills purchase directive (policy) on the development of private commercial banks in Ethiopia. Specifically, the study is aimed to:-

1. Assess the implications of the NBE bill purchase directive on the development of private commercial banks in Ethiopia;
2. Analyze the implications of NBE bills Purchase directive on various operational and financial performances of private commercial banks in Ethiopia;
3. Investigate how the directive affects various operational and financial performances of private commercial banks in Ethiopia;
4. Analyze the degree of NBE bills purchase directive implications on various operational and financial performances of private banks; and
5. Forward policy implications based on the discussion of findings of the study.

1.4. Scope of the Study

Banking sector in Ethiopia comprised of state and private owned banks, but this study focused on private commercial banks of Ethiopia by excluding public banks. Moreover, the regulatory organ of banking business issued several policies for the

overall banking sector of the country. The researcher's dimension of study was, however, delimited to selected policy issued with reference to private commercial banks; the NBE Bill Purchase Directive. Hence, the scope of this research is limited to the NBE Bills Purchase Directive implications on the development of private commercial banks in Ethiopia.

1.5. Limitations of the Study

This study also has limitations as any scientific work does. Assessment of a single policy (directive) may not give the whole picture; but it will indicate facts and figures in the regulatory practice, in terms of their role on the development of the Private Commercial Banks in Ethiopia. There was also time and financial constraint; because of this, I could not work on policies that could have implications for the growth and performance of the Private Banks in Ethiopia.

1.6. The significance of the research

NBE Bills purchase directive has been enacted in 2011 by regulatory organ and its implications to the private commercial banks are yet not well known in detail. Empirical studies were not conducted on the implications of this policy so far. This study thus reviewed, identified and analyzed the implications of the NBE Bills purchase directive over the development of private commercial banks. The findings from this study will help policy makers of the regulatory organ to have knowledge of directives' implications on the development private commercial banks. The interest groups in the banking sector will also benefit from the results so that to advocate change based on scholarly evidence. The finding of the study and recommendations forwarded may serve as a reference for concerned organs (Private Commercial Banks, Ethiopian Bankers Association, International financial organizations, etc.). Finally, the study may serve as a stepping-stone for those who have further intentions to undertake a research on the subject area.

1.7. Research Methodology

Methodology guides a research work in terms of scientific observation and measurement. Research methodology generally relies on quantitative and qualitative research principles.

1.7.1 Research Design, Type, and Approach

In order to capitalize on the strength of both approaches and compensate for the weakness of each approach, this study employed the combinations of qualitative and quantitative research approaches. The qualitative approach is selected for themes that required in-depth observation, description, explanation, analysis of the components of the Directive.

The qualitative approach is concerned with subjective assessment of attitudes, behaviors and opinions as well as the figures that are established. Qualitative approach was used in this study to conduct the subjective assessment of attitudes, behaviors and opinions of target data sources (respondents). It was also used to establish facts from both primary and secondary data sources. Questionnaire and in-depth interview tools were developed and used. Narration method was used to analyze the collected qualitative data.

Quantitative approach was selected in this study as it involves the generation of data in quantitative form that can be subjected to rigorous quantitative analysis in a formal and rigid fashion. It was selected in this study because the investigatory primarily uses postpositive claims for developing knowledge (i.e., cause and effect thinking, reduction to specific variables and hypotheses and questions, use of measurement and observation, and the test of theories), employs strategies of inquiry such as surveys, and collect data on predetermined instruments like questionnaire that yield statistics data.

Quantitative tools to the research like questionnaires and survey of different documents for data collection was used for the research. Data obtained via such

quantitative forms or approaches was analyzed quantitatively in order to assess the implications of directive on performances of private commercial banks like profitability, branch expansion, loans and advances, Capital and reserve, asset, liquidity and the like.

As far as research type concerned, as the primary objective of this research is to assess the implications of regulatory policy (NBE bills purchase directive) on the development of private commercial banks, descriptive research design and type is employed in this study. Descriptive research design enquires “what”, “how”, “why” and which are assumed to be more appropriate to help to have detailed insights, and understandings of the topic understudy. In this study, the implications of the NBE Bills Purchase Directive approached by inquiring the following specific questions:

1. What are the implications of the NBE bill purchase directive on the development of private commercial banks in Ethiopia?
2. What are the activities/performances of private commercial banks that have been affected by NBE Bills purchase directive?
3. How has the NBE bills Purchase directive affected the operational and financial performances of private commercial banks?
4. What is the extent of implications of NBE bills purchase directive on the performances of private commercial banks?
5. What do the discussions of findings of the study imply in terms of policy recommendation?

The descriptive research is appropriate to undertake a research in a situation where there is shortage of money available to undertake rigorous study. Hence, its cost is reasonable considering the amount of information needed to be gathered. Descriptive design is also used to collect large amount of data with

relative ease from a variety of sources and summarize data results in the thematic categories.

1.7.2 Data type and Source

For the purpose of this research both primary and secondary data were utilized from primary and secondary sources. Qualitative data were collected from primary Sources using interviews, questionnaires, letters and documentations. Secondary data were collected from secondary sources like reports and publications, books, journal articles, directives and the like.

1.7.3 Data Gathering Tools

Both primary and secondary data were collected using appropriate tools. To collect primary data on implications of NBE bills purchase directive on various banking performances, the extent of the implications, and policy recommendations, semi-structured questionnaires were employed. In addition to questionnaires, in-depth interview were conducted with senior bank officials on the components of the directive that affect private banks, specific activities of private banks affected by directive and alternative policy recommendations. Interview was also conducted with National Bank of Ethiopia official on issues like the main reasons for the issuance of the directive, analysis of the directive's implications when developed and others. Secondary data on impacts of NBE bills purchase directive also surveyed using document survey tool.

1.7.4 Sample and Sampling Techniques

Sampling is the “the act, process or technique of selecting a suitable sample, or a representative part of a population for the purpose of determining parameters or characteristics of the whole populations (Amer, N.D).A sample, on other hand, refers to a set of individuals/companies/ selected from an identified population with the intent of generalizing the findings to the entire population.

For the purpose of this study, target population (unit of analysis) was all private commercial banks that are currently in operation including the new entrant banks.

Since private commercial banks are limited in number (only 16), all of them were selected for the study.

From target population senior bank officials like presidents, vice-presidents, directors/Managers, head/experts/seniors/officers were selected with the use non-probability sampling technique (judgmental sampling). Non-probability sampling technique was used due to the fact that the knowledge/experience respondents have on the topic understudy. Thus, respondents thought to be have the knowledge/experience on the theme understudy include Presidents and vice-presidents of private commercial banks, directors/managers of Credit and corporate Planning and Business departments, heads/experts/seniors/officers working under these departments. Accordingly, these respondents approached using data collection techniques like questionnaires and interview. In addition to this, Monetary and financial analysis acting directorate director of National Bank of Ethiopia was interviewed purposely as NBE bills purchase directive was issued by his department.

1.7.5 Data Analysis Techniques

The analysis of the data was employed both quantitative and qualitative methods. The acquired quantitative data of various types from relevant sources were analyzed with the use of simple descriptive statistical techniques like percentages, ratios and averages. Table and graphs were used for presentation of the analyzed data. For qualitative data (data collected via interview), qualitative data analysis techniques; narration method was used. Narrations were developed for qualitative inquiries that were secured via in-depth unstructured interview. They included questions about the implications of the policy specific activities of private commercial banks; NBE bills purchase requirement directive components' implications on the private commercial banks' performances, main reasons behind the issuance of NBE bills purchase directive and the like.

1.8 Organization of the Research

The paper is organized into Four Chapters. The first chapter presents the background of the study, statement of problem, objectives, significance, and scope and limitation of the study. It also presents the methodologies of the research; including data types and sources, data collection tools, data analysis methods, research type and approaches. The second chapter is about the review of the relevant literatures and documents. The third chapter focuses on data result analysis, presentation and discussion. The final chapter, chapter four, presents summary of findings, conclusions and policy implications of the study.

Chapter Two

Literature Review

2.1 Conceptualizing Regulation

Before coming to the definition of regulatory policy, defining regulation is worth considering as regulatory policy is much more related regulation. As far as the definition of regulation concerned, Coglianese (2012: 8) said the word “regulation” itself can mean many things and has been defined variously by various researchers and practitioners. At its most basic level, “regulation” is treated as synonymous with law (ibid). They are rules or norms adopted by government and backed up by some threat of consequences, usually negative ones in the form of penalties. According to Orbach (2012:10) regulation is state intervention in the private domain, which is a byproduct of our imperfect reality and human limitations.

Often directed at businesses, regulations can also take aim at nonprofit organizations, other governmental entities, and even individuals (Coglianese, 2012: 8). Regulations can also derive from any number of institutional sources: parliaments or legislatures, ministries or agencies, or even voters themselves through various kinds of plebiscites. Given their variety, regulations can be described using many different labels: constitutions, statutes, legislation, standards, rules, and so forth (ibid).

OECD (2010), on the other hand, defined regulation as any instrument by which governments, their subsidiary bodies, and supranational bodies (such as the EU or the WTO) set requirements on citizens and businesses that have legal force. The term may thus encompass a wide range of instruments: from primary laws and secondary regulations to implement primary laws, subordinate rules, administrative formalities and decisions that give effect to higher-level regulations (for example, the allocation of permits), and standards. Regulations may emanate from non-governmental or self-regulatory bodies to which governments have

delegated regulatory powers (OECD, 2010). Regulations do not only address the activities of the private sector. They also include the rules and procedures that frame the internal operation of public authorities, including ministries and government agencies (ibid).

Kirkpatrick, et al (2004), moreover, defined regulation as the diverse set of instruments by which governments set requirements on enterprises and citizens. Regulations include laws, orders and rules issued by all level of governmental bodies to which governments have delegated regulatory powers. Regulation can take many forms and the form of regulation policy adopted in developing countries has shifted over the time (Minogue cited in Jillian, Kirkpatrick and Parker, 2006). Regulations touch our everyday life in thousand ways that we may never imagine (Dudley and Brito, 2012). They provide social benefits and impose social costs on individuals and businesses beyond the direct dollars expended to write and enforce them.

2.1.1 Purpose of Regulation

The overriding purpose of regulation should be to facilitate legitimate business activity while providing safeguards for the interests of stakeholders and ensuring fair competition in the market (Davies and Welch, 2009). Safeguards for stakeholders' include:

- Deterring and restraining companies from pursuing illegal or excessively risky practices which have the potential to have wider socio-economic consequences.
- Intervening and responding appropriately and effectively where breaches are considered likely to occur or have already occurred.

2.1.2 Categories of Regulation

Dudley and Brito (2012:9) divided regulations into two main categories: social regulations and Economic regulations. Social regulations address issues related to health, security, safety and environment. Agencies that register social regulation

activities are generally limited to a specific issue, but they also have the power to generate across industry boundaries. Economic regulations are often industry specific. Economic regulation usually governs a broad base of activities in particular industries, using economic controls such as price ceilings or floors, production quantity restrictions, and service parameters. Kirkpatrick, Parker and Zhang (2004), on the other hand, further classified regulations into three main categories: economic regulations, social regulations and environmental regulations.

2.2 Operationalizing Regulatory Policy

Coglianesse (2012) defined regulatory policy as the various rules, procedures and practices related to regulations. He also coated the definition of Jacobzone et al, 2007 in which they defined regulatory policy as “policies, tools and processes related to regulations”. Regulatory policies involve imposition of restriction or limitations on the behavior of individuals or groups: they reduce the freedom to act of those who are regulated (example business regulatory policies related to pollution control or regulation of transportation industries). In other words, regulatory policy is designed to limit the actions of persons or groups so as to protect the general or a substantial portion of the public.

Moreover, according to Malyshev (N.D) regulatory policy is the systematic development and implementation of government wide-tools and institutions used to shape the on how government use their regulatory powers. This includes integrating competition policy and market openness initiative in the regulatory policy agenda and changing the culture of regulators so that flexibility and outcome-oriented approaches are systematically favored in regulatory design.

The objective of regulatory policy, according to OECD, is to ensure that regulations are in the public interest. It addresses the permanent need to ensure that regulations and regulatory frameworks are justified, of good quality and “fit for purpose”. An integral part of effective public governance, regulatory policy helps to shape the relationship between the state, citizens and businesses. An

effective regulatory policy supports economic development and the rule of law, helping policy makers to reach informed decisions about what to regulate, whom to regulate, and how to regulate (ibid).

Regulatory policy can be viewed, strategically alongside fiscal and monetary policy as one of the three core levers at the disposal of governments for managing the economy and society, implementing policy and influencing behavior. Regulatory policy is a comparatively young discipline (OECD, 2010). It started to emerge in a few countries in the 1970s, in others much later. It has progressed steadily, through different phases, a process that can be expected to (and needs to) continue.

2.3 Financial Sector Regulation

The financial system is complex, comprising many different types of private sector financial institutions, including banks, insurance companies, mutual funds, finance companies, and investment banks, all of which are heavily regulated by the government (Mishkin, 2004:7). Financial regulation as stated by Jomini (2011) is designed to improve the way in which financial markets function by increasing financial stability, protecting consumers, improving information and limiting risk. Furthermore, Zhou, 2010: 2) pointed out that regulations in the financial sector are designed to limit the risk taking behavior of financial institutions and thus prevent potential financial crisis. Likewise, Di Giorgio, Di Noia and Piatti (2000:5) stated that the regulation of financial system can be viewed as a particularly important case of public control over the economy.

According to Chowdhury (1998), there are two distinct categories of financial regulation according its motives.

1. Economic regulation (e.g. controls over interest rates and credit allocation) aims to mitigate market failures in the allocation of resources.
2. Prudential regulation aims to protect the stability of the financial system (i.e. prevent systemic failures or financial crises) and to protect depositors/investors,

especially small depositors (Suarez, 1998: 308). Prudential regulation ensures that regulated entities are financially sound and promotes their prudent behavior (GSM association, 2008). The key aim of prudential regulation is protecting the interests of consumers and the quality of an institution's systems for identifying, measuring and managing the various risks in its business (ibid). Furthermore, White(2013) underlined the objective of prudential financial regulation is to ensure vital functions of financial sectors like facilitating payments, providing liquidity, pooling saving and risk sharing and credit intermediation between savers and investors are maintained.

2.3.1 Objective of financial regulation

Llewellyn (1999) said although a wider framework might be set by particular regulatory agencies, in the final analysis the three core objectives of financial regulations are:-to sustain systematic stability, to maintain the safety and soundness of financial institutions, and to protect consumer. Moreover, Jansson and Wenner (1997:4) stated that the fundamental purpose of financial regulation is to promote effective and efficient capital accumulation while maintaining the safety and soundness of financial institutions that take deposits from the public.

2.3.2 Theories of financial regulation

According to Hanson, Kashyap, and Stein (2011), there are two theories on financial regulation: micro prudential and macro prudential regulation.

➡ Micro Prudential Regulation

Micro prudential regulation refers to the Basel I type of regulation that focuses on the risk-taking behavior of individual financial institutions (Zhou, 2010:2; Zhou, 2011: 2).The general critique on micro-prudential regulation is that it fails to achieve the goal of maintaining the stability of a financial system as a whole. In other words, it fails to limit the system fails to limit the systemic risk within the system ((Zhou, 2010:2; Zhou, 2011: 2).

➡ Macro prudential Regulation

In the simplest term, one can characterize the macro prudential approach to financial regulation as an effort to control the social costs associated with excessive balance sheet shrinkage on the part of multiple financial institutions hit with a common stock. Macro prudential tools aim at the stability of the entire financial system (Zhou, 2011).

2.4 Bank Regulation

Banking regulation in its strictest sense refers to the framework of law and rules under which banks operate (Spong, 2000:5). Banking law and regulation extend to various aspects of banking, including who can open banks, what products can be offered and how banks can expand (Spong, 2000:5). The most important rationale for regulation in banking is to address concerns over the safety and stability of financial institutions, the financial sector as a whole, or the payments system (Bonn, 2005:6). Prudential banking regulation is designed to protect the banking system from crises because banking crises typically affect the entire economy (KPMG, 2013:6). According to Mishkin (2004), there are eight basic categories of banking regulation: the government safety net, restrictions on bank asset holdings, capital requirements, chartering and bank examination, assessment of risk management, disclosure requirements, consumer protection and restriction on competition. Each of these regulations is mentioned as follows.

2.4.1 Government safety-net

A government safety-net for depositors can short-circuit runs on banks and bank panics, and by providing protection for the depositor, it can overcome reluctance to put funds in the banking system (Mishkin, 2001; Mishkin, 2004; Telyukova, 2008). There is no generally accepted definition of the key elements of the financial safety net (Schich, 2008). A narrow definition is limited to deposit insurance and a lender of last resort function (ibid). Telyukova (2008), however, expanded it to three elements adding government bail outs to the previous components. Deposit insurance is a guarantee such as that provided by the Federal Deposit Insurance Corporation (FDIC) in the United States in which depositors are

paid off in full on the first \$100,000 they have deposited in the bank no matter what happens to the bank (Mishkin, 2001). With fully insured deposits, depositors do not need to run to the bank to make withdrawal even if they are worried about the bank's health because their deposits will be worth 100 cents on the dollar no matter what happens to the bank (Mishkin, 2004). Deposit insurance can give rise to moral hazard both on the part of depositors, who may reduce their monitoring and "policing" efforts, as well as on the part of banks, which may perceive the lessening of the threat of market discipline (Schich, 2008). According to Demirgüç-kut and Detragiache (2002) cited in Klomp and Haan (2011) a deposit insurance influences bank soundness in two opposite ways. On the one hand, bank runs are less likely to occur when deposits are insured. On the other hand, a deposit insurance system provides banks incentives to engage in more risk taking.

A lender of last resort function is providing temporary lending to the market in general at such time of financial distress, the central bank can relieve tensions and limit the potential fears that might prompt banks (Mishkin, 2004; Schich, 2008). Such actions are part of the lender of last resort functions of central banks (Schich, 2008). In other cases, funds are provided directly by the government to troubled institutions, or these institutions are taken over by the government and the government then guarantees that depositors will receive their money in full (Mishkin, 2004).

