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Chapter 2
The Development, Policy and Regulation of the Banking, Insurance and Microfinance Markets

2.1 History and Current State

i. The International History in Brief

Banks have come into existence as a result of commerce in Babylon, in Rome and in other cities of Italy.[1] The banking and credit services were mostly extended by private individuals until institutionalized banks, the most ancient of which was the Bank of Venice of 1157, were established to serve the finance needs of governments and facilitate commerce.[2]

Insurance also dates back to around 2000 B.C.[3] It served as risk pooling arrangement between two partners during the Venetian and pre-Venetian times and as means of promoting social stability and economic progress by encouraging specialization and enhancing risk management and business security as societies became modern.[4] It developed in two lines: in one line, it developed as cooperative, not-for-profit self-insurance scheme when the medieval mutual protection guilds evolved into the mutual or cooperative insurance companies of the modern times; and in the second line, it developed as commercial, for-profit insurance when the marine insurance of Venice and Genoa of the 14th century expanded to include fire and liability insurance in the 17th century and evolved into the joint stock insurance companies that managed life and mass risks during the 18th century and thereafter.[5]

Microfinance has also lived as mutual saving and self-help arrangement among merchants, craftsmen, factory workers and friends in Western Europe and Northern America until it vanished from the regions as of the late 19th century due to rise of large cooperative and savings banks, commercial insurance companies and government social insurance schemes.[6] It has grown in Asia, Latin America and Africa as of the mid-20th century because of the inability of the conventional banks and insurers to serve small clients.[7] It has also become

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1 Shekhar, 1995, at pp.1-5.
2 Ibid.
3 Pfennigstorf, 1996, at pp. 8-10; Thimm, 1999, at pp. 108-119; Rietbergen, 1999, at p. 41; and Nemeth, 2001, at p. 9.
4 Thimm, 1999, at pp. 105-106 & 120.
5 Thimm, 1999, at pp. 115-119; Nemeth, 2001, at p. 9; and Pfennigstorf, 1996, at pp. 8-10 & 49-52.
6 Swaan and Linden, (eds.), 2006; and Degefe Duressa Obo, 2009, at pp. 1 & 16-24.
7 It has grown as government subsidized credit from the 1950s up to the 1970s, as donor sponsored targeted credit from the 1980s up to the mid 1990s, and as regulated commercial microfinance after the mid 1990s. Its function has also begun as micro-credit provision and then widened to cover small amount financial products and services, including savings accounts, micro-insurance services, money transfer and payments services, and business entrepreneurship advice. Copestake, et al., (eds.), 2005; Berger, et al., (eds.), 2006; Swaan and Linden, (eds.), 2006; WSBI/ESBG, 2009, at pp. 13-19 & 37-113; and Degefe Duressa Obo, 2009, at pp. 1 & 16-24.

common among immigrant circles in Western Europe and Northern America in recent times in forms of small scale rotating savings and credit associations.[8]

The regulation of banking has also four historical roots.[9] First, banks and credit institutions were found at the behest of the ruler or the state, usually for purpose of facilitating state borrowing, beginning from the time of Venice, Genoa and Florence. Secondly, banks and credit institutions were considered as most important sectors of the economy and subjected to strict licensing despite the general idea of freedom of trade that gathered momentum in the period after the French Revolution and most countries had to develop specialized banks and credit institutions that had limited tasks unlike the universal banking system of Germany, Austria and Switzerland. Thirdly, the issuance of bank notes was considered as function within the sphere of state monetary sovereignty and the central banks had to take it over from the commercial banks since the late 19th century. Fourthly, several countries had to supervise credit as prerequisite for smooth functioning of their markets because of economic crises, bank crashes and abuses in the 19th and the 20th centuries. Most countries have, accordingly, shared a common legislative idea that banks and credit institutions must be subject to special public control.[10] They have, as a result, put their banks and credit institutions under heavier regulation than other institutions as of early times.

The systemic regulation of insurance has started in form of provision of corporation charter when insurance corporations appeared in the 18th century.[11] This was followed by enactment of general corporation codes and substantive controls on the insurers by specialized agencies in the 19th century.[12] Separate statutes have then appeared in Europe and elsewhere as of the early 20th century to regulate the terms and conditions of insurance contracts.[13] The regulations have ranged between comprehensive substantive regulation and liberal approach. At one extreme, some such as Germany, Austria, Italy, Belgium, Portugal, Luxembourg, Switzerland, USA, Canada and Japan have depended on comprehensive substantive regulation.[14] They have followed a system of substantive regulation that imposed legal, financial and technical controls on market entry and tight rules for determination of products, premiums and policy conditions.[15] At another extreme, some like UK, the Netherlands and New Zealand had liberal regimes that promoted competition and self-regulation and were limited to ensuring the financial stability of the insurers and the provision of

8 Ibid

9 Möschel, 1991, at pp. 5-13.

10 Möschel, 1991, at p. 5; Benston, 1998, at pp. 13-18; Gowland, 1990; and Murshed and Subagjio, 2000.

11 Pfennigstorf, 1996, at pp. 9-15; and Thimm, 1999, at p. 104.

12 Ibid.

13 The private side of insurance was left to general contract law until the statutes were introduced. Nemeth, 2001, at p. 10; and Pfennigstorf, 1996, at p. 9.

14 Möschel, 1991, at pp. 26-30; Chance, 1993, at p. 76; Pfennigstorf, 1996, at pp. 11-15 & 26-27; and Lemaire, 1997, at pp. 8-9, 10, 16-29 & 34.

15 Ibid.

information to consumers.[16] Others had requirements that addressed the licensing, contracting conditions, service accessibility, premiums and taxation of the insurers in between the two extremes.[17]

The majority of the countries have also separated between the non-life and life insurance services and regulated the life insurance services more heavily than the non-life.[18] Most of them have also imposed lesser control on commercial insurance and re-insurance than on personal line and mass risk related insurance.[19] They have subjected the insurers which covered risks outside their territory and the risks of their owners to the least control.[20] The insurance regulation in many of the countries was also traditionally targeted at the insurers and secondarily at the qualification and conduct of their intermediaries (especially brokers).[21]

Most of the developed market countries have, however, started the internationalization of banking with the rise of Eurocurrency and Eurobond markets in the 1960's and 70's and furthered their reforms in the banking and insurance markets in the 1980s and thereafter.[22] They have conducted big bangs and chores of bangs as of the late 1980s (i.e. 1988/9) and the reforms have led to the following:

- deregulation and internationalization of the banking and insurance markets,
- diversification of the banking and insurance products,
- increase of competition among the banks and insurers,
- development of electronic services,
- development of institutions that can combine the provision and marketing of different kinds of financial products in form of banc-assurance (all-finanz), and
- increase of the need for new regulatory approaches that can meet the demands of the developments.[23]

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16 Gilligan, 1999, at pp. 13-14, 27-36 & 99-209; Pfennigstorf, 1996, at pp. 12-13 & 26-27; Finsinger, Hammond and Tapp, 1985, at pp. 13, 21-49 & 50-60.

17 Lemaire, 1997, at p. 8; and Meier, 1988, at pp. 43-46 & 48

18 Rietbergen, 1999, at pp. 41-42; Merkin and Rodger, 1997, at p. 3; and Nemeth, 2001, at pp. 23 & 41.

19 Pfennigstorf, 1996, at p. 27.

20 Ibid.

21 The countries have increased their attention on regulation of intermediaries and providers of ancillary services only recently due to rise of interest among the insurers to delegate central tasks and responsibilities to non-insurers and interest among regulators to monitor competition. Pfennigstorf, 1996, at p. 28.

22 Finsinger, Hammond and Tapp, 1985, at pp. 61-92; Caddy, 1986, at pp. 32-57, 83-130 & 178-185; Meier, 1988, at pp. 33-48 & 109-134; Gowland, 1990; Norton, 1991; Laboul, 1992, at pp. 10-11 & 38-41; Hubbard, 1997, at pp. 416-419 & 421-422; Lemaire, 1997, at pp. 52; Rietbergen, 1999, at pp. 13, 16-18, 25-26, 95-122 & 149; and Scott, 2008, at pp. 421-443.

23 Gowland, 1990; Möschel, 1991, at pp. 26-30 & 92-93; Norton, 1991; Laboul, 1992, at pp. 10-11 & 38-41; Chance, 1993, at pp. 2 & 72-73; Pfennigstorf, 1996, at pp. 10-28; Lemaire, 1997, at pp. 1-8 & 35; Rietbergen, 1999, at pp. 13, 16-18, 25 & 95-122; Harner, 2000, at pp. 20-52 & 74-93; Fenn, 2001, at pp. 391-403; Klein, 2001, at pp. 403-404; Zax, 2001, at pp. 407-409; Gkoutzinis, 2006, at pp. 1-318; Alexander, et al., 2006; Scott, 2008, at pp. 421-443; and Empel, (ed.), 2008, at pp. 20-21.

The countries that relied much on self regulation of insurance (i.e. UK, the Netherlands and New Zealand) have also increased their governmental regulations in the period with a view to controlling illicit activities and abuses.[24]

Europe has also encouraged the integration, harmonization and liberalization of the banking and insurance markets and regulations of its member states through enactment of the following and subsequent directives and measures:

- the First Banking Council Directive 77/780/EC;
- the Second Banking Council Directive 89/646/EC and Directive 89/647/EC;
- the re-insurance directive (February 1964);
- the first generation directives on re-insurance (1964), non-life insurance (1973) and life insurance (1979);
- the second generation directives on large risks (1988), motor insurance (1990) and passive life insurance (1990); and
- the third generation directives of 1992.[25]

It has also furthered the widening of the banking and insurance markets through the following and subsequent actions:

- the European Economic Area (EEA) Agreement (signed on the second of May 1992);
- the EC-Switzerland Agreement on direct non-life insurance (signed in October 1989 and entered into force on the first of January 1993);
- the accession applications of the EFTA states to join the EC (beginning early February 1993); and
- the Maastricht Treaty (which covered issues of economic, monetary and political union and the creation of single currency) (agreed on the 11th of December 1991 and signed on the 7th of February 1992).[26]

The transition and emerging market countries of Latin America, Eastern Europe, Asia and Africa have also reformed their banking and insurance market as of the late 1980's and in the 1990's to raise domestic saving, increase investment, and improve resource allocation.[27] The East European, Asian and Latin American countries have opened up their markets for domestic and foreign private investment as they started their reforms in the late 1980s.[28] The African countries

24 Möschel, 1991, at pp. 92-93; Pfennigstorf, 1996, at p. 26; Gilligan, 1999, at pp. 21-27 & 183-209; Valdez, 1993; and Tsurumi, 2001. The EU has also encouraged the balancing of the self-regulation approach (for insurance) with the governmental regulation approach. It has also encouraged the pursuit of regulation through informal communication, consultation and advice instead of through formal administrative measures. Pfennigstorf, 1996, at pp. 27-28; Geradin, et al., 2005; and Cafaggi, 2006.

25 Möschel, 1991, at pp. 92-93; Rosa Greaves, 1992, at pp. 3-98; Chance, 1993, at pp. 4 & 6-65; Lemaire, 1997, at pp. 6-10; Merkin and Rodger, 1997, at pp. 4-17; Ritter, et al., 2000, at pp. 718-726; Nemeth, 2001, at pp. 13-21, 22 & 23-35; Sandström, A., 2006; and Empel, (ed.), 2008, at pp. 26-47.

26 Chance, 1993, at pp. 136-142; and Merkin and Rodger, 1997, at p. 15.

27 Zonis and Semler, 1992, at pp. 18-26, 88-95, 161-168, 232-240, 303-310 & 371-380; World Bank, 2000, at pp. 161-162; Bokros, 2001; Feldstein, 2003; and Urrutia, 1988.

28 Zonis and Semler, 1992, at pp. 18-26, 88-95, 161-168, 232-240, 303-310 & 371-380; Bokros, 2001; World Bank, 2000a; and Feldstein, 2003.

have focused on balance sheet restructuring and re-capitalization of their state owned banks and insurers in their initial reforms and attempted at privatising these banks and insurers, opening up the financial markets for domestic and foreign private investment, and improving the financial regulations as of the 1990s.[29] Both groups of countries have designed the contents of their regulatory systems based on the ideas and patterns of the regulations in their trading partners (usually the US, Western Europe and Japan) although they have also made their reforms according to the demands of their transitions to market economy.[30] They have also introduced and strengthened their microfinance regulations in more or less the same fashion as the banking and insurance regulations as the microfinance operations have increasingly become part of the financial markets.[31]

The evolution and content of the banking, insurance and microfinance regulations in both the developed and the transition and emerging market countries have also been influenced by:

- the general philosophies of the countries on the economic roles of their governments;
- the constitutional systems, economic developments, and economic and social policies of the countries;
- the historical compositions, structures and performances of the banking, insurance and microfinance markets of the countries; and
- the incidence of inefficiencies, scandals and failures in the markets.[32]

29 World Bank, 2000, at pp. 161-162; World Bank, 2000a; and Feldstein, 2003.

30 Thimm, 1999, at pp. 104-105; Pomfret, 2002, at pp. 57-60 & 76-133; Basu, 1997, at pp. 1-77; and Zonis and Semler, 1992, at pp. 18-26, 88-95, 161-168, 232-240, 303-310 & 371-380. Also Naya, et al., 1989, at pp. 13-51, 183-229; Slater and Strange, 1997, at pp. 1-251; and Shlaim and Yannopoulos, 1976, at pp. 1-348 for survey of the historical trade relations between the regions.

31 Copestake, et al., (eds.), 2005; Berger, et al., (eds.), 2006; Swaan & Linden, (eds.), 2006; WSBI/ESBG, 2009; and Degefe Duressa Obo, 2009, at pp. 15-24 & 46-52. The microfinance regulations are fashioned like the banking and insurance regulations with difference from the latter on technicalities and strength of regulation due to the special characteristics of the microfinance operations and institutions (Ibid.). The majority consensus in the literature has also become that the microfinance operation and institutions need to be regulated as the other financial operations and institutions by taking into account their special characteristics as they have come to be part of the financial system (Degefe Duressa Obo, 2009, at pp. 46-52).

32 Finsinger, Hammond and Tapp, 1985, at pp. 61-92; Möschel, 1991, at pp. 92-93; Zonis and Semler, 1992, at pp. 18-26, 88-95, 161-168, 232-240, 303-310 & 371-380; Valdez, 1993; Pfennigstorf, 1996, at pp. 10 & 27; Lemaire, 1997, at pp. 1-8; Basu, 1997, at pp. 1-77; Thimm, 1999, at pp. 104-105; Harner, 2000, at pp. 20-52 & 74-93; Tsurumi, 2001; Pomfret, 2002, at pp. 57-60 & 76-133; Copestake, et al., (eds.), 2005; Berger, et al., (eds.), 2006; WSBI/ESBG, 2009; and Degefe Duressa Obo, 2009.

See also the following for the theories and practices on the relationship between government and business in general: Machan, 1984; Ayres and Braithwaite, 1992; Caporaso and Levine, 1993; Kidane Mengisteab and Logan B. I., (eds.), 1995; Mercuro and Medema, 1997; P. Görant T. Hägg, 1997; Gunningham and Grabosky, 1998; Uche, 2000; Julia Black, 2001; Michael Hantke-Domas, 2003; McMahon G., (ed.), 1996; Masahiko Aoki, et al., (eds.), 1997; Matsuyama, 1997; Akio Hosono and Neantro Saavendra-Rivano, (eds.), 1998; Jaeho Yeom, 1998; Saba, 2000; Teichman, 2001; Voigt and Wagener, (eds.), 2002; Kamidza, Matlosa and Mwanza, 2002; Mandelbaum, 2003; Kuczynski and Williamson, (eds.), 2003; Schneider, 2004; Lapavitsas and Noguchi, (eds.), 2005; Kim, Dae-Hwan, 2005; Marukawa, 2005; David Levi-Faur and Jacint Jordana, 2005; Amann, (ed.), 2006; Amann and Baer, 2006; Boyd, et al., (eds.), 2006; Silva, 2006; Monica Prasad, 2006; Tawfik, 2007; Silva, 2009; Busch, 2009; and Solomon Abay, 2010.

The general trend has, however, been towards lessening of the use of heavy direct government regulation as the countries have promoted competition and tried to justify their regulations by specifically defined objectives that can not be achieved by the competition process alone.[33] The BCBS and IAIS have also encouraged countries to rely on indirect instruments of banking and insurance regulation (that may be available to them) as opposed to direct controls.[34] The aftermath of the 2008 financial and economic crisis has, however, also raised the interest of countries to expand and strengthen the regulations of their financial markets for the reason that unregulated markets are prone to systemic failure.[35] The continuing innovation in the banking and insurance markets has also increased the need for further reform of regulation.[36] The recent advice in the field of microfinance regulation is also towards development of a less restrictive regulatory regime that can enable the further development of microfinance.[37]

ii. The History in Ethiopia

Ethiopia felt the need for having formal banking only after establishment of Addis Ababa as its permanent capital in 1886.[38] It started it by establishing the Bank of Abyssinia on February 16 1906 in partnership with the British owned National Bank of Egypt after a 50-years-concession agreement was signed in 1905 between Emperor Minelik II and Mr. M. Gillivray (who represented the National Bank of Egypt).[39] It established this bank with powers of issuing bank notes and monitoring the legal tender as a central bank.[40] It also required the deposit of all government and public funds in the bank and the making of all payments by the bank to be in cheque.[41] The bank was, however, liquidated for replacement by the Bank of Ethiopia in 1931.[42] The latter bank was established in August 1931 with

33 Lemaire, 1997, at pp. 8-32; Thimm, 1999, at pp. 35 & 136-147; Pfennigstorf, 1996, at pp. 18-23 & 33; Chance, 1993, at p. 2; Merkin and Rodger, 1997, at pp. 2-3; Meier, 1988, at pp. 33-48; and Nemeth, 2001, at pp. 13-20, 50 & 67-72.

34 BCBS, 1997; BCBS, 2006; BCBS, 2006a; and IAIS, 2003.

35 The international organizations, including the World Bank, the IMF, the WTO and the G-20, have also supported the move towards strengthening the regulation of financial markets across countries (without protectionism) in the aftermath of the crisis. The US has done this by adopting its financial market regulatory overhauling bill on the 21st of July 2010. The other countries cooperating under the G-20 are also considering the ways for strengthening their regulations. Synder, 2007; Gert Wehinger, 2008; Stephen, 2008; McIlroy, 2008; Van Berkel, 2008; Adrian Blundell-Wignall, et al., 2008a; Adrian Blundell-Wignall, et al., 2009; Adrian Blundell-Wignall, et al., 2009a; Gert Wehinger, 2009; Gert Wehinger, 2009a; Hall, 2009; Ayadi and Behr, 2009; Vaughan, 2009; Coope, 2009; Christoph Ohler, 2009; J. Balvin Hannibalsson, 2009; World Bank, 2009b; IMF, 2009; WTO, 2009; G-20, 2009; Jónsson, 2009; Andrew and Mark, 2009; Andrew and Mark, 2009a; Michael and Harold, 2009; Martinez-Diaz, 2009; Goodhart, 2009; Chambers, 2010; Thorsten, 2010; Johnson and Kwak, 2010; and the news AP, 2009; AP, 2009a; AP, 2009b; AP, 2009c; AP, 2009d; AP, 2009f; AP, 2010a; Financial Post, 2010; Bloomberg, 2009a; and Bloomberg, 2010.

36 Chapman, 2010, at pp. 128-156; and Weber, 2010.

37 Copestake, et al., (eds.), 2005; Berger, et al., (eds.), 2006; Swaan and Linden, (eds.), 2006; WSBI/ESBG, 2009, at pp. 19 & 27-34; Degefe Duressa Obo, 2009, at pp. 15-24 & 46-52; and BCBS, 2010.

38 Bahru Zewde, 2002, at pp. 101-102; and NBE, 2001.

39 Ibid

40 The management of the bank was left to the Egyptian National Bank. Ibid

41 Ibid

42 It was blamed for being purely profit motivated, inefficient and ignorant of the credit needs of the country. Bahru Zewde, 2002, at p. 103; and NBE, 2001.

ownership of sixty percent of its capital by the government.[43] It operated only until invasion of the country by Italy in 1935. The Italians then established branches of the Banca d'Italia, Banco di Roma, Banco di Napoli and Banca Nazionale del lavoro and started operation in the main towns of Ethiopia as of that year.[44] The Barclays Bank also organized banking services in Addis Ababa beginning 1941.[45] All the branches other than those of the Banco di Roma, the Banco di Napoli and the Barclays Bank, however, ceased operation following the liberation of the country in 1941. The branches of Banco di Roma and Banco di Napoli remained in Asmara and the Barclays Bank withdrew from the country in 1943. The country then established the State Bank of Ethiopia which went operational on the 15th of April 1943.[46] It created it as central and principal commercial bank with powers to issue bank notes and coins as agent of the Ministry of Finance of the time and to engage in all commercial banking activities.[47] It conferred it with the powers of issuing national currency and dealing in foreign exchange in 1945 and 1949, respectively, and allowed it to operate until its dissolution in 1963.[48] It also established the Development Bank of Ethiopia by Imperial Charter of 1951.[49]

It separated the central and commercial banking functions of its banks for the first time by enacting a Monetary and Banking Proclamation and a National Bank of Ethiopia Charter Order, and thereby dissolving the State Bank of Ethiopia and creating the National Bank of Ethiopia as central bank and the Commercial Bank of Ethiopia Share Company as commercial bank, in 1963.[50] It also allowed the formation of private domestic banks and the entry of foreign banks through joint ventures with maximum foreign ownership of forty nine percent; re-licensed the Banco di Roma and Banco di Napoli Share Companies as foreign banks; and registered the Addis Ababa Bank Share Company as the first fully privately owned domestic bank under those laws.[51] It also established specialized institutions (including the Imperial Savings and Home Ownership Public Association, the Savings and Mortgage Corporation of Ethiopia, and the Agricultural Bank) in the 1960s and early 1970s.[52] The banking market of the country was, therefore, composed of the following by 1970:

- the National Bank of Ethiopia (with six branches),
- the Commercial Bank of Ethiopia (with sixty five branches),
- the Addis Ababa Bank Share Company (with nine branches),
- the Development Bank of Ethiopia (with nine branches),

43 NBE, 2001.
44 Ibid.
45 Ibid.
46 IGE-MI, 1960, at p. 35; and NBE, 2001.
47 Ibid.
48 It operated through twenty one branches (including a branch in Khartoum and a transit office in Djibouti) until it was dissolved in that year. Ibid.
49 IGE-MI, 1960, at p. 36.
50 IGE, 1963d; and IGE, 1963e.
51 IGE, 1963d; and NBE, 2001.
52 IGE, 1970a; NBE, 2001; and IGE-MI, 1970, at p. 94.

- the Agricultural and Industrial Development Bank Share Company (with five branches),
- the Banco de Roma Share Company (with one branch),
- the Banco de Napoli Share Company (with six branches),
- the Mortgage Company of Ethiopia (with one branch), and
- the Imperial Savings and Home Ownership Public Association (with two branches).[53]

Modern insurance was also introduced in the country as far back as 1906 when the Bank of Abyssinia transacted fire and marine insurance as agent of a European insurance company.[54] There were nine insurance companies in the country in 1954 which were either branches or agents of foreign companies except for the Imperial Insurance Company of Ethiopia that was established in 1951.[55] The number of insurance companies grew to thirty three in 1960 and thirty two of them were branches or agents of British, American, Egyptian, Italian, Swiss, French, Indian and New Zealand companies.[56] The insurance companies and their businesses were subject to the Commercial and Maritime Codes of the country of the time.[57] The required minimum subscribed and paid-up capitals for an insurance company were, accordingly, fifty thousand and twelve thousand five hundred Ethiopian Birr, respectively, and there was no restriction on the extent of foreign ownership of the insurers.[58] The country, however, enacted a new proclamation in 1970 and required the insurers to be domestic companies with fully subscribed share capital of not less than four hundred thousand Ethiopian Birr (for a general insurance business), six hundred thousand Ethiopian Birr (for a long-term insurance business) and one million Birr (for both types of businesses).[59] The proclamation did not prohibit foreigners from engaging in insurance business but required them to locate their head offices inside the country and to make at least fifty one percent of their paid-up capitals (when they intended to engage in general insurance business) and at least thirty percent of same (when they intended to engage in life insurance business) owned by Ethiopian nationals or by companies of Ethiopian nationals.[60] Fifteen domestic insurance companies, thirty six agents, seven brokers, three actuaries and eleven loss assessors were then licensed under the proclamation.[61]

The country did not also have comprehensive monetary, banking and insurance regulation prior to enactment of the Monetary and Banking Proclamation and the National Bank Charter Order in 1963 and the Insurance Proclamation in 1970.[62] Only the enactment of those proclamations launched comprehensive regulation. The Monetary and Banking Proclamation and the National Bank Charter Order

53 IGE-MI, 1970; and NBE, 2001.
54 IGE-MI, 1970; and NBE, 2001.
55 Ibid.
56 IGE-MI, 1960, at pp. 39-42; and NBE, 2001.
57 IGE, 1960; and NBE, 2001.
58 IGE, 1960, at arts. 306 & 312(1)(b); and NBE, 2001.
59 IGE, 1970b, at art. 6.
60 Id. at arts. 2(7), 2(11) & 43(3)-(5).
61 NBE, 2001.
62 Bahru Zewde, 2002, at pp. 101-102; and Itana Ayanna, 1994, at p. 240.

defined the national monetary system, entrusted the central banking function to the National Bank of Ethiopia, left commercial banking to the other banks, and authorized the National Bank of Ethiopia to control and regulate the monetary, credit and banking systems of the country.[63] The National Bank of Ethiopia also launched its banking regulation in that year and adjusted the scope and modalities of its regulation according to the changes in economic policy in the subsequent years.[64] The insurance proclamation also entrusted the power of regulating insurance to an Insurance Council and an Insurance Controller's Office.[65]

The country, however, pursued a socialist policy of banking and insurance after 1974. The military government nationalized the foreign and private equity participations in the Addis Ababa Bank, the Banco di Roma, and the Banco di Napoli in 1975 and merged them to form the second largest bank in the country (next to the Commercial Bank of Ethiopia S.C.) called the Addis Bank in 1976.[66] It merged the Savings and Mortgage Corporation S.C. and the Imperial Savings and Home Ownership Public Association to form the Housing and Savings Bank in 1975.[67] It also made the Imperial Agricultural and Industrial Development Bank under trusteeship of the National Bank of Ethiopia in 1976 and re-established it as a separate bank in 1979 with the task of financing the agricultural and industrial sectors of the country with short, medium and long-term credits.[68] It then merged the Addis Bank with the Commercial Bank of Ethiopia S.C. in 1980 and made the latter continue as the only commercial bank.[69] It also nationalized and merged all the private insurers and formed the single Ethiopian Insurance Corporation in 1975.[70] It also changed the guidance of the National Bank of Ethiopia by enacting a new Monetary and Banking Proclamation in 1976.[71] The financial market of the country was, therefore, composed of only the National Bank of Ethiopia as the central bank, the Commercial Bank of Ethiopia as the commercial bank, the Housing and Savings and the Agricultural and Industrial Development Banks as specialized banks, and the Ethiopian Insurance Corporation as the commercial insurer until 1994.

The country has reformed its financial sector following the economic policy change in 1991. It has re-established the National Bank of Ethiopia (NBE) as central bank and financial market regulator and opened the banking and insurance sectors for domestic private investment by enacting Monetary and Banking, Licensing and Supervision of Banking Business and Licensing and Supervision of

63 IGE, 1963d; and IGE, 1963e.
64 Itana Ayanna, 1994.
65 Both the Council and the Controller's Office were constituted outside the NBE. Only the Council had included the NBE as a member. It was responsible for policy matters while the Controller's Office was in charge of the daily regulatory activities. IGE, 1970b, at arts. 4 & 5.
66 PMGE, 1974d; and PMGE, 1975e.
67 PMGE, 1975j.
68 PMGE, 1979a.
69 PMGE, 1980; and NBE, 2001.
70 PMGE, 1975e.
71 PMGE, 1976i.

Insurance Business Proclamations in 1994.[72] It has introduced a regulatory regime for microfinance institutions for the first time in its history and required their formal establishment as financial companies under supervision of the NBE to cater for the credit needs of small scale producers, service providers and peasant farmers by enacting a microfinance institutions supervision law on the 5th of July 1996.[73] It has also required the NBE to encourage the participation of banks, insurers and other financial institutions in the provision of microfinance services and to promote the development of traditional savings institutions of the Ethiopian society along with the microfinance institutions by the microfinance supervision laws.[74] It has also authorized the banks to directly engage in microfinance business without need for obtaining separate microfinance business license by its recent microfinance business law.[75] It has also, through the reforms, subjected the banks, insurers and microfinance institutions to supervision laws that are similarly fashioned and complementary to one another although it has pursued heavier regulation on the banks than the insurers and on the insurers than the microfinance institutions in practice.[76]

The NBE has, accordingly, licensed twelve private banks, eleven private insurers, thirty microfinance institutions and more than one thousand insurance auxiliaries along with the hitherto existing government owned three banks and one insurer until June 2010.[77]

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72 TGE, 1994; TGE, 1994a; and TGE, 1994b. The Monetary and Banking and Licensing and Supervision of Banking Business Proclamations are amended in 2008 (FDRE, 2008a; and FDRE, 2008b).

73 Formal microcredit was begun in the country by NGOs in the 1980s (Degefe Duressa Obo, 2009, at p. 83). The country has, however, required the formal establishment of all microfinance operations as microfinance share companies (institutions) within the financial sector as of July 1996 and authorized them to i) accept saving, demand and time deposits from their members and micro-operators; ii) extend loans to micro-operators; iii) develop income generating projects for micro-operators; iv) provide managerial, technical, marketing and counselling services to micro-operators; v) acquire, buy and sell negotiable financial instruments; vi) draw and accept locally payable drafts; and vii) acquire and dispose of movable and immovable properties in their own names (FDRE, 1996g, at the preamble and arts. 3 & 26). It has also enacted a new microfinance business law in 2009 and authorized them further to undertake micro-insurance, micro-financial leasing and micro-fund management businesses for the benefit of the peasant farmers and micro and small scale entrepreneurs (FDRE, 2009, at art. 3).

74 FDRE, 1996g, at art. 12(3). Several informal saving, finance and self-help mechanisms have lived in the urban and rural parts of the country for long, the most popular of which are the *Equb* and *Edir* (See Degefe Duressa Obo, 2009, at pp. 77-83). There are also several multipurpose savings and credit cooperatives in the country that are regulated under a separate cooperative societies regime (See Degefe Duressa Obo, 2009, at p. 84 and the Year Books of the country cited as FDRE(MOI), 2003/2004; FDRE(MOI), 2004/2005; and FDRE(MOI), 2005/2006, at pp. 141-159, 162-181 & 83-86, respectively. Note also the discussion under the securities market chapter below). The microfinance supervision laws are intended to empower the NBE to encourage the development of these and other institutions of the society along with the microfinance institutions and to link them with the formal financial institutions for the benefit of the low income sections of the society.

75 FDRE, 2009, at art. 4(1).

76 TGE, 1994a, at art. 34; TGE, 1994b, at art. 44; FDRE, 1996g, at art. 24; FDRE, 2009, at arts. 19(3) & 28; the Directives of the NBE; and the discussion under the ‘areas and instruments of regulation’ subtitle below.

77 Tables 1(Chap. 2); 9(Chap. 2) & 10(Chap. 2); the registers of the banking, insurance and microfinance supervision departments of the NBE; and the annual and quarterly reports of the banks, insurers and the NBE for 1996 up to 2010. Some banks are also in process of formation.

The country has not, however, achieved desirable level of banking, insurance and microfinance services. All the services are at their beginning stage of development and a substantial size of the Ethiopian population still lives without them.[78] The banks, insurers and microfinance institutions are also weak in their fixed capitals, service types, governance and competitiveness.[79] They have not diversified, modernized, automated and networked their services.[80] The banks, other than the Development Bank of Ethiopia, also concentrate on short and medium term trade finance while the insurers concentrate on short term general insurance making the total long-term insurance less than six percent of the total insurance business in the country.[81] The microfinance institutions also concentrate on short-term deposit taking and lending with very small section of the society despite their extensive authorization to stimulate the development of micro and small scale operations.[82] The payments system of the country has also remained largely to be based on the cash mode of payment.[83] The country has, therefore, still to face the challenges of enhancing the capacity and increasing the coverage, diversity and modernity of the banking, insurance and microfinance institutions and services.

2.2 The Objectives of Regulation

i. The International Experience

The banking, insurance and credit market regulations in the developed market countries have been used to pursue the following five groups of objectives:[84]

1. They have been used to achieve monetary policy objectives. The governments and central banks in the countries have often formulated monetary policy as one of their major economic policies and transmitted it through the instruments of financial regulation.[85] Hence, the central banks have often contracted and expanded the money supply through the reserving, interest, premium and foreign exchange rules to control inflation, maintain price stability and balance of payments equilibrium, and achieve the goals of economic efficiency, growth and employment.

78 Table 1(Chap. 2); annual and quarterly reports of the banks, the insurers, the microfinance institutions and the NBE for the years up to 2010; Gebreyesus Gunte, 1999; Lakew Lemma, 2000; and Degefe Duressa Obo, 2009, at pp. 72-77.

79 Annual and quarterly reports of the NBE for the years up to 2010; Tables 6(Chap. 2) & 7(Chap. 2); Degefe Duressa Obo, 2009, at pp. 72-77; and the discussions under the 'market entry and exit', 'capital adequacy', 'competition' and 'governance' regulation subtitles below.

80 Tables 6(Chap. 2) & 7(Chap. 2); Degefe Duressa Obo, 2009, at pp. 72-77; and annual and quarterly reports of the banks, insurers, microfinance institutions and the NBE for 2008, 2009 and 2010.

81 Tables 8(Chap. 2) & 11(Chap. 2); and annual and quarterly reports of the banks, insurers and the NBE for the years up to 2010.

82 FDRE, 1996g, at art. 3; FDRE, 2009, at art. 3; Tables 9(Chap. 2) & 10(Chap. 2); annual and quarterly reports of the NBE for the years up to 2010; and Degefe Duressa Obo, 2009, at pp. 72-77.

83 Note the discussion under the 'payments and settlement systems' subtitle below; Table 6(Chap. 2); and annual and quarterly reports of the NBE for the years up to 2010.

84 Möschel, 1991, at pp. 14-24; Pfennigstorf, 1996, at pp. 16-34; Hubbard, 1997, at pp. 51-56, 9 & 21-24; and Empel, (ed.), 2008, at pp. 20-21.

85 Möschel, 1991, at p. 15; and Empel, (ed.), 2008, at pp. 20-21. Monetary policy stands as one of the cornerstone policies along with agricultural, industrial, trade and fiscal policies.

2. They have been used to ensure the health, stability and efficiency of the financial markets. The banks, insurers and other financial institutions have been at the heart of the economic system because of their risk sharing, liquidity provision, information processing, and payments facilitation services.[86] The importance of these service to the economy, the exposure of the financial institutions to varieties of risks, the need for consumer protection from loss of savings, and the need for avoidance of public panic about the financial institutions have, accordingly, justified the regulation of these institutions.[87] Hence, the financial regulators in the countries have often relied on the capital adequacy, reserving, accounting, balance sheet, valuation, liquidity, solvency, functional separation, risk diversification, risk transferring, information exchange, fund guarantee, insider dealing, governance, auditing, interest, premium, foreign exchange, liquidity support and lender of last resort rules of financial regulation to meet the indicated objectives.

3. They have been used to promote competition. The competition mechanism has been useful to:

- avoid the dominance of few financial institutions over the economy;
- control the loss of impartiality in the allocation of resources;
- stimulate economic restructuring;
- increase resource mobility, flexibility, efficiency and innovativness;
- cut cost;
- control destructive behaviour and governance problems; and
- increase consumer welfare.[88]

The financial regulators have, therefore, often employed the rules of the general competition laws and the specific instruments of financial regulation (including the market entry and exit, functional separation, product distribution, information disclosure, contracting term, insider trading and market manipulation rules) to promote competition.[89] The international economic organizations, including the World Bank, the IMF and the WTO, have also appreciated the need for strengthening competition in the financial sector and reducing regulations that weaken this.[90] They have also advocated for the consideration of competition as one of the major aims of financial regulation and recognized the need for restraining it when it fails to achieve its aims.[91]

86 Hubbard, 1997, at pp. 21-24 & 52; and Pfennigstorf, 1996, at pp. 16-17.

87 Hubbard, 1997, at p. 24; Möschel, 1991, at p. 17; Pfennigstorf, 1996, at pp. 29-30; Thimm, 1999, at pp. 122 & 126-127; Finsinger, Hammond and Tapp, 1985, at pp. 6-8 & 12; and Merkin and Rodger, 1997, at p. 2.

88 World Bank and OECD, 1999, at p. v; Möschel, 1991, at pp. 17 & 20-22; Pfennigstorf, 1996, at pp. 18-20; and the discussion under the 'competition regulation' subtitle below.

89 Note the discussion under the 'instruments of regulation' subtitle below.

90 Quareshi, 1999, at pp. 177-178, 283 & 348-350; World Bank, 2000, at pp. 160-161 & 168; World Bank, 2002; Möschel, 1991, at pp. 17 & 20; Pfennigstorf, 1996, at pp. 18-23; and the GATS, at arts. iv, v, viii, ix, part iv and the annexes on financial services.

91 They have seen the need for promoting competition in the interest of flexibility, efficiency and innovation; enforcing regulation in the interest of security, stability and consumer welfare; and balancing between the two in the interest of compatibility. Ibid.

4. They have been used to protect investors, consumers, the public and the economy from the dangers of market failure. Social and economic policy has required that investors, consumers, the public and the economy have to be protected from misunderstanding, fraud, information asymmetry, bounded rationality, transaction cost, monopoly, cartelization, and lose of saving due to failure of the financial institutions.[92] They have required that:

   - the failures of the financial institutions should not lead to social and economic disturbances;
   - the financial institutions should give accurate and timely information to the users of their services;
   - all the participants in the financial markets should have access to information;
   - all financial decisions should be made prudently; and
   - the financial regulations should ensure the materialisation of these.[93]

   Hence, the regulators in the countries have also often used the insider dealing, market manipulation, product distribution and contracting rules; the reasonableness, non-discrimination, equity, fairness, transparency and information disclosure requirements; and the fund guarantee schemes of financial regulation to protect consumers, the public and the economy from the risks of financial market failure.[94]

5. They have been used to promote miscellaneous economic and social policy objectives, including the following:

   - protecting small businesses from rigorous competition,
   - preventing foreign ownership and competition,
   - enforcing government and sectoral financing,
   - assuring financial service availability and affordability,
   - protecting financial market structure and reputation,
   - increasing employment,
   - distributing social risk, and
   - pursuing constitutional principles, such as democracy, due process and federalism.[95]

Hence, the regulators have also used the market entry and exit, (service, investment and geographic) diversification, interest, premium, and financial reserving requirements of financial regulation and the general requirements of

92 Möschel, 1991, at pp. 18-19; Pfennigstorf, 1996, at pp. 18-25 & 29-33; Thimm, 1999, at pp. 121-136; and Finsinger, Hammond and Tapp, 1985, at pp. 11-13. The OECD has also shown that the financial understanding and awareness of consumers have often been low due to the increased sophistication of the financial markets and services and hence that the financial regulators and competition authorities need to put the necessary attention on the objectives of consumer protection and building consumer awareness (OECD, 2005b; and OECD, 2008h).

93 Hubbard, 1997, at p. 51.

94 Cartwright, 1999, at pp. 3-279 (for detailed discussion of the objective and mechanisms of consumer protection in financial services).

95 Möschel, 1991, at pp. 22-24; and Pfennigstorf, 1996, at pp. 31-32.

adherence to constitutional and administrative principles of good administration to enforce these types of objectives.

The reconciliation and prioritization of the aforementioned objectives has, however, been variable across the countries as a matter of economic, social, political and constitutional philosophy. The countries have passed through cycles of regulation and deregulation to enforce the objectives, solve specific problems, and respond to lobbies for and against regulation.[96] They have, however, also generally recognized the incompatibility between regulation and free competition and continuously strived towards making sure that the contents and practices of the former do not violate the latter.[97] They have also often tried to balance between the objectives of promoting profitability and ensuring financial stability and health.[98] They have also considered the fifth set of objectives as matters outside the realm of monetary and financial policy as a matter of principle and pursued them through the instrumentality of financial regulation only when the policy and law makers have framed them outside this policy (i.e. in the realms of trade, fiscal and other policies) and the financial regulators could coordinate them with the objectives and instruments of financial regulation.[99] The use of financial regulation to pursue this set of objectives has, however, also diminished through time.

The regulations in the transition and emerging market countries of Eastern Europe, Asia, Latin America and Africa have also been guided by the new free market policies of the countries and the dynamics of their transitions to free market.[100] The free market principle has required the countries to create freely competitive financial markets and to regulate the latter to meet the other objectives without detriment to the free competition objective.[101] The governments of the countries have, however, also appreciated the need for government regulation for sake of ensuring economic development and prudence (among others) and tended, in practice, to consider the achievement of unencumbered competition alone secondary at best.[102] They have tended to take into account the experience in the developed market countries in this regard and to reprioritise the objectives of regulation according to the perceived demands of their transitions.[103] They have, therefore, used their banking, insurance and credit market policies and regulations to meet the objectives of developing the markets, expanding the financial services, promoting competition, ensuring efficiency and

96 Chance, 1993, at p. 2; Merkin and Rodger, 1997, at pp. 2-3; Nemeth, 2001, at pp.13-20; Lemaire, 1997, at pp. 31-32; Meier, 1988, at pp. 33-48; and Pfennigstorf, 1996, at pp. 25-26 & 32-33.

97 Ibid.

98 Thimm, 1999, at pp. 160-161; and Finsinger, Hammond and Tapp, 1985, at p. 16.

99 Möschel, 1991, at pp. 22-24; and Pfennigstorf, 1996, at pp. 31-32.

100 Zonis and Semler, 1992, at pp. 18-26, 88-95, 161-168, 232-240, 303-310 & 371-380; Pfennigstorf, 1996, at p. 33; Murshed and Subagjio, 2000; Manzetti, 2000a; Kaufman, 2000; Pomfret, 2002; Stallings and Studart, 2002; and González, et al., 2003.

