



**ADDIS ABABA UNIVERSITY SCHOOL
OF LAW GRADUATE STUDIES**

***THE LEGAL AND INSTITUTIONAL FRAMEWORK
FOR THE REGULATION OF COMMERCIAL BANKS
IN ETHIOPIA: STRENGTHS AND WEAKNESSES***

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ADVISOR: TILAHUN TESHOME (PROFESSOR)

**SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR
THE DEGREE OF MASTER OF LAWS (LL.M.) IN BUSINESS LAW AT THE
SCHOOL OF LAW ADDIS ABABA UNIVERSITY**

**FEBRUARY, 2018
ADDIS ABABA, ETHIOPIA**

DECLARATION

I HEREBY CERTIFY THAT THIS THESIS IS MY ORIGINAL WORK AND WORKS OF OTHERS INCLUDED IN THIS THESIS WORK ARE PROPERLY CITED.

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**ADDIS ABABA UNIVERSITY SCHOOL OF GRADUATE STUDIES SCHOOL OF LAW
APPROVAL SHEET BY THE BOARD OF EXAMINERS**

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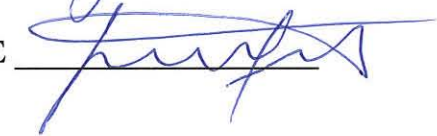
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Table of Contents

ACRONYMS	i
1.INTRODUCTION	1
1.1 Background of the Study.....	1
1.2 Research Questions.....	2
1.3 Scope of the Study.....	2
1.4 Objectives of the Study.....	3
1.4.1 General objective.....	3
1.4.2 Specific Objectives.....	3
1.5 Significance of the Study.....	3
1.6 Research Method.....	3
1.7 Limitation of the Study.....	4
1.8 Organization of the paper.....	4
2. CONCEPT, THE NEED FOR AND APPROACHES TO BANK REGULATION AND SUPERVISION.....	5
2.1 Concept of Bank Regulation and Supervision.....	5
2.1.1 Prospects of Bank Regulation and Supervision.....	6
2.1.2 Standard Instruments of Bank Regulation.....	10
2.1.3 Reasons behind Recent Regulatory Reform in Banking at Global Level.....	14
2.1.3.1 Banking Crisis.....	14
2.1.3.2 Growth of BHCs.....	15
2.1.3.3 Technological Innovations.....	16
2.2 The Need for Banks Regulation and Supervision.....	18
2.2.1 Protection of Depositors.....	18
2.2.2 Monetary and Financial Stability.....	19
2.2.3 Efficient and Competitive Financial System.....	19
2.2.4 Consumer Protection.....	22
2.2.5 Risk of Bank Runs and Moral Hazard.....	22
2.2.5.1 Risk of Bank Runs.....	22
2.2.5.2 Excessive Risk Taking (Moral Hazard).....	23
2.2.5.3 Systemic Dangers of Bank Failure.....	23
2.2.5.4 Dangers to Soundness of Payment System.....	24

2.3 Contrasting Approaches and Areas of Bank Regulation.....	26
2.3.1 Contrasting Approaches.....	26
2.3.1.1 Public Interest Approach.....	26
2.3.1.2 Private Interest Approach.....	26
2.3.2 Areas of Bank Regulation and Supervision.....	27
2.3.2.1 Activity restrictions.....	27
2.3.2.2 Entry Requirements and Restrictions.....	28
2.3.2.3 Capital Requirements	28
2.3.2.4 Supervisory Powers.....	29
2.3.2.5 Market Monitoring.....	30
2.3.2.6 Government Ownership.....	32
2.3.2.7 Regulatory and Supervisory Convergence.....	32
2.3.3 Bank Regulation and Supervision around the World.....	33
2.3.3.1 Single versus Multiple Bank Supervisors.....	33
2.3.3.2 Supervisory Role of Central Banks.....	34
2.3.3.3 Scope of Supervisory Authority.....	35
2.3.3.4 Independence of Supervision.....	36
2.3.3.5 Explicit Deposit Insurance Schemes.....	37
2.3.3.6 Role of External Governance in Bank Regulation.....	38
2.4 Core Principles of Effective Banking Supervision.....	38
2.4.1 BHCs Regulation.....	41
2.4.2 Change in Bank Control	41
2.4.3 Credit Extension	42
2.4.4 Securities Regulation.....	43
2.4.5 Examination and supervisory influence on credit quality	44
2.4.6 off balance sheet items.....	46
3. THE LEGAL AND INSTITUTIONAL FRAMEWORK FOR BANK REGULATION AND SUPERVISION IN ETHIOPIA	49
3.1 Entry into Banking.....	49
3.2 Bank Ownership.....	52
3.3 Regulatory Capital Adequacy Regime.....	55
3.4 Banking Activities.....	56

3.5 External Auditing Requirements.....	57
3.6 Bank Governance.....	60
3.7 Liquidity & Diversification Requirements.....	63
3.7.1 Risk Concentrations.....	63
3.7.2 Regulatory Liquidity Requirements.....	64
3.8 Asset Classification, Provisioning and Write-offs.....	66
3.8.1 Asset Classification.....	66
3.8.2 Provisioning for Classified Loans.....	68
3.9 Accounting/Information Disclosure.....	69
3.10 NBE's Enforcement Powers.....	71
3.11 Supervision.....	74
3.11.1 Institutional Structure and Mandate	74
3.11.2 Supervisory Approach.....	75
3.11.3 Systemic Supervision.....	76
3.12 Consumer Protection.....	76
4. CONCLUSION AND RECOMMENDATIONS.....	77
4.1 Conclusion.....	77
4.2 Recommendations.....	78
REFERENCE.....	79

ACRONYMS

ACH:	Automated Clearing House
AMLCFTP:	Anti-Money Laundering and Combating Financing of Terrorism Proclamation
Art/s.	Article/s
ATM:	Automotive Teller Machine
BBP:	Banking Business Proclamation
BCP:	Basel Core Principles
BHC:	Bank Holding Company
BIB:	Bunna International Bank
M/BoD:	Member/s/ of Board of Director/s
BSD:	Bank/ing Supervision Directorate
CBO:	Cooperative Bank of Oromia
Comm.C.	Commercial Code of Empire of Ethiopia
CEO:	Chief Executive Officer
CG:	Corporate Governance
DARA:	Documents Authentication and Registration Agency
EBA:	Ethiopian Bankers' Association
EFT:	Electronic Fund Transfer
EIC:	Examiner-in-charge
FATAF:	Financial Action Task Force
FDRE:	Federal Democratic Republic of Ethiopia
FG (E):	Federal Government (of Ethiopia)
FI:	Financial Institution/s
Forex:	Foreign Exchange
FRB:	Federal Reserve Bank
FRS:	Federal Reserve System
FS:	Financial Statement/s
GDP:	Gross Domestic Product
HC:	Holding Company/ies
HPR:	House of Peoples' Representatives

HRM:	Human Resources Management
IAS:	International Auditing Standard
IFC:	International Financial Corporation
IMF:	International Monetary Fund
IRA:	International Rating Agency/ies
ISMD:	Information Systems Management Directorate
MaAA:	Memorandum and Articles of Association
MIS:	Management Information System
NBE:	National Bank of Ethiopia
NBEEP:	NBE Establishment Proclamation
NPS:	National Payment System
NPSP:	NPS Proclamation
NPSSD:	National Payment and Settlement System Directorate
Para/s.	Paragraph/s
PM:	Prime Minister
POS(T):	Point of Sale (Terminal)
RG:	Regional Government
RM:	Risk Management
RTGS:	Real Time Gross Settlement
SEO:	Senior Executive Officer
U.S. (. A):	United States (of America)
WB:	World Bank
WeB:	Wegagen Bank

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Owing to its strategic importance to overall health of an economy, Banking Sector is one of the industries requiring special regulation and supervision by special government or government-private owned, but autonomous, regulatory body. This regulatory body may have different naming including Reserve Bank, Central Bank or National Bank in different countries. These regulatory authorities are entrusted with authority to develop and regulate a financial sector in general by particularly focusing on banking business. In Ethiopia, NBE is a government authority entrusted with centralized regulatory and supervisory power over banking, insurance, micro financing, payment operations and other financial businesses determined by it.¹ Regardless of differences in naming and scope of regulatory authorities' power, such regulatory bodies have common duties and responsibilities including duty to ensure rapid economic development, stable price and Forex rate, healthy financial system and undertake such other activities as are conforming to economic growth of their respective countries.² Furthermore, in every part of the globe, NPS is an essential component of financial infrastructure, whose safety, security and efficiency is critical to ensure financial stability, economic growth and financial inclusiveness, and, hence, it is necessary to provide rules on establishment, governance, operation, regulation and oversight of NPSs by bank regulatory bodies³.

Banks play an important role in economic development through mobilization of funds from within and outside a country and channeling such funds to various sectors of an economy and occupy a central place in payment and settlement system of a country's economy. The business of banking has number of attributes which, if not managed properly, generate financial system and macroeconomic instability and the cost of such instability to general public and the Government attracts regulatory and supervisory power exercise by a pertinent regulatory body.⁴ Therefore, this paper aims at examining the institutional and legal framework for the

¹ NBEP, 2008, Art. 14, Pro. (as amended) No.591," Neg. Gaz.", year 14, no.50

² Id., preamble, paras.1 and 2

³ NPSP, 2011, paras.1 and 2, Pro. No. 718, "Neg. Gaz.", year 17, no.84

⁴ BBP, 2008, paras. 1, 2, 3 and 4, Pro.No.592," Neg. Gaz.", year 14, no.57

regulation of banks in Ethiopia with a special emphasis on strengths and weaknesses of such framework against the objectives and purposes entrusted to NBE by general and sector specific laws along with banks self-regulation as per their bylaws and the role of EBA. Consequently, appropriate points of recommendation, based on the findings of the study, are provided. The word "Bank/s" refers to private and government owned Commercial Banks operating in Ethiopia, licensed and/or regulated and supervised by NBE for the purpose of the study.

1.2 Research Questions

As the topic of this paper is "The Legal and Institutional framework for the regulation of commercial Banks in Ethiopia," the following issues were raised and analyzed on the existing legal regime and the institutional framework.

1. Which laws are applicable on Banks?
2. Are these laws adequate to regulate Banks in Ethiopia?
3. Are these laws consistently applicable?
4. Are all directives and circulars issued by NBE enforceable?
5. To what extent is NBE authorized by law to regulate and supervise Banks and what is left for self-regulation?
6. Does NBE have the required capacity to regulate and supervise Banks along with other FIs in Ethiopia?
7. Should NBE have branches to regulate and supervise Banks in Ethiopia?
8. What is the role of individual banks and EBA in Regulating and supervising banks in Ethiopia?

1.3 Scope of the Study

The study mainly focuses on legal and institutional framework to regulate Banks in Ethiopia. Further, bylaws of EBA and Banks are considered as self-regulatory instruments. International rules including Basel risk-based supervision rules and FATAF recommendations and other rules issued by WB, IMF, IFC and other international institutions which are accepted by Ethiopia are also addressed. To strengthen the findings of the study, international experiences on legal and institutional framework to regulate Banks were also considered.

1.4 Objectives of the Study

1.4.1 General objective

The general objective of the study is assessing the adequacy of the existing legal and institutional framework for the regulation of Banks in Ethiopia and come up with recommendation that will address the gaps.

1.4.2 Specific Objectives

The specific objectives of the study include: assessing existing legal and institutional frameworks to regulate Banks in Ethiopia, adequacy of such frameworks, legality of directives and circulars issued by NBE, bylaws and practice of self-regulation by Banks and their association, onsite and offsite supervision working procedures or manuals and practices of NBE, related investigation reports, case studies and experiences which are relevant to solve the research problems and come up with recommendations based on findings of the study.

1.5 Significance of the Study

The study is significant to elucidate the current status of NBE's regulatory frameworks and their strengths and weaknesses in the banking business sector of Ethiopia and propose solutions for identified problems based on findings, and pave the way for other researchers to make further studies by taking the study as point of departure.

1.6 Research Method

This research used both primary and secondary sources. Primary sources include relevant laws governing Banks and interviews. Secondary sources include literature reviews, periodic reports review from NBE and Banks. Case studies demonstrating the manner and scope of NBE's regulatory and supervisory power were also used.

1.7 Limitation of the Study

Finding out the legal and institutional regulatory problems encountered by NBE, EBA and Banks in Ethiopia was subjected to number of problems, mainly, from relevant officers in disclosing relevant information, time and access to meet pertinent interviewees. The study was further exposed to financial and material resource limitations.

1.8 Organization of the Paper

This study investigates the institutional and legal frameworks governing regulation of banks in Ethiopia with a particular emphasis on strengths and weaknesses along with the way forward to address the gaps. The paper is structurally organized by chapters constructed on topics and sub-topics followed by detailed descriptions. The paper has 4 chapters each accompanied by detailed topics. This chapter deals with the introduction of the study and addresses background, problem to be investigated, scope, objectives, significance, methodology, limitations and organization of the paper as provided herein above.

Chapter 2 deals with overview, prospects and standard instruments of banks regulation, recent regulatory reforms and reasons behind, issues related to the need for institutional and legal frameworks for banks regulation including protection of depositors and consumers, monetary and financial stability, efficient and competitive financial system, risks of bank runs and moral hazards and essential laws to further this purpose; contrasting approaches for banks regulation, areas of bank regulation and supervision, requirements and restrictions imposed on banks, best practices and legal and institutional frameworks for bank regulation, roles of private monitoring and external effect of governance, rules and principles of bank regulation and roles of bank self-regulation and other important rules for Bank Regulation.

Chapter 3 deals with the details of Ethiopian legal and institutional frameworks, identifies the gaps and shows the strengths with regard to NBE's roles of regulation and supervision of banking and national payment system operation. Chapter 4 deals with conclusion and recommendations drawn from the findings of this study. Finally, the Bibliography is made part there to which shows the sources of data used to conduct the study.

CHAPTER TWO

CONCEPT, THE NEED FOR AND APPROACHES OF BANK REGULATION AND SUPERVISION

2.1 Concept of Bank Regulation and Supervision

Banking regulation and supervision is exercised everywhere including in developed countries to fill market gaps arising from private and market monitoring.⁵ This power is exercised by a bank regulatory body commonly referred to as a central bank which designs and implements legal and institutional frameworks required to keep a financial sector healthy and stable.⁶ The FGE formulates and executes Ethiopia's financial policies and strategies.⁷ The FG also administers the NBE which prints and supplies money, mints coins, regulates Forex and money in circulation.⁸ The HPR approves general policies and strategies of economic, social and development, and fiscal and monetary policy of the country.⁹ The HPR enacts laws on matters relating to local currency, the administration of the NBE, and Forex.¹⁰ Whereas the Council of Ministers ensures the proper execution of these financial and monetary policies; administers the NBE, decides on the printing of money and minting of coins, borrow money from domestic and external sources, and regulate Forex matters.¹¹ This lies the basis for Ethiopia's legal and institutional frameworks for the regulation and supervision of banks to ensure safety, soundness and stability of the banking system.¹² Consequently, setting up rules on establishment, governance, operation, regulation and oversight of the banking and national payment system ensuring safety, security and efficiency of the whole financial system is inevitable.¹³

In the absence of proper bank regulation and supervision, banking crises would be inevitably manifested in bank managers in too many countries simply take deposits from the public and pass them to friends and related businesses.¹⁴ Unless this abusive behavior is

⁵ FDRE Industrial Development Strategy, translated from Amharic to English by the writer, 1994 E.C., p. 98

⁶ Ibid

⁷ Constitution of the FDRE, 1995, art.51(4), Proc. no.1, year 1, no.1

⁸ Id. art.51(7)

⁹ Id. art.55(10)

¹⁰ Ibid

¹¹ Id. art.77(4)

¹² Supra note 4, para. 5

¹³ Supra note 4, para. 2

¹⁴ James R. Barth, Gerard Caprio, JR. and Ross Levine, Rethinking Bank Regulation till Angeles Govern, (Cambridge University Press, 2006), p.1

shaped, it discourages business initiative; prevents the poor and persons unconnected with good ideas from realizing their dreams and improving their economic condition; and yields widespread bankruptcies, rising unemployment, and even soaring street violence.¹⁵

When banks direct the flow of capital toward those enterprises with highest expected social returns and monitor firms carefully after providing funds, this encourages entrepreneurship and economic growth.¹⁶ Regulators and supervisors have two equally compelling concerns to consider: (1) no evidence showing any single set of best practices is appropriate to promote well-functioning banks in every country specifically, practices that appear to succeed in the US, Europe, or Japan may not succeed in countries with different institutional or political settings because “one size may not fit” for all. (2) Basel II approach to regulation stresses direct official supervision, which may not work as well as an approach that emphasizes market discipline though there is a risk that policies developed by official supervisors will unduly emphasize and empower official supervision.¹⁷ In Ethiopia, NBE is a government body entrusted with the power to regulate and supervise banks on the basis of legal and institutional frameworks. It exercises its regulatory power by issuing legal frameworks including directives, circulars, guidelines and procedure manuals to implement the parent banking laws. It further exercises its supervisory powers by conducting onsite supervision and offsite surveillance.¹⁸ NBE has adopted the Basel I risk based supervisory approach in addition to its own in-house developed supervisory approaches and tools used on case by case basis.¹⁹

2.1.1 Prospects of Bank Regulation and Supervision

It is argued that regulation differs from prudential supervision and the two are proposed to be vested in two distinct bank regulatory authorities and should not be concentrated with in the central bank unlike to the case in Ethiopia where both responsibilities concentrate with NBE.²⁰ Such arguments presuppose (1) conflicts of interest when combining the two responsibilities; (2) concentration of power in a central bank endowed with highly independent status; and (3) conglomeration and blurring of boundaries between different financial products, calling for

¹⁵ Ibid.

¹⁶ Id., p. 2

¹⁷ Id., p. 5

¹⁸ Interview with Ato Tesfamariam Hailu, A/Principal Bank Examiner at the NBE BSD, Oct. 16, 2017.

¹⁹ Ibid

²⁰ Ibid

close interplay between banking, insurance, and securities supervision.²¹ None of these factors are considered in providing with broad regulatory and supervisory power to NBE in Ethiopia.²² This results in issuing and implementing inconsistent and unlawful legal frameworks and inadequate institutional frameworks for the regulation and supervision of banks.²³ Recently emerging institutional and legal frameworks combine elements of: (1) clear mandate for monetary policy to have price stability as primary objective; (2) statutory independence of central bank; and (3) entrustment of banking supervisory tasks to an agency separate from central bank.²⁴ In Ethiopia, NBE is the sole regulator and supervisor of banks, insurance companies, micro finance institutions, securities markets and any other financial intermediaries.²⁵ However, it fails to properly exercise such concentrated powers and its developmental role due to lack of expertise resulting in issuance and implementation of unlawful directives and circulars accompanied by confusing onsite inspections within its inadequate institutional framework.²⁶ There is no checking and balancing system during regulatory and supervisory exercise by NBE from any government body save to its own verdict to pass any decision on banks.²⁷

The terms bank supervision and bank regulation are often used inter-changeably despite they actually refer to distinct, but complementary, activities and hence bank supervision involves ~~the monitoring, inspecting, and~~ examining of banking organizations to assess their condition and their compliance with relevant laws and regulations; whereas bank regulation entails issuing specific regulations and guidelines governing the operations, activities, and acquisitions of banking organizations.²⁸ NBE is similarly exercising its powers and responsibilities assuming bank regulation and supervision are interchangeable. Consequently, institutional and legal framework for banks regulation and supervision in Ethiopian needs reconsideration to minimize conflicts of interest, power concentration and unbalanced independence with no cases of checks and balances.²⁹

²¹ Tommaso Padoa Schioppa, Central Banks and Financial Stability: Exploring a Land in Between, the Transformation of the European Financial System Policy Panel Introductory Paper, Second European Central Banks' Central Banking Conference Frankfurt, Oct.2002, p. 9

²² Supra note 18

²³ Ibid

²⁴ Supra note 21., p. 19

²⁵ Supra note 18

²⁶ ibid

²⁷ ibid

²⁸ The FRS: Purposes and Functions, book chapter, p. 59

²⁹ Supra note 18

There was a civil case between NBE and WeB reflecting the possibilities of conflicts of interest and scenarios of banks regulation and supervision. It was based on sesame export loan agreement signed between the WeB and Dr. Muse 80% of it guaranteed by NBE where the loan will be repayable from export proceeds of the agreed sesame within six months unless WeB allowed extension of such repayment period by notifying NBE.³⁰ NBE agreed that if the exporter failed to repay such loan within the agreed time, it will pay 80% of such loan in an unconditional and irrevocable manner including by waiver of its legal and contractual rights to raise defenses not to pay back during failure.³¹ WeB then requested NBE to discharge its obligation to repay the amount guaranteed stating that the exporter has failed to repay the loan as per the agreed terms and conditions.³² Consequently, NBE conducted on-site inspection concerning the contractual performance of the parties against the amount of sesame exported and the amount of Birr repaid to WeB by the exporter within the agreed time.³³ During inspection, NBE learnt that WeB signed other merchandise loan agreements with the exporter for the sesame export to cover administrative costs and the export proceeds were used for the repayment of the merchandise loan signed latter without the knowledge of NBE as guarantor.³⁴ The inspection report witnessed that the amount of the export proceeds were more than the amount of loan guaranteed by NBE.³⁵ These findings were sufficient enough for NBE to be free from its obligations by claiming that the loan is already repaid by the exporter though the bank used the export proceeds for the repayment of other loans secured by collateral in bad faith.³⁶

However, there was problem in the text of the inspection report made to NBE where the EIC placed contradicting conclusion by which WeB's claim was proper and requiring NBE to repay the guaranteed amount against the clearly established inspection findings.³⁷ Finally, NBE declined the bank's request of repayment by ensuring that the loan is already paid back by the exporter regardless of the examiner's mistaken conclusion.³⁸ WeB lodged its claim to court by

³⁰ WeB v. Dr. Muse Yaekob (Mandura Ethiopia P.L.C.) and NBE (Fed. High Ct., 2003 E.C., Civil F.N. 111398/2003) (unpublished)

³¹ Ibid.