Although a government safety net has been successful at protecting depositors and preventing bank panics, it is a mixed blessing (Mishkin, 2004). The most serious drawback of the government safety net stems from moral hazard, the incentives of one party to a transaction to engage in activities detrimental to the other party (Mishkin, 2001). Moral hazard is an important concern in insurance arrangements in general because the existence of insurance provides increased incentives for taking risks that might result in insurance (Mishkin, 2004). Moral hazard is a prominent concern in government arrangements to provide a safety net. Because

with a safety net depositors know that they will not suffer losses if a bank fails, they do not impose the discipline of the market place on banks by withdrawing deposits when they suspect that the bank is taking on too much risk (ibid). Consequently, banks with a government safety net have an incentive to take on greater risks than they otherwise would.

2.4.2 Restrictions on Asset holding and capital requirements

Bank regulations that restrict asset holdings and bank capital requirements are directed at minimizing moral hazards, which can cost the taxpayers dearly (Mishkin,2004;Telyukova,2008). Bank asset and capital requirements takes several forms:-restrictions on types of assets banks can hold (no common stocks), diversifications requirements for the types of loans a bank can make and capital requirements (Mishkin, 2001; Telyukova, 2008). Bank regulations that restrict banks from holding risky assets such as common stock are a direct means of making banks avoid too much risk (Mishkin, 2004). Bank regulations also promote diversification, which reduces risk by limiting the amount of loans in particular categories or to individual borrowers (Mishkin, 2001). Requirements that banks have sufficient bank capital are another way to change the bank's incentives to take on less risk. When a bank is forced to hold a large amount of equity capital, the bank has more to lose if it fails and is thus more likely to pursue less risky activities. In the aggregate, higher capital requirements will tend to make the banking system more resilient because distressed banks may drain other banks of their liquid reserves while general liquidity is declining (Murphy, 2013).

Bank capital requirements take two forms (Mishkin, 2004; Telyukova, 2008). The first type is based on the so-called leverage ratio, the amount of capital divided by the bank's total assets (Heremans, 1999; Mishkin, 2004). To be classified as well capitalized, a bank's leverage ratio must exceed 5%; a lower leverage ratio, especially one below 3%, triggers increased regulatory restrictions on the bank (Telyukova, 2008). The second type is based on the so-called Basel Accord, risk based capital requirements (Heremans, 1999; Mishkin, 2004). The Basel Accord,

which required that banks hold as capital at least 8% of their risk-weighted assets, has been adopted by more than 100 countries, including the United States.

Assets and off-balance-sheet activities were allocated into four categories; each with a different weight to reflect the degree of credit risk (Mishkin, 2004). The first category carries a zero weight and includes items that have little default risk, such as reserves and government securities in the OECD, Organization for Economic Cooperation and Development, (industrialized) countries. The second category has a 20% weight and includes claims on banks in OECD countries. The third category has a weight of 50% and includes municipal bonds and residential mortgages. The fourth category has the maximum weight of 100% and includes loans to consumers and corporations. Off-balance-sheet activities are treated in a similar manner by assigning a credit-equivalent percentage that converts them to on-balance-sheet items to which the appropriate risk weight applies (ibid).

2.4.3 Banking Supervision: Chartering and Examination

Overseeing who operates banks and how they are operated, referred to as bank supervision or more generally as prudential supervision, is an important method for reducing adverse selection and moral hazard in the banking business (Mishkin, 2004). According to Mishkin (1997) quoted in Heremans (1999) an adverse selection problem arises as financial activities may attract entrepreneurs wishing to engage in speculative activities. Chartering banks is one method for preventing this adverse selection problem; through chartering, proposals for new banks are screened to prevent undesirable people from controlling them (Heremans, 1999; Mishkin, 2001; Mishkin; 2004).

Regular on-site bank examinations, which allow regulators to monitor whether the bank is complying with capital requirements and restrictions on asset holdings, also function to limit moral hazard (Heremans, 1999; Telyukova, 2008). According to Dang (2011) on site bank examination includes the regular visit on banks followed by the managements, evaluating the accuracy of the financial

statements, accounting records, internal records and compliance and regulation. Bank examiners give banks a so-called CAMELS rating (the acronym is based on the six areas assessed: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk) (Mishkin, 2004). A CAMEL rating has proven to be an effective internal supervisory tool for evaluating the soundness of a financial firm, on the basis of identifying those institutions requiring special attention or concern (Dang, 2011). Its purpose is to provide an accurate and consistent evaluation of a bank's financial condition and operations in the areas such as capital, Asset, quality, management, earning ability and liquidity (ibid).

Actions taken to reduce moral hazard by restricting banks from taking on too much risk help reduce the adverse selection problem further, because with less opportunity for risk taking, risk-loving entrepreneurs will be less likely to be attracted to the banking industry (Mishkin,2004). Note that the methods regulators use to cope with adverse selection and moral hazard have their counterparts in private financial markets.

Chartering is similar to the screening of potential borrowers, regulations restricting risky asset holdings are similar to restrictive covenants that prevent borrowing firms from engaging in risky investment activities, bank capital requirements act like restrictive covenants that require minimum amounts of net worth for borrowing firms, and regular bank examinations are similar to the monitoring of borrowers by lending institutions (Mishkin, 2004).

2.4.4 Assessment of Risk Management

According to Dionne (2013) risk management is a relatively recent corporate function and modern risk management started after late 1955. Traditionally, on-site bank examinations have focused primarily on assessment of the quality of the bank's balance sheet at a point in time and whether it complies with capital requirements and restrictions on asset holdings (Mishkin, 2004). Although the traditional focus is important for reducing excessive risk taking by banks, it is no longer felt to be adequate in today's world, in which financial innovation has produced new markets and instruments that make it easy for banks and their

employees to make huge bets easily and quickly. Thus, an examination that focuses only on a bank's position at a point in time may not be effective in indicating whether a bank will in fact be taking on excessive risk in the near future (Mishkin, 2004).

This change in the financial environment for banking institutions has resulted in a major shift in thinking about the bank supervisory process throughout the world. Bank examiners are now placing far greater emphasis on evaluating the soundness of a bank's management processes with regard to controlling risk (Mishkin, 2001). Mishkin (2004) explained four elements of sound risk management are assessed to come up with the risk management rating: (1) The quality of oversight provided by the board of directors and senior management, (2) the adequacy of policies and limits for all activities that present significant risks, (3) the quality of the risk measurement and monitoring systems, and (4) the adequacy of internal controls to prevent fraud or unauthorized activities on the part of employees.

2.4.5 Disclosure Requirements

To ensure that there is better information for depositors and the marketplace, regulators can require that banks adhere to certain standard accounting principles and disclose a wide range of information that helps the market assess the quality of a bank's portfolio and the amount of the bank's exposure to risk (Mishkin, 2001 and Mishkin, 2004). More public information about the risks incurred by banks and the quality of their portfolio can better enable stockholders, creditors, and depositors to evaluate and monitor banks and so act as a deterrent to excessive risk taking (Mishkin, 2001). Such information would supplement disclosures based on traditional accounting conventions by providing information about risk exposure and risk management that is not normally included in conventional balance sheet and income statement reports (Mishkin, 2004).

2.4.6 Consumer Protection

The existence of asymmetric information also suggests that consumers may not have enough information to protect themselves fully (Mishkin, 2004). Murphy (2013) stated that lenders must comply with a variety of statutes and regulations when offering financial products to consumers. Consumer protection regulation has taken several forms. First is 'truth in lending' mandated under the Consumer Protection Act of 1969, which requires all lenders, not just banks, to provide information to consumers about the cost of borrowing including a standardized interest rate (called the annual percentage rate, or APR) and the total finance charges on the loan (Mishkin, 2004).

2.4.7 Restriction of Competition

Increased competition can also increase moral hazard incentives for banks to take on more risk (Mishkin, 2001 and Mishkin, 2004). Declining profitability as a result of increased competition could tip the incentives of bankers toward assuming greater risk in an effort to maintain former profit levels (Marcus, 1984 and Keeley, 1990 in Mishkin, 2001). Thus, governments in many countries have instituted regulations to protect banks from competition (Mishkin, 2004). These regulations have taken two forms in the United States in the past. First were restrictions on branching, which reduced competition between banks. The second form involved preventing nonbank institutions from competing with banks by engaging in banking business, as embodied in the Glass-Steagall Act, which was repealed in 1999 (ibid).

Although restricting competition propped up the health of banks, restrictions on competition also had serious disadvantages: They led to higher charges to consumers and decreased the efficiency of banking institutions, which did not have to compete as hard (Mishkin, 2001; Mishkin, 2004). Thus, although the existence of asymmetric information provided a rationale for anticompetitive regulations, it did not mean that they would be beneficial. Indeed, in recent years, the impulse

of governments in industrialized countries to restrict competition has been waning (Mishkin, 2004).

However, Allen and Helling (2001) in Murphy (2013) extended the types of banking regulatory policies into fourteen (14) adding six-additional regulations on Mishkin. These regulations include asset restriction, capital adequacy, conduct on business, competition policy, conflict interest rules, investment requirement, fit and proper entry tests, limits on interest on deposits, limits on interest on loans, liquidity requirements, reporting large transactions, reserve requirements and restriction on geographical reach.

2.4.8 Rationale for banking regulation

Goodhart(2010) putted three theoretical reasons for banking regulations that includes Externalities, the protection of non-professional consumers of banking services and the control of monopoly power .Moreover, as quoted from Sudin Haron (1996), the main reason for regulation is to provide a sound, stable and healthy financial system.

2.5 Government Intervention in the financial market

The role of modern government in financial market is a long standing debate that engaged economists around the world (Stiglitz, Vallejo and Park, 1993). There is a role for the government in financial markets, but the success of government interventions has been mixed (Stiglitz, Vallejo and Park, 1993 and Stiglitz, 1994). It is important that interventions be well designed (Stiglitz, 1994). Historically, the overriding reason for government intervention has been the desire to avoid systemic risk, mainly by *ex post rescue* operations of financial intermediaries (Heremans, 1999: 10). Preventive measures were mostly of a structural nature by limiting competition. The focus on market efficiency and individual consumer protection by deposit insurance and prudential measures is of a more recent date (Stiglitz, 1994).

2.5.1 Areas of government intervention in the financial market

Stiglitz (1989) identified the following key areas in which governments all over the world have intervened in the financial markets to help make them serve the public interest better.

A. Safety and soundness

As general concept, safety and soundness authority refers to examining and regulating the probability of a firm's default, and the magnitude of the losses that its owners and creditors would suffer if the firm defaulted (Jickling and Murphy, 2010). According to Murphy (2013) Safety and soundness refers to a broad range of issues that relate to the health of a financial institution. He stated that Safety and soundness encompasses risk management, capital requirements, the diversification of a bank's portfolio, provisions for liquidity, allowances for loan and lease losses, concentrations of transactions with a single counterparty or in a single region, exposure to potentially expensive litigation, adequate training and expertise of management and staff, adequate procedures for internal controls, and many other issues (Murphy, 2013). Depositors put their money into banks, in the expectation that they will be able to get their money out when they need it (Besley, 2010). Banks, of the money to earn returns and in a competitive world, those returns less charge are returned to the depositors (Mishkin, 2004). According Stiglitz (1994) there are two difficulties: (a) the bank may not invest repay the depositors; or (b) the best use of the money is long-term investments, but individuals may demand their money before the projects reach maturation. Other investors may not have confidence in the project(s) the bank has undertaken, and so it cannot sell the project for what it had hoped to get. This latter problem is known as that of maturity transformation short term funding for long-term projects. The inability to get funds is referred to as a liquidity problem, as distinct from the solvency problem (where the bank has, say, squandered the money).

There is a macro-economic liquidity problem, where the Central Bank has so tightened credit, in an unexpected way, that there is simply no one able to purchase the project (Stiglitz, 1994).

B. Macro-Economic stability

The objective of safety and soundness is closely related to that of systemic risk and macro-economic stability (Mishkin, 2004). When a small bank fails, we may be concerned about the depositors, but the ripple effects will be limited. However, when a large bank fails or a large number of medium sized banks fail it has macro-economic effects (Stiglitz, 1994).

The deepest and longest lasting downturns are related to bank failures (though sometimes the causality runs the other way deep and long downturns will inevitably be reflected in bank failures)(ibid). By the same token, if the government has to bail out a small bank, the costs are easily managed. According to Stiglitz (1994) the costs of systemic crises can be huge, that is why it is especially important for the government to prevent systemic risk.

Nevertheless, macro-prudential regulation is designed to ensure that the financial system does not contribute to cyclical fluctuations, and in so doing, reduces the risk of systemic failure (Stiglitz, 1989). Credit bubbles have been a major source of economic volatility since the beginning of capitalism (Miao and Wang, 2013). An increase in credit fuels a bubble, which increases the value of collateral, which leads to further credit expansion (Amar et al, 2010). Banking regulations, strictly enforced, have often contributed to this credit cycle. When the bubble breaks, bank net worth is greatly reduced, and banks are forced to contract their credit greatly (Miao and Wang, 2013). The contraction of credit contributes to the economic downturn. There is an obvious way to try to tame the credit cycle: when the economy is in a boom, increase capital requirements, which dampens the availability of credit. Tightening mortgage standards directly dampens a

housing bubble; increasing margin requirements may dampen a stock market bubble (Amar et al, 2010).

C. Access to Credit and Allocation of Credit

Stiglitz (1994) explained a major responsibility of the financial sector is to allocate credit. From a social point of view, what matters is social return. From the bank's perspective, the question is what returns it can extract, related to the interest rates it can charge and (a) the likelihood of well aligned with that of the bank; and (b) the bank bore all the costs of failure. There are major failures in both individual and organizational incentives that lead to excessive risk taking and shortsighted behavior (Stieglitz, 1994). However, it similarly can lead to more lending for speculative real estate and consumption than for productive investments in, say, manufacturing or employment generation, or to increase productivity in agriculture (Mishkin, 2004).

The gap between social and private returns has always been there, but it may be getting worse, and may be worse in developing countries (Stiglitz, 1994). Development entails large developmental externalities, development requires long-term credit, but banks have traditionally focused on short term lending (which can itself be explained by information imperfections)(Mishkin,2001). Nevertheless, changes in corporate governance in recent years have encouraged them to be even shorter sighted.

Foreign banks' interest and information exacerbates these problems. Key to job creation to employment and enterprise requires highly specific information, in which foreign banks may be at a comparative disadvantage. Recent empirical evidence shows that foreign banks do, indeed, lend (proportionately) less to SME's (and this in turn helps explain why developing countries where foreign banks play more important role have grown more slowly.)

The problems are further exacerbated by the greater concern that foreign banks may have that the governments may expropriate or take other actions that will

reduce their capacity to “extract rents” from the country. This induces the firm to have an even shorter-term horizon. According to Stiglitz (1994) there are three ways of dealing with this problem. The government may impose constraints on lending _ minimums (e.g. to underserved sectors, like agriculture and SME’s) or maximum (real estate) by imposing higher capital adequacy requirements or deposit insurance debts. Thirdly, the government can set up specialized development banks.

D. Consumer Protection

In almost all countries, governments have taken an important role in protecting both depositors and borrowers (Besley, 2010; Stiglitz, 1994).

a. Protecting Depositors

Besley (2010) stated depositors typically are concerned about the safety of their deposits as well as the return that those deposits yield. Depositors have to be protected; because there is no way that the typical depositor can be sure of the financial position of a bank (Stiglitz, 1994). Two main types of intervention appear justified on this account (Besley, 2010). The first is deposit insurance and the second is building structures to intermediate funds across groups and regions thereby reducing credit market segmentation. According to Stiglitz (1994) deposit insurance is motivated by three market failures: First, an information market failure: because of asymmetries of information, banks may take advantage of unwary depositors, putting their money into investments that are risky. Without deposit insurance, there would be a lack of confidence in the banking system, particularly in difficult times. This leads then to the second market failure: this lack of confidence in banks could lead to a run on the banks, with large systemic effects. (There are other contractual designs, e.g. a mutual fund, which would not (likely) give rise to such runs. However, there are distinct advantages to the debt contract. According to Dwyer and Gilbert (1989) runs are, of course, related to the problem of maturity transformation, that the assets and liabilities differ in

maturity. This too in principle could be avoided, but only at a high cost. Long-term investments yield higher returns, but short term deposits provide some discipline against the bank's misuse of funds (Dwyer, and Gilbert, 1989).

Nevertheless, some critics of deposit insurance argue that deposit insurance actually creates its own moral hazard problem: depositors do not have any incentive to monitor banks, and thus banks have an incentive to undertake risky lending, which allows them to pay higher interest rates (Stiglitz, N.D). Nevertheless, as we have noted, there is in fact no way that depositors could effectively monitor banks; but even if they could, monitoring is a public good (Stiglitz, 1994). It is inefficient to have every individual engaged in monitoring. Monitoring should be done by a public body (Besley, 2010). Regulators have to be attentive to the incentive effects that insurance gives rise to just as any insurance company needs to be attentive to moral hazard. In this case, it should look carefully at any firm paying high deposit rates: is it doing so because its transactions costs are lower, i.e. because it is more efficient, or because it is undertaking more risk (Stiglitz, 1994).

b. Protecting borrowers

Banks around the world have learned that they can greatly enhance their profits by engaging in predatory lending and abusive credit card practices (Stiglitz, 1994). This is not the place to provide a catalogue of the ingenuity that the banks have demonstrated. Banks often try to be deceptive about the interest rate and fees charged, including overdraft fees, and there has been an ongoing battle in the United States and other countries to elicit greater transparency, and to ensure that the fees are disclosed in a way that the borrower understands (ibid).