101 Zonis and Semler, 1992, at pp. 18-26, 88-95, 161-168, 232-240, 303-310 & 371-380; and Pomfret, 2002, at pp. 57-60 & 76-104.

102 Zonis and Semler, 1992, at pp. 18-26, 88-95, 161-168, 232-240, 303-310 & 371-380; Murshed and Subagjio, 2000; Stallings and Studart, 2002; Pfennigstorf, 1996, at p. 33; Pomfret, 2002, at pp. 57-60 & 76-133; and Manzetti, 2000a, at pp. 83-101.

103 Ibid.

safety, preventing and correcting financial crises, encouraging information flow, achieving monetary policy goals, protecting investors and consumers, creating the conditions for economic development, and enforcing general economic and social policy objectives that are contributory to their development and transition to free market although they have differed in the prioritisations of the objectives and the degrees of their successes.[104] They have also targeted their microfinance regulations at formalizing and expanding the microfinance services, enhancing the financial inclusion of the poor, preventing failure and creating the conditions for economic development.[105]

The BCBS, IAIS and OECD have also emphasized on the need for defining regulatory objectives according to domestic problems and encouraged both the developed and the developing market countries to prioritise between objectives that are more or less like the five groups of objectives indicated above and to enforce them according to the preconditions for effective enforcement that can be available in their domestic situations.[106] The 2008 financial and economic crisis has also made the prevention of systemic failure and protection of investors and consumers among the top priorities of financial market regulation.[107] The recent recommendation regarding microfinance regulation is also towards further balancing between the objectives of expanding availability and increasing the benefits of microfinance, on the one hand, and promoting the commercial business approach (i.e. competition), enhancing sustainability, preventing failure, and protecting consumers, on the other.[108]

ii. The Case of Ethiopia

Ethiopia did not define the reasons and objectives of its banking and insurance laws prior to enactment of the Monetary and Banking Proclamation of 1963, the NBE Charter Order of 1963, and the Insurance Proclamation of 1970. Only these

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104 Pfennigstorf, 1996, at p. 33; Kaufman, 2000, at pp. 109-138; Murshed and Subagjio, 2000; Manzetti, 2000a, at pp. 83-101; Stallings and Studart, 2002; Pomfret, 2002, at pp. 57-60 & 76-133; Jhingan, 2002, at p. 424; González, et al., 2003, at pp. 1-430; and Petersen, 2004, at pp. 116 & 120-122.

105 WSBI/ESBG, 2009, at pp. 19 & 27-34; Degefe Duressa Obo, 2009, at pp. 15-24 & 46-52; Berger, et al., (eds.), 2006; and Copestake, et al., (eds.), 2005.

106 BCBS, 1997; BCBS, 2006; BCBS, 2006a; IAIS, 2003; and OECD, 2009f. The recent OECD framework for effective and efficient financial regulation has in particular emphasised on the need for understanding the financial landscape, identifying the underlying problems, defining the regulatory objectives according to the problems, and matching the regulatory instruments with the defined regulatory objectives (OECD, 2009f). The domestic regulation rule of the GATS also follows similar approach by setting a 'necessity test' which requires that regulatory instruments should not be more burdensome than necessary to meet their objectives (GATS, at art. VI(4-5)).

107 It has shown the need for balancing between the objectives of preserving the safety and soundness of the financial system and protecting investors and consumers, on the one hand, and the objectives of promoting competition, innovation and efficiency, on the other. Walker, 2007; Marcelo, et al., 2008; Quagliariello, 2008; Christoph Ohler, 2009; J. Balvin Hannibalsson, 2009; Stephen, 2009; Goodhart, 2009; Thorsten, 2010; World Bank, 2009b; IMF, 2009; WTO, 2009; G-20, 2009; OECD, 2009f; AP, 2009; AP, 2009a; AP, 2009b; AP, 2009c; AP, 2010a; and Bloomberg, 2010.

108 Berger, et al., (eds.), 2006; WSBI/ESBG, 2009, at pp. 19 & 27-34; and Degefe Duressa Obo, 2009, at pp. 15-24 & 46-52. The consultative document of the Basel Committee on 'Microfinance Activities and the Core Principles for Effective Banking Supervision' has also recommended the effective adaptation of the objectives of banking supervision to the microfinance sector (BCBS, 2010).

laws included objectives. The Monetary and Banking Proclamation and the Charter Order made it clear that the purpose of the NBE was fostering monetary stability and credit and exchange conditions that are conducive to the balanced growth of the economy of the country.[109] The Insurance Proclamation also made it clear that the Insurance Council was to issue policies that would promote and regulate sound insurance and that the Insurance Controller's office was to implement the policies of the Council.[110]

The country's attention in the post-revolution period was to meet the government's annual, medium and long-term plans.[111] The NBE was required to accelerate the balanced economic development of the country, to encourage and promote the development of the country's productive forces, and to promote production, employment and income according to national plan.[112] Both the banking and insurance policies and operations were, accordingly, guided by national objectives that were decided by the then National Office of Central Planning and directly administered by the government.[113]

The country has conducted financial and economic policy reforms in the post-1991 period. It has focused on the functions of restructuring and increasing autonomy of the government owned financial institutions, expanding the credit and savings facilities to the private sector, enhancing the prudence of the money supply and the exchange rate of the Ethiopian birr, and balancing the state budget by its transitional period economic policy.[114] It has focused on the following in pursuing the financial reform during and after the transitional period:

- developing the financial system,
- controlling inflation,
- mobilizing domestic saving,
- promoting private sector investment,
- enhancing competition,
- reducing deficit financing by bank borrowing,
- improving financial efficiency,
- preventing financial crisis,
- encouraging transparency,
- eliminating credit control,
- improving the environment for the financial institutions,
- smoothing the operational relationship between the financial institutions,
- encouraging the financial institutions to provide medium and long-term credits,
- expanding the financial services to small and micro enterprises,

109 IGE, 1963d; and IGE, 1963e, at arts. 3, 5 & 7.
110 IGE, 1970b, at arts. 5 & 4(2).
111 Itana Ayanna, 1994, at pp. 241-243.
112 PMGE, 1976i, at arts. 3 & 6.
113 Itana Ayanna, 1994, at pp. 241-243; Befekadu Degefe and Berhanu Nega, (eds.), 1999/2000, at pp. 284-296 & 304-308; PMGE, 1977; and PMGE, 1978e.
114 TGE, 1991, at pp. 34-36. The transitional period economic policy was effective from 1991 up to 1995.

- developing inter-bank money and foreign exchange markets,
- widening the participation in the treasury bills market,
- increasing the international reserve,
- deregulating the international current account,
- reducing the control on foreign exchange supply,
- increasing the market determination of interest, premium and foreign exchange rates,
- standardizing the reporting system of the financial institutions, and
- enhancing the regulatory capacity of the NBE.[115]

It has also focused on the following in pursuing the general economic policy reform:

- reducing fiscal deficit,
- maintaining macroeconomic and price stability,
- liberalizing investment,
- increasing privatisation,
- promoting private sector development,
- enhancing public and private sector capacities,
- increasing economic growth,
- increasing international competitiveness, and
- implementing development programs (such as in agriculture, infrastructure, education, health, population and foreign trade).[116]

It has also authorized the NBE to promote the objectives of maintaining price and exchange rate stability, fostering healthy financial system, and creating the conditions for rapid economic development by its establishing laws.[117]

It does not, however, expressly define and prioritize the specific objectives of its banking, insurance and microfinance regulations in the banking, insurance and microfinance supervision laws, and indicates only generally that the NBE has to be guided by the aforementioned objectives in carrying out its functions as central bank.[118] It does not also have comprehensive financial regulatory policy that defines the specific purposes of its regulations.[119] The NBE does not also indicate

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115 Itana Ayanna, 1994, at p. 246; Ibrahim Abdullahi, 1998; Befekadu Degefe and Berhanu Nega, (eds.), 1999/2000, at pp. 296-302 & 308-317; Ethiopia, 1998/99-2000/01; Yohannes Ayalew, 2000; FDRE, 2001b, at pp. 186-202; FDRE, 2002g, at pp. 96-124; Ethiopia, 2002; Ethiopia, 2003; Ethiopia, 2004; and Ethiopia, 2006. It has included all these in its poverty reduction strategy (Ethiopia, 2002).

116 Ibid.

117 TGE, 1994, at art. 6; and FDRE, 2008a, at art. 4.

118 TGE, 1994a; TGE, 1994b; FDRE, 1996g; FDRE, 2008b; and FDRE, 2009.

119 There are only some general statements in the rural and industrial development policies and strategies of the country which indicate that the country's financial market has to develop and mobilize resources in a way that it will support the development and rural finance needs of the country and that this has to be done by diversifying the financial market, modernizing the financial services, increasing the competitiveness of the financial institutions, streamlining the financial services to productive and developmental ventures, linking between the operations of the banks, microfinance institutions, rural cooperative societies and the farmers, and not liberalising the financial market in the short run (FDRE, 2001b, at pp. 186-202; and FDRE, 2002g, at pp. 96-124).

the specific objectives of its regulations in its directives consistently.[120] It only claims in its reports that it focuses on the objectives of controlling inflation, maintaining price and exchange rate stability, encouraging financial market development and competition, and creating the environment for economic growth.[121] It has also refrained in practice from directly regulating credit and implementing the general economic and social policy objectives (that are usually outside the realm of monetary and financial policy) through the instruments of the banking, insurance and microfinance regulations.[122] The specific objectives of the banking, insurance and microfinance regulations of the country are, therefore, only inferred in practice from the powers and objectives of the NBE as central bank, the monetary policy framework of the NBE, the country's general economic policy, and the pieces of principles included in the competition and other laws of the country.

The country needs to expressly define and prioritize the specific objectives of its banking, insurance and microfinance regulations in the respective supervision laws and the NBE needs to link its directives and regulatory measures to the specific objectives consistently so that the objectives of regulation will not be overlooked and the regulatory power abused during enforcement. This will also enable the financial institutions, consumers and stakeholders to clearly know about the reasons and objectives of financial regulation, appreciate the importance and legality of the instruments used, and contribute to the enforcement of regulation.

The economic transition in the country implies that it needs to take into account the experience of the regulations in both the developed and the transition and emerging market countries, make the objectives of its banking, insurance and microfinance regulations like the ones in the latter, and thereby manage the dynamics of its transition towards free market. Hence, the country also needs to focus on the following in defining the specific objectives:

- developing the markets;
- disseminating, diversifying and modernizing the financial services;
- promoting competition, efficiency and innovativeness in the financial system;

The 2009 monetary policy framework of the country does not also deal with the specific objectives of the banking, insurance and microfinance regulations as its focus is on monetary policy (NBE, 2009).

120 It stated the reasons and objectives of only directives no. SBB/24/99, SBB/25/2000, SBB/26/2001, SBB/28/2002, SBB/31/2002, SBB/32/2002, SBB/33/2002, SBB/43/2007, SBB/46/2010, SBB/47/2010, SBB/48/2010 & MFI/18/2006; the REL, IBM, IBFM and ERD directives; and the Foreign Exchange Auction Amendments.

121 Note the Governors' notes to the annual reports of the NBE for 1995 up to 2009.

122 The government has also shifted its domestic borrowing from the commercial banks to the central bank. FDRE, 1996g; FDRE, 2009, at arts. 3, 4 & 21; FDRE, 1996i, at arts. 33-45 & 59; FDRE, 1997e, at arts. 50-57 (with focus on arts. 50(3), 50(4) & 75); TGE, 1994a, at art. 17(4) & the preamble; FDRE, 2008b, at art. 22; TGE, 1994, at arts. 25(1)(e), 25(3), 26, 27 & the preamble; FDRE, 2008a, at arts. 12(6) & 13; FDRE, 2001b, at pp. 186-202; EPRDF, 2000, at pp. 81-105; NBE, 1999/2000, at sections 5.2.2, 5.3, 7.3 & 7.4; NBE, 2000/2001, at section VII; NBE, 2001/2002, at sections 5.3.2, 5.4, 7.1 & 7.4; NBE, 2002/2003, at sections 5.3.2, 5.4. & 7.5; NBE, 2003/2004, at sections 5.3., 5.4.1 & 7.4; and Befekadu Degefe and Berhanu Nega, (eds.), 1999/2000, at pp. 371-377.

- maintaining financial market health, stability and security;
- preventing systemic failure;
- protecting consumers, the public and the economy from abuse and financial failure;
- increasing information disclosure and prudential decision making;
- meeting the monetary policy objectives; and
- achieving economic and social policy objectives contributory to its development and transition to free market.

It, however, also needs to learn from the international experience and enforce the last set of objectives through the instruments of financial market regulation by formulating them outside the realm of monetary and financial policy and to the extent that they can be coordinated with the other objectives of financial regulation. It also needs to enhance the competition regime for the financial markets and enforce the other objectives of regulation without endangering the competition objective.

The monetary policy of the country also needs to continue to focus on the objectives of controlling inflation, influencing the cost and availability of financial services, maintaining price and exchange rate stability, and achieving balance of payments equilibrium since these are ongoing problems in the country.

2.3 The Areas and Instruments of Regulation

2.3.1 Prudential Regulation

2.3.1.1 Market Entry and Exit Requirements

A. Introduction

Most countries subject their banks and insurers to market entry and exit requirements.[123] They often impose number, nationality, location, legal form, initial capital, ownership spreading (and quality), business plan, organizational structure, and management quality related requirements for licensing.[124] The international organizations on financial regulation also recommend the adoption of licensing regimes that include many of the aforementioned requirements.[125] Ethiopia also includes many of these requirements in its banking, insurance and microfinance regulations.[126] The following sections discuss these requirements and the rules on granting and termination of licence.

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123 Möschel, 1991, at pp. 51-55 & 112; Pfennigstorf, 1996, at p. 64; and IAIS, 2005b, at pp. 14-17.

124 Möschel, 1991, at pp. 51, 55-56 & 112-114; Pfennigstorf, 1996, at pp. 52, 64-83, 105-109 & 111; Thimm, 1999, at pp. 166-167; Lemaire, 1997, at p. 35; Finsinger, Hammond and Tapp, 1985, at p. 16; and IAIS, 2005b, at pp. 14-17.

125 BCBS, 2006, at Principle 3 and its explanatory note; and the IAIS, 2003, at Principles 6-10 & 16 with the explanatory notes to them.

126 TGE, 1994a, at arts. 3-5, 7-9, 10(e), 26, 27(2) (a-b) & 27(3); FDRE, 2008b, at arts. 3-9, 11, 14-17 & 50; TGE, 1994b, at arts. 6-8, 25, 39, 40, 41 & 44; FDRE, 1996g, at arts. 4-8, 10, 12-14 & 17-18; and FDRE, 2009, at art. 4-8, 25 & 28.

B. The Requirements
a. Number and Nationality

i. The International Experience

A number of the developed market countries had rules which prohibited or restricted the foreign ownership of their financial institutions and the admission of foreign institutions into their markets.[127] They had absolute limits, quotas, needs tastes and ceilings.[128] They had the belief that their domestic markets and the monetary controls of their central banks would be threatened if foreigners were to be allowed into their markets.[129] The majority of them also had rules which prohibited the cross-sectoral penetration and convergence of their financial institutions, activities and products.[130] Many of them have, however, removed these restrictions, allowed the internationalization of the financial institutions, opened up their financial markets for foreign entry, recognized the creation of financial conglomerates and moved towards full participation in international trade as innovation, competition and movement of capital grew and the financial institutions became increasingly international in the 1980s and thereafter.[131]

Most of the transition and emerging market countries of Eastern Europe, Asia and Latin America and some of the countries in Africa have also removed these types of restrictions and opened up their financial markets for foreign investment after the reforms of the late 1980s and the 1990s.[132]

The international economic institutions (including the WTO, the World Bank and the IMF) have also generally promoted global financial sector liberalization and market integration.[133] They have felt that limitation to openness will diminish economic growth (and welfare) and hence that an economic system looking forward to market forces and competition at its core has to gradually move towards opening up of its financial markets to foreign investment.[134]

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127 Möschel, 1991, at pp. 22 & 51-52; World Bank, 2000, at p. 162; Pfennigstorf, 1996, at pp. 66 & 75-77; and Laboul, 1992, at pp. 10 & 38-41.

128 Many of the developing countries and some like Canada still have varieties of these restrictions. World Bank, 2000, at p. 162; and Pfennigstorf, 1996.

129 Möschel, 1991, at p. 133; and Pfennigstorf, 1996, at pp. 66 & 75-77.

130 Laboul, 1992, at pp. 10 & 38-41.

131 Möschel, 1991, at p. 142; Pfennigstorf, 1996, at p. 66; Hubbard, 1997, at pp. 416-419 & 421-422; Laboul, 1992, at pp. 10-11 & 38-41; Thimm, 1999, at pp. 167-169; Rietbergen, 1999, at pp. 13, 16-18, 22, 25-26, 95-122 & 149; Lemaire, 1997, at p. 52; Meier, 1988, at pp. 6-7, 14, 17 & 47-48; Nemeth, 2001, at pp. 45-46; and Gkoutzinis, 2006, at pp. 1-318. Note also the discussion under the 'history and current state' subtitle above.

132 Zonis and Semler, 1992, at pp. 18-26, 88-95, 161-168, 232-240, 303-310 & 371-380; World Bank, 2000, at pp. 161-162; Bokros, 2001; World Bank, 2000a; Feldstein, 2003. Note also the discussion under the 'history and current state' subtitle above.

133 Bokros, 2001; World Bank, 2000, at pp. 164-169; World Bank, 2000b; and Urrutia, 1988. The WTO has played the leading role through the GATS (See the GATS, at the preamble, arts. IV, V, XIV up to XXI & the annexes on financial services; and WTO, 2003)

134 All of them have transformed their views from considering the state as engine of economic growth to a neo-liberal approach that markets and market friendly states should operate in an internationally liberalized market (GATS; Rietbergen, 1999, at p. 30; World Bank, 2000, at pp. 164-169; Paloni and Zanadari, 2006; and Quareshi, 1999).

The foreign banks and insurers, once admitted into the domestic market, have, however, also been included in the domestic regulatory system because of the economic sovereignty of the state.[135] The concerns that have often followed the liberalization measure were also the problems of foreign decision, the regulatory treatment of the foreign and domestic institutions, and the need for reciprocity. The making of choice from national or differential treatment has also been core question. The regulatory solutions and practices have, however, varied from country to country with most of them favouring the national treatment principle.[136]

The consensus in the aftermath of the 2008 financial and economic crisis has also been towards, not protectionism, but the strengthening of liberalization policies, risk prevention and failure resolution capabilities, and international cooperation.[137]

ii. The Case of Ethiopia

Ethiopia does not currently have limits on the number of banks, insurers and microfinance institutions that have to be licensed. Its aim is to expand the provision of these services.[138] It, however, prohibits the ownership of these institutions by foreign natural and foreign owned juridical persons.[139] It needs to

135 Möschel, 1991, at pp. 133-134; Quareshi, 1999, at pp. 34-45, 53-59 & 69-71; and the schedules of commitments of the countries that have acceded to WTO from the WTO website. The processes of deregulation, competition, economic integration and internationalization of businesses in the 1980s and the 1990s have, of course, led to the questioning of the meaning of the nation-state and made the notion of national sovereignty relative. The global situation has also shifted in the last few decades from one where the determinants of economic activity were 'nationally defined political and economic parameters' into one where the determinants are international competition and international design or adjustment of institutional frameworks by international organizations (Thimm, 1999, at pp. 1-3 & 10-36). The economic sovereignty of the state is not, however, thrown away. Even the EU has proceeded with the help of 'mutual recognition' principle that maintained the regulatory roles of its member states. The principles of harmonization and mutual recognition have led to regulatory transformation and not necessarily to the diminishment of the roles of the national governments. They have led to multi-level governance system where markets are made open for international competition, minimum regulations are made by directives and regulations of the EU at the supra-national level and enforced by laws and administrative rules of the national governments at the national level, and the residue regulation is left to the national governments (Thimm, 1999, at pp. 2, 3-9 & 20-35; Chance, 1993, at p. 2; Nemeth, 2001, at pp. 20-21, 42-59 & 62-83; and Quaglia, 2010). The WTO does not also prescribe, but recognizes, the domestic regulation of the liberalized services markets and institutions as long as the regulatory requirements are administered reasonably, objectively and impartially (GATS, at article VI; and Panourgias, 2006).

136 Möschel, 1991, at pp. 136-140; Pfennigstorf, 1996, at pp. 66 & 75-79; World Bank, 2000, at p. 162; and the schedules of commitments of the countries that have acceded to WTO from the WTO website.

137 WTO, 2009; World Bank, 2009; World Bank, 2009b; IMF, 2009; IMF & FSB, 2009; and G-20, 2009. Several researches have also argued that the internationalization of the financial markets should not be taken as the real cause of the 2008 financial and economic crisis although it might have contributed to its contiguity (Andrew and Mark, 2009; Andrew and Mark, 2009a; Michael and Harold, 2009; Enrique and Vincenzo, 2009; Goodhart, 2009, at pp. 9-29; Chorafas, 2009, at pp. 3-33 & 61-179; and Liedtke, (ed.), 2010, at pp. 5-66).

138 Note the preambles to the laws: TGE, 1994a; FDRE, 2008b; TGE, 1994b; FDRE, 1996g; and FDRE, 2009.

139 TGE, 1994a, at art. 4(2); FDRE, 2008b, at arts. 4(1)(d), 2(5) & 9; TGE, 1994b, at arts. 2(3) & 4(1)(a); FDRE, 1996g, at arts. 2(2) & 4(1)(b); FDRE, 2009, at art. 25; FDRE, 1996c, at art. 6(1)(a); and FDRE, 2003a, at art. 3 and Schedule 2(1). The NBE also imposes the nationality requirement

trade off between the short-term harms and the long-term benefits of opening up of its financial market for foreign investment given the merits and demerits of the latter. The underdevelopment of regulatory capacity, weakness of international competitiveness of the domestic financial institutions and non-liberalization of the foreign exchange regime of the country justify gradualism. Rapid financial market liberalization can be followed by crisis unless adequate macroeconomic performance and regulatory infrastructure is put in place.[140] Liberalization can also help to meet the objectives of raising national savings, increasing investment, and improving resource allocation only when it is done with deep commitment, careful sequencing and effective regulation.[141] It can, therefore, be argued that the macroeconomic conditions, the regulatory capacity and the financial institutions need to grow well before Ethiopia attempts at liberalizing its financial market.[142] However, long delay of opening up of the financial market for these reasons can not also be justified as it is also through the simulation of international exposure that both regulatory and market capacities can be built. It will not also be compatible with the country's accession to the WTO as the latter does not favour the undue delay of services liberalization despite its acceptance of the principle of progressive liberalization.[143] The prohibition of foreign ownership of the financial

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on insurance auxiliaries. It however, also recognizes the provision of services by foreign actuaries, loss assessors and loss adjustors (TGE, 1994b, at art. 25; and Directives No. SIB/11/1996; and SIB/12/1996). The insurers of the country have also acquired actuarial services from non-Ethiopian actuaries (usually Kenyans) upon recognition of the NBE (See annual reports of the long-term insurers). The underdevelopment of regulatory capacity, weakness of international competitiveness of the domestic financial institutions and non-liberalization of the foreign exchange regime of the country are the reasons stated in policy for the prohibition of foreign ownership of the banks, insurers and microfinance institutions (FDRE, 2002g, at pp. 109-114).

140 Many of the failures that followed the financial market liberalization in Asia and Latin America in the 1990s were caused by instability of capital flow and rapid liberalization in the absence of adequate macroeconomic performance and regulatory supervision (Urrutia, 1988; Sikorski, 1996; Dickie, 1997, at pp. 35-45; Djiwandono, 1997, at pp. 57-69; Helleiner, 1998, at pp. 1-219; Stiglitz, 2000; Haggard, 2000, at pp. 130-144; Alberto, et al., 2000, at pp. 1031-1055; Sharma, 2000, at pp. 47-51; Tsurumi, 2001; Stallings and Studart, 2002, at pp. 1-20; Gray, 2003; and Feldstein, 2003, at pp. 1-512). Ethiopia has to learn from that.

141 Ibid.

142 Many support this approach for Ethiopia. Alemayehu Geda, 2000; Eyob Tesfaye, 1999; and NBE-ERD, 1998.

143 Ethiopia is already in the process of accession to WTO (See Melaku Geboye Desta, 2009 and website of the WTO for the general story). The GATS does not force acceding countries to commit their financial services for foreign investment at once. It only requires the progressive liberalization of the services markets through negotiation of commitments and recognizes the making of market access limits and domestic regulation (GATS, at the preamble, articles VI, XIX(1), XVI, XX; and the annexes on financial services forming part of it). It also encourages the recognition of the special situation of least developed countries and the facilitation of their increased participation in world trade (and membership in WTO) by requiring the member countries to refrain from demanding much commitment by the least developed countries during the accession and negotiation processes (See the GATS, at the preamble and articles IV & XIX (2); the 'Modalities for Special Treatment of LDC Members' of the WTO Council for Trade in Services of September 05 2003; and the 'Guidelines for Accession of Least-Developed Countries' of the WTO General Council of 10 December 2002). Given these, however, it is unlikely that a country will succeed with its accession negotiations or continue in its WTO membership with total exclusion of the liberalization of its financial services markets. The recent accessions to the GATS and the July 2008 services 'Signalling' Ministerial Conference of the WTO for the Doha round negotiations have already shown that there are grown interests for greater commitment towards liberalization of the financial and other services markets (See the WTO data base on the accession commitments from its website; the 2009 WTO annual report (WTO, 2009), at pp. 19ff; and the WTO news on services

institutions has also already resulted in distortion of the ownership and governance of the microfinance institutions of the country.[144] Both rapid reform and long delay of liberalization are not, accordingly, justified for the country as the former can lead to crisis unless followed by strong regulation while the latter will mean unduly postponing the potential benefits of international competition and inflow of finance to the country.[145] The country needs to strike balance between the two interests. It needs to work both to build its regulatory and market capacities and to open up its markets for international investment without much delay if it has to experience the benefits of international competition and inflow of finance.[146] It may have to start by inducing its financial institutions to open and operate branches outside the country, on top of the correspondence businesses they currently engage in, so that they will experience international competition and then proceed to allow the entry of foreign financial institutions into its market and/or the foreign ownership of its institutions. It, however, needs to implement the liberalization measure gradually and in a way that will not necessitate capital account liberalization until it becomes able to absorb international risks. It is also recommended internationally that a developing country needs to control its capital account at the initial stages of its reform and follow a reform sequence of: first, develop fiscal and monetary control (i.e. limit government spending, have broad based tax system, reduce tax rates, control inflation, and stabilize prices); second, enhance banking, insurance and microfinance regulation and develop domestic capital market (with institutional investors and the necessary regulation); third, liberalize the banking and capital markets without opening up the international capital account; and fourth, open up the international capital account and allow the free convertibility of foreign exchange.[147] Ethiopia needs to work on the first two steps currently and head towards the third and fourth through time.

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negotiations under the Doha development agenda from its website - with emphasis on the report of the chairman of the Trade Negotiations Committee for services on the "signalling" Conference of July 26 2008, cited in this study as WTO, 2008).

144 The microfinance institutions have obtained donated capitals from external sources which are substantially higher than their subscribed capitals and these are represented by pseudo shareholding structures that have led to governance problems (Tables 9(Chap. 2) & 10(Chap. 2); the record of the microfinance supervision department of the NBE; and Degefe Duressa Obo, 2009, at pp. 6, 87-164, 179-190, 213-218 & 223-227).

145 The international experience has also shown that both rapid reform and long delay of liberalization (with too much domestic regulation) can not meet the objectives of raising saving, increasing investment and improving resource allocation although strict regulation is found desirable in particular at the initial stages of financial adjustment and liberalization (Urrutia, 1988, at pp. 3-6).

146 The 2008 financial and economic crisis has, of course, slowed down the international flow of finance to developing countries (Reuters, 2009; WTO, 2009; World Bank, 2008a; World Bank, 2009; World Bank, 2009b; World Bank, 2010b; World Bank, 2010c; and IMF, 2010g). One can, however, be optimist about the future and advice Ethiopia to work towards the indicated measures. The government banks and insurer are also big enough to compete with foreign banks if they enhance their services, working styles, human capacities and technologies. The country needs to work in both directions.

147 Dickie, 1997, at pp. 38-45; Helleiner, 1998, at pp. 1-219; Sharma, 2000, at pp. 62-70; and Alberto, et al., 2000, at pp. 1051-1055. The 2008 financial and economic crisis has also shown that international openness of financial accounts, strong cross-border financial linkage and strong dependence on foreign capital inflow will increase exposure to crisis unless adequately regulated. The case of Iceland is example (EC, 2009; J. Balvin Hannibalsson, 2009; and Jónsson, 2009).

The country also needs to take care of the factors that influence the international expansion of financial companies and the way international companies expand if it has to attract one. The choice of location and form of penetration of the international services companies are often influenced by the history and size of their established businesses; the market size in the host countries; the economic interaction between the home and host countries; the physical and cultural distance between the home and host countries; the number of entry barriers in the host countries (more specifically the government regulations and the distribution methods); and the competitive advantages in comparison to the potential competitors in the host countries.[148] The market potential, the productivity of capital and labour, the presence of important customers who establish offices abroad, the potential for high growth rates, the lowness of concentration and competition, the potential for spreading risks, the highness of economic interaction with the home country, the smallness of the geographical and cultural distance between the home and host countries, and the potential for long-term and stable market relationship are also said to be major deriving factors in raising the interests of service companies for foreign penetration.[149] The international financial institutions are also said to have expanded by type of business, type of product and type of distribution channel in the past.[150] Their international investment has also been affected by a 'follow-the-client' motive.[151] Hence, Ethiopia needs to take into account the direction of its foreign trade and incoming foreign investment, try to open up its financial market to the financial institutions of its major trading partners, and enhance its financial market and regulatory capacities until it joins the WTO and fully liberalizes the market.[152]

The country also needs to take note of the experience it had with the foreign owned banks and insurers in the 1930s up to the 1970s. Some of the institutions like the Bank of Ethiopia and the Addis Ababa Bank S.C. had more value for development objectives of the country than their profit motives while the many others which operated as branches of the foreign banks and insurers were more profit motivated than being developmental.[153] The Imperial Government of the time had only to entertain both groups of institutions for reason of their importance to disseminate financial services in the country. That being history, the country currently needs to:

- give attention to the roles the foreign financial institutions can play in the enhancement of competition and the development of the quality and types of its financial services, and

148 Rietbergen, 1999 at pp. 19-23 & 65-93.

149 Id., at pp. 27-28 & 95-122.

150 The most common forms of their expansion are said to be opening of a branch or a subsidiary in a foreign market, acquisition of or merger with a foreign company, exporting and selling of services through strategic alliances, and international cooperation through networking and joint venture. Id., at pp. 21, 28-30, 32 & 65-93.

151 Id., at pp. 27-28 & 95-122.

152 See Table 23(Chap. 2); quarterly reports of the NBE for 2008, 2009 and 2010; and records of the Ethiopian Investment Agency for 2008, 2009 and 2010 for the direction of Ethiopia's external trade and incoming foreign investment during the last one and a half decades.

153 Note the discussion under the 'history and current state' subtitle above.

- design a regulatory system that can discourage the potential problem of hit and run and encourage the contribution of the foreign financial institutions to the development of its financial system.

It also needs to cooperate with the home country regulators of the financial institutions in this respect.

b. Location and Registration

i. The International Experience

Many of the countries used to have geographic and branching limits to facilitate supervision, ensure financial and managerial capacity, prevent the contiguity of risk, promote division of labour, and/or reflect tradition of federalism and decentralization.[154] They have removed these types of limits from their modern regulations although they still have registration requirements as elements of their licensing regimes.[155]

ii. The Case of Ethiopia

Ethiopia has not decentralized the formation and regulation of its financial institutions. It establishes the government banks and insurer by laws of the Federal Government.[156] It requires the private banks, insurers and microfinance institutions to meet formation requirements under the federal laws and get their licenses from the NBE.[157] It requires them to register principally in the federal commercial register at the Ministry of Trade and Industry and to operate under supervision of the NBE.[158] It requires the banks and insurers to get branching permit from the NBE and the microfinance institutions to notify their branching to the latter.[159] It requires all of them to disclose the addresses of their principal offices and branches to the NBE and the commercial registers of the places where their branches are located and strictly prohibits them from changing or closing

154 Möschel, 1991, at pp. 52-55; Caddy, 1986, at pp. 60-61; and Lovett, 1992, at p. 183. Note also the discussion under the 'history and current state' subtitle above.

155 The United States has removed them as of the 1970s. The other countries have removed them subsequently. Möschel, 1991, at pp. 52-55; Caddy, 1986, at pp. 60-61; and IAIS, 2005b, at pp. 14-17.

156 TGE, 1994d; TGE, 1994e; TGE, 1994f; TGE, 1994g; and FDRE, 2003.

157 IGE, 1960, at arts. 312-324, 210, 211, 214 & 219-223; FDRE, 1997a, at arts. 20 & 5 (as applied by FDRE, 1997b); FDRE, 2010a, at arts. 5-9, 12 & 30-31; TGE, 1994a, at arts. 3 & 5(7); FDRE, 2008b, at arts. 3, 4(1)(d) & 60(3); TGE, 1994b, at art. 6; FDRE, 1996g; and FDRE, 2009, at art. 4.

158 The Ministry administers a federal commercial register which also serves as national archive. The regional governments also administer regional commercial registers. The banks, insurers and microfinance institutions are required to register in the federal commercial register at the Ministry on their first establishment upon approval by the NBE. The microfinance institutions are also required to re-register in the NBE when the amount of saving they mobilize reaches one million Birr. TGE, 1994a, at art. 5(7); FDRE, 2008b, at art. 4(d); TGE, 1994b, at art. 6(4); FDRE, 1996g, at arts. 4, 10, 14 & 24; FDRE, 2009, at arts. 5(1)(c) & 6(5); FDRE, 1997a; FDRE, 1997b; FDRE, 1997c; FDRE, 2003b; FDRE, 2003f; and FDRE, 2010a, at arts. 5 & 6(1-4).

159 TGE, 1994a, at arts. 5(1)(a) & 5(4); FDRE, 2008b, at art. 3(3)(a); TGE, 1994b, at arts. 6 & 44; FDRE, 1996g, at art. 14; FDRE, 2009, at art. 6(5); and Directives No. SBB/22/96; SIB/2/1994; SIB/8/1995; and MFI/07/96.

their places of businesses without written consent of the NBE.[160] It does not, however, limit the branching and geographic areas available for the banks, insurers and microfinance institutions. These rules are justified by the interest of the country to disseminate the banking, insurance and microfinance services. They are not also inconsistent with the international experience.

The country, however, needs to use its licensing and branching regulation to balance between two interests. On one hand, the need for balanced economic growth across regions of the country necessitates increasing the size of the financial institutions and decentralizing them.[161] Hence, the geographic and branching regulations need to be liberal and facilitative of formation and growth of the financial institutions across the regions. On the other hand, the need for making the financial institutions prudent and beneficial to the economy necessitates that they should not simply flourish in number and grow in size but also be able and competitive. This requires that the country needs to have tight geographic and branching regulation. Hence, the country needs to enforce four types of measures.

First, it needs to remove the licensing and prior permission requirements for branching and change of place of business. These need not be permitted or licensed by the NBE, but must be notified to it. The feasibility of branching can be left to each financial institution and the effect of branching can be regulated at the level of overall operation of the financial institutions. The NBE also needs to focus on regulating the overall health of the financial institutions instead of on each branching step. It, however, needs to regulate the closing of branches to ensure service stability.[162] The measures the country has taken regarding the microfinance institutions in these regards are commendable and the banking and insurance branching regulations need to follow them.

Secondly, it needs to fix maximum number of branching or branching ratio in the law to restrain the further expansion of the largest banks, insurers and

160 TGE, 1994a, at arts. 5(1)(a) & 5(4); FDRE, 2008b, at art. 3(3)(a); TGE, 1994b, at art. 44; FDRE, 1996g, at art. 14; FDRE, 2009, at arts. 5(1)(a), 5(2) & 17(5); and Directive No. MFI/07/96. It used to require them to obtain operational permits from the regional governments and to undergo summary registrations in the trade bureaus of the latter for their branches once they have obtained the branching permit from the NBE (FDRE, 1997a, at art. 5(4); and FDRE, 1997c, at art. 13(1)). It has eased these requirements by its recent commercial registration and business licensing law. The latter law imposes only duty to notify the branching to the commercial registers of the places where the branches are to be located (FDRE, 2010a, at arts. 6(2-4) & 31(3)).

161 Decentralization of banking and insurance is crucial in facilitating balanced economic growth particularly in a transition economy. The World Bank also recommends it. World Bank, 2000, at pp. 49 & 166-167.

162 The NBE used to consider branching authorization as one means of assuring the health, stability and legality of banks and insurers. Its banking and insurance supervision departments have, however, become convinced by the view that branch authorization requirement is unnecessary intervention as branching is a business decision to be left to the banks and insurers while the overall financial position of the institutions can be supervised on an on going basis and the NBE can prohibit branching at any time it feels necessary to discipline the institutions. NBE BSD, 2005, at pp. 31-32; and NBE ISD, 2005, at pp. 62-64.

microfinance institutions.[163] This will do two things: it, on one hand, will make the large banks, insurers and microfinance institutions concentrate more on efficiency and competitiveness than on size and, on the other, correct and prevent market dominance so that new entry and competition may not be discouraged.[164] The number or ratio can be fixed by taking into account the size disparity between the private and government owned institutions.[165]

Thirdly, it needs to promote geographic diversification of branching. The banking, insurance and microfinance services are concentrated in Addis Ababa and few towns (and regions) to which the banks, insurers and microfinance institutions tend to affiliate themselves.[166] The country needs to motivate the institutions to branch out and expand their services across cities and towns of all the regional states of the country.[167]

Fourthly, it needs to decentralize the formation of banks, insurers and microfinance institutions to the regions and retain the making of regulation by the NBE from the centre. The formation of the banks and insurers need not be limited to the federal level. They also need to be formed through principal registration in the regions where their head offices may be situated as it is the case with the microfinance institutions.[168] The NBE also needs to exercise one-stop-shop service and make it available at the regional state level in order to facilitate the process of formation of the banks and insurers at that level. The one-stop-shop service will also be meaningful if the NBE registers the applicant by itself on behalf of the principal commercial register (wherever this may be) and transfers a copy of the registration to that register as well as to the federal commercial register at the Ministry of Trade and Industry for the national record purpose.

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163 This won't be incompatible with the GATS even if the country accedes to WTO as the GATS does not outlaw domestic regulations (and the making of limitations on market access) for domestic policy reasons as long as the measures are not discriminatory and the necessary specification is made in the schedule of commitment of the country.

164 The governmental banks and insurer still dominate the Ethiopian financial market although the market share of the private banks and insurers is growing steadily (Tables 19(Chap. 2); 20(Chap. 2); and the annual and quarterly reports of the NBE for 2008, 2009 and 2010). The government owned microfinance institutions also dominate the microfinance sector in terms of branch size, asset, capital and operational outreach (Table 10(Chap. 2); and Degefe Duressa Obo, 2009, at pp. 87-105 & 220-222).

165 Note the size disparity between the institutions from Tables 2(Chap. 2); 4(Chap. 2); 10(Chap. 2); 19(Chap. 2); 20(Chap. 2); and the annual and quarterly reports of the NBE for 2008, 2009 and 2010.

166 Tables 2(Chap. 2), 3(Chap. 2), 4(Chap. 2); 5(Chap. 2); 9(Chap. 2); and the annual and quarterly reports of the banks, insurers, microfinance institutions and the NBE for 2008, 2009 and 2010. The banks, insurers and microfinance institutions are concentrated in Addis Ababa, Dire Dawa and four out of nine regions of the country, namely Tigray, Amhara, Oromia, and SNNPR (Southern Nations, Nationalities and Peoples Region). Those outside Addis Ababa and Dire Dawa are further concentrated in six towns of the regions, namely Nathreth, Jimma, Awassa, Bahir Dar, Gonder and Mekele.

167 The opening up of financial institutions in the towns can also have the effect of modernizing the towns although the institutions may have to face operational challenges at the start. The diversification requirement has also to be applied regarding the regulation of product distribution (note the discussion under the 'regulation of product distribution' subtitle below).

168 The microfinance institutions are being licensed by the NBE with principal registration and head offices not necessarily located in Addis Ababa.

The country should not, however, decentralize the regulatory and supervision functions of the NBE for two reasons. Firstly, the regions lack the capacity to regulate financial institutions. Secondly, the objectives of financial regulation (in particular the objectives of managing the national monetary system and achieving financial security and stability) can be addressed best if coordination and regulation is made from the centre even when the regions possess that capacity. The regional governments need, accordingly, to be in charge of only conducting registration of the financial institutions and their branches in the commercial registers.

The decentralization measure need not also limit the discretion of the financial institutions to locate their branches on business profitability grounds. It needs to be enforced through techniques that will balance between the objectives of decentralization and business profitability (such as by using incentives for the financial institutions and implementing reforms that will enhance the operational situations in the regions).

c. Legal Form

i. The International Experience

Most of the countries exclude individual traders from being bankers and insurers and require incorporation of the banks and insurers as public companies with minimum number of founding members.[169] They justify this by the need to impose fixed capital, limited liability, defined governance structure and strong regulation on the banks and insurers and the use of the public company form to facilitate these. The microfinance regulations of many of the countries do not, however, insist on the public company form of incorporation although they promote the commercial business approach.[170]

ii. The Case of Ethiopia

Ethiopia allows only share companies (besides the government enterprises) to undertake the banking, insurance and microfinance businesses.[171] The requirement is justified by reasons similar to the ones invoked in the other countries. The country needs to continue with it as it is the share company form that can facilitate financial regulation by fixing capital, limiting liability, separating ownership and control, allowing ownership flexibility, and imposing strong capital and governance structures under the current business organization law of the country.

169 Möschel, 1991, at pp. 55-56 & 143-149; Pfennigstorf, 1996, at pp. 32, 49-53 & 65; Lemaire, 1997, at pp. 32-33; Meier, 1988, at pp. 2; Mangla and Uppal, 1990; and IAIS, 2005b, at p. 15.

170 Copestake, et al., (eds.), 2005; Berger, et al., (eds.), 2006; Swaan & Linden, (eds.), 2006; WSBI/ESBG, 2009; and Degefe Duressa Obo, 2009, at pp. 15-24 & 46-52.