³² Ibid.

³³ Ibid.

³⁴ Ibid.

³⁵ Ibid.

³⁶ Ibid.

³⁷ Ibid.

³⁸ Ibid.

joining the exporter and NBE for the repayment of the loan stating that there is no clear law obliging it to use such export proceeds only for the repayment of such guaranteed loan provided that the bank has loans advanced to such exporter.³⁹ The defendants argued that the loan was repaid by making successful continuous exports of sesame having proceed amounts exceeding the agreed amount of loan with in the agreed time and this justify that the loan is repaid.⁴⁰ Further, NBE argued that the loan is said to be repaid when the exporter assures the shipment of the item to be exported up on submission of pre-shipment documents to the lender bank; and the lender bank has obligation to always act in good faith during the performance of the loan agreement made with no collateral but the guarantee given by NBE only to encourage exporters believing that banks are cooperative.⁴¹ Finally, the court decided that the loan is not repaid yet and the defendants have the obligation to repay it by stating that NBE has waived its right to defend any repayment claims from the WeB; and the obligation was unconditional and irrevocable.⁴²

An appeal was lodged to an appellate court on the ground that WeB is paid back by the exporter (2nd appellant) due to the truth that an amount of money exceeding the amount of the loan agreement was received by it from the sesame export proceeds that release NBE from its guarantee obligation for the repayment of that loan.⁴³ This was realized by pre-shipment documents received by WeB from the exporter as per articles 5 and 11 of NBE's export credit guarantee directive no. SBB/34/2004.⁴⁴ WeB responded that the loan was not repaid yet and its balance sheet shows that the loan was receivable.⁴⁵ It further argued that NBE's directive had no clear provision requiring a lending bank to use export credits only for the repayment of the guaranteed loan by NBE in the presence of other loan agreements between the bank and same exporter.⁴⁶ WeB also raised the ambiguous conclusion of NBE's examiner who previously recommended that WeB's action was lawful and NBE was responsible to repay the guaranteed loan as a defense.⁴⁷ However, the exporter responded and admitted that he already had paid his loan back to the lender and the guarantor had discharged its obligation stating that

³⁹ Ibid.

⁴⁰ Ibid.

⁴¹ Ibid.

⁴² Ibid.

⁴³ In the matter of the Estate of WeB (Fed. High Ct., 2003 E.C., Civil F.N. 111398/2003) (unpublished), Reversed, (Fed. Sup.Ct., 2005 E.C., Civil FN.: 90679/2005) (unpublished)

⁴⁴ Ibid.

⁴⁵ Ibid.

⁴⁶ Ibid.

⁴⁷ Ibid.

the bank has abused the export proceeds due to its discretion to credit its own account as a banker.⁴⁸

The court finally decided that the decision rendered by the lower court was not proper and ruled out it on the ground that the agreed loan was repaid since the pre-shipment documents were accepted by WeB.⁴⁹ This was because it had a legal requirement to act in good faith as NBE had no other guarantee apart from believing it to commit for the repayment of such loan on its behalf with no collateral.⁵⁰ It was also not proper to use the export proceeds for the repayment of other loans advanced for the exporter against agreed collateral after such loan was advanced upon NBE's guarantee without a notice given to NBE.⁵¹ Similarly, the court ruled the bank's argument concerning the NBE's expert recommendation against NBE itself on the ground that the examiner was not a legal expert and replace provisions of the law.⁵² It finally decided that NBE had already discharged its obligation and the bank's claim is not reasonable.⁵³ WeB finally lodged its appeal to the federal Supreme Court cassation bench where the court finally decided that its claim was not reasonable and NBE may not be required to repay the already paid loan by the export proceeds of sesame exported by the exporter.⁵⁴ Consequently, the decision rendered by the Supreme Court appellate bench was reaffirmed.⁵⁵ This case reflects the facts on the ground with regard to banks regulation and supervision by NBE exercising both authorities with no checks and balances. Such distinct authorities require a clear demarcation by proper legal and institutional frameworks.

2.1.2 Standard Instruments of Bank Regulation and Supervision

Standard instruments of bank regulation include: (1) deposit insurance, (2) capital adequacy requirements and (3) lender of last resort.⁵⁶ These three policies are linked one with the other where deposit insurance protects the smallest depositors from a bank bankruptcy and prevents bank runs; capital adequacy requirements are necessary to make sure that bank managers

⁴⁸ Ibid.

⁴⁹ Ibid.

⁵⁰ Ibid.

⁵¹ Ibid.

⁵² Ibid.

⁵³ Ibid.

⁵⁴ In the matter of the Estate of WeB (Fed. Sup. Ct., 2005 E.C., Civil FN., 90679/2005) (unpublished), affirmed, (Fed.Sup. Cass. Ct., FN.: 98874/2007) (unpublished)

⁵⁵ Ibid.

⁵⁶ Supra note 14, p.9

follow a responsible credit policy, in the absence of effective control on the part of depositors; and lender of last resort policies further reduce risk of banks bankruptcies through emergency liquidity assistance facilities designed to avoid temporary situations of illiquidity leading to insolvency of a bank.⁵⁷ The same works in Ethiopia save to the absence of deposit insurance scheme which is under establishment to constitute tools for bank regulation and supervision.⁵⁸

NBE uses tools of supervision including:⁵⁹ (1) full scope on-site examination i.e. tool of assessing a bank's CAMEL components and the RM system and making a conclusion about its safety and soundness conducted at least once every 24 months; (2) targeted examination i.e. an onsite examination which does not cover all CAMEL components but focuses on specific product, area, or risk e.g. consumer loans, treasury or operational risk; (3) planned meetings i.e. meetings with bank's management to discuss its financial performance, risk profile, strategies, the market in which it operates, and/or any other issue of supervisory concern conducted at least once during supervisory period; (4) ad-hoc meetings i.e. meetings with bank's management either at NBE or onsite to discuss business developments or plans and issues or concerns arising from risk assessment process or offsite analysis; (5) meetings with external auditors of banks i.e. meetings with external auditors to discuss supervisory issues and any other issue that might need attention of both the auditor and the supervisor and/or a meeting with bank management; and (6) off-site surveillance i.e. involves continuous off-site monitoring on bank's performance and condition together with progress on implementation of various instructions, rules, bank reports and recommendations from the supervisor.

With regard to implementing regulatory and supervisory instruments, NBE conducted on-site examination on CBO and sent its final report to CBO in August 18, 2015.⁶⁰ CBO had also given its response on such findings and meeting was conducted between two concerned vice governors of NBE and CBO's BoDs resulting in mutual agreement of majority of the examination findings.⁶¹ CBO's Board then took administrative measures as per these findings and notified NBE accordingly.⁶² Consequently, on the basis of the findings and bank's responses, NBE dismissed CBO's board chairman and his vice from board membership and

⁵⁷ Ibid.

⁵⁸ Supra note 18

⁵⁹ Banking Institutions risk-based supervision framework, issued by the NBE, Aug. 2009, p.12 and 13, see also Supra note 18

⁶⁰ Amharic letter, translated by the writer, written by NBE and sent to CBO in September 11, 2008 E.C.

⁶¹ Ibid.

⁶² Supra note 4, art.6(4(f))

suspended them from serving as board members in any FI in the country for three years.⁶³ CBO also fired its president and his vice accompanied by five years suspension not to be employed in any FI in the country.⁶⁴ Furthermore, NBE fired CBO's trade services director i.e. Ato Banteayehu Kebede and accompanied by five years suspension not to be employed in any FI in the country.⁶⁵ NBE then instructed CBO to send evidence showing that NBE's decisions are implemented and new board members and employees are appointed as replacement to these persons within a week along with CBO's plan to correct its failures as per the findings.⁶⁶ The bank took all actions as per NBE's instruction within that time.⁶⁷

The legal ground stated for such NBE's decisions were articles 17(1) and 31(4) concerning board members and president and his vice, and article 31(3) for other employees of a bank.⁶⁸ NBE is authorized, for sufficient cause, to suspend or remove director, CEO or SEO and/ or order the dismissal or suspension of one or more directors, CEO or SEOs of the bank, or impose fines on such persons in accordance with NBE's directives prescribed for such purpose where inspection of a bank results in finding that it has failed to comply with relevant laws or with terms and conditions of license or has engaged in practices detrimental to interests of depositors or has serious weaknesses in its CG.⁶⁹ NBE is also authorized to instruct in writing corrective measures to be taken by bank itself.⁷⁰

The case was finally taken to court where the plaintiff was an employee of CBO and served as director of trade service process where import and export, and forex bureau and remittance team are coordinated, claiming that NBE instructed CBO to dismiss and suspend him from employment in any FI for five years with no reason and, CBO fired him by a letter as per the instruction.⁷¹ The cause of his dismissal was stated as the improper implementation of Forex open position and reporting requirement and the plaintiff claimed that he rather contributed in solving related problems occurred before his employment not recognized and such responsibilities were vested in the forex bureau and remittance team; and NBE had no power

⁶³ Ibid.

⁶⁴ Ibid

⁶⁵ Supra note 4, art.6(4(f))

⁶⁶ Supra note 60

⁶⁷ Supra note 4, art.6(4(f))

⁶⁸ Ibid

⁶⁹ Supra note 4, art.17(1) and 31(4)

⁷⁰ Id. art.31(3)

⁷¹ Banteayehu Kebede Arfasa v.NBE (Fed. First Ins. Ct, 2008 E.C, Civil F.N. 236790/2008) (unpublished)

to pass such instruction.⁷² The plaintiff also argued that NBE has no power to take and/or instruct such action be taken by the bank and his right to be heard was violated which were valid grounds for the court to rule out the decision NBE's and notify all persons notified with his dismissal.⁷³

NBE defended that the plaintiff had violated the proper reporting format of CBO's forex open position reflecting its assets and liabilities in forex as per accepted reporting system established under NBE's directive.⁷⁴ Stating that it was a clear manifestation of continuing the previously happened irregularities even after his appointment as head of the forex bureau and remittance team which was verified through the special on-site examination report made in CBO by NBE's investigating group.⁷⁵ The court investigated the claims and defenses presented thereto and finally decided that NBE had no power to fire and suspend director of a process (Trade Service Director) and instructed CBO to notify the revocation of its letter concerning the plaintiff to all concerned bodies notified his dismissal and suspension before.⁷⁶

NBE then lodged an appeal to an appellate court which had ruled out the appeal stating that NBE has no power to dismiss and/or suspend banks' employees other than president (CEO and his Vice without investigating details of the case.⁷⁷ NBE finally lodged an appeal to federal cassation bench and the case was dealt by a bench of three presiding judges who ordered the registrar office to interchange ideas of the parties in writing and ordered the stoppage of execution proceedings as per the decisions of lower courts.⁷⁸ However, one judge had dissenting opinion stating that NBE's action was based on article 31(3) of the BBP which authorizes NBE to instruct a bank to take corrective actions by itself.⁷⁹ This authority is limited only to order a bank correct failures as per the examination findings and may not extend to actions of dismissal and suspension like in the case of MBoDs and CEOs and SEOs.⁸⁰ The

⁷² Ibid

⁷³ Ibid

⁷⁴ Ibid

⁷⁵ Ibid

⁷⁶ Ibid

⁷⁷ In the matter of the Estate of Banteayehu Kebede (Fed. First Inst. Ct., 2008 E.C., Civil F.N. 236790/2008) (unpublished), affirmed, (Fed. High. Ct., 2008 E.C., Civil F.N. 185529/2008) (unpublished)

⁷⁸ In the matter of the Estate of Banteayehu Kebede (Fed. High. Ct., 2008 E.C., Civil F.N. 185529/2008) (unpublished), (Fed. Sup. Cass. Ct., 2009 E.C., Civil F.N. 136441/2009) (unpublished)

⁷⁹ Id., Mtisla Haile

⁸⁰ Ibid.

judge then concluded that the decision rendered by the lower courts was proper and there is no appealable ground thereto.⁸¹ The writer agrees that NBE's intervention was excessive.

2.1.3 Reasons behind Recent Regulatory Reform in Banking at Global Level

2.1.3.1 Banking Crisis

Origins of banking crisis include: low real interest rates, a search for yield, apparent excess liquidity and a misplaced faith in financial innovation.⁸² Due to lending-of-last-resort framework, central banks, including NBE, have maintained and even strengthened a cautious stance towards it by adopting the policy of case-by-case discretion and decline to specify in advance which FIs would be granted emergency liquidity and conditions thereto.⁸³ Banking crisis refers to collapse in domestic asset markets, widespread bank failures, and bankruptcies of many firms and very severe economic downturn liabilities of financial intermediaries.⁸⁴ Banking crisis results from interrelated factors of macroeconomic instability caused by large and sudden capital inflows, major failures in corporate governance at banks, lack of investor and consumer sophistication, inadequate disclosure and transparency about financial position of banks, critical gaps in regulatory framework and regulations, uneven supervision and enforcement, unstructured governance and management processes exposing banks to moral hazard problems and weaknesses in business environment bringing the entire financial system of a country to brink of collapse.⁸⁵

Banking crisis undermines economic growth by disrupting credit intermediation; imposes large fiscal costs; causes large and uncontrollable fluctuations in the quantity of money and credit.⁸⁶ Hence, banking regulation and supervision is designed not only to protect depositors, but also minimize systemic risk of the collapse of the whole financial system.⁸⁷ A systemic crisis in one country and failure of its authorities to deal with it appropriately leads to global banking crisis due to weak regulation and lethargic supervision triggered by preponderance of weak banks characterized by persistent illiquidity, insolvency, under capitalization, high level of

⁸¹ Ibid.

⁸² Banking Crisis: dealing with the failure of the UK banks, 7th Report of Session 2008–2009, p.3

⁸³ Supra note 14, pp.7 and 8

⁸⁴ Supra note 18

⁸⁵ Ibid

⁸⁶ Ibid

⁸⁷ Ibid

nonperforming loans and weak corporate governance, among others.⁸⁸ This crisis can be solved by addressing these problems and factors through proper regulatory and supervisory legal and institutional frameworks.⁸⁹

In Ethiopia, the common functional areas, in banking business, regulated and supervised by NBE include: lending operations, treasury activities (asset/liability management), investment operations, retail banking activities, payment systems and MIS.⁹⁰ NBE moves towards risk based supervision of banks on the basis of international experience presupposing enhanced supervisory reliance on External Auditors, EBA and banks' self-regulation.⁹¹ This supervisory approach requires supervisors to ensure existence of strong RM practice in supervised banks.⁹² A survey report made by NBE reflected that banks' boards of directors have given fairly adequate attention to RM, RM function was assigned to relatively qualified staffs, RM policies and procedures are in place, and business continuity/contingency plans exist for operational and liquidity risks save to weaknesses that dominate and attract supervisory concerns regarding the banking sector RM practices detecting prospects of bank runs and moral hazard.⁹³ There are also legal and institutional framework problems in Ethiopia concerning the regulatory and supervisory practices by NBE in this regard.⁹⁴

2.1.3.2 Growth of BHCs

The growth of BHCs, i.e. companies holding stock in bank/s or having certain other ownership interests, was one of the significant changes received much legislative attention in the 1950s.⁹⁵ This change prompted the formation of multi- BHCs and their acquisition of banking and nonbanking interests under the control of central banks and any nonbanking activities of a BHC had to be closely related to the business of banking.⁹⁶ The scenario where banks are owned or controlled by another company results in forming a BHC.⁹⁷ Central banks need to have supervisory authority for all BHCs, regardless of the status and nature of the subsidiary

⁸⁸ Ibid

⁸⁹ Ibid

⁹⁰ Revised Bank Risk Guideline, issued by the NBE, May 2010, p.44, see also Supra note 18

⁹¹ Banks RM survey report, conducted by the NBE, Nov. 2009, p.1, see also Supra note 18

⁹² Ibid

⁹³ Ibid

⁹⁴ Ibid

⁹⁵ Uyen Dang, The CAMEL Rating System in Banking Supervision: A Case Study, (Arcada University of Applied Sciences, 2011), p.26

⁹⁶ Ibid

⁹⁷ Supra note 18

bank of the HC.⁹⁸ Central Banks have to conduct annual inspection and special supervisory program, on BHCs in more flexible approach relying on off-site monitoring and supervisory ratings.⁹⁹ Central Banks must review and assess the consolidated organization's operations, risk-management systems, and capital adequacy to ensure that the HC and its non-bank subsidiaries do not threaten the viability of the company's depository institutions.¹⁰⁰ Regulation and supervision of BHCs is required to avoid the creation of monopoly or restraint of trade in banking industry through acquisition of additional banks by BHCs; and to keep banking and commerce separate by restricting nonbanking activities of BHCs.¹⁰¹

The results of an on-site examination or inspection have to be reported to the BoDs and management of a bank or HC in a report of examination or inspection, which includes a confidential supervisory rating of the financial condition of a bank or its HC.¹⁰² Supervisory rating system is a supervisory tool to identify institutions that raise concern or require special attention.¹⁰³ This rating system for banks is commonly referred to as CAMELS, which is an acronym for its six components.¹⁰⁴ In its ongoing off-site supervision of banks and BHCs, a central bank needs to use automated screening systems to identify organizations with poor or deteriorating financial profiles and to help detect adverse trends developing in banking industry.¹⁰⁵ However, in Ethiopia, there is no institutional and legal framework to regulate and supervise BHCs yet.¹⁰⁶ Consequently, NBE faces problems in the regulation of BHCs especially in the case of indirect shareholders where their owner is exercising a hidden voting and controlling right.¹⁰⁷

2.1.3.3 Technological Innovations

Banks offer EFT services, through ATM, POST, electronic direct deposits and withdrawals and pay by internet systems, to their customers.¹⁰⁸ EFT poses difficulties to banks and regulators urging for prudential regulation concerning issuance of stop payment order, availability of only fewer records to prove or disprove transactions, possibilities of tampering

⁹⁸ Ibid

⁹⁹ Ibid.

¹⁰⁰ Ibid.

¹⁰¹ Ibid.

¹⁰² Supra note 18

¹⁰³ Ibid.

¹⁰⁴ Ibid., see also Supra note 18

¹⁰⁵ Ibid.

¹⁰⁶ Ibid.

¹⁰⁷ Ibid.

¹⁰⁸ Miller/ Jentz, Business Law Today, (7th Standard Ed.), ps.581 and 582

a person's private banking information, and customers no longer rely on it having time between writing of a check and its deduction from an account (float time).¹⁰⁹ Such innovated banking services need to be subjected to prudent institutional and legal framework in every sphere of the world including Ethiopia.

NBE discharges its responsibility to regulate and supervise a bank's MIS through its ISMD together with other respective directorates vested with the supervision of banking business through on-site and off-site supervision as per the procedures and guidelines issued by BSD; national payment, clearing, netting and settlement system oversight and off-site supervision as per the oversight procedure and guideline issued by NPSSD; and Forex monitoring, inspection, allocation and registration system as per procedures and guidelines issued for this purpose by Forex monitoring and reserve management directorates.¹¹⁰ My interviewee reflected that the directorate has not yet developed its own MIS procedure and guideline and does not have separate supervisory authority, but to accompany when requested by other directorates unlike to those vested with first instance supervisory authority separately which reflects the weakness of NBE's institutional and legal framework.¹¹¹ However, he is hopeful to develop such MIS supervision and risk monitoring procedure and guideline which is started by individual efforts as part of the intuitional and legal framework for the regulation of banks.¹¹²

MIS supervision aims at examining the adequacy of banks systems facilitating banking transactions without compromising the safety and soundness of the financial system of the country.¹¹³ In its on-site/oversight examination, ISMD checks any applications, platforms, systems and infrastructures and their security levels.¹¹⁴ An expert assigned to examine a bank's MIS carefully inspects such system and draws findings compiled with the report of the other directorate requested such supervision.¹¹⁵ Once such MIS and business supervision report is submitted to the proper directorate, the experts are required to attend exit meeting with the bank under inspection.¹¹⁶ The final report is open for acceptance or objection by that bank during and/or exit meeting.¹¹⁷ Lack of harmonized supervision among NBE's directorates

¹⁰⁹ Id., p.581

¹¹⁰ "Interview with" (Confidential), Oct. 12, 2017

¹¹¹ Ibid

¹¹² Ibid

¹¹³ Ibid

¹¹⁴ Ibid

¹¹⁵ Ibid

¹¹⁶ Ibid

¹¹⁷ Ibid

causes inconsistencies and confusion for the bank under inspection.¹¹⁸ Furthermore, NBE lacks supervisory knowledge, skill and capacity enabling it to lead banks' innovated working behavior.¹¹⁹ There is no comprehensive legal and institutional frameworks for banks regulation coping with innovative banking services being provided.¹²⁰ Therefore, NBE needs to further evaluate and improve its manpower, procedures, legal and institutional framework with respect to ensuring harmonized supervisory role to ensure the soundness and healthiness of the financial system in general in line with the basic features of innovative banking, outsourcing and agency arrangements.¹²¹

2.2 The Need for Banks Regulation and Supervision

2.2.1 Protection of Depositors

Banking poses problems on customers and creditors because¹²²: (1) customers who maintain deposit account use bank primarily when writing and cashing checks and carrying out other financial transactions, assuming role of bank creditors and become linked with fortunes of their bank unlike in most other businesses, where customers simply pay for goods or services and never become creditors of a firm; (2) under fractional reserve system of banking, deposits are only partially backed by reserve banks hold in the form of cash and balances maintained with central banks reflecting that depositor's safety is linked to many other factors as well, including the capital in a bank and, condition and value of its loans, securities, and other assets. Depositor protection depends on many factors other than deposit activities of banks where few assets backing bank deposits are considered riskless, and virtually all bank operations entail some potential exposure to loss; and since notable portion of bank deposits are available on demand, bank liquidity can be important factor in maintaining depositor's confidence.¹²³ Restrictions on bank risk taking, deposit insurance system funded through premiums paid by banks, and FG's assumption of overall responsibility for monetary stability and depositor protection are also used.¹²⁴ NBE takes role of protecting depositors through its regulatory and supervisory powers and responsibilities; draws and implements institutional and legal framework for regulation of

¹¹⁸ Ibid

¹¹⁹ Ibid

¹²⁰ Ibid

¹²¹ Ibid

¹²² Kenneth Spong, Banking Regulation: Its Purposes, Implementation, and Effects, (5th ed., 2000), p. 6, accessed at Mar. 02, 2017 and available at <http://www.kc.frb.org>.