F. Competition

There is one more important reason for government intervention in the financial sector: to maintain competition (Stiglitz, 1994). In many countries, the banking sector is highly concentrated, and even when it is not, banks often act in ways, which suggest tacit collusion (Mishkin, 2001). It is hard to explain otherwise the persistently high returns far in excess of competitive levels. Occasionally, we see evidence of strongly anti-competitive behavior. The credit card companies Visa and Master Card (originally owned by the banks) set the interchange fees (the fees they charge merchants) at an extra-ordinarily high level, far in excess of the competitive level (Mishkin, 2004). It should take but a fraction that of the merchant; it simply entails the movement of a few electrons. Yet the banks and the credit card companies charged amounts that were ten, a hundred, a thousand times more (Stiglitz,1994). One grocery company was, in effect, splitting its profits almost 50-50 with the credit card company on credit card sales: for moving a few electrons, the banks/credit card company got as much the grocery (ibid).

2.6. The role of the financial system in the economic development

It is increasingly recognized that the financial system plays a crucial role in the process of economic development (Smith and Todaro, 2012:729). Professor Joseph E. Stiglitz (1994) likened financial sector to the brain of economy: It is central to the management of risk and the allocation of capital. It runs the economy's payment mechanism. It intermediates savers and investors, providing capital to and growing business. When it does its functions well, economy prosper, when it does its jobs poorly, economies and societies suffer (ibid).

Furthermore, Jomini (2011) said that the financial sector provides some of the 'oil' required for an economy to achieve its potential growth – it is designed to improve the productive potential of the whole economy. Moreover, Song and Thakor (2012) argued that there is strong evidence that the development of the financial sector ... consisting of the banks and financial markets Positively

affects real sector growth through the efficient mobilization and allocation of capitals. At the heart of every robust economy is a sound banking system (Errico and Farahbaksh, 1989: 4). The government helps make this possible by adopting sound macroeconomic policies, including a sound fiscal as well as monetary policy, acting to establish financial markets where they do not yet exist, and providing prudential regulation of the financial system (Smith and Todaro, 2012).

Smith and Todaro, 2012; White, 2013 and Barth, Gan and Nolle, N.D, stated the following six major functions that financial sector provides that are important both at firm level and at the level of the economy as the whole.

1. *Providing payment services.* It is inconvenient, inefficient, and risky to carry around enough cash to pay for purchased goods and services (Smith and Todaro, 2012). Financial institutions provide an efficient alternative. The most obvious examples are personal and commercial checking, check clearing, and credit and debit card services; each is growing in importance, in the modern sectors at least, even in low-income countries.

2. *Matching savers and investors.* Although many people save, such as for retirement, and many have investment projects, such as building a factory or expanding the inventory carried by a family microenterprise, it would be only by the wildest of coincidences that each investor saved exactly as much as needed to finance a given project (White,2013). Therefore, it is important that savers and investors somehow meet and agree on terms for loans or other forms of finance. This can occur without financial institutions; even in highly developed markets, many new entrepreneurs obtain a significant fraction of their initial funds from family and friends (Smith and Todaro, 2012). However, the presence of banks, and later venture capital or stock markets, can greatly facilitate matching in an efficient manner. Small savers simply deposit their savings and let the bank decide where to invest them.

3. *Generating and distributing information.* From a society wide viewpoint, one of the most important functions of the financial system is to generate and distribute information (Smith and Todaro, 2012). Stock and bond prices in the daily newspapers of developing countries (and increasingly on the Internet as well) are a familiar example; these prices represent the average judgment of thousands, if not millions, of investors, based on the information they have available about these and all other investments. Banks also collect information about the firms that borrow from them; the resulting information is one of the most important components of the “capital” of a bank, although it is often unrecognized as such. In these regards, it has been said that financial markets represent the “brain” of the economic system (Stiglitz, 1994).

4. *Allocating credit efficiently.* Channeling investment funds to uses yielding the highest rate of return allows increases in specialization and the division of labor, which have been recognized since the time of Adam Smith as a key to the wealth of nations(Smith and Todaro,2012; white, 2013).

5. *Pricing, pooling, and trading risks.* Insurance markets provide protection against risk, but so does the diversification possible in stock markets or in banks’ loan syndications (Stieglitz, 1994).

6. *Increasing asset liquidity.* Some investments are very long-lived; in some cases—a hydroelectric plant, for example—such investments may last a century or more (Smith and Todaro, 2012; White, 2013). Sooner or later, investors in such plants are likely to want to sell them. In some cases, it can be quite difficult to find a buyer at the time one wishes to sell—at retirement, for instance. Financial development increases liquidity by making it easier to sell, for example, on the stock market or to a syndicate of banks or insurance companies.

More specifically, banks play a key role in improving economic efficiency by channeling funds from resource surplus unit to those in better productive investment opportunities (Zerayehu, Kagneu, and Abebe, 2013). Moreover, According to Allen and Carletti (2008) Banks perform various roles in the economy. First, they ameliorate the information problems between investors and borrowers by monitoring the latter and ensuring a proper use of the depositors' funds.

Second, they provide inter-temporal smoothing of risk that cannot be diversified at a given point in time as well as insurance to depositors against unexpected consumption shocks. Because of the maturity mismatch between their assets and liabilities, however, banks are subject to the possibility of runs and systemic risk. Third, banks contribute to the growth of the economy. Fourth, they perform an important role in corporate governance. Private Banks, along with asset managers or private equity firms, play a pivotal Role in economic development (Santiso, 2008:5). They are also potential partners for public aid donors.

2.7 Development of banking

Banking is of ancient origin, though little is known about it prior to the 13th century (Fasil and Mehratbeb, 2009). Many of the early —banks dealt primarily in coin and bullion, much of their business being money changing and the supplying of foreign and domestic coin of the correct weight and fineness (Hildreth,2001). Another important early group of banking institutions was the merchant bankers, who dealt both in goods and in bills of exchange, providing for the remittance of money and payment of accounts at a distance but without shipping actual coin (Hildreth, 2001). Business arose from the fact that many of these merchants traded internationally and held assets at different points along trade routes.

For a certain consideration, a merchant stood prepared to accept instructions to pay money to a named party through one of his agents elsewhere; the amount of the bill of exchange would be debited by his agent to the account of the merchant banker, who would also hope to make an additional profit from exchanging one

currency against another (Fasil and Mehratbeb, 2009). Because there was a possibility of loss, any profit or gain was not subject to the medieval ban on usury. There were, moreover, techniques for concealing a loan by making foreign exchange available at a distance but deferring payment for it so that the interest charged could be camouflaged as a fluctuation in the exchange rate (ibid).

Another form of early banking activity was the acceptance of deposits (Hildreth, 2001). These might derive from the deposit of money or valuables for safekeeping or for purposes of transfer to another party; or, more straightforwardly, they might represent the deposit of money in a current account (ibid). A balance in a current account could also represent the proceeds of a loan that had been granted by the banker, perhaps based on an oral agreement between the parties (recorded in the banker's journal) whereby the customer would be allowed to overdraw his account.

English bankers in particular had, by the 17th century, begun to develop a deposit banking business, and the techniques they evolved were to prove influential elsewhere (Orsigher, 1967). The London goldsmiths kept money and valuables in safe custody for their customers. In addition, they dealt in bullion and foreign exchange, acquiring and sorting coin for profit (Hildreth, 2001). As a means of attracting coin for sorting, they were prepared to pay a rate of interest, and it was largely in this way that they began to supplant as deposit bankers their great rivals, the —money scriveners. The latter were notaries who had come to specialize in bringing together borrowers and lenders; they also accepted deposits (ibid).

It was found that when money was deposited by a number of people with a goldsmith or a scrivener a fund of deposits came to be maintained at a fairly steady level (Orsigher, 1967). Over a period of time, deposits and withdrawals tended to balance. In any event, customers preferred to leave their surplus money

with the goldsmith, keeping only enough for their everyday needs (Hildreth, 2001). The result was a fund of idle cash that could be lent out at interest to other parties. About the same time, a practice grew up whereby a customer could arrange for the transfer of part of his credit balance to another party by addressing an order to the banker.

This was the origin of the modern check. It was only a short step from making a loan in specie or coin to allowing customers to borrow by check: the amount borrowed would be debited to a loan account and credited to a current account against which checks could be drawn; or the customer would be allowed to overdraw his account up to a specified limit (Fasil and Mehratbeb, 2009). In the first case, interest was charged on the full amount of the debit, and in the second the customer paid interest only on the amount actually borrowed. A check was a claim against the bank, which had a corresponding claim against its customer.

Another way in which a bank could create claims against itself was by issuing bank notes (Fasil and Mehratbeb, 2009). The amount actually issued depended on the banker's judgment of the possible demand for specie, and this depended in large part on public confidence in the bank itself. In London, goldsmith bankers were probably developing the use of the bank note about the same time as that of the check. (The first bank notes issued in Europe were by the Bank of Stockholm in 1661). Some commercial banks are still permitted to issue their own notes, but in most countries, this has become a prerogative of the central bank (ibid).

In Britain the check soon proved to be such a convenient means of payment that the public began to use checks for the larger part of their monetary transactions, reserving coin (and, later, notes) for small payments (Fasil and Mehratbeb, 2009). As a result, banks began to grant their borrowers the right to draw checks much in excess of the amounts of cash actually held, in this way —creating money i.e., claims that were generally accepted as means of payment. Such money came to be

known as —bank money or —credit. Excluding bank notes, this money consisted of no more than figures in bank ledgers; it was acceptable because of the public's confidence in the ability of the bank to honor its liabilities when called upon to do so.

When a check is drawn and passed into the hands of another party in payment for goods or services, it is usually paid into another bank account (Fasil and Mehratbeb, 2009). Assuming that the overdraft techniques are employed, if the check has been drawn by a borrower, the mere act of drawing and passing the check will create a loan as soon as the check is paid by the borrower's banker. Since every loan so made tends to return to the banking system as a deposit, deposits will tend to increase for the system as a whole to about the same extent as loans. On the other hand, if the money lent has been debited to a loan account and the amount of the loan has been credited to the customer's current account, a deposit will have been created immediately (ibid).

One of the most important factors in the development of banking in England was the early legal recognition of the negotiability of credit instruments or bills of exchange. The check was expressly defined as a bill of exchange. In continental Europe, on the other hand, limitations on the negotiability of an order of payment prevented the extension of deposit banking based on the check. Continental countries developed their own system, known as giro payments, whereby transfers were affected on the basis of written instructions to debit the account of the payer and to credit that of the payee.

2.8 Banks- general over view

Banks are intermediaries between savers and borrowers (Deloitte, 2012). In its simplest form, the business model of commercial banks is to accept deposits from savers in order to make loans to borrowers—in other words, banks borrow from depositors and offer loans to individuals, business firms, nonprofits, and governments (Murphy, 2012:5). Although savers could offer loans directly to

potential borrowers, there are several advantages of relying on specialized lenders. For example, savers essentially pay banks to act on their behalf, identifying credit-worthy borrowers, banks to act on their behalf (agency relationship writing and administering loan contracts, and enforcing the loan terms if the borrower defaults).

Banks also mobilize and allocate capital efficiently and prudently to facilitate the process of saving and investment and to promote long-term growth (Taci and Fries, 2002).

Another potential source of profit of banks centers on timing. Since long-term interest rates are generally higher than short-term interest rates, banks can earn profits by borrowing short-term in order to offer longer-term loans (often referred to as a maturity transformation or maturity mismatch)(Murphy, 2012:5).

2.8.1 Economic Significance of banks

The existence of a strong and effective banking system is very important for the economic development of a country via undertaking the following activities (Fasil and Merhatbeb, 2009).

First, Banks through acceptance of deposit of money from persons who do not need it at the present and lending it to persons who want it for investment, serve as financial intermediaries thereby providing ideal source of fund for investment that is crucial in increasing production, exports, creation of jobs and foreign exchange earnings of the country. Second, bank lending to customers who need the money for consummation, purchase of various goods and services, construction of houses, and education increases demand for those goods and services, thereby encouraging producers and service providers to expand their undertakings and increase production. Expansion and increase in production requires employment of additional workers, thereby creating new jobs, encourage producers and suppliers of raw materials to increase their production and supply.

Third, Banks also play a positive role in encouraging savings by providing an incentive to save through payment of interest on deposits/savings and providing safety and security. Saving is also an important source of future investment and the improvement of the living standards of the society. Fourthly, the power of the national bank in fixing interest rates is particularly crucial in both investment and saving. If the rate of interest fixed by the bank on deposits /i.e. the interest banks pay on money deposited on saving and other accounts / is attractive, it will encourage people to save their money rather than spend it. However, such interest should not discourage people from investment and productive activities and turn them to rent collection /potential investors may decide to deposit their money and collect interest/. If the rate of interest charged by banks on money given on loan to borrowers is lower, it may encourage potential borrowers and investors to borrow and invest, thereby contributing their part in the expansion and increase of production of goods and services, creation of employment opportunities, increase in exports and foreign exchange earnings of the country.

Finally, the existence of a network of banks covering all parts of a country facilitates business transactions in the country by making payments easier, safer and cheaper. Payment through banks also avoids the risk of loss or theft of money.

2.9 Central bank and its roles

According to Smith and Todaro (2012) Central bank is defined as the major financial institution responsible for issuing nations currency, managing foreign reserves, implementing monetary policy and providing banking services to the government and commercial banks (Smith and Todaro, 2012:734). Moreover, Fasil and Merhatbeb (2006) defined it as an institution, the Bank of England, the US Federal system, the Bank of France or Bank of Japan, which is entrusted with the power of regulating the size of a nation's money supply, the availability and cost of credit, and the foreign exchange value of its currency.

In the process, central banks have become varied in authority, autonomy, functions and instruments of actions. Virtually everywhere, however, there has

been a vast, and explicit broadening of central bank responsibility for promoting domestic economic stability and growth and for defending the international value of currency. It has substantial public responsibilities and a broad array of executive powers. Central banks' major activities, as Smith and Todaro (2012) stated, can be grouped into five functions.

1. Issuer of currency and manager of foreign reserves. Central banks print money, distribute notes and coins, intervene in foreign exchange markets to regulate the national currency's rate of exchange with other currencies and manage foreign asset reserves to maintain the external value of the national currency.
2. Banker to the government. Central banks provide bank deposit and borrowing facilities to the government while simultaneously acting as the government's fiscal agent and underwriter.
3. Banker to domestic commercial bankers. Central banks also provide bank deposit and borrowing facilities to commercial banks and act as a lender of last resort to financially troubled commercial banks.
4. Regulator of domestic financial institutions. Central banks ensure that commercial banks and other financial institutions conduct their business prudently and in accordance with relevant laws and regulations. They also monitor reserve ratio requirements and supervise the conduct of local and regional banks.
5. Operator of monetary and credit policy. Central banks attempt to manipulate monetary and credit policy instruments (the domestic money supply, the discount rate, the foreign exchange rate, commercial bank reserve ratio requirements, etc.) to achieve major macroeconomic objectives such as controlling inflation, promoting investment, or regulating international currency movements.

According to Epstein (2006) there are at least three other roles of central banks that are less considered. One is the distributive role of central bank policy. Central

banks' policies can have differential impacts on different classes and groups: workers and capitalists, debtors and creditors, finance and industry, those operating in traded and non-traded goods. Linking this to the political economy of central banking, for example, bankers may oppose expansionary monetary policy because it might lower real interest rates and raise inflation, whereas workers and industrialists may prefer looser policy.

A second less-known role is the political role of central banks. These days, this role is primarily discussed in the context of whether or not the central bank is independent of the government (as opposed to being integrated into the government) with a focus, primarily, on the impact of central bank 'independence' on inflation. However, the political role of central banks is much more multi-faceted than this. During the period of de-colonization following the Second World War, it was recognized that by promoting financial unification, central banks can play an important political role in helping to establish national sovereignty and unity. More recently, central banks, which are relatively independent from government, often represent and promote particular interests, constituencies and ideologies in the public and private spheres and thereby affect the color and tenor of overall political debate over economic policy (Epstein, 1982). In recent times, these have often been aligned with those in financial circles, including external actors like the IMF, in promoting financial liberalization, inflation targeting and the elimination of capital controls.

A third underappreciated role is the allocative role: central bank policy can deliberately or inadvertently affect the profitability and access to credit of different industries. This developmental role is currently under-emphasized, relatively to the other two.

2.10 History and Development of banking system in Ethiopia

Mauri (2003) stated that there are five principal events, which may conveniently be taken as dividing Ethiopian banking history into periods. The first event was

establishment in 1906 of the Bank of Abyssinia, marking the advent of banking into the country (Mauri, 2003). The second event was Italian occupation in 1936 (Mauri, 1967; Tuccimei, 1999 in Mauri 2010). The third event was in 1943, establishment of the state bank of Ethiopia, marking the rebirth of the Ethiopian independent banking (Tewdros and Vijay, 2011). The fourth event was the revolution of 1994, which wiped out the monarchy, nationalized companies and shaped a “socialist banking” two tier model “suited” to Ethiopia. The fifth event was the collapse of socialist regime followed by a financial sector reform and liberalization according to monetary and banking proclamation of 1994 (Alemayehu, 2006).

Notwithstanding of these events, several authors including Mauri witnessed that the birth of modern banking system to Ethiopia was in the early 1900s. (See Alemayehu, 2006; Addison and Alemayehu, 2001; Hanvey, 1996; Mauri, 2003; Tewdros and Vijay, 2011). Modern banking in Ethiopia started in 1905 with the establishment of Abyssinian Bank based on 50 years agreement with the Anglo-Egyptian National bank (Alemayehu, N.D:2). Its capital was 1 million shillings. According to the agreement, the bank was allowed to engage in commercial banking (selling shares, accepting deposits and effecting payments in cheques) and to issue currency notes. The agreement prevented the establishment of any other bank in Ethiopia, thus giving monopoly right to the Bank of Abyssinia (Hanvey, 1996).