171 TGE, 1994a, at arts. 2(6), 3 & 11; FDRE, 2008b, at arts. 2(5), 4(1)(d) & 60(3); TGE, 1994b, at arts. 6, 4(2), 4(3) & 44; FDRE, 2009, at art. 2(3) & 1(c-d). The share companies are publicly tradable commercial companies to be formed under the Commercial Code of the country (IGE, 1960, at arts. 304ff; and FDRE, 2010a).

d. Initial Capital

i. The International Experience

All legal systems impose minimum capital requirement to allow the carrying out of financial businesses. They either fix the required capital by law or leave it to determination by the concerned supervisory authority.[172] They also require that the required minimum capital has to be paid fully within a defined period of time during the foundation stage of the company.[173] They also require that the legal form, number of branches, size of market, and type, volume, and risk of business of the company has to be considered in the determination of the initial capital requirement.[174]

ii. The Case of Ethiopia

Ethiopia requires the banking, insurance and microfinance companies to have fully subscribed and partly paid up share capital before commencement of business and to maintain unimpaired minimum capital throughout their life after commencement of business.[175] It requires them to deposit a portion of their subscribed capital, which is equal to an amount fixed by law or the NBE, in blocked bank account before commencement of business and to collect the balance within a period of five years.[176] It requires them to collect the full payment of all contributions in kind before commencement of business.[177] It requires the insurance companies to meet minimum capitals fixed in the insurance supervision law by type of business and the banks and microfinance institutions to meet and keep amounts to be determined by directives of the NBE.[178] It leaves full discretion to the NBE to fix the minimum initial capitals to be met by the

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172 Möschel, 1991, at pp. 56-57; Pfennigstorf, 1996, at pp. 72 & 93; IAIS, 2005b, at pp. 27-30; Lovett, 1992, at pp. 117 & 128-129; Lemaire, 1997, at pp. 35 & 46; Meier, 1988, at pp. 143-147; Copestake, et al., (eds.), 2005; Berger, et al., (eds.), 2006; Swaan & Linden, (eds.), 2006; and WSBI/ESBG, 2009.

173 Möschel, 1991, at p. 57; Lovett, 1992, at pp. 128-129; Pfennigstorf, 1996, at pp. 72 & 93; Lovett, 1992, at pp. 117 & 128-129; Lemaire, 1997, at pp. 35 & 46-48; Meier, 1988, at pp. 143-147; and Barth, Brumbaugh and Yago, 2001, at p. 378.

174 Möschel, 1991, at p. 57; Lovett, 1992, at pp. 128-129; Lemaire, 1997, at pp. 46-48; and Barth, Brumbaugh and Yago, 2001, at p. 378.

175 TGE, 1994a, at arts. 3, 12 & 13(1); FDRE, 2008b, at arts. 4(e), 4(f) & 18; TGE, 1994b, at arts. 4 & 7(1)(a); FDRE, 1996g, at arts. 4(1)(c) & 12(1); and FDRE, 2009, at arts. 5(1)(d-e), 14(1), 14(2)(b), 14(3) & 17(3).

176 FDRE, 2008b, at arts. 4(1)(e) & (f); TGE, 1994b, at art. 4(1)(c); FDRE, 1996g, at arts. 4(1)(c) & 12(1); FDRE, 2009, at art. 5(1)(d-e). The general share company law of the country also requires the payment of balances of all subscriptions within a period of five years from the date of registration of the company (IGE, 1960, at art. 338).

177 IGE, 1960, at art. 339.

178 TGE, 1994a, at art. 13(1); FDRE, 2008b, at arts. 4(1)(f) & 18(1); TGE, 1994b, at art. 4(1)(b) & (c); FDRE, 1996g, at arts. 4(1)(c) & 12(1); and FDRE, 2009, at arts. 5(1)(e), 14(1) & 14(3). The insurance supervision law fixes three million Birr for the companies that apply to undertake general insurance business, four million Birr for those applying to undertake long-term insurance business, and seven million Birr for those applying to undertake both businesses (TGE, 1994b, at art. 4(1)(b)). The 2009 microfinance business law also authorizes the NBE to fix different capital requirements for the different microfinance institutions based on their risk profiles (FDRE, 2009, at art. 14(3)).

banks and microfinance institutions.[179] It also authorizes the microfinance institutions to obtain assistance and concession credits from foreign sources for purpose of their capitalizations (and lending businesses).[180]

The NBE has required the applicants for bank licence to meet a non-risk weighted capital requirement without making distinction between the initial and ongoing adequacy requirements of the law until the 21st of August 1995. It has required them to commence their businesses with the minimum capital of ten million Birr which was indicated in the law as the ongoing adequacy requirement.[181] It has introduced rules on computation of risk-weighted assets and required the banks to maintain a capital adequacy ratio of not less than eight percent of their risk-weighted assets as of the 21st of August 1995.[182] It has then fixed a minimum capital requirement of seventy five million Birr and required all the existing and new banks to meet this amount starting from the 1st of June 1999.[183] It currently requires all the applicants for banking license to meet the seventy five million Birr requirement and the applicants for microfinance business license to meet a minimum paid up capital of two hundred thousand Birr.[184]

The government banks and insurer are required to have authorized capitals allocated by the government, twenty five percents of which are to be paid by the government at the times of their establishments and the balances of which are to be paid within a period of five years from the dates of their establishments.[185] They are subject to the banking (insurance) and public enterprises laws and to supervision by the NBE and a Financial Public Enterprises Agency established under the Council of Ministers of the country.[186] The public enterprises laws establish them with the capitals allocated by the government and regulate their governance structures while the banking and insurance supervision laws require

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179 FDRE, 2008b, at arts. 4(1)(f) & 18; FDRE, 1996g, at arts. 4(1)(c) & 12(1); and FDRE, 2009, at arts. 5(1)(e), 14(1) & 14(3). The 1994 banking supervision law of the country authorized the NBE to set the minimum unimpaired capital to be maintained by the banks in accordance with internationally accepted guidelines provided that such minimum shall in no case be less than the greater of Birr ten million or eight percent of the bank's risk weighted assets in terms of the most recent annual balance sheets of the banks (TGE, 1994a, at art. 13(1)). The 2008 law leaves only the discretion to the NBE (FDRE, 2008b, at arts. 4(1)(f) & 18). The country does not require the insurance companies to risk weight their initial capitals. The insurance supervision department of the NBE does not also check the capitals of the companies for this as the companies have only to meet the capital requirements fixed in the law according to the lines of their businesses (NBE ISD, 2005, at pp. 28-29, 30-31 & 35).

180 FDRE, 1996g, at art. 11(2-3); and FDRE, 2009, at art. 22. The 1996 law allowed this subject to prior approval by the Ministry of Finance of the country (same citation). The microfinance institutions have also, in practice, obtained donated capitals from external sources which are substantially higher than their subscribed capitals (Table 9(Chap. 2)).

181 TGE, 1994a, at art. 13(1).

182 Directive No. SBB/9/95.

183 It has required the existing banks to make their adjustments within a period of three years (i.e. until the end of June 2002) and to continue, in the meantime, to maintain the minimum capital level of not less than eight percent of their risk-weighted assets (Directive No. SBB/24/99).

184 Directives No. SBB/24/99; and MFI/01/96.

185 TGE, 1992b, at arts. 19 & 20. The authorized capital has to be reduced to the extent it is paid if the payment of the balance is not completed within the five years period. Ibid.

186 TGE, 1994e, at art. 2(2); TGE, 1994f, at art. 2(2); TGE, 1994g, at art. 2(2); FDRE, 2002b, at arts. 3 & 5; FDRE, 2003, at art. 2(2); and FDRE, 2004aa.

them to meet the minimum capital requirements that are set by the NBE from time to time.[187] They are expected to meet the greater of the two requirements.[188]

The effect of capital related requirements depends on the amount the market renders necessary.[189] It is also important that the regulator assesses the impact of the requirements on new entry, competition and the prudential and other objectives of regulation.[190] It is also important that the entry and ongoing requirements are set separately. The use of same fixed capital requirement for entry and ongoing adequacy and the frequent adjustment of this requirement in order to make the capitals of the new entrants equivalent to the adequacy levels of the existing actors can bar new entry into the market and cripple competition.[191] The use of separately fixed entry and ongoing requirements can, on the contrary, accommodate the capacity differences between new entrants and existing actors and allow competition without endangering prudence. The capital related regimes of Ethiopia for the insurance and microfinance businesses tend to be in line with this although the former lacks capital adequacy requirements as such and the latter leaves both the initial capital and the ongoing requirements to discretion of the regulator (i.e. the NBE).[192] The capital regime for banking, however, fails to distinguish between the initial and the ongoing requirements due to the indistinctive use of the fixed capital requirement by the NBE.

The country, therefore, needs to make changes on the capital regimes. First, distinction needs to be made between the initial and the ongoing capital requirements in the banking and microfinance supervision laws and enforcement. Secondly, the initial capital requirements on the banks and microfinance institutions need to be fixed in the law (as it is the case with the insurers) and the ongoing capital requirements need to be left to decision of the regulator (i.e. the NBE). Thirdly, the ongoing capital requirements on the banks, the insurers and

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187 TGE, 1994a, at art. 11; FDRE, 2008b, at arts. 18(1) & 60(3); TGE, 1994b, at arts. 4(2) & (3).

188 In practice, they are established with authorized and paid up capitals greater than the minimum the NBE required (TGE, 1994d, at art. 6; TGE, 1994e, at art. 6; TGE, 1994f, at art. 6; TGE, 1994g, at art. 6; FDRE, 2003; FDRE, 2005a; and FDRE, 2007c).

189 Möschel, 1991, at p. 57; and Pfennigstorf, 1996, at pp. 72 & 93.

190 This type of assessment is important in Ethiopia as the formation of new financial institutions in the country is slowed down. Only four private banks (namely, the Cooperative Bank of Oromia S.C., the Lion International Bank S.C., the Zemen Bank S.C. and the Oromia International Bank S.C.) are established after the June 1999 increment of the entry capital for banks. Also only three insurers (namely, the Nib Insurance Company S.C., the Lion Insurance S.C., and the Ethio-Life Insurance S.C.) are established during the period while the number of microfinance institutions has reached and stagnated at thirty. (Tables 1(Chap. 2) & 9(Chap. 2); the annual report of the NBE for 2008; and the records of the banking, insurance and microfinance supervision departments of the NBE for 2009).

191 This is likely to happen when the entry requirement becomes large suddenly as it was the case in Ethiopia when the NBE increased the capital requirement on the banks from ten to seventy five million birr at once. The importance of differentiating between initial and ongoing capital requirements is also seen in other systems (Pfennigstorf, 1996, at pp. 72 & 93).

192 The insurance supervision law fixes the initial capital requirements in figures and sets solvency requirements as risk-based percentages (TGE, 1994b, at arts. 4 & 20). The microfinance business law differentiates between the initial and operational requirements and leaves both to determination by the NBE (FDRE, 1996g, at arts. 4(1)(c), 12(1) & 16; and FDRE, 2009, at arts. 5(1)(e), 14(1), 14(2)(b) & 14(3)). The NBE directives for the microfinance institutions also follow this differentiation in practice (Directives No. MFI/01/96, at art. 2; and MFI/16/2002).

the microfinance institutions need always to be related to risk. These measures will enable the regulatory system to accommodate the capacity differences between new and existing institutions, ease market entry, allow competition, and ensure prudence at the same time.

e. Ownership Spreading

i. The International Experience

Many of the countries ensure widespread share ownership so that there will be no danger of self-dealing between principal shareholders and the financial institutions. They do this by imposing limitations on the individual shareholding levels in the financial institutions.[193]

ii. The Case of Ethiopia

Ethiopia spreads the shareholding in the banking, insurance and microfinance institutions by prohibiting all persons from holding more than five percent (more than twenty percent in the case of the insurers) of the total shares of the institutions on their own as well as jointly with their spouses and persons below the age of eighteen years who are related to them by consanguinity in the first degree.[194] It also prohibits the influential shareholders of the banks (i.e. those who hold two percent or more of the total subscribed capitals of the banks directly or indirectly) from acquiring shares in other banks.[195] These restrictions are justified by the need to prevent undue dominance of the institutions by few shareholders and are consistent with the international experience despite difference in detail. The country needs to pursue them to enhance the health of governance of the financial institutions. The country, however, also needs to make sure that the restrictions are not too much to limit investment choice. The levels imposed on the banks and microfinance institutions are highly restrictive while these institutions have high need of capital.[196] They need to be relaxed.

f. Business Plan, Organizational Structure and Disclosure

i. The International Experience

The regulators in almost all countries require the applicants for banking, insurance and microfinance license to submit their business plans and information on their legal forms, head offices, organizations, branches, intended businesses, capitals, and names, nationalities and qualifications of their founders and initial

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193 Möschel, 1991, at pp. 75; Pfennigstorf, 1996, at pp. 67-72; Laboul, 1992, at pp. 27-34; IAIS, 2005b; Copestake, et al., (eds.), 2005; Berger, et al., (eds.), 2006; Swaan & Linden, (eds.), 2006; and WSBI/ESBG, 2009.

194 FDRE, 2008b, at art. 11(1); TGE, 1994b, at art. 5(1); FDRE, 2009, at arts. 10(1) & 28(1); and SBB/47/2010. It exempts the federal and regional governments from this limit (See same citation).

195 FDRE, 2008b, at arts. 2(11) & 11(4). The 2009 microfinance business law also extends the application of this rule to the microfinance institutions (FDRE, 2009, at art. 28(1)).

196 Note the annual reports of the NBE for assessment of their capital needs.

managers.[197] Some of the regulators also require the submission of profitability forecasts.[198] The requirements are imposed to supply the regulators with information on the future prudence and growth potentials of the applicants.

ii. The Case of Ethiopia

Ethiopia requires the applicants for banking, insurance and microfinance business license to provide the NBE with information on their formation costs and liabilities, feasibility studies, projected financial statements (for the first three years of operation for the banks and insurers and one year of operation for the microfinance institutions), proposed organizational structures and functions, curriculum vitae (of chief executive(s), founders and directors), ownership certificates (and/or lease agreements) (for their buildings, vaults, equipments and fixtures); and evidences (for their paid up capitals, valuations of contributions in kind and insurance coverages, if any).[199] It also requires the founders of the banks under formation to publish 'notice of intention to engage in banking business' to the public through widely circulating newspapers.[200] It also requires the banks and insurers that apply for branching permit to supply the NBE with the feasibility studies for the branches and the title deeds (and/or rental agreements) for the premises of the branches.[201] The supervision departments of the NBE do not, however, sufficiently appraise the feasibility studies of the applicants in practice.[202] They do not also require the applicants to present and defend their feasibility studies.[203]

The aforementioned requirements of Ethiopia are justified by reasons similar to the ones invoked in the other countries, i.e. the need to ensure the future prudence and growth potentials of the applicants. The country needs to retain and strengthen them. The supervision departments of the NBE, however, also need to

197 Möschel, 1991, at pp. 57-58; Lovett, 1992, at p. 121; Pfennigstorf, 1996, at p. 73; IAIS, 2005b, at pp. 15-16; Copestake, et al., (eds.), 2005; Berger, et al., (eds.), 2006; Swaan & Linden, (eds.), 2006; and WSBI/ESBG, 2009.

198 This has been true in the United States and the EU. Möschel, 1991, at p. 58; Lovett, 1992, at pp. 121-122; and Pfennigstorf, 1996, at p. 73.

199 TGE, 1994a, at art. 5(1); FDRE, 2008b, at arts. 4(1) & 4(3); TGE, 1994b, at arts. 6(2), 35 & 44; FDRE, 1996g, at arts. 5 & 6; FDRE, 2009, at arts. 5(1)(a), 5(2) & 28(1); and Directives No. SBB/1/1994; SBB/39/2006; SIB/1/1994; MFI/01/96; MFI/02/96; and MFI/04/96.

200 It does not impose this on the founders of the insurers and the microfinance institutions. It used to require the banks, insurers and microfinance institutions to publish their formations under the general commercial registration and business licensing laws (IGE, 1960, at arts. 219-224; and FDRE, 1997a as amended). It has removed this requirement from the general commercial registration and business licensing laws as of 2003 and retained only the notice publication requirement on the banks (FDRE, 2003f , at art. 2(2); FDRE, 2010a, at art. 9; and FDRE, 2008b, at art. 4(1)(c)).

201 NBE BSD, 2005, at pp. 30, 32 & 33; and NBE ISD, 2005, at p. 61.

202 They lacked criteria and minimum content for assessment. The bank supervision department used to check only the consistency of figures and arguments while the insurance supervision department used to compare only the level of sales, premiums, and loss and expense ratios envisaged by the applicants with the existing experience in the insurance market. NBE BSD, 2005, at pp. 17, 20-24 & 32; and NBE ISD, 2005, at pp. 26-28, 30, 35-36 & 62.

203 Ibid.

exercise pre-business commencement examination so that they will make sure that the disclosures made by the applicants are appropriate and practical.[204]

g. Management and Ownership Quality

i. The International Experience

Many of the legal systems require major owners and senior managers of the financial institutions to be qualified, competent and reliable.[205] They assess the good reputation, reliability, professional qualification, and managerial and entrepreneurial capability of the owners and managers not just based on their specific career training or education but also by considering their past personal and business performances.[206] They also either limit the engagement of key personnel of the banks and insurers in outside managerial activity or require the notification of external activities and sometimes of shareholding in other enterprises to the regulators in order to ensure undivided attention of the personnel to the banks and insurers they are in charge.[207] A number of the countries also require management by at least two managers with the hope that it will improve internal control of the financial institutions and limit the detrimental effects of erroneous assessments of the regulators.[208] Some of them also used to require members of the bank management to be nationals or to have permanent residence at the banking centre in order to increase the personal responsibility of the managers, make the managers familiar with the legal and extra-legal environments of the banks, and follow up the day-to-day performances of the banks and the managers.[209]

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204 The microfinance supervision department is empowered to check that the microfinance institutions have put in place the necessary assets, policies, manuals and licensing conditions before commencement of their operation (Directive No. MFI/04/96). The banking and insurance supervision departments are not expressly empowered to do this. The initiative with the microfinance supervision department needs to lead to development of a general system where all the supervision departments can conduct pre-business commencement examination on the banks, insurers and microfinance institutions.

205 Möschel, 1991, at pp. 58-59; Lovett, 1992, at p. 121; Pfennigstorf, 1996, at pp. 66-67; IAIS, 2005b, at pp. 17-18; Copestake, et al., (eds.), 2005; Berger, et al., (eds.), 2006; Swaan & Linden, (eds.), 2006; and WSBI/ESBG, 2009. Some like Ireland also require members of the supervisory boards to possess these qualities. Others like United Kingdom, Switzerland, Australia, Luxembourg and the EU also extend the requirements to the shareholders who are in position of qualified ownership or control of the company. The recent advice is to impose the requirements also on members of the boards of directors (Bob Garratt, 2006).

206 Ibid.

207 Belgium, France, Canada and the United States used to limit such external engagement while Germany required notification. Others like the Netherlands, Switzerland and Luxembourg did not set limitations of this type at all. The severity of the limitations has also varied from country to country and exceptions were sometimes made. IAIS, 2005b, at pp. 59-60; and Lovett, 1992, at p. 121.

208 The rule in most of the countries is to have managers who head lines of functions and account to a chief executive and the boards of directors of the financial institutions. Möschel, 1991, at p. 59; and IAIS, 2005b, at pp. 59-60.

209 The use of this rule has diminished through time because of the internationalization trend. Möschel, 1991, at pp. 59-60; and IAIS, 2005b, at pp. 59-60.

ii. The Case of Ethiopia

Ethiopia authorizes the NBE to enact qualification, fitness and propriety criteria for influential shareholders of the banks and the directors and chief executives of the banks, insurers and microfinance institutions.[210] It bars persons declared bankrupt or making a composition with creditors and persons convicted of an offence involving dishonesty or fraud from managing the banks, insurers and microfinance institutions without prior written approval of the NBE.[211] It requires the directors and chief executive officers of the banks and microfinance institutions to cease their functions when they or the companies in which they are directors or executive officers are declared bankrupt or convicted for liability.[212] It requires the persons who were directors, managers and principal officers or otherwise concerned directly or indirectly with the management of any financial institution that has been wound up, whether in Ethiopia or abroad, to get prior written approval of the NBE when they want to be directors, managers or principal officers of the banks, insurers and microfinance institutions or to engage directly in the management of these institutions in any other capacity.[213] It authorizes the NBE to enact directives on the appointment and tenures of directors of the banks and microfinance institutions and prohibits the directors and chief executives of the financial institutions (and the business entities in which these persons hold more than ten percent equity interest) from being directors of a bank and the employees of a bank from being directors of another bank at the same time.[214] It also authorizes the NBE to issue directives on duties, responsibilities and good corporate governance of the boards of directors of the microfinance institutions.[215]

The NBE also requires, in practice, that all the directors of the banks, insurers and microfinance institutions shall be at least thirty years of age (for the banks and insurers, twenty five years for the microfinance institutions) and have minimum of high school education with ability to read and grasp financial statements (and reports) and adequate managerial experience in business and similar organization.[216] It requires that the chief executives shall be at least thirty five years of age (for the banks and insurers, thirty years for the microfinance institutions) and have minimum of first degree or equivalent in relevant field and reputable managerial experience of minimum of (ten years for the banks and insurers, three years for the microfinance institutions) in a financial or related

210 TGE, 1994a, at art. 5(1); FDRE, 2008b, at arts. 4(1) (g), 4(1) (h) & 14(4); TGE, 1994b, at arts. 6(2), 35 & 44; FDRE, 1996g, at arts. 5 & 6; and FDRE, 2009, at arts. 5(1)(f) & 11(1).

211 TGE, 1994a, at art. 30(1); FDRE, 2008b, at arts. 15(1) & 15(2); TGE, 1994b, at 43(1); FDRE, 1996g, at art. 18; and FDRE, 2009, at art. 11(3).

212 FDRE, 2008b, at art. 16; and FDRE, 2009, at arts. 11(3)(a) & 28(1).

213 TGE, 1994a, at art. 30(2); FDRE, 2008b, at art. 15(2); TGE, 1994b, at art. 43(2); FDRE, 1996g, at art. 24; and FDRE, 2009, at art. 28(1).

214 FDRE, 2008b, at arts. 14, 15(3) & 15(4); and FDRE, 2009, at arts. 5(1)(f) & 11(2).

215 FDRE, 2009, at art. 11(4)).

216 Directives No. SBB/1/ 1994, at art. 5 (as amended by SBB/39/2006, art. 5); SIB/1/1994, at art. 5; & MFI/03/96, at art. 4.

institution.[217] It also prefers that they are married or responsible to a family.[218] It also prohibits the members of the boards of directors of the banks from being members in the boards of other financial institutions and from acting as chief executives of the same bank.[219] It also limits the office terms of the members of the boards of directors of the banks to maximum of six consecutive years with a possibility that up to one-third of the outgoing directors can be retained for an extra one term and that the resigned members can be re-appointed after lapse of six years.[220]

The country does not, however, have rules that bar criminals and unreliable persons (other than those convicted for an offence involving dishonesty or fraud) from participating in the banks, insurers and microfinance institutions. It does not also require multiplicity of chief executives, residence at a banking or financial centre and particular nationality of the chief executives of the financial institutions. It does not also prohibit foreigners from being chief executives of the financial institutions provided that they obtain work permit from the appropriate authorities.[221] The limits on board tenure and outside managerial engagement are also partial and confined to membership of the boards of directors and executives of the banks and microfinance institutions.[222] The NBE does not also evaluate the competence and integrity of the shareholders, directors and chief executive officers of the banks, insurers and microfinance institutions and enforce the rules that bar the persons convicted of dishonesty or fraud from managing the banks, insurers and microfinance institutions in practice because of poor level of the country's data base.[223] The government banks and insurer are also managed by a management board appointed by the government under advice of the Financial Public Enterprises Agency, a general manager (or president) and several deputy general managers (or presidents) appointed by the government under advice of the management board, and several officials who are appointed by the general and deputy mangers (or presidents).[224]

The Ethiopian rules on management and ownership quality are justified by reasons similar to the ones invoked in the other legal systems. They, however, need to be improved due to the domestic situation of the country.

First, a number of the financial institutions are affected by unqualified and inexperienced officers and the requirements on managerial profession and

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217 Directives No. SBB/1/1994, at art. 4 (as amended by SBB/39/2006); SIB/1/1994, at art. 4; & MFI/03/96, at art. 5.

218 Ibid.

219 Directive SBB/39/2006, at art. 5.1.4.

220 Id., at art. 5.1.5.

221 They can not, however, be board members since these have to be shareholders of the financial institutions and foreigners are prohibited from this.

222 They do not limit the extent to which the management and key personnel of the banks, insurers and microfinance institutions can engage in outside managerial activities. The directors and executives of the insurers are not also subject to them except that they are not allowed to be directors of an insurer and a bank at the same time by virtue of the banking business law (FDRE, 2008b, at art. 15(3)).

223 NBE BSD, 2005, at pp. 15-16 & 24; and NBE ISD, 2005, at pp. 29-30 & 33-34.

224 TGE, 1992b, at arts. 10-16; and FDRE, 2004aa.

experience need to be more stringent than they have been so far and be applicable on the managers other than the chief executives of all the financial institutions.[225] Emphasis must not be put on possession of degree and length of service, but on the presence of managerial and entrepreneurial capability and quality in the leadership of financial institutions. Capacity building programs and a national testing or certification centre, which will examine the competence of existing and future leaders of the financial institutions and check the continuity of these, need also to be organized so that the managerial quality requirements can be enforced adequately.[226] Both the programs and the requirements need also to apply to all managers of the financial institutions so that there will be governance efficiency across the financial sector.

Secondly, many of the board members, executives and managers of the private banks and insurers are retirees of the financial and non-financial institutions of the government whose managerial and entrepreneurial capability is limited. Maximum age limits need to be set along with the minimum age limits and the capacity building programs to curb the problem.[227]

Thirdly, the limits on outside managerial engagement need to be applied on all members of the boards of directors, executives and managers of all the financial institutions so that there will be no problem of divided attention and conflict of interest in the leadership and management of the institutions.

Fourthly, the country needs to strengthen its financial criminal tracing mechanism and bar all criminals and unreliable persons not only from managing but also from owning the financial institutions. These persons are always likely to influence the management of the financial institutions even if the NBE may attempt to supervise it.[228]

Finally, the supervision departments of the NBE need to consider the legality, need and feasibility of the instruments they use whenever they implement requirements on the shareholding and leadership of the financial institutions. Some of the measures already taken, such as the restriction on the office terms of members of the boards of directors of the banks, are not necessary as long as the perceived problems behind them can be controlled through the rules on transactions between related parties and the institutions can be stimulated to raise

225 The banking and insurance supervision departments of the NBE have already found that the qualification and related requirements on the directors of the banks and insurers are insufficient. They have found that a number of the banks and insurers are managed by officers who have no experience of managing a financial institution at all and hence, that there is need for checking the competence and integrity of all the officers other than the chief executives. Studies have also already shown that several of the microfinance institutions are managed by unqualified board members, executives and officers. NBE BSD, 2005, at pp. 15-16 & 24; NBE ISD, 2005, at pp. 21-26, 29-30 & 33-34; and Degefe Duressa Obo, 2009, at pp. 6, 87-164, 179-190, 213-218 & 223-227.

226 Studies have also recommended for the introduction of these types of requirements to enhance board performance (Bob Garratt, 2006; Itana Ayanna, et al., 2003; and Degefe Duressa Obo, 2009, at pp. 6, 87-164, 179-190, 213-218 & 223-227).

227 This is necessary until the country enacts a retirement law for the private sector (note the discussion under the 'rationale and direction of reform' subtitle of the pension chapter below).

228 It is unlikely that the NBE controls all the connections between the shareholders and managers.

their leadership capacities through the forces of competition and indirect intervention (indicated above).

C. The Rules on Granting and Termination of License

i. The International Experience

Most countries make obtaining license or branching permit a legal right to applicants as long as legally specified preconditions are fulfilled.[229] They also subject the decision of the regulator to principles of administrative law and judicial review to ensure that the right is respected.[230] Some enumerate the grounds for denial (or permit) clearly and restrictively.[231] Others recognize discretionary decision by the regulator on different grounds.[232] Some also recognize third party participation in the decision making process such as associations of the financial institutions.[233] The licensing procedure is also one stop process in most countries.[234] The regulators in most of the countries are also obliged to enter the licensed banks and insurers in special registers either as condition for effectiveness of the licenses or for declaratory and informational purpose.[235]

License can also be revoked in many of the countries by application of the general rules of administrative law, special rules meant for the financial licenses, or combination of the two.[236] The most common grounds considered for license revocation by the regulator are the following:

- failure to use the license,
- improper obtaining of the license, such as through misrepresentation, threat or bribery,
- failure to sustain the preconditions of reliability and professional qualification,
- serious infringement of existing regulation despite warning, and
- use of the revocation measure by the regulator as part of crisis management.[237]

Some of the countries also enforce rules according to which license will terminate by force of law when business is not commenced within a specified period.[238]

229 Möschel, 1991, at pp. 65-66; Pfennigstorf, 1996, at pp. 72-75; and IAIS, 2005b, at pp. 16-17.
230 Ibid. Note also the discussion under the means of enforcement chapter below.
231 Germany has, for instance, been doing this. Möschel, 1991, at pp. 65-66; and Pfennigstorf, 1996, at pp. 72-75; and IAIS, 2005b, at pp. 16-17.
232 The US, for instance, reserves discretion to the regulators regarding both domestic and external applications. The granting of license for domestic applications, however, looks like a duty in practice. The EU reserves discretion to the regulators regarding the licensing of applicants from non-member states. Ibid.
233 USA, Germany and France are examples. Ibid.
234 Möschel, 1991, at pp. 65-66; Lovett, 1992, at pp. 118ff; Pfennigstorf, 1996, at p. 72; and IAIS, 2005b, at pp. 16-17.
235 Belgium, France, Ireland, Italy, the Netherlands, Switzerland and Hong Kong are examples. Ibid.
236 Germany is example of the practice that combined the two. Möschel, 1991, at p. 66; Pfennigstorf, 1996, at p. 138; and IAIS, 2005b, at pp. 16-17.
237 Möschel, 1991, at pp. 66-67; Pfennigstorf, 1996, at p. 138; and IAIS, 2005b, at pp. 16-17.
238 Möschel, 1991, at p. 67; and IAIS, 2005b, at pp. 16-17.

ii. The Case of Ethiopia

The National Bank of Ethiopia is required by law to issue and renew the banking, insurance and microfinance licenses on annual basis.[239] It has to respond to the applicants for license and for branching permit within a period of ninety (sixty for microfinance) and thirty days, respectively, from the date of its receipt of the applications.[240] The granting of license or branching permit is, however, left to discretion of the NBE.[241] The laws do not also expressly regulate the procedure for licensing (and branch permitting) and the grounds for refusal.[242] Both the initial issuance and renewal of licenses and the permitting of branching have also been multi-step and slow processes in practice.[243] The NBE has, accordingly, been re-engineering its working systems.[244]

The banking, insurance and microfinance licenses issued in Ethiopia can be revoked by the NBE only on grounds indicated by law.[245] They do not lapse by force of law although they are issued on annual basis.[246] The current grounds for license revocation are i) failure to commence operation within a period of twelve months following the grant of license; and ii) licensing of the institution based on false or wrong information.[247] The country also requires the NBE to publish its revocation decision in a newspaper of wide circulation at the place where the head office of the concerned bank, insurer or microfinance institution is located and entitles the concerned bank, insurer or microfinance institution to petition to the federal high court within thirty days from effective date of the revocation.[248]

The country also prohibits the banks, insurers and microfinance institutions and the insurance auxiliaries from closing, changing (and/or disposing of) the businesses to which they are licensed and from restructuring their capitals unless

239 TGE, 1994a, at art. 5(8); FDRE, 2008b, at arts. 3 & 7; TGE, 1994b, at arts. 6(3), 25(3) & 44; FDRE, 1996g, at art. 6(5); and FDRE, 2009, at arts. 7 & 28(1). The licenses for insurance auxiliaries are also issued by the NBE on annual basis (TGE, 1994b, at art. 25; and Directives No. SIB/3/1994; SIB/4/1994; SIB/10/1996; SIB/11/1996; SIB/12/1996; SIB/13/1996; SIB/15/1997; SIB/18/1998; SIB/21/2001; SIB/22/2002; SIB/29/2007; & SIB/30/2007). The general commercial registration and business licensing laws of the country also require annual renewal of licenses (and registrations) (FDRE, 2010a, at arts. 18 & 36).

240 TGE, 1994a, at art. 5(5); FDRE, 2008b, at art. 5(1); TGE, 1994b, at art. 44; FDRE, 1996g, at art. 24; FDRE, 2009, at art. 6(1); and Directive No. SIB/8/1995, at art. 4.

241 TGE, 1994a, at arts. 3-5; FDRE, 2008b, at arts. 3-5; TGE, 1994b, at arts. 6 & 44; FDRE, 1996g, at arts. 6 & 24; and FDRE, 2009, at arts. 4-6.

242 They do not also require the NBE to give reasons for its refusal (Ibid).

243 NBE BSD, 2005, at pp. 18-33; and NBE ISD, 2005, at pp. 16, 31-39 & 63.

244 NBE BSD, 2005, at pp. 34 & 67; and NBE ISD, 2005, at p. 108.

245 TGE, 1994a, at arts. 4-5 & 10(1); FDRE, 2008b, at art. 32; TGE, 1994b, at arts. 6, 7(1), 26(4)(h) & 44; FDRE, 1996g, at art. 9; and FDRE, 2009, at art. 8.

246 The NBE has to renew them unless it has grounds for revocation (Ibid). The insurance auxiliary licenses, however, lapse annually and the country authorizes the NBE to renew them only upon satisfaction that the requirements for new license issuance are met by the auxiliaries (TGE, 1994b, at art. 25(3)).

247 FDRE, 2008b, at art. 32; TGE, 1994b, at arts. 7(1), 26(4)(h) & 44; and FDRE, 2009, at art. 8.

248 FDRE, 2008b, at arts. 32(2)-(5); TGE, 1994b, at art. 44; FDRE, 1996g, at arts. 9 & 24; and FDRE, 2009, at arts. 8(2, 3 & 5).

authorized by the NBE.[249] It makes the violation of these rules ground for receivership (which may lead to license revocation and dissolution).[250]

The banking, insurance and microfinance licensing laws of the country need to be improved in light of both the aforementioned international experience and the country's domestic situation. First, they need to list the grounds for license refusal and expressly make the obtaining of license a legal right as long as the conditions of licensing are met. The decision should not be left to complete discretion of the NBE. Secondly, they need to require the NBE to adhere to principles of administrative law including the conduct of hearing, the reasoning of decisions, the making of decisions transparent, and the proper handling of complaints. Thirdly, they need to require the NBE to keep a register of licensees in which it has to record the particulars about the licensees that are useful for the conduct of prudential supervision.

The grounds for license revocation also need to be refined further for the following reasons. First, the supervision laws of the country need to make participation of the financial institutions in corrupt and illicit financing practice among the grounds for license revocation so that the laws will be in line with the country's effort to fight against these crimes. Secondly, the laws need to make the most serious regulatory violations among the grounds for same so that the NBE will sanction the violations irrespective of the measure of receivership.[251] Thirdly, the measure of license revocation needs to be preceded by warning for correction and hearing as enforcement of regulation by persuasion is often more useful to solve problems than immediate sanction.[252] Fourthly, the laws need to allow the

249 TGE, 1994a, at arts. 5(3), 5(4) & 27(2)(d); FDRE, 2008b, at art. 3(3)(b) & (d); TGE, 1994b, at arts. 35 & 44; FDRE, 1996g, at arts. 4, 6, 17(4) & 24; and FDRE, 2009, at art. 17(5) & 28(1). It also prohibits the banks from introducing new services unless authorized by the NBE (FDRE, 2008b, at art. 3(3)(b)).

250 It subjects the restructuring, amalgamation, bankruptcy, dissolution and liquidation of the banks and microfinance institutions to the rules of the banking and microfinance business laws and the general commercial code and those of the insurers to the rules of the general commercial code; and authorizes the NBE to put the banks and microfinance institutions under receivership when the indicated prohibitions are violated, the institutions are on the eve of failure and/or the measure of receivership is requested by resolutions of their shareholders. It allows the enforcement of the bankruptcy, dissolution and liquidation processes on the insurers by the regular courts upon application by the NBE, the concerned insurer and/or interested party. TGE, 1994a, at arts. 26 & 27; TGE, 1994b, at arts. 35, 39, 40 & 44; FDRE, 2008b, at arts. 3(3)(b)-(h) & 33-48; FDRE, 1996g, at arts. 4, 6, 13, 17 & 24; FDRE, 2009, at arts. 17, 19 & 28(1); and IGE 1960, at arts. 217-218, 495-509, 544-554 & 968-1170.

251 The 1994 banking supervision law of the country had a rule that allowed the NBE to revoke the licenses of the banks (and the insurers and microfinance institutions by its extended application) on the ground of regulatory violation (TGE, 1994a, at art. 20(3)(h); TGE, 1994b, at arts. 7(1), 26(4)(h) & 44; and FDRE, 1996g, at art. 9). The 2008 banking business law makes the regulatory violations ground for receivership while the 2009 microfinance business law makes them ground for both license revocation and receivership (FDRE, 2008b, at arts. 31(8) & 33(1)(e); and FDRE, 2009, at arts. 18(7)(h) & 19(1)(a)).

252 The 1994 banking supervision law of the country had rule that required the conduct of hearing by the NBE before making its decision on revocation of license and this has been applicable to the insurers and the microfinance institutions by extension (TGE, 1994a, at art. 10(2); TGE, 1994b, at art. 44; and FDRE, 1996g, at arts. 9 & 24). The 2008 banking business law does not have this rule while the 2009 microfinance business law has it (FDRE, 2008b, at art. 32; and FDRE, 2009, at art. 18(5)).

making of petition to the regular courts only after exhaustion of re-hearing and internal complaint process within the regulator. License related disputes are usually technical and re-hearing and internal complaint processes are more expeditious and appropriate means for resolving them than court decisions.[253]

The annual license renewal requirement of the country is also hardly useful to the financial market. First, it is unlikely that the NBE can refuse to renew license and interrupt the financial institutions annually. This measure will be against the objective of maintaing financial stability. The NBE needs to revoke licenses only as last resort measure during serious forbearance. Secondly, the license renewal requirement on the financial institutions can not be justified by the country's established practice for licensing other businesses and the use of the requirement to generate public money. The practice of licensing the financial institutions need not parallel the practice in the other businesses as the financial market requires stability more than the others. Public money can also be raised through means other than the requirement of license renewal in the financial market. Thirdly, imposing the license renewal requirement on the private financial institutions discriminates between them and the government owned financial institutions. It subjects them to licensing costs while the government financial institutions live without these once they are established by law. This type of discrimination need not be sustained so that the private and government institutions can be in level playing field. The country, therefore, needs to remove the annual license (and registration) renewal requirement from the financial regulatory regime and the NBE needs to focus on the use of the license revocation and other instruments for its prudential regulation.

2.3.1.2 Capital Adequacy, Reserving and Provisioning Requirements

i. The International Experience

Almost all countries subject the banks to risk based capital requirements that tie in some or all of the banks' transactions to their capitals and allow the expansion of their transactions only with adequate increase of capital.[254] They also require the insurers to have margins of safety to cover their liabilities through requirements of risk-based surplus ratio and solvency margin.[255]

The countries often define the concept of 'capital' for purpose of the capital adequacy and solvency requirements with consideration of liquidity, risk and valuation.[256] They often define it as the aggregate of assets and liabilities of the

253 Note also the discussion under the means of enforcement chapter below.

254 Möschel, 1991, at pp. 86 & 96-97; Hubbard, 1997, at pp. 416-417 & 422; and Lovett, 1992, at pp. 125-126 & 235.

255 Pfennigstorf, 1996, at pp. 72 & 84-94; IAIS, 2005b, at pp. 27-30; Sandström, 2006; Ayadi, 2007; Eling and Holzmüller, 2008; Sproule, 2009; and Cummins, 2009. The US states rely on premium-based 'surplus ratios' for the ongoing insurers while the EU relies on risk-based 'solvency margin' requirements (Note same citation and the discussion under the 'liquidity and solvency requirements' subtitle below).

256 Möschel, 1991, at pp. 97-103; Pfennigstorf, 1996, at pp. 90-93; IAIS, 2005b, at pp. 27-30; and Sandström, 2006.

institutions that have to be weighted by risk factors for the capital adequacy requirement and by risk or valuation factors for the surplus ratio or solvency requirement. They include the paid up capitals and reserves of the institutions into the concept of capital. Most of them also require strict valuation of the institutions' assets and liabilities that form the capital requirement. Some of the countries also make distinctions such as between primary and secondary capital, between base primary capital and limited primary capital and between core capital and supplementary capital in defining the assets and liabilities that form the capital.[257]

The countries also refer by the concept of adequacy, surplus or margin to the relationship that should exist between the financial institution's capital or asset and the reference factors. They usually put the requirement in any of the following four ways:

- they fix minimum (with some attempt to differentiate between the risks associated with various financial activities);
- they fix standard (based on risk-weighting requirements);
- they prescribe individualized ratios per type of financial institution (based on historical development and nature of the latter); or
- they consider the capital ratios as one amongst a number of other evaluation requirements.[258]

Almost all the countries also require the banks, insurers and credit institutions to keep reserves and provisions that are necessary to supplement their capitals.[259] They often define the requirements in their banking and insurance regulations and supplement them through the general commercial and other laws.[260] They also apply special supervisory requirements on financial groups to avoid the problem of double counting of capital when the financial institutions own interests in legally independent subsidiaries.[261] They follow a deduction and/or consolidation procedure to avoid the double counting of capital.[262]

The 2008 financial and economic crisis has also increased the need for strengthening the level and risk-prevention-orientation of the capital adequacy,

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257 Ibid.

258 Möschel, 1991, at pp. 103-104; Lovett, 1992, at pp. 125-126 & 235; Pfennigstorf, 1996, at pp. 85-90 & 92; and IAIS, 2005b, at pp. 27-30.