¹²³ Id., p.63

¹²⁴ Ibid

banks in Ethiopia.¹²⁵ However, there is no clear and adequate legal and institutional depositors' protection framework enabling NBE directly protect depositors by listing-out specific mechanisms, measurements and authorize a specific department for this purpose in addition to the exercising of generic regulatory and supervisory power.¹²⁶

2.2.2 Monetary and Financial Stability

Bank regulation keeps fluctuations in business activity and problems at individual bank from interrupting flow of transactions across economy and threatening public confidence in banking system.¹²⁷ Central banks are responsible for controlling overall volume of money circulating throughout economy and thus providing stable base for payment system.¹²⁸ Banking system Supervision and regulation is policy aspect of monetary stability fostering development of strong banks with adequate liquidity and discourages banking practices that might harm depositors and disrupt payment system.¹²⁹ Financial crises and unintended fluctuations in money supply have been prevented primarily by promoting confidence in banks and guaranteeing safety of deposits.¹³⁰ NBE is exercising that role along with its other objectives entrusted to it by law.¹³¹ Despite its regulatory and supervisory power of ensuring monetary and financial stability of Ethiopia, the existing legal and institutional frameworks for the regulation of banks needs to be reviewed in line with emerging innovative changes which have capacity to make the financial system of the country unstable unless banks are properly regulated and supervised.¹³²

2.2.3 Efficient and Competitive Financial System

Customers in good banking system get quality services at competitive prices where creating regulatory framework encouraging efficiency and competition, and ensures adequate level of banking services throughout economy justifies bank regulation.¹³³ In competitive banking system, banks operate efficiently and utilize their resources wisely to keep their customers and remain in business where competition is driving force in keeping banks innovation in their

¹²⁵ Supra note 18

¹²⁶ Ibid

¹²⁷ Supra note 122, p.7

¹²⁸ Ibid

¹²⁹ Interview with Eyob Gebreyesus, Director NPSSD at NBE, May 28, 2017

¹³⁰ Ibid, see also Supra note 122, p. 7

¹³¹ "Interview", (confidential), Sept.10,2017

¹³² ibid

¹³³ Supra note 122, p.9

operations and in designing new services for customers.¹³⁴ Competition and efficiency depend on number of banks operating in market, freedom of other banks to enter and compete, and ability of banks to achieve appropriate size for serving their customers for which regulators must be concerned with concentration of resources in banking industry and with opportunities for entry and expansion across individual banking markets.¹³⁵

My interviewee states that¹³⁶, during examination, NBE's examiners are required to perform analysis of CAMEL components considering certain financial, managerial, and compliance factors that are common to all banks.¹³⁷ In making CAMEL analysis, the examiners endeavor to ensure that all banks are evaluated in comprehensive and uniform manner, and that supervisory attention is appropriately focused on banks exhibiting financial and operational weaknesses or adverse trends.¹³⁸ CAMEL analysis serves as a useful vehicle for identifying problem or deteriorating banks; for categorizing banks with deficiencies in particular component areas; and for assisting banking supervision in following safety and soundness trends and assessing the aggregate strength and soundness of banking industry.¹³⁹ Under CAMEL, each bank is assigned composite rating based on evaluation and rating of five essential components of bank's financial condition and operations addressing adequacy of capital, quality of assets, capability of management (quality of RM), quality and level of earnings, and adequacy of liquidity.¹⁴⁰ Evaluations of components take bank's size and sophistication, nature and complexity of its activities, and its risk profile into consideration.¹⁴¹

Composite and component ratings are assigned based on 1 to 5 numerical scale where 1 indicates highest rating, implying strongest performance, RM practices and least degree of supervisory concern; while 5 indicates lowest rating, implying weakest performance, inadequate RM practices and, therefore, highest degree of supervisory concern.¹⁴² Composite rating generally bears close relationship with component ratings where composite rating is not derived by computing arithmetic average of component ratings but rather, ratings are dependent

¹³⁴ Ibid

¹³⁵ Ibid

¹³⁶ Supra note 90, see also Supra note 18

¹³⁷ Supra note 75, p.17, see also Supra note 18

¹³⁸ Ibid

¹³⁹ Ibid

¹⁴⁰ Ibid

¹⁴¹ Ibid

¹⁴² Ibid

on worst rating in any of CAMEL components.¹⁴³ Each component rating is based on both quantitative and qualitative analyses of factors comprising that component and its interrelationship with other components.¹⁴⁴ Rating definitions under Composite 4 and 5 are similar with exception of two factors that could lead a bank being rated 5 instead of 4: (1) If volume and severity of problems are beyond management's ability or willingness to control or correct; and (2) If immediate outside financial or other assistance is needed in order to be viable.¹⁴⁵ Assigned composite and component ratings are disclosed to bank's BoDs and senior management.¹⁴⁶ Ability of management to respond to changing circumstances and address risks arising from changing business conditions, or initiation of new activities or products, is an important factor in evaluating bank's overall risk profile and level of supervisory attention warranted.¹⁴⁷

NBE's quality assurance framework for on-site examination comprises quality and consistency check on examination findings and assessment of specific portfolio, composite risk rating and CAMEL rating assigned and areas of supervisory concerns identified, and supervisory actions to be taken.¹⁴⁸ Once on-site examination is completed, NBE sends report to the examined bank with clear and concise contents of CAMEL ratings, risk ratings, and any supervisory issues or concerns related to the bank for full scope on-site examination; and findings arising from specific areas examined for targeted examination, along with specific and time bound recommendations listed in order of importance.¹⁴⁹ Findings and recommendations are first discussed during exit meeting with bank's senior management, and its RM and/or internal audit departments followed by management meeting with its CEO and board and/or board committees.¹⁵⁰ Feedbacks from discussions will be taken into account in finalizing the examination report that will be finally addressed to its Board Chairperson.¹⁵¹ NBE also recognizes works of external parties such as external auditors as input to supervisory assessments facilitate risk-focused assessments and minimize duplication of efforts.¹⁵² It sends 'reliance letters' for this purpose to external parties annually to communicate its intention to

¹⁴³ Ibid

¹⁴⁴ Ibid

¹⁴⁵ Ibid

¹⁴⁶ Ibid

¹⁴⁷ Id, p.18

¹⁴⁸ Ibid

¹⁴⁹ Ibid

¹⁵⁰ Ibid

¹⁵¹ Ibid

¹⁵² Id., p.19

rely on their work upon assessment of parties' competency and reliability.¹⁵³ However, there are gaps in legal and institutional frameworks for the implementation and checking and balancing of NBE's regulatory and supervisory power over banks in Ethiopia.¹⁵⁴ There is also no independent, international or national, rating agency other than the NBE itself.¹⁵⁵

2.2.4 Consumer Protection

Banking regulation protects consumer interests in various aspects of banking relationship implemented through series of legislative and institutional frameworks which: (1) requires FIs to provide their customers with meaningful disclosure of deposit and credit terms to make informed choices among different institutions and financial instruments;¹⁵⁶ (2) ensure equal treatment and equal access to credit among all financial customers;¹⁵⁷ and (3) purposes associated with consumer protection include: promoting financial privacy and preventing problems and abusive practices during credit transactions, debt collections, and reporting of personal credit histories.¹⁵⁸ In Ethiopia, though consumer protection is not clearly included in any banking law and no special body is established for this purpose, banks are required by NBE to address customer compliant handling system in proposed new products and subjected for on-site examination.¹⁵⁹ This witnesses the weakness of the existing legal and institutional framework for the regulation of banks with respect to consumer protection.¹⁶⁰

2.2.5 Risk of Bank Runs and Moral Hazard

2.2.5.1 Risk of Bank Runs

Liquidity requirement leads to problem when all depositors demand their deposits back at same time; where any bank (even if perfectly solvent) would face serious problems in meeting its obligations.¹⁶¹ A single bank might obtain refinancing on financial market but the problem would severely persist in cases of low liquidity on market or when threatens big portion of the

¹⁵³ Ibid

¹⁵⁴ Supra note 18

¹⁵⁵ Ibid

¹⁵⁶ Supra note 122, p.10

¹⁵⁷ Ibid

¹⁵⁸ Ibid

¹⁵⁹ Supra note 18

¹⁶⁰ Ibid

¹⁶¹ Supra note 122, p.10

banking sector.¹⁶² It is commonly understood that whenever depositors start fearing insolvency of their bank, their reaction is to go and withdraw their deposits creating serious problems to the banks and such behavior is normally referred to as a bank run.¹⁶³ In Ethiopia, NBE is entrusted with this responsibility which is not accompanied by specific and adequate legal and institutional frameworks designed to deter bank runs and enhance fair competition, customer protection and information disclosure.¹⁶⁴ The NBE has adopted the Basel I risk based supervision, guidelines and risk based inspection and surveillance though not adopted comprehensive legal and institutional frameworks which are enforceable.¹⁶⁵

2.2.5.2 Excessive Risk Taking (Moral Hazard)

Banks grant loans financed by deposits they received and this is by itself a powerful incentive for banks to grant credit in non-prudent way and take too much risk.¹⁶⁶ However, this incentive is somehow mitigated by possibility that market, both via depositors and other competing banks, could monitor the risks assumed by bank's management.¹⁶⁷ The same works in Ethiopia where banks assume excessive risk and extend loans and advances to the extent not affecting the legally required 15% liquidity ratio from their total deposits.¹⁶⁸ Consequently, NBE is required to improve its legal and institutional frameworks to minimize this risk.¹⁶⁹

2.2.5.3 Systemic Dangers of Bank Failure

Feldstein Argues:

“The banking system as a whole is a ‘public good’ that benefits the nation over and above the profits that it earns for the banks’ shareholders. Systemic risks to the banking system are risks for the nation as a whole. Although the management and shareholders of individual bank are, of course; eager to protect the solvency of their own banks, they do not adequately take into account the adverse effects to the nation of systemic failure. Banks left to them will accept more risk than is optimal from a

¹⁶² Ibid

¹⁶³ Ibid

¹⁶⁴ Supra note 18

¹⁶⁵ Supra note 122, p.10

¹⁶⁶ Darryl Biggar and Alberto Heimler, An Increasing Role for Competition in the Regulation of Banks, Report Paper, June 2005, p.7

¹⁶⁷ Ibid

¹⁶⁸ Liquidity Requirement (5th Replacement) Directive, 2014, art. 4, Directives No. SBB 57, see also Supra note 18

¹⁶⁹ ibid

systemic point of view. That is the basic case for government regulation of banking activity and the establishment of capital requirements”.¹⁷⁰

The statement reflects the role of banks in an economy and crisis that may happen when they got insolvent due poor regulation and supervision. Financing is the key basis for economic development and this is the core banking activity achievable only if banks are remaining solvent. This also works in Ethiopia requiring the healthiness of banks accompanied by NBE’s effective institutional and legal framework keeping bank failure away. There are two useful mechanisms to distinguish if failure of one bank could lead to failure of other banks or other non-bank firms: (1) failure of one bank leading to decline in value of assets sufficient to induce failure of another bank (“consequent failure”); and (2) failure of one bank leading to failure of another fully solvent bank, through some contagion mechanism (“contagion failure”).¹⁷¹ The first mechanism is based on the fact that failure of a bank, like failure of any other firm in economy, may, of course, lead to failure of other firms exposed towards failing bank.¹⁷² The second mechanism is based on the argument that there is an important asymmetry between information available to banks, and to depositors and other outside investors.¹⁷³ To this end, the existence of strong institutional and legal framework and proper implementation determines banks’ failure or the extent of a danger to the overall economy during the exercise of regulatory and supervisory power by NBE.¹⁷⁴

2.2.5.4 Dangers to Soundness of Payment System

“An efficient payment system, in which transferability of claims is effected in full and on time, is a prerequisite for an efficient macro economy. Disruptions in the payment system carry the risk of resulting in significant disruptions in aggregate economic activity. To some observers, instability in the payment system is more threatening than instability in deposits. This fear appears to reflect the larger dollar volume of daily payments, the speedy movement of the funds and the unfamiliarity of the clearing process”.¹⁷⁵

¹⁷⁰ Supra note 166, p.8

¹⁷¹ Ibid

¹⁷² Ibid

¹⁷³ Ibid

¹⁷⁴ Supra note 18

¹⁷⁵ Supra note 166, p.8

The statement describes the role of stable and effective national payment system in an economy where its failure leads to failure in whole macro-economy. This fact accelerates effective government regulation and supervision by adopting effective legal and institutional frameworks. In Ethiopia, NBE has similarly adopted some legal and institutional frameworks to ensure the safety and soundness of the national payment system.¹⁷⁶ Until recently, standard form of settlement between banks was end-of-day net settlement and banks would accumulate their obligations to other banks throughout the day to settle smaller net obligations at end of trading day.¹⁷⁷ The risk of this form of settlement is it usually requires participants to grant unsecured and unlimited credit to other participants during the day until final settlement occurs.¹⁷⁸ The key solution to such problems is to prevent intraday build-up of credit exposures by insisting inter-bank payments occur at the same time as the exchange of the corresponding assets which is known as “real-time” settlement.¹⁷⁹

This classic payment and settlement system is widely practiced in Ethiopia due to the dominance of traditional banking over innovative banking being adopted elsewhere in the globe.¹⁸⁰ NBE has also recently designed an intra-day loan facility framework as a temporary problem solving instrument for the settlement of unsecured and unlimited banks credit exposure in every day.¹⁸¹ This framework is designed as a bilateral agreement signed between NBE and each participant bank to the RTGS without having any basic legal and institutional framework ensuring its compliance with parent frameworks and its smooth implementation.¹⁸² Banks in Ethiopia participating in the RTGS process are currently adopting some innovated payment services appreciating the need for real time transactions up on approval and support of NBE.¹⁸³ This existing situation requires a well-designed legal and institutional framework for the regulation and supervision of participant banks to the system and proper implementation by NBE.¹⁸⁴ Apart from NBE’s regulatory and supervisory role, Ethiopian Switch (were all banks are its members) and Premier Switch (five private banks are members) are the

¹⁷⁶ Supra note 129

¹⁷⁷ Supra note 166, p.8

¹⁷⁸ Ibid

¹⁷⁹ Ibid

¹⁸⁰ Supra note 129

¹⁸¹ ibid

¹⁸² ibid

¹⁸³ ibid

¹⁸⁴ Ibid

responsible self-regulatory clearing houses authorized by NBE to facilitate and keep the national payment system in line with NBE's payment, settlement, clearing and netting rules.¹⁸⁵

2.3 Contrasting Approaches and Areas of Bank Regulation

2.3.1 Contrasting Approaches

2.3.1.1 Public Interest Approach

This approach presumes that: (1) there are significant market failures and (2) government has incentives and capabilities to ameliorate these market failures.¹⁸⁶ This view holds governments regulate banks to facilitate efficient functioning of banks by ameliorating market failures, for benefit of broader civil society as public interest would be served if the banking system allocated resources in a socially efficient manner and performed well other functions of finance.¹⁸⁷ In Ethiopia, the Legal and institutional framework for banks regulation and supervision is designed based on this approach where financing and foreign currency supply are directed to priority areas identified by government.¹⁸⁸

2.3.1.2 Private Interest Approach

This view holds banking policies are primarily shaped by private interests of regulator rather than by public interest; and governments regulate banks to facilitate financing of government expenditures, funnel credit to politically attractive ends, and generally to maximize welfare and influence of politicians and bureaucrats, where public interest objective is ostensible goal.¹⁸⁹ Key role of banks in allocating scarce capital motivates private interest view.¹⁹⁰

¹⁸⁵ Ibid

¹⁸⁶ Supra note 14, p.22

¹⁸⁷ Id., pp. 18 and 19

¹⁸⁸ Supra note 18

¹⁸⁹ Supra note 14., p. 35

¹⁹⁰ Id., p. 20

2.3.2 Areas of Bank Regulation and Supervision

2.3.2.1 Activity restrictions

From public interest view, there are five main theoretical reasons that have been advanced for restricting the degree to which banks can engage in securities, insurance, and real estate activities, or own nonfinancial firms.¹⁹¹ These reasons are: (1) conflicts of interest may arise when banks engage in these diverse activities and banks may attempt to “dump” securities on or shift risk to ill-informed investors so as to assist firms with outstanding loans; (2) to the extent that moral hazard encourages riskier behavior by banks, they will have more opportunities to increase risk if allowed to engage in a broader range of activities; (3) broad financial activities and mixing of banking and commerce may lead to formation of extremely large and complex entities that are extraordinarily difficult to monitor; (4) large institutions may become so politically and economically powerful that they become “too big to discipline”; and (5) large financial conglomerates may reduce competition and hence efficiency in the financial sector.¹⁹²

But, from private interest view, regulatory restrictions are inefficient; such restrictions may reduce the franchise value of banks and thereby limit incentives for prudent behavior by banks and; by limiting banks’ activities, regulatory restrictions could impede bankers’ ability to diversify income streams, leading to greater instability.¹⁹³ In Ethiopia, banks are restricted to only provide banking activities with no need for separate product license, invest in financial infrastructures, operate systems, issue payment instruments and hold equity shares in insurance companies up to 5% of their capital in insurance companies and up to a maximum of 10% in any non-financial companies including real-estate business.¹⁹⁴ However, there are institutional and legal framework gaps with regard to the areas requiring restriction and the actual restrictions and decisions being rendered by NBE.¹⁹⁵ For instance, non-financial institutions like “Ethiopia-inclusive” established to provide technology services are providing banking services

¹⁹¹ Id., p. 47

¹⁹² Ibid

¹⁹³ Id., p. 48

¹⁹⁴ Limitation on investment of banks Directive (as amended), 2015, art.2.3, Directive No. SBB 60, see also Supra note 18

¹⁹⁵ Ibid

2.3.2.2 Entry Requirements and Restrictions

Regulators in most countries including Ethiopia screen entrants to better assure that applicants are “fit and proper” by imposing fairly identified basic requirements before a banking license is accepted or rejected.¹⁹⁶ There are also limitations related to the ability of foreign banks to enter the domestic banking industry through (1) Acquisition (2) Subsidiary or (3) Branch.¹⁹⁷ In Ethiopia, there are frameworks laying down entry requirements and restrictions especially on foreigners and non-bank domestic companies from undertaking banking services.¹⁹⁸ However, there is no strong institutional framework for the implementation of these existing laws in equitable and lawful way.¹⁹⁹ Example, the case of shareholding by foreigners Ethiopian origin.