From the beginning of its activity, Bank of Abyssinia made conscious efforts to build up its administrative organization and lay out a network of branches in the country (Mauri, 2003). Soon after the inauguration of the headquarters in Addis Ababa, a branch office was opened in Harar (Zervos, 1936 in Mauri, 2003), long known as a trading center with the Somali coast. Then, it opened its branch offices in Dire Dawa, Gore and Dembi-Dolo as well as an agency office in Gambela and a transit office in Djibouti. Apart from serving foreigners residing in Ethiopia, and holding government accounts, it could not attract deposits from Ethiopian

nationals who were not familiar with banking services. In the meantime, two French banking institutions, the Banque de l'Indochine and the Compagnie de la Banque Orientale, likewise established themselves in Addis Ababa in 1915 (Pankhurst, 2006: 139).

The financial sector was dominated by foreign ownership until the Abyssinian Bank was nationalized in 1931 and renamed the Bank of Ethiopia, thereby becoming the first bank to be nationally owned in Africa (Belay, 1990:83, Befekadu, 1995:234 in Addison and Alemayehu, 2001). In 1931, the bank of Abyssinia was replaced by the Bank of Ethiopia which was wholly owned by the government and members of the Ethiopian Aristocracy, becoming the first 100% African –owned bank on the continent; it was also authorized to issue notes and coins and act as the government bank (Hanvey, 1996; Tewdros and Vijay, 2011).

The Bank of Ethiopia, which was fully owned by Ethiopians and with a capital of pound Sterling 750,000, was started operation in 1932. The majority shareholders of the Bank of Ethiopia were the Emperor and the political elites of the time. The Bank was authorized to combine the functions of central banking (issuing currency notes and coins) and commercial banking. As Bank of Abyssinia, the Bank of Ethiopia opened branches in Dire Dawa, Gore, Dessie, Debre Tabor and Harrar.

Further financial institutions were established during the Italian occupation of the late 1930s (Addison and Alemayehu, 2001). As the result of this, during the occupation (1936-1941), the operation of the Bank of Ethiopia came to a halt, but a number of Italian financial institutions were working in the country. These were Banco Di Roma, Banco Di Napoli and Banca Nazionale Del Lavoro. It should also be mentioned that Barclays Bank had opened a branch and operated in Ethiopia during 1942-43. In 1943, the state bank of Ethiopia was established with two departments performing the separate functions of an issuing bank and a commercial bank (Tewdros and Vijay, 2011).

With the departure of the Italians and the restoration of Emperor Haile Silassie's government, the State Bank of Ethiopia was established in 1943 with a capital of 1 million Maria Theresa Dollars by a charter published as General Notice No. 18/1943 (E.C). The Bank, which is, like its predecessor, combined the functions of central banking with those of commercial banking, opened 21 branches, including one in Khartoum (the Sudan) and a transit office in Djibouti. In 1945, the Agricultural Bank was established but was replaced by the Development Bank of Ethiopia in 1951, which changed into the Agricultural and Industrial Development Bank in 1970.

In 1963, the State Bank of Ethiopia split into the National Bank of Ethiopia and the Commercial Bank of Ethiopia S.C. with the purpose of segregating the functions of central banking from those of commercial banking (Alemayehu, 2006; Itana, N.D). These new banks started operation in 1964. Consequently, NBE assumed central banking functions of the country while CBE took up commercial banking business of the old bank (Itana, N.D). The powers and functions assigned to the National Bank were more or less the usually accepted ones of the majority of central banks elsewhere. Basically, the functions of the central bank are divided into the following major areas:-

1. The regulation, availability and cost of money and credit.
2. The management of gold and international reserve assets.
3. The licensing and supervision of banks and other financial institutions.
4. Holding the central treasury of the government and rendering general banking services to government departments and agencies.

The commercial bank on the other hand took up the duties of:-

1. Holding in deposit public's money with guaranteed security.
2. Giving loans for all sorts of commercial and personal needs.
3. Offering assistance in matter of foreign exchange to businesspersons.

4. Providing safekeeping for an individual's most valuable possessions

The Imperial Savings and Home Ownership Public Association (ISHOPA) and the Investment Bank of Ethiopia were also founded in 1963. The later was renamed as Ethiopian Development Corporation S.C. in 1965. In the same year, the Savings and Mortgage Company of Ethiopia S.C. was also founded. In the period to 1974, several other financial Institutions emerged including the state owned:

1. The Agricultural and Industrial Development Bank (established largely to finance state Owned enterprises)
2. The Savings and Mortgage Corporation of Ethiopia
3. The Imperial Savings and Home Ownership Public Association (which provided savings and Loan services)

A number of other private financial institutions were also established during the 1960s (Addison and Alemayehu, 2002:2).Major Private commercial institutions, many of which were foreign owned, included

1. The Addis Ababa Bank
2. The Banco di Napoli
3. The Banco di Roma

In addition, there were several insurance companies.

The shift to Marxist government in 1975 brought several changes to the banking system and saw the nationalization of private banks and insurance companies. Under this government (the Derg regime), all privately owned financial institutions including three commercial banks, thirteen insurance companies and two non-bank financial intermediaries were nationalized on 1 January 1975 (Befekadu, 1995: 273, Harvey 1996 cited in Addison and Alemayehu, 2002).

According to Alemayehu (2006), these nationalized 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 institution. As Addison and Alemayehu (2002) said NBE's bank supervision and regulation was largely restricted to off-site inspection of a few bank branches. Moreover, 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 (Alemayehu, 2006).

The socialist oriented government left behind only three banks in Ethiopia; including the National Bank of Ethiopia. Each of these Banks enjoyed monopoly in their respective market (Melesse, 2006:18-19). The following was the structure of the sector at the end of the era.

- The National Bank of Ethiopia(NBE)
- The Commercial Bank of Ethiopia (CBE)
- Agricultural and Industrial Development Bank (AIDB)
- Housing and Savings Bank of Ethiopia (HSBE)

With the overthrow of the Derg Regime in 1991, Ethiopia began its transition to a market economy (Addison and Alemayehu, 2002:1). This transition has had profound implications for the financial system. New financial institutions have emerged, the role of the private sector in the financial system has been expanded, and the role of the central bank is being reformulated (ibid). NBE's role in overseeing the commercial banks was codified and Sector-specific interest rates administered by NBE were also ended, and replaced with a minimum deposit rate (10 per cent) and a maximum lending rate (15 per cent) (Addison and Alemayehu, 2002). In addition to this, The Commercial Bank of Ethiopia was re-established in 1994 by proclamation No. 202 taking over the rights and obligations of the Commercial Bank of Ethiopia, which was established under proclamation No. 184/198(Negarit Gazeta, 1994).

2.11 National Bank of Ethiopia

The National Bank of Ethiopia was created by order No 30/1963 and reconstituted by the Monetary and Banking Proclamation No 83/1994 as an autonomous organ, which is engaged in the provision of regular banking services to the government and other banks and insurance companies (NBE, 2008). The purpose of the National Bank of Ethiopia is to maintain stable rate of price and exchange, to foster a healthy financial system and to undertake such other related activities as are conducive to rapid economic development.

2.11.1 Powers and duties of National Bank of Ethiopia

The bank will have the following powers and duties that will help it to achieve its purpose.

1. Coin, print or cause to be coined, printed and circulated the legal tender currency; Dispose or cause to be disposed coins and notes issued legally; Issue its own debt and payment instruments.
2. Regulate and determine the supply and availability of money and credit as well as the applicable interest rates and other charges; Formulate and implement exchange rate policy; Manage and administer the international reserves of Ethiopia.
3. License and supervise banks, insurers and other financial institutions; Create favorable conditions for the expansion of banking, insurance and other financial services.
4. Set limits on gold and silver bullion and foreign exchange assets, which banks and authorized dealers can hold; Set limits on the net foreign exchange position and on the terms and the amount of external indebtedness of banks and other financial institutions.
5. Make short term and long term refinancing facilities available to banks and other financial institutions as might be necessary; accept deposits of any kind from foreign sources; Collect data from any person and prepare periodic economic studies, on the balance of payments, money supply, price forecasts and other relevant statistical indicators for analysis and for the formulation and

determination of monetary, saving and exchange policies as are useful to Ethiopian economy.

6. Act as banker, fiscal agent and financial advisor to the Government; Take such steps to establish, modernize, conduct, monitor, regulate and supervise payment, clearing and settlement systems.

7. Act in compliance with international monetary and banking agreements of Ethiopia and represent Ethiopia in the International Monetary Fund and other international financial organizations formed by central banks;

8. Coin/Mint special commemorative coins; Establish and manage deposit insurance fund; Exercise such other powers and functions to execute its purposes as central banks customarily perform.

2.12 Financial Sector Reform in Ethiopia

Economic liberalization began Just before the fall of the Derg regime. However, with the initiation of the economic reform program of the current government, two proclamations were issued in 1994, Monetary and Banking Proclamation (No. 83/1994), and the Licensing and Supervision of Banking Business (No. 84/1994). The first proclamation in addition to increasing the role of the National Bank of Ethiopia made illegal any NBE lending other than the government while the second proclamation empowered the Central Bank to supervise the financial institutions.

Moreover, two further proclamations, 200/1994 and 203/1994 restructured and renamed the Agricultural and Industrial Bank, and Housing and Saving Bank into Development Bank of Ethiopia and Construction and Saving Bank of Ethiopia, respectively. It was also noted in the proclamations that the two banks were recapitalized as public enterprises and hence, the financial sector reform did not invite private sector participation in the present government owned banks else entry of foreign banks in full share as well as with restricted share as partners with Ethiopian citizens.

After the 1994 financial liberalization measures, the authorities concentrated their efforts on building capacity in the financial sector as well as on other priority areas of economic transition, in particular further liberalization of the foreign exchange system and trade liberalization measures. In tandem with such institutional arrangement of the financial sector, sequence of policy measures, which include interest rate marketing and exchange rate reforms among others were undertaken. But financial liberalization accelerated again when the lending rate was decontrolled and left to be determined by the banks themselves as late as January 1998, compared to October 1992, when the bias between public and private charging of deposit rate was abolished.

Now the National Bank of Ethiopia (NBE) has set only the floor of the interest rate and it is up to the banks to calculate and offer higher interest and compete to attract customers, which show that national bank is trying to homogenize private and state owned banks. In all the reform periods, a positive lending interest rate was recorded except in 2002/03, which was markedly 22 known as sever draught year. However, the floor for saving deposit was set at 3 percent commencing the year 2002; this resulted in a negative real deposit interest rate to be recorded triggered by the increasing inflationary pressure.

The financial sector liberalization was also strengthened by the reform on financial instruments, which includes devaluation of exchange rate, introduction of treasury bills, interbank foreign exchange market and others. In addition, a framework for an interbank money market, in which banks and non-bank financial institutions can borrow and lend at market as determined rates have been laid down.

2.13 Regulatory environments of banking sector/Banking laws/ in Ethiopia
Book IV Title III of the Commercial Code of Ethiopia, which deals with banking transactions, fails to provide a definition of a bank and banking transactions though the latter may be gathered from the various sections governing the various types of transactions undertaken by banks (Negarit Gazeta, 1960).

The period 1990s was a turning point for the development of the Ethiopian banking sector. Since then, banking business in Ethiopia is governed by two Proclamations. The first, Monetary and Banking Proclamation No. 83/1994(Negarit Gazeta, 1994), defines the powers and responsibilities of the National Bank of Ethiopia, which is the Central Bank of the country. National Bank of Ethiopia was established by this proclamation as judicial entity, separated from government and outlined its functions. The second is a proclamation to provide for the Licensing and Supervision of Banking Business No. 84/1994, which define and determine what banks and banking transactions are under the Ethiopian legal system.

It also sets out the conditions under which commercial banks can be licensed and the supervisory requirements they should observe in the course of their operation. According to Art 2 (12) of the Monetary and Banking Proclamation No 83/1994, banking business means any operation involving receiving money on deposit, lending money, receiving commercial instruments on deposit, accepting, negotiating/ transferring, discounting commercial instruments and other evidences of debt, and buying and selling of gold and silver notes and foreign exchange.

Similarly, Art 2 (2) of the Licensing and Supervision of Banking Business Proclamation No 84/1994 defines banking business as:

Any business involving acceptance of money on deposit, using such funds or deposits, in whole or in part, for loans or investments on the account of and at the risk of the person undertaking the business, purchasing, selling and deposit of negotiable instruments (shares, bonds and other securities/ and checks, bills and notes, and buying and selling of gold and silver bullions and foreign exchange).

On the other hand, the term bank is defined, under Art 2(1) and (4) of the same proclamation, as a share company whose capital is wholly owned by Ethiopian nationals and/or business organizations wholly owned by Ethiopian nationals and which is registered under Ethiopian laws and which has its head office in Ethiopia and licensed to undertake banking business by the National Bank of Ethiopia.

In addition to this, Art 4(2) of the same proclamation clearly prohibits foreign nationals and business organizations from undertaking banking business in Ethiopia. The definition of a bank and this provision exclusively reserve the banking sector to Ethiopian nationals or business organizations wholly owned by Ethiopian nationals. This is mainly on the ground of protection of domestic banks which are at an early stage of development, at least until they develop their financial and manpower capabilities, to be able to compete with foreign banks which have enormous financial strength, experience, technology and knowhow. Such barrier to foreign firms to participate in domestic banking business helped to maintain public banks dominance. According to Kiyota, Peitsch and Stern (2007), the financial liberalization index, which measures banking security and independence from government on scale of 10 to 100(100 being the most liberal), is only 20 for Ethiopia(the lowest in Sub-Saharan Africa).

Moreover, since proclamation No.84/1994, the minimum capital requirements required to establish new bank have been revised twice. At first, the initial minimum capital requirements was 10 million, which was revised, to be 75 million in 1999 by Directive No.SBB/24/99 and the current minimum capital requirements are 500 million according the proclamation No.23/2011. The National Bank of Ethiopia Directive Number SBB/29/2002 also limits the aggregate loan or extension of credit by any commercial bank to any single borrower to a maximum of 25% of its total capital. Commercial banks are also given the legal right to fix their lending interest rates, while the minimum saving (deposit) rate is fixed by National Bank of Ethiopia.

Monetary and Banking proclamation No.83/1994 and the Licensing and Supervision of Banking Business No.84/1994 also laid down the legal basis for private investment in the banking sector. Accordingly, the private sector are allowed (owners have to be Ethiopian nationals, however) to engage in banking businesses. Due to this policy shift, the country has witnessed a proliferation of private banks. For instance, at the end of June, 2011 there were 14 operational private commercial banks (NBE, 2011).

2.14 Establishment of Commercial Private Banks in Ethiopia after financial reform

Since the time of liberalization onwards (1992 to date), private banks have been allowed to operate in Ethiopia. At the beginning, to establish a new private commercial bank, the 1994 proclamation provision requires only a minimum capital requirement of ten million birr, though it changed to 75 million in 1999 and 500 million in 2011 respectively. Accordingly, from the period of 1994 to date, sixteen private commercial banks have gone operational.

The following table vindicates the so far operated private commercial banks to date with their establishment years.

Table 1: List Commercial private banks in Ethiopia

S.No	Name of bank	Establishment year
1	Awash international bank	1994
2	Dashen Bank	1995
3	Bank of Abyssinia	1996
4	Wegagen Bank	1997
5	United Bank	1998
6	Nib International Bank	1999
7	Cooperative Bank of Oromia	2004
8	Lion international Bank	2006
9	Oromia International Bank	2008
10	Zemen Bank	2008
11	Bunna International Bank	2009
12	Birhan International Bank	2009
13	Abay Bank	2010
14	Addis International Bank	2011
15	Enat Bank	2012
16	Dehub Global Bank	2012

Source: www.nbe.gov.et

Chapter Three

Data Analysis, discussion and Presentation

This chapter presents data results on different issues obtained from primary and secondary data sources. Data results were obtained from the survey questionnaires. The profile of the respondents (sex, age, educational level, working experience in banking industry, field of highest training (specialization), current position and service on current position) have been presented. Likewise, it presents the implications of NBE bills purchase directive on different operational and financial performances (loans and advances, deposit mobilization, incomes, expenses, profitability, liquidity, assets and capital and reserves). The results on the implications of the directive on the performances of private banks were presented to develop recommendations for National bank of Ethiopia. The chapter as well presents the in-depth interview results of key informants. Meta-data from survey of documents is also presented to triangulate evidence.

3.1 The Description of NBE bills Purchase Directive

NBE bills purchase directive is a regulatory policy issued by National Bank of Ethiopia in April 2011. The directive requires private banks to purchase NBE bills equivalent to 27 percent of any new disbursements (The World Bank, 2013). The bills have annual interest rate of three percent and maturity period of five years (NBE, 2013). According to the interview conducted with the official of the National Bank of Ethiopia, the directive's main Objective is to get adequate funds for priority sectors' project to bring about sustainable economic development.

The question posed to the official as the regulatory organ (NBE) conducted the necessary analysis of implications bills purchase directive have on the development of private commercial banks when developed and the official replied as the regulatory organ (NBE) conducted comprehensive analysis and came up with the idea of positive implications on the development of private commercial banks. According to the official, the positive implications of the directive ought weigh

negative implications of the directive. With this, the regulatory organ reached at the conclusion that the directive has a negative implication which is not as such significant and not put private banks into the loss, the official said.

Key informant senior officials of private banks also questioned about the components of NBE bills purchase directive that affects private commercial banks in positive and negative ways. According them so, the directive's price (interest rate) stipulated under Article of 9(2) of NBE bills purchase directive, the percentage amount of allotment mentioned under article 4(2) of NBE bills purchase directive and the tenure years of the bills which is also mentioned under article 9(1) of NBE bills purchase directive are the major component of NBE bills purchase directive that negatively affects the private commercial banks. They also added that as none of the directive's components contributes to the development of private commercial banks rather the benefits it made for government.