259 Möschel, 1991, at pp. 97-103; Pfennigstorf, 1996, at pp. 72 & 84-94; IAIS, 2005b, at pp. 33-36.

260 Ibid.

261 They usually regulate the participation between financial institutions more generously than the participation between financial and non-financial institutions. Möschel, 1991, at pp. 105; and Pfennigstorf, 1996, at pp. 91-92.

262 The deduction procedure requires that the book value of the participation interest should be deducted from the parent institution's capital. The consolidation procedure sees the associated institutions as one unit and requires the working out of the relevant capital for the whole group. It requires that the balance sheet of the parent institution should show the assets and liabilities of the subsidiary in a manner that will indicate the parent institution's share of the subsidiary's capital. The consolidation procedure has been more accepted in the international practice than the deduction procedure. Möschel, 1991, at pp. 105-107; and Pfennigstorf, 1996, at pp. 91-92 & 105-107.

reserving and provisioning requirements on banks, insurers and other financial institutions.[263]

ii. The Case of Ethiopia

Ethiopia considers the capital adequacy requirement as important instrument of only the banking and microfinance regulations and subjects the insurers to solvency as opposed to capital adequacy requirements as it is the case in the international experience.[264] It requires the banks and microfinance institutions to maintain capital adequacy (i.e. unimpaired minimum capital) that shall not be less than a minimum amount that will be determined by the NBE.[265] It authorizes the NBE to determine the minimum requirements, the methods of computation of the required capital, and the kinds of assets and liabilities that may be considered during computation.[266] It also authorizes the NBE to prescribe different capital requirements that may be maintained by different banks and microfinance institutions depending on their risk profiles.[267] It also prohibits the banks, insurers and microfinance institutions from redeeming their shares and reducing their capitals voluntarily without prior written approval of the NBE.[268] It does not, however, set qualitative distinctions such as between primary and secondary capital, between base primary capital and limited primary capital, and between core capital and supplementary capital for purpose of determination of the capital adequacy requirement.

The NBE also guides the determination of the capital adequacy ratios from the banks and microfinance institutions by directives on contributions in kind and computation of risk weighted assets.[269] It defines the capital adequacy ratios as percentages of the total capitals of the concerned institutions to their total risk weighted assets; sets rules that govern computation of the total capitals and risk weights of the asset of the institutions; and requires the banks and microfinance institutions to maintain capital adequacy ratios of not less than eight and twelve percents of the risk weighted assets, respectively.[270] It limits the capital adequacy requirement on the microfinance institutions to the institutions that are re-

263 Campbell, 2007; Christoph Ohler, 2009, at pp. 25-28; Goodhart, 2009, at pp. 47-58 & 95-112; Chorafas, 2009, at pp. 183-234; and Thorsten, 2010. The recent global discussion in respect of the banks includes the setting of rules which will require them to have strong capital reserves that can prevent them from future failure (Note the proposals made to the G-20 in 2010).

264 Note the discussion under the 'liquidity and solvency requirements' subtitle below.

265 It also prohibits them from declaring and paying dividends from their annual profits until they correct deficiencies that may occur in the minimum capital. TGE, 1994a, at arts. 12(1) (a) & 13(1); FDRE, 2008b, at art. 18; FDRE, 1996g, at arts. 12(1) & 24; and FDRE, 2009, at arts. 14(1, 2(b), 2(c) & 3) & 18(7)(f).

266 TGE, 1994a, at art. 12(1)(b); FDRE, 1996g, at arts. 12(1) & 24; FDRE, 2008, at art. 18; and FDRE, 2009, at art. 14.

267 FDRE, 2008b, at art. 18(2); and FDRE, 2009, at art. 14(3).

268 TGE, 1994a, at art. 27(2)(c); FDRE, 2008b, at art. 3(3)(f); TGE, 1994b, at art. 44; FDRE, 1996g, at art. 24; and FDRE, 2009, at art. 17(3) & 28(1).

269 Directives No. SBB/3/95; SBB/9/95; MFI/02/96; and MFI/16/2002. The first two directives entered into effect on the 21st of August 1995 and the latter two on the 21st of October 1996 and the 1st of May 2002, respectively.

270 Directives No. SBB/9/95; and MFI/16/2002.

registered with it (i.e. that have mobilized a deposit level of more than one million Birr).[271] It requires the total capitals of the banks and microfinance institutions to be determined by adding their paid up equity and donated capitals and legal and other reserves that are acceptable to it.[272] It requires the exclusion of all contributions in kind (such as built in vaults, buildings and vehicles) from the adequacy requirements and sets a rule that they can be accepted as capital contributions in excess of the required minimum capital by the banks and microfinance institutions only up to twenty five percent of the paid up capitals of the banks and ten percent of the paid up capitals of the microfinance institutions provided that they are valued by professional assessors acceptable to the NBE.[273] It requires the banks and microfinance institutions to calculate the total risk weighted assets according to tables that have set the assets, weights and formula to be followed.[274] It also avoids the problem of double counting of capital by the banks by requiring them to calculate the minimum capital adequacy requirement on a consolidated basis.[275] It also controls the double counting of capital between the banks and insurers that have cross-ownership by requiring them to net out their capitals during determination of their capital adequacy and solvency ratios.[276] It does not, however, see the need for having these types of rules for the microfinance institutions.

The country also requires the banks and insurers to keep legal reserves, statutory deposits and reserves that may be required by law and the NBE from time to time and the banks, insurers and microfinance institutions to make provisions to the satisfaction of the NBE in respect of items identified by law and directives of the NBE.[277] It requires the banks to transfer annually a sum not less than twenty five percent of their net profits to legal reserve accounts in the NBE until the balances of these accounts equal their capitals and to maintain cash reserve balances with the NBE as the NBE may prescribe.[278] It requires the insurers to deposit statutory amounts equal to fifteen percent of their paid up capitals with the NBE in respect of each of the classes of insurance business they undertake and to transfer ten percent of their annual net profits to legal reserve accounts in the NBE until the balances of the reserve accounts equal their capitals.[279] It authorises the NBE to

271 Directive No. MFI/16/2002, at art. 4.

272 Directives No. SBB/9/95, at art. 2.1; and MFI/16/2002, at art. 2.3.

273 Directives No. SBB/3/95, at arts. 2.1, 2.2 & 2.3; and MFI/02/96, at art. 2.

274 Directives No. SBB/9/95, at art. 3; MFI/16/2002, at art. 2.5; and Table 13(Chap. 2).

275 Directive No. SBB/9/95, at art. 2.2.

276 NBE BSD, 2005, at pp. 72-73.

277 TGE, 1994a, at art. 12(2), 16(5), 13(1), & 13(4); FDRE, 2008b, at arts. 19, 20(3) & 21(1)-(2); TGE, 1994b, at arts. 9-12; and FDRE, 2009, at art. 14(2)(a). The microfinance institutions are not subject to special reserve requirements by the NBE. They are subject only to the general reserving requirements under the commercial code of the country (FDRE, 1996g; FDRE, 2009, at art. 14; and IGE, 1960, at arts. 453-455).

278 TGE, 1994a, at arts. 12(2)(a), 13(4) & 14; FDRE, 2008b, at arts. 19(1) & 20(3). The country also empowers the NBE to determine the sum to be transferred to the legal reserve account after the indicated balance is maintained (TGE, 1994a, at art. 13(4); and FDRE, 2008b, at art. 19(2)). The 1994 law of the country required the banks to maintain statutory balance (i.e. cash reserve) with the NBE as percentage of their total deposit liabilities (TGE, 1994a, at art. 16(5)).

279 The insurers are not required to continue to the transfer once that balance is attained. The NBE may, however, require them to maintain other reserves. TGE, 1994b, at art. 12.

determine the forms and methods of computation of the legal and other reserve accounts and the percentages of the cash balances the banks should keep with it.[280] It also prohibits the reduction of the balances of the legal reserve accounts of both the banks and the insurers except for the purposes and under the circumstances the NBE may prescribe by directives.[281] It authorizes the NBE to take measures and impose sanctions as it may consider necessary to rectify deficiencies in the reserve accounts.[282] It considers the reserve balances and statutory deposits of the banks and insurers at the NBE as part of the usable assets of the banks and insurers provided that the NBE will permit the use of the deposits subject to quick rectification requirement.[283] It requires the banks to:

- provide for their loans, advances, bad or doubtful receivables, assets pledged to secure loans (when the values of such assets are not included in the calculation made to ascertain the banks' compliance with capital and reserve requirements and the effect of pledge is that such assets are not available for purpose of meeting the liabilities of the banks to the public), and other items as the NBE may prescribe;
- depreciate their fixed assets in accordance with law;
- amortize their capitalized expenditures in five years; and
- fully cover their operating and accumulated losses from their annual net profits before paying dividends to their shareholders.[284]

It requires the insurers to provide for uncollected premiums whose contract duration has expired, outstanding claims (from the insurers) that are not paid, liabilities incurred under the insurance contract that are not claimed, and items the NBE may identify for provisioning from time to time.[285] It leaves discretion to the NBE for the items that have to be provided by the microfinance institutions.[286]

In practice, the NBE requires the banks to maintain statutory (cash) reserve as percent of their total demand, saving and time deposit liabilities and sanctions the deficiencies in the reserve at a rate twice the average rate of interest on loans and advances charged by the banks.[287] It requires the commercial banks to:

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280 FDRE, 2008b, at arts. 18(1), 19(1) & 20(3). The 1994 banking supervision law used to require the NBE to take into account the methods employed by the Ministry of Finance and Economic Development in determining the methods of computation and the forms of the legal and other reserve accounts. It also used to authorize the NBE to prescribe different percentage requirements in respect of the demand, saving and time deposits of the banks without exceeding a legal limit of twenty percent. TGE, 1994a, at arts. 12(2)(b) & 16(5).

281 TGE, 1994a, at art. 12(2)(c)(1) & (2); FDRE, 2008b, at art. 19(3); and TGE, 1994b, at art. 44.

282 TGE, 1994a, at art. 13(3); FDRE, 2008b, at art. 20(4); and TGE, 1994b, at arts. 26(4) (c) & 44.

283 TGE, 1994a, at art. 16(5); FDRE, 2008b, at art. 19(3); TGE, 1994b, at arts. 9-11.

284 FDRE, 2008b, at art. 21(1)-(6). It also authorizes the NBE to i) issue directives on the amount and calculation of the provisions and ii) follow up the adequacy of the provisions, depreciations and amortizations of the banks (FDRE, 2008b, at art. 21(2) & (6)).

285 TGE, 1994b, at art. 16.

286 FDRE, 1996g, at art. 16; and FDRE, 2009, at art. 14(2)(a).

287 It required them to maintain a reserve balance of five percent of their total demand, saving and time deposits until the 20th of July 2007 and raised this to ten and fifteen percent as of the 20th of July 2007 and the 7th of April 2008, repectively, to curb the inflation problems the country faced in those years (Directives No. SBB/4/1995; SBB/6/1995; SBB/14/1996; SBB/37/2004; SBB/42/2007; and SBB/45/2008).

- classify and provide for their loans and advances quarterly;
- provide for their operating and accumulated losses from their annual net profits until they fully cover the losses;
- provide fully for the values of the assets pledged to them to secure liability;
- amortize their formation expenses (i.e. the expenses they incurred to organize, extend or purchase business, good will and share underwriting services during formation) in a period of five years;
- write off or provide for their non-collectable claims (other than their loans and advances);
- provide for depreciation of their fixed assets;
- establish loan review system by which they will follow up the health and adequacy of their loans and provisions; and
- submit quarterly reports on their loan classifications and provisioning to the bank supervision department of the NBE.[288]

It requires them to:

- classify their loans and advances into pass, special mention, substandard, doubtful and loss loans;
- consider the loans and advances that are fully protected by the current financial and paying capacity of the borrower and are not subject to criticism as pass loans, the loans and advances overdue for thirty up to ninety days as special mention loans, the loans and advances overdue for ninety up to one hundred eighty days as substandard loans, the loans and advances overdue for one hundred eighty up to three hundred sixty days as doubtful loans, and the loans and advances overdue for three hundred sixty and more days as loss loans; and
- provide for one hundred and a minimum of fifty, twenty, three and one percent of the total outstanding principal balances of the loss, doubtful, substandard, special mention and pass loans, respectively.[289]

It requires the development finance institutions to classify and provide for their loans, assets, losses and claims in similar fashion as the commercial banks with difference in technicalities due to the medium and long term nature of their lending.[290]

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288 Directives No. SBB/18/96; SBB/28/2002; SBB/32/2002; and SBB/43/2007. The provisions of the government banks were regulated under a Regulation and Coordination of Public Financial Operations Proclamation No. 163/1979 until this law was repealed in 1992 (PMGE, 1979; and TGE, 1992b, at art. 3(2)(a)). The country has then subjected the government and private banks to same provisioning requirement beginning 1994 (TGE, 1994a, at art. 15(1); and FDRE, 2008b, at arts. 21(1) & 60(3)).

289 It also requires the banks to limit the total balances of their overdraft facilities to maximum of twenty five percent of their total loans and advances (Directives No. SBB/18/96; SBB/28/2002; SBB/32/2002; and SBB/43/2007).

290 Directive No. SBB/48/2010. The directive defines 'development finance institution' to mean 'an institution which is engaged mainly in medium and long term project finance business, *with* the purpose of promoting development in the industrial, agricultural, construction, services, commercial or other economic sectors'.

It requires the insurers to meet the statutory reserve requirements fixed by law and to provide for the overdue premium claims in their general insurance businesses.[291] It requires them to provide for a minimum of twenty five percent for the claims that are overdue from ninety up to one hundred eighty days from the effective date of the insurance policy, a minimum of fifty percent for the claims that are overdue from one hundred eighty up to three hundred sixty days and a minimum of seventy five percent for the claims that are overdue for over three hundred sixty days.[292]

It requires the microfinance institutions to:

- limit their loan repayment periods to maximum of five years;
- classify their loans to substandard, doubtful and loss loans (i.e. to loans overdue from ninety one up to one hundred eighty days, from one hundred eighty one up to three hundred sixty five days, and for over three hundred sixty five days, respectively); and
- provide for the substandard, doubtful and loss loans up to twenty five, fifty and one hundred percents, respectively.[293]

It also requires them to provide for depreciation of their fixed assets according to law and for their operating and accumulated losses until they recover them fully.[294]

The banks have also capital adequacy, reserve and provision levels in excess of the requirements of the NBE in practice while the insurers often adhere to the levels the law and the NBE require from time to time.[295] The microfinance institutions often fail to comply with the requirements of both the law and the NBE.[296]

The reserves and statutory (cash) deposits of the banks, insurers and microfinance institutions are meant to serve the purposes of maintaining the integrity of their capitals and guaranteeing their liabilities. They are usually included in the determination of the capital adequacy and solvency positions of the banks,

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291 Directive No. SIB/26/2004, at art. 4; and TGE, 1994b, at art. 12.

292 Directive No. SIB/26/2004, at art. 4.

293 MFI/18/2006, at arts. 4.3, 6 & 7. It used to differentiate between the re-registered and non-re-registered microfinance institutions to require the re-registered institutions to meet the aforementioned requirements and the non-re-registered institutions to limit the durations of their loan repayment periods to twenty four months; classify their loans into bad and doubtful loans (i.e. into loans that are overdue for more than one year and six months, respectively); and provide for the bad and doubtful loans fully and up to fifty percent, respectively (Directives No. MFI/05/96, at arts. 4 & 5; and MFI/17/2002, at art. 3.3, 3.4, 5 & 6). It removed the differentiation between the two groups of institutions and required all the microfinance institutions to adhere to the aforementioned uniform requirement as of 06 December 2006 (MFI/18/2006, at arts. 4.3, 6, 7 & 10).

294 FDRE, 2009, at arts. 14(2)(a) & 28; FDRE, 2008b, at arts. 21(3) & (5); and Directives No. MFI/05/96, at art. 5; MFI/17/2002; and MFI/18/2006.

295 Tables 14(Chap. 2); 15(Chap. 2); 16(Chap. 2); the annual and quarterly reports of the NBE for 2008, 2009 and 2010 for the banks; and the registers of the insurance supervision departments of the NBE for 2008, 2009 and 2010 for the insurers and microfinance institutions.

296 Muluneh Alemu, 2008, at pp. 11-12; and Degefe Duressa Obo, 2009, at pp. 6, 87-164, 179-190, 213-218 & 223-227.

insurers and microfinance institutions.[297] The provisioning, depreciation and amortization requirements have, however, only complementary role. They are used to assure the availability, to the banks, insurers and microfinance institutions, of the values of the properties or claims for which they have to provide, depreciate or amortize. They are, therefore, taken into account but not included in calculating the capital adequacy and solvency requirements of the institutions.[298]

The Ethiopian capital adequacy, reserving and provisioning regulation is acceptable in light of the operational challenges the banks, insurers and microfinance institutions face in the country. The country, however, needs to consider four areas of improvement for the following reasons.

First, both the banking supervision law and the practice of the NBE do not, as it is discussed above, distinguish between the start-up and the ongoing capital requirements on the banks and this has slowed down the market entry and development of the banking sector in the country. The country needs to distinguish between the two requirements, fix the start-up requirement in the law, leave the ongoing requirement to decision of the NBE, and thereby encourage market entry, prudence and competition. The NBE only needs to continue to set the ongoing requirements in respect of the banks and the microfinance institutions as percentages of their risk weighted assets so that each bank and microfinance institution can meet the requirements according to its operational level and risk exposure once it has entered into the market.

Secondly, Ethiopia's exclusion of the insurers from a capital adequacy requirement to let them only to the reserving and solvency requirements does not make the insurance companies keep the integrity of their capital continuously although it is in line with the international practice.[299] Large liabilities are likely to pierce the capital and reserve bases of the insurers unless the insurers increase these through time. Most of the insurers in the country also have subsistent capital and that is likely to expose them to shock even if they comply with the initial capital and ongoing reserving and solvency requirements.[300] The solvency requirement does not also guarantee the continued integrity of capital as it is not a supplement to capital by itself but an operational margin to be kept. It is also dependent on the quality of asset valuation in respect of which the Ethiopian insurers are weak. The reserving requirements are also less helpful as they require only the maintenance of reserves as percentages of the small capital bases of the insurers.[301] The country, therefore, needs to require the insurers to maintain a risk weighted capital adequacy level in the fashion this is done for the banks and the microfinance

297 TGE, 1994a, at arts. 12(1) (a) & 13(1); FDRE, 2008b, at art. 21(6); FDRE, 2009, at arts. 14(1) & 14(2)(b); TGE, 1994b, at art. 20; and Directives No. SBB/3/95; SBB/9/95; SIB/26/2004; and MFI/16/2002.

298 TGE, 1994a, at art. 15(1); FDRE, 2008b, at art. 21(6); TGE, 1994b, at arts. 16 & 12; FDRE, 2009, at art. 14(1); and Directive No. MFI/16/2002.

299 The insurance supervision department of the NBE also feels that the solvency test and reserve requirements are not enough to check the prudence of insurers (NBE ISD, 2005, at pp. 104 & 106).

300 Note the capital sizes of the insurers from annual reports of the NBE.

301 The insurance supervision department of the NBE also recommends that the statutory deposit requirement needs to be linked to the premium writing levels of the insurers.

institutions and thereby ensure the continued growth of the risk absorption capacity, competitiveness and stability of the insurers. This measure will also make the country's insurance regulation consistent with the international recommendations as the maintenance of risk weighted capital level is also implicit in the capital and solvency definitions of the IAIS Core Principles and Methodology for insurance supervision.[302]

Thirdly, the capital adequacy requirement in the banking and microfinance regulations is not in line with the latest international recommendation.[303] It is more in line with the 1988 Basel Capital Accord than the 2004 Capital Adequacy Framework. The country needs to improve on it.

Fourthly, the banks and insurers often complain against the reserving and provisioning requirements of the NBE although they comply with them while the microfinance institutions usually fail to comply with the requirements of both the law and the NBE.[304] The NBE needs to take into account the compliance situations of the banks, insurers and microfinance institutions in setting the requirements.

2.3.1.3 Accounting, Balance Sheet and Valuation Rules

i. The International Experience

Regulations governing balance sheet and valuation are of great importance for determining the true financial position of a financial institution. Many countries impose strict valuation, write-off, compulsory disclosure and similar requirements to fortify the disguising potential of hidden reserves that may be created by undervaluing assets and overvaluing liabilities.[305] The international trend also seems to be towards use of compulsory disclosure requirements that compel the financial institutions to give information in their reports that enable the making of inference on the formation and correction of hidden reserves.[306] Almost all countries also distinguish between accounting for purpose of company law and accounting for purpose of regulation.[307] They require the financial institutions to prepare two separate sets of financial reports, i.e. annual reports under company law (including their balance sheet and profit and loss accounts) and regulatory reports as prescribed by regulation. They require the company law reports for use by shareholders (and the public) and the regulatory reports for use by the regulators. They also require the regulatory reports to be more detailed than the company law reports. They have also developed a 'mark-to-market' accounting

302 IAIS, 2003, at Principle 23; and Table 4(Chap. 5).
303 Note the discussion under the 'use of international principles' subtitle of the means of enforcement chapter below; and Table 3(Chap. 5).
304 Note annual reports of the banks and insurers; Muluneh Alemu, 2008, at pp. 11-12; and Degefe Duressa Obo, 2009, at pp. 6, 87-164, 179-190, 213-218 & 223-227.
305 Nemeth, 2001, at p. 45; Pfennigstorf, 1996, at pp. 91 & 101; and Möschel, 1991, at pp. 107-109.
306 Ibid.
307 Möschel, 1991, at pp. 107 & 110-111; and Pfennigstorf, 1996, at pp. 101-102.

and valuation principle through time.[308] The 2008 financial and economic crisis has also increased the need for strengthening the accounting, asset valuation and compulsory disclosure requirements on banks, insurers and other financial institutions.[309]

ii. The Case of Ethiopia

Ethiopia requires the banks, insurers and microfinance institutions to keep books of accounts following generally accepted accounting principles; to have all their assets, whether forming part of their capital or not, valued by experts acceptable or approved by the government; to have their books of accounts audited by independent auditors to be appointed under approval of the NBE and their supervising bodies; and to report the state of their financial activities and affairs to the NBE and to the bodies responsible to supervise them.[310] It requires the banks and microfinance institutions to record their activities and keep documents for each type of transaction in a form and with entry as the NBE may prescribe.[311] It requires the insurers to keep a register of policies (in which they shall record the policies they issued, the names and addresses of the policy-holders and the transfer or assignment of the policies) and a register of claims (in which they shall record the claims lodged with them, the names and addresses of the claimants, the date and amount of the claims, the discharge of the claims with the amount of discharge and the rejection of the claims with the date and ground of rejection).[312] It requires the long-term insurers to have their financial condition and liability investigated by a licensed actuary annually for the first five years following their commencement of business and at least every three years thereafter.[313] It requires the insurers undertaking both long-term and general insurance businesses to administer and use the two businesses separately and to keep separate accounts and funds for them.[314] It also authorizes the NBE to require the banks, insurers

308 Goodhart, 2009, at pp. 53-55; and Liedtke, (ed.), 2010, at pp. 107-149.

309 Campbell, 2007; Close, 2007; Frolov, 2007; Lanam, 2007; Cude, 2007; Wroblewski, 2007; Greenwald, 2007; McIlroy, 2008; Hall, 2009; Goodhart, 2009, at pp. 53-55; Liedtke, (ed.), 2010, at pp. 107-149; IASB, 2010c; IASB, 2010d; IASB, 2010f; IFAC, 2010a; IFAC, 2010b; and IFAC, 2010e.

310 TGE, 1994a, at arts. 12, 13, 15, 18 & 19; FDRE, 2008b, at arts. 23-28; TGE, 1994b, at arts. 17, 18 & 44; TGE, 1992b, at arts. 5, 19-22, 27-28 & 32-34; IGE, 1960, at arts. 63-85 & 368-387; FDRE, 1996g, at arts. 12(2)(c) & 22; FDRE, 2009, at art. 15(1a, 2, 3); and Directives No. SBB/19/96 & MFI/08/96. The insurance and microfinance supervision laws and the commercial code of the country refer to generally accepted accounting principles while the banking supervision law refers to internationally accepted accounting standards. The country has not, however, officially adopted any of these principles. The private banks and insurers are, in practice, audited by Ethiopian and non-Ethiopian Chartered Accountants/Auditors/ who got their certification from London while the government insurer and banks are audited by the Audit Service Corporation of the Government (See annual reports of the banks and insurers).

311 TGE, 1994a, at art. 19; FDRE, 2008b, at art. 23(3); FDRE, 1996g, at art. 24; and FDRE, 2009, at art. 15(1)(b-c).

312 TGE, 1994b, at art. 21.

313 TGE, 1994b, at arts. 19 & 25.

314 TGE, 1994b, at arts. 15(1)(b-c)). It also authorizes the NBE to prescribe requirements for separate keeping and administration of accounts and funds for particular sub-classes of the long-term and general insurance businesses (Id., at art. 15(2)). The NBE has, however, classified the businesses so far only for purpose of financial reporting (Directive No. SIB/17/1998).

and microfinance institutions to revaluate and/or re-audit their financial positions when it feels that their reports are defective or inadequate.[315]

The aforementioned rules of Ethiopia imply that valuations have to be as realistic as possible and, hence, that the creation of hidden reserves by undervaluing assets and overvaluing liabilities is prohibited. The country also authorizes the NBE to check compliance to this prohibition through compulsory reporting and inspection requirements.[316] However, the rules are framed generally to indicate bookkeeping and reporting duties and one can see the prohibition of hidden reserves from them only by interpretation. The country needs to expressly prohibit the creation of such reserves and the NBE needs to closely enforce the prohibition so that the financial capacities of the institutions will be strengthened. Instances of violation are already seen in practice when some of the banks inflated the net recoverable values (NRV) of their collaterals to reduce provisions.[317] The adoption of clear prohibition of hidden reserves will also make the Ethiopian regulation in line with the international experience. The country also needs to standardize and enact the accounting principles which the banks, insurers and microfinance institutions have to follow instead of making general reference to internationally accepted accounting principles. The search for such principles has led the banks, insurers and microfinance institutions to divergent accounting practices and this needs to be corrected.[318]

2.3.1.4 Liquidity and Solvency Requirements

i. The International Experience

Both liquidity deficiency and excess are not healthy for financial institutions. Liquidity deficiency makes them unable to meet the liquidity demands of their clients while liquidity excess is likely to cripple their incomes and increase their liabilities. Banks usually face liquidity deficiency when they engage in large maturity transformation (i.e. in large transformation of short-term deposits into long-term loans). They face liquidity excess when their lending business is thin. Microfinance institutions face liquidity deficiency when they have loan collection problems and weak deposits and financial resources due to poor financial basis of their clients. Insurers face liquidity deficiency when they face large mismatch between premiums and claims, with the latter growing in greater disproportion to the former. They also face liquidity problems due to internal and external factors, internally by their own rating, reserve valuation, risk selection, re-insurance, investment and sale related decisions and externally by inflation, regulatory

315 TGE, 1994a, at arts. 18(7) & 20(3)(c); FDRE, 2008b, at art. 27(3); TGE, 1994b, at arts. 30 & 31; and FDRE, 2009, at arts. 13(2) & 28(1).

316 TGE, 1994a, at arts. 19; FDRE, 2008b, at arts. 28-31; TGE, 1994b, at arts. 17(2), 19(2-4), 30 & 31; and FDRE, 2009, at arts. 15(2-4) & 18.

317 NBE BSD, 2005, at pp. 55 & 64.

318 See annual reports of the banks, insurers and microfinance institutions.

changes on structure of insurance, and developments in the underwriting and investment markets.[319]

Hence, liquidity requirements need to balance between profit and liquidity deficiency (and excess) levels since both of these are desirable for a financial institution.[320] Varieties of liquidity theories are developed on how to do this for the banks.[321] The "golden rule of banking" insists on absolute matching of the amount and maturity dates of the assets and liabilities of banks. The sediment theory insists on the determination of the potential for long-term lending by maturity of deposits depending on the type of depositors and the general economic circumstance. The shiftability theory advises the accumulation of assets which can be sold in the market without delay and significant loss as alternative sources of liquidity. The maximum load theory links the concept of liquidity with the wider concept of solvency and requires that the capital of a bank must always be sufficiently large to cover the total losses that might be incurred. Most countries require the banks to meet liquidity requirements that frequently incorporate elements of the various theories instead of sticking into one of the theories.[322] They have moved away from the golden rule theory to elements of the sediment and shiftability theories.[323]

Most countries also believe in the need for imposing surplus and solvency requirements on insurers because of:

- the exposure of insurers to internal and external risks (and the need for avoidance of panic),
- emphasis on the relevance of insurance for the financial and other sectors of the economy; and
- need for consumer protection from loss of life-time savings and retirement benefits.[324]

They often set legal minimums which are expressed by solvency margin (i.e. the surplus of assets over liabilities) or solvency ratio (i.e. a ratio of the solvency margin to the net premium incomes of the insurers).[325] They include the concept of liquidity in the solvency requirement by requiring that the assets of an insurer should be adequate and disposable at any time to pay its claims.[326] They also rely on portfolio (risk/asset) diversification requirements to control the risk compositions of the assets of the insurers.[327] They consider all these requirements

319 Thimm, 1999, at p. 122; Finsinger, Hammond and Tapp, 1985, at p. 12; and Merkin and Rodger, 1997, at p. 2.

320 Möschel, 1991, at pp. 77-78.

321 Id., at p. 78.

322 Ibid.

323 Id., at pp. 78-79.

324 Thimm, 1999, at pp. 121 & 126-127; Finsinger, Hammond and Tapp, 1985, at pp. 6-8 & 12; and Pfennigstorf, 1996, at pp. 85-92.

325 The EU solvency control regime followed the latter approach. Thimm, 1999, at pp. 122-126 & 160; and Sandström, 2006.

326 Thimm, 1999, at p. 160; Pfennigstorf, 1996, at pp. 85-90; and Sandström, 2006.

327 Thimm, 1999, at pp. 160-161.

as early warning means, as guarantee for continued existence of the insurers, and as safeguard to consumer protection.[328]

The main resources to which the financial institutions resort to avoid the liquidity deficiency problem also often include:

- cash and similar deposits within the central bank;
- assets which can be sold in the market (or returned to the central bank for money) quickly and without large loss; and
- borrowing.[329]

The 2008 financial and economic crisis has also increased the need for strengthening the liquidity and solvency requirements on banks, insurers and other financial institutions and the mechanism for providing liquidity and solvency.[330] The solvency regimes are also undergoing reform (in both USA and Europe).[331]

ii. The Case of Ethiopia

Ethiopia requires the banks and microfinance institutions to meet liquidity requirements as the NBE may require from time to time.[332] It defines the 'liquid assets' of the banks by law and authorizes the NBE to require them to keep their liquidity in those assets and as it may direct from time to time.[333] The NBE currently requires the banks to maintain a liquidity position of not less than twenty five percent of their total current liabilities (i.e. sum of the current, saving and time deposits and similar liabilities with less than one month maturity period).[334] It requires them to keep the twenty percent liquidity in the primary liquid assets and the other five percent in the secondary liquid assets as defined by the 1994 law.[335] It requires them to submit weekly liquidity position reports by showing the end-

328 Thimm, 1999, at pp. 127-131; Finsinger, Hammond and Tapp, 1985, at p. 15; and Sandström, 2006.

329 Thimm, 1999, at pp. 121-160; and Pfennigstorf, 1996, at pp. 85-90.

330 BCBS, 2008; BCBS, 2009; OECD, 2008g; Eling and Holzmüller, 2008; Christoph Ohler, 2009, at p. 26; Sproule, 2009; Cummins, 2009; Sebastian Schich, 2009b; Goodhart, 2009, at pp. 47-53, 55-57 & 59-92; Chorafas, 2009, at pp. 183-234; Thorsten, 2010; and Liedtke, (ed.), 2010, at pp. 107-149.

331 Ayadi, 2007; Sproule, 2009; Cummins, 2009; and Liedtke, (ed.), 2010, at pp. 135-140.

332 TGE, 1994a, at art. 16(1)(a); FDRE, 2008b, at art. 20(1); FDRE, 1996g, at arts. 16 & 24; and FDRE, 2009, at art. 14(2)(b).

333 Both the 1994 and 2008 banking supervision laws have defined the concept of 'liquid asset'. The 1994 law has made distinction between primary and secondary liquid assets while the 2008 law does not (TGE, 1994a, at arts. 16(1)(b) & 16(2); and FDRE, 2008b, at art. 20(2)). The 2009 microfinance business law leaves the definition of liquid assets of the microfinance institutions to full discretion of the NBE (FDRE, 2009, at art. 14(2)(b)).

334 It required them to maintain a liquidity position of not less than fifteen percent of their total current liabilities until 07 April 2008 and raised the requirement to twenty five percent as of that date to influence the inflation pressure the country faced in the year (Directives No. SBB/15/96; and SBB/44/08).

335 It used to require them to keep at least five percent of the required liquidity in the primary liquid assets and up to the other ten percent in the secondary liquid assets until this was changed on 07 April 2008 (Directives No. SBB/15/96; and SBB/44/08). The NBE has also expanded the legal definition of secondary liquid assets to include i) deposits held in the OECD currencies that are payable by banks of the OECD countries; ii) securities of 31, 180 and 370 days tenure issued by the OECD countries; and iii) deposits held in the non-OECD currencies as it may approve from time to time (Directives No. SBB/15/96 & SBB/44/08; and TGE, 1994a, at arts. 16(1)(b) & 16(2)).

of-week balance of each Wednesday.[336] It also requires them to show the values of each liquid asset, deposit and similar liability in respect of which the liquidity is fixed.[337] It requires the re-registered microfinance institutions (and the institutions whose total deposit is more than one million Birr) to maintain a liquidity position of not less than twenty percent of their total deposits.[338] It requires them to keep the required liquidity in cash, treasury bills, and deposits with banks and other microfinance institutions.[339] It has also introduced an inter-bank money market on the 30th of September 1998 to facilitate the management of liquidity problems.[340]

The country also requires the insurers to meet a solvency margin fixed by law according to the type of business they undertake.[341] It requires the general insurers to maintain a solvency margin of not less than the greater of their statutory deposits or fifteen percent of the net premium they wrote in the last preceding financial year.[342] It requires the long-term insurers to maintain a solvency margin of not less than the greater of their statutory deposits or ten percent of their mathematical reserves as may be determined by an actuary.[343] It requires the insurers that carry on general and long-term insurance business to maintain the solvency margins required by law in respect of each business separately.[344] It also authorizes the NBE to prescribe the method of computation and the kinds of assets and liabilities that shall be considered for purpose of computing the solvency requirements.[345] The NBE also, in practice, requires the insurers to consider all their assets (with the exclusion of only some items) and liabilities in making the calculation.[346]

In practice, the banks of the country also often keep liquidity levels which are substantially higher than the amount the law requires while the insurers and the microfinance institutions often comply with the solvency and liquidity requirements of the law and the NBE.[347]

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336 Directives No. SBB/15/96; and SBB/44/08.

337 The bank supervision department of the NBE assesses liquidity only historically because of lack of data to predict the future. NBE BSD, 2005, at p. 40.

338 Directive No. MFI/15/2002.

339 Ibid.

340 The market is regulated by a directive and a Code of Conduct of the NBE and only the banks have participated in it so far (Directives No. IBM/02/98 & NBE, 1998b; and quarterly and annual reports of the NBE from 1998 up to 2010).

341 TGE, 1994b, at art. 20 (1) & (2); and Directive No. SIB/26/2004, at art. 2.4. The concept of solvency margin in the law refers to the excess of assets over liabilities to be kept by the insurers.

342 It requires them to meet this requirement after two years (or more as the NBE may fix) have expired from the date of commencement of their business (TGE, 1994b, at art. 20(1)). All the insurers are required to keep statutory deposits equal to fifteen percent of their paid up capitals in respect of each of the class of business they undertake (TGE, 1994b, at art. 9(1)). The net premium is the gross premium written during the year less the re-insurance premium ceded thereon (TGE, 1994b, at arts. 2(18) & 20(1)).

343 TGE, 1994b, at art. 20(2).

344 TGE, 1994b, art 20(3).

345 The NBE has to take into account the method of computation employed by the Ministry of Finance of the country in making the prescription. TGE, 1994b, at art. 12(1) (b).

346 Directive No. SIB/26/2004.

347 Tables 15(Chap. 2); the annual and quarterly reports of the NBE for 2008, 2009 and 2010; and the registers of the insurance and microfinance supervision departments of the NBE.

The bank and microfinance liquidity regulations of the country are pragmatic as they permit the NBE to respond to liquidity problems without sticking to single theory. They take care of both the asset to liability ratio, hence debt paying ability, of the banks and microfinance institutions and the convertibility of their assets into cash. They are justified from these points of view. The country, however, also needs to have indirect liquidity requirements that focus on the methods of financing of loans. These types of requirements have proved their worth in the international experience. They are found to be more effective than the direct ratios as they address the most important financial sources of the banks and microfinance institutions.[348] They also facilitate the implementation of diversification measures.[349]

The insurance solvency requirement of the country, however, fails to make the insurers maintain sufficient liquidity. It is not also in line with the IAIS Core Principles and Methodology for insurance supervision which includes the maintenance of liquidity in the solvency definition.[350] It is also only when the insurers keep the solvency levels with the necessary liquidity that they can be able to meet their obligations in true terms. Imposing liquidity requirements on them is important for these reasons. Hence, the country also needs to classify the assets of the insurers in terms of their convertibility to cash and require them to meet liquidity levels along with the solvency requirements.

2.3.1.5 Functional and Ownership Separation Requirements

i. The International Experience

The majority of both the OECD and other countries used to assign the production and marketing of banking, insurance and other financial services to different institutions and to prohibit or restrict integration.[351] They used either to prohibit financial intra and inter-sectoral integration in principle or to allow these through:

- establishment of subsidiaries, holding companies and/or joint ventures;
- acquisition of controlling shareholding through cross-sectoral investments; or
- creation of financial conglomerates (i.e. groups that bring together legally independent entities whose activities fall in at least two different sectors under a more or less centralized management).[352]

They also used to separate between commercial banking and investment banking, between banking and other commercial activities, between long-term and short-term banking, between insurance and other businesses, and between life and non-

348 Möschel, 1991, at pp. 78-79.
349 Ibid.
350 IAIS, 2003, at Principle 23; and Table 4(Chap. 5).
351 Laboul, 1992, at p. 24.
352 Id., at pp. 27-37.

life insurance businesses.[353] They also used to limit the cross ownerships between the financial institutions and the shareholdings in them that might have the effect of diluting the separation of functions.[354] They did all these with a view to enhancing competition, curbing the contiguity of risk, controlling double counting of capital, reducing managerial influence, ensuring consumer protection, and addressing the economic, technical, operational, staff and risk characteristics of the different services separately.[355]

Many of both the OECD and other countries have, however, experienced an ever increasing functional and ownership linkage between the insurance, banking and other financial services through cross-sectoral financial and business deals, operational arrangements, investments and product expansions after the late 1980s.[356] The separation between non-life and life insurance services has also become meaningless as more and more companies combined life and non-life insurance services.[357] The integration has increased the flexibility of insurance contracts and investments, the competitiveness and risk taking behaviours of insurers, and the expansion of insurance products.[358] It has also resulted in the creation of financial conglomerates called all-finanz or banc-assurance.[359] Many of the countries have also been considering the need for adjusting their regulatory systems (which were based on the separation principle) in order to deal with the situation of conglomeration.[360]

353 They used to impose more serious regulations on the production of the financial services than on their marketing and distribution (Laboul, 1992, at pp. 9-10 & 17-34; Pfennigstorf, 1996, at pp. 67-72; Möschel, 1991, at pp. 70-75; and Lovett, 1992, at pp. 163-169 & 190-196). The US also used to separate among the life, health, property and casualty insurance services due to the consumer movements of the 1970s which emphasized on the availability of policy choice to consumers while the many other countries also used to separate between the life and non-life insurance businesses due to their historical reasons (Meier, 1988, at pp. 2-17; Caddy, 1986, at pp. 58-82 & 209-216; Chance, 1993, at p. 5; Pfennigstorf, 1996, at p. 70; and note the discussion under the 'history and current state' subtitle above).

354 Laboul, at pp. 27-37; Möschel, 1991, at pp. 70-75; Pfennigstorf, 1996, at pp. 67-72; and Lovett, 1992, at pp. 163-169 & 190-196.

355 Laboul, 1992, at pp. 9-10 & 17-34; and Pfennigstorf, 1996, at pp. 67-72.

356 Laboul, 1992, at pp. 7-8, 10, 15, 17 & 27-42; Chance, 1993, at p. 2; Rietbergen, 1999, at p. 13; and Carmichael and Pomerleano, 2002, at pp. 39 & 38.

357 Rietbergen, 1999, at p. 16.

358 Laboul, 1992, at pp. 13-14.

359 The forms of bank conglomeration have ranged from the model of universal banking to a model of non-operating holding company. The universal banking model has become common in Europe to permit banks to carry out investment banking, securities dealing and other non-bank activities. The holding company model has originated in the United States and spread to other countries in either of three forms. In its first form, banks have established insurance, securities dealers and other non-bank financial institutions as subsidiaries. In, its second form, insurance or securities dealers have penetrated the savings components of banks and formed other financial institutions as their subsidiaries. In, its third form, different financial services have been offered through subsidiaries of a non-operating holding company. The all-finanz or banc-assurance model has then become common when banks and the other financial savings institutions entered into each others' business (and customer base) to sale their products. Its impetus has come from banks that needed to protect their shrinking market as a result of development of the savings and pension products of insurers. It was then enhanced by insurers that wanted to integrate with the banks and other financial institutions. Chance, 1993, at p. 72.