2.3.2.3 Capital Requirements

The three alternative capital regulatory variables capture different but complementary measures of stringency of regulatory capital requirements.²⁰⁰ The first measure is overall capital stringency determined on whether: (1) there are explicit regulatory requirements regarding amount of capital a bank must have relative to various guidelines including the minimum capital-to-asset ratio requirement risk weighted in line with the Basel I guidelines; (2) minimum ratio varies as a function of an individual bank’s credit risk; (3) minimum ratio varies as a function of market risk; (4) market value of loan losses not realized on accounting books are deducted from the book value of capital before the minimum capital adequacy is determined; (5) unrealized losses in securities are deducted from book value of capital before minimum capital adequacy is determined; and (6) unrealized Forex losses are deducted from book value of capital before minimum capital adequacy is determined.²⁰¹

The second measure is initial capital stringency determined on whether the source of funds counted as regulatory capital include assets other than cash or government securities as well as on whether the sources are verified by regulatory or supervisory authorities.²⁰² Conditions

¹⁹⁶ Supra note 14., p.311

¹⁹⁷ Ibid

¹⁹⁸ Supra note 4, art. 9, see also Supra note 18

¹⁹⁹ Ibid

²⁰⁰ Supra note 14., p.311

²⁰¹ Id, pp. 115 and 116

²⁰² Ibid

considered to evaluate this requirement are whether: (1) initial disbursement or subsequent injections of capital is done with assets other than cash or government securities; (2) initial disbursement of capital is done with borrowed funds; and (3) sources of funds are used as capital verified by regulatory/supervisory authorities.²⁰³ The third measure is capital regulatory index- simply the sum of overall capital stringency and initial capital stringency i.e. it captures both the amount of capital and verifiable sources of capital that a bank is required to possess which is not correlated with GDP per capita or the size of the banking system relative to GDP.²⁰⁴ But, in Ethiopia, the regulatory capital is specified in an objective manner in the absence of clear legal and institutional framework indicating the regulatory capital variables and conditions thereto.²⁰⁵ Despite this fact, NBE makes these variables and conditions part of its on-site inspection and off-site surveillance process.²⁰⁶

2.3.2.4 Supervisory Powers

Official supervisory power is constructed on capability based facts if a regulator may²⁰⁷: (1) meet with external auditors to discuss their reports without approval of a bank; (2) let auditors communicate directly to it if there is any presumed involvement of MBoDs or senior managers in illicit activities, fraud, or insider abuse; (3) let off-balance sheet items be disclosed to it; (4) take legal action against external auditors for negligence; (5) force a bank to change its internal organizational structure; (6) order a bank's directors or management to constitute provisions to cover actual or potential losses; (7) suspend directors' decision to distribute dividends, bonuses or management fees; (8) let its declaration supersede some rights of shareholders – when a bank is insolvent; (9) intervene –suspend or supersede some or all ownership rights of a problem bank; regarding bank restructuring and reorganization: and (10) remove or replace directors or management. The NBE exercises all these supervisory powers save to directly taking a legal action against external auditors where it indirectly forces respective banks take such legal action instead.²⁰⁸ But, a clear legal and institutional framework is yet required to shape the supervisory role of NBE accordingly.²⁰⁹

²⁰³ Ibid

²⁰⁴ Id., p.121

²⁰⁵ Supra note 18

²⁰⁶ Ibid

²⁰⁷ Supra note 14., p. 122

²⁰⁸ Supra note 18

²⁰⁹ Ibid

2.3.2.5 Market Monitoring

Regulators focus on banks' private monitoring where banks obtain and publish certified audits or ratings from international rating agencies; make directors legally liable if they disclose erroneous or misleading information; compel banks to produce reliable, comprehensive and consolidated information on full range of banking activities and risk-management procedures; and impose "no deposit insurance" policy to stimulate private monitoring of banks.²¹⁰ Regulatory capture view holds that banks influence politicians who, in turn, unduly influence supervisors and regulators, and consequently greater reliance on market discipline is important.²¹¹ As supervisors do not have their own wealth invested in banks, they have different incentives than private creditors when it comes to monitoring and disciplining banks and bank failures may be incorrectly regarded as supervisory failures backed by reluctance to close them.²¹² Market discipline lets MBoDs and managers carry burden of proving, to market, that a bank is not taking excessive risks rather than subjecting officials to burden of proving, in review process, that bank is taking excessive risks.²¹³ However, the role of self-regulation by banks and their associations and NBE's supervisory power are not clearly designed by proper framework to avoid such risks in Ethiopia accompanied by absence of rating agencies.²¹⁴

A group of nine NBE staffs conducted a survey and came-up with recommendation to strengthen banks' RM requiring: NBE to review existing RM guidelines and order banks to comply with them, and, design and implement short-term training programs to banks' board members and RM staffs; banks to produce their own RM programs acceptable to NBE by giving due attention to credit, operational and liquidity risks.²¹⁵ As per the recommendations and, international standards and best practices, NBE has revised RM guideline issued in 2003 by including minimum RM (risk identification, measurement, monitoring and control) standards for banks.²¹⁶ This guideline has introduced risk-based supervision and contributes towards safety and soundness of banking system by addressing common and interrelated risks facing banks in the country, namely, credit, liquidity, market and operational risks.²¹⁷

²¹⁰ Supra note 14. pp.59 and 60

²¹¹ Id, p.60

²¹² Ibid

²¹³ Ibid

²¹⁴ Supra note 18

²¹⁵ Supra note 91, p.4, see also Supra note 131

²¹⁶ Supra note 90, p.1, see also Supra note 131

²¹⁷ Ibid., see also Supra note 131

To insure practical enforcement of this guideline, banks having no RM system were instructed to immediately set-up such system incorporating, at minimum, elements set by NBE including RM functions reporting system directly to board/its RM committee for independence.²¹⁸ Banks have accordingly issued and implemented, after review and approval by NBE, comprehensive RM program containing, at least, requirements of active board and senior management oversight; adequate policies, procedures and limits; adequate risk monitoring and MIS; and adequate internal control system.²¹⁹ NBE continuously reviews adequacy of RM program implementation by each bank and any updates thereto through off-site analysis and on-site examinations along with risk assessment visits to banks.²²⁰ Degree of supervisory intervention by NBE extends to the scope of supervision guideline commensurate with risk profile of banks; bilateral prudential meeting with bank management and external auditor; and/or tripartite meeting with bank management and external auditor every fiscal year; apart from continuous periodic meetings with a bank throughout supervisory cycle, i.e. a maximum of 24 months unless shortened depending on risk profile of each bank, to obtain information and/or discuss supervisory concerns.²²¹

Supervisory cycle is period between two consecutive onsite examinations whereas supervisory period is a period equivalent to 12 months which coincide with NBE's annual supervisory plan (from July to June).²²² NBE adopted risk-based bank supervision model integrated with CAMEL system; and implements consolidated banks supervision aiming at encouraging soundness and efficiency of banking as a whole instead of preventing failures of individual bank.²²³

NBE considers work of each bank's management and internal control, self-regulatory and supervisory functions depending on competency and reliability of such functions; and rely on findings of external auditors for fairness of FS to avoid duplication of supervisory efforts.²²⁴ Banks are quarterly rated by NBE to determine level of supervisory intervention actions by

²¹⁸ Ibid.

²¹⁹ Id., pp.1 and 2, see also Supra note 131

²²⁰ Id., p.2, see also Supra note 131

²²¹ Supra note 75, p.2, see also Supra note 131

²²² Id., p.13, see also Supra note 131

²²³ Id., p.1, see also Supra note 131

²²⁴ Id., p.2, see also Supra note 131

NBE per its 'Guide to Intervention for Banks'.²²⁵ Banks may submit objection on NBE's quarterly ratings and examination reports within reasonable period of time.²²⁶ NBE has assigned its banking supervision coordination responsibility to BSD in general and, FIs supervision Process (FISP) in particular where responsibility of quality assurance of examination reports is vested in quality assurance committee under this directorate.²²⁷

2.3.2.6 Government Ownership

Public interest view advocates argue that government ownership of banks, especially in underdeveloped countries, facilitates mobilization of savings and allocation of savings towards strategic projects with long-term beneficial effects on economic and financial developments because governments have adequate information and sufficient incentives to ensure socially desirable investments by overcoming capital market failures, exploiting externalities, and investing in strategic sectors unlike private banks that only allocate credit in line with potentially short-run private interests.²²⁸ Private interest view advocates, in contrast, argue that governments do not have sufficient incentives to ensure socially desirable investments and tends to politicize resource allocation, soften budget constraints, and otherwise hinder economic efficiency by lending to state enterprises, which often are highly inefficient witnessing that government ownership of banks facilitates the financing of politically attractive projects, but not necessarily economically efficient projects.²²⁹ In Ethiopia, Commercial Bank of Ethiopia is the only FGE owned bank which influences the banking sector and invests in financing government priority areas.²³⁰ Consequently, FGE has a visible hand directing the sector through its bank leading all private banks in all aspects in the country.²³¹

2.3.2.7 Regulatory and Supervisory Convergence

Developing best practice standards on bank regulation was characteristic of number of areas, apart from BCP, related to the financial sector, recognized by Financial Stability Forum, WB and IMF, i.e. accounting, auditing, anti-money laundering and combating financing of terrorism, CG, data dissemination, fiscal transparency, insolvency and creditor rights,

²²⁵ Ibid

²²⁶ Ibid

²²⁷ Ibid

²²⁸ Supra note 14, p.60, see also Supra note 131

²²⁹ Ibid

²³⁰ Supra note 131

²³¹ Ibid

insurance supervision, monetary and financial policy transparency, payment systems, and securities regulation.²³²

International forces affect regulatory choices when: (1) foreign entry and cross-border banking increase, greater bank competition leads to concerns about unfair competition and lobbying for changes in regulation and supervision; (2) cross-border operation of banks exposes economies and, their depositors and taxpayers to potential transmission of shocks and even loss, especially during gaps in regulation or supervision; (3) supervisors learn from international practices because of lower communication and transportation costs, as seen in virtual explosion of meetings (physical and virtual) and conferences on bank supervision in recent years; (4) banks operating in number of countries represent force for harmonization, as it is less costly to have to comply with one set of regulations, compared with alternative of complying with as many regulatory systems as number of countries in which a bank has branches or subsidiaries.²³³ However, Ethiopia has closed its banking policy where a foreigner is prohibited from participation in Ethiopian banking service in any form.²³⁴ Further, domestic non-bank entities are prohibited from undertaking banking service.²³⁵ Yet, there are legal and institutional framework gaps for proper regulation and supervision of banks in this regard especially in coping with international influence and innovative services.²³⁶

2.3.3 Bank Regulation and Supervision around the World

2.3.3.1 Single versus Multiple Bank Supervisors

Multiple Supervisors refers to sharing of official bank regulatory and supervisory responsibilities between two or more separate authorities in a nation unlike to nations authorizing single authority for all bank regulatory and supervisory responsibilities like Ethiopia.²³⁷ Although each option has its own advantages and disadvantages, one of the strongest reasons that some advocate a single bank supervisory authority is the fear of a “competition in laxity” between multiple bank supervisors, while those who favor a system with two or more bank supervisors stress benefits of “competition in innovation” among

²³² Supra note 14, p.67

²³³ Id., pp.63 and 64

²³⁴ Supra note 4, art. 9, see also supra note 131

²³⁵ Ibid

²³⁶ Ibid

²³⁷ Supra note 18

multiple bank supervisors.²³⁸ Only 26 countries, including US, assign banking supervision to multiple supervisory authorities and, particularly in US, bank regulators specialize which allows banks to switch regulators when they switch business strategy, thereby improving performance.²³⁹ The banking sector in Ethiopia exclusively relays on the verdict of NBE through its regulatory and supervisory powers even in the absence of clear legal and institutional frameworks authorizing it.²⁴⁰ The writer agrees with multiple supervisory structures for public confidence, innovation and, checking and balancing purposes in banking sector though single authority makes sense in low-income countries with more limited financial resources and relative scarcity of skilled banking personnel.

2.3.3.2 Supervisory Role of Central Banks

Assigning supervisory responsibility to central bank ensures its direct and unimpeded access to pertinent information and thus readily available firsthand knowledge of condition and performance of banks; identify and respond to emergence of potential systemic problem in a timely manner which is important, to the extent monetary policy lays out through credit channel, during credit crunch; and implement lender-of-last-resort functions better, including distinguishing solvent but illiquid banks from simply insolvent banks.²⁴¹ In contrast, assigning bank supervision responsibility to central bank is criticized for its disadvantages of inherent conflict of interest between supervisory responsibilities and responsibility for monetary policy, especially during an economic downturn, when central bank is tempted to pursue too-loose monetary policy to contain adverse effects on bank earnings and credit quality.²⁴² This encourages banks to extend credit more liberally than warranted based on credit quality conditions to complement an expansionary monetary policy initially beneficial to banking industry, and ultimately be harmful to overall economy.²⁴³ This conflicting interest of NBE is being seen in Ethiopia which is useful for banks regardless of its disadvantages to the whole economy.²⁴⁴

²³⁸ Supra note 14, p.60

²³⁹ *Id.*, pp. 84 and 85

²⁴⁰ Supra note 18

²⁴¹ Supra note 14, p.88

²⁴² *Ibid*

²⁴³ *Ibid*

²⁴⁴ Supra note 131

The writer argues that bank regulatory and supervisory authority decentralization makes better to avoid conflicts of purposes and ensure legal compliance. Monetary authority is appraised of banks' condition because central bank may implement more expansionary monetary policy in downturns if ability of banking system to extend credit becomes seriously impeded, even it has no bank supervisory role. Task of supervision needs to be separated from regulation and assigned to different and independent authority from central bank. Hence, central bank and supervisory authority will share information and cooperate for their common and respective goals. Decentralized structure of bank supervision positively affects performance and stability of banking industry, and key dimension of bank performance – bank profitability as per workable legal and institutional frameworks.

2.3.3.3 Scope of Supervisory Authority

It is argued that supervisor with broad scope covering all financial services is necessary to effectively supervise financial conglomerates operating in banking, securities, and insurance industries through various subsidiaries and affiliates which are complex and powerful corporations in many countries and, in particular, to ensure supervisory oversight of RM practices are unregimented, uncoordinated, or incomplete.²⁴⁵ However, it is counter argued that supervisory authority with broad scope would result in undue concentration of power that would otherwise be dispersed among several authorities and, otherwise, could increase likelihood of regulatory capture and retard financial innovation.²⁴⁶

In Ethiopia, NBE has broad scope supervisory power.²⁴⁷ Due to the difficulty to set a single RM system that would fit for all banks, each bank developed its own comprehensive (addressing all common risks) RM system customized to its needs and circumstances.²⁴⁸ Such system includes:²⁴⁹ (1) risk identification; (2) risk measurement i.e. accurate and timely measurement of significance of each risk in terms of size, duration and probability of adverse occurrences; (3) risk control i.e. minimizing risks and/ or their adverse consequences, avoiding or placing limits on certain activities/risks, mitigating risks and/or offsetting risks through internal policies, standards and procedures defining responsibility and authority; (4) risk

²⁴⁵ Supra note 14, p.88

²⁴⁶ Ibid

²⁴⁷ Supra note 18

²⁴⁸ Supra note 90, p.36, see also Supra note 131

²⁴⁹ Id., p.37, see also Supra note 131

monitoring i.e. developing reporting systems identifying adverse changes in risk profiles of significant products, services and activities, and monitoring changes in controls put in place to minimize adverse consequences through MIS.

The writer argues for limited scope supervisory authority because excessive power concentration is disadvantageous while decentralized powers can be integrated through proper legal and institutional frameworks. Financial conglomerates operating in banking, securities, and insurance industries through various subsidiaries and affiliates are among the most complex and powerful corporations in many countries including Ethiopia. A sole regulator, like NBE, covering all financial services is necessary to supervise such entities effectively by ensuring supervisory oversight of RM practices by such conglomerates in non- fragmented, coordinated and complete manner.²⁵⁰ However, this broad scope of authority creates undue concentration of power that would otherwise be dispersed among several authorities witnessing the likelihood of regulatory capture and retards financial innovation.²⁵¹ The issue of consolidating or integrating supervision of banking and other financial services may be realized by designing integrated frameworks governing activities of different FIs assuring that similar financial products and services offered by different entities are subject to equal regulatory and supervisory treatment.²⁵² This is because such laws typically apply to FIs and not to specific products and services save to conditions in need of peculiar legal and institutional frameworks.²⁵³

2.3.3.4 Independence of Supervision

Supervisors who have direct contact with banks and represent the main line of government defend against unsafe and unsound banking practices seek to detect, assess, and monitor activities and practices that expose banks to excessive risk relative to their levels of capital, and to require banks to appropriately manage their risk exposures.²⁵⁴ The authorities may even deem it necessary to ultimately liquidate banks when all other corrective actions fail presupposing their being independent from undue pressure and influence exerted by politicians and banks though accountable for their actions.²⁵⁵ To measure degree of independence, four

²⁵⁰ Supra note 131

²⁵¹ Ibid

²⁵² Ibid

²⁵³ Ibid

²⁵⁴ Supra note 14, p.88

²⁵⁵ Ibid

variables are employed: (1) Political- measures degree to which supervisory authority is independent of executive branch of government based on question to whom supervisory bodies are responsible or accountable;²⁵⁶ (2) Banks- whether or not supervisors are legally liable for their actions and be sued or otherwise held legally liable for actions they take against a bank having “chilling” effect on strong or tough enforcement actions;²⁵⁷ (3) Fixed Term- term of service of head of regulator based on presumption that fixed and relatively long term affords greater degree of independence.²⁵⁸ (4) Overall- sum of these three factors where higher summation values signify greater independence.²⁵⁹ None of these variables are incorporated in a clear legal and institutional framework and enforced in Ethiopia but their effect is inevitable.²⁶⁰ Political influence, responsibility of NBE for its actions and the term of its governor are not determined by laws and enforced by organizational structure.²⁶¹

2.3.3.5 Explicit Deposit Insurance Schemes

Four different quantitative variables are important to capture various features of deposit insurance schemes to be adopted: (1) deposit insurer’s power- whether deposit insurance authority has responsibility to make decision to intervene in bank, cancel or revoke deposit insurance, take legal action against MBoDs or officials, or has ever taken any legal action against MBoDs or officers; (2) deposit insurance funds-to-total bank assets- ratio of accumulated funds to total bank assets.²⁶² (3) Funding with insured deposits- percentage of banking system’s assets actually funded with insured deposits.²⁶³ (4) various factors mitigating moral hazard- measures whether banks fund deposit insurance scheme or pay risk-based premiums as well as whether there is formal coinsurance component.²⁶⁴ However, Ethiopia has not yet developed a legal and institutional framework for this scheme though currently under consideration.²⁶⁵

²⁵⁶ Id., p.97

²⁵⁷ Ibid

²⁵⁸ Ibid

²⁵⁹ Id., p. 98

²⁶⁰ Supra note 131

²⁶¹ Ibid

²⁶² Supra note 14, pp. 133, 134 and 135

²⁶³ Ibid

²⁶⁴ Id., pp.135 and 136

²⁶⁵ Supra note 131

2.3.3.6 Role of External Governance in Bank Regulation

External governance index is based upon accounting practices, external audits, financial statement transparency, and external ratings and creditor monitoring based on four variables²⁶⁶: (1) accounting practices: indicate whether bank accounting practices are in accordance with IAS.²⁶⁷ (2) Strength of external audit- measures effectiveness of external audits of banks based on whether regulator has power to oversight and take legal action against external auditors for negligence.²⁶⁸ (3) financial statement transparency- captures transparency of bank FS based on whether: (1) accrued, unpaid, interest/principal enters in income statement while loan is still performing; (2) FIs are required to produce consolidated accounts covering all bank and any nonbank financial subsidiaries; (3) off-balance sheet items are disclosed to public; (4) banks are obliged to disclose their RM procedures to public; (5) MBoDs are legally liable when they disclose erroneous or misleading information; and (6) accrued, although unpaid, interest/principal enters in income statement while loan is still nonperforming.²⁶⁹ (4) external ratings and creditor monitoring- measures extent to which subordinated debt is allowable or required part of capital and credit ratings are used for all banks by both international and domestic rating agencies, and percentages are directly related to income level of a country and relationship is especially strong for share rated by international rating agencies.²⁷⁰ External Governance Variable is, therefore, sum of these four variables and higher summation values indicate greater degree of external governance.²⁷¹ But, the role of such external governance are not clearly recognized by law and enforced by competent institution in Ethiopia though considered during on-site inspection and off-site surveillance.²⁷²

2.4 Core Principles for Effective Banking Supervision

There are 25 BCPs adopted by Basel Committee on bank supervision. The background for the issuance of BCPs was to address bank regulatory and supervisory gaps, create strong institutional and legal frameworks along with accepted supervisory modalities, ensure effective

²⁶⁶ Supra note 14, pp.135 and 136

²⁶⁷ Id., p.142

²⁶⁸ Id., pp. 142 and 144

²⁶⁹ Id., pp.145 and 146

²⁷⁰ Id., p.147

²⁷¹ Ibid

²⁷² Supra note 131

RM and public confidence in individual banks and the banking system throughout the world. Many Countries, including Ethiopia, use these BCPs as minimum standard for sound prudential regulation and supervision of banks and banking systems; as benchmark for assessing quality of their supervisory systems and as a tool for identifying future work to achieve baseline level of sound supervisory practices.²⁷³ IMF and WB also use them to assess the effectiveness of countries' banking supervisory systems and practices.²⁷⁴ Adopting such BCPs is highly important for effective banks regulatory and supervisory system.²⁷⁵

BCP1 covers objectives, autonomy, powers and resources of bank supervisory authority in general and deals with definition of responsibilities and objectives; skills, resources and independence; legal framework; enforcement powers; requirements for adequate legal protection; and information sharing for supervisory authority in particular.²⁷⁶ Licensing and structure of banking is addressed under BCPs2-5 respectively deal with banks permissible activities; licensing criteria and process; requirements of supervisors to review, approve/reject, all significant transfers of ownership in banks; and requirements of supervisors to review major acquisitions and investments by banks.²⁷⁷ Prudential regulations and requirements are dealt under BCPs6-15 respectively dealing *with*: minimum capital adequacy requirements where it must not be less stringent than those in Basel Capital Accord for internationally active banks; granting and managing of loans and making of investments; requirements for evaluating asset quality, and adequacy of loan loss provisions and reserves; rules for identifying and limiting concentrations of exposures to single borrowers, or to groups of related borrowers; rules for lending to connected or related parties; requiring banks to have policies for identifying and managing country and transferred risks; requiring banks to have systems to measure, monitor and control market risks; requiring banks to have systems to measure, monitor and control all other material risks; calling banks to have adequate internal control systems; and rules for prevention of fraud and money laundering.²⁷⁸

Methods of ongoing supervision are stipulated under BCPs16-20 which respectively: defines overall framework for on-site and off-site supervision; requires supervisors to have regular

²⁷³ Basel Committee on Banking Supervision, CBPs for effective supervision, Sep. 2012, p.7

²⁷⁴ Supra note 14, p.147

²⁷⁵ Id., p.359

²⁷⁶ Ibid

²⁷⁷ Ibid

²⁷⁸ Ibid

contacts with bank management and staff, and to fully understand banks' operations; sets out requirements for off-site supervision; requires supervisors to conduct on-site examinations, or to use external auditors for validation of supervisory information; and requires conduct of consolidated supervision.²⁷⁹ Information requirements are placed under BCP21 which requires banks to maintain adequate records reflecting true condition of a bank, and to publish audited FS whereas remedial measures and exit procedures requires supervisors to have, and promptly apply, adequate remedial measures for banks when they do not meet prudential requirements, or are otherwise threatened are dealt under BCP22.²⁸⁰ Cross-border banking requiring supervisors to apply global consolidated supervision over internationally active banks; and establish contact and information exchange with other supervisors involved in international operations, such as host country authorities; and local operations of foreign banks to be conducted to standards similar to those required from local banks, and that supervisor has power to share information with home country supervisory authority are respectively dealt with under BCPs23-25.²⁸¹

These BCPs are implemented by properly designing and enforcing legal and institutional frameworks for banks regulation which determine core implementing modalities of regulating BHCs, change in bank control, credit extension, securities, examination and supervisory influence on credit quality and off-balance sheet items which are basic in putting the above BCPs into effect. In Ethiopia, there is no comprehensive legal and adequately organized institutional framework for the regulation of banks which took the BCPs and their implementing modalities in to practice yet. These modalities respectively address institutional and legal requirements for persons directly and indirectly holding shares in a bank with particular emphasis on HCs, the voting and managing roles and limitations of bank shareholders, credit exposure to related and unrelated single or several counterparties, issuance and dealing with securities, roles of effective examination and supervision on credit quality, and the regulation of banks' contractual commitments as provided here under.