Questions concerning about the implications NBE bills purchase directive on specific activities of private banks raised to key informant senior private bank officials. Accordingly, they responded as the directive affected almost all of their banking activities including lending activities, international banking activities, profit-making activities, branch expansion, and deposit mobilization activities. According to them, the directive affected the lending activities of private commercial banks by reducing volume of loans as 27% of every loan disbursement went to NBE bills. Furthermore, the directive affected the lending activities of private commercial banks by instigating them to change their loan prices upwardly and portfolios of loans from sector like export and import which requires short term loans to other economic sectors like construction.

They also said that the directive affected the international banking activities of private banks by means of creating fund shortage for purchasing foreign currencies by which international banking activities undertaken. According to the key informants, Profit making activities of private commercial banks were affected as a

result of paying too low interest rate (3%) for the purchased NBE bills of private commercial banks regulatory organ. Deposit mobilization activities of private commercial banks were affected by dissatisfaction of loanee customers as loanee customers are depositors by default. The key informant officials also added that the directive affected branch expansion activities of private commercial banks via compelling them to expand their branches so as get additional funds. From this it can be inferred with the findings that (1) NBE bills purchase directive's all components has negative implications than positive implications (2) NBE bills purchase directive has an implications on almost all activities of private commercial banks.

3.2 Profile of the Respondents

Looking at the profiles of the respondents would help the readers appreciate the compositions of the respondents. Thus, sex, age, educational level, work experience in banking industry, current position and service (experience) on current position is taken as the basic features considered in this study. This background information of the respondents is also assumed as indicators to show human resource and related picture of the private banking industry in the country. Questionnaires were distributed to 56-target sample population, of which were 52 responded and returned. The rest of the respondents were unable to respond to the questionnaires due to different reasons. Therefore, the response rate of the survey was 93 percent.

3.2.1 Respondents' Age and Sex

Table 2: Respondents' Sex and Age

S.No	Sex	Frequency& %	Age	Frequency& %
1	Male	47 (90)	20 – 40	41 (79)
2	Female	5 (10)	50-60	11 (31)
	Total	52	Total	52

Source: Own Survey result, 2014

The sex of the respondents is male dominated, as the above table revealed, majority of the respondents are males than females. They constitute 90% of the total respondents. The remaining 10% of the respondents are females. This shows female employees are minimal in private commercial banks especially at position level of selected departments/organs.

As regards to the age of the respondents, they are between 20- 40 years which dominated the total respondents. They constituted 41(79%) of the total respondents as presented in the above table 2. The Respondents whose age fall between 50-60 constituted only 11(31%). This implies majority of the respondents are young adults.

3.2.2 Respondents Education level, Work Experiences and field of Specialization

The educational level of the respondents is dominated by degree holders, because the greater parts of the respondents make up of this category. As revealed in the table 3 below, these respondents comprised of 52%, followed by master holders that comprised of 48% of the total respondents.

Table 3 : Respondents' Education level, Work experience and field of Specialization

Education level	Freq. & %	Work experience in banking	Freq. & %	Specialization of field	Freq. & %
Degree	27(52)	Less than 15 years	40(77%)	Economics, Finance & Banking	43(82)
Master	25(48)	Above 15 years	12 (23%)	Others	9 (17%)
Total	52(100)	Total	52(100)	Total	52(100)

Source: Own Survey result, 2014

With regard to the work experience in the banking industry, majority of the respondents, that is, 40(77%), have worked more than five and less than 15 years in the banking industry. The remaining respondents constitute of 12 (23%) worked more than 15 years in the banking industry. This clearly indicates that majority of the respondents are not strange to banking industry and have

understanding of banking environments, activities and operation which play paramount role on the quality of the data obtained.

As regards the field of highest training (specialization) of the respondents, majority of the respondents (82%) trained in economics, finance and banking professions. The remaining respondents (17%) trained in other field of specialization as disclosed in the above table 3. This means majority of the respondents have specialized in banking and related fields.

3.2.3 Respondents' Current Position

The current positions of the respondents are dominated by heads/ experts/ seniors and directors/ managers because they both held majority of the respondents' position (44% each). Officer and presidential position of the respondents is very slightest, in which each of them constituted 2% and 4% of the total respondents respectively. Vice president Position respondents constitute 6% of the total respondents. This implies majority of the respondents held higher position in the private commercial banks.

Table 4: Respondents' Current Position

Position	Frequency & %
President/CEO	2 (4%)
Vice- President	3 (6%)
Directors/ Manager	23 (44%)
Head/Expert/Senior	23 (44%)
Officer	1 (2%)
Total	52 (100%)

Source: Own Survey result, 2014

3.2.4 Respondents service year on their current position

None of the respondents have more than 6-10 years on their current position as depicted in table 5. Respondents' accounted for 85% of the total respondents

have less than five years of experience on their current position. The remaining respondents (15%) have 6-10 years on their current position. This implies that majority of respondents have less than one 5 years of experience on their current position.

Table 5 : Respondents service year on their current position

Service year on their current position	Frequency &%
Less than 5 years	44 (85%)
6-10 years	8 (15%)
11-15 years	–
16-20 years	–
21-25 years	–
Above 25 years	–
Total	52 (100%)

Source: Own Survey Result , 2014

3.3 Implications of NBE bills purchase directive on the performances of PCBs

The implications of NBE bills purchase directive had reflected negatively on various performances of the private commercial banks. This is because majority of the respondents' response revealed as the directive has been imposing negative implications on their several performances.

As it can be seen in table 6 from the total response of the respondents, 22% responses revealed that the directive had affected the size of Loanable fund, 20% responses vindicated the negative implication of directive on profitability, 19% responses showed the negative implication on liquidity. Moreover, 18% responses of respondents' revealed negative implications on income and expense, 11% responses of respondents' revealed negative implications on capital and reserves, 10% responses respondents revealed negative implications on assets of the private

commercial banks. Other responses (1%) showed as the directive has been affecting other activities of private commercial banks.

This implies that NBE bills purchase directive has negative implications on almost all performances of private commercial banks though their implications varied from performance to performance. The following table portrays the implications of the directive on several performances of private commercial banks.

Table 6 : NBE bills purchase directive implications on different banking performances

NBE bills Purchase directive implication areas of private commercial banks	Frequency& %
Loanable fund size	51 (22%)
Income and Expense	40 (18%)
Profitability	46 (20%)
Liquidity	42 (19%)
Assets	22 (10%)
Capita and reserve	24 (11%)
Others	2 (1%)
Total	227 (100%)

Source: Own Survey Result, 2014

In addition to the above survey result, the result of interview obtained from key informant senior bank professionals of different private banks is reminiscent of above premise. According them, the implications of the directive is principal over almost all banking activities like lending, international banking, deposit mobilization and the like. This clearly indicates that the implications of NBE bills purchase directive are enormous on both on and off balance sheet items though the implications varies from item to item as it can be seen on the above table 6. As per the above survey result, its implication is high on the size of Loanable fund, profitability and liquidity of private commercial banks while, the directive's

implication is slightly high on assets as well as on capital and reserves of the private commercial banks.

Furthermore, the IMF country report (2012) stated that the requirement (directive) on private banks to purchase NBE bills equivalent to 27 percent of any new loans appears to have a sizeable negative impact on private banks intermediation activities. The report also added that the requirement also has the potential of creating maturity mismatches as private banks collect savings at two to three-year maturity and even shorter in some cases, but have to freeze these resources for five years at rates lower than cost of funds. There is also a risk that as the profitability of private banks reduces on account of less intermediation because of this directive, they could raise non-interest income charges such as fees and commissions to recoup these losses further impacting negative on the private sector(IMF,2012).

In the next sections, the NBE bills purchase directive implications on different balance sheet and off balance sheet items of private commercial banks is discussed.

3.3.1 Implications on NBE bills purchase directive on Loanable fund of PCBs

The effects of NBE bills purchase directive on Loanable fund has been reflected by several signals such as reducing the size of Loanable fund, forcing private banks to change their price(lending rate),dissatisfying loanee customers, instigating banks to alter loan provision strategy, reducing private banks' loans and advances market share and prohibiting financing priority sectors(import and export). This is because, as shown in the next table p.55, 31% of respondents' response revealed that the bills purchase reduced the size of their Loanable fund and 20% of respondents' response revealed as the bills purchase dissatisfied their loanee customers. Moreover, 15% of the respondents' response showed as the bills purchase forced their banks to change loan provision strategy and 13% of the respondents responses disclosed as the bills forced them to change lending interest rates.

Likewise, 20% (10% each) of the respondents' response marked as the bills reduced loan and advance market share and prohibited financing priority sectors like import and export.

Table 7: The implications of NBE bills purchase directive on Loanable fund

How did NBE bills purchase directive affect Loanable fund and other loan and advance related activities?	Frequency&%
It reduced the size of Loanable fund	50 (31%)
It Forced banks to change lending interest rate	22 (13%)
It dissatisfied loanee customers	33(20%)
It forced bank to alter loan provision strategy	24 (15%)
It reduced bank loans and advances market share in the industry	17 (10%)
It prohibited financing priority sectors e.g. Export	17 (10%)
Total	163 (100%)

Source: Own survey result, 2014

Reduction in the volume of Loanable fund is one of areas highly affected by NBE bills purchase directive because majority of the response of the respondents voted for this.

Likewise, according to the data obtained and computed from annual reports of private banks indicated, the loanable funds of private commercial banks reduced by birr 6.6 billion in 2010/11, 12.6 billion in 2011/12 and 18.4 billion in 2012/13 and these amount was channeled to purchase NBE bills in respective years (see table 8, p.58) though its average growth rate was lower before the directive than after the amendment of the directive because of credit cap imposed on private banks before NBE bills purchase directive.

Moreover, the aggregate average lending price of private commercial banks has been 12.21% before enactment of the directive (before April, 2011) which went up to 13.31% after the directive enactment marking an average price increase of

1.10%. The directive also affected the loan provision strategy of private banks in which private banks focused on the strategy of granting loans to medium and long term project/activities than short term projects after the enactment of the directive. This is because in order to avoid frequent purchase of NBE bills as the purchase of the bills is contingent on the every disbursement of fresh loans. As well they shifted their strategy of loan product pricing in which they made upward price revision for their credit products after the amendment of the directive. Key informant loanee customers of private banks were also approached to confirm their dissatisfaction with the directives and they explained as the directive dissatisfied them by limiting the size of the loan they requested and made private banks to increase their price on loans on them.

Table 8: Average prices of different credit facilities before and after the directive amendment

S.No	Credit Facility type	Average Price before the directive in percentage	Average Price after the directive in percentage	Average Change
1	Terms loans	11.97	13.02	1.05
2	Transport loans	12.64	13.66	1.02
3	Building and Construction loan	12.32	13.45	1.13
4	Agriculture loan	12.20	13.10	0.90
5	Merchandise loan	11.49	12.86	1.37
6	Construction Machinery loan	12.99	14.19	1.20
7	Personal loan(other than staff) loan	12.80	13.48	0.67
8	Advance on Import bills	11.26	12.72	1.46
	Average	12.21	13.31	1.10

Source: Private Commercial banks and own computation

The response of in-depth interview made with key informant private banks' officials was also consistent with above survey results. The informants argued that the directive has been affecting lending activities of private commercial banks by reducing the volume of Loanable fund. They further commented that the directive that "forced them to increase their lending price and disabled them to provide the amount of loan customers requested thereby brought loanee customers dissatisfaction and loss of customers". They also added that the directive changed

the portfolios of their loans. This has caused a substantial amount of our loan channeled to the obligatory purchase of NBE bills (i.e. 27%) of each fresh loan disbursement.

The following table unveiled the amount of NBE bills purchased by private commercial banks (volume of loanable fund reduced) during the last three fiscal years.

Table 9: NBE bills Purchase amount of Private commercial banks in millions of birr

Banks	Fiscal years			Average
	2010/11	2011/12	2012/13	
AIB	1,589	2,485	3,149	2,407
DB	971	2,025	2,923	1,973
BOA	817	1,461	2,090	1,456
WB	900	1,597	2,359	1,619
UB	807	1,546	2,185	1,513
NIB	563	1,211	1,911	1,229
CBO	231	427	567	408
LIB	165	347	523	345
ZB	216	391	729	445
OIB	290	457	708	485
Bunna	11	236	393	213
BIB	27	182	349	189
ADIB		40	103	71
AB	48	176	374	199
DGB			40	40
EB			4	4
Total	6,635	12,579	18,404	12,593

Source: Banks' Annual report of 2010/11-12/13 and Own Computation

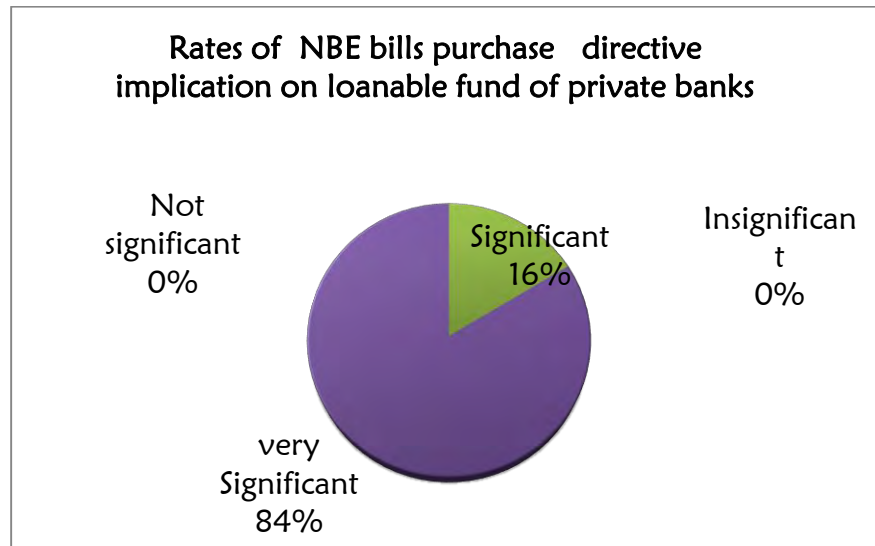
As portrayed in the above Table 9, private commercial banks purchased NBE bills increasing from time to time in which it was birr 6.6 billion in 2010/11, 12.6 billion in 2011/12 and 18.4 billion in 2012/13, which would have been the amount of Loanable fund, which is directly reduced from the loans and advance accounts of the private commercial banks during these respective years. It represents 25%, 36% and 41% of the total loans and advances of private commercial banks during fiscal years of 2010/11, 2011/12 and 2012/13 respectively. This clearly indicates that private commercial banks' Loanable fund volumes have been reduced by

considerable amount which, in turn, have direct chained implications on interest income, profitability and capital and reserve of private commercial banks.

3.3.1.1 Rates of NBE bills Purchase Directive Implications on Loanable fund of PCBs

The NBE bills purchase directive implications are very significant on the Loanable fund of private commercial banks because majority of the respondents rated the implications as very significant. These respondents accounted for 84% of the total respondents. The rest of the respondents, 16%, rated the implications as significant as depicted in the following figure 1. There is no respondent that rated the implications as insignificant and not significant at all.

Figure 1 : Rates of NBE bills purchase directive implication on Loanable fund



Source: Own Survey result, 2014

This clearly points toward the implications of the directive are very great on the Loanable fund of private commercial banks.

3.3.2 Implications of NBE bills Purchase Directive on Income of PCBs

The NBE bills purchase directive have a negative foremost effect on the income of private commercial banks by reducing private banks' interest income because more than half of the respondents' response (52%) revealed that the directive affected the income of private commercial banks by reducing their interest income. Moreover, the directive's implication also reflected on the income of

private banks by reducing their overall income as well as market share of income. This is because of the fact that, the respondents' response of 29% and 19% found out as NBE bills implication has been seen by reducing the overall income and market share of income of private banks respectively. From this analysis, we can conclude that NBE bills purchase directive negative implications implied largely in reducing the interest income of private commercial banks. The following table unveils the survey result of respondents on implication of NBE bills purchase directive over the income of private commercial banks.

Table 10: Implications of NBE bills purchase directive on Income of PCBs

How did the directive affect the incomes of your bank?	Frequency& %
Reduced the overall incomes of the bank	28 (29%)
Reduced the Interest income of the bank	51 (52%)
Reduced market share of income of the bank	19 (19%)
Total	98 (100%)

Source: Own Survey Result, 2014

Likewise, an in depth interview made with key informant of private banks' professionals revealed the same results. They described that the NBE bills price is very low (3% per annum) compared to market price of Loans(around 11% on average) so that private banks are losing considerable amount of interest income. This has, they said, a direct effect on interest, overall income and market share of income in the banking industry. It can be inferred from this that NBE bills purchase directive reduced the interest income in particular and overall income of private commercial bank. The following table (table 11) disclosed the interest income foregone by private banks because of purchasing NBE bills.