360 They have focused on a number of regulatory issues including the anti-competitive concentration the linkage creates; the accumulation and transfer of risks that may lead to systemic failure; the exercise of internal fund transfers and internal credits that may be non-prudential; the transfer of

The 2008 financial and economic crisis has, however, also re-triggered discussion on the desirability of the conglomeration of financial institutions.[361] Many have argued that the conglomeration of these institutions has increased the contiguity of the crisis and, hence, that it needs to be re-considered.[362] The latest recommendation is towards overhauling of failure resolution schemes and continuation of the non-restrictive regulatory approach with development of a fire-walled business structure (i.e. the separation of businesses of the financial institutions, in particular of the banks, under a non-operating holding company structure (NOHC) which should be subjected to group leverage ratios for its capital).[363]

ii. The Case of Ethiopia

Ethiopia expressly separates the banking businesses from non-banking and other commercial activities and the insurance businesses from non-insurance activities in principle.[364] It allows the banks, insurers and other financial institutions to engage in microfinance businesses (by virtue of their banking licenses for the banks and subject to authorization by the NBE for the insurers and others).[365] It requires the banks to obtain prior authorization by the NBE whenever they want to engage in non-banking businesses other than the microfinance business.[366] It requires the government banks to specialize by type of the credit they extend and

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profits and external loans within the group that may endanger the rights of third parties; the centralization of management of the sectors that may lead to inefficiency and anti-competitiveness; the transfer of data and information between the sectors that may lead to confusion between the sectors and to third parties; the potential conflict of interest that may exist between the group members; and the conflict of competence that may exist between the regulatory authorities which used to specialize in the sectors. They have not, however, come up with comprehensive laws that deal with all aspects of the linkage. Laboul, 1992, at pp. 11-12, 41-42, 31-35, 43-90 & 115-149; Chance, 1993, at p. 73; Pfennigstorf, 1996, at pp. 67-72; and IAIS, 2005b, at p. 16.

361 Adrian Blundell-Wignall, et al., 2008a; Aguirre, et al., 2008; Gert Wehinger, 2009a; Adrian Blundell-Wignall, et al., 2009a; Sebastian Schich, 2009b; and Thorsten, 2010.

362 The US, which has originated the crisis, has also passed through the debate. It had introduced the principle of separation of functions for commercial banks by the Glass-Steagall Act and followed it from the 1930s up to 1999. The President Bill Clinton administration had then abolished the principle and allowed the commercial banks to engage in investment banking and other non-commercial-banking functions as of 1999. The President B. Obama administration has supported the return to the separation principle in the aftermath of the 2008 financial and economic crisis. The 2010 financial regulatory overhauling bill of the country has then restricted the commercial banks' ability to engage in the non-commercial banking businesses by ceilings and related regulations on their investments to control their undertaking of excessive risks. Research has also emphasized on the need for breaking down the concentrated banking structure of the country in order to prevent the advent of future crisis. (AP, 2010a; Financial Post, 2010; Bloomberg, 2010; and Johnson and Kwak, 2010). Some have also, of course, argued that the continuation of universal banking is more useful than the functional banking approach (Aguirre, et al., 2008).

363 Adrian Blundell-Wignall, et al., 2008a; Gert Wehinger, 2009a; Adrian Blundell-Wignall, et al., 2009a; Sebastian Schich, 2009b; and Thorsten, 2010. Some have also proposed restructuring of the banking sector into small limited purpose (mutual) banking in order to contain the contiguity of future crisis (Kotlikoff, 2010). The debate is not finished.

364 TGE, 1994a, at art. 27(3); FDRE, 2008b, at art. 50; and TGE, 1994b, at art. 7(1) (e).

365 TGE, 1994g, at art. 5(8); FDRE, 1996g, at art. 12(3); and FDRE, 2009, at art. 4(1).

366 TGE, 1994a, at art. 27(3); FDRE, 2008b, at art. 50; FDRE, 2009, at art. 4(1); and Directive No. SBB/12/1996, at art. 2. The law also authorizes the NBE to issue directives that may regulate the undertaking of banking businesses related to non-interest bearing deposit mobilization and fund utilization (as in the case of Islamic banking) (FDRE, 2008b, at art. 22(2)).

the sector of the economy they finance.[367] It does not require the private banks to specialize by type of business. It only requires them to disclose their projected operations, by including the major categories and sectors of their intended loans, to the NBE during their applications for license and authorizes the NBE to regulate their credit operations.[368] It requires the insurers to obtain prior authorization by the NBE whenever they want to carry out businesses other than insurance business.[369] It also separates the banking and insurance businesses from financial leasing business by subjecting the latter to a separate regulatory regime.[370] It provides for the creation of linkage between the microfinance institutions and the formal banks and insurers and the transformation of the microfinance institutions into bank or other financial institution through re-licensing by the NBE (and provided that the NBE may require the transformed institutions to continue with the microfinance operations).[371] It does not, however, have rules that govern the microfinance institutions when the latter want to carryout activities other than the microfinance operations without being transformed into a bank or another financial institution.[372] It only seems that the NBE may apply the prior authorization requirements of the banking and insurance supervision laws to this case.[373]

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367 It requires the Commercial Bank of Ethiopia to provide short and medium term loans freely and long term loans within a ceiling and to engage in banking activities that are customarily carried out by commercial banks; the Development Bank of Ethiopia to provide short and long term investment loans to development projects and to engage in activities that are customarily carried out by development banks; the Construction and Business Bank S.C. to extend loans to the housing, construction, hotel, tourism, industry and personal sectors and to engage in activities that are customarily carried out by construction and business banks. TGE, 1994f, at art. 5; TGE, 1994d, at art. 5; TGE, 1994g, at art. 5; FDRE, 2003, at art. 6; and FDRE, 2005a.

368 TGE, 1994a, at art. 5(1); SBB/1/1994, at art. 3 (as amended by SBB/39/2006); FDRE, 2008b, at art. 4(1)(a); TGE, 1994, at art. 7(2); and FDRE, 2008a, at art. 15(1)(a)(2). The NBE does not regulate the credit operations of the banks in practice. It only requires them to meet the liquidity and other requirements. The banks, however, tend to follow restrictive credit policies in practice due to weak financial and entrepreneurial capacities. They tend to focus on the extension of short and medium term (one to five years) loans to the export, import, retail and transport sectors and to limit their long term credits. Their annual loan collection to disbursement ratio has also been 89.9% on average during the last one and a half decades showing their strong focus on short term lending. Only the Development Bank of the country has tried to make long-term finance available consistently which is very small. Table 11(Chap. 2); and the annual and quarterly reports of the NBE for 2008, 2009 and 2010.

369 TGE, 1994b, at art. 7(1)(e).

370 FDRE, 1998. It allows the microfinance institutions to engage in financial leasing business at the micro level (FDRE, 2009, at art. 3). The market for financial leasing is not, however, grown well in the country.

371 FDRE, 2009, at art. 21.

372 FDRE, 1996g; and FDRE, 2009, at arts. 17 & 28(1). The definition of 'microfinance business' in the 2009 microfinance business law is, however, also extensive enough to allow the microfinance institutions to engage in deposit taking, lending, micro-insurance, asset ownership, financial leasing, fund management, payments facilitation, entrepreneurship, money transfer and other operations at the micro level (FDRE, 2009, at art. 3).

373 The 2009 microfinance business law also rules that the unauthorized undertaking of activities other than the microfinance businesses by the microfinance institutions is good cause for receivership and liquidation by the NBE (FDRE, 2009, at art. 19(1)(i). The microfinance business laws also authorize the NBE to apply the relevant rules of the banking and insurance supervision laws on the microfinance institutions (FDRE, 1996g, at arts. 16 & 24; and FDRE, 2009, at art. 28(1)). None of the microfinance institutions has, however, also asked the NBE for permission to engage in a non-microfinance business yet.

The country also restricts the equity participations of the commercial banks, insurers and microfinance institutions. It authorizes the NBE to regulate the investment and asset portfolios of the banks, insurers and microfinance institutions and the NBE restricts these.[374] It allows the banks to:

- hold shares in an insurance company only up to 20% (twenty percent) of the latter and without exceeding 10% (ten percent) of their own equity capital;
- hold shares in a single non-banking company only up to 20% (twenty percent) of the company's share capital and without exceeding 10% (ten percent) of their own net worth;
- have equity participation in other banks upon prior authorization of the NBE and only up to a level the NBE may fix from time to time;
- invest in other securities only up to 10% (ten percent) of their net worth; and
- commit in real estate acquisition and development other than for their own business premises only up to 20% (twenty percent) of their net worth and to obtain the NBE's prior approval when they want to exceed this limit.[375]

It allows them to engage in securities business through limited liability subsidiary company in which their holding shall not exceed 10% (ten percent) of their equity capitals.[376] It requires them to limit the aggregate sum of all their investments at any one time (excluding their investments in government securities) to 50% (fifty percent) of their net worth.[377]

It prohibits the insurers from issuing financial and unconditional guarantee bonds.[378] It allows them to invest in shares of other companies only up to fifteen percents of their funds.[379] It allows the general insurers to invest in real estate business only up to ten percent of their funds and the long-term insurers to do same only up to twenty five percent.[380] It allows both types of insurers to invest in

374 TGE, 1994a, at art. 27(3); FDRE, 2008a, at art. 16(1)(a); FDRE, 2008b, at art. 22; TGE, 1994b, at arts. 14, 42(e) & (f); FDRE, 1996g, at art. 24; FDRE, 2009, at arts. 14(2)(d) & 28(1); and Directives No. SBB/12/1996; SIB/23/2002; SIB/24/2004; SIB/25/2004; and MFI/07/96.

375 Directive No. SBB/12/1996.

376 Id., at art. 8.

377 Directive No. SBB/12/1996. The banks have, in practice, invested only about 19.7, 10.6 and 0.029 percents of their total assets in treasury bills, government bonds and equity shares of other companies (Table 17(Chap. 2); and the annual reports of the banks for 2008 and 2009). The country authorizes the Development Bank and the Commercial Bank of Ethiopia to buy and sell negotiable instruments including company securities and to participate in equity investments and the Construction and Business Bank S.C. to invest and participate in equity investments of real estate development without imposing special limit on the extent of these investments. Only the limits of the NBE seem to govern the aforementioned investments of the banks as the NBE has not exempted them expressly from the rules of its directives.

378 Directives No. SIB/23/2002; and SIB/24/2004. The NBE refers, by the 'financial guarantee bond', to the undertaking of an insurance company to pay to a lending bank or any other creditor of an outstanding claim not paid by the principal debtor. It, by the 'unconditional bond', refers to the undertakings of an insurer other than the financial guarantee bond that are payable on demand without any precondition. The insurers used to issue both types of instruments until the NBE prohibited them on the 23rd of December 2002.

379 Directive No. SIB/25/2004, at arts. 2.1 & 2.2.

380 Ibid. It refers, by the 'real estate business' to the construction and acquisition of buildings and the acquisition of lands for construction business. Directive No. SIB/25/2004, at art. 1.4.

other fields of investment only up to ten percent of their funds.[381] It, accordingly, limits much of the businesses of the insurers to the business of insurance proper.[382]

It also requires the microfinance institutions to limit their total investments in allied activities to ten percent of their equity capitals and their equity investments in any single enterprise to three percent of their own net worth.[383]

The country does not, however, separate between life and non-life insurance businesses. It only requires the acquisition of separate licenses for the two lines of businesses and allows the acquisition of both types of licenses by one applicant.[384] It does not also prohibit cross shareholding between the banking, insurance, microfinance and other companies. It only requires each of them not to exceed a holding level of ten percent of the capital of the other by its general commercial law.[385] It also encourages merger between the microfinance institutions subject to prior approval by the NBE so that they will enhance their capacities.[386] It also makes the banking, insurance and microfinance supervision laws complementary to one another despite the functional separation between the banks, insurers and microfinance institutions.[387]

Hence, the Ethiopian position on the relationship between commercial banking, insurance, microfinance and investment is neither unification nor separation. It stands in between as it is based on limits that can be adjusted by the NBE according to circumstances. It enables the NBE to enhance the health of the banks, insurers and microfinance institutions according to circumstances. It also leaves discretion to the NBE so that it will consider future developments towards conglomeration in the country's financial market. The complementary relationship between the banking, insurance and microfinance supervision laws is also useful to pave the way for regulatory integration in case the country adopts a policy of allowing financial conglomerates in the future.

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381 Ibid.

382 The insurers have also invested only about 5.6, 0 and 8.4 percents of their total assets in treasury bills, government bonds and shares of other companies in practice (Table 18(Chap. 2); and the annual reports of the insurers for 2008 and 2009).

383 The NBE considers the banking and non-banking financial services and all agricultural input, warehousing and transportation services as allied activities to the microfinance institutions. Directive No. MFI/07/96.

384 TGE, 1994b, at art. 6(1) & 8.

385 The general commercial law requires that if one of the companies holds more than the ten percent limit, the other must not reciprocally own; and that if both companies own reciprocally and the holding level of one or both of the companies exceeds the ten percent limit, the situation has to be declared to the NBE and to the Ministry of Trade and Industry and either both companies should reduce their holdings to an amount below the ten percent limit or one of the companies should dispose of its holdings (IGE, 1960, at art. 344). The 2008 banking business law also authorizes the NBE to issue directives that will regulate the relationship between the banking and insurance companies (FDRE, 2008b, at art. 54(2)).

386 FDRE, 1996g, at art. 13; and FDRE, 2009, at art. 17(1).

387 TGE, 1994a, at art. 34; FDRE, 2008b, at art. 60; TGE, 1994b, at art. 44; FDRE, 1996g, at art. 24; and FDRE, 2009, at arts. 28 & 19(3).

The country, however, needs to separate between the banking, insurance, microfinance, securities, pension and other markets in the short run. First, it is likely that the integration will make the markets dependent on one another and prone to risk and contagion. This is not healthy in a country where both markets are growing from the scratch and have many future challenges. Secondly, the banks and insurers have failed to contribute to the creation and development of the microfinance and securities markets and pension institutions although they have the authorization to play roles in these regards and this failure justifies the separate treatment of the indicated markets and institutions. Thirdly, the country needs to enhance competition between the different markets and institutions in order to make them attract different pools of investment, capital and talent; enhance efficiency; and serve the public with alternative sources of finance. This requires that the existing banks and insurers do not dominate the markets but concentrate on the development of their own fields. Fourthly, the NBE lacks capacity to regulate financial conglomerates and needs to build its regulatory capacity before the different markets are integrated. Hence, the country needs to have clear rules that separate between the indicated markets and institutions in the short run. There should not also be rules that tend to allow merger between the markets and institutions such as the rule of the NBE which invites the banks to have subsidiary companies for securities trade.

The country need not, however, separate between the short and long-term credit businesses of the banks since the current financial capacities of the banks do not allow them to concentrate on the long-term business alone. The banks need to engage in the short, medium and long-term credit businesses flexibly to minimize the risks of long-term credit and to grow before they specialize in a long term business. Most of the banks do, however, also limit their credit businesses to short and medium term loans making the country lack dependable long-term finance as indicated above. They need to balance between the short, medium and long term businesses and increase the provision of long-term finance to the different sectors. The country, therefore, also needs to impose diversification requirements that will make the banks meet this.

The country also needs to continue to regulate the reciprocal ownership between the financial institutions since this is useful to enhance the control of excessive risk exposure, double counting of capital, and conflict of interest in the management of the institutions.

2.3.1.6 Risk Diversification Requirements

i. The International Experience

Banks need to diversify loan risks. They need to distribute the sum total of their loan funds amongst a number of borrowers and make large-scale default less probable. The banking regulators around the world impose diversification requirements for this reason.[388] They usually impose the diversification

388 Möschel, 1991, at pp. 81-84.

requirements as large-scale credit regulation or single borrower limits.[389] They usually take the economic unit of the individual borrower, the geographical location, legal form and size of the borrower, the nature of trade or industry to be financed, and the kind of assistance envisaged as criteria for diversification.[390] They rely on three common yardsticks, namely the banks' own capital, the volume of all loans, and the sum total of all liabilities.[391] Some countries also require resolution by the management or supervisory boards of the banks for granting large loans.[392] Some also require the banks to diversify their liabilities to depositors.[393] Regional and sectoral diversification requirements are also imposed sometimes to control damage to a bank due to economic decline of a region or sector.[394]

Many countries have also reformed their insurance portfolio regulations when insurers internationalised their businesses and faced increased competition.[395] The EU and its member countries have relaxed their portfolio regimes for the insurers and emphasised on the regulation of investments of their technical reserves.[396] The US has enhanced the investment flexibility and financial transparency of its insurers by changing its bond rating system, imposing risk-based capital requirements, and increasing the roles of its rating agencies.[397] Many of the other countries have also appreciated the need for introducing portfolio diversification requirements in their insurance markets so that the institutions in the markets will limit their risks and enhance their health as the markets become increasingly internationalised.[398]

ii. The Case of Ethiopia

Ethiopia requires the banks and microfinance institutions to diversify their borrowers by adhering to maximum single borrower limits as the NBE may fix from time to time.[399] The NBE requires the banks to limit the total liabilities of

389 Id., at pp. 81-82.
390 Ibid.
391 The banks' own capital is the most predominant yardstick. Liabilities are least used as yardstick. Ibid.
392 Ibid.
393 Id., at p. 84. The usefulness of this requirement is, however, disputed as one large deposit does not normally mean any particular risk to a bank unlike a single large loan. The regulation of maturity transformation is, accordingly, considered to be a more sensible instrument than the use of quantitative controls on the deposits themselves as it is usually when maturity is transformed from the short-term deposits to long-term loans that the risks arise. Ibid.
394 Ibid.
395 Nemeth, 2001, at pp. 63-66.
396 Thimm, 1999, at pp. 162-166; and Pfennigstorf, 1996, at p. 100.
397 Fenn, 2001, at pp. 366-391; Klien, 2001, at pp. 399-403; Barth, Brumbaugh and Yago, 2001, at pp. 368-370; Pfennigstorf, 1996, at pp. 99-100; and Marc, et al., 2009.
398 Thimm, 1999, at pp. 162-166; Pfennigstorf, 1996, at pp. 99-100; IAIS, 2005b, at pp. 37-39; Fenn, 2001, at pp. 366-391, Klien, 2001, at pp. 399-403; and Barth, Brumbaugh and Yago, 2001, at pp. 368-370.
399 The laws authorize the NBE to regulate the credit facilities of the banks and microfinance institutions and the NBE has set single borrower limits by using this authority (TGE, 1994, at art. 7(2); FDRE, 2008a, at art. 15(1)(a)(2); TGE, 1994a, at art. 17; FDRE, 2008b, at art. 22(1); FDRE, 1996g, at art. 24; FDRE, 2009, at arts. 3(1), 14(2)(a, d) & 16; and Directives No. SBB/16/96;

any single borrower to twenty five percent of their total capitals.[400] It requires the microfinance institutions to limit their total loans to any single borrower and the total loans to any group of borrowers under group guarantee to maximum of one and four percent of their total capitals, respectively.[401] The banks and microfinance institutions also diversify their borrowers in practice.[402]

The country also requires the insurers to diversify their investments in the manner the NBE prescribes from time to time.[403] The NBE also requires the general insurers to invest not less than sixty five percent of their funds in treasury bills and bank deposits and the long term insurers to invest not less than fifty percent of their funds in same.[404] It requires the general insurers to limit their real estate investments to ten percent of their funds and the long term insurers to twenty five percent.[405] It requires both of them to limit their equity investments in company shares to fifteen percent of their funds and the aggregate of their bank deposits in any one bank to maximum of twenty five percent.[406] It allows them to make other investments of their choice only up to ten percent of their funds.[407]

The country does not, however, impose regional and sectoral business diversification requirements on the banks, insurers and microfinance institutions. It does not also impose borrower and deposit diversification requirements on the banks.

The single borrower limits of the NBE are justified by the underdevelopment of the banks and microfinance institutions in the country. They will promote their health by helping them to diversify their risks. The rules of the NBE on

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SBB/29/2002; MFI/05/96, at art. 3; MFI/17/2002, at arts. 3.1 & 3.4(a); and MFI/18/2006, at arts. 4.1 & 4.2).

400 Directive No. SBB/29/2002. The limit used to be 15% under directive no. SBB/16/96. The directives have defined the term "total capital" to include the paid up capital, legal reserve and other unencumbered reserves held by a bank. They have also defined the term "single borrower" to refer to individuals, enterprises, and business organizations which act individually (and in combination) and further defined what constitutes a combination and an "extension of credit".

401 MFI/18/2006, at arts. 4.1, 4.2 & 5. It used to differentiate between the re-registered and non-re-registered microfinance institutions to require the non-re-registered institutions to limit their single borrower loans to maximum of five thousand Birr and the re-registered institutions (and the institutions whose total deposit was more than one million Birr) to limit their single borrower loans to maximum of one percent of their total capitals (Directives No. MFI/05/96, at art. 3; and MFI/17/2002, at art. 3.2). It also used to require the re-registered microfinance institutions (and the institutions whose total deposit was more than one million Birr) to limit the aggregate amount of their loans in any one year to maximum of twenty percent of their total disbursement in the preceding year (Directive No. MFI/17/2002, at art. 3.1). It has removed this differentiation and subjected all the microfinance institutions to the aforementioned uniform requirement as of 06 December 2006 (MFI/18/2006, at arts. 4.1, 4.2, 5 & 10)

402 They tend to disburse their loan funds to borrowers who apply for relatively small sums.

403 TGE, 1994b, at arts. 14, 42(e) & 42(f).

404 Directive No. SIB/25/2004. The insurers have invested only up to 5.6 percent of their total assets in treasury bills and none in government bonds in practice (See their annual reports).

405 Ibid.

406 Ibid. The insurers have invested only about 8.4 percent of their total assets in equity shares of other companies in practice. They have also kept a sum of money amounting to about 52.5 percent of their total assets in bank accounts subject to the one bank - twenty five percent limit of the NBE. Table 18(Chap. 2) and annual reports of the insurers.

407 Ibid.

investments of the insurers are, however, restrictive. They dictate and limit the investment choices of the insurers and cripple their growth. The NBE needs to leave sufficient flexibility to the insurers and indicate only the diversification requirements they need to respect. The country also needs to introduce regional, sectoral and deposit diversification requirements in order to enhance both the diversification of risks and the dissemination of services of the financial institutions.[408]

2.3.1.7 Risk Transferring Requirements

i. The International Experience

Banking risk can be transferred through mechanisms of risk sharing, insurance and risk shifting to customers. Many countries have encouraged their banks to share risk through credit and underwriting syndicates by exempting the syndicates from their antitrust laws.[409] Many have also recognized the debtor default, exchange rate, interest rate, and price change risks of banks as insurable risks and allowed or required the banks to insure them.[410] They have also relied on deposit insurance and state assumption of particular types of risk, such as in relation to the financing of foreign trade, to distribute risks.[411] The banking and credit laws of many countries also require the shifting of risk to customers through requirement and realization of collaterals for loans.[412] They prescribe upper ratios for loans and uniform procedures for valuation of collaterals, standardize the assessment of proceeds from the sale of collaterals, and require the banks and credit institutions to receive collaterals for the different types of their credits up to defined levels.[413] The regulators of the countries also use the capital adequacy and liquidity instruments to make sure that the banks' loans and collaterals are backed by allowances for possible losses.[414] Many of the countries also allow the insurers to transfer their liabilities to others, and thereby to avoid the risk of sudden insolvency due to large claims, through the mechanism of re-insurance.[415] They also regulate the re-insurance business to prevent the complete transfer of the insurance business from one insurer to another and to avoid ruin on the solidity of the insurers.[416] The 2008 financial and economic crisis has also increased the need for strengthening these types of regulations, in particular the regulation of the lending businesses and non-performing loans of the banks, along with the other measures.[417]

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408 The bank supervision department of the NBE also believes that large depositor reporting requirements will help it to assess the stability of depositors of the banks. NBE BSD, 2005, at pp. 40 & 43.

409 Möschel, 1991, at p. 80.

410 Ibid.

411 Möschel, 1991, at p. 80; and Lovett, 1992, at pp. 130-138. The 2008 financial and economic crisis has also increased the need for using deposit insurance and state assumption of risk as instruments of crisis regulation (Note the discussion under the 'fund guarantee requirements' subtitle below).

412 Möschel, 1991, at pp. 80-81.

413 Ibid.

414 Ibid.

415 Pfennigstorf, 1996, at pp. 127-128.

416 Ibid.

417 Campbell, 2007; Goodhart, 2009, at pp. 42-44 & 95-97; and Bloomberg, 2010.

ii. The Case of Ethiopia

Ethiopia does not have rules for risk sharing by credit and underwriting syndicates although its banks sometimes try to syndicate loans. It only uses its mortgage and pledge laws to resolve the credit relationships between the banks that participate in the syndicates. It does not also require the banks and microfinance institutions to adhere to particular collateral threshold. It only encourages the microfinance institutions to extend their loans on group guarantee and property collateral bases.[418] It does not also require insurance of the banking, insurance and microfinance business risks. It only foresees the establishment of deposit insurance system by the NBE and requires the banks, insurers and microfinance institutions to insure the losses that may follow the negligence or dishonesty of their directors, managers, officers and employees when they have not maintained special reserves for these losses.[419] Nor does it force the insurers to buy re-insurance cover by law.[420] It only considers the banking, insurance and microfinance business risks as insurable risks when they meet the definition of risk in its general insurance law.[421] The country also leaves the terms of collateral and re-insurance contracts of the banks, insurers and microfinance institutions to discretion of the parties. Neither the law nor the NBE prescribes the types, conditions and margins of the collaterals that shall be submitted to the banks and the extent and terms of re-insurance the insurers should buy. The terms relating to collaterals usually form part of the credit policies of the banks while the terms of re-insurance are usually imposed by the re-insurers.[422] The NBE also deals with collaterals of the banks only indirectly, i.e. when it inspects the credit policies of the banks and enforces the capital adequacy, liquidity and provisioning requirements on them. It does not also regulate the business of re-insurance but tries to deal with its terms when it assesses the overall financial health of the insurers.[423]

418 FDRE, 1996g, at arts. 15 & 2(6); and FDRE, 2009, at art. 16. The NBE used to require the microfinance institutions to make their credit facilities available predominantly under the group guarantee scheme. It also used to require them to limit the size of the credit facilities they make available on the property collateral basis (without, however, fixing particular threshold for this). (Directives No. MFI/17/2002, at art. 4; and MFI/18/2006, at art. 5). The 2009 law has left discretion to the microfinance institutions (FDRE, 2009, at art. 16).

419 FDRE, 2008a, at arts. 5(18) & 25; TGE, 1994a, at art. 28; FDRE, 2008b, at art. 21(7); and TGE, 1994b, at art. 44(a). It does not expressly impose these requirements on the microfinance institutions. One can only expect this through the extended application of the banking business law on the institutions (FDRE, 1996g, at art. 24; and FDRE, 2009, at art. 28(1)).

420 TGE, 1994b.

421 The general insurance law of the country considers losses arising out of unforeseen events or from negligence of the would be beneficiary of an insurance arrangement and losses or damages due to the fault of persons for whom such a beneficiary is vicariously responsible as insurable risks. It does not consider losses arising out of intentional default of the beneficiary as insurable risks. (IGE, 1960, at art. 663). These rules apply to the banking, insurance and microfinance business related risks in the absence of special law for these (FDRE, 2008a, at arts. 5(18) & 25; TGE, 1994a, at arts. 28 & 32; FDRE, 2008b, at art. 21(7); TGE, 1994b, art. 44(b); and FDRE, 2009, at art. 28(1)).

422 In practice, the banks accept securities usually at a value higher than the amount of the loan and insist on full insurance coverage of the securities while the insurers take the rates of the re-insurers.

423 The country empowers the NBE to regulate the manner of undertaking re-insurance business (TGE, 1994b, at art. 37). The NBE does not, however, do this.

In practice, the banks, insurers and microfinance institutions try to reduce their risks by transferring them to their customers and business partners. The banks and microfinance institutions require their customers to produce sufficient collateral before they are given credit facilities.[424] The insurers buy re-insurance to cover their liabilities and shift risk to the insured by undervaluing the properties they insure.[425] The NBE also requires the applicants for banking and insurance license to buy insurance for their properties and liabilities so that they will distribute their risks as of the time they start their businesses.[426] Both the banks and the insurers also often buy:

- motor and liability insurance for their vehicles;
- fire, burglary and house breaking insurance for their furniture, equipment and premises;
- money and currency transport insurance for money deposited with or being transported by them; and
- fidelity insurance for losses that may arise due to negligence or dishonesty of their directors, managers, officers and employees.[427]

They also require their customers to insure the properties they propose as collateral.[428] All these are done, however, at free discretion of the banks and insurers.

The country needs to enforce three major changes on its risk transferring regime for the following reasons and purposes.

First, it needs to require the commercial banks and microfinance institutions to insure themselves against the insurable risks associated with their operations. This will enhance protection of both the institutions and their customers against potential institutional run. The risks to be insured should not be limited to bank deposits and the losses that may arise from the negligence or dishonesty of their directors, officers or employees. They need to include the other risks that are common in banking and credit businesses.[429] The insurance requirement should not also be made alternative to maintenance of special reserve account (as in the

424 The banks usually prefer property to personal security and rarely extend clean credit facility while the microfinance institutions often stick to the group and property guarantee schemes.

425 Both the government and private insurers buy their re-insurance covers from foreign re-insurers (See their annual reports).

426 Directives No. SBB/1/1994; SBB/39/2006, at art. 3; and SIB/1/1994 (with TGE, 1994a, at art. 5(12); FDRE, 2008b, at arts. 4(1)(a) & 4(3); and TGE, 1994b, at art. 6(2)). The NBE does not impose this insurance requirement on the microfinance institutions (FDRE, 1996g; FDRE, 2009; and the microfinance directives of the NBE).

427 Most of them buy the insurance from the Ethiopian Insurance Corporation. Only some of the insurers have bought these from the private insurance companies such as the National Insurance Company (S.C.), the Awash Insurance Company (S.C.), the United Insurance Company (S.C.), the Africa Insurance Company (S.C.), the Nile Insurance Company (S.C.) and the Global Insurance Company (S.C.).

428 All the banks have rules in their credit policies that favour this.

429 The most common risks in banking are solvency risk, security risk, credit default risk, discount risk, interest rate risk, currency risk, financial assets price risk, and entrepreneurial risk (Möschel, 1991, at pp. 67-68).

case of the fidelity insurance the country has introduced). It needs to stand on its own as the banks and microfinance institutions may not always make profit to create the reserves. It need not also be left to discretion of the banks and microfinance institutions since it is useful not only for the protection of the banks and microfinance institutions but also for their customers and the economy as a whole. It also needs to be introduced with techniques to reduce moral hazard as insurance protection may be incentive for irresponsible behaviour.

Secondly, it needs to regulate the terms and conditions of collaterals of the banks and microfinance institutions in order to prevent abuse and enhance prudence of the institutions. Leaving the terms to discretion of the banks and microfinance institutions has resulted in valuation abuses in the past. The country needs to introduce rules that define collateral value-to-loan ratios, require both the banks and microfinance institutions to diversify the guarantees they receive, standardize the procedure for valuation of collaterals, and subject all these requirements to strict supervision by the NBE. The measures will both strengthen the prudence of the banking and microfinance institutions in the country and make the country's banking and microfinance systems in line with the international experience.

Thirdly, the country needs to require the insurers to re-insure a defined threshold of their liabilities, promote and regulate the undertaking of domestic re-insurance business, and reduce dependence on foreign re-insurance in order to enhance both the protection of consumers and domestic capacity. It needs to do this by enhancing the current re-insurance business of the Ethiopian Insurance Corporation and encouraging the private insurers to engage in the business. These measures are also useful to diversify the financial market and services in the country.

2.3.1.8 Information Acquisition and Exchange Requirements

i. The International Experience

Information exchange is important for banks and credit institutions to control over-indebtedness of borrowers. It is also useful for insurers to control over-insurance of risks. Many countries prohibit banks and credit institutions from making loans until the financial circumstances of their clients are revealed to them.[430] They facilitate the disclosure of information by using credit recording centres (credit information exchange or control risk bureaus) that inform the banks and credit institutions about the total indebtedness of their clients or by requiring the exchange of information through the regulators.[431] Many countries, however, lack information exchange requirements between insurers although they also make the acquisition of over-insurance illegal. They often rely on their insurance contract laws, insurer reporting requirements, and voluntary

430 Möschel, 1991, at p. 68.
431 Id., at p. 69.

cooperation between their regulators and insurers to address the problem of over-insurance.[432]

ii. The Case of Ethiopia

Ethiopia does not generally require the banks and microfinance institutions to refuse lending to a client until the financial circumstances of the latter are fully disclosed to them. It only authorizes the NBE to establish a credit-information-sharing system for the banks and to issue a know-your-customer standard for the banks and the microfinance institutions.[433] It also only encourages the microfinance institutions to lend on group guarantee basis among others so that they can know and control the indebtedness of their clients in group.[434]

The NBE has also created a credit recording and information exchange centre and issued a know-your-customer standard for the banks and required them to:

- inform the indebtedness of their borrowers to the centre,
- get information from the centre before making credit facilities to their clients, and
- review the audited financial statements (for the latest financial year) of their clients when they are about to lend them ten million birr and above.[435]

These measures of the country are commendable since they enhance the health of the banks and microfinance institutions. They are also consistent with the international experience. The country, however, needs to consider three additional measures in order to enhance the borrower information retrieval system and strengthen the performance of the banks, insurers and microfinance institutions.

First, it does not require and empower the credit recording and information exchange centre at the NBE to collect, record, analyse and disseminate information on the general financial circumstances of borrowers on top of the indebtedness reports from the banks. It needs to require and empower the centre to engage in the indicated tasks since retrieval of full information about the overall financial situation of clients is critical to the banks.

432 Pfennigstorf, 1996, at pp. 38-42.

433 FDRE, 2008b, at arts. 53 & 57; and FDRE, 2009, at art. 24.

434 FDRE, 2009, at art. 16; FDRE, 1996g, at art. 15; and Directives No. MFI/17/2002, art. 4; and MFI/18/2006, at art. 5.

435 Directives No. SBB/36/2004; and SBB/46/2010. It has created the credit recording and information exchange centre and required all the banks to be members to it as of 2004 (Directive No. SBB/36/2004). The centre has then got legal recognition when the 2008 banking business law was enacted on the 25th of August 2008 (FDRE, 2008b, at art. 57). The search for information about borrowers was left to each bank until creation of the centre in 2004 and the lack of information sharing system used to affect the credit business of the banks seriously. The Commercial Bank of Ethiopia, for instance, was reported to have lost up to 49.7% of its loans by 1995 due to its inability to collect information (EPressA, 1995). The banks were then in discussion to create a self-regulated information exchange system to curb the information problem in the years before creation of the credit recoding centre at the NBE. They also had the intention to establish pooled rating system to assess the creditworthiness of their clients in the years between 1996 and 2000. The NBE was also optimist about these. The intention has not, however, materialized.

Secondly, the insurers and microfinance institutions are excluded from membership to the centre.[436] The country needs to make them members to the centre so that they can retrieve information about their clients through it and enhance their health. The measures will also strengthen the linkage and cooperation between the banks, insurers and microfinance institutions as the country's microfinance regulation aspires.[437]

Thirdly, the country needs to introduce accounting and auditing requirements on the non-financial sector businesses as part of its effort to formalize and regulate them and require the banks and microfinance institutions to review the financial statements of all the businesses before they extend credit facilities of any size to them so that the banks and microfinance institutions will cater for their credit risks.[438]

2.3.1.9 Fund Guarantee Requirements

i. The International Experience

Many countries often rely on deposit insurance systems to protect depositors against bank failures. Some introduced these systems in the first half of the nineteenth century while most others developed them in the 1970's.[439] Most countries pursue them to protect depositors against bank failures and to cure ailing banks.[440] The countries often arrange and run the deposit insurance systems under direct responsibility of their governments and only sometimes by the banking industry or jointly by the banking industry and the governments.[441] They often compel their banks to be members to the insurance system and limit the exceptions.[442]

The deposit insurance coverage has, as a rule, been enforced based on territoriality principle to cover all domestic banks and domestic branches and subsidiaries of foreign banks.[443] Hence, many of the countries require the insurance of all resident and non-resident deposits in their banks and exclude deposits in foreign

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436 The banking business law also focuses only on creation of a credit-information-sharing system among the banks (FDRE, 2008b, at art. 57).

437 FDRE, 1996g, at art. 12(3); and FDRE, 2009, at arts. 3, 4(1) & 21.

438 The majority of the enterprises in the non-financial sector do not follow formal accounting (See Census Report of the Central Statistical Agency of Ethiopia (CSA, 2005a) and note the discussion under the 'potential functions and need for development of the market' subtitle of the securities market chapter below). The recent tax laws have already imposed accounting and auditing obligations on them and this needs to be strengthened by the regulatory laws (FDRE, 2002d; FDRE, 2002e; FDRE, 2002f; FDRE, 2002i; FDRE, 2002j; FDRE, 2002k; and the amendments in 2008 and 2009).

439 The earlier deposit insurance systems were established in New York (in 1829), in India (between 1834 and 1865) and in Czechoslovakia (in 1924). The US also created the Federal Deposit Insurance Corporation (FDIC) in 1933. Möschel, 1991, at p. 93; and Lovett, 1992, at p. 133.

440 Hubbard, 1997, at pp. 416, 418 & 422; Möschel, 1991, at pp. 93-94; and Hall, 2003, at pp. 52-54 & 49.

441 Möschel, 1991, at p. 94; and Lovett, 1992, at pp. 133-137.

442 The banks have usually been insured on voluntary basis even when exceptions were recognized. Non-membership has usually been rare. Möschel, 1991, at p. 94.

443 Id., at p. 94.

branches of their banks, foreign currency deposits, inter-bank deposits, secured deposits, deposits with a maturity of over five years and certificates of deposit from their insurance requirements.[444] Some also exempt the branches of foreign banks and the deposits made in foreign banks from their insurance requirements when they consider that these institutions enjoy protection under a foreign deposit insurance system.[445] Most of the countries do not also require full insurance coverage but coverage up to a ceiling per depositor per institution.[446] They require the financing of the deposit insurance scheme by periodic contributions, levy made when the need arises, or both.[447] They also allow fund raising by borrowing.[448] They often require the contributions to be made at rates related to the total volume of the insured deposit, at percentages of the bank's own capital, at graduated scales, or based on fixed lower and upper ceilings.[449] Most of the countries also confer legal right on the depositors that face bank default which will enable them to get automatic payment from the deposit insurance money.[450]

Many countries also protect the insurers from failure, and the insurance policyholders from insurer insolvency, by

- private solvency guarantee funds to which the insurers should contribute from their premiums, and
- state guarantee funds by which the state compensates the victims of insurance failure from its own funds.[451]

They have introduced the solvency guarantee and policyholder protection funds as of the late 1970s in order to prevent the economic hardships the insurers and their clients face due to catastrophes and the increasing challenges of competition.[452]

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444 Ibid.
445 Ibid.
446 Ibid.
447 Id., at p. 95.
448 Ibid.
449 Argentina has been the only country that introduced variable limits for contributions that should be calculated based on the risk exposure of the banks' lending businesses. Ibid.
450 Only few countries leave this to full discretion of the administrators of the deposit insurance scheme. Ibid.
451 The majority countries follow the former to mitigate the moral hazard problems of protection. Finsinger, Hammond and Tapp, 1985, at pp. 15-16; Pfennigstorf, 1996, at pp. 142-144; and IAIS, 2005b, at p. 50.
452 The US introduced the first insolvency guarantee funds in New York in 1935. It spread them throughout the states through the Model Act of the NAIC. It has been requiring the state insurance regulators to intervene and salvage an insurer with severe financial distress by implementing a rehabilitation plan or assisted sale or merger and to liquidate it when the salvage attempt failed. The state regulators have also been running guarantee funds to cover deficiencies when the insurance companies were liquidated due to insolvency. Europe, on the other hand, had little need for guarantee funds due to the cartel pricing practices of the insurers that kept insolvency problems at insignificant levels. Only Belgium, Germany, Italy and France used to have funds for protection of victims of road accidents and UK to have guarantee funds to protect clients against both life and non-life insurer insolvencies that were financed by levy on the insurers without claiming any state fund. The guarantee fund requirement has, however, spread across Europe and the rest of the world in recent times. Lemaire, 1997, at pp. 48 & 53-57; Pfennigstorf, 1996, at pp. 142-144; and IAIS, 2005b, at p. 50.

Both the bank deposit insurance and insurer fund guarantee schemes have, however, reasons and problems.[453] They are often justified by the concerns of averting institutional run and contagion, creating equal condition of competition between small and large institutions, and assuring consumer protection.[454] They are, however, prone to moral hazard problem as the conducts of both the market participants and the regulators are often modified when the arrangements are put in place.[455] They are also affected by problems of design as they involve a number of questions including the following:

- the source of funding (whether it should be private or public);
- the timing of funding (whether it should be pre or post- insolvency);
- the basis of contribution (whether it should be flat or risk-based);
- the exposure base (whether it should be the volume of assets, liabilities or premiums);
- the number of funds (whether there should be one fund for all lines of business or separate funds for each line of business);
- the depositor and policyholder coverage (whether the fund should cover all depositors and policyholders or some of them);
- the geographic coverage (whether resident depositors and policyholders of a foreign bank or insurer and foreign depositors and policyholders of a domestic bank or insurer should be covered);
- the integration between the insured deposit or insurance policy and the fund (whether the fund should give first coverage, deductible coverage or co-payment coverage in relation to the deposit or insurance policy and whether the fund coverage should be limited by the deposit or policy coverage or by its own limit); and
- the supply of information to consumers (whether depositors and policyholders should be made aware of the fund coverage).[456]

Hence, countries are often advised to design the schemes with techniques of solving these problems.[457]

The 2008 financial and economic crisis has also shown the importance of strengthening the use of deposit insurance and fund guarantee schemes to protect consumers and investors and enhancing the effectiveness of these schemes by controlling the moral hazard, anti-competitiveness, abusive use and other side

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453 Möschel, 1991, at p. 96; Lemaire, 1997, at pp. 57-59; Hall, 2003, at p. 54; and Pfennigstorf, 1996, at p. 143.

454 Ibid. Many of the countries have also justified the guarantee schemes by the information imperfection their policyholders face. They have often felt that the imperfectness of information and the long-term nature of insurance contracts (in particular life insurance) disable the policyholders from effectively evaluating the probabilities and costs of future insolvencies even if information at the time of contract is perfect. They also take information imperfection as one of the key justifications for solvency regulation. Lemaire, 1997, at pp. 48 & 53-57; Pfennigstorf, 1996, at pp. 142-144; and IAIS, 2005b, at p. 50.