²⁷⁹ Ibid

²⁸⁰ Ibid

²⁸¹ Ibid

2.4.1 BHCs Regulation

Bank regulatory and supervisory frameworks must stipulate rules on how BHCs operate:²⁸² (1) controlling creation and expansion of BHCs; (2) separating BHCs' business of managing and controlling banks from unrelated [nonbanking] business; (3) maintaining competition among banks and minimize inherent danger in concentration of economic power through centralized control of banks; and (4) subjecting BHCs to examination and regulation. Such frameworks define BHCs and set general standards for HC formations, acquisition of additional banks, and expansion into nonbanking activities.²⁸³ In US a company that has control over bank as BHC includes corporations, partnerships, associations, or long-term trusts if it:²⁸⁴ (1) directly or indirectly owns, controls, or has power to vote at least 25 percent of any class of bank's voting stock; (2) controls in any manner election of majority of bank's directors; or (3) is judged by FRB to exert controlling influence over bank management or policies through other means.²⁸⁵ But, in Ethiopia there is no institutional and legal framework for the regulation and supervision of banks HCs.²⁸⁶

2.4.2 Change in Bank Control

It prohibits any person, directly or indirectly, or through or in concert with one or more other persons, from acquiring control of bank or HC through purchase, assignment, transfer, pledge or other disposition of the target's voting stock unless the person gives prior notice to appropriate regulatory body and it has not disapproved the acquisition within statutory time period.²⁸⁷ Approval of such request by regulator bases on possibility to result in monopoly, lessens competition or restraints trade, jeopardizes financial stability, it will not be to the interest of depository bank and public, acquiring person fails to furnish all required information and if it would create adverse effect on bank insurance fund.²⁸⁸ There is legal and institutional gap in the regulation and supervision of banks in Ethiopia with regard to bank and its HC control.²⁸⁹

²⁸² Michael P. Malloy, Principles of Bank Regulation, Concise Horn Book Series, second ed. p, pp.42 and 43

²⁸³ Ibid

²⁸⁴ Id., pp. 43 and 44

²⁸⁵ Id., p.46

²⁸⁶ Supra note 18

²⁸⁷ Supra note 14, p. 147

²⁸⁸ Supra note 14, pp. 149 and 150

²⁸⁹ Supra note 18

2.4.3 Credit Extension

Banks are prohibited from extending credit to insiders i.e. directors, Executive Officers and Principal Shareholders or insider's related interest except to the extent specifically permitted by statute.²⁹⁰ When credit is made substantially in same terms including interest rates and collateral requirements, prevailing to comparable transactions by the bank with persons who are not insiders; such credits involve no more than normal risk of repayment or other unfavorable features; and follows credit underwriting procedures that are no less stringent than procedures to comparable transactions with non-insider persons.²⁹¹ There is legal framework governing bank credit extension in Ethiopia though there is a problem in institutional frameworks to properly supervise implementation of such rules.²⁹² Credit to related parties, companies or individuals are granted on an arm's-length basis and that amount of credit granted is suitably monitored.²⁹³ Such controls are implemented by making terms and conditions of such credits not more favorable than credit granted to non-related borrowers under similar circumstances and by imposing absolute limits on such credits.²⁹⁴

Further, a bank's credit-granting criteria may not be altered to accommodate related companies and individuals, rather material transactions with related parties are subjected to prior approval of BoDs (excluding board members with conflicts of interest), and reported to banking supervisory authorities.²⁹⁵ Banks are required to have credit granting procedures in place that identify connected counterparties as single obligor by aggregating exposures to groups of counterparties (corporate or non-corporate) that exhibit financial interdependence by way of common ownership, common control, or other connecting links (for example, common management, family ties).²⁹⁶ Identification of connected counterparties requires careful analysis of impact of the above factors (e.g. common ownership and control) on financial interdependence of parties involved.²⁹⁷ Related parties include a bank's subsidiaries and affiliates, its major (owning 2% and above) shareholders, directors and senior management, and their direct and related interests, as well as any party that bank exerts control over or that

²⁹⁰ Supra note 14, pp. 162 and 163

²⁹¹ Ibid

²⁹² Supra note 18

²⁹³ Supra note 90, p.8, see also Supra note 131

²⁹⁴ Supra note 14, pp. 162 and 163

²⁹⁵ Ibid

²⁹⁶ Ibid

²⁹⁷ Ibid

exerts control over the bank.²⁹⁸ Credit concentration occurs when bank's portfolio contains high level of direct or indirect credits to single counterparty; group of related counter parties; industry; geographical region; type of credit facility (i.e. overdrafts); and class of collateral.²⁹⁹

Since excessive concentration renders bank vulnerable to adverse changes in area in which credit is concentrated and to violations of statutory and regulatory limits, sound and prudent RM minimizes concentration of risk by diversifying credit portfolio.³⁰⁰ Credit diversification policy must be clearly stated and include: goals for portfolio mix; place exposure limits on single counter parties and groups of associated counter parties, key industries or economic sectors, geographical regions and new or existing products; and be in compliance with NBE/s statutory and regulatory limits on large exposures.³⁰¹ In considering potential credits, banks recognize necessity of establishing provisions for identified and expected losses in line with NBE directives on provisions and holding adequate capital to absorb unexpected losses for their credit-granting decisions as well as overall portfolio RM process.³⁰²

2.4.4 Securities Regulation

Covers two areas of concern :(1) regulation of banks as issuers of securities; and (2) restrictions on banks as participants in securities markets because banks are subjected to securities regulation, like other issuers and traders in securities save to restrictions; acting as securities transfer agent; and securities market professionals are fully subject to securities regulation and supervision.³⁰³ But, in Ethiopia, there is no clearly organized institutional and legal framework in this regard so far.³⁰⁴ Even it is not clear if securities regulation and supervision lays under NBE's power and responsibility though currently it tries to set some institutional and legal frameworks on primary and secondary market for FG securities and securities issued up on FG's full guarantee in limited scale.³⁰⁵

²⁹⁸ Ibid

²⁹⁹ Ibid

³⁰⁰ Id.,9

³⁰¹ Ibid

³⁰² Ibid

³⁰³ Id. pp. 251 and 252

³⁰⁴ Supra note 18

³⁰⁵ Ibid

2.4.5 Examination and supervisory influence on credit quality

Bank Examination and supervision influences types, maturity, and quality of bank loans than through lending statutes where loans are primarily evaluated with regard to their overall quality and their risk under different economic conditions.³⁰⁶ Examiners classify credits, with excessive risks, questionable collection characteristics and calling attention of bank management and directors, as substandard, doubtful, loss and special mention credits.³⁰⁷ Where: (1) substandard credit involves more than normal risk due to performance, financial condition, insufficient collateral, or other factors, and deserves more than normal servicing and supervision; (2) doubtful credits have a probable loss, amount of which cannot be readily determined; (3) loss credits are regarded as uncollectible; and (4) special mention credit has potential weaknesses that affects repayment if left uncorrected and deserves management's close attention.³⁰⁸

NBE's Examination procedures focus on developing appropriate documentation to adequately assess management's ability to identify, measure, monitor, and control risks; and on determining whether a bank's management understands and adequately controls types and levels of risks assumed.³⁰⁹ In performing full scope examination, examiners use core assessment and expanded procedures to assess whether risks within bank are appropriately identified and managed.³¹⁰ Examination procedures are tailored to fit scope memorandum for examination; and determines and validates bank's condition.³¹¹ Core assessment covers procedures to review areas of:³¹² (1) capital adequacy; (2) asset quality and credit risk; (3) management & quality of RM; (4) earnings; (5) liquidity and liquidity risk; (6) market risk; and (7) operational risk.

Desk officers are designated as central point of contact between NBE and a bank under examination and work as EIC for each bank for a minimum period of two years and serve as focal point for supervision.³¹³ They are responsible to: (1) prepare and update institutional

³⁰⁶ Lex Mundi Bank Finance and Regulation Practice Group: A Global Practice Guide on Bank Finance and Regulation, accessed at www.lexmundi.com/GlobalPracticeGuides, on April 07, 2017 p.3

³⁰⁷ Ibid

³⁰⁸ Id., p.74

³⁰⁹ Supra note 75, p.16, see also Supra note 131

³¹⁰ Ibid

³¹¹ Ibid

³¹² Ibid

³¹³ Id., p.2

profile and supervisory plan in timely manner; (2) know a bank's financial condition, management structure, strategic plan and direction, operations and risk profile; (3) know and keep abreast with changes in RM policies including those pertaining to new products and services; (4) remain up-to-date and know all supervisory activities, monitoring and surveillance information, correspondences and various requests by banks, meetings with management and external auditor and enforcement issues; (5) ensure appropriate follow-up of supervisory concerns, corrective actions, or other matters which come to light through ongoing communications, meetings or surveillance including report of examination; (6) Participate in examination process to ensure consistency with a bank's supervisory plan and effective allocation of resources, and facilitate requests for information from a bank; (7) and visit the bank assigned to him upon obtaining necessary clearance from NBE.³¹⁴ EIC is also responsible to coordinate preliminary review including pre-examination meeting; prepare scope of memorandum; lead team of on-site examination; prepare report of examination; and accompany Bank Supervision Deputy Director during presentation of examination report to board of the examined bank.³¹⁵

Scope memorandum is integral product in risk-based methodology identifying key objectives and scope of on-site examination; tailoring size, complexity and current rating of a bank and defining objectives of examination.³¹⁶ It contains, at least: ³¹⁷ (1) scope and objectives of examination; (2) summary of bank's institutional overview and Risk Assessment Summary (RAS) after incorporating information from preliminary review of both on-site and off-site information; (3) summary of pre-examination meeting; (4) summary of audit review and reliance on RM systems and internal and external audit findings; (5) examination focus and procedures; and (6) resources planning. For supervisory assessment purposes, risk intrinsic to business activity and arises from exposure and uncertainty from potential future events, or changes in business or economic conditions are inherent risks classified as credit risk (asset quality); market risk; liquidity risk (liquidity); and operational risk.³¹⁸

With regard to Board responsibility, NBE's survey report revealed that all or some of board members in 87% of the banks did not sit for training on RM while 60% of them were not

³¹⁴ Id., p.2 and 3

³¹⁵ Id., p.3

³¹⁶ Id., p.15

³¹⁷ Ibid

³¹⁸ Id., p.5

provided with relevant and up-to-date economic, business and market data for informed decision-making.³¹⁹ Concerning structure and resources, only relatively insignificant (0.14-0.43% of their respective total budget), or unknown budget was allocated to RM function in 75% of the banks.³²⁰ It was also investigated that only part or none of the staffs were trained in RM in 73% of the banks.³²¹ 60% and 74% of banks had not documented RM strategy and, policies and programs, respectively along with the fact that 50% or above of the banks lack timeframe to periodically review RM documents.³²² 60% of banks do not define risk limits under their RM policies, 93% of the rest rely on NBE limits for counterparty, and above 3/4th of them did not define limits at all for geography, product, security, sector etc.³²³ Internal communication of risk appetite and findings is low in 60% of the banks, and RM process is either partly or fully not integrated with HRM and policies in vast majority (87%) of the banks.³²⁴ 77% of external auditors and 60% of internal auditors of the banks do not independently review effectiveness of banks' RM functions.³²⁵ RM function of 93% of banks does not capture risks related to procurement and HRM; 87% of banks do not conduct workshop to identify risks in each activity/product; 60% of them have not created risk register; 87% of them do not exercise stress testing as RM tool; and 93% of banks do not have continuity/disaster recovery/contingency plan in place for other risks like market, reputation, etc.³²⁶ Credit, operational and liquidity risks were key bank risks over last two years before the survey year, and expected to continue for next five years.³²⁷

2.4.6 Off Balance Sheet Items

Contingent liabilities and commitments that are not directly reflected on a bank's balance sheet include: (1) commercial and standby letters of credit; (2) law suits; (3) repurchase agreements; (4) loan commitments; (5) futures, forward, and standby contracts for securities; (6) commitments to buy and sell Forex; and (7) interest rate swap agreements.³²⁸ Regulatory tools like prohibition, supervisory and examination process, reporting, management oversight on

³¹⁹ Supra note 91, p.1, see also Supra note 131

³²⁰ Id., p. 2

³²¹ Ibid

³²² Ibid

³²³ Id., p.3

³²⁴ Ibid

³²⁵ Ibid

³²⁶ Ibid

³²⁷ Ibid

³²⁸ Supra note 306, p.113

these activities and bank's staff to judge and limit a bank's risk exposure, and let items backed by risk-based capital requirements, are used to estimate or control risk from off-balance sheet commitments.³²⁹

Banks involve in originating financial contracts resulting in acquisition of assets and liabilities at some future date as part of their operations but not considered as assets or liabilities by themselves in generally accepted accounting principles.³³⁰ Consequently, banks do not recognize them on face of balance sheet but rather off-balance sheet. Such items are diverse in nature and purpose including:³³¹ (1) letters of credit (L/C) i.e. a letter addressed by a bank on behalf of a buyer of merchandise to a seller, authorizing him to draw drafts up to agreed amount under specified terms and undertaking conditionally or unconditionally to provide payments for drafts drawn especially to finance Forex transactions; (2) undrawn loan/overdraft facilities i.e. an unconditional commitment to lend when a borrower requests under the facility including commitments for which the bank has already charged commitment fee or other consideration or otherwise has legally binding commitment save to a bank's absolute discretion to withdraw the commitment in case of credit deterioration; (3) guarantees, acceptances or performance bonds i.e. an undertaking by bank (guarantor) to stand behind current obligations of a third party and to carry-out these obligations when the third party fails. Such guarantees, acceptances and performance bonds are regarded as direct credit substitutes with liability equivalent to that of loan, acceptances and performance bonds.³³²

Off-balance sheet business is exposed to several risks which, in principle, are not different from on-balance sheet business risks and regarded as integral part of the bank's overall risk profile.³³³

The major risks associated with off-balance sheet business include:³³⁴ (1) Forex risk i.e. reduced or increased exposure to exchange rate changes but manageable by constantly monitoring banks' Forex positions arising from off/on-balance sheet business; (2) interest rate risk i.e. risk of increase in interest rate and credit risk during contract period; (3) liquidity risk i.e. risk of failure to obtain funds from market at competitive rates to meet bank's obligations when fall due e.g., maturing deposits, drawings under approved facilities; (4) credit risk i.e.

³²⁹ Ibid

³³⁰ Supra note 90, p.41, see also Supra note 131

³³¹ Id., pp.41 and 42

³³² Supra note 18

³³³ Ibid.

³³⁴ Id., pp.42 and 43

risk when counterparties fail to perform on/off-balance sheet obligation e.g., guarantees, non-cash covered L/Cs; and (5) operational risk i.e. risks of inadequate information systems or operational controls e.g., accounting, funds transfer and financial controls leading to breaches, fraud or unforeseen catastrophe negatively affecting a bank.

Off-balance sheet risks are effectively managed by designing correct policies and procedures; stating goals and strategies; dual control, segregation of duties and function; and audit, risk control and MIS services; setting limits e.g., exposure limits, approval limits and ensure follow-up in compliance with statutory and regulatory requirements of NBE; and designing proper information and accounting MISs to enable checking and reconciliation procedures to be carried out on routine basis for early detection of potential loss.³³⁵

³³⁵ Id., p.43

CHAPTER THREE

THE LEGAL AND INSTITUTIONAL FRAMEWORK FOR BANK REGULATION AND SUPERVISION IN ETHIOPIA

Currently, there are seventeen banks in Ethiopia including one fully government owned and sixteen private banks.³³⁶ Banks are licensed and operating as per the NBEEP (as amended) .No. 591/2008, BBP No. 592/2008, NPSP No. 718/2011, AMLCFTP No.780/2013, Comm.C., NBE directives and circulars, and frameworks, guidelines and procedures adopted by NBE.³³⁷ Banks have also developed internal by-laws, guide lines and procedures to strengthen their self-regulatory practice as per these laws, bilateral arrangements between banks and NBE, NBE and EBA; and tri-patriate arrangements between NBE, DARA and EBA.³³⁸ The word “bank”* is defined as a private bank licensed, regulated and supervised by NBE to undertake banking business and a bank owned by the Government that is not licensed but regulated and supervised by NBE.³³⁹

3.1 Entry into Banking

Only banks licensed and/or regulated and supervised by NBE, and nobody else, is authorized to undertake banking services.³⁴⁰ Only one license is granted for all banking activities when documents evidencing trade name registration from Ministry of Trade or equivalent Regional Bureau along with other requirements set by NBE are submitted.³⁴¹ Draft bylaws, intended organizational chart, structure of Board (composition, committees, and functions), market / business strategy, financial projections for the first three years, financial information on main potential shareholders, background/experience of future MBODs and senior managers, and

³³⁶ Biritu, NBE Bulletin No.124, July 2017 available at www.nbe.gov.et

³³⁷ Supra notes 10, 102, 121, 123 and 330

³³⁸ Interview with Ato Tsegay Tesfamichael, Assistant bank examiner at the NBE, Oct.03, 2017

³³⁹ Supra note 1, art.2 (3). The ‘\’ refers to the discrepancy between this proclamation and the BBP in defining the word ‘bank’. Art. 2(1) of the BBP seems to alternatively use the government owned and private bank by using the disjunctive word ‘or’ instead of the conjunctive word ‘and’ under the NBEEP. But, the writer argues that the word is mistaken under the BBP and agrees with the former reference as both government and private owned banks are operating and regulated by NBE together in the country. Thus, the word ‘bank’ refers to both government and private owned banks operating in Ethiopia for the purpose of this study.

³⁴⁰ Supra notes 10, 102, 121, 123 and 330

³⁴¹ Requirements for Licensing and License Renewal of Banking Business Directive, 2013, art.5.1, directive No. SBB 56

Lacking this key authority, NBE may not be effective in properly regulating banking business carried out by persons not licensed by it. The provision is not clear even if the court decides or NBE reports again on future business of persons undertaking banking business without license after the return of money and properties held by them. Therefore, the writer argues that NBE shall be clearly authorized and institutionally restructured to have a law enforcement department to order immediate and efficient return of such moneys or property to depositors or owners thereof by quasi-judicial role without the need to wait for court decisions for such action. The final order passed by NBE has also to be valid before court provided that it is made based on proven and admissible facts. This will result in amending the law and reform its institutional set-up to clearly authorize NBE to take such actions.

A bank under formation ensures that its capital is fully subscribed and the minimum capital is fully paid up in cash and deposited in a bank in the name and to the account of the bank under formation.³⁵⁴ Banks, at minimum, maintain capital to risk weighted assets ratio of 8% at all times.³⁵⁵ Source of capital and finance is indicated and verified by NBE before granting license.³⁵⁶ Issued shares are fully subscribed and, at minimum, one-fourth of the subscribed shares are fully paid in cash showing that the initial disbursement or subsequent injections of the paid up capital may not be paid-in assets other than cash. Capital contributions in kind may not be considered for the purposes of fulfilling minimum required paid-up capital and may not exceed 25% of paid up capital in excess of minimum required capital.³⁵⁷ But, the law is not clear if it is possible that initial capital contributions by prospective shareholders be in the form of funds sourced from loan though it is practically prohibited by NBE.³⁵⁸ Foreign nationals or organizations fully or partially owned by foreign nationals are prohibited from opening banks

³⁵³ Id., art.3(5)

³⁵⁴ Minimum Capital Requirement for Banks Directive, 2011, art. 2.2 and 4, Directive No. SBB 50, see also supra note 4, art.4 (1(e and f)). Note that there is a discrepancy between art.2.2 and 4 of the NBE directive concerning the minimum paid up capital to be paid by founding members of the applicant bank. The writer argues that both provisions are referring to the same requirement and the latter one is correct. Thus, it will be essential to show that former reference is mistaken and note an additional requirement imposed on founders.

³⁵⁵ Id, art.4.4, “risk-weighted assets ratio” refers to a bank’s capital standard reflecting the riskiness of its loan portfolio i.e. a loss-absorbing capital a bank needs to sustain it through difficult markets which measures the amount of its assets adjusted for risk.