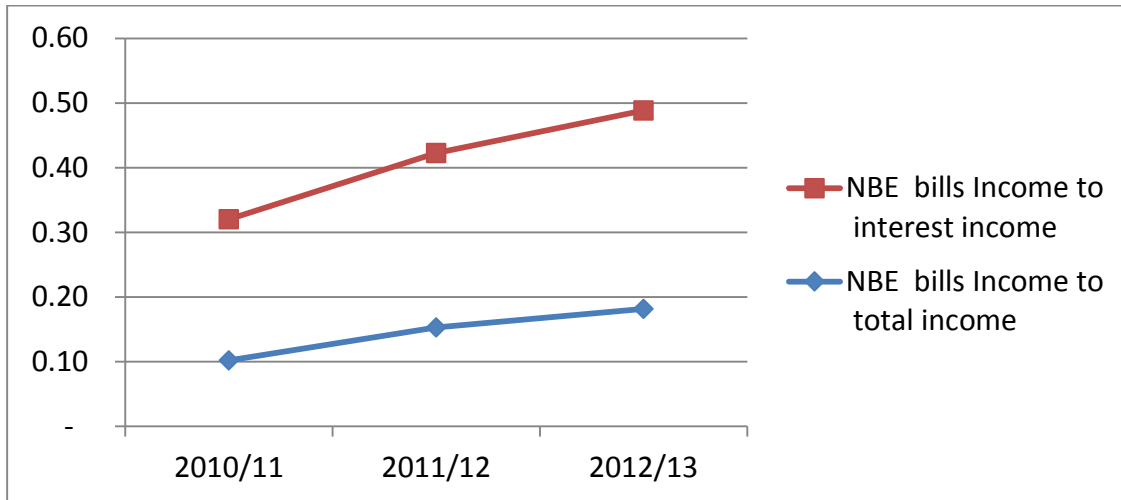
Table 11: PCBs' Interest income foregone because of purchasing NBE bills in thousands

S.No	Banks	2010/11		2011/12		2012/13	
		NBE bills interest income @net lending rate(8.9%)		NBE bills	Interest income@ net lending rate(8%)	Amount of NBE bills	Interest income@ net lending rate
1	AIB	1,589,214	141,440	2,484,718	221,140	3,145,808	279,977
2	DB	971,000	86,419	2,025,450	180,265	2,922,820	260,131
3	BOA	816,603	72,678	1,461,233	130,050	2,090,348	186,041
4	WB	899,887	80,090	1,597,430	142,171	2,358,984	209,950
5	UB	806,823	71,807	1,545,682	137,566	2,185,123	194,476
6	NIB	563,281	50,132	1,211,281	107,804	1,911,097	170,088
7	CBO	230,762	20,538	426,965	38,000	567,247	50,485
8	LIB	164,943	14,680	346,517	30,840	523,212	46,566
9	ZB	216,484	19,267	390,684	34,771	728,917	64,874
10	OIB	289,900	25,801	456,603	40,638	707,898	63,003
11	Bunna	11,367	1,012	235,514	20,961	393,361	35,009
12	BIB	26,980	2,401	181,595	16,162	348,847	31,047
13	AdB		-	40,229	3,580	102,633	9,134
14	AB	47,524	4,230	175,575	15,626	374,458	33,327
15	DGB				-	40,048	3,564
16	EB					4,010	357
	Total	6,634,768	590,494	12,579,476	1,119,573	18,404,811	1,638,028

Source: Private commercial bank's annual report (2010/11-12/13) and own computation

As table 11 depicts, the private commercial banks' diminishing interest income is due to NBE bills purchase. They lost interest income amounted to birr 590.5 million, 1.1 billion, and 1.6 billion in 2010/11, 2011/12 and 2012/13 respectively as shown in table 10. It was 10% of total income and 22% of interest income, 15% of total income and 27% of interest income and 18% of the total income and 31% of interest income earned by private commercial banks in 2010/11, 2011/12 and 2012/13 respectively, marking increasing share of interest and total income of private banks. This clearly indicates that, NBE bills purchase directive have a sizable negative implications on income of private commercial banks via diminishing their interest income which is the basic reason the very existence of banking businesses. The following graph illustrates the percentage share of income lost by private commercial banks from year to year because purchase of NBE bills.

Figure 2: Share of income lost by private commercial banks because of purchase of NBE bills



Source: Private Banks Annual reports of 2010/11-12/13 and Own Calculation

Furthermore, the growth rate of income of private commercial banks demonstrated lesser growth rate after the endorsement of the directive when compared with before the acting out of the directive. It was 40% on average before the directive endorsement while it went down to 25% after the directive enactment showing 15 percentage declines as revealed in the underside table. Slight positive average growth rate was observed only in Bank of Abyssinia and Wegagen bank from the endorsement of the directive while all others unveiled negative growth rate.

Table 12: Average growth rate of private banks income before and after the directive

S.No	Banks	Average growth rate of income Before the Directive (2007/08-2009/10)	Average growth rate of income after the directive(2010/11-2012/13)	Average growth rate change
1	Awash	0.42	0.24	(0.18)
2	Dashen	0.20	0.20	(0.00)
3	BOA	0.16	0.18	0.02
4	Wegagen	(0.01)	0.10	0.10
5	United	0.36	0.05	(0.31)
6	NIB	0.33	0.14	(0.19)
7	CBO	0.79	0.68	(0.11)
8	Lion	0.97	0.45	(0.52)
	Average	0.40	0.25	(0.15)

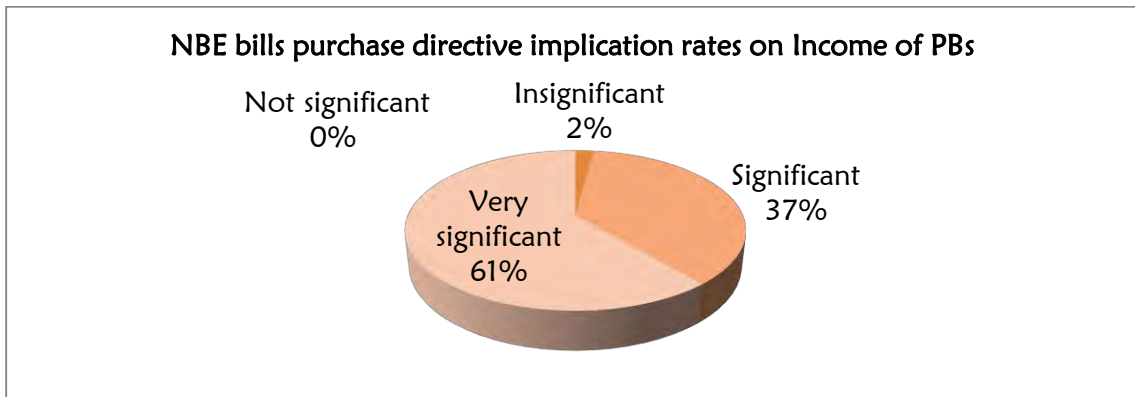
Source: Private Banks annual reports (2008/09- 2012/13) and Own Computation

3.3.2.1 Rates of NBE bills Purchase directive Implications on income of PCBs.

The negative implications of NBE bills purchase directive is very significant on the income of private commercial banks because the majority of respondents alleged NBE bills purchase directive has very significant implications on the income of private commercial banks. They made up of 61% of the total respondents. Following them, 37% of the total respondents said that the directive has significant negative implications on the income private commercial banks.

Very small portion of respondents (2%) whispered that the directive has insignificant implication on the income of private commercial banks. There is no respondent who said that the implication of NBE bills purchase directive is not significant at all. This clearly indicates that the directive has very significant implication on the income of private commercial banks.

Figure 3: Rates of NBE bills purchase directive Implication on income of PCBs.



Source: Own Survey result, 2014

Beside this survey result, it can be possible to come up with the extent of implication the directive had on income of private commercial banks from table 10 and 11 above. It was very significant as commercial private banks lose about birr 59.5 million, 1.11 billion and 1.6 billion in the years of 2010/11, 2011/12 and 2012/13 respectively.

3.3.3 Implications NBE bills Purchase Directive on Expense of PCBs.

The NBE bills purchase directive has a negative implication on the expense of private commercial banks via increasing their interest expense. This is because the greater part of the respondents said that the directive has been affected the expense of the private banks by increasing their interest expense. These respondents accounted for 43% of the total respondents. On other hand, 22% of the respondents explained that the directive has no impact on the expense of the banks.

Table 13: NBE bills purchase directive implications on Expense of PCBs.

How did the directive affect the expenses of your bank?	Frequency& %
Increased the overall expense of the bank	14 (20%)
Increased the interest expense of the bank	30 (43%)
Increased expense market share of the bank	9 (13%)
Has no impact on the expense	16 (23%)
Total	69 (100%)

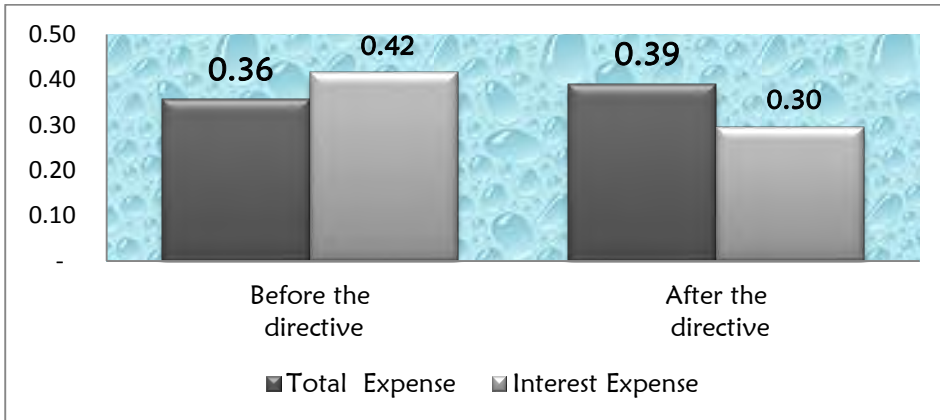
Source: Own Survey result, 2014

Furthermore, as per the result of interview made with key informant of private bank senior professionals, the directive has a negative implication on the expenses of the private commercial banks via increasing their interest expense. They said that, an increase in expense was triggered by alteration of deposit structure, from demand and saving deposits that demands low cost of fund (interest rate) to fixed time deposit, which by its nature demands high cost of fund (interest rate). From this, we can understand that NBE bills purchase directive negatively implied in increment of interest expense of the banks.

Furthermore, the assessment of before and after the directive for total expense average growth rate showed akin finding with survey and interview result though interest expense revealed contrasting finding to survey and interview result. As shown on the following figure, the average growth rate for the total expense of

private banks before the enactment of the directive was 36% and it grown up to 39% after the amendment of the directive marking 3% increment. However, the average growth rate of interest expense was 42% before the directive came into force while to declined to 32% showing 10% decrement.

Figure 4: Total and interest expense growth rate of private banks before and after the NBE bills purchase directive



Source: Own Computation

3.3.4. Implications of the NBE bills purchase directive on Profitability of PCBs

The NBE bills purchase directive has negative implications on the profitability of the private commercial bank by reducing their amount of profit. This is because the majority of respondents' response supposed that the directive has affected the profitability of private banks via reducing their profit. These respondents' response accounted for 43% of the total responses. Subsequently, it implied negatively by disabling banks not to maximize the value of shareholders of the bank. This is because about 38% of the respondents responses believed as the directive affect the profitability via minimizing the values of shareholders. It also reduced the profit market share of the private banks in the industry. These respondents response made up of 18% of the respondents response. This means the negative implications of NBE bills purchase directive has been largely reflected by reducing the profitability in private banks.

Table 14: NBE bills purchase Directive implication on profitability of the private banks

NBE bills purchase directive implication on profit of private commercial banks	Frequency & %
It reduced the profitability of the bank	44 (43%)
It minimized the value of shareholders' the bank	38 (37%)
It reduced profit market share of banks in the industry	18 (18%)
It has no impact on profit of the banks	2 (2%)
Total	102 (100%)

Sources; Own Survey result, 2014

The interview conducted with regulatory organ (NBE) official and key informant officials of private banks are also consistent with the directive's negative implication on profitability of private commercial banks. The interviewed official of NBE stated that the directive has a trivial negative impact on the profitability of the private banks but it cannot make them for loss rather decrease their profits.

The secondary data obtained from annual bulletins of banks and computed also convinced the adverse implications of NBE bills purchase directive on profitability via reducing their profit from year to year. As it is portrayed in table 15, NBE bills purchase directive has adverse implication by reducing the amounts of Profit of private commercial banks. During 2010/11 fiscal year, for instance, they lost a total amount of profit estimated to birr 228.9 million, which grew up to birr 418.9 million as at the end of 2011/12 fiscal year. During the last fiscal year, 2012/13, the total amount of profit foregone by private commercial banks reached at birr 615.9 million, on average a single bank loss amounted to birr 38.5 million. In general, the average profit foregone by private commercial banks during the last three years stood at birr 420.2 million.

Table 15: Calculation of NBE bills implication on profit of private commercial banks in thousands

Banks	2010/11		2011/12		2012/13	
	NBE bills	Profit @ 3.45%	NBE bills	Profit @3.33 %	NBE bills	Profit @3.34%
AIB	1,589,214	54,828	2,484,718	82,741	3,145,808	78,790
DB	971,000	33,500	2,025,450	67,447	2,922,820	23,644
BOA	816,603	28,173	1,461,233	48,659	2,090,348	63,831
WB	899,887	31,046	1,597,430	53,194	2,358,984	11,651
UB	806,823	27,835	1,545,682	51,471	2,185,123	1,339
NIB	563,281	19,433	1,211,281	40,336	1,911,097	18,946
CBO	230,762	7,961	426,965	14,218	567,247	3,428
LIB	164,943	5,691	346,517	11,539	523,212	69,818
ZB	216,484	7,469	390,684	13,010	728,917	12,507
OIB	289,900	10,002	456,603	15,205	707,898	105,070
Bunna	11,367	392	235,514	7,843	393,361	17,475
Birhan	26,980	931	181,595	6,047	348,847	72,983
AdB		-	40,229	1,340	102,633	97,622
AB	47,524	1,640	175,575	5,847	374,458	3,138
DGB		-		-	40,048	24,346
EB					4,010	1,338
Total	6,634,768	228,899	12,579,47	418,897	18,404,811	615,926

Source: Private commercial banks' annual report and NBE annual report and own computation

Moreover, the assessment of the before and after the directive for profit Average growth rate of private banks advocate the negative implication of the directive on the profit. The average growth rate for profit of private banks before the directive came into forth has been 119% while it came down to 26% since the directive has implemented confirming the reduction in the growth of profit for private commercial banks. Even in some banks like Wegagen, United and Nib International bank pointed reduction in their profit level during the implementation period of the directive as portrayed in the table 16.

Table 16: Private Banks' profit average growth rate before and after the NBE bills purchase directive.

S.No	Banks	Average growth rate of Profit Before the directive (2007/08-2009/10)	Average growth rate of profit after the directive(2010/11-2012/13)	Average growth rate change
1	Awash	0.42	0.07	(0.35)
2	Dashen	0.18	0.16	(0.02)
3	BOA	2.99	0.17	(2.83)
4	Wegagen	0.29	(0.01)	(0.30)
5	United	0.46	0.09	(0.37)
6	NIB	0.34	0.05	(0.29)
7	CBO	4.09	0.98	(3.12)
8	Lion	3.39	0.57	(2.82)
	Average	1.52	0.26	(1.26)

Source: Private commercial banks annual reports and Own computation

The IMF country report, moreover, has shown that the directive has tangible impact on the banking sector, their profitability in particular. It stated that the NBE directive introduced in April 2011 is having tangible impacts on banking sector, including maturity mismatch and less profitability (IMF, 2012). This because private banks collect savings at two to three years maturity and even shorter in some cases, but have to freeze these resources for five years at rates lower than cost of funds. This clearly indicates that NBE bills purchase directive has significant adverse implication on the profitability of private commercial banks via diminishing their profits and consequently making the banks to not accomplish their mission of maximizing shareholders value as shareholders' value is getting attractive dividend payment obtained from profits of the banks.

3.3.5 Implications of NBE bills Purchase directive on Liquidity of PCBs

The NBE bills purchase directive has negative implications on the liquidity of private commercial banks by reducing the liquid asset of the banks to repay their liability. Majority of respondents (56%) from the total respondents explained that NBE bills purchase directive reduced the liquid asset of the banks to repay its liability. Other respondents also label that NBE bills purchase directive as having

adverse implication on the banks activity by making the banks not to earn as much as they could. These respondents constitute 39% of the total respondents. Only very small respondents (5%) said that the directive has no impact on the liquidity of the banks. It can be understood from this finding that the NBE bills purchase directive has adverse implication on liquidity of private commercial banks via reducing their liquid asset that they used for repayment their liability.

Table 17: NBE bills purchase directive implication on liquidity of private commercial banks

NBE bills purchase directive implications on liquidity of private commercial banks	Frequency & %
It reduced the liquid asset of the bank to repay its liability	44 (56%)
It made the bank not to earn as much as it could be	31 (39%)
It has no impact on liquidity ratio of the banks	4 (4%)
Total	79 (100%)

Source: Own Survey result, 2014

Furthermore, the data accessed from the financial statements of private commercial banks indicated that liquidity (Loan to Deposit ratio) of private commercial banks after the directive enactment is higher than before the directive enactment reflecting that the reduction of liquid asset of banks to repay its liability. It was 62%, on average before the enactment of the directive and 76% on average after the enactment of the directive marking 14 percentage increases as depicted in table 18.

Table 18: Private Banks' average liquidity ratio before and after NBE bills purchase directive.

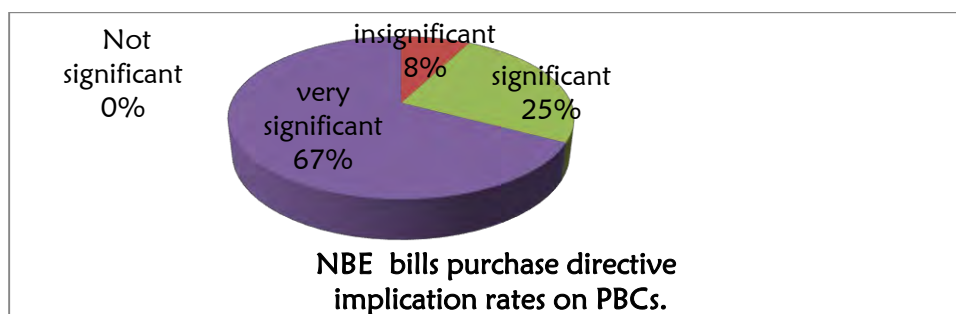
S.No	Banks	Average liquidity ratio(loan to Deposit) before the directive (2007/08-2009/10)	Average liquidity ratio(loan to Deposit) after the directive (2007/08-2009/10)	Average liquidity ratio change
1	Awash	0.57	0.82	0.25
2	Dashen	0.58	0.69	0.11
3	BOA	0.62	0.75	0.13
4	Wegagen	0.66	0.82	0.16
5	United	0.62	0.83	0.21
6	NIB	0.69	0.82	0.13
7	CBO	0.64	0.59	(0.04)
8	Lion	0.57	0.76	0.19
	Average	0.62	0.76	0.14

Source: Private Banks annual reports and own calculation

3.3.5.1 Rates of NBE bills purchase implication on Liquidity of PCBs.

Respondents are also asked to rate the implications of NBE bills purchase directive on the liquidity of private commercial banks. Accordingly, the directive has very significant implications on the private commercial bank's liquidity. This is because majority of the respondents (67%) supposed as the directive had have very significant on the liquidity of the private commercial banks. Respondents accounting for 25% of the respondents articulated as the directive have significant impact on the liquidity of the private banks. Only 8% of the respondents said that the directive has insignificant implication on liquidity. None of the respondents said that the implications of the directive on the liquidity were not significant at all. This clearly signals that NBE bills purchase directive as very significant impact on the liquidity of the private commercial banks.