455 Ibid.

456 Lemaire, 1997, at pp. 60-63; and Pfennigstorf, 1996, at pp. 143-144;

457 Ibid.

effects that may follow them along with the strengthening of other measures to control the taking of risk by the financial institutions.[458]

ii. The Case of Ethiopia

Ethiopia does not currently impose deposit insurance and fund guarantee requirements on its banks, insurers and microfinance institutions. It only foresees the establishment of a deposit insurance system by the NBE and requires the banks, insurers and microfinance institutions to insure the losses that may follow the negligence or dishonesty of their directors, managers, officers and employees when they have not maintained special reserves for these losses.[459] It does not also force the insurers to buy re-insurance cover by law. The NBE also requires the applicants for banking and insurance licenses to buy only property and liability insurance while the banks (and insurers) also often buy only:

- motor and liability insurance for their vehicles;
- fire, burglary and house breaking insurance for their furniture, equipment and premises;
- fidelity insurance for losses that may arise due to negligence or dishonesty of their directors, managers, officers and employees; and
- money and currency transport insurance for the money being transported between their safes and strong rooms.[460]

The country needs to impose the guarantee schemes on the banks, insurers and microfinance institutions so that both the institutions and their clients will be protected against future runs.[461] It also needs to determine and regulate the scope and nature of the schemes by taking into account the international experience. It, accordingly, needs to define the risks to be covered by the schemes in the law; make the membership to the schemes compulsory for all the financial institutions; require arrangement of the schemes with the domestic insurers based, as a rule, on the territoriality principle; encourage the coverage of all domestic deposits; require the financing of the schemes by risk-based periodic contributions of the member institutions; authorize the financing of the schemes by levy and loan as the need for these arises; and allow only partial payment from the schemes to limit the moral hazard problem that may follow from them.

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458 Su, 2007; LaBrosse, 2007; Kaufman, 2007; Blair, et al., 2007; Campbell and LaBrosse, 2007; Campbell, 2007; Sebastian Schich, 2008; Sebastian Schich, 2008a; LaBrosse, 2008; Cariboni, et al., 2008; Sebastian Schich, 2009; Sebastian Schich, 2009a; Christoph Ohler, 2009; Gert Wehinger, 2009a; Milne and Wood, 2009; BCBS-IADI, 2009; Goodhart, 2009, at pp. 42-44, 45-47 & 93-94; Aviram Levy and Sebastian Schich, 2010; Ayadi and Lastra, 2010; Cariboni, et al., 2010; and Thorsten, 2010. Note also the discussion under the 'lender of last resort' subtitle below.

459 Note the discussion under the 'risk transferring requirements' subtitle above.

460 Ibid.

461 The banking and insurance supervision departments of the NBE have also seen the importance of creating the deposit insurance and fund guarantee schemes for all the financial institutions (NBE BSD, 2005, at p. 74; and NBE ISD, 2005, at p. 107).

2.3.2 Competition Regulation
2.3.2.1 The General Adoption of Competition Regulation

i. The International Experience

Competition regulation was often attacked by three arguments.[462] First, Harberger argued as early as 1954 that the economic inefficiency resulting from monopoly is too small to justify the need for competition policy and regulation. Secondly, Bhagwati argued as early as 1965 that the behaviour of existing firms is disciplined if barriers to international trade are relaxed and the domestic economy trades with a competitive world market. Thirdly, the theory of contestable markets, advocated by Baumol as early as 1982, argued that firms in the market will not abuse their powers as long as the market is contestable through free entry (and exist) of firms. Many, including the Chicago School of Law and Economics, also argued that the competition process will protect itself better than a government intervention can do, hence, that the best way to protect competition is to leave it to the market, not to subject it to law.[463]

The adoption of competition policy and laws has, however, increased across the globe through time despite difference in the technicalities of the laws.[464] It is felt that sound competition and competition policies and laws aiming at identifying and controlling anticompetitive actions and behaviours are essential features of a successful market economy.[465] Competition is taken to be useful to decentralize decision-making; promote innovation and technology change; increase economic efficiency; enhance economic restructuring, development and internationalisation; and ensure consumer welfare.[466] Each of the three arguments against competition policy has also been criticized. First, it has been argued that Harberger underestimated the economic welfare losses associated with monopoly and imperfection of competition.[467] Secondly, it has been shown that trade policy can not be substitute for competition policy as Bhagwati argued since dangers to competition also come from trade itself.[468] Thirdly, the theory of contestable markets has been challenged through two sets of questions.[469] The first set asked if the theory is a competition or deregulation theory since it was also argued that the theory was designed to justify the presence of firms that escape regulation in the market under the guise of market openness. The second set asked if market power and its abuse can be resolved merely by making the market contestable since it was also found true that market power and its abuse can persist despite ease of entry and exit.

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462 Bahaa Ali El Dean and Mahmoud Mohieldin, 2001, at pp. 5-6.
463 Gerber, 2001, at p. 12; and Cseres, 2005, at pp. 23-25.
464 Richard Whish, 2001, at p. 14; and Ewing, 2006, at pp. 1-361.
465 World Bank and OECD, 1999, at p. v; Ajit Singh, 2002, at pp. 1-25; and Ewing, 2006, at pp. 1-61.
466 Ibid.
467 Bahaa Ali El Dean and Mahmoud Mohieldin, 2001, at p. 6.
468 Id., at p. 7.
469 Richard Whish, 2001, at p. 13; Bahaa Ali El Dean and Mahmoud Mohieldin, 2001, at p. 6; and Cseres, 2005, at p. 63.

The developed market countries have, accordingly, started to introduce competition policies and laws as early as 1889.[470] The transition and emerging market countries have also seen the importance of having sound competition regimes following the free market reforms after the late 1980s.[471] Their deregulations have necessitated the existence of competition regimes although they have also needed government regulation due to their development goals and the high level of imperfection in their markets.[472] The majority of them (more than one hundred countries by now) have, therefore, introduced competition policies and laws in the 1990s and thereafter while a number of others have continued to appreciate the need for having such a regime in the subsequent years.[473]

The different systems of competition policy and law have often addressed different concerns because of difference in the economic development and in the reasons for adoption of the policies and laws in the different countries.[474] They are, however, often used to achieve the following four major types of objectives:

- to create, maintain and promote effective competition by preventing abuse of economic power and anticompetitive private action;[475]
- to eliminate anticompetitive government intervention that lessens competition in the market, leads to inefficient use of resources and reduces consumer welfare;[476]
- to achieve economic efficiency and dynamism;[477] and

470 Canada and USA, for instance, enacted their competition laws in 1889 and 1890, respectively; Australia in 1906; New Zealand in 1908; Germany in 1923; Japan in 1947; and Israel and most European countries in 1957. Austria also saw the first competition law proposals in the 1890s. World Bank, 2002, at p. 139; Pradeep S. Mehta, 2002/2003; at pp. 80 & 86; and Gerber, 2001, at pp. 6, 7 & 43-141.

471 Bahaa Ali El Dean and Mahmoud Mohieldin, 2001, at p. 22; Pradeep S. Mehta, 2002/2003, at pp. 80 & 86; and World Bank, 2002, at p. 139.

472 Ibid.

473 Few of them have introduced their competition laws in the years before 1990: Lebanon in 1967; India in 1969; Pakistan in 1970; Thailand in 1979; Republic of Korea in 1980; Sri Lanka in 1987; and Cyprus in 1989. Some others have introduced them in the 1990s: Poland and Hungary in 1990; Russia, Kazakhstan, Czech Republic, Taiwan, Tunisia, Venezuela and Peru in 1991; Belarus, Lithuania, Uzbekistan, Bulgaria, Mexico and Fiji in 1992; Slovenia, Estonia, Tajikistan, Mongolia, China, Jamaica and Ivory Coast in 1993; Kyrgyzstan, Zambia, Slovak Republic, Turkey and Brazil in 1994; Georgia in 1996; and Indonesia in 1999. Most others have introduced them in 2000 and thereafter. Bahaa Ali El Dean and Mahmoud Mohieldin, 2001, at p. 22; Pradeep S. Mehta, 2002/2003, at pp. 80 & 86; World Bank, 2002, at p. 139; and Ewing, 2006, at pp. 1-17.

474 World Bank, 2002, at p. 139; Ewing, 2006, at pp. 1-74; and Naím and Tulchin, 1999, at pp. 1-275. Many of the countries have introduced their competition regimes because of anticompetitive behaviour of firms, economic crisis or international pressure. The United States, Sweden, Denmark, the Netherlands and Norway have introduced or reformed their regimes due to the anticompetitive behaviour of their firms (monopoly in USA and cartel abuse in the others). France, Indonesia and Romania have adopted their regimes because of economic crisis. Japan, Germany and most countries of Central and Eastern Europe, Asia, Latin America and Africa have introduced their regimes due to pressure of the international development towards free market. Ibid.

475 World Bank and OECD, 1999, at p. 2; Naím and Tulchin, 1999, at pp. 1-275; Ritter, et al., 2000, at pp. 13-22; Richard Whish, 2001, at p. vi; and Ewing, 2006, at pp. 1-74.

476 World Bank and OECD, 1999, at pp. 2-3 & 81-82; Naím and Tulchin, 1999, at pp. 1-275; Ritter, et al., 2000, at pp. 3-74 & 751-799; Richard Whish, 2001, at p. 21; Ewing, 2006, at pp. 1-74; and Clarke and Morgan, 2006, at pp. 232-258.

477 Gerber, 2001, at pp. x-xi; and Pradeep S. Mehta, 2002, at p. 79.

- to enhance consumer welfare.[478]

They are also used to achieve the following five types of additional objectives:

- to create or preserve economic freedom and free enterprise system;
- to disperse economic power, redistribute resource, maintain economic equity, and strengthen the notions of individual freedom of choice, economic opportunity and democracy;
- to allocate economic decision making power between the government and the market and maintain pluralism;
- to protect small businesses; and
- to achieve trade and development policy objectives.[479]

The prioritisation of the aforementioned objectives and the scope and design of competition policy and law is, however, also variable.[480] The solution is largely determined by country specific factors and choices and the decision involves synchronizing between legal, economic, social and political objectives and principles.[481]

Hence, the policy makers in the developed market countries of Europe and Northern America have, in practice, used the competition laws to protect competition from non-governmental and governmental restraints and to achieve goals as diverse as economic freedom, economic efficiency, consumer welfare, political stability, economic growth and economic integration.[482] They have used them to influence private economic decision, structure economic and political relationships, and create a liberal society which is concerned with economic freedom, consumer welfare and social justice.[483] Influenced by this experience, the transition and emerging market countries have also tried to use their competition policies and laws to create and maintain competitive market with the ultimate aim of meeting the objectives that were targeted by the advanced competition policies and laws.[484]

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478 Richard Whish, 2001, at p. 16; and Cseres, 2005, at pp. 1-417.

479 Richard Whish, 2001, at pp. 17-20; World Bank and OECD, 1999, at p. 4; Gerber, 2001, at pp. x-xi, 16 & 417-420; Ewing, 2006, at pp. 1-361; Naím and Tulchin, 1999, at pp. 1-275; Ritter, et al., 2000, at pp. 13-22; and Clarke and Morgan, 2006, at pp. 1-273.

480 World Bank and OECD, 1999, at pp. 1-4; Naím and Tulchin, 1999, at pp. 1-275; Gerber, 2001, at pp. 9-13; David Smith and Su Sun, 2001; and Ewing, 2006, at pp. 1-361.

481 World Bank and OECD, 1999, at pp. 1-4, Gerber, 2001, at pp. 9-13; David Smith and Su Sun, 2001; Ewing, 2006, at pp. 1-361; Naím and Tulchin, 1999, at pp. 1-275; and Clarke and Morgan, 2006, at pp. 1-168.

482 Peritz, 1996/2000, at pp. 3 & 301-302; Naím and Tulchin, 1999, at pp. 1-275; Ritter, et al., 2000, at pp. 3-799; Gerber, 2001, at pp. 2001: x-xi, 1-2 & 417-420; Nemeth, 2001, at p. 57; Ajit Singh, 2002, at pp. 16-18; World Bank, 2002, at pp. 138-140; Ewing, 2006, at pp. 1-327; Cseres, 2005, at pp. 1-417; and Clarke and Morgan, 2006, at pp. 1-273.

483 Ibid.

484 Bahaa Ali El Dean and Mahmoud Mohieldin, 2001, at p. 10; and Naím and Tulchin, 1999, at pp. 1-275. Some researchers have also favoured the harmonization of competition laws towards those objectives (Ewing, 2006, at pp. 1-361).

ii. The Case of Ethiopia

Ethiopia recognized the need for regulating anti-competitive practices when it enacted the commercial code of May 1960.[485] It took lesson from the 1900 Paris Convention for the protection of Industrial Property (as amended in Lisbon in 1958) and prohibited unfair competition by the code with a major objective of protecting the good will and preserving the businesses of traders.[486] It strengthened the competition regime by repealing its price control laws and enacting an Unfair Trade Practices Decree in 1963.[487] It tried to use both the unfair competition rules of the code and the Unfair Trade Practices Decree to promote business stability and commerce.[488] The value of these laws was, however, lost with the advent of socialism in the country in 1974.

The country currently enforces a competition law that aims at:

- preventing and eliminating anti-competitive and unfair governmental and non-governmental trade practices;
- safeguarding the interests of consumers; and
- maximizing economic efficiency and social welfare (in the supply and distribution of goods and services).[489]

It prohibits all agreements, dominant positions and unilateral practices that will harm competition by this law and controls the exercise of unilateral acts and practices that can harm good will and business by the 1960 commercial code.[490]

2.3.2.2 Treatment of the Financial Markets

i. The International Experience

A number of the countries in the globe have moved from general acceptance to general prohibition of restraints to competition in their financial markets.[491] They used to exempt their banks, insurers and credit institutions from the general competition requirements and to allow cooperation among them.[492] The European competition regime in the Treaty of Rome was originally developed for trade in goods and generally considered inapplicable to financial and other services

485 IGE, 1960, at the preface.

486 IGE, 1960, at arts. 130-134, 30, 40, 47, 55, 144, 158, 159, 204 & 205; and Winship, 1974, at pp. 52-53.

487 IGE, 1963g, at arts. 3(h) & 5.

488 IGE, 1960, at the preface; and IGE, 1963g, at the preamble.

489 FDRE, 2003c, at the preamble & art. 3.

490 FDRE, 2003c, at arts. 4, 6, 10 & 11; and IGE, 1960, at arts. 130-134. The competition law foresees the exemption, from its application, of only the following: i) the commercial activities exclusively reserved by law for government, ii) the developmental enterprises that may have to be encouraged by government, and iii) the basic goods and services that may have to be subject to price regulation by government (FDRE, 2003c, at arts. 4 & 5).

491 Bröker, 1989, at pp. 9-100; Pfennigstorf, 1996, at pp. 18-23; Rosa Greaves, 1992, at pp. 3-98; Ritter, et al., 2000, at pp. 718-726; and Ewing, 2006, at pp. 1-74.

492 Bröker, 1989, at pp. 89-92; Merkin and Rodger, 1997, at pp. 173-178; Nemeth, 2001, at pp. 57-58; Möschel, 1991, at pp. 91-92; and Pfennigstorf, 1996, at pp. 18-21.

until the European Court of Justice invoked it in the 1980s to invalidate price fixing agreements between insurers.[493] The McCarran-Ferguson Act of the US also generally exempted banking and insurance businesses from its application but for two exceptions: one that makes the Sherman, Clayton, and the Federal Trade Commission Acts applicable to banking and insurance businesses when there is no specific federal or state regulation and another that recognizes the applicability of the Sherman Act to agreements or acts of 'boycott, coercion or intimidation' between banks or insurers.[494] Germany, Austria, UK and France also used to exempt banks, insurers and credit institutions from their competition laws while Canada used to include only price-fixing agreements of these institutions in its competition law and Italy and Switzerland did not prohibit the restraint of competition by these institutions at all.[495]

Many of the countries also used to recognize the imposition of restraints to competition by government and the banks, insurers and credit institutions themselves.[496] The governmental restraints to competition often included fixed, minimum and maximum interest and premium rates that had to be determined by the governments based on changes in economic circumstances; ceilings imposed by the governments on lending for reason of monetary policy or credit quota; and rules for prevention of advertising that were often designed to avoid excessive competition or protect profitability.[497] The restraints of competition within the private autonomy of the banks, insurers and credit institutions were usually made by voluntary arrangements between them to lay down parameters (that leave the involved institutions with less substantial scope for action) with or without notice to and express approval of a governmental authority.[498] The concerted actions were sometimes brought about by associations of the financial institutions and rate advisors and the actual effects of the restraints of competition were sometimes achieved through the mechanisms of conscious parallelism, rule of conduct and change of market structure.[499]

The growing importance of competition between the financial institutions and the prevalence of the free market idea have, however, led many of the countries to replace the traditional general exemption of banks, insurers and credit institutions from their competition regimes by narrowly defined exemptions for purpose of cooperation or regulation.[500] Most of them have, accordingly, come to subject the institutions to their competition regimes as a matter of principle and to allow regulation only for purpose of controlling financial soundness, meeting monetary policy objectives, supplying information to consumers, and achieving other

493 Merkin and Rodger, 1997, at pp. 173-178; and Nemeth, 2001, at pp. 57-58.
494 Pfennigstorf, 1996, at p. 21.
495 Möschel, 1991, at pp. 92-93; and Pfennigstorf, 1996, at pp. 22-23.
496 Bröker, 1989, at pp. 50-73 & 79-82; Möschel, 1991, at pp. 90-91; Thimm, 1999, at pp. 171-178 & 197.
497 Ibid.
498 Bröker, 1989, at pp. 89-92; Lemaire, 1997, at pp. 36-37; Möschel, 1991, at p. 92; and Nemeth, 2001, at p. 57.
499 Ibid.
500 Bröker, 1989, at pp. 77-100; Pfennigstorf, 1996, at pp. 18-21; Möschel, 1991, at pp. 91-92; and Rosa Greaves, 1992, at pp. 3-98.

defined objectives.[501] They have made free competition a key policy objective and taken the position that regulation should not be detrimental to the level of performance and competitiveness of the financial institutions whatsoever its objective may be.[502] They have believed that competition with adequate safeguard against failure can promote efficiency and serve customers in the long run more than strict regulations that may aim at these. They have, accordingly, criticized and deregulated all forms of restraint to competition in their banking, insurance and credit markets.[503] They have ceased or reduced the issuance of interest and premium rate regulations and credit quotas and made the self restraints of the banks, insurers and credit institutions under the realm of their competition laws.[504] They have also subjected the changing of ownership and the merger of their banks, insurers and credit institutions to one of three types of measures:

- continuation of existing licenses subject to notification of the new situation to the regulators;
- treatment of the existing licenses as not covering the new situation and requirement of the obtaining of new licenses; or
- control of the ownership change or transfer process itself under special rules meant for the banks, insurers and credit institutions or the general competition law meant for all ownership transfers and mergers.[505]

Hence, the EU has already subjected all agreements between the financial institutions that may restrain competition in the European market to scrutiny of the European commission and the competition authorities of the member states under the general competition regime of the Union.[506] Germany has moved from complete to partial exemption of the banking, insurance and credit businesses from competition law and submitted them finally to the no exemption regime of the European Court of Justice.[507] UK has moved from complete exemption to restricted exemption of the financial institutions from its competition regime as its regime was harmonized with the EU.[508] The Italian law of 1990 and the French Ordinance of 1986 have adhered to the EU rules while Switzerland did not have

501 Möschel, 1991, at pp. 91-92; Pfennigstorf, 1996, at pp. 18-21; Rosa Greaves, 1992, at pp. 3-98; Ritter, et al., 2000, at pp. 718-726; and Ewing, 2006, at pp. 1-74.

502 Merkin and Rodger, 1997, at pp. 159-161; Meier, 1988, at pp. 171-178; Finsinger, Hammond and Tapp, 1985, at pp. 167-179; Bröker, 1989, at pp. 47-100; Rosa Greaves, 1992, at pp. 3-98; Ritter, et al., 2000, at pp. 718-726; and Ewing, 2006, at pp. 1-74.

503 Möschel, 1991, at pp. 91-92; Thimm, 1999, at pp. 171-179 & 197; Lemaire, 1997, at p. 37; Bröker, 1989, at pp. 47-100; Rosa Greaves, 1992, at pp. 3-98; Ritter, et al., 2000, at pp. 718-726; and Ewing, 2006, at pp. 1-74.

504 Nemeth, 2001, at pp. 65-66; Möschel, 1991, at pp. 90-92; Thimm, 1999, at pp. 171-179 & 197; Lemaire, 1997, at p. 37; Bröker, 1989, at pp. 47-100; Rosa Greaves, 1992, at pp. 3-98; Ritter, et al., 2000, at pp. 718-726; and Ewing, 2006, at pp. 1-74.

505 Möschel, 1991, at p. 61; Rosa Greaves, 1992, at pp. 75-76, 86-87 & 97-98; Ritter, et al., 2000, at pp. 718-726; Clarke and Morgan, 2006, at pp. 68-69.

506 The application of the Rome Treaty rules to the insurance industry was made clear as of 1987. Merkin and Rodger, 1997, at pp. 161-178; Nemeth, 2001, at pp. 57-58; Pfennigstorf, 1996, at p. 21; Möschel, 1991, at pp. 92-93; Rosa Greaves, 1992, at pp. 3-98; Ritter, et al., 2000, at pp. 718-726; and Empel, (ed.), 2008, at pp. 26-47.

507 Pfennigstorf, 1996, at p. 22; and Möschel, 1991, at pp. 92-93.

508 Pfennigstorf, 1996, at p. 23; and Clarke and Morgan, 2006, at pp. 1-168 & 262-273.

per se prohibition of anti-competitive agreements.[509] The US Supreme Court has also narrowed the exemption of banks, insurers and credit institutions from the competition regime gradually by restricting its interpretation of the exceptions from the Sherman, Clayton and the Federal Trade Commission Acts and expanding the applicability of the Sherman Act to agreements and acts of the banks, insurers and credit institutions.[510] Canada has also applied the general rules against restraint of competition on the banks, insurers and credit institutions gradually.[511] Japan has also subjected the financial institutions to the Antimonopoly law of 1947.[512]

ii. The Case of Ethiopia

Ethiopia tries to ensure competition between the banks, insurers and microfinance institutions under its general competition law and the interest, premium and foreign exchange rules. The general competition law does not exempt the banks, insurers and microfinance institutions from its rules.[513]

The NBE used to fix interest rates of the banks directly until 1995.[514] It used to set minimum and maximum interest rate ceilings on the deposit and lending businesses of the banks and microfinance institutions until January and June 1998, respectively.[515] It also used to regulate the supply of domestic credit and foreign exchange under administratively determined quota until May 1993.[516] It currently requires the banks and microfinance institutions to adhere to minimum ceilings on their saving and time deposit rates and authorizes them to freely determine their lending, penalty and demand deposit rates.[517] It does not also subject the credit and foreign exchange allocations to administrative quota requirements.[518] It does not also impose ceilings on the premium rates of the insurers although it is authorized by law to regulate these.[519]

The country also controls the anti-competitive use of advertisement through the rules of the general competition law on anti-competitive trade acts and practices.[520] It also subjects the transfer of ownership and merger of the private banking, insurance and microfinance companies to prior written approval and supervision of the NBE (which shall act under the commercial code rules) and the merger and transfer of ownership of the government banks and insurer to

509 Pfennigstorf, 1996, at p. 23; and Möschel, 1991, at pp. 92-93.
510 Pfennigstorf, 1996, at pp. 21-22; Meier, 1988, at pp. 6-7, 14, 17 & 49-84; and Caddy, 1986, at pp. 28-31 & 32-57.
511 Möschel, 1991, at pp. 92-93.
512 Pfennigstorf, 1996, at p. 23; and Heath, 2001.
513 FDRE, 2003c.
514 Table 12(Chap. 2).
515 Table 12(Chap. 2); Directives No. MFI/09/96 & MFI/10/98; and Itana Ayanna, 1994, at pp. 240-244.
516 Public Notice of the NBE (NBE, 1993).
517 Directives No. NBE/INT/7/98 up to NBE/INT/10/2007; MFI/13/2002; and MFI/19/2007.
518 Note the discussions on these under the 'objectives of regulation' subtitle above and the 'interest, foreign exchange and premium regulations' and 'regulation of product distribution' subtitles below.
519 TGE, 1994b, at art. 36.
520 FDRE, 2003c, at art. 10.

decisions and regulations of the Council of Ministers of the Federal Government of the country (which shall act under the public enterprises laws and the commercial code of the country).[521]

The banks, insurers and microfinance institutions do not also expressly agree to restrain competition and to set parameters that may restrain trade in practice. They do not act in concert for these purposes through their associations and otherwise. They are not also reported for having abused their market positions.

The aforementioned position of Ethiopia is justified in light of the need to promote competition in the banking, insurance and microfinance markets and the international trend on the treatment of competition between financial institutions. The country, however, also needs to address the following five problems.

First, the existence of the minimum ceiling on deposit interest rates has anti-competitive effect despite its uses as means of monetary policy intervention and pacesetter of the interest rate determinations by the banks and microfinance institutions.[522] It disables the banks and microfinance institutions from unilaterally adjusting their rates in favour of cheap money policy according to market demands.[523] The removal of interest rate ceilings needs to be furthered to fully enable the making of market based interest rates by the banks and microfinance institutions although the NBE has also to continue with its responsibility to make sure and regulate that the interest rate policies and rules of the banks and microfinance institutions do always have positive effect on the country's economy.

Secondly, the banks and insurers avoid competition through conscious parallelism although they do not agree expressly to restrain competition or to set parameters that restrain trade practice.[524] The microfinance institutions also avoid competition by dividing the geographic areas of their businesses passively.[525] Any passive or active restraint to competition to be adopted within the private autonomy of the banks, insurers and microfinance institutions is not commended

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521 TGE, 1994a, at arts. 27(2)(a) & 10(1)(e); FDRE, 2008b, at arts. 3(3)(c) & (d); TGE, 1994b, at arts. 7(d), 40 & 44; FDRE, 1996g, at arts. 17(1-2) & 24; and FDRE, 2009, at art. 17(1-2) & 28(1). The public enterprises law leaves the merger and transfer of ownership of the government banks and insurer to discretion of the government, i.e. the Council of Ministers (TGE, 1992b, at arts. 35-37, 47(2) & 47(3)). The microfinance supervision law encourages merger between the microfinance institutions (FDRE, 1996g, at art. 13; and FDRE, 2009, at art. 17(1-2) & 28(1)).

522 Note the discussion under the 'interest, foreign exchange and premium regulation' subtitle below.

523 The NBE currently fixes the minimum ceiling for the banks and the microfinance institutions at 5 percent per annum (Note the NBE news cited as NBE, 2010a; and Directive No. MFI/19/2007). It used to fix it at 12, 11, 10, 7, 6, 4, 3 and 4.5 percents per annum in that succession in the past (See Table 12(Chap. 2) at the second row; and Directives No. NBE/INT/10/2007 (as amended by practice); MFI/09/96 up to MFI/13/2002; and MFI/19/2007).

524 They have almost avoided competition in the types and prices of their services (Note the similarity of their services from Tables 6(Chap. 2) and 7(Chap. 2) and the similarities of their interest and premium rates from the annual reports and records of the NBE).

525 They do not agree expressly for market division. They have, however, affiliated their formation and operations to particular regions and areas. Note the records of the microfinance supervision department of the NBE and Tables 9(Chap. 2) and 10(Chap. 2).

in light of the country's objective to promote competition. Specific measures need to be taken against the behaviour of conscious parallelism among the banks and insurers and the market division tendencies of the microfinance institutions since the general competition law of the country does not address these matters clearly.[526] The banks, insurers and microfinance institutions and their associations need also to aim at promoting competition. The control of avoidance of competition is not, of course, something that can be accomplished by prohibitive rules alone although these may assist in the effort. The country needs to address the problem through indirect methods that can stimulate competition such as by imposing diversification requirements; making the banking, insurance and microfinance markets contestable; permitting entry of foreign competitors in the markets; enforcing codes of conduct; and providing incentives for the geographic diversification and competitively desirable behaviours.

Thirdly, the dominant position of the government banks and insurer has the effect of reducing competition although instances of abuse of dominance are not reported yet. The country has, of course, prohibited the creation of dominant position in trade by its general competition law.[527] It does not, however, implement the prohibition in practice and the government banks and insurer have continued to dominate the banking and insurance businesses, and to leave marginal opportunity for the private banks and insurers.[528] The country needs to enforce the rule strictly and take measures that will correct the market dominance already created. It needs to take measures that will restrain the government banks and insurer from increasing their market dominance, enable the private banks and insurers to raise their market shares, and thereby enhance competition.

Fourthly, the general competition law of the country suffers from several shortcomings. It does not, for instance, define the undesirable market share for control of market dominance, regulate merger, choose between the per se and rule-of-reason approaches of competition law, and make the competition law enforcement proactive. The commercial code, banking, insurance and microfinance supervision, and government enterprises laws do not also target the control of anti-competitive merger, acquisition or transfer of ownership although they require the prior authorization of these by the NBE or the Council of Ministers (in case of the government banks and insurer).[529] Both the NBE and the Council of Ministers do not also have defined procedures for handling the authorization of the mergers, acquisitions and transfers of ownerships of the banks, insurers and microfinance institutions.[530] The country needs to remove

526 FDRE, 2003c, at arts. 6, 10 & 11.

527 FDRE, 2003c, at art. 11(1).

528 Note the market shares in Tables 19(Chap. 2) & 20(Chap. 2); and the annual and quarterly reports of the NBE for 2008, 2009 and 2010.

529 They do not require the NBE and the government explicitly to look into the anti-competitive effects of the proposed merger, acquisition or transfer of ownership (IGE, 1960, at arts. 544-554; TGE, 1994a, at arts. 27(2)(a) & 10(1)(e); FDRE, 2008b, at arts. 3(3)(c) & (d); TGE, 1994b, at arts. 7(d), 40 & 44; FDRE, 1996g, at arts. 13, 17(1-2) & 24; and FDRE, 2009, at arts. 17(1-2) & 28(1)).

530 The NBE has approved one merger (between the Lion Insurance S.C. and the United Insurance Company S.C. to increase the capital of the United Insurance Company S.C.) on the 5th of

these shortcomings. It needs either to re-enact the competition law to remove them or adopt specific rules for the financial market. The latter can be done by the Council of Ministers of the government or the NBE under authority of the competition law.[531]

2.3.3 Market Conduct Regulation

2.3.3.1 Regulation of Insider Dealing and Market Manipulation

i. The International Experience

Most countries have regulations of insider loan and market manipulation to control the granting of credit to persons who may influence the lending process to the detriment of a bank or credit institution.[532] They determine the scope of their regulations based on the group of potential borrowers who are suspected by their banking regulators for being in a position to influence the lending and its terms. Hence, they usually regulate the loans of a bank or credit institution to its directors, influential shareholders, senior officials and family members of these and to enterprises linked with the bank or credit institution through shareholding, management or business correspondence.[533] They do not, however, regulate the problems of insider dealing and market manipulation in insurance directly.[534] They tend to control these through their product, contract and premium regulations.[535]

ii. The Case of Ethiopia

Ethiopia prohibits the making of all kinds of direct and indirect dealings between companies and directors of the companies and between the companies and other concerns in which directors of the companies participate as owners, partners, agents, directors or managers without prior approval of the boards of directors of the companies and notice to their auditors.[536] It authorizes the NBE to determine the conditions and limitations on the loans, advances, credit facilities, financial guarantees and other contracts to be made, directly or indirectly, between the banks and persons related to them and requires the making of all loans and transactions between the banks and insurers to be on terms and conditions similar to the ones between the banks and other persons and as the NBE may direct.[537] It prohibits the insurers from granting loans, advances, financial guarantees and

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February 2003 in the absence of such procedure (NBE BSD, 2005, at pp. 15-16 & 24; NBE ISD, 2005, at pp. 30 & 35; and Public Notice of the NBE (EPressA, 2003)).

531 The competition law authorizes the Council of Ministers to issue regulations and notices (FDRE, 2003c, at art. 29). The NBE can also shoulder the responsibility of making and enforcing competition rules under the general competition law as long as promotion of competition can be considered as one of the major objectives of financial market regulation.

532 Möschel, 1991, at pp. 76-77; and Lovett, 1992, at pp. 159-160.

533 Ibid.

534 Pfennigstorf, 1996, at pp. 108-109 & 111-128; and IAIS, 2005b.

535 Ibid.

536 The auditors have to submit special report to the general meeting of the shareholders of the company and the latter may approve or disapprove the dealings. Disapproval by the general meeting of shareholders of the company does not, however, nullify the dealings but make the directors liable. IGE, 1960, at art. 356 (3)-(5).

537 TGE, 1994a, at art. 17; and FDRE, 2008b, at arts. 22(1) & 54.

other credits to their shareholders, directors, managers, auditors, actuaries, officers and auxiliaries and to any person connected with these persons.[538] It prohibits both the banks and the insurers from extending credits to all persons against the security of their own shares.[539] It also makes the rules in its banking supervision law and the insider dealing and market manipulation rules in its commercial code applicable on the microfinance institutions to control the occurrence of these types of problems.[540]

The NBE has also issued directives dealing with limitations on bank loans to related parties in general and on accommodations to directors and persons for whom the directors are guarantors in particular with a view to controlling abuses and impermissible gains to the directors and the related persons that will unduly affect the banks.[541] One of the directives regulates the accommodations granted to directors of a bank, jointly or severally or with any other person and to persons to whom the bank or one or more directors of the bank are guarantors.[542] It requires the banks to secure prior written approval of the NBE when they want to grant, or to permit to be outstanding, directly or indirectly, unsecured loans, advances or credit facilities of an aggregate amount in excess of thirty thousand Birr to their directors, whether severally or jointly with any other physical person, or to any physical person for whom they or any one or more of their directors are guarantors. The other directives limit the amount of business loan to be granted to one related party and the maximum aggregate sum to be granted to all related parties to percentages of the total capital of the lending bank.[543] They exclude loans fully secured by deposits held in the lending bank, loans secured by central government securities and loans fully secured by cash substitutes (including securities other than those issued by the Federal Government) from the limits.[544]

The country's authorization of the NBE to regulate the insider transactions between banks and the persons related to them and to define the concept of 'related party' (instead of defining this by law) is useful to address the technical expertise that will be necessary to determine the scope of insider regulation (as this is not a job for a body like parliament but for a regulator) and to enable the NBE to cater for the behaviour of the related parties from time to time. The NBE, however, needs to refine the insider dealing and market manipulation regulation for the following reasons.

538 The prohibition does not include the granting of loans on security of life policies. The country allows the insurers to extend loans under security, and up to the surrender values, of their life policies. TGE, 1994b, at art. 29(1).

539 TGE, 1994a, at art. 32; FDRE, 2008b, at art. 60(3); and TGE, 1994b, at art. 29(2).

540 FDRE, 1996g, at art. 24; and FDRE, 2009, at art. 28(1).

541 Directives No. SBB/11/96; SBB/17/96; SBB/30/2002; and SBB/10/95. The NBE has not issued insider dealing directives in relation to the insurers and the microfinance institutions.

542 Directive No. SBB/10/95.

543 Directives No. SBB/11/96; SBB/17/96; and SBB/30/2002. Directive No. SBB/30/2002 fixes the percentage requirements for one related party and the maximum aggregate sum at fifteen and thirty-five percents, respectively.

544 Directives No. SBB/30/2002; and SBB/17/96.

First, the NBE regulates the loan contracts between the banks and their directors more seriously than the contracts with other related parties. It makes all the contracts between the banks and their directors above the defined threshold void unless prior approval is obtained from it and subjects the loans of the banks to their directors and to persons for whom the directors stand as guarantors to double rule.[545] The rules seem to be based on suspicion that directors influence bank lending and its terms more than any other related party. Whether other related parties are less influential than directors is, however, doubtful as a number of other related parties including significant shareholders and senior officials of the banks are also influential in practice. Similar treatment of all the insider transactions is commendable.

Secondly, the NBE has focused only on unsecured loans in enforcing the insider loan regulation. Secured loans are, however, also prone to the problem of insider dealing since the lending decision on them and their terms and collaterals are also open to negotiation. The NBE needs to expand the scope of its insider regulation to cover both types of loans.

Thirdly, the NBE needs to aim at balancing between the interests of controlling abuse and promoting competition in the design and enforcement of its insider dealing and market manipulation rules since both are desirable objectives of financial regulation. It needs to enact and enforce the insider dealing and market manipulation rules to control abuse. It need not, however, use them broadly so as to include prohibitions of any type of preferential treatment since this will lead to creation of uniform market conduct to the determinant of competition. It needs to enact and enforce them based on existence of real threat that lending decisions are no longer made impartially. It needs to study the sources of insider influence from time to time and make the insider dealing rules based on real threat as opposed to suspicion. Preventive measures such as reporting requirements and structural limits by reference to fractions of the bank's own capital (such as the single borrower limit) are also preferable.

The country also needs to make the insider and market manipulation rules in respect of the insurers and microfinance institutions similar to the rules in respect of the banks so that the NBE will control abuses and promote competition in respect of all the financial institutions alike.

545 It subjects them to the structural limit in Directive no. SBB/30/2002 and to the prior approval requirement in Directive no. SBB/10/95.

2.3.3.2 Regulation of Contract Terms

i. The International Experience

Banking contracts are usually brief and simple. Many countries leave them to the parties provided that the latter adhere to the substantive rules of the applicable contract laws. Only few instances of regulatory intervention exist in connection with loan securities that aim at minimizing the risk of debt failure.[546] Insurance contract is, on the contrary, usually linguistically complex and prone to problems related to the abstract and inter-temporal nature of its product, advance payment of premium, mismatch between the premium payment and the insurance benefit, transaction cost to the parties, uncertainty about the future, and inability of the ordinary person to evaluate the implications of entering into it (and to influence it when he or she can evaluate the implications).[547] It is, therefore, prone to adverse selection and moral hazard problems and these features make it a special kind of contract that needs special regulation on top of the normal rules of applicable contract laws.[548] The forms of regulation in experience include control of unfair terms, requirements for inclusion of compulsory clauses, requirements of standardization, and ex-ante controls and ex-post supervision of the insurance contract.[549] They usually exist as strong, limited and middle control systems.[550] The regulators in all the systems are also expected to weigh and balance between the interests of consumer protection and competition (and innovation) in their design and enforcement of the contract regulations.[551] The use of standardized contracts is wide spread in practice in many countries in the area of mass risks as opposed to large risks.[552] The standard terms are usually used to reduce variation and cost on the premium income.[553] They often assume a 'normal policyholder with average diligence and intelligence' and make the insurer responsible only for unclear terms.[554] The use of standardized contracts is, however, also criticized everywhere due to complexity and lack of transparency of clauses of the contracts.[555] The regimes for protection of policyholders are also criticized for

546 Note the discussion under the 'risk transferring requirements' subtitle above.

547 Thimm, 1999, at pp. 179-183. The transaction costs in insurance include the search and information costs to the insured, the screening costs to the insurer, and the contracting and enforcement costs to both the insurer and the insured.

548 Pfennigstorf, 1996, at pp. 111-112; Merkin and Rodger, 1997, at pp. 45-50; Clarke, 2005; Clarke, et al., 2009; and Reichert-Facilides, 2009.

549 Thimm, 1999, at pp. 183-186; Pfennigstorf, 1996, at pp. 117-121; and IAIS, 2005b, at pp. 18-21.

550 The regulators in the strong control system prescribe prior approval requirements to make sure that the insurance contracts include certain terms and conditions that are felt essential to protect policyholders. Those in the limited control system leave the determination of insurance terms and conditions to the market and set strong regulation of agents and brokers to ensure the professional marketing of products. Those in the middle control system require the inclusion of certain terms and conditions for sake of consumer protection through revision of the instruments without prior approval requirements. Ibid.

551 Thimm, 1999, at pp. 183-186; and Finsinger, Hammond and Tapp, 1985, at p. 16.

552 Pfennigstorf, 1996, at pp. 119-121; Thimm, 1999, at pp. 186-188; Merkin and Rodger, 1997, at pp. 13, 14, 37-42 & 45; and Nemeth, 2001, at pp. 45, 48-52, 53-55 & 83.

553 Ibid.

554 Id., at pp. 55-56.

555 Id., at p. 56.

failure to protect them effectively in practice.[556] Some have, accordingly, called for the re-design and harmonization of the regulation of insurance contracts across both Europe and other countries.[557]

ii. The Case of Ethiopia

Ethiopia leaves the banking and microfinance contracts to negotiation of the parties within the framework of its general contract law.[558] These contracts are usually brief and the country seems to have excluded their general regulation by the NBE for this reason. It regulates only the credit, interest rate, and insider trade terms of the contracts as part of its general lending, interest rate and insider dealing regulations.[559] The country, however, foresees the complexity problem in the insurance contracts and expressly authorizes the NBE to control the terms of these contracts.[560] It authorizes it to:

- examine the insurance terms and conditions of the insurers at any time it may feel necessary;
- ensure that the terms of all insurance contracts do not violate the rights of the policyholders under the laws of the country; and
- require the revision of illegal and unsound terms and conditions that may be included in the insurance contracts.

It also authorizes it to examine and order the revision of the long-term insurance contracts and conditions based on reports of actuaries. The NBE also requires the insurers to report the terms and conditions of their policies, proposal forms and endorsements to it in practice although it hardly examines their legality and soundness.[561]

The current position of the country does not contradict with the international experience. It, however, needs to be improved for the following reasons.

First, the country seems to be worried more by the terms and conditions of the long-term insurance than by those of the general insurance. This is legitimate in light of the duration involved in long-term insurance. However, the terms and conditions of the general insurance are equally complex and disastrous to the ordinary consumer in the current context of the country. They are more litigated in the courts of the country in practice than the terms and conditions of the long-term insurance. They also affect a large portion of the consumer population in the country given the large size of general insurance compared to the long-term

556 Id., at pp. 67-81.
557 Ibid.
558 TGE, 1994a; FDRE, 2008b; FDRE, 1996g; and FDRE, 2009.
559 TGE, 1994, at arts. 7(2), 28(1)(b) & 30; FDRE, 2008a, at arts. 5(4) & 15(1)(2); TGE, 1994a, at art. 17; FDRE, 2008b, at arts. 22 & 54; FDRE, 1996g, at arts. 12(2)(a-b) & (e-f); and FDRE, 2009, at arts. 3(1), 14(2)(a) & 28(1).
560 TGE, 1994b, at art. 36.
561 NBE ISD, 2005, at pp. 17, 18, 29 & 33.

insurance in the country.[562] The country needs to give attention to the soundness of both the general and long-term insurance terms and conditions and the NBE needs to examine the soundness of these terms and conditions more actively than it used to do so in order to ensure the protection of all consumers.[563]

Secondly, the banking and microfinance contracts in the country are based on adhesive (i.e. take it or leave it) offers of the financial institutions and much of the population of the country lacks the bargaining power and necessary information to influence the terms and conditions of the financial institutions.[564] The country needs to authorize the NBE and the NBE needs to monitor the bad effects these contracts may have on consumers despite their briefness.

