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Financial market development, policy and regulation: the international experience and Ethiopia's need for further reform

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Chapter 1

Introduction

1.1 Background

Ethiopia had market led economic policy in the 1950s and 60s although the direct role of the government in the economy was not minimal. The private sector and business organizations of the time were considered as crucial elements for economic growth. The government was acting as development agent and market regulator. It enacted a commercial code and other legislation to facilitate the operations of the private sector. Business organizations, including public companies, were flourishing. The policy and regulation of the financial market in the country was also guided by objectives similar to those in the free market economies. The financial market of the time consisted of government and private banks and insurers, an infant market for company and government securities, and a governmental pension system. It was dominated by bank finance. The formal securities market was only born under the auspice of the State Bank of Ethiopia, and later by the National Bank of Ethiopia (NBE), to facilitate the formation, equity financing and governance of public companies and trading in securities.

The Ethiopian government, however, shifted from being market regulator into being owner and planner of the economy by a socialist revolution in 1974. The policy change was followed by nationalization of private sector entities and prohibition of formation of private business organizations. All the market institutions of the time including those in the financial market were nationalized and new entry into the market was banned. The infant securities market was also closed and the banking and insurance markets were forced to serve national plans.

The post 1991 government of the country has re-introduced market led economic policy and implemented reform measures that have encouraged the creation of private companies in both the financial and the non-financial sectors of the country. It has enabled the birth and growth of private banking, insurance and microfinance institutions. It has also allowed the development of inter-bank money and foreign exchange markets and created an agricultural commodity market which is operated outside the financial sector. It has also reformed the pension system through time. A fully fledged securities market is not, however, created yet. The pension system of the country has also remained to be occupational and governmental.

1.2 The Research Problem and Questions

The ‘development, policy and regulation’ of the Ethiopian financial market has been ongoing concern after the free market approach was adopted and private investment allowed in 1991. Both the services of the banks, insurers and microfinance institutions and the policy and regulatory regimes for the financial market are discussed for being underdeveloped although the country is in its second decade since introduction of the new policy. There has also been discussion in the business community, the academia and some of the government

institutions about creation of a securities market and institutional savers. The government has not, however, enabled these and its reforms have remained to be partial. The absence of formal securities market and institutional savers is also discussed for having led to problems, including the issuance and trading of securities through informal arrangements and weaknesses in the ownership base, financing and governance of companies. The rules in the commercial code, and elsewhere, of the country on formation, financing and governance of companies have also been discussed for being incomplete from time to time.

Hence, two interconnected questions are at stake in the country, namely, a question of further diversification of the financial market (a development question) and a question of designing appropriate regulatory regime for it (a regulation question). This study focuses on the issues surrounding these in order to contribute to the market and regulatory development in the country. It, accordingly, focuses on the following research questions:

1. What do the current structure, operation, policy and regulation of the financial market in the country and the reforms in the past look like?
2. a. Is there need for further reform of the structure, policy and regulation of the financial market in the country and what should the reform be, if any?
b. What are the lessons that can be drawn from the international experience and recommendations in this respect?

1.3 The Research Objective and Significance

The research is not triggered by the 2008 financial and economic crisis. None of the financial institutions in Ethiopia has failed because of the crisis. It is justified only by the need to know about the financial market, policy and regulation of the country and the ways for further development. It, accordingly, aims at achieving two equally important objectives. First, it aims at contributing to knowledge about the financial market, policy and regulation of the country. Second, it, in light of the research background, problems and questions indicated above, aims at indicating the need, areas and nature of further action by the country in order to further develop its financial market, policy and regulation. The research is, accordingly, useful to both the pursuit of knowledge and the identification of the reform measures for Ethiopia.

1.4 The State of Literature and Research Methodology

Unlike the wealth of literature in respect of the financial market regulatory systems outside Ethiopia, not much is written in connection with the system in Ethiopia. Only some articles are published in journals, proceedings, magazines and newsletters that focus on aspects of the existing financial market of the country and tip on some reforms without treating the policy, regulation and development of the market in a holistic way. This study takes advantage of the gap and is conducted through the following:

- Review of the studies available in Ethiopia;
- Analysis of the existing policies and laws of the financial market in the country;
- Use of data from official reports and unpublished records of the financial institutions, the regulators and related institutions in the country, including the banks, insurers and microfinance institutions, the National Bank of Ethiopia (NBE), the Ministry of Trade and Industry, the Trade Practice Commission, the Ethiopian Investment Agency, the Privatisation and Public Enterprises Supervisory Agency, the Social Security Agency, the Ministry of Finance and Economic Development, the Ministry of Revenues, the Ministry of Information, the Central Statistics Agency, the Addis Ababa Chamber of Commerce, the Justice and Legal System Research Institute, and the Ethiopian Press Agency;
- Field study of the financial market practices in the country (through visits and discussions with appropriate personnel);
- Use of own work experience as former employee in the financial market of the country;
- Literature study and consultation of the laws and regulatory practices of countries outside Ethiopia;
- Consultation of the principles, standards and works of the international organizations, including the Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS), the International Organization of Securities Commissions (IOSCO), the International Organisation of Pension Supervisors (IOPS), the International Social Security Association (ISSA), the Bank for International Settlement (BIS), the Organization of Economic Co-operation and Development (OECD), the International Corporate Governance Network (ICGN), the Global Corporate Governance Forum (GCGF), the International Accounting Standards Committee (IASC) (renamed as International Accounting Standards Board), the International Federation of Accountants (IFAC), the BIS Committee on Payment Settlement Systems (CPSS), the G-7 Financial Action Task Force on Money Laundering (FATF), the G-7 Financial Stability Forum (FSF), the World Trade Organization (WTO), the International Monetary Fund (IMF), the United Nations Conference on Trade and Development (UNCTAD), the United Nations Industrial Development Organization (UNIDO), the International Competition Network (ICN), and the G-20;
- Comparison of the Ethiopian policies, laws and practices with the policies, laws, practices and recommendations in the international experience; and
- Assessment of the current financial market regulatory and supervisory laws and practices in Ethiopia against the core principles of the Basel Committee on Banking Supervision (BCBS) and the International Association of Insurance Supervisors (IAIS).

The study also uses quantitative data to substantiate conclusions. It is, however, fundamentally qualitative, focusing on the legal policy and regulatory issues. It also draws the major lessons from the systems and practices across countries and the

international recommendations in view of the increased internationalisation and convergence of the financial market regulations around the world, the still persistence of difference in the specific regulatory solutions of countries, and the use of international experience for reflection and benchmarking. The assessment of Ethiopia's regulation against the internationally accepted principles of the BCBS and IAIS is also done for purpose of reflection on the state of development of the country's current regime. The use of the IOSCO and IOPS principles by the country is, however, only anticipated.

The approach taken is, therefore, to draw lessons from both the international regulatory experience and recommendations and the domestic situation of the country and to contribute to the further development of the structure, policy and regulation of the financial market in the country.

1.5 The Scope of Research

The research focuses on the development, policy and regulation of the existing formal banking, insurance and microfinance markets in Ethiopia and the future securities and pension markets and institutions of the country. It does not include study of the modalities for formalization, development and regulation of the informal savings, currency exchange, insurance and social security schemes in the country although the importance of formalizing and regulating these institutions is indicated in connection with the main study. The question of development (indicated above) is also discussed in view of the need for transforming the Ethiopian financial market from a market where short term bank finance dominates; securities are issued and traded only informally; financial instruments and services are not disseminated, diversified and modernized adequately; and negligible insurance and pension coverage exists into a market where the issuance and trading of securities is formally institutionalised and regulated; the generation of long-term finance is facilitated; the coverage, type and modernity of the banking, insurance and microfinance services are enhanced; debt and equity finances compete; and private pensions operate as institutional savers and investors. It is discussed along with the question of regulation (i.e. the question of improving the policy and regulatory system of the existing banking, insurance and microfinance markets and designing new policy and regulatory system for the future securities and pension markets and institutions of the country). Much of the study, however, focuses on the policy and regulatory thinking necessary for the markets.

1.6 The Chapters

All the chapters are structured in a way that they will address both the international experience and the Ethiopian situation. The second chapter focuses on the organization, development and regulation of the existing banking, insurance and microfinance markets and institutions in the country. It discusses the history, current state, structure, policy and regulation of the markets and institutions and indicates the measures that need to be taken for the future

development of these in light of both the international experience and the domestic situation of the country. The third chapter focuses on the future development and regulation of securities market in the country. It discusses the history, current state, potential functions, and need for development of the market and the policy and measures that need to be taken by the country in designing its structure and regulation in light of both the international experience and the domestic situation. The fourth chapter focuses on the future development and regulation of private pensions in the country as institutional savers and investors. It discusses the history, current state, potential functions, and need for development of these institutions and the policy and measures that need to be taken by the country in designing their structure and regulation in light of both the international experience and the domestic situation. The fifth chapter focuses on the mechanism of regulatory enforcement. It discusses the identity, powers, functions and coordination of the regulatory enforcement organs, the sanctions behind regulation, the judicial and non-judicial legal protections against regulatory flaws, the political and non-political backings of regulatory enforcement, and the international cooperation and use of international standards for regulatory enforcement and indicates the measures for further action by the country in respect of these in light of both the international experience and the domestic situation. The sixth chapter summarizes the study and conclusions and indicates the measures that need to be taken by the country.