Figure 5: Rates of NBE bills implications on private commercial banks' liquidity



Source: own Survey Result, 2014

3.3.6 The Implications of NBE bills Purchase directive on Assets of PCBs.

The implication of NBE bills purchase directive on assets of the private banks is uncommon because majority of the respondents from the total respondents elucidated as the directive has no impact on the assets of the banks. These respondents make up 44% of the total respondents as it is illustrated in the underneath table 15. 40% of the respondents said as the directive reduced the size of assets of the banks while the remaining respondents articulated that the implication of the directive by increasing their size of assets. From this analysis, it can be drawn that NBE bills purchase directive has no as such impact on the size of the assets of private commercial banks.

Table 19: NBE bills purchase directive implication on assets of private banks

NBE bills purchase Directive implications on assets of Private commercial banks	Frequency & %
It reduced the asset size of the bank	21 (40%)
It increased the asset size of the bank	8 (15%)
It has no impact on the asset size of the bank	23 (44%)
Total	52 (100%)

Source: Own Survey result, 2014

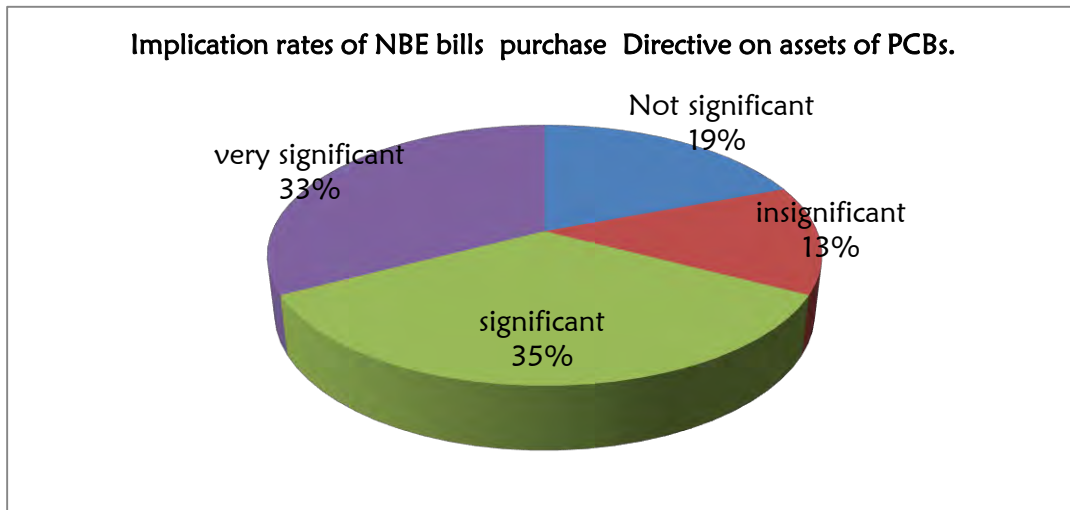
According to the interview conducted with key informant of private bank professionals on the implications of NBE bills purchase directive on the assets, they said that it has no as such impact on the size of the asset rather on the potential growth of assets. As well, some interviewed respondents that the directive changed the portfolio of assets from cash to long-term bond. In a nutshell, it can be said the directive has no as such impact on the size of the assets rather on the potential growth of assets.

3.3.6.1 Rates of NBE bills purchase directive Implications on Assets of PCBs

Along with articulating implications of NBE bills purchase directive on assets, respondents were asked to rate the implications of the directive on assets of private commercial banks. Hence, majority of respondents rated the implications of the directive on the assets of the private commercial as significant. These

respondents constitute 35% of the respondents. Following these respondents, about 33% of the respondents said the directive has very significant implication on the assets of private commercial banks. Respondents constitute of 13% and 19% rated the implications of directive on assets as insignificant and not significant at all respectively. This means that the degree of implications of NBE bills purchase directive on asset was significant.

Figure 6: Rates of NBE bills purchase directive implication on asset



Source: Own Survey result, 2014

3.3.7 Implications of NBE purchase directive on Capital and reserve of PCBs

The NBE bills purchase directive has negative implications on the capital and reserve of private commercial banks via reducing their capital and reserve. To this end, majority of the respondents (62%) of the view that NBE bills purchase directive implied in the reduction of the banks' capital and reserve. Respondents comprised of 31% replied as the directive has no impact on the capital and reserve of the bank. The remaining 8% of the respondents said the directive increased the capital and reserve of the banks which may be because of increasing paid up capital. This finding clearly signals that the NBE bills purchase directive implied in the reduction of capital and reserve of private commercial banks.

The data result obtained via an in depth interviews from key informant of private bank senior officials are also consistent with this premise by reasoning out that the directive has an implication on the profit of the banks and also has chain effects of the capital and reserve of the banks.

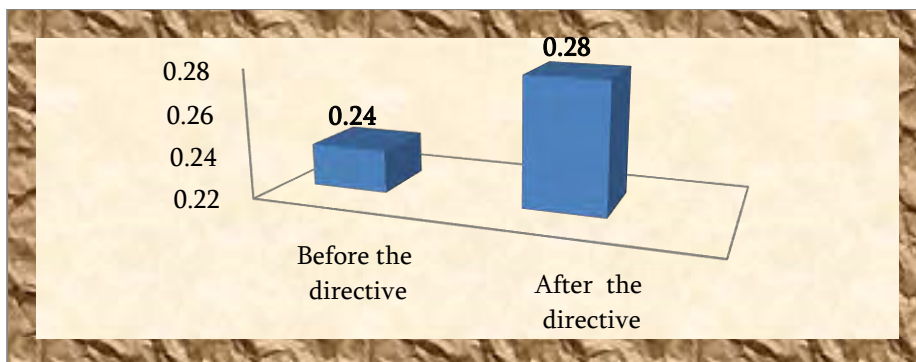
Table 20: NBE bills purchase directive implication on capital and reserve of PCBs.

NBE bills Purchase directive Implication on Capital and reserve of private commercial banks	Frequency & %
It reduced the capital and reserves of the bank	32 (62%)
It increased the capital and reserves of the bank	4 (8%)
It has no effect on the capital and reserves of the bank	16 (31%)
Total	52 (100%)

Source: Own Survey result, 2014

The assessment of the before and after the directive on capital and reserve of private commercial banks revealed conflicting findings with the survey and interview results of the study as indicated in the underneath figure. The average growth rate of private banks' capital and reserve has been 24% before the ratification of the directive while it grown up 28% after the implementation of the directive. However, the growth rate of private banks' capital and reserve revealed increasing at decreasing rate in which it was 32% in 2012 and declined to 23% during 2013.

Figure 7: Capital and reserve of private banks before and after the NBE bills purchase directive

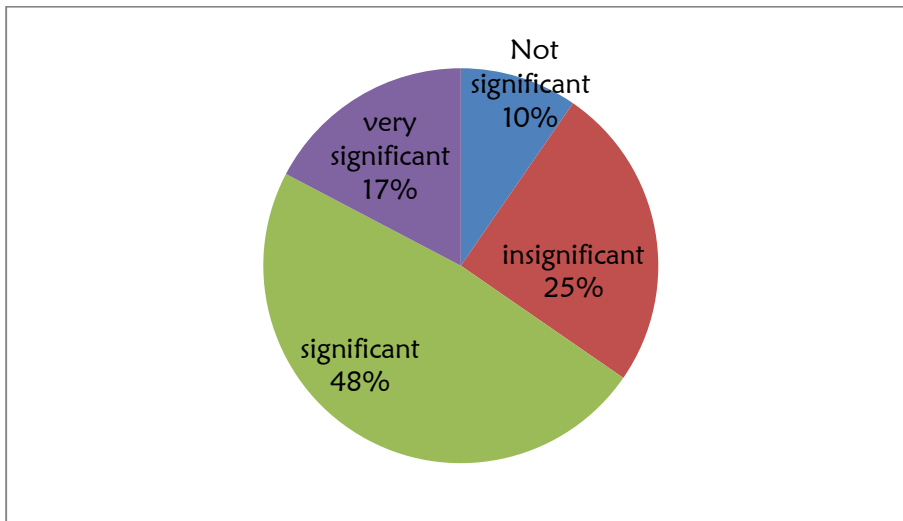


Source: Own Computation

3.3.7.1 Rates of NBE bills Purchase directive implication on Capital and reserve of PCBs

NBE bills purchase directive has significant impact on the capital and reserve of private commercial banks because about 48% of the respondents said that the directive has significant implications on the capital and reserve of the private commercial banks. Subsequent to these respondents, the majority of the respondents (25%) explained as the directive has insignificant impact on the capital and reserve of the private commercial banks as shown on the following figure 6. Respondents accounted for 17% and 10% rated the implication as very significant and not significant at all respectively.

Figure 8: Rates of NBE bills purchase directive implication on capital and reserve of PCBs



Source: Own Survey result, 2014

From this analysis and findings, one can conclude that NBE bills purchase directive has significant implication of the capital and reserves of private commercial banks.

3.3.8 Implications of NBE bills purchase directive on deposits and deposit mobilization of PCBs

The directive has a negative implication on the deposit of the private commercial banks via reducing their deposits. This is because half of the respondents said that the directive has a negative impact on the deposit of the bank through reducing their deposits. As marked in the table 16 below, 35% respondents said that the

directive has no impact on the deposits of the banks whereas 15% of the total respondents deduced as the directive increased the deposit of their banks. This implies that NBE bills purchase directive has negative implication on the deposit of private banks by reducing their deposits.

The interviewed key informant senior bank officials also replied the same response on the issue. They explained that the directive has a negative implication on the deposit of the banks. Their reason for this was that the extending loan is complementary for the deposit mobilization. However, as the directive lessens the amount of loan extended, it equally lessens the amount of deposits of the bank, as most loanee customers are depositors by default. This has an implication of increasing inflation at national level.

They added that the directive made the grew of time deposit in the banks as banks faced fund shortage and they go for the search of time deposit based on price negotiation. Therefore, according them, the directive changed private banks deposit structure in which time deposit relatively grown up and other saving type turn down. This means that NBE bills purchase directive implied on deposit of private commercial banks via reducing their deposit amount and altering their deposit structure.

Table 21: NBE bills purchase directive implication on the deposits of PCBs.

NBE bills purchase directive's implication on deposit of private commercial banks	Frequency and %
It increased the deposit of the banks	8 (15%)
It reduced deposit of the banks	26 (50%)
It has no impact on deposit of the banks	18 (35%)
Total	52 (100%)

Source: Survey result and Own calculation, 2014

The result of before and after directive assessment furthermore revealed the negative implications of the directive on the deposits of private banks as shown in

the following table. The deposit growth rate of private banks has been 34% before endorsement of the directive in which went down to 23% after the implementation of the directive showing the negative implication of the directive on the private commercial banks.

Table 22: Average growth rate of deposit of private banks before and after the directive.

S.No	Banks	Average growth rate of deposit before the Directive (2007/08-2009/10)	Average growth rate of deposit after the directive(2010/11-2012/13)	Average growth rate Change
1	Awash	0.34	0.28	(0.07)
2	Dashen	0.28	0.16	(0.13)
3	BOA	(0.13)	0.18	0.31
4	Wegagen	0.23	0.14	(0.09)
5	United	0.39	0.15	(0.24)
6	NIB	0.29	0.14	(0.16)
7	CBO	0.67	0.50	(0.17)
8	Lion	0.66	0.28	(0.39)
	Average	0.34	0.23	(0.12)

Source: Private bank' annual report (2007/08-2012/13)

3.3.9 The Implications of NBE bills purchase directive on the branch expansion of PCBs.

Unlike almost all above performance of private commercial banks, NBE bills purchase directive has positive implication on the branch expansion of private commercial banks. Furthermore, the assessment of before and after the directive revealed that positive implications of the directive on the branch expansion of private banks. As can be seen from the following table, the branch expansion of private banks before the directive enactment was 4 on average while gone up to 15 after the implementation of the directive.

Table 23: Average branch expansion of private banks before and after the directive

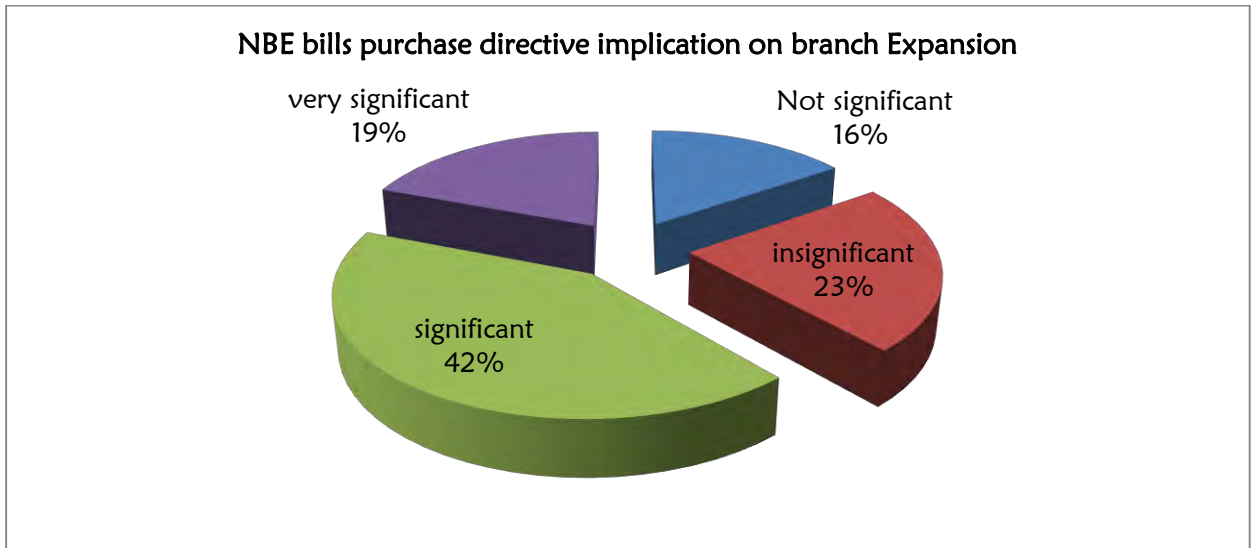
S.No	Banks	Average branch expansion before the directive (2007/08-2009/10)	Average branch expansion after the directive (2010/2011-2012/13)
1	Awash	6	23
2	Dashen	6	22
3	BOA	3	12
4	Wegagen	3	11
5	United	4	13
6	NIB	3	11
7	CBO	10	17
8	Lion	3	12
	Average	4	15

Source: Private Banks' annual report (2007/08-2012/13)

The directive has significant implication on the branch expansion of private commercial banks as it can be seen in the following figure 7. Of the total respondents, almost around half of the respondents deduced that the directive has significant positive implication on the branch expansion of private commercial banks.

The interviews made with key informant senior bank officials of private banks also reinforce these ideas. They said banks are aggressively expanding their branches since the directive come into force as to search for funds and compensate the shortage of funds they face because of the directive. The interview made with National Bank of Ethiopia official also raises this positive implication of the directive private commercial banks. He also added the positive implications of the directive on private commercial banks since it forced them to introduce new products, systems and services to attract customers. This implies that the NBE bills purchase directive has significant positive implication on branch expansion of private commercial banks.

Figure 9: NBE bills purchase directive implication rates on branch expansion

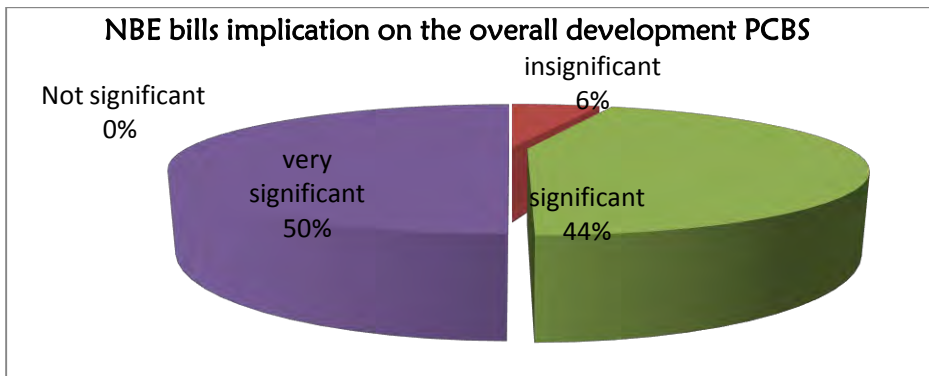


Source: Own Survey result, 2014

3.3.10 Implications of NBE bills purchase directive on Overall development of PCBs

NBE bills purchase directive has very significant negative implication on the overall development of private commercial banks because half of the surveyed respondents said the directive has very significant implication on the development of overall development private commercial banks. Correspondingly, about 44%-surveyed respondents said that the directive has significant implication on the overall development of private commercial banks as it can be seen on the following figure 8.

Figure 10: NBE bills purchase on the overall development of PCBs



Source: Own survey result, 2014

It can be understood from this analysis and finding that NBE bills purchase directive has very significant negative implications on the development of private commercial banks.