2.3.3.3 Regulation of Product Distribution

i. The International Experience

The distribution of financial services often involves the use of varied modes and networks ranging from direct writing and use of salaried workers to the use of networks of branches, subsidiaries, independent agents and brokers (who are not employees of the parties and whose market share may vary from market to market and between differing lines of businesses).[565] The internationalisation of financial services has also increased the importance of access to effective distribution networks and the choice of the distribution channels has evolved from the use of independent brokers to the use of direct marketing techniques, tied agents, employed sellers and all-finanz or banc-assurance arrangements.[566] All these mechanisms need to be regulated to:

- achieve a marketing combination that will economize production and transaction costs,
- protect consumers by enabling information supply and rational decision making, and
- make the financial markets effective, efficient and safe.[567]

Much of the regulation in the area of product distribution, however, relates to the distribution mechanisms of insurance products.[568] Hence, many of the countries tend to emphasize on regulation of the structure and conduct of the

562 The general insurance business is about 94% of the total insurance business in the country (Table 8(Chap. 2); and the records and annual reports of the insurers for 2008 and 2009).

563 The NBE should examine the policies, proposals and endorsements of all the insurers for this purpose.

564 Note the information asymmetry problem discussed in the 'regulation of information disclosure' subtitle below.

565 Thimm, 1999, at pp. 188-197; and Merkin and Rodger, 1997, at pp. 76-83.

566 Chance, 1993, at pp. 71-72; and Rietbergen, 1999, at pp. 56-59. The desirability of the financial conglomerate is, however, under discussion in the aftermath of the 2008 financial and economic crisis for the reason that it has increased the contiguity of the crisis (Note the discussion under the 'functional and ownership separation requirements' subtitle above).

567 Thimm, 1999, at pp. 189-196.

568 Id., at pp. 189 & 194-196.

intermediaries of insurance distribution.[569] The use of diverse distribution channels has, however, also become common in banking as networks have come to exist with forms of e-banking and other innovations and the latest recommendation is that these also need to be regulated.[570]

Many of the countries also hardly regulate the product types and sectoral and regional distribution of the financial services since they often consider these types of regulations as incompatible with the free market idea.[571] These types of requirements are often found in the transition and emerging market countries to achieve development objectives.[572]

ii. The Case of Ethiopia

Ethiopia requires the insurers to employ only auxiliaries that are licensed by the NBE and authorizes the latter to license all the insurance auxiliaries on annual basis.[573] The NBE also requires - i) Ethiopian nationality, - ii) completion of secondary level education, - iii) possession of sufficient experience and training, - iv) cleanliness from court conviction for a crime of dishonesty, and - v) possession of sufficient professional indemnity insurance, property guarantee and/or cash deposit with it to licence the auxiliaries.[574] It requires:

- i) the applicants for insurance agency license to:

  - have at least secondary level of education,
  - prove minimum of five years of work experience in the underwriting or claims department of an insurance company or have sufficient training in insurance sales agency by an institution acceptable to the NBE, and
  - maintain professional indemnity insurance or deposit for a minimum of twenty thousand Birr per the lines of agency they want to be licensed;

- ii) the applicants for insurance broking license to:

  - have at least diploma in insurance or business related field from a higher education institution acceptable to the NBE,

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569 Finsinger, Hammond and Tapp, 1985, at pp. 30-36; Chance, 1993, at pp. 73-75; Merkin and Rodger, 1997, at pp. 86-88 & 90-94; Thimm, 1999, at pp. 196-199; Nemeth, 2001, at pp. 80-81; and IAIS, 2005b, at pp. 18-21 & 54-56. The US has had regulations for four main types of distribution channels: an independent agency system, an exclusive (tied) agency system, a direct selling system, and a broking system (Meier, 1988, at pp. 45 & 164-166; and Lemaire, 1997, at p. 33).

570 Gkoutzinis, 2006; Chapman, 2010, at pp. 128-156; and Weber, 2010.

571 Möschel, 1991, at p. 84; Lovett, 1992, at p. 142; and Pfennigstorf, 1996, at pp. 7, 112-113 & 132-133.

572 Pfennigstorf, 1996, at p. 33; IAIS, 2005b, at pp. 18-21; Kaufman, 2000, at pp. 109-138; Murshed and Subagjio, 2000; Stallings and Studart, 2002; and Pomfret, 2002, at pp. 57-60 & 76-133.

573 TGE, 1994b, at arts. 2 & 25.

574 Directives No. SIB/4/1994, SIB/13/1996, SIB/15/1997, SIB/18/1998 & SIB/30/2007 for the licensing of insurance agents; SIB/3/1994, SIB/21/2001 & SIB/29/2007 for the licensing of insurance brokers; SIB/12/1996 for the licensing of loss assessors and adjusters; SIB/10/1996 & SIB/22/2002 for the licensing of insurance surveyors; and SIB/11/1996 for the licensing of actuaries.

- meet minimum of eight years reputable managerial experience in the head office of an insurance company with responsibility to oversee the operations of underwriting and claims, and
- maintain professional indemnity insurance for a minimum of one million Birr or three times the annual general commission earned by the broker in the last accounting period prior to the making or renewal of the indemnity insurance policy whichever is greater;

- iii) the applicants for loss assessor or loss adjuster license to:

  - have at least diploma in their fields from a higher education institution acceptable to the NBE, and
  - maintain professional indemnity insurance or property guarantee for a minimum of one hundred thousand Birr; and

- iii) the applicants for insurance surveyor or actuarial license to:

  - have at least diploma in their fields from a higher education institution acceptable to the NBE,
  - meet minimum of seven years of work experience in insurance underwriting and claims handling or have diploma in insurance from a higher education institution acceptable to the NBE on top of the qualification in their fields,
  - maintain professional indemnity insurance or property guarantee for a minimum of fifty thousand Birr (for insurance surveyor license), and
  - maintain professional indemnity insurance or property guarantee for a minimum of one hundred thousand Birr (for actuarial license).

It requires the applicants for insurance surveyor license to have diploma from a polytechnic or similar institute and the applicants for actuarial license to have this from the Institute of Actuaries (London), the Faculty of Actuaries (Scotland), the Society of Actuaries (USA) or other institute with similar status to license actuaries.

It requires all the juridical person applicants to be owned fully by Ethiopian nationals and be organized under the commercial code of the country with unlimited liability.[575] It requires them to have Chief Executives who meet the qualification, experience and integrity requirements, and to maintain the indemnity insurance, property guarantee or bank deposit, imposed on the physical person applicants. It also requires the applicants for broker license and the spouses and relatives of these persons in the first degree consanguinity not to own equity in any insurance company and loss adjusting firm; and the applicants for insurance surveyor license not to own same in any insurance company and loss adjusting,

575 Directives No. SIB/4/1994, SIB/13/1996, SIB/15/1997, SIB/18/1998 & SIB/30/2007 for the insurance agents; SIB/3/1994, SIB/21/2001 & SIB/29/2007 for the brokers; and SIB/10/1996, SIB/11/1996, SIB/12/1996 & SIB/22/2002 for the rest.

loss assessing or broking firm.[576] It has also issued codes of conduct for the brokers and required them to:

- conduct their businesses with good faith, professional skill and integrity,
- place the interests of their clients above all other considerations, and
- refrain from misleading and extravagant advertisements.[577]

It has also required them, by the code, to:

- extend objective and independent advice to their clients;
- provide their clients with sufficient information about the insurers they represent and their products;
- inform their clients about the amount of commissions they receive from the insurers and the premiums and other charges the clients have to pay;
- clarify their responsibilities to the clients in completing the insurance proposals, claims and other material documents;
- refrain from withholding any evidence or document relating to the insurance bought by their clients without disclosing adequate reason to the clients;
- refrain from disclosing any information about their clients obtained in the course of their businesses except upon consent of the client or a court order;
- respect the wishes of their clients to terminate their relationship with them;
- disclose their identities, occupations and purposes during advertisement;
- use the broker title only for the broking business; and
- inform the codes of conduct to the public and their employees with a statement that the public can make complaint to the NBE.[578]

The NBE does not, however, indicate the risks and liabilities to be covered by the indemnity insurance, property guarantee or deposit to be kept by the insurance auxiliaries except for the insurance brokers. It does not also have rules on the issuance of multiple licenses to a single applicant who can meet the criteria for more than one type of auxiliary business and on the use of independent and exclusive (tied) agents. It has, in practice, often issued exclusive agency licenses (that tie an insurance agent to a single insurer at a time) and licensed the agents as life, non-life and both by depending on the level of their expertise.[579]

The country does not also impose service diversification and regional and sectoral service distribution requirements on the banks, insurers and microfinance institutions.[580] It does not also require them to submit product distribution reports as it leaves the matters to the discretion of the institutions. The

576 SIB/22/2002, at art. 4; and SIB/29/2007, at art. 8.

577 Directives No. SIB/9/1995; and SIB/29/2007, at art. 7.

578 Ibid.

579 Directives No. SIB/4/1994; SIB/13/1996; SIB/15/1997; SIB/18/1998; and SIB/30/2007.

580 It has, of course, authorized the NBE to regulate the credit businesses of the banks and microfinance institutions within the free market principle. The NBE has not, however, regulated the credit businesses of the institutions directly after 1991. TGE, 1994, at arts. 7(2), 28(1)(b) & 30; FDRE, 2008a, at arts. 5(4) & 15(1)(a)(2); FDRE, 2008b, at arts. 3(3)(b), 22 & 54; FDRE, 1996g, at arts. 12(2) & 15; and FDRE, 2009, at arts. 3(1), 14(2)(a) & 28(1).

institutions also determine their credit and operational policies freely although they have to notify them to the NBE. The country, however, prohibits the banks from introducing new services without prior written authorization of the NBE.[581]

The NBE has not also adopted standards on the basis of which it may assess the qualification and competence of the auxiliaries.[582] The actuarial reports submitted to it have also come from an actuary whom the NBE did not license but with whom the Ethiopian insurers worked and the NBE recognized.[583] The licensing of the other auxiliaries was also slow and cumbersome.[584]

The current regulation of Ethiopia is commendable in light of the free market principle of the country. The stringent regulation of brokers by the NBE is also justified by the degree of their responsibility.[585] The country, however, needs to implement three sets of improvement for the following reasons.

First, the country is only partially consistent with the insurance core principles of the IAIS which recommend that insurance supervisors should set requirements, directly or through the insurers, that regulate the conduct of intermediaries.[586] The country needs, according to this principle, to regulate the operations of not only brokers but also of the other auxiliaries.

Secondly, the requirement of prior authorization for introduction of new services by the banks deters the innovativeness, flexibility and service diversification of the banks.[587] The country needs to remove it.

Thirdly, the current laws and practices of the banks, insurers and microfinance institutions have failed to diversify the types of services and the sectors and regions they serve. The services of the institutions are concentrated by type, sector and region and neither the NBE rules nor the credit and operational policies of

581 FDRE, 2008b, at art. 3(3)(b). This rule also holds for the microfinance institutions under the 2009 microfinance business law (FDRE, 2009, at arts. 17(5) & 28(1)).

582 It relies much on documentary proof of the qualification and experience requirements imposed on them (NBE ISD, 2005, at p. 58).

583 The long term insurers were valued by a Kenyan actuary (See annual reports of the Ethiopian Insurance Corporation, the Awash insurance S.C., the Africa Insurance S.C, the United Insurance S.C., the Nile Insurance S.C. and the Nyala Insurance S.C.).

584 NBE ISD, 2005, at pp. 44-60.

585 The Ethiopian brokers often tend to negotiate premiums, draft policies, provide risk management advice, handle claims, and represent both the insurers and the consumers besides their normal task of placing the insurers and consumers in business. Most of them also tend to bargain with the insurers on the placing of customers and the commissions the insurers pay to them. The insurance supervision department of the NBE also believes that the current regulation of brokers, in particular the qualification criteria and the minimum ceiling of the professional indemnity insurance, are not enough in view of the multiple functions the brokers engage in, the extent of the risk they place on the public, and the professional competence and reputation the works of the brokers demand. Its supervision reports show that the insurance brokers licensed so far are extending inadequate professional services. NBE ISD, 2005, at pp. 48 & 50-52.

586 IAIS, 2003, at ICP 24.

587 The licensing of a new bank called Zemen Bank S.C. (which went operational in 2008/2009) was, for instance, protracted because of proposal of the bank to be fully electronic bank without physical branches and opposition of the NBE to the idea.

the institutions focus on the economic and social policy objectives and priorities of the country.[588] The services of the institutions are not also automated and networked yet.[589] The country needs to introduce product diversification, automation and networking and sectoral and regional service distribution requirements to curb the failure.[590] The NBE also needs to coordinate between the fundamental objectives of its financial regulation and the economic and social policy objectives of the country and try to introduce the diversification, automation, networking and distribution requirements according to the dynamics of the transition in the country.[591] These measures should not, however, imply the direction of financial services by the NBE in the way this has been done in the centrally planned (socialist) systems. The NBE only needs to set the diversification, automation, networking and distribution requirements and stimulate the banks, insurers and microfinance institutions to comply with them in cooperation with the government (such as by tax and regulatory incentives) so that the free market principle will not also be defeated.

2.3.3.4 Regulation of Governance and Auditing

i. The International Experience

Improvement in the internal decision making process of financial institutions such as introduction of high-quality data recording; expansion of internal avenues of communication; installation of high-quality information processing, planning and performance systems; introduction of special documentation systems; division of work systems into decision-making components and agencies; and implementation of control measures play important role in risk avoidance.[592]

588 The banks usually address the domestic trade, import and export, agriculture, manufacturing and housing sectors with the lion's share going to the short term domestic trade and import sectors. The microfinance institutions focus on keeping deposits and lending although they are authorized by law to extend more extensive services. About 94 percent of the country's insurance business is also devoted to the provision of short term (general) insurance. The services of the banks, insurers and microfinance institutions are also concentrated in Addis Ababa, Dire Dawa and four (out of nine) regions of the country, namely Tigray, Amhara, Oromia and SNNPR (Southern Nations, Nationalities and Peoples Region). The services in the regions are also further concentrated in six towns, i.e. Nathreth, Jimma, Awassa, Bahir Dar, Gonder and Mekele. Tables 2(Chap. 2), 3(Chap. 2), 4(Chap. 2), 5(Chap. 2), 8(Chap. 2), & 9(Chap. 2); NBE ISD, 2005, at p. 19; FDRE, 1996g, at art. 3; FDRE, 2009, at art. 3; and the records and annual reports of the banks, insurers, microfinance institutions and the NBE for 2008, 2009 and 2010. Note also the discussions under the 'market entry and exit' and 'functional and ownership separation' requirements subtitles above.

589 Note the discussion under the 'history and current state' subtitile above.

590 Diversification requirements can be appropriate regulatory instruments within the realm of banking and insurance regulation to coordinate and meet the economic and social policy objectives and priorities of the country once the objectives and priorities are made clear in the non-financial policies. Note the discussion under the 'objectives of regulation' subtitle above.

591 The country has already authorized the NBE to enhance dissemination of the banking, insurance, microfinance and other financial services according to needs of the country (TGE, 1994, at arts. 7(9) & 28(1)(b); FDRE, 2008a, at arts. 5(8) & 15(1)(a)(2); TGE, 1994a, at art. 34; TGE, 1994b, at art. 3; FDRE, 1996g, at arts. 11 & 12(3); and FDRE, 2009, at art. 3(1), 14(2)(a), 28(1), and the preamble). It has also recognized the possibility of regulating the distribution, sale and movement of basic goods and services in its general competition law and the NBE can rely on this (FDRE, 2003c, at art. 23).

592 Möschel, 1991, at p. 70; and Pfennigstorf, 1996, at pp. 66-67.

These are, however, often considered to be under the domain of management of the financial institutions and excluded from regulation.[593] The regulators in many countries also use only indirect mechanisms such as the requirements of reliability, professional qualification, double management, and management incompatibility rules to address the objective.[594] The governance and auditing of the financial institutions are, therefore, largely left to the general company law regimes of the countries and influenced by the different theories on company management and organizational design that affect the general company law regimes.

The theories of the company and its management have evolved from a more traditional classical model that emphasized on notions of individualism to increased influence of managerial principles in the 1930s and then to the market testing of different national models and concepts in the subsequent periods.[595] The need for corporate governance and controlling mechanisms has also rose in practice as the management and ownership of the modern corporation separated increasingly and the traditional assumption that corporate managers will act in the interest of shareholders by maximizing profit (or wealth) failed to hold, leading to the modern principal-agent problem (that corporate managers do not always act in the interest of shareholders).[596] Arguments have also existed that recognise the exposure of the modern company to conflict of interest problems between management, shareholders and other stakeholders and, hence, that propose solution to the problem of control.[597] The extent to which corporate managers may depart from the shareholders' and stakeholders' interests is also said to be a matter of organizational structure and the influence of the latter is often explained in terms of theories of agency and transactions costs.[598] Equity-based and debt-based mechanisms of corporate governance and control are also developed through time to include the following:

- market control via equity (i.e. the takeover mechanism);
- market control via debt (i.e. the prevention of inappropriate use of retained earnings by reduction of the internal resources at the disposal of managers through high indebtedness);
- direct control via equity (i.e. the control of firms by institutional shareholders that act directly or through boards); and
- direct control via debt (i.e. the control of firms through relationship banking).[599]

593 Ibid.

594 Möschel, 1991, at p. 70; Pfennigstorf, 1996, at pp. 66-67; and IAIS, 2005b, at pp. 17-18.

595 Gilligan, 1999, at pp. 9-11; Wheeler, 1993; Teubner, 1993; Kraakman, et al., 2004; and Plessis, et al., 2005.

596 Davis, 1995, at pp. 183-185; Kraakman, et al., 2004, at pp. 1-214; and Plessis, et al., 2005, at pp. 1-386.

597 Eisenberg, 1993, at pp. 111-131 & 140-141; Kraakman, et al., 2004, at pp. 1-214; and Plessis, et al., 2005, at pp. 14-52.

598 Davis, 1995, at pp. 185-186; Kraakman, et al., 2004, at pp. 1-214; and Plessis, et al., 2005, at pp. 1-386.

599 The first three control mechanisms were prominent in the Anglo-Saxon countries which used to emphasize on the liquidity of shareholding and disclosure of financial information while the fourth was most common in Germany and Japan which used to emphasize on the information closely held

The modern company laws and concepts have, however, recognized the limits of all the aforementioned theories, arguments and approaches as they believe in the existence of a large number of managerial and non-managerial agents in the public company, in the divergence of interests of the shareholders, stakeholders and managers of the company, in the virtual impossibility of bargaining in between the shareholders, the stakeholders and the managers of the company, and in the inefficiency of markets to check managers fully.[600] They have often tended to set mandatory structural, disclosure, related party, and fair dealing rules for the company that are designed to protect shareholders, investors, creditors and other stakeholders despite variations on detail from country to country.[601] Accordingly, the company laws of most countries recognize the institutions of shareholders meetings, board of directors, company management and internal and external auditors in designing the management and organizational structure of the public company while some like Germany and China (following the German model) also add a supervisory board that oversees the board of directors.[602] A number of the European countries (including Germany and England) and China also recognize the participation of employees or representation of their interests in the company governance.[603] Many of the countries also have indirect mechanisms of ensuring accountability and safeguarding against malfeasance of management including *ex ante* controls on abuse of power, disqualification of directors, control through stock market, control by public agencies, and enforcement of civil and criminal sanctions against violations of corporate obligations.[604]

Most countries also require the financial institutions to have auditors (and actuaries for the insurers) who will verify all the information relating to the financial conditions of the institutions and check compliance of the operations of the latter with regulatory requirements.[605] The researchers in the field of financial market regulation have also confirmed the inability of markets alone to discipline the management of financial institutions and the need to twin these control mechanisms with the use of effective government regulation.[606]

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by banks. The role of institutional investors in corporate governance and control has also grown in the emerging market economies through time. Davis, 1995, at pp. 186-191; and OECD, 2007.

600 Davis, 1995, at pp. 97-111; Kraakman, et al., 2004, at pp. 1-214; Plessis, et al., 2005, at pp. 1-386; and Grossfeld, 2006, at pp. 3-143.

601 Ibid.

602 Maitland-Walker, 1997; ONG and Baxter, 1999, at pp. 103-112; Lucas and Maltsev, 1996, at pp. 372-391; Kraakman, et al., 2004, at pp. 1-214; Plessis, et al., 2005, at pp. 1-386; and Grossfeld, 2006, at pp. 3-143.

603 Blanpain and Barbagelata, 1992; ONG and Baxter, 1999, at pp. 112-115; Plessis, et al., 2005, at pp. 301-315; and Grossfeld, 2006, at pp. 135-140.

604 The strictness of these measures has, however, differed from country to country due to ideological differences. Followers of the capitalist ideology, including UK, have refrained from imposing strict and heavy punishments for fear that these may discourage entrepreneurial spirit and individualism while others like China have believed that strict measures will promote the ideology of collectivism. ONG and Baxter, 1999, at pp. 102-103 & 116-122; Plessis, et al., 2005, at pp. 258-319; IAIS, 2005b, at pp. 17-18; and Grossfeld, 2006, at pp. 3-143.

605 Pfennigstorf, 1996, at pp. 102-103; Fearnley, et al., 2002, at pp. 254-265; and IAIS, 2005b, at pp. 17-18 & 22-26.

606 See, for instance, Leather and Raines, 2000, at pp. 163-184; and Gup, 2000, at pp. 187-202.

The making of accounting, auditing, disclosure and corporate governance reforms is also generally considered to be important matter that has to be addressed continuously both in the context of financial market regulation and outside as governance inefficiencies, scandals and financial crimes are still alive every where.[607] The effort in most countries (both developed and developing) has, accordingly, been (and seems to continue to be) towards advancing the systems by shifting increasingly from a regulatory system that relies on quantitative controls only to a system that complements the quantitative controls by qualitative prudential and governance requirements, such as by defining the mechanisms for management of risks and specifying the valuation and auditing functions, board and management tasks (and responsibilities), and shareholders rights.[608] The Global Corporate Governance Forum, the OECD, the International Accounting Standards Committee, the International Federation of Accountants, the International Corporate Governance Network and many national institutions have also been assisting the reforms.[609] The OECD Principles of Corporate Governance have also, in particular, been useful to benchmark the corporate governance regimes and practices of both the OECD and the Non-OECD countries.[610] The 2008 financial and economic crisis has also increased the need for controlling corporate abuses, enhancing corporate governance mechanisms, and further revising the OECD corporate governance principles.[611] The latest recommendation, as drawn from the experiences of private equity and venture capital funds and the general discussion on corporate governance systems in some countries like Germany, is also towards development of a governance system that will incorporate the relationships among all the stakeholders of the corporation (i.e. the owners, the lenders, the managers, the employees and other social groups).[612]

ii. The Case of Ethiopia

Ethiopia leaves the improvement of internal decision-making process to the banks, insurers and microfinance institutions like the practice else where. It:

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607 Lubrano, 2003, at p. 459; OECD, 2004b; OECD, 2004c; Kraakman, et al., 2004, at pp. 1-214; Plessis, et al., 2005, at pp. 1-386; Campbell, 2007; Close, 2007; Frolov, 2007; Lanam, 2007; Cude, 2007; Wroblewski, 2007; Greenwald, 2007; McIlroy, 2008; Hall, 2009; Bloomberg, 2009a; IASB, 2010c; IASB, 2010d; IASB, 2010f; IFAC, 2010a; IFAC, 2010b; and IFAC, 2010e.

608 Rocha, Hinz and Gutierrez, 2001, at pp. 172-177. Recent studies have also pointed out the usefulness of board professionalism and shareholder empowerment in both financial and non-financial companies to enhance the performance and control of company governance (Adrian Blundell-Wignall, 2007, at pp. 55-87; OECD SGCG, 2007, at pp. 88-110; Bob Garratt, 2006, at pp. 1-224; Plessis, et al., 2005, at pp. 320-386; and Kraakman, et al., 2004, at pp. 1-214).

609 Lubrano, 2003, at p. 459; OECD, 2004b; OECD, 2004c; OECD, 2006b; OECD, 2009; OECD, 2009a; OECD, 2009b; OECD, 2009c; OECD, 2009d; OECD, 2010; OECD, 2010a; IASB, 2010; IASB, 2010a; IASB, 2010b; IFAC, 2010; IFAC, 2010a; IFAC, 2010b; IFAC, 2010c; and IFAC, 2010d.

610 OECD, 2004b; OECD, 2004c; OECD, 2006b; and the country related works of the OECD under the Principles.

611 Grant Kirkpatrick, 2009; Haynes, 2009; Bloomberg, 2009a; OECD, 2006b; OECD, 2009; OECD, 2009a; OECD, 2009b; OECD, 2009c; OECD, 2009d; OECD, 2010; and OECD, 2010a.

612 Schwartz, 2010; and Grossfeld, 2006, at pp. 135-141.

- defines the composition and responsibilities of the shareholders' meetings, boards of directors and auditors of the institutions;

- requires the banks to have information management, internal control, human resource organization and risk management systems, policies and procedures before commencement of business as the NBE may prescribe;

- authorizes the NBE to:

    - regulate the appointment and tenures of the directors and executives of the banks;
    - enact qualification, fitness and propriety criteria for the influential shareholders of the banks and the directors and chief (and senior) executives of the banks, insurers and microfinance institutions;
    - fix the number of employees who may participate in the boards of directors of the banks; and
    - call and participate in the shareholders' meetings of the banks;

- prohibits the directors and chief executives of the financial institutions (and the business entities in which these persons hold more than ten percent equity interest) from being directors of a bank and the employees of a bank from being board chairpersons of same bank and directors of another bank;

- bars persons declared bankrupt or making a composition with creditors, persons convicted of an offence involving dishonesty or fraud and persons who were directors, managers or principal officers or otherwise concerned directly or indirectly in the management of any financial institution that has been wound up in Ethiopia or abroad from managing the banking, insurance and microfinance institutions without written approval of the NBE; and

- requires the directors and executive officers of the banks to cease their functions when they or the companies in which they are directors or executive officers are declared bankrupt or convicted for bank liability.[613]

The NBE also intervenes to regulate the governance of the banks, insurers and microfinance institutions and their internal decision making processes indirectly through the personal licensing and disclosure requirements.[614] It requires the banks, insurers and microfinance institutions to disclose the qualities of their management and the organizational structures, risk management policies and

613 IGE, 1960, at arts. 347-428; TGE, 1994a, at arts. 5(1) & 30(1) & (2); FDRE, 2008b, at arts. 4(1)(g), 4(1)(h), 6, 12, 14-17 & 24-27; TGE, 1994b, at arts. 6(2), 35, 43(1)-(2) & 44; FDRE, 1996g, at arts. 5, 6, 18 & 24; and FDRE, 2009, at arts. 11, 14(2)(e) & 28(1).

614 Directives No. SBB/1/ 1994; SBB/39/2006; SIB/1/1994; MFI/01/96; MFI/02/96; & MFI/04/96. Note also the discussions under the 'market entry and exit requirements' subtitle above and the 'regulation of information disclosure' subtitle below.

working manuals they adopt to itself and to the public.[615] It imposes age, qualification and integrity requirements on the chief executives and members of the boards of directors of the banking, insurance and microfinance companies and requires their appointment upon its approval.[616] It prohibits members of the boards of directors of the banks from being members in the boards of other financial institutions and from acting as chief executives of the same bank to ensure the existence of undivided attention in the leadership of the banks and eliminate the exercise of abuse by the directors.[617] It also limits the office terms of the members of the boards of directors of the banks to maximum of six consecutive years (subject to possibilities of retention of up to one-third of the outgoing members for extra one term and re-appointment of the members after lapse of six years of leave) to rotate the directorship roles of the shareholders and control the possible influences and abuses the directors may exert on the management and businesses of the banks.[618]

The country also requires the banks, insurers and microfinance institutions to appoint independent auditors under approval of the NBE (and the government for the government banks and insurer) and to have their books of accounts audited annually by these auditors.[619] It requires the long-term insurers to have their financial conditions and liabilities investigated by licensed actuaries annually for the first five years from commencement of their businesses and at least every three years thereafter.[620] It authorizes the NBE to appoint auditors for the banks, insurer and microfinance institutions when they fail to make the appointment by themselves and to require them to re-audit their financial positions or re-appoint new auditors when it feels that their audit reports are defective or inadequate.[621] It also authorizes the NBE to lay down the minimum auditing standards including the tenures of auditors, the scope and depth of audit, and the making of reports and valuations of assets and liabilities by the banks, insurers and microfinance institutions.[622] The NBE has not issued directives on the matter, however. It has only issued a directive that regulates the requirements and procedures for approval of the auditors to be appointed by the banks.[623] It has also neither defined the

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615 Ibid. It requires the licensed banks and microfinance institutions to adopt risk management policies and operational manuals before commencement of operation. It does not impose these requirements on the insurers. Directives No. SBB/39/2006, at art. 9.1; and MFI/04/96, at art. 2.

616 Directives No. SBB/1/1994; SBB/39/2006, at arts. 4 & 5; SIB/1/1994; and MFI/03/96.

617 SBB/39/2006, at art. 5.1.4. The purposes of prohibition are not stated by the bank. They are only implied from the spirit of the directive. The NBE does not impose similar prohibitions on directors of the insurers and microfinance institutions.

618 SBB/39/2006, at art. 5.1.5. It does not impose similar requirements on the insurers and microfinance institutions.

619 It requires the approval of the auditors of the private banks, insurers and microfinance institutions by the NBE and the approval of the auditors of the government owned banks and insurer by the government. TGE, 1994a, at art. 18; FDRE, 2008b, at arts. 24-27; TGE, 1994b, at art. 18; FDRE, 1996g, at arts. 12(2)(d) & 22; and FDRE, 2009, at arts. 12-13.

620 TGE, 1994b, at art. 19 & 25.

621 TGE, 1994a, at art. 18(2), (3), (7) & 20(3)(c); FDRE, 2008b, at arts. 24(4) & 27(3); TGE, 1994b, at arts. 30, 31 & 44; FDRE, 1996g, at art. 24; and FDRE, 2009, at arts. 12(2) & 13(2).

622 TGE, 1994a, at art. 18 (5); FDRE, 2008b, at arts. 24(3), 26(1) & (2); TGE, 1994b, at art. 44; FDRE, 1996g, at art. 24; and FDRE, 2009, at art. 12(3).

623 Directive No. SBB/19/96. It has not issued similar directives for the insurance and microfinance auditors.

roles of the external auditors nor demarcated their roles from the roles of its examiners. The auditors are, therefore, only subject to the general powers and responsibilities put on all auditors in the general commercial law of the country and the general indications in the banking and microfinance business laws.[624] They are, accordingly, subject to the general duty to verify the proper drawing, truth, fairness and legality of the balance sheets and profit and loss accounts of the banks, insurers and microfinance institutions and to report on the state of financial activities and affairs of the institutions to the management bodies of the institutions and the NBE.[625]

The government banks and insurers in the country are audited in practice by the government owned Auditor General Office while the private banks, insurers and microfinance institutions are audited by independent private auditors whom they appoint annually upon approval of the NBE.[626] The long term insurers, including the government insurer, are also appraised by foreign actuaries recognized by the NBE.[627]

The banks, insurers and microfinance institutions in the country have generally been weak in their data recording, documentation, communication, information processing, planning, decision making, auditing, governance and risk managment.[628] None of them has developed adequate corporate governance structures and risk management mechanisms because of inexperience and little appreciation of the problem.[629] Their operational policies and procedures are not well developed, either.[630] A number of board members of the banks, insurers and microfinance institutions also engage in outside management and board membership.[631] The boards of some of the banks, insurers and microfinance institutions are also sometimes chaired by representatives of their institutional

624 The banking and microfinance business laws require the auditors to make the audits and to report the findings and conclusions to the shareholders of the banks and the microfinance institutions and to the NBE according to internationally accepted auditing standards. TGE, 1994a, at arts. 18, 32 & 34; FDRE, 2008b, at arts. 26(1)-(2) & 60(3); TGE, 1994b, at art. 18(1); FDRE, 1996g, at art. 24; FDRE, 2009, at arts. 13 & 28(1); and IGE, 1960.

625 TGE, 1994a, at arts. 18(1), 18(6), 32 & 34; FDRE, 2008b, at arts. 26(1)-(2), 27 & 60(3); TGE, 1994b, at art. 18(1) & (2); FDRE, 1996g, at art. 24; FDRE, 2009, at arts. 13 & 28(1); TGE, 1992b, at arts. 5, 19-22, 27-28 & 32-34; and IGE, 1960, at arts. 63-85 & 368-387. The external auditors have also, in practice, limited their verifications and reports to the financial operations (i.e. the balance sheets and income and cash flow statements) of the audited banks, insurers and microfinance institutions. Only the banking supervision department of the NBE has intended to require them to include managerial assessment reports (NBE BSD, 2005, at p. 38). The 2009 microfinance business law requires the external auditors of the microfinance institutions to do the latter (FDRE, 2009, at art. 13(1) second clause).

626 See annual reports of the institutions. Some of the microfinance institutions have failed to audit their operations and the NBE was insisting on them to do this (Wolday Amha, 2006, at p. 66).

627 See annual reports of the insurers.

628 NBE, 2010; NBE BSD, 2005, at p. 53; NBE ISD, 2005, at pp. 83-86; Itana Ayanna, et al., 2003; Wolday Amha, 2006, at pp. 60 & 66; Degefe Duressa Obo, 2009, at pp. 6, 87-164, 179-190, 213-218 & 223-227; and annual reports of the banks, insurers and microfinance institutions.

629 They have only intended to improve on these limitations. Ibid.

630 Ibid.

631 Ibid and note the practice.

shareholders contrary to the company law of the country.[632] The auditing profession in the country is also at rudimentary stage.[633] The NBE has not also taken any measure to correct the aforementioned for the simple reason that it has not seen problems of mismanagement yet.[634] The measures the NBE took so far are also either partial solutions to the aforementioned problems or inappropriate interventions.[635] The country does not also have mechanisms for stakeholder participation in the governance of the financial institutions.

The NBE needs to follow a proactive as opposed to reactive approach of regulation to make the banks, insurers and microfinance institutions improve on their managerial limitations and control the potential problems of mismanagement and conflict of interest in the management of the banks, insurers and microfinance institutions. It needs to learn from the international developments, set minimum standards and principles on governance (including the data recording, documentation, communication, information processing, planning, decision-making, reporting and auditing) of the institutions by way of enforcing its responsibilities to promote the soundness of banking, insurance and microfinance, and require the banks, insurers, microfinance institutions and their auditors to have systems by which they will ensure meeting the standards. It needs to ensure undivided attention (and control the advent of conflict of interest problems and abuses) in the leadership and management of the banks, insurers and microfinance institutions by expanding the application of the current limits on outside managerial engagement of the boards of directors of the banks to the boards of directors of both the insurers and the microfinance institutions and imposing similar limits on the outside managerial engagement of the chief executives of the banks, insurers and microfinance institutions. It also needs to assist the microfinance institutions to build their governance structures and management capacities by way of carrying out its responsibility to extend technical assistance to them.[636]

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632 The company law of the country (included in the commercial code) allows board membership of the institutional shareholders of a company. It, however, requires chairmanship of the boards by physical person shareholders only. IGE, 1960, at art. 347(4).

633 NBE BSD, 2005, at p. 52; and NBE, 2010. The Federal Auditor General of the country has ordered all the auditors in the country to adhere to the auditing standards and techniques employed by the International Federation of Accountants beginning July 01 2003 (Rose Mestika, 2003). The profession is not, however, well grown yet (NBE, 2010).

634 NBE BSD, 2005, at p. 73; and SBB/39/2006. Its banking supervision department has only conducted risk management survey on the banks and recommended that the NBE needs to enhance the risk management capabilities of the banks and move towards risk based supervision (NBE, 2010).

635 The disclosure requirements (on organizational structures, risk management policies, working manuals, and quality of management of the banks, insurers and microfinance institutions) and the prohibitions (on multiplicity of board membership of the bank directors) are only partial. The restrictions on office terms of directors of the banks are inappropriate.

636 The 1996 microfinance business law used to expressly impose this responsibility on the NBE (FDRE, 1996g, at art. 11(1)). The 2009 law is silent about it. It only authorizes the NBE to issue directives on the duties, responsibilities and good governance of the boards of directors, the management information and internal control systems, and related governance matters of the microfinance institutions (FDRE, 2009, at arts. 11(4) & 14(2)(e)). The NBE is, however, expected to continue with the responsibility to assist the microfinance institutions since the latter are only at their infant stage of development (Note the study reports of the Association of Microfinance

It also needs to avoid interventions through requirements that are likely to have negative effect in the quality of management of the banks, insurers and microfinance institutions such as the restriction on the office terms of members of the boards of the banks. This bars the accumulation of leadership experience which is important given that the financial institutions have short history. The NBE needs to control the undesirable influences of the directors and executives of the banks, insurers and microfinance institutions indirectly, such as through the insider dealing rules, and promote competition to stimulate continuous improvement in the leadership quality of the banks, insurers and microfinance institutions. It also needs to ensure competence in the leadership of the institutions through indirect intervention, such as by training and testing. It also needs to recognize the right of membership of the shareholders of the banks, insurers and microfinance institutions in the boards of the institutions and balance between the enforcement of this right and its regulations. Its supervision departments also need to consider the legality, need and feasibility of the instruments they use whenever they want to implement stringent requirements on the directorship and shareholding of the financial institutions.

The country also needs to devise mechanisms for stakeholder participation in the governance of the financial institutions.

2.3.3.5 Regulation of Information Disclosure

i. The International Experience

Regulation of information disclosure is important partly because it is a form of regulation with less interference and partly because imperfections justify it.[637] It is justified by the fact that financial products and markets are information sensitive and prone to problems of information asymmetry, power differential and bounded rationality.[638]

Almost all countries require their financial institutions to disclose information to the regulators, customers and the public.[639] The duties of disclosure to the regulators usually include:

- annual balance sheet and profit and loss accounts;
- semi-annual, quarterly and weekly financial reports;
- personal data reports (such as appointment and dismissal of chief executives, interests of chief executives in other enterprises and outside employment of senior staff);

Institutions of the country and Degefe Duressa Obo, 2009, at pp. 6, 87-164, 179-190, 213-218 & 223-227).

637 Thimm, 1999, at p. 147.

638 Thimm, 1999, at pp. 148-151; and Finsinger, Hammond and Tapp, 1985, at p. 14.

639 Möschel, 1991, at p. 110; Pfennigstorf, 1996, at p. 101; Hubbard, 1997, at p. 51; and IAIS, 2005b, at pp. 30-32 & 39-41.

- organizational fact reports (such as changes in the articles, memorandum of association and name of the financial institution and the establishment, transfer and closure of branches);
- transaction reports of high-risk content (such as on insider credit, large-scale credit and foreign currency commitment of certain magnitude);
- failure to fulfil obligations (such as losses exceeding certain amount and facts which jeopardize the position of creditors);
- country risk reports (for international operations); and
- all information the regulators may need (and require) to be submitted for the exercise of their supervisory function.[640]

The disclosure to the customers and the general public usually goes less far than the disclosure to the regulators due to consideration that financial institutions have legitimate interest in a degree of secrecy when it is a matter of disclosure of information to bodies other than the regulators.[641] Hence, the disclosure laws of most countries do not require the financial institutions to reveal the details of their transactions to the public in order to balance between the public interest for information disclosure and the privacy interests of the financial institutions and their customers.[642]

Some countries also assist the disclosure of information by information processing and rating agencies. The US is well known for this.[643] A number of the transition and emerging market countries have also assisted the development of their financial markets and regulations through the use of newly introduced rating agencies.[644]

The 2008 financial and economic crisis has also increased the need for strengthening mandatory disclosure requirements in order to increase the protection of consumers as well as enhance the health of the financial sector.[645] It has, however, also triggered discussion on the desirability and regulation of the rating agencies.[646]

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640 Möschel, 1991, at pp. 110-111; Pfennigstorf, 1996, at pp. 101-102; IAIS, 2005b, at pp. 30-32; Hubbard, 1997, at p. 51; Thimm, 1999, at pp. 156-157; Caddy, 1986, at pp. 131-153; and Lemaire, 1997, at pp. 37-40.

641 Möschel, 1991, at p. 110; Pfennigstorf, 1996, at p. 101; Hubbard, 1997, at p. 51; and IAIS, 2005b, at pp. 30-32 & 39-41.