³⁵⁶ Supra note 341, art.5.2.11(i)

³⁵⁷ Contribution in Kind Directive, 1995, art. 2.3, Directive No. SBB 3

³⁵⁸ Supra note 18

source of funds to be used are submitted together with application for license.³⁴² Currently, the minimum paid up capital for banking business is Birr 500 Million regardless of scope and type of the intended banking business; and its source is verified by NBE.³⁴³ However, banks are working to increase their paid up capital to 2 billion for next five years as part of their 2nd Growth and Transformation Plan and passed resolution as per NBE's instruction to increase their paid up capital.³⁴⁴ Initial capital may not be paid in a fund borrowed; contributed in assets other than cash; and infected by sourcing problems related to money laundering or financing of terrorism.³⁴⁵ Some applications were denied, during the transitory period of increment of minimum paid-up capital, due to under-capitalization and proposal quality problem.³⁴⁶ NBE processes and issues a new banking business license to applicants within 90 days from the receipt of application to final disposition.³⁴⁷

A person may not undertake a banking business and/or use the word 'bank' or its derivatives to other areas of business in Ethiopia unless licensed by NBE.³⁴⁸ Three of my interviewees from BSD agreed that NBE has authority to take legal action against entities undertaking banking activities without license from it.³⁴⁹ There were incidents where banking businesses were carried out by persons not licensed by NBE but only inspected and instructed to stop such business by NBE without taking other legal action.³⁵⁰ These problems were related to persons providing digital banking services, clearing house operations, real estate business and "Equb" services provided by persons like "Gojo Equb" which had huge capital aiming at providing local and cross boundary financing services to its members.³⁵¹ NBE is authorized to require and inspect, or cause to be inspected, all books, minutes, accounts, cash, securities, records, vouchers and other documents possessed or hold by such persons.³⁵² However, it does not have authority to take direct legal action against those persons undertaking banking activities without license from it and hold money or other property obtained through such act other than lodging application to Federal High Court for ordering immediate and efficient return of such moneys or property to depositors or owners thereof.³⁵³

³⁴² Supra notes 10 and 330

³⁴³ Supra notes 18, 131 and 338

³⁴⁴ *ibid*

³⁴⁵ *ibid*

³⁴⁶ *ibid*

³⁴⁷ *ibid*

³⁴⁸ Supra note 4, art.3 (1 and 2)

³⁴⁹ Supra notes 18, 131 and 338

³⁵⁰ *Ibid.*

³⁵¹ Supra note 18

³⁵² Supra note 4, art.3(4)

or branch offices or subsidiaries of foreign banks or joint venture in Ethiopia or acquire shares of Ethiopian banks.³⁵⁹

3.2 Bank Ownership

Under banking business laws, company refers to a share company as defined under the Comm.C. where its capital is wholly owned by Ethiopians and organizations wholly owned by Ethiopian nationals; and registered under laws of, and having its head office in, Ethiopia.³⁶⁰ There was a controversial issue in relation to non-Ethiopian national shareholders of Ethiopian origin.³⁶¹ They had been shareholders for a longer period since they acquired such shares either as foreign national of Ethiopian origin or as Ethiopian who later changed their nationality without surrendering their shares in Ethiopian banks.³⁶² The case was latter referred to police for investigation which was also referred to prosecutors.³⁶³ The FGE passed a decision, by recognizing the role of Ethiopian Diasporas, having yellow card, to the country's development by remitting Forex, to close the criminal charge files and explicitly investigate only intentional violent shareholders who will not surrender their shares on this grace period.³⁶⁴ Consequently, NBE issued controversial circulars defining indirect foreign national shareholders and guideline on surrendering procedure of such shares to Ethiopian nationals.³⁶⁵ This guideline allowed these shareholders to surrender their shares at par-value where the difference between par-value and current market price will be deposited to FG treasury.³⁶⁶ Such shareholders' right to sell their shares in current market value was given to respective banks by such guideline and the revenue margin from such sales was unlawfully and unreasonably transferred to government.³⁶⁷ The writer opposes the NBE's action which has unlawfully deprived the shareholders property right.

A person who holds directly or indirectly 2% or more of total subscribed capital of a bank is referred to as an influential shareholder.³⁶⁸ Bank's influential shareholders, directors, CEO and

³⁵⁹ supra note 4, art.9

³⁶⁰ supra note 4, art.2(5) and supra note 1, art.2(15)

³⁶¹ Supra notes 18, 131 and 338

³⁶² Ibid.

³⁶³ Ibid.

³⁶⁴ Ibid.

³⁶⁵ Ibid.

³⁶⁶ Ibid.

³⁶⁷ Supra note 131

³⁶⁸ Ibid

SEOs are regarded as persons with significant influence in a bank.³⁶⁹ Influential shareholder of a bank is prohibited from acquiring shares in other bank.³⁷⁰ Directors, CEO and SEOs of a bank meet qualification, fitness and propriety criteria including: knowledge, experience and age for which influential shareholders are not required.³⁷¹ But, influential shareholders meeting integrity and financial soundness requirements are approved by NBE.³⁷² When such person fails to fulfill criteria, NBE takes legal actions like suspending the voting right, suspending or removing from positions of director, CEO or SEO.³⁷³

Transfer of a share making a person influential shareholder is approved by NBE before such transfer is recorded in register of share as per the relevant NBE directives.³⁷⁴ A person, other than FGE, is prohibited from holding more than 5% of a bank's total subscribed shares either on his own or jointly with his spouse or with a person who is below the age of 18 who is related to him by consanguinity to the first degree.³⁷⁵ Non-bank financial, related parties and non-financial firms own voting shares in banks only up to 5%.³⁷⁶ However, the law has not clearly set limits on shares to be held by RGs in banks though seemingly FG has decided on affairs of autonomous RGs by reserving its right to hold unlimited shares in a bank but limiting RGs' shares to 5%. My interviewees agreed that RGs' shareholding right is cleanly limited to 5% and that is practiced.³⁷⁷

The number of shares that may be held in a bank by a company, becoming indirect shareholder, partially or fully owned by persons who have shares in the bank, direct shareholders, is set to be determined by NBE.³⁷⁸ But, NBE has not issued a directive to determine it yet and the banking sector lacks legal and institutional framework in this regard. My interviewees agree that there is problem in relation to regulation and supervision of banks due to hidden challenge of indirect shareholders in exercising voting right resulting to directorship and managerial

³⁶⁹ Supra note 4, art.2(11) and Requirements for persons with significant influence in banks Directive, 2012, art.2.6 and 2.10, Directive No. SBB 54

³⁷⁰ supra note 4, art.11(5)

³⁷¹ Supra note 18

³⁷² Supra note 4, art.4 (1(g and h)) and Requirements for persons with significant influence in banks Directive, 2012, art.2.6 and 2.10, directive No. SBB 54

³⁷³ Requirements for persons with significant influence in banks Directive, 2012, art.6.1 and 6.2, Directive No. SBB 54

³⁷⁴ Supra notes 18, 131 and 338, see also supra note 4, art.10(3)

³⁷⁵ supra note 4, art.11(1)

³⁷⁶ Ibid, see also Supra notes 18, 131 and 338

³⁷⁷ Supra notes 18, 131 and 338

³⁷⁸ supra note 4, art.11(3)

control.³⁷⁹ There were cases, example, related to “Star Business Group” and others who had been difficult challenge to the banking sector by controlling voting and managerial rights shifting directions of their bank’s credit portfolio to related parties due to their indirect shareholding.³⁸⁰ This hinders NBE from identifying beneficial owner i.e. any natural person who ultimately owns or controls a customer or an account, person on whose behalf a transaction is being conducted, or person who ultimately exercises effective control over legal person or arrangement.³⁸¹ Generally, requirements for evaluation / approval of bank shareholders with significant influence include: minimum level of education, financial and/or banking related experience, financial capacity to support bank capital, no criminal record, no bankruptcy record and lack of conflict of interest.³⁸²

NBE may oppose the ultimate (beneficial) owner who failed to fulfill minimum requirements during ownership assessment and require him to be publicly disclosed.³⁸³ However, NBE has not determined to what extent related parties like business associates can hold shares in bank unlike to the case of spouse or a person who is below the age of 18 related to him by consanguinity to first degree.³⁸⁴ Related party to a bank refers to a shareholder, director, CEO, or senior officer of that bank and/or spouse or related to first degree of consanguinity or affinity of such persons; and partnership, common enterprise, private limited company, share company, joint venture, corporation, or senior officer of a bank and/or spouse or related to first degree of consanguinity or affinity of such persons has business interest as shareholder, director, CEO, or senior officer, owner or partner.³⁸⁵ Shareholders of a bank holdings 2% or more of its subscribed capital are treated as related party and subjected to provisions of law governing related parties to such bank.³⁸⁶ Banks are responsible to identify such related parties as per the law and practice.³⁸⁷

³⁷⁹ Supra notes 18, 131 and 338

³⁸⁰ Supra note 131

³⁸¹ AMLCFTP, 2013, art.2(18), proc. no.780, year 19, no. 25

³⁸² Supra notes 18, 131 and 338

³⁸³ Ibid

³⁸⁴ Ibid

³⁸⁵ Credit exposure to single borrowers and related counterparties, Directive 2012, art.3.7, Directive No. SBB 53

³⁸⁶ Id., art.8

³⁸⁷ Id., art.9, see also Supra notes 18, 131 and 338

3.3 Regulatory Capital Adequacy Regime

Basel I regulatory capital adequacy regime is adopted by NBE and every bank discharges its obligations on solo basis at individual bank level.³⁸⁸ Risks of credit, market, operational and liquidity are covered by current regulatory minimum capital requirements where minimum required risk-based regulatory capital ratio is uniformly 8% since 2014 as set under Basel I.³⁸⁹ In 2014-2016, actual risk-based capital ratio and actual Tier 1 capital ratio of banking system was respectively 15.55%, 14.67% and 14.65%.³⁹⁰ NBE has authority to require additional capital that is over-and-above this minimum required capital for individual banks when its risk exposure is high, and require banks to perform an internal assessment of their capital adequacy against their economic capital.³⁹¹ It also reviews internal assessments performed by banks.³⁹² NBE had plan to move to Basel II framework during the introduction of Business Process Re-engineering (BPR) in 2010, though not yet implemented and target calendar year of adoption is not revealed.³⁹³

Banks operating in Ethiopia open two separate Birr accounts (i.e. reserve, and payment and settlement accounts) with NBE.³⁹⁴ Reserve account is exclusively used to maintain reserve balance from which a bank may not withdraw any money before prior approval of NBE whereas payment and settlement account is used to carry out all day to day transactions of a bank through NBE.³⁹⁵ Banks maintain, all times, in their reserve account 5% of all Birr and Forex deposit liabilities held in the form of demand (current) deposits, saving deposits and time deposits.³⁹⁶ In computing balance of total deposits for reserve purposes, cash items in process of collection, if included under deposits, are deducted there from; which are not acceptable as reserve by NBE until credited to the reserve account; and reserve requirement is computed on net deposit balance i.e. excluding cash items in process of collection and shown at the end of each reporting week.³⁹⁷ Deficiencies in reserve balance are subject to penalty assessed at a price twice the current average rate of interest on loans and advances charged by banks

³⁸⁸ Supra notes 18, 131 and 338

³⁸⁹ Ibid

³⁹⁰ Ibid

³⁹¹ Supra note 4, art.18(2), see also Supra notes

³⁹² Ibid

³⁹³ Ibid

³⁹⁴ Reserve requirement (6th replacement) Directive, 2013, art.2, Directive No. SBB 55,

³⁹⁵ Id., art.2.1(a and b) and 2.2, see also Supra note 129

³⁹⁶ Id., art.3, see also Supra note 129

³⁹⁷ Id., art.4(4.1- 4.3), see also Supra note 129

computed on the amount of deficiency in reserve and multiplied by number of days over which the reserve account remained deficient.³⁹⁸

3.4 Banking Activities

Banking Business includes activities of: receiving funds from public through authorized means by NBE; using such funds, for account and at risk of a banker, for loans or investments in manner acceptable by NBE; buying and selling of gold and silver bullion and Forex; transfer of funds to other local and foreign persons on behalf of banks themselves or their customers; discounting and negotiation of promissory notes, drafts, bills of exchange and other evidence of debt; and any other activity recognized as customary banking business by NBE.³⁹⁹ Dealing in securities is business of buying and selling of equity and debt securities for own account whether through broker or otherwise to make profit from trading.⁴⁰⁰ The BBP seems to allow banks to engage in securities activities as banking business but not clear if full range or less than full range of these activities can be conducted directly in banks or in subsidiaries, or in another part of common holding or parent company. However, banks are prohibited, under NBE Directive, from dealing in securities save to the exception allowing them to deal with NBE, FG and, securities fully and unconditionally backed by FG, and provide brokerage services to its customers acting as their agent.⁴⁰¹ The writer argues that banks need to be allowed to engage in full range in securities as primary dealers like other banking activities as per the BBP and other frameworks inevitable for securities regulation.

Banks are not allowed to engage in insurance activities either in full or less than full range of activities directly or through subsidiaries, or in another part of a common holding or parent company except holding equity shares not exceeding 5% of a single insurance company's subscribed capital.⁴⁰² Banks are also prohibited from engaging in non-banking business save to interest free banking services, hold equity interest in financial infrastructures and hold up to 10% equity shares in single non-banking business other than insurance.⁴⁰³

³⁹⁸ Id., art.5(5.1- 5.3), see also Supra note 129

³⁹⁹ Supra note 4, art.2 (2) , see supra note 1, art. 2(2) and Supra notes 18, 131 and 338

⁴⁰⁰ Supra note 194, see also Supra notes 18, 131 and 338

⁴⁰¹ Id., art. 4.8 and 6.3, see also Supra notes 18, 131 and 338

⁴⁰² Id., art.4.1, see also Supra notes 18, 131 and 338

⁴⁰³ Id., art.4.3 and 4.4, see also Supra notes 18, 131 and 338

Financial infrastructures are set of institutions or system enabling effective operation of financial intermediaries including payment and settlement systems, credit information bureaus, collateral registers and other financial service systems determined by NBE.⁴⁰⁴ Banks may invest up to 10% of their net worth in real estate acquisition and development business, except for its own business premise, up on NBE's approval.⁴⁰⁵ However, a bank's aggregate equity investment in all non-banking businesses including insurance companies may not exceed 10% of its net worth.⁴⁰⁶ Furthermore, banks may have equity participation in any FI other than insurance companies not exceeding 5% of single FI's subscribed capital at subject to prior approval of the NBE.⁴⁰⁷

3.5 External Auditing Requirements

Banks appoint a professional and independent external auditor subject to NBE's approval as every company limited by shares is required to elect one or more auditors and one or more assistant auditors through general meeting.⁴⁰⁸ Banks' external auditor has to obtain professional certification or pass specific exam to qualify as such; register with an appropriate public and/or professional body; have minimum required bank auditing experience; and its qualification approved or reviewed by NBE on the basis of pre-defined list of approved auditors or by providing written approval.⁴⁰⁹ When banks fail to appoint external auditor, NBE may appoint it though practically banks appoint almost in cooperation with NBE.⁴¹⁰ A person is not qualified for appointment as an external auditor of bank if he is a shareholder, founder, contributor in kind, beneficiary holding special benefits, bank's director or one of its subsidiaries or HC, its employee receiving salary or periodical remuneration in connection with duties other than auditing from it or is firm of auditors of which any partner or staff member falls within these categories of persons.⁴¹¹ NBE screens out qualification of such persons before approval and, during on-site examination and of-site surveillance throughout their term.⁴¹²

⁴⁰⁴ Id., art. 2.4, see also Supra notes 18, 131 and 338

⁴⁰⁵ Id., art.4.7, see also Supra notes 18, 131 and 338

⁴⁰⁶ Id., art.4.6, see also Supra notes 18, 131 and 338

⁴⁰⁷ Id., art.4.9, see also Supra notes 18, 131 and 338

⁴⁰⁸ COMM.C.,1960, art.368, proc.no.166, year 19, no.3, see also supra note 14, art.24, and Supra notes 18, 131 and 338

⁴⁰⁹ Supra note 338

⁴¹⁰ Supra note 4, art.24(4), see also Supra notes 18, 131 and 338

⁴¹¹ Supra note 4, art.24(2), see also Supra note 408, art.370(1) and Supra notes 18, 131 and 338

⁴¹² Supra notes 18, 131 and 338

NBE issued directive on the minimum professional experience and knowledge of banks' external auditors.⁴¹³ Banks confirm that their auditor is properly assessed prior to appointment and declare, in their view, that the auditor complies with all legal requirements backed by auditors' declaration stating that it is qualified; itself and its partners or associates do not operate an account or have not been granted any type of facilities in the bank except in normal course of business and at an arm's length; they do not represent directly or indirectly interest of shareholders or directors of the bank in any business venture; and its partners do not have any business association with those shareholders or directors.⁴¹⁴ Once approved by NBE, if the bank removes such auditor for whatever reason, reasons for such removal is immediately submitted to NBE by the concerned bank.⁴¹⁵

Auditors elected by meeting of subscribers hold office until first annual general meeting and those elected by annual general meeting hold office for three years.⁴¹⁶ However, NBE determines tenure of external auditors appointed to perform audits of banks by directive and in this absence auditor holds office until next annual general meeting of bank shareholders and if it terminates service before term of office, the bank forthwith notify such fact to NBE.⁴¹⁷ But, banking laws fail to stipulate mandatory rotation requirements i.e. limits on the number of consecutive years audited and possibility of reelection) in place for lead auditor (engagement/concurring partner) and the auditing firm itself.⁴¹⁸ External auditor is required to report its audit findings and conclusions to bank shareholders and NBE, and not to operate an account with, or be granted any type of loan, advance or facility from, that bank except in normal course of business and at an arm's length basis.⁴¹⁹ NBE is authorized to determine depth and coverage of audit to be performed by external auditors by directive and it continuously performs during supervision.⁴²⁰ Auditors conduct their audits in accordance with IAS⁴²¹ No auditor is appointed as director or manager of a bank, which they audit, and its subsidiaries or its HC within three years from date of services termination.⁴²²

⁴¹³ Supra note 4, art.24(3), see also Supra notes 18, 131 and 338

⁴¹⁴ Approval of appointment of an independent auditor for banks Directive, 1996, art. 3.2, Directive No. SBB 19, see also Supra notes 18, 131 and 338

⁴¹⁵ Id., art.3.5, see also Supra notes 18, 131 and 338

⁴¹⁶ Supra note 408, art. 369(1-2), see also Supra notes 18, 131 and 338

⁴¹⁷ Supra note 4, art. 24(1-3), see also Supra notes 18, 131 and 338

⁴¹⁸ Supra notes 18, 131 and 338

⁴¹⁹ Id., art.26(1 and 3), see also Supra notes 18, 131 and 338

⁴²⁰ Id., art.26(2), see also Supra notes 18, 131 and 338

⁴²¹ Id., art.26(1), see also Supra notes 18, 131 and 338

⁴²² Supra note 408, art.370(2), see also Supra notes 18, 131 and 338

Auditors submit to NBE complete audit report including audit findings and recommendations, within time limit set by law, and if the report is not satisfactory, NBE orders second audit or require prompt appointment of new auditor who makes an independent audit.⁴²³ However, in cases where NBE identifies that the bank has received inadequate audit, it takes actions against the bank and its external auditor, and the external auditor is subjected to independent oversight by NBE.⁴²⁴ Audit reports on FS of banks are publicly disclosed together with these FS.⁴²⁵ Bank supervisors receive complete audit report, including audit findings and recommendations on the FS, auditor's letter to bank management and other communications made with a bank's audit committee.⁴²⁶ Auditors are strictly required to immediately report matters to NBE and other concerned bodies when they intend to issue qualified opinions on accounts of a bank they are auditing; and in course of performance of auditing duties, when it finds out: a serious breach of, or non-compliance with, provisions of banking /other laws ; criminal offence involving fraud or other dishonesty has been committed by the bank or any of its directors or employees; losses have been occurred which reduce total capital of a bank by 25% or more; serious irregularities occurred jeopardizing a bank's ability to continue conducting its business or security of its depositors or creditors; or any other grave irregularities or offences occurred.⁴²⁷

NBE calls at any time banks' external auditors to discuss issues related to a bank being audited.⁴²⁸ Generally, auditors directly communicate with NBE on any presumed involvement of MBoDs or senior managers in illicit activities, fraud, or insider abuse and to promptly inform NBE when they identify other information that could affect safety and soundness of a bank.⁴²⁹ Auditors also inform BoDs of irregularities or breaches of legal or statutory requirements and, where the irregularities or breaches are grave they also inform the general meeting and to public prosecutor of any matters which would appear to disclose the commission of an offence.⁴³⁰

⁴²³ Supra note 4, art. 27(2 and 3), see also Supra notes 18, 131 and 338

⁴²⁴ Supra notes 18, 131 and 338

⁴²⁵ Supra notes 18, 131 and 338

⁴²⁶ Supra notes 18, 131 and 338

⁴²⁷ Supra note 4, art.27(4(a-e)), see also Supra notes 18, 131 and 338

⁴²⁸ Id., art.27(5), see also Supra notes 18, 131 and 338

⁴²⁹ Supra notes 18, 131 and 338

⁴³⁰ Supra note 408, art.376 (1-2)

⁴³¹ Supra notes 18, 131 and 338

NBE does not delegate any of its supervisory tasks to external auditors save to accepted audit findings by NBE to avoid reduplication of efforts.⁴³¹ There were two banks audited by one external auditor from among the top ten banks in Ethiopia where NBE examined their auditing functions through oversight, direct communication with and prompt report concerning matters that affect banks' safety and soundness.⁴³²

3.6 Bank Governance

NBE issued directive concerning BoDs': qualification and competency; minimum number; duties, responsibilities and good CG; maximum number of service years and conditions for re-election; maximum remuneration; and maximum number of employees who may serve as members.⁴³³ But, there is no legal and institutional framework, practical requirement set for the structure of remuneration packages of senior management and disclosure requirements thereto.⁴³⁴