3.3.11 Recommendations for Regulatory Organ on NBE bills purchase directive

Respondents were also asked to forward recommendations for regulatory organ on NBE bills purchase directive. Accordingly, majority of the respondents recommend that the regulatory organ (National Bank of Ethiopia) should reduce the percentage amount of allotment for NBE bills purchase. They make up 39% of the total respondents. As second recommendation, they forwarded that NBE should increase interest rate paid for the bills, as the current price of bills is too low and even cannot compensate the cost of funds. Response of these respondents accounted for 38%. Least responses of the respondents voted for the phasing out of the directive (23%) as shown in the following table 18. From this, we can conclude that lessening the percentage amount of allotment for NBE bills purchase of bills is the primary recommendation for regulatory organ.

Table 24: Recommendation for regulatory organ on NBE bills purchase directive

Recommendations	Frequency & %
Phasing out the directive	18 (23%)
Lessen the amount allocated for the purchase of bills	31 (39%)
Increasing interest income paid for the bills	30 (38%)
Total	79 (100%)

Source: Own Survey result, 2014

In addition to above recommendations, basing the percentage of allotments on net deposit increment, outstanding balance of loans and other criteria are recommendations forwarded by the key informant senior private bank professionals. They also added that National Bank of Ethiopia should introduce directed credit policy which is common in many developing countries. By this, it

can channel considerable amount of loans to the priority sectors' projects it deems to benefit. They said that by introducing such policy (directive) both private commercial banks and the government would be benefited.

Furthermore, the IMF country report (2012) recommended the regulatory organ by proposing the appropriate pricing of NBE bills and changing the basis for the allotment from gross to net disbursement.

Chapter Four

Summary, Conclusion and Recommendation

The main objective of this study, as described at the onset of this document, is to assess the implications of the Bills purchase directive of National Bank of Ethiopia on the development of private commercial banks. In line to this, this section summarizes the findings, concludes and forward policy implications.

4.1 Summary of findings

A total of 16 private commercial banks have participated in this study. From 16 private commercial banks, the respondents that ought to be have understanding of the problem and assigned on a variety of positions and functions including bank presidents, vice presidents, Department directors/ managers, Division heads/ team managers, experts/ seniors and officers were filled and responded the questionnaires. Accordingly, the following paragraphs detailed the summary of research findings.

According to the survey result, NBE bills purchase directive have been reflected in all private commercial banks affecting negatively almost all their performances and their on and off balance sheet items like the size of Loanable fund(loan and advances), income and expense, profitability, liquidity, capital and reserve and asset.

The directive affected the Loanable fund and associated loans related variables of private commercial banks by reducing the size of Loanable funds, forcing banks to change their lending interest rate, dissatisfying loanee customers and changing portfolios, loan provision strategy, reducing loans and advances market share, and prohibiting banks not to finance priority sectors. It has affected the income of private commercial banks through declining the interest income, over all income and income market share of private commercial banks.

The directive has affected the expense of private commercial banks via increasing their interest expense, overall expense and increasing market share of expense according to survey and interest result. There are also respondents that said the directive has no impact on the expense of the bank. The result obtained from secondary data sources reveals, however, as the directive did not increase the interest income of private banks.

NBE bills purchase directive has additionally affected the profitability of Private commercial banks by reducing their profits, making banks not to maximize their share holders' value and reducing profit market share of private commercial banks. Some respondents also thought as the directive has no impact on the profitability of the banks.

Moreover, the NBE bills purchase directive has affected the liquidity of private commercial banks by reducing the liquid asset of the banks to repay its liability and making banks not to earn as much they could be. There are also respondents supposed that the directive has no impact on the liquidity of the banks. NBE bills purchase directive has affected the assets of private commercial banks via reducing the asset size and increasing asset size. However, Upper hand respondents voted for the directive has no impact on the asset of private commercial banks.

Furthermore, the NBE bills purchase directive has affected the capital and reserves of the private commercial banks via reducing their capital and reserves as the majority respondents explained. Small number of respondents however, explained as the directive increased their capital and reserves of banks. There are also respondents whose response that said the directive has no effect on capital and reserves of the private commercial banks.

Respondents rated the implications of NBE bills purchase directive on various performances of private commercial banks. Accordingly, majority of the respondents rated the implications of the directive as significant on the asset, branch expansion, capital and reserve and very significant on loan and advances, liquidity, income and overall development of private commercial banks. Recommendations like reducing the percentage allotment to NBE bills, Increasing interest rate of the bills and phasing out the directive is forwarded for NBE by respondents.

4.2 Conclusion

This study was set out to assess the implications of regulatory policies on the development of private commercial banks particularly focusing on policy, NBE bills purchase directive. Relying on this broad objective, a number of specific objectives were developed. In order to achieve these specific objectives, a number of research questions have been formulated that is aimed to answer. The main research questions are:

1. What are the implications of NBE bills Purchase Directive on the Development of private commercial banks?
2. What are the activities /performances of private commercial banks that have been affected by NBE bills purchase directive?
3. How has the NBE bills purchase directive affected various performances (operational and financial) of private commercial banks in Ethiopia?
4. What is the extent of implications of NBE bills purchase directive on various performances of private commercial banks?
5. What do the discussions of findings on the study imply in terms of policy recommendation?

In order to answer these stated research questions, the study took into consideration mixed research approach, i.e. quantitative and qualitative approach

and descriptive research type. The research problem was approached with data collection tools like questionnaires, in depth interview and document survey. Data obtained using these tools were analyzed and presented. Accordingly, the following paragraphs concluded study based on analysis and discussions.

The implications of bills purchase directive of NBE negatively reflected on almost all private commercial banks' performances/activities consequently on the development of private commercial banks. Hence, the on and off balance items like Loanable fund, income and expense, profitability, liquidity, asset and capital and reserves were affected by the directive. The directive negatively affected the Loanable fund of private commercial banks by reducing their Loanable fund largely, which brought multiplier effect on other loan related variables. These include upward revision of lending rate, dissatisfaction of loanee customers, and change in loan portfolios of banks, reduction of loan and advance market share and prohibition of financing priority sectors.

The directive has also negative implications on the income of private commercial banks via reducing mostly their interest income in particular, overall income and income market share in the industry. The reduction of income implied in reduction of profit, which is the very main reason for the survival, and growth and development of private commercial banks. As the study depicted the share of lost income because of purchase of NBE bills marked an increasing trends during the last three fiscal years. This reflects that if the directive carries on in this manner it would make private commercial banks unprofitable and crowd them out from the market.

The study also revealed as the directive has negative implications on the expense of the private commercial banks via increasing the expenses of private commercial banks. Likewise, the study revealed that the negative implication of bills purchase directive on the profitability, liquidity and capital and reserve of private

commercial banks. It affected the profit of private commercial banks through reducing their profits, which resulted in the banks' inability to maximize the shareholders' value and reduction of profit market share in the industry. It also affected the liquidity of private commercial banks by reducing the liquid asset of the bank to repay its liquid liability and making the bank not to earn as much they could be. Likewise, it affected the capital and reserve of the private commercial banks by reducing their reserve.

The study also came up with that the directive has no implication on the asset size of private commercial banks since the bills are one of the elements of asset of private commercial banks; however, it affected the potential growth of rate of assets and asset portfolio of banks. The assessment also disclosed, the couples of positive implications that directive had, enhancing branch expansion of private commercial banks and forcing them to develop new products, services and system to attract customers.

The study also disclosed that the extent of implication the directive have on the performances of private commercial banks. Hence, the implications of the directive was rated as significant on asset, capital and reserve, branch expansion and very significant on liquidity, income, Loanable fund and overall development of private commercial banks.

Recommendation like reducing the percentage allotment for bills, increasing interest rates of NBE bills and phasing out the directive were forwarded by the respondents in the study.

In a nutshell, the negative implications of the bills purchase directive on the development of private commercial banks were huge when compared to its positive implications. The negative implication of the bills purchase lies on almost all banking activities and consequential performances like loans, deposits, income, expense, profitability, liquidity, and capital and reserve. However, the directive

had positive implications on the branch expansion of private commercial banks and development new products.

4.3 Recommendations

Banking sector in general, private banking sector in particular is the blood line of one country's economy. Making them to stay stable and encouraging their robust growth is thus an indispensable deed of government. In Ethiopia, banking business in general and private banking business in particular is infantile, which demands enabling environments for their robust development in the future. In contrary, the findings of this research came up with government regulatory organ's making of disabling environments for private banking industry. Thus, relying on the finding and conclusion drawn from this research paper, the following policy implications were forwarded by the researcher.

4.3.1. Need to Redress the Components of the Directive that Negatively Affected the Private Banks

As the study revealed, the directive has negatively affected almost all performances of private commercial banks. Loanable fund is one of performances of private commercial banks that highly affected by the directive, as the directive obliged private commercial banks to allocate considerable of amount their lucrative funds (27%). This component of the directive was not only affected private banks but also limit the private sector involvement in the economy by limiting the amount of loans channeled to this sector by private commercial banks. This in turn has a negative implication on the expansion of the economy. Finally, it may crowd out private sector involvement in the economy. This can be mitigated by devising or modifying the directive via either reducing the percentage amount of allotment or changing the basis of allotment to, for instance, deposits. The regulatory organ (National Bank of Ethiopia) can do this consulting with Private commercial banks. Such alterations will provide win-to-win benefit for both Private Banks and government regulatory organ.

Another performance of private commercial banks that has been affected by the directive is their income. Their income is affected because the directive offer very low price(3%) which is less than cost of collecting savings (5%) from the public. This even makes private commercial banks to incur net loss of 2%. Not only incurring a net loss of 2% but also the price (rate) calculated on the bills is far less than the market lending price which is around 11% having 8% discrepancy. This lending price disparity made private commercial to loss considerable amount of income. This can be solved by making appropriate pricing of the NBE bills. National Bank of Ethiopia would do this by consulting with private commercial banks.

4.3.2. Need to Redress Liquidity Problem against Maturity Mismatch

Another major area of pitfall of this study concluded was that the liquidity problem made by maturity mismatch. Private commercial banks collect deposit for maximum of three tenure years. Nevertheless, they purchase NBE bills that have a minimum of five tenure years for collection. This exposed private commercial banks to liquidity problem by creating maturity mismatch. This problem can be solved by lessening tenure years for the collection of principal of the bills purchased. National Bank of Ethiopia will do this with consulting private commercial banks.

Apart from this, various countries' regulatory organ (Central bank) craft direct credit policy, which order banks to allocate some percentage amounts of their loans to finance priority sector projects. This could be an alternative policy for government regulatory organ as it benefits both private commercial banks and the financed sector projects.

4.4. Future Research Agenda

- ↳ Alternative policies of financing priority sector projects by private Commercial banks: Experience of other countries
- ↳ The impact of NBE bills purchase directive on the development of private sectors
- ↳ NBE bills purchase directive and private commercial banks' Coping up mechanism.
- ↳ The impact of NBE bills purchase directive on deposit structure of private banks

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Appendices

Annex-1

Date -----

Dear Sir/ Madam

I am working on my Master's Thesis by the title: "Role of Regulatory Policies on the Development of Private Commercial Banks in Ethiopia – the Analysis of the Implications of the Bills Purchase Directive of National Bank of Ethiopia". I would much appreciate it, if you could kindly take a little of your time to complete the attached questionnaire items. There is no anticipated risk in your participation as your information supplied will be held strictly confidential. It will be utilized for academic purpose only.

You and your organization and to a larger extent the Ethiopian Banking Sector, the National Bank of Ethiopia will all benefit from the result of this research work. The result may be utilized as an input for policy makers of National Bank of Ethiopia.

I ask sincere apology for bothering you with the lengthy questionnaire items. But in order to get full information for the study and meet the research objective, the question items presented are quite important.

I kindly request you to read the instruction of each section before responding and please complete each section and answer all the questions. I assure you that neither you nor your organization will be identified.

I take this opportunity for thanking you in advance for your kind participation and timely return of your completed questionnaire. If you have any queries, I am available as per your convenience at (Tele 09-13-97-38-59 or email 'shibiruamsalu@yahoo.com').

~ X ~

5. Would you please indicate how long you have served (many years did you work) in your current job position level in this organization?

- 1. Less than 5 years
- 2. 6-10 years
- 3. 11- 15 years
- 4.16- 20 years
- 5.21-25 years
- 6.Above 25 years

Part 2.Questionnaires on the implications of NBE bills on the development of Private Banks. It consists of structured and semi structured questions, so please answer it accordingly. The questions may have more than one answer.

1. How have the implications of NBE bills purchase directive been reflected on your bank?

- A. It affected the size of Loanable fund
- B. It affected the income and expense of the banks
- C. It affected the profitability of the bank
- D. It affected the liquidity ratio of the bank
- E. It affected the assets of the bank
- F. It affected the capital and reserve of the bank
- G. Others(specify).....
.....
.....
.....

2. How did the directive affect the Loanable fund and other variables related loans of your bank?

- A. It reduced the amount of Loanable fund of the bank
- B. It entailed the bank to increase the price (interest rate) of Loanable fund
- C. It dissatisfied the loanee customers and affects the portfolios the banks
- D. It instigates bank to change the strategy of its loan provision.
- E. It reduced the bank’s loans and advances market share in the industry
- F. It prohibited the bank not to finance priority sectors (export, import, agriculture)

G. others
(Specify).....
.....

3. How did the directive affect the Incomes of your bank?

- A. It reduce the overall income of the bank
- B. It reduce the interest income of the bank
- C. it reduces market share of income of the bank in the industry
- D. It has no impact on the income of the bank
- E. Others (specify).....
.....
.....

4. How did the directive affect the expenses of your bank?

- A. It increased the overall expense of expenses of the bank
- B. It increased the interest expense of the bank
- C. It increased Expense market share of the bank
- D. It has no impact on the expenses of the bank
- E. others (specify)

.....
.....
.....

5. How did the directive affect the Profit of your bank?

- A. It reduced the profit of the bank
- B. It made the bank not to maximize the value of shareholders by increasing profits
- C. It reduced the profit market share of the bank in the banking industry
- D. It has no impact on the profitability of bank
- E. Others
(Specify).....
.....
.....
.....

6. How did the directive affect Liquidity of your bank?
- A. It reduced the liquid asset of the bank to repay its liquid liability.
 - B. It made the bank not to earn as much as it could be.
 - C. It has no impact on the liquidity of the bank
 - D. Others
- (specify).....

7. How did the directive affect the assets of your bank?
- A. It reduced the size of assets of the bank
 - B. It increased the size of asset of the bank
 - C. It has no impact on the size of the assets of the bank
 - D. Others
- specify).....

8. How did the directive affect the capital and reserve of your bank?
- A. It reduced the capital and reserves of the bank
 - B. It Increased the capital and reserves of the bank
 - C. It has no effect on the capital and reserves of the bank
 - D. Others(specify).....
-

 ...

8. How did the directive affect the deposit of your bank?
- A. It increased the deposits of the bank
 - B. It reduced the deposits of the bank
 - C. It has no effect on the deposit of private bank
 - D. Others(specify).....
-

.....

9. Do you have any other implication in your opinion that the new directive has affected the private banks and can you explain how (specify) it did so?

.....

Part 3. How do you rate the implications of NBE bills purchase requirement directive on various operational and financial performances of private commercial banks? Mark 'X' in appropriate box.

S.No	Possible areas in which the new directive affected private banks	Not significant at all	Insignificant	Significant	Very significant
1	The implication NBE bills purchase requirement directive on the asset of private commercial banks				
2	The implication of NBE bills purchase requirement on the deposit mobilization of private commercial banks.				
3	The implication of NBE bills purchase requirement on the loans and advances of private commercial banks				
4	The implication of NBE bills purchase requirement directive on the income of private commercial bank				
5	The implication of NBE bills purchase requirement directive				

	on the branch or service outlet expansion				
6	The implication of NBE bills purchases requirement directives on the capital and reserve of the private commercial banks.				
7	The implication of NBE bills purchase requirement directive on the liquidity of private commercial banks.				
8	The implication of NBE bills purchase requirement directive on the overall development private commercial banks.				

4. What you recommend the regulatory organ (National Bank of Ethiopia) for NBE bills purchase directive?

1. The National Bank of Ethiopia should phase out the directive
2. The National bank of Ethiopia should lessen the amount allocated for the purchase of bills
3. The National bank of Ethiopia should increase the interest income paid on bills for Private Commercial banks
4. Other recommendation(specify)

.....
.....
.....

Thank you

Annex-2

Interview questions

Section one: Interview questionnaires designed for the presidents, Directors, Managers, team managers and experts of the selected private commercial banks.

Please tell me your position.....

1. What are the components of the NBE Bill Purchase Directive that have had impacts on the development of the private commercial banks in Ethiopia (both in positive and negative ways?)
2. Which specific activities of private commercial banks are affected by the directive? How and why are these specific activities of the private banks more affected?
3. What do you recommend so forth for the regulatory organs in the banking sector in terms of directives in general and the NBE Purchase Directive in particular to improve?

Section two: Interview questions designed for National Bank of Ethiopia

Please tell me your position.....

1. What is/are the reason/s behind the issuance of NBE bills purchase directive?
2. Did you make analysis of the implications of this directive on the development of private commercial banks when you developed this directive?
3. As your opinion, what are the implications of NBE bills purchase directive on the development of private commercial banks (in positive and negative ways)?
4. Do you think that the directive's positive implications outweigh negative implications? How?
5. Don't think that the directive's negative implication on operational and financial performances of private commercial banks?
6. What do you think in the future in order to curb this problem?

Statement of Declaration

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

Declared by:

Name: Shibiru Amsalu

Signature _____

Date _____

Confirmed by Advisor:

Name: Dr. Filmon

Signature _____

Date _____

Place and date of submission: Addis Ababa University, May, 2014

Statement of Certification

This is to certify that Shibiru Amsalu Hundara has carried out his research work on the topic, “**Assessing implications of Regulatory policy on the development of Private commercial banks: A case of NBE bills Purchase Directive**”. The work is original in nature and is suitable for the submission for the reward of MA Degree in Public Management and Policy.

Advisor: Filmon (PhD): _____