There is scattered and non-comprehensive bank governance framework for banks including CG directive that explicitly addresses some areas in governance of banks.⁴³⁵ Establishment and requirements of board nomination committee, various board sub-committees including audit committee, risk and compliance committee and HRM committees are covered.⁴³⁶ Persons with significant influence fulfill fit and proper criteria and their appointment or shareholding is subject to NBE's approval.⁴³⁷ Only shareholders are governing banks where no framework is set for independent BoDs and their participation in various committees.⁴³⁸ However, the need for independent supervisory board is being considered under amendment process of Comm.C.by which every bank will be required, at least, to have one independent supervisory board member.⁴³⁹ Currently corporate bodies are serving as directors, but only physical persons serve as chairperson of BoDs.⁴⁴⁰ CEO of a bank is employee of the bank and may not be MBoDs.⁴⁴¹

⁴³² Supra notes 18, 131 and 338

⁴³³ Supra note 4, art. 14(4(a-f)), see also Supra notes 18, 131 and 338

⁴³⁴ Supra notes 18, 131 and 338

⁴³⁵ Supra notes 18, 131 and 338

⁴³⁶ Bank CG Directive, 2015, Art.10.4.10 and art.6.1.4, Directive No. SBB 62, Supra notes 18, 131 and 338

⁴³⁷ supra note 373, art.4, see also Supra notes 18, 131 and 338

⁴³⁸ Supra note 408, art.347(1), see also Supra notes 18, 131 and 338

⁴³⁹ Supra notes 18, 131 and 338

⁴⁴⁰ Supra note 408, art.347(4), see also Supra notes 18, 131 and 338

⁴⁴¹ Id., art.348(4), see also Supra notes 18, 131 and 338

NBE issued directive to govern credit exposure to single and related counter parties to insure that banks have sufficiently diversified their credit risks to minimize losses due to failure of single or related counter party to repay loans.⁴⁴² Related party to a bank refers to shareholder, director, CEO, or senior officer of that bank and/or their spouse or relative to first degree of consanguinity or affinity or partnership, common enterprise, private limited company, Share Company, joint venture, corporation, or any other business in which these persons have business interest in either of these positions.⁴⁴³ CG directive lists related parties in a similar way but business interest exists when either of the persons owns 10% or more interest as shareholder or serves as director, CEO, or SEO.⁴⁴⁴ Thus, regulatory definitions of related parties include significant/controlling shareholders, board directors, CEO, or senior officer of bank, their respective relatives including spouses, and their business interests and relatives.⁴⁴⁵ Regulatory exposure limit, as percentage of a bank's regulatory capital, on related party exposures and aggregate sum of loans or advances extended or permitted to be outstanding, directly or indirectly to one related party or all related parties that, at any one time, may not exceed 15% and 35% of the total capital of the bank respectively.⁴⁴⁶

For the purpose of asset classification and governance, bank means, excluding government owned banks, a bank licensed by NBE and engaged mainly in deposit mobilization, short term commercial lending and international banking by excluding institutions established mainly to engage in medium and long term project financing to promote development in industrial, agricultural, construction, services, commercial or other economic sectors.⁴⁴⁷ Consequently, bank governance rules and requirements are not currently applicable to banks not licensed by NBE and banks established for a specific purpose. However, the writer believes that rules and requirements on bank governance must apply uniformly to all banks regardless of scope of their business including state banks. NBE exercises approval authority with respect to appointment of any director, CEO or SEO of a bank during licensing or at any other time and such appointment is not valid without NBE's written approval.⁴⁴⁸

⁴⁴² credit exposures to single and counter parties Directive, 2012, art.2, Directive No. SBB 53

⁴⁴³ Id., art.3.7

⁴⁴⁴ Supra note 436, art.2.11.1 and art.2.11.2, see also Supra notes 18, 131 and 338

⁴⁴⁵ Ibid.

⁴⁴⁶ Supra note 442, art.6.2 and 6.3, see also Supra notes 18, 131 and 338

⁴⁴⁷ Supra note 442, art.3.4. But, see the definition of the term 'bank' under arts.2 (3) and 2(1) of the NBEEP (as amended) and BBP proclamations. The writer agrees with these definitions and believes that the directive should comply with these parent laws and the NBE shall extend its governance to government owned Banks in addition to those licensed by it in a similar way.

⁴⁴⁸ supra note 4, art.14(2), see also Supra notes 18, 131 and 338

A person who served as director, CEO or SEO or otherwise directly or indirectly participated in management of any bank, wound up anywhere, may act as director, CEO or SEO or otherwise be directly or indirectly participate in management of a bank only after prior approval of NBE.⁴⁴⁹ A person who has been convicted of any offence involving breach of trust or fraud, anywhere, may not be bank's director or employee; director or CEO of FI may not, at same time, serve as MBoDs; business entity in which a bank's director or CEO has 10% or more equity interest may not serve as MBoDs; and no bank employee serves as chairperson of MBoDs of that bank or director of any other bank.⁴⁵⁰

But, NBE prohibits bank employees, permanent or temporary, from sitting on board of any bank.⁴⁵¹ Director or CEO or SEO or other person who participates, directly or indirectly, in a bank's management ceases his service therein when: he or the bank has instituted bankruptcy proceedings or declared bankrupt; or his or the bank's assets have been sequestrated because of bankruptcy or foreclosed by a bank because of failure to repay loan granted by the bank; or he is convicted of default on repayments of bank or other credits or tax payment; or he or the bank carries non-performing loans from any bank; or he fails to fulfill any qualification of competency requirement set by NBE.⁴⁵² NBE suspends or removes director, CEO or SEO of a bank when it believes that there is sufficient cause.⁴⁵³ Failure to comply with prohibitions and cessation of services as director, CEO or SEO or in any managerial position of a bank on one's own initiative; and an action of that person went detrimental, in NBE's opinion, to stability or soundness of the financial sector, economy or public interest suffices sufficient reason for removal or suspension.⁴⁵⁴

Where the number of directors fall below the minimum prescribed by law due to action of removal by NBE, it immediately assumes powers of BoDs and, within 30 days, calls meeting of shareholders for directors to be elected to replace them.⁴⁵⁵ But, where CEO or SEO of a bank

⁴⁴⁹ Id., art.15(2), see also Supra notes 18, 131 and 338

⁴⁵⁰ Id., art.15(1,3 and 4), see also Supra notes 18, 131 and 338

⁴⁵¹ Limits on board remuneration and no. of employees who sit on a bank's board Directive, 2016, art.5, directive No. SBB 63, see also Supra notes 18, 131 and 338. But the writer agrees that this prohibitive provision contravenes with the prohibition of a staff from being chairperson of the BoDs of the bank employed in under the BBP, and prohibiting that employee, going out of scope of prohibition under its parent law, from being member of BoDs of his bank is not lawful.

⁴⁵² Id., art.16(1-4), see also Supra notes 18, 131 and 338

⁴⁵³ Id., art.17(1), see also Supra notes 18, 131 and 338

⁴⁵⁴ Id., art.17(2(a and b)), see also Supra notes 18, 131 and 338

⁴⁵⁵ Id., art.17(3), see also Supra notes 18, 131 and 338

is removed by NBE in similar manner, BoDs of that bank fills vacant post immediately with person who fulfills required competency criteria.⁴⁵⁶ NBE takes regulatory action when it considers that remuneration or compensation is excessive and limits maximum remuneration of directors.⁴⁵⁷ However, there is no framework setting limit on and used to evaluate remuneration or compensation of managers, officers and staffs as part of supervisory process to ensure that banks are not leading to excessive risk-taking.⁴⁵⁸ Board remuneration includes board compensation (i.e. any payment other than allowance payable, in cash or other, to director from a bank's net worth), and allowance (i.e. amount of money payable in kind or in cash from any account of a bank to a director to cover incidental costs related to their board membership) paid to each MBoDs.⁴⁵⁹ Accordingly, MBoDs may earn up to maximum of Ethiopian Birr 100,000 annual board compensation and 4000 monthly board allowances, and no other payment, in any mode, may be made.⁴⁶⁰

3.7 Liquidity & Diversification Requirements

3.7.1 Risk Concentrations

There is regulatory exposure limit, as percentage of a bank's regulatory capital, on related, single unrelated party, exposures and aggregate sum of loans or advances extended or permitted to be outstanding, directly or indirectly to one related party or all related parties at any one time, or any one person not related to the bank at no time, may not exceed 15%, 35% and 25% of the bank's total capital respectively.⁴⁶¹ Banks are also limited from extending loans to related parties on preferential terms with respect to conditions, interest rates and repayment periods other than terms and conditions normally applied to other borrowers; and NBE prohibits banks from extending any loan or advance to any person on sufficient ground.⁴⁶²

⁴⁵⁶ Id., art.17(4), see also Supra notes 18, 131 and 338

⁴⁵⁷ Id., art.14 (4(e)), note that the writer argues that the NBE needs to be authorized even to limit the remuneration of senior managers and other employees of a bank and evaluate its reasonability as part of its supervisory process in a similar way. But, also note that the NBE's authority needs to be limited to the extent that the remuneration is going to be excessive in line with the business process in the banking business and ensuring that it may lead the bank to excessive risk-taking.

⁴⁵⁸ Supra notes 18, 131 and 338

⁴⁵⁹ Supra note 442, art.2(2.2, 2.3 and 2.6), see also Supra notes 18, 131 and 338

⁴⁶⁰ Id., art.4(1, 2 and 3), see also Supra notes 18, 131 and 338

⁴⁶¹ Supra note 442, art.6.1- 6.3, see also Supra notes 18, 131 and 338

⁴⁶² Id., art.6.4 and 6.5, see also Supra notes 18, 131 and 338

Loans fully secured by cash collateral i.e.(credit balances on accounts in books of lending bank over which customers have given it formal letter of cession and the bank at its discretion has transferred from the customer's accounts to specific or general cash collateral account(s) or blocked it); and loans fully secured by cash substitutes (i.e. security issued by FGE; unconditional obligation or guaranty issued in writing by FGE or domestic FI, where the beneficiary bank maintains current written and well documented evaluation evidencing that the FI is financially sound and capable of honoring the guaranty on demand with respect to repayment of both principal and interest, or specific amount, and the lending bank has not been advised of any determination by the guarantor to deny payment under terms of the obligation; and unconditional obligation or guaranty issued in writing by foreign bank with an "A" or above rating by standard and poor's corporation, Moody's investor services, or any other international rating agency acceptable to NBE in their latest rating) are exempted from exposure limit set under this law.⁴⁶³

With regard to asset diversification, loan, advance or extension of any credit to one or more borrowers in categories of: (1) corporation, share company, public enterprise or any business entity and its majority owned subsidiaries (i.e. subsidiary controlled by business entity holding over 50% of its capital); (2) one or more private limited companies and individuals who fully own or are majority owners of such company, and/or their spouses and/or relatives in the first degree of consanguinity or affinity, businesses which have majority ownership in such companies; (3) partnership or joint venture and its general or limited liability partners or participants in the venture; and (4) common enterprise and the participants there in who borrow for that enterprise must be combined and subjected to limit to one borrower.⁴⁶⁴ But, NBE lacks regulatory frameworks or supervisory guidelines regarding asset diversification and on whether banks can advance loans abroad.⁴⁶⁵

3.7.2 Regulatory Liquidity Requirements

There are rules and requirements concerning banks' liquidity management of Forex, central bank reserve and/or deposit requirements, regulatory minimum ratio on liquid assets (e.g. as

⁴⁶³ Id., art.3.1, 3.2 and 7, see also Supra notes 18, 131 and 338

⁴⁶⁴ Id., art.3.5, 5.2 and 5.2(a-c), 5.3-5.5, see also Supra notes 18, 131 and 338

⁴⁶⁵ Supra notes 18, 131 and 338

percentage of total balance sheet or deposit base) and maturity mismatches.⁴⁶⁶ Banks maintain adequate liquid assets, cash reserve balance with NBE and transfer to their legal reserve account sum of not less than 25% of their net profit at the end of each financial year.⁴⁶⁷ When a bank's legal reserve account equals its capital, amount to be transferred to legal reserve account is 10% of its annual net profit.⁴⁶⁸

Banks have developed their own liquidity management policies, at minimum, covering: MIS; stress testing/scenario analysis; maturity gap analysis; cash flow projections; diversification of funding sources; limits on net cumulative funding mismatch; internal controls; contingency fund planning including stress testing; and major currencies.⁴⁶⁹ They also have established Asset and Liability Management Committee (ALCO) to manage their assets, liabilities and off-balance sheet items to fully meet a bank's contractual commitments.⁴⁷⁰ Banks maintain liquid assets not less than 15% of their net current liabilities i.e. minimum regulatory liquidity requirement, and they grant no new or additional loan or credit accommodation to any person without NBE's prior written approval during shortage of this liquid asset.⁴⁷¹ Bank liquid assets include, when accepted by NBE, cash deposits with NBE, and other local and foreign banks; other assets readily convertible into cash expressed and payable in Birr or Forex; deposits held in and securities issued by Organization for Economic Cooperation and Development (OECD) member countries' currencies or in other currencies approved by NBE and payable by their banks; and other assets declared to be liquid by NBE.⁴⁷² Banks hold reserves in Forex or other Forex-denominated instruments (i.e. retention of 15% of their Forex) in order to fulfill their liquidity requirements.⁴⁷³

⁴⁶⁶ Supra note 168, see also Supra notes 18, 131 and 338

⁴⁶⁷ supra note 4, art.20(1 and 3) and 19(1), see also Supra notes 18, 131 and 338

⁴⁶⁸ Legal Reserve Directive, 1995, art.2.2, Directive No. SBB 4, see also Supra notes 18, 131 and 338

⁴⁶⁹ Id., art.4.2, see also Supra notes 18, 131 and 338

⁴⁷⁰ Id., art.4.1, see also Supra notes 18, 131 and 338

⁴⁷¹ Id., art.4.3 and 5, see also Supra notes 18, 131 and 338

⁴⁷² supra note 4, art.20(2(a-d)), see also Supra notes 18, 131 and 338

⁴⁷³ Supra notes 18, 131 and 338

3.8 Asset Classification, Provisioning and Write-offs

3.8.1 Asset Classification

Five categories of banks' asset classifications are pass, special mention, substandard, doubtful and loss.⁴⁷⁴ Banks mainly engaged in medium and long term project finance business, with purpose of promoting development in industrial, agricultural, construction, services, commercial or other economic sectors are covered by this framework.⁴⁷⁵ Medium and long term loans are loans with original repayment/maturity period of 2 years or more and all loans with less than 2 years repayment period are short term loans.⁴⁷⁶ Loans held by a bank are accounted and categorized as per these classification requirements and in recording loans or advances not subjected to such requirements i.e. short term loans require written request from a bank to NBE for confirmation of proper application of these requirements.⁴⁷⁷ With respect to their medium and long term loans and advances; and upon special confirmation for short term loans and advances made to borrower including government, banks comply with this framework and NBE accordingly makes on-site examination and off-site surveillance.⁴⁷⁸ Specific borrowers like government and/or state-owned enterprises are not especially classified at or above certain category though it is true that governments and government guaranteed enterprises are presumed as accrued borrowers.⁴⁷⁹ All non-performing, except well secured, loans are placed on non-accrual status, and well secured loans are loans secured by cash collateral or cash substitutes sufficient, including proper documentation evidencing a bank's claim on the collateral, to repay full (principal plus accrued interest) debt.⁴⁸⁰

Loan under 'pass' category is not subjected to any criticism because they are fully protected by current financial and paying capacity of borrower.⁴⁸¹ However, short and, medium and long

⁴⁷⁴ Asset Classification and Provisioning for Development Institutions Directive, 2012, art.7, Directive No. SBB 52, see also Supra notes 18, 131 and 338

⁴⁷⁵ Id., art.4.4, see also Supra notes 18, 131 and 338

⁴⁷⁶ Id., art.4.6 and 4.14, see also Supra notes 18, 131 and 338. Note that the writer uses the word 'bank' instead of 'development finance institution' used under this directive to refer 'Banks' being involved in medium and long-term financing as a development finance institution.

⁴⁷⁷ Id., art.13, see also Supra notes 18, 131 and 338

⁴⁷⁸ Supra notes 18, 131 and 338

⁴⁷⁹ Supra notes 18, 131 and 338

⁴⁸⁰ Supra note 474 art.6.1 and 4.17, see also Supra notes 18, 131 and 338. Please see to the definition for cash collateral or substitute under this note. But, the definition under this NBE directive includes other liquid and readily marketable securities approved in writing by NBE and held in the vaults of development FI in addition to the elements given under the above-mentioned note (Supra note 474 art.4.3.4).

⁴⁸¹ Id., art.7.1.1, see also Supra notes 18, 131 and 338

term loans respectively past due for less than 30 and 180 days, and any loan, or portion thereof fully secured, principal and interest, by cash or cash substitutes, regardless of past due status or other adverse credit factors may be classified under this category.⁴⁸² Whereas short and, medium and long-term loans respectively past due 30 days or more but less than 90 days, and 6 months or more, but less than 12 months are, at minimum, classified under ‘special mention’ category of loans.⁴⁸³ Short and, medium and long-term loans respectively past due 90 days or more, but less than 180 days, and 12 months or more, but less than 18 months are, at minimum, classified under ‘substandard’ category of loans.⁴⁸⁴

Renegotiated non-performing loans are also categorized as ‘substandard’, unless equivalent of all past due interest is paid by the borrower in cash during renegotiation, where, in case of loans with monthly or quarterly installment repayments, at least, 3 consecutive repayment; in case of loans with semi-annual installment repayment, at least, 2 consecutive repayments; and in case of loans with annual installment repayments, at least, 1 repayment, are made by such borrower consistently and timely in accordance with restructured terms of loan.⁴⁸⁵ Banks upgrade classification of loan or advance immediately once restructured.⁴⁸⁶ When a bank has multiple outstanding loans to single borrower and one loan or advance meets criteria for non-performing and non-accrual status, the bank prepares a current written evaluation of borrower’s credit worthiness evidencing that repayment prospects for other loans are reasonably assured, and if repayment prospects for other loans are questionable or uncertain, all such loans are, at minimum, classified as ‘substandard’ and placed in non-accrual status regardless of asset classification requirements set by NBE.⁴⁸⁷ ‘Doubtful’ category of loans is comprised of short and, medium and long term loans respectively past due 180 days or more, but less than 360 days, and 18 months or more, but less than 3 years.⁴⁸⁸

‘Loss’ category of loans is comprised of short and, medium and long-term loans respectively past due 360 days or more, and 3 years or more.⁴⁸⁹ Bank may not reschedule, restructure or renegotiate short term loan to a borrower for more than 3 times, and before it collects in cash

⁴⁸² Id., art.7.1.1(a-c), see also Supra notes 18, 131 and 338

⁴⁸³ Id., art.7.1.2(a and b), see also Supra notes 18, 131 and 338

⁴⁸⁴ Id., art.7.1.3(a and b), see also Supra notes 18, 131 and 338

⁴⁸⁵ Id., art.7.1.6(a - c), see also Supra notes 18, 131 and 338

⁴⁸⁶ Supra notes 18, 131 and 338

⁴⁸⁷ Supra note 474 art.7.1.7 and 6.5, see also Supra notes 18, 131 and 338

⁴⁸⁸ Id., art.7.1.4(a and b), see also Supra notes 18, 131 and 338

⁴⁸⁹ Id., art.7.1.5(a and b), see also Supra notes 18, 131 and 338

full amount of interest in arrears, and minimum of 25% or 50% of outstanding principal if respectively made for second and third time.⁴⁹⁰ NBE subjects loans to more severe classifications if there is: (1) significant departure from primary source of repayment; (2) repayment terms which are too liberal or inconsistent with purpose and nature of the loan or advance and/or collateral held; (3) delinquencies which have been technically cured by modifying repayment terms, refinancing or renewing the loan or advancing additional funds for the purpose of meeting repayment requirements on existing loan or advance.⁴⁹¹

Criteria taken into account to classify loans and advances as 'non-performing' include: significant financial difficulty of borrower and deterioration in its creditworthiness, breach of contract (e.g. default or delinquency in interest or principal payments), restructuring (i.e. concession granted, for economic or legal reasons relating to borrower's financial difficulty, that lender can't otherwise consider), borrower bankruptcy or other financial reorganization, days past due status and existence of collateral, guarantees and/or other credit securities.⁴⁹² 'Non-performing' loans are loans whose credit quality has been deteriorated to put the full collection of principal and/or interest of such loan or advance, as per the contractual repayment terms, in question.⁴⁹³ Short term loans, and medium and long term loans whose principal and/or interest is due and uncollected, respectively, for 90 consecutive days or more, and for 12 consecutive months or more beyond scheduled payment date or maturity; and entire principal balance of loans outstanding exhibiting such situation are considered as 'non-performing' loans.⁴⁹⁴ Accrued but uncollected interest on loans is properly accounted for and interest/principal entered in bank's income statement, though unpaid, while the loan is classified as non-performing.⁴⁹⁵

3.8.2 Provisioning of Classified Loans

Banks timely and adequately provision to 'provisions for loan losses account' as means to ensure disclosed capital and earnings performance are accurately stated.⁴⁹⁶ Banks maintain minimum provision percentages of 1%, 3%, 20%, 65% and 100% respectively against outstanding principal amount of (short, medium and long term) loans or advances classified as pass, special mention, substandard, doubtful and loss.⁴⁹⁷

⁴⁹⁰ Id., art.7.1.8 and 7.1.9(a and b), see also Supra notes 18, 131 and 338

⁴⁹¹ Id., art.7.2, see also Supra notes 18, 131 and 338

⁴⁹² Supra notes 18, 131 and 338

⁴⁹³ Supra note 474 art.4.9, see also Supra notes 18, 131 and 338

⁴⁹⁴ Id., art.4.10(4.10.1- 4.10.3), see also Supra notes 18, 131 and 338

⁴⁹⁵ Id., art.3.3, see also Supra notes 18, 131 and 338

⁴⁹⁶ Id., art.3.4, see also Supra notes 18, 131 and 338

These minimum provision percentages are applicable against total outstanding principal balance, not against amount of past due payments, for each loan or advance or portion thereof, classified regardless of whether the loan or advance is analyzed and provided for individually or as part of group.⁴⁹⁸ When reliable information on historical loan loss experience, current economic conditions, delinquency trends, ineffectiveness of lending policies and/or collection procedures, or lack of timeliness and accuracy in loan review function suggests that losses are likely to be more than these minimum provision percentages, NBE instructs banks to maintain larger provisions.⁴⁹⁹

Before applying these provisions, bank is allowed to deduct any accrued but uncollected interest held in suspended interest account by debiting such account, and, where loans are secured by physical collateral net recoverable value and if such value to be deducted does not exceed 97% of outstanding non-performing loan, or estimated collateral value backing the 'non-performing' loan, whichever is lower from outstanding non-performing loans.⁵⁰⁰

3.9 Accounting/Information Disclosure

At end of each financial year, a bank's BoDs prepare detailed inventory and valuation of assets and liabilities; draw up balance sheet, along with return of liabilities which do not appear in balance sheet, such as guarantees, and profit and loss account, and prepare report on state of a company's activities and affairs during last financial year.⁵⁰¹ Such report gives detailed information on profit and loss account, exact statement of total amount of remuneration of directors and auditors, and proposals for distribution of dividends.⁵⁰² Inventory, balance sheet, profit and loss account and BoDs' report is submitted to auditors and NBE not less than 40 days before notices calling annual general meeting are dispatched.⁵⁰³

Every bank keeps exhibits, at every place of its business, including its branches and sub-branches, in conspicuous place throughout the year; copy of last audited statement of financial position covering, at minimum, balance sheet, profit and loss account, comprehensive income

⁴⁹⁷ Id., ar.8.3, see also Supra notes 18, 131 and 338

⁴⁹⁸ Id., ar.8.5, see also Supra notes 18, 131 and 338

⁴⁹⁹ Id., ar.8.4, see also Supra notes 18, 131 and 338

⁵⁰⁰ Id., art. 8.6(8.6.1 and 8.6.2), see also Supra notes 18, 131 and 338

⁵⁰¹ Supra note 408, art.446(1 and 2) and 449

⁵⁰² Id., art.446(3)

⁵⁰³ Id., art.447

and expense report and cash flow analysis in respect of all of its operations and, in respect of all of its operations; and cause such balance sheet position, and profit and loss account, statement of comprehensive income, and expense accounts together with auditors' report and notes thereto, to be published in newspaper of wide circulation within two weeks after annual shareholders' meeting.⁵⁰⁴ Every bank sends to NBE duly signed FS and other reports prescribed by and within time period determined by NBE.⁵⁰⁵ Reports are subjected for review and possible changes by NBE before publication.⁵⁰⁶ Balance sheet and, profit and loss account, showing separate heads of losses or profits arising out of company's various activities, is prepared, each year, in same form as in preceding years and methods of valuation remain same, unless general meeting adopts variations in mode of presentation of accounts or methods of valuation on reasoned advice of auditors.⁵⁰⁷

Banks submit any related party loan/Forex transactions, as defined by their BoDs, to NBE within 15 working days from date of transaction specifying name, type and amount of transaction involved, and report status of such transactions, at least, once a month, after the board certifies that they are carried out at an arm's length in compliance with all regulatory requirements, banks' own policies and procedures.⁵⁰⁸ MBoDs or employee who obstructs proper performance of auditors' duties or inspection of a bank by inspector authorized by NBE; with intent to deceive, makes any false or misleading statement or entry or omits any statement or entry in any book, account, report or statement of bank; or knows or ought to have known insolvency of a bank and receives or authorizes acceptance of deposit is civilly and criminally liable.⁵⁰⁹ Approval of balance sheet by meeting of shareholders may not affect liability of directors, auditors or general managers in respect of their management. Further, provided that a bank fails to comply with banking laws or with terms and conditions of license or has engaged in practices detrimental to interests of depositors or has serious weaknesses in its CG, NBE orders dismissal or suspension of one or more MBoDs, CEO or SEOs of a bank, or impose fines on such persons.⁵¹⁰

⁵⁰⁴ supra note 4, art.28(2(a and b) and 28(3), see also art. 12.2.4, 12.2.5 and 12.2.6 under Supra note 442 and note that NBE directive seems to amend the 2 weeks time for publication to a month which reflects that some provisions under NBE directive supersedes provisions under their parent law. But, the writer argues that such provision has no effect and construed as an extension to the period mentioned under the proclamation

⁵⁰⁵ Id., art.28(1), see also Supra notes 18, 131 and 338

⁵⁰⁶ Supra notes 18, 131 and 338

⁵⁰⁷ Supra note 408, art.448(1 and 2), see also Supra notes 18, 131 and 338

⁵⁰⁸ Supra note 442, art.12.2.1 and 12.2.2, see also Supra notes 18, 131 and 338

⁵⁰⁹ supra note 4, art.58(6(a-c)), see also Supra notes 18, 131 and 338

⁵¹⁰ Id., art.31(4), see also Supra notes 18, 131 and 338

NBE also instructs, in writing, banks to take corrective measures on such persons.⁵¹¹ Dealings between, directly or indirectly, between a bank and MBoDs require prior approval of BoDs of such bank and notice must be given to the auditors and, if not approved, he is liable for damages arising from fraud and if he fails to meet his liability the BoDs is liable for that dealing.⁵¹² Auditors are similarly, civilly and criminally, liable to the bank and third parties for any fault in exercise of their duty which occasioned loss; and knowingly gives or confirms false report concerning position of the bank or fails to inform public prosecutor of an offence he knows to have been committed.⁵¹³

3.10 NBE's Enforcement Powers

Enforcement powers vested at NBE include: cease and desist-type orders for imprudent bank practices; forbearance (i.e. to waive regulatory and supervisory requirements); instruct banks to meet supervisory requirements (e.g. capital, liquidity etc.) that are stricter than legal or regulatory minimum; require banks to enhance governance, internal controls and RM systems; require banks to apply specific provisioning and/or write-off policies; require banks to constitute provisions to cover actual or potential losses and restrict or place conditions on types of business conducted by a bank; withdraw a bank's license; require banks to reduce/restructure their operations (e.g. via asset sales and branch closures) and adjust their risk profile; require banks to reduce or suspend dividends to shareholders; require banks to reduce or suspend bonuses and other remuneration to MBoDs and managers; suspend or remove MBoDs or managers; and require commitment/action from controlling shareholder(s) to support a bank with new equity (e.g. capital restoration plan).⁵¹⁴

There was a case where NBE had conducted off-site surveillance on BIB by investigating its MaAA, minutes of general meeting along with FS and it has realized that BIB's founders were entitled to an agreed amount from BIB's net profit to the extent and time allowed under the Comm.C.⁵¹⁵ The MaAA is found that it makes discrimination among the founders recognized

⁵¹¹ Id., art.31(3), see also Supra notes 18, 131 and 338

⁵¹² Supra note 408, art.356(1 and 5), see also Supra notes 18, 131 and 338

⁵¹³ Id., art.380(1 and 2), see also Supra notes 18, 131 and 338

⁵¹⁴ Supra notes 18, 131 and 338

⁵¹⁵ Supra notes 18, 131 and 338

by the Comm.C by introducing two categories of founders i.e. organizing and ordinary founders.⁵¹⁶

BIB has accordingly paid a net profit of 10% and 6% respectively for these founders for the past two years.⁵¹⁷ NBE had approved BIB's MaAA, minutes of general meeting along with FS and no similar objection was raised in these two years.⁵¹⁸ But, at the third and final year of payment to the founders, NBE objected that the MaAA, the minutes of general meeting along with FS which are against the provisions of the Comm.C. where no discrimination among founders is made and no recognition of organizers apart from the ordinary founders.⁵¹⁹ This shows that the influence of such persons in lobbying the rest of the shareholders to allocate their own interest to them and NBE is responsible to correct such abusive actions and discrimination.⁵²⁰ NBE further argued that such persons have used much money on the guise of subscription fee to transfer their liabilities and duties to third parties during formation which is not legally allowed.⁵²¹ Consequently, there was no special obligation left for them unlike to the other founders and they may not be entitled to special payment unlike the ordinary founders.⁵²²

NBE's suspension of this additional payment to these founders from annual net profit of BIB, for their contribution as organizers, beyond the amount payable to other founders were disputable.⁵²³ As a result, these BIB's founders have lodged their application to the court claiming that the decision of NBE suspending their payment is illegal because the decision contravenes with the freedom of BIB's shareholders decision to reward persons who contributed more during formation of BIB; its own decision on the same subject matter and approval for the past two years.⁵²⁴ The argued that BIB's shareholders including the ordinary founders have agreed that they have done more and they deserved to be paid more.⁵²⁵ The court

⁵¹⁶ Ibid.

⁵¹⁷ Ibid.

⁵¹⁸ Marshal FikreMarkos (Representative) v. NBE (Fed. High Ct., 2009 E.C., Civil F.N.190612/2009) (unpublished)

⁵¹⁹ Bid.

⁵²⁰ Bid.

⁵²¹ Bid.

⁵²² Bid.

⁵²³ An Amharic letter, translated by the researcher, written by the NBE and sent to BIB in February 09, 2008 E.C.

⁵²⁴ Supra note 450

⁵²⁵ Ibid.

examined the statements of claim and defenses along with evidences; and conducted oral litigation, and it is pending yet.⁵²⁶ The writer agrees that shareholders have the right to assign payments they wish to founders for their contribution but not proper to create new groups.

NBE, generally, has an early intervention framework (e.g. prompt corrective action) that forces automatic action when certain regulatory concern/thresholds of minimum regulatory capital adequacy ratio or other regulatory requirements (e.g. liquidity ratio, fit and proper criteria) or evaluation of likely non-viability given trends and risk factors are breached.⁵²⁷ Where a bank is declared insolvent, it may not accept deposits.⁵²⁸ The Comm.C. and other relevant laws are also applicable on banks with respect to receivership and liquidation.⁵²⁹ When NBE determines that bank has become insolvent and; is unable to fulfill its obligations or meet its depositors' demands in normal course of business; or resolution of its shareholders have decided, subject to prior approval by NBE, to put their bank under receivership, NBE appoints receiver, accountable to it, or acts as a receiver if it finds necessary, to take possession and control of that bank.⁵³⁰

However, bank shareholders, holding, in aggregate, at least 25% voting shares, may appeal to Federal High Court against appointment or actions of a receiver within 30 days, respectively, after date on which receivership is announced in newspaper and such action has been taken.⁵³¹ Where appeal is lodged, receivership continues until court delivers final ruling on the appeal which is required to hold hearing on the matter within 10 days of filing of the appeal, and decide the appeal within 20 days of end of investigation.⁵³² Legislature determines the time of hearing and deciding of the appeal against constitutional provision authorizing courts of any level to adjudicate freely from any interference of any governmental body, government official or from any other source.⁵³³

⁵²⁶ Ibid.

⁵²⁷ Ibid

⁵²⁸ Supra note 4, art.49

⁵²⁹ Id., art.48

⁵³⁰ Id., art.33 (1(b, g and p)), and 33(3 and 4)

⁵³¹ Id., art. 38(1) and 47(1), note that persons representing at least 25 percent of the aggregate amounts of deposits; creditors comprising at least 50 percent in value of the aggregate of the claims of creditors other than depositors; and shareholders representing at least 25 percent in value of the aggregate of the subscribed share capital of the bank are entitled with the right too lodge an appeal against actions of the receiver as provided under art.47(2(a-c)) of this BBP.

⁵³² Id., art. 38(2)

⁵³³ Supra note 7, art.79(2)

Jurisdiction of the court is also limited only to adjudicate, on the appeal lodged against actions of NBE or receiver, the sole issue of whether NBE or receiver acted in an arbitrary and capricious manner in establishing the receivership or winding up the bank when found not viable to continue.⁵³⁴

Generally, there is separate bank insolvency framework that is distinct from that of non-financial firms.⁵³⁵ But, separate BHCs insolvency framework is not available.⁵³⁶ NBE has powers to perform problem bank resolution activities without need for court approval except in High Court's appellate jurisdiction.⁵³⁷ NBE is authorized to declare insolvency of a bank, supersede shareholders' rights, remove and replace bank senior management and MBoDs, undertake bank resolution mechanisms, appoint and oversee bank liquidator/receiver.⁵³⁸ It may use mechanisms like, to resolve problem bank prior to its closure and liquidation, opening bank assistance, purchase and assume transaction (with or without government support), government intervention (e.g. via conservatorship or nationalization) or bridge bank.⁵³⁹

3.11 Supervision

3.11.1 Institutional Structure and Mandate

NBE supervises banks for prudential purposes and there is no other single bank supervisory body, superintendent or multiple bank regulators, superintendents including or excluding it.⁵⁴⁰ NBE licenses, regulates and supervises banks, insurance companies and other FIs.⁵⁴¹ Such duties and responsibilities presuppose attributes of business of banking which, if not managed properly, have potential to generate financial system and macroeconomic instability and licensing and supervision of banking business ensures safety, soundness and stability of banking system.⁵⁴² NBE, governed by BoDs; governor and vice governors appointed by the government; and has necessary staff, is accountable to the PM.⁵⁴³ The BoDs is composed of seven members where the governor and vice governor are permanent ex-officio members and

⁵³⁴ Supra note 4, art.38(3) and 47(3), The writer argues that these provisions are showing the influence of the legislature even in framing issues by the adjudicator which is unconstitutional.

⁵³⁵ Supra notes 18, 131 and 338

⁵³⁶ Ibid

⁵³⁷ Ibid

⁵³⁸ Ibid

⁵³⁹ Ibid

⁵⁴⁰ Ibid

⁵⁴¹ Supra note 1, art. 5(7) and 14

⁵⁴² Supra note 4, preamble paras.3 and 5

⁵⁴³ Supra note 1, art.3(4 and 5), note that though the provision refers to one vice governor, there are currently 3 vice governors who are government appointed i.e. supervision, monetary stability and corporate service cluster vice governors.

the chairperson and remaining four members are government appointed.⁵⁴⁴ The Governor is appointed by and upon decision of the PM with no need of approval by parliament like other high civilian officials of the FGE other than nominees for ministerial posts, from among members of the two Houses or from among persons who are not members of either House and possess the required qualifications, and nominations for posts of Commissioners, President and Vice-President of Federal Supreme Court and Auditor General submitted by PM for approval to House of Peoples' Representatives.⁵⁴⁵ Such appointment is not also based on recommendation by an external expert or panel of experts but only on the will of government.⁵⁴⁶ The governor has no fixed term unless removed by decision of the PM for loss of confidence.⁵⁴⁷

3.11.2 Supervisory Approach

Activities having relative supervisory importance include analysis and monitoring of compliance and trends observed from reported prudential returns; review of accuracy of reports and of regulatory compliance; and assessment of risk profile, strategic direction, financial condition, internal governance and controls, and RM.⁵⁴⁸ Internal organization of banking supervision is best characterized by integrated on-site and off-site activities for each entity under senior/managing supervisor; resident supervisory teams in large systemic complex banks and groups and existence of specialized examiners (e.g. Treasury, MIS, RM) that can be used across different banks.⁵⁴⁹ Bank risk rating methodology used by NBE include: rating system using only ratios and indicators built with reported information; rating system combining quantitative information with qualitative assessments of management and control; or broader risk rating system combining quantitative and qualitative measures of inherent risk, management and controls, and residual risk by type of bank activity and/or risk category.⁵⁵⁰ Intensity and frequency of supervisory activities explicitly are linked to a bank's risk rating and such risk rating is disclosed to a bank's BoDs.⁵⁵¹

⁵⁴⁴ Id., art.3(6)

⁵⁴⁵ Supra note 7, art.74(1,7 and 9), note that there is a wrongly referred sub-article under the English version of this article i.e. art.74(9) cross referring to sub-art.3 instead of sub-art.7 which is corrected under the Amharic version.

⁵⁴⁶ Supra notes 18, 131 and 338

⁵⁴⁷ Ibid.

⁵⁴⁸ Ibid.

⁵⁴⁹ Ibid.

⁵⁵⁰ Ibid.

⁵⁵¹ Ibid.

3.11.3 Systemic Supervision

There are specialized clusters dealing with financial stability and systemic supervision within NBE.⁵⁵² Factors considered by NBE in assessing systemic risk include: bank capital ratios, leverage ratios, profitability ratios, liquidity ratios, growth in bank credit, sectorial composition of bank loan portfolios, Forex position of banks, non-performing loan ratios, provisioning ratios and stock market prices.⁵⁵³ NBE is responsible for publishing financial stability report in its monthly, quarterly and annual magazines.⁵⁵⁴

3.12 Consumer Protection

Despite the fact that there are no separate financial consumer protection laws and regulations applicable to banks and there is no separate unit or team designated to work on consumer protection within NBE, NBE is responsible to implement, oversee and/or enforce any aspect of bank customer protection in cooperation with trade computation and consumer protection authority which implements, oversees and enforces the general consumer protection laws.⁵⁵⁵ NBE and banks are, by default, authorized by law to operate a system.⁵⁵⁶ However, there are legal and institutional framework gaps with regard to NPS infrastructures and participants like operators, payment instrument issuers, payment and technology service providers, agents and outsources where some of them are not clearly made subject to NBE's regulatory, licensing and oversight authority.⁵⁵⁷ When NBE believes so, interests of consumers, including terms and conditions governing their relationship with operators are considered before issuance of an authorization for operating system.⁵⁵⁸ Due to the unique feature of banking services and the vulnerability of bank depositors and customers, the writer agrees with specific customer protection frameworks which have to be implemented by a body different from bank regulatory and supervisory body to avoid conflict of roles and interests.

⁵⁵² Ibid.

⁵⁵³ Ibid.

⁵⁵⁴ Ibid.

⁵⁵⁵ Ibid.

⁵⁵⁶ *supra* note 4, art.2(18)

⁵⁵⁷ *Supra* note 129

⁵⁵⁸ *Supra* note 4, art.6(4(f))

CHAPTER FOUR

CONCLUSION AND RECOMMENDATIONS

4.1 Conclusion

NBE has issued various legal frameworks and has designed institutional frameworks for the regulation and supervision of banks in Ethiopia. Deposit insurance scheme, capital requirements and lender of last resort are common regulatory instruments. Countries authorize separate entities to regulate and supervise banks. But, only NBE is government body authorized to regulate and supervise them in their payment and banking services in Ethiopia. It issues rules and procedures for banks and examines, oversees and investigates their operations through its supervisory authority. This authority concentration and absence of checks and balances paves the way for non-compliance with basic laws and issues unlawful directives and circulars. NBE has authority to take administrative action against banks but not on those entities that undertake banking activities without a given license apart from reporting to the federal high court unlike other central banks like Indian reserve bank having their own law enforcement system and bodies.

There is no sector specific or general consumer protection law and enforcing institutions especially regarding bank mergers and consolidation. There are legal and institutional gaps in the need of attention like rules on BHC, equity ownership and control especially by indirect (business organization) shareholders, electronic banking, third party involvement as technology and payment services provider, agents, payment instrument issuers, and outsourcing arrangements.

There is no explicit deposit insurance scheme though a draft regulation is being made, there is no system to make banks subject to national and international rating agencies, and NBE does not have wider regulatory and supervisory authority over banks' external auditors. No specific guidelines or requirements explicitly address areas in the governance of banks like establishment of compensation committee, requirement for a majority of independent directors in BoDs in internal audit and compensation committees and independent RM function, structure of remuneration packages for senior management and other bank employees, and disclosure of such packages.

4.2 Recommendations

The writer has come up with the following policy recommendations based on the findings of this study:

1. The supervisory and regulatory authority of banks needs to be separated from other FIs and a system of professional checking and balancing system needs to be in place with regard to NBE's Regulatory and Supervisory authority.
2. Explicit deposit insurance scheme needs to be in place by establishing an independent Deposit Insurance corporation with required authority over participants to it.
3. The banking laws have to be revised to empower NBE so as to take provisional legal actions against persons conducting banking business without license until the due process of law takes place as if they are banks for these activities.
4. Banks need to be rated by national and/or international rating agency.
5. New laws and institutions for the regulation and supervision of BHCs, EFT, and Consumer Protection, Payment service providers, third party insolvents like agents, payment instrument issuers, operators, and indirect shareholders need to be issued and properly enforced.
6. Directives and circulars issued by NBE should comply with their respective parent laws and those rules beyond scope of NBE's authority need to be corrected and NBE needs to be subjected for checking by an independent supervisor.
7. NBE's intervention in banks needs to be limited to the extent determined by law and ensuring that private monitoring is encouraged.
8. Sector specific consumer protection law needs to be issued but should be enforced by the trade computation and consumer protection authority to avoid the conflict of purposes within the NBE.
9. There should be a system on the need for independent board as a means to balance shareholder's interest and public interest, remuneration of board, and CEOs and other employees needs to be publicly disclosed and should be part of NBE's supervisory process.
10. NBE should have full regulatory, supervisory and oversight authority over bank's External Auditors.
11. The extent related parties like business associates can own capital in a bank needs to be clearly determined.

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