642 Möschel, 1991, at p. 111; Pfennigstorf, 1996, at pp. 101-102; and IAIS, 2005b, at pp. 30-32.

643 Lemaire, 1997, at pp. 35-51; and Marc, et al., 2009.

644 Petersen, 2004, at p. 120.

645 Frolov, 2007; Lanam, 2007; Cude, 2007; Wroblewski, 2007; Greenwald, 2007; and Grant Kirkpatrick, 2009.

646 The agencies were invented decades ago to assist the disclosure of information through their coordination roles and neutrality. They have, however, contributed to the contiguity of the 2008 financial and economic crisis by compromising their neutrality, inflating their ratings and igniting investor (and public) panic. These problems have led to need for balancing between the use and the side-effects of the agencies. The question has been on whether the solution should be made by eliminating the agencies or by strengthening the regulations on them and their use by the investors. The 2010 US financial regulatory overhauling bill has not eliminated them; it has only increased the regulatory requirements on them. Arnoud and Todd, 2002; Weber and Darbellay, 2008; Coskun, 2008; Marc, et al., 2009; Marco and Paolo, 2009; Patrick, et al., 2009; Goodhart, 2009, at pp. 113-140; Chapman, 2010, at pp. 182-192; AP, 2010a; and Bloomberg, 2010.

ii. The Case of Ethiopia

Ethiopia requires the banks, insurers and microfinance institutions under formation to disclose information relating to their formation and licensing to the NBE, the trade registrar and the public.[647] It requires them to disclose information about their capitals, shares, contributions, founders, directors, mangers, auditors, business plans, principal offices, prospective branches, projected financial statements, and memoranda and articles of association to the NBE. It requires them to deposit their memoranda and articles of association in the federal commercial register at the Ministry of Trade and Industry and confers right on the public to inspect the entries in the register.[648] It also requires the founders of the banks under formation to publish notice of intention to the public in widely circulating newspapers for a period of four consecutive weeks from the date of formation application of the banks.[649]

It requires the operational banks, insurers and microfinance institutions to record and report their operations to the NBE, their customers and the general public at regular intervals.[650] It requires the banks and microfinance institutions to record (and keep documents for) each type of deposit and transaction and to report the latter to the NBE as it occurs.[651] It requires the banks to register their external loans (and credit facilities) to an investor in the NBE when these occur.[652] It requires the insurers to submit their audited balance sheets, profit and loss accounts, actuarial investigation reports, shareholder reports and minutes of general meetings of shareholders to the NBE annually.[653] It requires the banks and insurers to submit:

647 IGE, 1960, at arts. 312-324, 210, 211, 214, 219-225, 462, 87 & 123(g); TGE, 1994a, at arts. 5(1) & 5(3); FDRE, 2008b, at art. 4(1)(c); TGE, 1994b, at arts. 6(2) & 44; FDRE, 1997, at arts. 5, 6(1), (2), 8, 9, 14, 17, 22 & 34; FDRE, 1997b, at arts. 6, 12, 16, 18, Schedule B-Forms 2, 4, 6 & Schedule C-Form 1; FDRE, 1997c, at arts. 7, 12, 14, 21, Schedule B-Forms 3, 5, 6 & Schedule C-Form 1; FDRE, 2003b, at art. 2(8); FDRE, 1996g, at art. 6; FDRE, 2009, at arts. 5(1)(a) & (c), 5(2) & 28(1); and Directives No. SBB/1/1994; SBB/39/2006; SIB/1/1994; and MFI/01/96.

648 It used to require the private banks and insurers to publish information about their formation, capitals, intended businesses, shareholding, management, auditors and durations of establishment in newspapers of country wide circulation by its general commercial registration and licensing laws and the banks and insurers used to adhere to that until the requirement was abolished on the 13th of November 2003 (FDRE, 1997a; FDRE, 1997b; FDRE, 1997c; FDRE, 1999a; FDRE, 2003b; FDRE, 2003d; FDRE, 2003f, at arts. 2(2) & 2(3); and FDRE, 2010a, at art. 9). The particulars about the government banks and insurer are usually disclosed through publication of their establishing laws by including information about the missions, purposes, capitals, liabilities, management and durations of their establishments (See the establishing laws of the government banks and insurer).

649 FDRE, 2008b, at art. 4(1)(c). It does not impose this on the insurers and microfinance institutions (TGE, 1994b, at arts. 3, 4 & 6; and FDRE, 2009, at art. 5).

650 TGE, 1994, at arts. 56 & 58; FDRE, 2008a, at art. 22; TGE, 1994a, at arts. 5(3), 17, 19(1, 3-5 & 7-9); FDRE, 2008b, at arts. 23 & 28; TGE, 1994b, at arts. 17(2), 18, 19, 22 & 23; FDRE, 1996g, at art. 12(2)(c); FDRE, 2009, at art. 15; and Directives No. SBB/10/95, SBB/17/96, SIB/17/1998, and MFI/08/96.

651 The laws also authorize the NBE to prescribe the forms and entries of the records. TGE, 1994a, at arts. 19(1-5), (8) & (9); FDRE, 2008b, at art. 23; FDRE, 1996g, at art. 12(2)(c); FDRE, 2009, at arts. 15(1-3) & 28(1); and Directive No. MFI/08/96.

652 FDRE, 1996c, at art. 19(1); FDRE, 2002c, at art. 19(1); and Directives No. REL/001/97; REL/002/1997; REL/003/98; REL/004/1998; and REL/005/2002.

653 TGE, 1994b, at arts. 18, 19, 22 & 23. The actuarial valuation requirements are applied to long-term insurers only (Ibid.).

- personal data reports (such as on appointment and dismissal of their chief executives and auxiliaries, interests of their chief executives in other enterprises), and outside employment of their senior staffs;
- organizational fact reports (such as on changes in the articles and memorandum of association and/or names of the companies and on the establishment, transfer and closure of their branches);
- risk content reports (such as on insider credit, large-scale credit and foreign currency commitment); and
- business failure reports (such as on losses and facts which jeopardize the position of creditors) to the NBE as these occur.[654]

It requires all the institutions to make financial and operational reports to the NBE periodically, as the NBE may request, and in the manner the NBE may prescribe from time to time.[655] It requires all of them to exhibit their audited annual balance sheets and profit and loss accounts in respect of all their operations at conspicuous places of their businesses and branches throughout every accounting year and the banks and insurers to publish same (with the notes to them) in newspaper of wide circulation.[656] It also authorizes the NBE to publish the list of licensed institutions, the general data about them, the discount and credit transactions it may have with them and the appointment of receiver (for the banks and the microfinance institutions) provided that it may refuse the disclosure of reports of the banks, insurers and microfinance institutions that relate to their business particulars, investments and re-insurance arrangements.[657]

In practice, the banks submit daily open foreign currency position reports; weekly reserve and liquidity reports; monthly balance sheets and credit exposure reports; quarterly income, expense, capital adequacy, loan classification and provisioning reports; and annual financial and audit reports to the NBE while the insurers and microfinance institutions submit only quarterly and annual financial and audit reports as the NBE requires.[658] All of them submit the reports to the NBE in hard copies and the supervision departments of the NBE enter them in excel

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654 TGE, 1994, at arts. 56 & 58; FDRE, 2008a, at art. 22; TGE, 1994a, at arts. 5(1), (3), (4), 19, 27(2) & 29; FDRE, 2008b, at arts. 14(2) & 28(5); and TGE, 1994b, at arts. 6(2), 17(2), 19, 22, 23, 35 & 44.

655 It requires the banks to make the reports monthly, semi-annually and annually; and the insurers and microfinance institutions to make them quarterly, annually and as the need arises (TGE, 1994a, at art. 19(3)-(9); FDRE, 2008b, at art. 28(4); TGE, 1994b, at arts. 17(2), 18, 19, 22, 23, 35 & 44; FDRE, 1996g, at art. 12(2)(c) & 24; FDRE, 2009, at art. 15(2-3); and Directives No. SIB/17/1998; and MFI/08/96). The NBE has also prescribed the miscellaneous reporting forms which the banks, insurers and microfinance institutions have to follow in making their reports (Directives No. SBB/14/1996; SBB/15/1996; SBB/21/1996; SBB/23/1997; SBB/27/2001; SBB/29/2002; SBB/30/2002; SBB/32/2002; SBB/33/2002; SBB/43/2007; SBB/44/2008; SBB/48/2010; SIB/17/1998; MFI/08/1996; and MFI/18/2006).

656 TGE, 1994a, at art. 19(6); FDRE, 2008b, at art. 28(2)-(3); TGE, 1994b, at art. 18(3)); and FDRE, 2009, at art. 15(2)(b). It does not impose the newspaper publication requirement on the microfinance institutions (FDRE, 1996g; and FDRE, 2009, at arts. 15 & 20).

657 The laws, therefore, seem to make the disclosure of information a principle and the protection of privacy of the financial institutions and their customers an exception. TGE, 1994a, at art. 31; FDRE, 2008b, at arts. 8, 15(2), 28(4), 33(2) & 55; TGE, 1994b, at art. 24(1-2); and FDRE, 2009, at arts. 15(4), 19(3) & 20.

658 NBE BSD, 2005, at pp. 38, 41 & 49; NBE ISD, 2005, at p. 96; and Directive No. MFI/08/96.

spreadsheets.[659] The financial statements and reports of the institutions, however, tend to be deficient and untimely. The banks do not account for depreciation allowances, taxes, loan loss provisions and other non-cash expenses to the level of detail the NBE expects and sometimes overstate their reports while the insurers and microfinance institutions sometimes submit reports and accounts that are inadequate, inaccurate or inconsistent with their true situations.[660] The banks, insurers and microfinance institutions also usually fail to report to the NBE on time while some of the banks refuse to report on their large borrowers.[661] The banks, insurers and microfinance institutions do not also exhibit their audited annual balance sheets and profit and loss accounts to the public as the law requires; nor do they publish sufficient information on their operations, reserves, liquidity, capital adequacy, solvency and asset quality to the public. The banks and insurers publish their annual balance sheets and profit and loss statements in the Ethiopian Herald only occasionally and without the notes to the accounts while the microfinance institutions do not do this at all.[662] They include the details of their balance sheets, profit and loss accounts and annual operations in their annual reports and distribute the reports to the NBE, to the government organs whom they think have stake in them, to investors to whom they want to advertise and to their shareholders, directors, managers and staff. They usually distribute the reports (other than the ones they make to the NBE and their shareholders) selectively as part of their business promotion and public relation works.[663] They also disclose information on their capitals, branching and services through advertisement brochures which are distributed only occasionally. They are hardly concerned with the idea of public information disclosure as a matter of principle. The NBE also pays little attention to the public disclosure requirement. It neither publishes its supervisory reports to the public in full and on time nor discusses them with the individual banks, insurers and microfinance institutions.[664] Both the NBE and the financial institutions also make the off-site and on-site examination reports and documents confidential under the guise of privacy and the laws seem

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659 The country has not automated the financial reporting and off-site report preparation and submission processes (Note the business re-engineering reports of the NBE).

660 NBE BSD, 2005, at pp. 37 & 41; NBE ISD, 2005, at p. 103; Degefe Duressa Obo, 2009, at pp. 209, 6, 87-164, 179-190, 213-218 & 223-227; and annual reports of the banks, insurers and microfinance institutions.

661 NBE BSD, 2005, at pp. 46, 47 & 50; and Wolday Amha, 2006, at p. 65. These problems are particularly true with the government banks and insurer which often invoke the non-automation of their works, the delay of their audits by the government auditor, and the protection of privacy of their customers as excuse. Ibid.

662 The Ethiopian Herald is newspaper of countrywide circulation published by a government enterprise called Berhanena Selam Printing Enterprise. Note that the problem of 'publishing accounts without the notes to them' is also seen in other countries (IAIS, 2005b, at p. 32).

663 They also distribute them to researchers only subject to support letters.

664 The NBE, of course, publishes list of the licensed financial institutions and some major developments in the banking, insurance and microfinance markets in its quarterly and annual reports. It does not, however, publish full supervision reports about the markets and institutions in respect of its instruments of regulation and achievements. Its publications also focus more on the banks than the insurers and the microfinance institutions. The release of its quarterly and annual reports is also always delayed by more than a quarter and a year, respectively. Its supervision departments do not also discuss their inspection and off-site reports with the management of the banks, insurers and microfinance institutions as the law requires. Note the quarterly and annual reports of the NBE; TGE, 1994a, at art. 20(2)(c); FDRE, 2008b, at art. 30; FDRE, 2009, at arts. 15 & 20; NBE BSD, 2005, at pp. 40-42; and NBE ISD, 2005, at pp. 96 & 103-104.

to back this.[665] They often reverse the disclosure principle and privacy exception and this is aggravated by vagueness of the privacy exception in the laws.[666] The country also lacks public and private information processing and rating agencies that can assist in the public disclosure of information by the financial institutions. All this has adversely affected the regulatory efficiency of the NBE and the making of prudential financial decision by the public. The NBE is hardly making fully informed decision in regulating the financial institutions while a large section of the public knows little about the financial and operational positions of the banks, insurers and microfinance institutions.

The NBE, therefore, needs to require the banks, insurers and microfinance institutions to make sufficient, reliable and timely reporting and disclosure of all information not restricted by law. It also needs to publish its own supervisory reports to the public on time by excluding only the information that may be expressly restricted by law for the privacy reason. It needs to follow up and enforce the reporting and public disclosure requirements so that it will enhance the enforcement of its regulation and the making of prudential financial decision by the public. The supervision laws also need to define clearly and narrowly the information that should be restricted for reason of privacy or public interest and require the reporting and public disclosure of all other information as a matter of principle. They need to require the financial institutions and the NBE to disclose information that relate to the capitals, reserves, investments, branches, service types, business diversities, asset qualities, liabilities, earnings, liquidities, capital adequacy levels, provisions and annual performances, among others, both timely and with sufficient detail.[667] They need to require timely publication of all the unrestricted information in newspapers of countrywide circulation and through websites of the institutions (and the NBE) and continuous deposit of it in the registers of the financial institutions and the NBE for public consultation in order to enhance dissemination.[668] They also need to require the NBE and the financial institutions to automate their off-site reporting processes. The country also needs to encourage the creation of information processing and rating agencies that may assist in the pubic disclosure of information with the necessary regulation.

665 TGE, 1994a, at art. 20(2)(c); FDRE, 2008b, at art. 30(2); TGE, 1994b, at art. 24; FDRE, 1996g, at art. 24; NBE BSD, 2005, at pp. 40-42; and NBE ISD, 2005, at pp. 96 & 103-104.

666 The supervision laws set the privacy exception without clearly specifying the information that should be kept secrete for the reason of privacy (TGE, 1994a, at art. 31; FDRE, 2008b, at arts. 28(4) & 55; TGE, 1994b, at art. 24; FDRE, 1996g, at art. 24; and FDRE, 2009, at arts. 15(4) & 18(6)(b)).

667 The banking supervision department of the NBE has already shown intention to prescribe the information the banks should publish to the public (NBE BSD, 2005, at p. 43). This has to be backed by law so that it will get full force.

668 These measures may, of course, imply cost to the financial institutions. The question is, however, whether to give more value for public information than the cost it may imply or the vice versa. The country needs to favour the provision of information (and look for ways of addressing the cost) since the public disclosure of information is critical to enhancing the making of prudential financial decision.

2.3.4 Systemic Stability Regulation

2.3.4.1 Regulation of Interest, Foreign Exchange and Premium

i. The International Experience

The regulators in many of the developed market countries follow liberal approach in the regulation of interest, foreign exchange and premium.[669] They set ceilings or fully allow the determination of interest rates by the market.[670] They follow floating foreign exchange systems that make the exchange rate risks remain largely within the banking system or fixed systems that make the risks absorbed by their central banks.[671] They also either apply file and use or use and file procedures to enable the approval of premium rates by their regulators or fully recognize the determination of these rates by competition in the market.[672] The European countries used to require:

- compliance to official rates or maximum and minimum ceilings;
- prior submission of premiums to the regulators for approval;
- proof of certain loss experience as basis for premium calculation to the regulators; and
- use of statistics, defined risk categories, and official inputs (such as official mortality tables in life insurance) in the past.[673]

They have followed liberal approach when the European Commission prohibited the use of ex-ante controls of premium rates and contract conditions except as part of a general price control system.[674]

Most of the US states also used to require approval of the rates of property and casualty insurance and any adjustment on them by the insurance commissioner (or a rate-setting board) or to require justification of the rates and the changes on them by loss experience and sound actuarial valuation before they are put into use.[675] Some of them currently follow a ‘file and use’ or a 'use and file' system (to enable the insurance companies to operate with their rates after approval of the regulators in the former case or without waiting for response of the regulators in the latter case) while the others make the rates open to competition and impose solvency and financial reporting requirements to control the risk of destructive risk-taking under expectation that the force of competition will keep the rates at reasonable levels.[676] A number of the states also vary their regulations between lines of property and casualty insurance (such as between automobile insurance, workers’ compensation insurance, homeowners’ insurance, commercial insurance,

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669 Thimm, 1999, at pp. 171-179; Edwards, 1999; Möschel, 1991, at pp. 85-86; Pfennigstorf, 1996, at pp. 121-125; and IAIS, 2005b, at pp. 20-21.
670 Möschel, 1991, at pp. 85-86.
671 Möschel, 1991, at p. 86; Edwards, 1999; and Solomon Jemaneh, 1999.
672 Pfennigstorf, 1996, at pp. 121-125.
673 Thimm, 1999, at pp. 171-179; and Pfennigstorf, 1996, at p. 122.
674 Ibid.
675 Lemaire, 1997, at p. 36; Meier, 1988, at pp. 44 & 153-156; and Pfennigstorf, 1996, at pp. 123-125.
676 Lemaire, 1997, at p. 36; and Pfennigstorf, 1996, at p. 123.

general liability insurance, ocean marine insurance, surety insurance and re-insurance) and tend to regulate the rates of workers' compensation schemes more heavily than the other lines of insurance.[677] Most of them also make the life insurers free from direct price regulation by requiring them to adhere only to mortality tables and reserve requirements that are meant to guarantee the payment of future claims.[678] The Insurance Service Office (ISO) and the National Council on Compensation Insurance (NCCI) of the country also used to provide rate advising and trended data publication services to the life and non-life insurers of the country until they stopped the rate advising services in 1989 and 1990, respectively, to continue only with the data publication service for fear that the insurers were using the rate advices for price fixing.[679]

Most of the transition and emerging market countries, however, tend to impose direct interest, exchange and premium regulations and the usual advice is to reduce the extent of direct regulation in the interest of competition and to adopt indirect instruments of regulation that can balance between the benefits and dangers of risk taking.[680]

ii. The Case of Ethiopia

Ethiopia had heavy regulation of interest and foreign exchange as of the beginning of its foreign exchange regime in 1942.[681] It started to control trade in foreign currency (and negotiable instruments denominated in foreign currency) by the Currency Proclamation No. 31 of 1942 and established its foreign exchange control system by the Currency (Amendment) Legal Notice No. 127 of 1949.[682] It made the function of interest rate regulation part of the central banking function of the State Bank of Ethiopia when it established it in 1943.[683] It dissolved the State Bank and transferred both functions to the National Bank of Ethiopia in 1963.[684] It controlled all transactions in foreign exchange and the use of foreign currency directly (through the NBE) until 1994.[685]

677 Meier, 1988, at pp. 7-11, 44-45 & 150-157; Lemaire, 1997, at p. 36; and Pfennigstorf, 1996, at p. 124.
678 Ibid.
679 Lemaire, 1997, at pp. 36-37.
680 Thimm, 1999, at pp. 171-179; Finsinger, Hammond and Tapp, 1985, at p. 16; Caddy, 1986, at pp. 154-177; and IAIS, 2005b, at pp. 20-21.
681 Some liberalization was introduced only in 1953 to freely allocate foreign exchange (Luther, 1961, at pp. 111-114).
682 IGE, 1942b; and IGE, 1949.
683 Luther, 1961, at pp. 111-114.
684 IGE, 1963d; IGE, 1963e; and IGE, 1963f.
685 It issued several foreign exchange control rules (in forms of regulations, amendments, notices and directives) as of 1977. The first comprehensive enactment was the Foreign Exchange Regulations - National Bank Of Ethiopia Notice No. 1/1997 (NBE, 1977), issued by the NBE on January 5, 1977 pursuant to an authority vested in it by article 61(3), 65, 67, and 73 of the Monetary and Banking Proclamation No. 99 of 1976 (PMGE, 1976i). The notice had full force until it was reformed under the Monetary and Banking Proclamation no. 83 of 1994 (See TGE, 1994 with the post-1994 foreign exchange directives of the NBE discussed below).

It has reformed the system and allowed the NBE to authorize the financial institutions to engage in foreign exchange transactions as of 1994.[686] It currently authorizes the NBE to:

- regulate the supply of money and interest rates of the financial institutions;
- regulate the use of foreign currency, the carrying out of foreign exchange transactions, and the exchange rates of the financial institutions; and
- prescribe the conditions, limitations and circumstances under which residents of the country and the financial institutions can hold foreign currency and instruments of payment in foreign currency.[687]

It also requires and authorizes the NBE to control the premiums of both the long-term and general insurers.[688] It requires it to ensure that the long-term insurance premiums are workable and sound to both the insurers and the insured and authorizes it to require examination of the rates by actuaries at any time when it suspects their soundness. It authorizes it to control the premiums and contract terms of the general insurers in order to safeguard the rights of the policyholders.[689]

The NBE has also reformed the interest rate and foreign exchange rules gradually. It fixed the interest rates of the banks directly until 1995.[690] It started to allow both the banks and the microfinance institutions to determine their deposit and lending rates within minimum and maximum ceilings in 1995 and 1996, respectively.[691] It continued to fix the minimum rates on savings and time deposits and the lending rates on its own credit and discount facilities and authorized the banks and microfinance institutions to fix their lending rates freely in January and June 1998, respectively.[692] It also amended the saving and time deposit rates of the banks and microfinance institutions separately until they became equal in 2002 and were merged in 2007.[693] It currently allows the banks and microfinance institutions to freely determine their lending, penalty and deposit rates provided that they make their saving and time deposit rates above the minimum it fixes.[694] It authorizes the boards of the banks and microfinance institutions to set the rates

686 TGE, 1994, at arts. 39 & 51-57.

687 TGE, 1994, at art. 51(3), 7(3), (4), (5), (6), 39, 40 & 51-57; FDRE, 2008a, at arts. 5(4), 5(5)-(6), 5(9)-(10) & 19-21; FDRE, 1996g, at art. 12(2)(f); and FDRE, 2009, at art. 28(1).

688 TGE, 1994b, at art. 36.

689 Ibid. The law does not authorize the NBE to control the premium and commission rates of the general insurers directly. It only requires and authorizes the NBE to supervise the terms of the insurance contracts to safeguard the rights of policyholders. TGE, 1994b, at art. 36(2).

690 Table 12(Chap. 2).

691 Table 12(Chap. 2) for the banks; and Directives No. MFI/09/96 & MFI/10/98 for the microfinance institutions. The NBE used to require the microfinance institutions to make their lending rates lower than 2% above the maximum lending rate of the normal banks and to make their saving and time deposit rates higher than 1% above the minimum saving and time deposits of the banks by the former directive. It increased the ceiling of the lending rates of the microfinance institutions to 15.5 percent per annum by the latter directive.

692 Table 12(Chap. 2) for the banks; and Directive No. MFI/11/98 for the microfinance institutions.

693 Table 12(Chap. 2) for the banks; and Directives No. MFI/09/98 up to MFI/13/2002 & MFI/19/2007 for the microfinance institutions.

694 Last column of Table 12(Chap. 2) for the banks; and Directive MFI/19/2007 for the microfinance institutions.

based on explicit and clear criteria to be reported to the NBE.[695] It also allows the banks to negotiate on their inter-bank lending rates.[696]

It has also authorized the commercial banks to engage in foreign exchange transaction through units called foreign exchange bureaux as of 1996 and allowed the foreign exchange bureaux of the commercial banks to operate at their own rates through time.[697]

It allocated foreign exchange directly based on administratively determined (official) rates until the introduction of auction regime in May 1993.[698] It enforced the administrative and auction regimes in parallel in the period between May 1993 and July 1995.[699] It introduced a weighted average rate system in February 1995 to facilitate the financing of imports between auction dates.[700] It unified the regimes in July 1995 and allowed application of the marginal rates computed from each foreign exchange auction to all foreign exchange transactions to be undertaken between auction dates.[701] It administered the exchange auctions bi-weekly until August 03, 1996 and weekly as of that date.[702] It subjected the auctions to a number of restrictive rules in the early years of the reform.[703] It allowed exporters and recipients of inward remittances to retain their foreign currencies in forex retention accounts to be opened in the commercial banks as of 1996.[704]

It delegated its foreign exchange functions to the commercial banks by introducing a transitional weekly wholesale foreign exchange auction system, and requiring the banks to meet open foreign currency positions, as of August 1998.[705] It authorized the banks to intermediate between exporters and importers without prior transaction-by-transaction approval of the NBE and to administer the financing of all imports and exports other than coffee as of the same year.[706] It allowed them to open forex retention accounts for resident government organizations, companies, institutions (other than diplomatic missions) and individuals in the same year so that the latter can keep their inward remittances in the accounts.[707] It also authorized the banks to retain foreign currencies in foreign accounts with their correspondents and to utilize the balances from the accounts for their intermediation functions subject to daily and monthly reports and ex-

695 Directives No. NBE/INT/8/2001; NBE/INT/9/2002; NBE/INT/10/2007; and MFI/19/2007.
696 Last column of Table 12(Chap. 2).
697 Directives No. FXD/01/1996; FXD/03/1996 (as amended by NBE, 1997b; and NBE, 1996c); FXD/09/1998; and FXD/17/2001.
698 Public Notice of the NBE (NBE, 1993) as amended.
699 Ibid.
700 Public Announcement of the NBE (NBE, 1995a).
701 Public Notice of the NBE (NBE, 1995b).
702 Notices of the NBE (NBE, 1996a; NBE, 1996b; and NBE, 1997a); and NBE, 1999.
703 Notices of the NBE (NBE, 1996a; NBE, 1996b; and NBE, 1997a).
704 Directives No. FXD/02/96; No. FXD/04/96; and FXD/05/1998.
705 NBE, 1998a; and Directives No. SBB/23/97; SBB/27/2001; and FXD/07/1998 (as amended by Directives No. FXD/12/2000; FXD/13/2000; FXD/16/2001; FXD/18/2001; FXD/19/2001; FXD/20/2002; FXD/22/2004; and FXD/26/2004)].
706 Directive No. FXD/07/1998.
707 Directive No. FXD/11/1998.

post examinations by the NBE.[708] It allowed service providers of the country to accept and pay credit cards, foreign currency cash notes and travellers Cheques denominated in foreign currency as of that year.[709] It also introduced an inter-bank foreign exchange market in September 1998 to enable the commercial banks to deal in their foreign exchanges and satisfy their unmet demands in between the weekly wholesale auctions.[710] It also allowed them to freely transact in foreign exchange with their clients, to respect the open foreign currency position requirement and to make daily operational reports as of that year.[711]

It phased out the transitional weekly wholesale foreign exchange auction market and replaced it by a daily inter-bank foreign exchange market in October 2001.[712] It allowed the banks to deal in foreign currencies other than the US Dollar in that year as long as they meet the open foreign currency position requirement and make transaction-by-transaction and daily reports.[713] It allowed the opening of non-transferable and transferable Birr accounts by diplomatic missions, government institutions, international organizations and individuals in the years before 2001 and introduced an inter-bank clearing system in 2001 to facilitate the transfer of foreign exchange for purpose of making payments between the indicated institutions and individuals.[714] It also allowed the banks to open time deposit and current accounts in US dollar, Pound Sterling, Euro and Yen for non-resident Ethiopians and non-resident foreign nationals of Ethiopia origin as of 2004 with a view to encouraging the inflow of foreign direct investment and growth of the foreign exchange reserves of the country.[715] It currently regulates the level of foreign exchange holdings of the residents of the country under a directive issued in 2007.[716]

The NBE does not, however, regulate premiums of the insurers. Its insurance supervision department does not also evaluate the premium and commission rate proposals of the long-term insurers for lack of expertise although it receives these proposals from the insurers with actuarial certificates.[717] The Ethiopian insurers, therefore, seem to follow a file and use approach in practice although the law requires the prior approval of their rates and contract terms by the NBE.[718]

The interest and foreign exchange rules of Ethiopia are commendable since they enable prevention of the interest and foreign exchange risks of the banks and microfinance institutions and encourage credit. They make the banks and microfinance institutions less prone to rate change and foreign currency risks. Both the NBE and the boards of the banks and microfinance institutions avoid

708 Ibid.
709 Directives No. FXD/06/98; FXD/21/2003; and FXD/23/2004.
710 Directive No. IBM/01/1998. It also enacted a code of conduct for the market (NBE, 1998b).
711 Notice of NBE (NBE, 1998a); and Directive No. FXD/11/1998.
712 Directive No. IBFEM/02/2001.
713 Directives No. IBFEM/02/2001; SBB/23/97; and SBB/27/2001.
714 National Bank of Ethiopia, Letter of May 4 2001- Ref: IBOD/162/01, 4 May 2001 (NBE/ 2001).
715 Directives No. FXD/24/2004; and FXD/25/2004.
716 Directive No. FXD/34/2007.
717 NBE ISD, 2005, at pp. 19-21.
718 TGE, 1994b, at art. 36.

the disturbance of existing transactions by applying their interest rate rules in prospect (i.e. as of the dates of their enactment).[719] The banks also square their excess long foreign currency positions as strictly as the NBE requires them to do so.[720] The NBE also intervenes in the inter-bank foreign exchange market actively to control undesirable rate changes and the banks follow orders of the NBE during enforcement of their exchange rates. The banks are also allowed to offset the potential risks of rate change by selling their foreign exchanges to the public at freely negotiable rates.[721] The NBE also applies its minimum deposit rate ceilings as pacesetter of the interest rate determinations of the banks and microfinance institutions, hence, as means for its monetary and financial policy intervention to stabilize the markets. It also adjusts the minimum ceilings from time to time.[722]

The NBE, however, needs to build its risk absorption capacities, urge the banks and microfinance institutions to build these capacities, and continue to shift its roles from direct to indirect control of the interest and foreign exchange markets in order to both enhance competition and ensure the health of the institutions.[723] It also needs to pursue cheap money (i.e. low interest) policy with appropriate regulation in order to maximize the advantages of this policy. A cheap money policy is said to have the advantages of making credit cheap and encouraging investment.[724] It may, of course, also have the disadvantages of discouraging saving, encouraging speculative borrowing and increasing inflation if it is not followed by policies that discriminate between productive and unproductive loans and stabilize prices.[725] The NBE needs to take care of both the advantages and disadvantages and encourage the banks and microfinance institutions to minimize the disadvantages by discriminating between productive and unproductive credits.[726]

The NBE also leaves the premium rates and terms of both the general and long term insurers to discretion of the insurers in practice and both the consumers and the NBE hardly know about the grounds of the rates and terms of the insurers. Nor do the insurance auxiliaries play a role in the determination of the premium rates and terms as the insurers often tend to offer the rates and terms on a take-it-

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719 Directives No. NBE/INT/1/1992 up to NBE/INT/10/2007; MFI/09/96 up to MFI/13/2002; and MFI/19/2007.

720 NBE BSD, 2005, at p. 47.

721 Directive No. FXD/11/1998; and NBE, 1998a.

722 Second row of Table 12(Chap. 2) for the banks; and Directives No. MFI/09/98 up to MFI/13/2002 & MFI/19/2007 for the microfinance institutions.

723 Both the NBE and the banks also lack the capacity to supply foreign exchange to banks that may fall in short position and this has to be improved (NBE BSD, 2005, at p. 47; and Andualem Berhanu, 2000).

724 Jhingan, 2002, at pp. 343-344. A cheap money policy is also used as one of the means for recovery from the 2008 financial and economic crisis (AP, 2010; and Ricardo, 2010 for the US experience).

725 Ibid.

726 The commercial banks are in favour of making discrimination between categories of depositors and borrowers and diversifying their rates - they sometimes declare this in their annual reports. They, however, do little of the discrimination in practice. Their interest rates hardly discriminate between groups of borrowers and depositors. They only differentiate between the types of accounts and usually follow (or make little difference from) the recommended rates of the NBE. They also tend to avoid competition by maintaining similar margin rates. Note Table 12(Chap. 2) and the interest rates of the banks in the annual reports of the NBE.

or-leave it basis. The insurers also compete destructively in the determination of their premium rates and terms.[727] The NBE needs to regulate the premiums of the insurers and check their fairness more actively. It needs to require them to adopt clear premium rate and valuation rules and policies and to disclose these rules and the grounds for their premium rates to itself and the public.

The insurance supervision law of the country also seems to be more concerned with regulation of the premiums of the long-term insurers than the premiums of the general insurers.[728] The country needs to give equal attention to regulation of the premiums of both the general and the long term insurers as the size of the problem due to the general insurers is also high given the large size of the general insurance business in the country.[729] The NBE also needs to enforce the regulation through the prior approval approach since the file and use approach has not been useful in practice so far.

There is also informal foreign currency exchange market in the country which is often kown as black or parallel market and whose exact size is not known.[730] The country needs to formalize and regulate it in order to avoid market distortion.

2.3.4.2 Payments and Settlement Systems Oversight

i. The International Experience

Most countries consider the existence of efficient payments and settlement system and regulation of the medium of exchange as significant public policy concern.[731] They have, accordingly, allowed the evolution of their mediums of exchange from precious metals to currency and then to commercial instruments and authorized their central banks and financial market regulators to enhance the medium of exchange and to oversee the payments and settlement systems for the fundamental reason that increase in the efficiency of these systems will reduce the cost of transactions, ease and speed up payments, and enhance the efficiency of their economies. The developed market countries have gone further to:

- reform their payments systems as of the mid-1980s,
- allow electronic payments and fund transfers in the 1980s and 1990s, and
- integrate and internationalise their payments and settlement systems and enhance the roles of their central banks and financial market regulators to oversee their payments and settlement systems in the post 1990s period.[732]

727 Note annual reports of the insurers for the complaints; and NBE ISD, 2005, at pp. 19, 29 & 33.
728 TGE, 1994b, at art. 36.
729 The size of the general insurance business in the country is nearly 94% of the total insurance business (Table 8(Chap. 2); and the records and annual reports of the insurers for 2008 and 2009).
730 Note the reference to this market in the annual reports of the NBE.
731 Hubbard, 1997, at pp. 21-24; and Massimo Cirasino, et al., 2007, at pp. 1-3 & 5-12.
732 Benjamin, 2000, at pp. 20-30 & 189-221; and Massimo Cirasino, et al., 2007, at pp. 1-3, 5-12 & 18-19.

Many of the transition and emerging market countries have also exerted effort to integrate and modernize their payments and settlement systems in recent times in cooperation with the World Bank and the IMF.[733] The reforms have focused on enhancing the existing payments and settlement systems, defining and increasing the oversight roles of the central banks, adopting electronic payments systems, and enhancing international cooperation.[734] The G10 Payments and Settlement Systems Committee and the Financial Action Task Force on Money Laundering have also issued guidelines for the development and supervision of national payments systems which should be based on well defined and transparent legal system among others.[735]

ii. The Case of Ethiopia

Ethiopia started to modernize its medium of exchange and payments system in the 1940s. It authorized the Bank of Abyssinia to facilitate the making of payments (by cheque) and regulate the medium of exchange when it created and authorized it to act as both commercial and central bank as early as February 1906.[736] It developed its medium of exchange from use of precious metals to currency between 1942 and 1949.[737] It recognized the use of the Maria Theresa Dollar and the East African Shilling as legal tenders in 1942.[738] It made the Ethiopian Birr its official currency and authorized the State Bank of Ethiopia to print it, and to receive deposits in both the Birr and the East African Shilling, as of May 1945.[739] It required the Bank to convert the East African Shilling into the Birr as of July 1945 and ended the use of Maria Theresa as legal tender (by recognizing its tradability as valuable metal) as of November 1946.[740] It transferred the functions of facilitating the payments system and regulating the medium of exchange from the Bank of Abyssinia to the Bank of Ethiopia in 1931, to the State Bank of Ethiopia in 1943 and to the National Bank of Ethiopia in 1963.[741] It allowed the use of different commercial instruments, including bills of exchange, promissory notes and cheques, by the banks and the public as it codified its commercial code in 1960.[742] It authorized the NBE to continue to regulate the medium of exchange and the financial system when it re-established it in 1976.[743]

It has also authorized the NBE to regulate the medium of exchange and the financial system when it re-established it in 1994.[744] The NBE has also established

733 Massimo Cirasino, et al., 2007, at pp. 1-4, 5-12, 27-103 & 185-220.
734 Ibid.
735 Massimo Cirasino, et al., 2007, at pp. 253-259; FATF, 1996; FATF, 2004; and FATF, 2004a.
736 Bahru Zewde, 2002, at pp. 101-102; and NBE, 2001.
737 IGE, 1942c; IGE, 1945b; IGE, 1945c; IGE, 1946a; and IGE, 1949g.
738 The exchange rate between the two currencies was to be determined by the Ministry of Finance of the time. IGE, 1942c.
739 IGE, 1945b; and IGE, 1945c.
740 IGE, 1945b; IGE, 1946a; and IGE, 1949g.
741 NBE, 2001; IGE-MI, 1960, at p. 35; IGE, 1963d; and IGE, 1963e.
742 IGE, 1960, at arts. 715-895; and Winship, 1974, at pp. 24-25 & 84-99.
743 PMGE, 1976i; PMGE, 1985; and PMGE, 1988.
744 TGE, 1994.

the Addis Ababa Clearing Office since 1995 to facilitate the issuance, payment and clearing of payment instruments drawn against the banks (including Cheques, Drafts and Casher's Payment Orders).[745] It has also allowed service providers to accept and pay credit cards, foreign currency cash notes and travellers Cheques denominated in foreign currency as of 1998.[746]

The country currently requires the NBE to regulate the medium of exchange, provide payment and clearing services to the banks and other financial institutions, and establish, modernize and regulate the national payments, clearing and settlement systems.[747] The NBE has also established special office that studies the ways for transformation of the country's payments and settlement systems.[748]

The supervision departments of the NBE do not, however, actively oversee the country's payments and settlement systems partly because they consider this function as being outside the scope of their supervisory functions and partly because they consider their interventions unnecessary for a reason that the current payments and settlement systems of the country are not sophisticated enough to call for regulation.[749] The country's payments and settlement systems have also stagnated with the cash mode of payment. Most transactions are settled in cash (making the use of Cheques and other payment instruments only occasional) and the use of electronic payment systems is only in the beginning.[750] The use of bills of exchange and promissory notes is not also known to the public in the country.[751]

The NBE needs to actively engage in the development and regulation of the payments and settlement systems of the country and its supervision departments need to intervene proactively to cooperate with the banks and the other financial

745 NBE, 1995c.

746 Directives No. FXD/06/98; FXD/21/2003; and FXD/23/2004.

747 FDRE, 2008a, at arts. 5(1-2, 15), 16(1)(c) & 17-18.

748 It has also included the development of national payments and settlement systems in its most recent financial sector capacity building project (which is designed for implementation in cooperation with the International Development Association (IDA) of the World Bank) (See website of the NBE, accessed on the 20th of September 2007). It is also working on a draft national payments system proclamation. The consultants to the NBE on modernization of the national payments system have also issued study reports and proposed vision and strategic framework (NBE, 2010b).

749 The banking supervision department only circulates the list of delinquent current account holders and cheque issuers among the banks (NBE BSD, 2005, at pp. 4-5 & 74).

750 Only the Commercial Bank of Ethiopia, the Dashen Bank S.C., the Abyssinia Bank S.C. and the Zemen Bank S.C. have started to facilitate the withdrawal of deposits and making of payments through Automated Teller Machines and electronic cards while few hotels and some of the oil companies accept the credit cards of the Dashen and Abyssinia Banks and the Travellers' Cheques of tourists (Table 6(Chap. 2); Simeneh Teklu, 2005; and annual reports of the banks for 2008 and 2009).

751 The country had recognized the use of varieties of commercial instruments including bills of exchange and promissory notes when it enacted its commercial code in 1960. The banks and the public had also started to use bank Cheques during the Imperial time. The Military Government, however, discouraged the use of all these instruments and introduced only Casher's Payment Orders to facilitate the making of payments between government institutions, the banks and individuals. The post 1991 reforms have revived the commercial code regime for all the varieties of commercial instruments recognized in the code. The public has not, however, started to use the bills of exchanges and promissory notes yet.

institutions in order to transform the country's payments and settlement systems as many of the central banks and the financial market regulators around the world have done this so. The NBE also needs to require and encourage the banks, insurers and microfinance institutions to plan and work on modernization of the country's payments and settlement systems more actively than they have done so far. It needs to require and encourage them to disseminate the use of commercial instruments, pursue the introduction of electronic payments systems, and expand their services to the wider public. It also needs to upgrade the Addis Ababa Cheque Clearing Office to a National Clearing Office to facilitate the use and clearing of all commercial instruments across the financial institutions of the country as long as these instruments continue to be important.[752]

2.3.4.3 Emergency Liquidity Support, Lender of Last Resort and State Ownership

i. The International Experience

Many countries use public fund to support financial institutions in one of three forms.[753] In the first form, the state owns the banks, insurers and other financial institutions and bears a *de jure* obligation to guarantee their obligations. In a second form, central banks, large domestic banks or the supervisory authorities overcome temporary liquidity bottlenecks that solvent financial institutions may occasionally experience or a decision maker (who is assumed to be in possession of better insight and information about the market than the financial institutions) arranges long-term correcting measures for the financial institutions in problem. In a third form, public fund (mostly arranged by central banks and sometimes by the government, the central banks, the deposit insurers, and/or the large commercial banks) is used as lender of last resort to enable the recovery of financial institutions from true insolvency.[754]

The state ownership approach has declined in a number of countries through time. The developed market countries used to have it for a number of reasons four of which were dominant:

- to promote the development of home-grown banks (and counter the power of strong private banks at the early stage of economic development);
- to ensure consistency of economic growth with national objectives;
- to ensure credit to underdeveloped groups or sectors such as agriculture and small businesses; and
- to manage financial crises.[755]

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752 The NBE has already indicated intention to do this in its strategic plan of 2004/2005 although the intention has not materialized yet (Simeneh Teklu, 2005, at p. 10). It is important that the NBE implements the intention.

753 Möschel, 1991, at pp. 87-88; Pfennigstorf, 1996, at pp. 52 & 138-141; Caprio, et al., 2004, at pp. 1-371.

754 Möschel, 1991, at p. 88.

755 Caprio, et al., 2004, at p. 2.

All of them (to the exception of Germany and USA where one finds some state owned or sponsored institutions) have, however, privatised and almost eliminated the state ownership of financial institutions as of the late 20th century.[756] The state ownership approach has existed in the transition and emerging market countries for reasons similar to the aforementioned and more so for political reasons.[757] Some of these countries have, however, also privatised, closed or shrank the size of their state owned banks as the economic reasons for and the efficiency of the state owned institutions are questioned in the post 1990s period.[758] Many of the others have also agreed on the weak performance of the state owned financial institutions although they have resisted to the privatisation idea.[759]

The lender of last resort measure has become increasingly important and is often implemented by the regulators in many countries with rehabilitation measures short of liquidation to prevent credit crunch and bank run and to ensure integrity of the payments and inter-bank funding systems.[760] The rehabilitation measures are usually graduated according to the level of failure of the financial institutions.[761] The basic operating principles of the lender of last resort measure are also changed in practice. It served originally as short-term measure at the discretion of the central bank to prevent temporarily illiquid, but solvent, financial institutions from failing and creating systemic and contagious crisis.[762] It was then applied to true insolvency, rather than temporary illiquidity, situations.[763] It currently serves as one of the steps of the regulator to recover a truly insolvent financial institution during crisis situation.[764] Many of the countries have also introduced the most common method of financing temporary illiquidity of the financial institutions from the funds of a central bank which is known as repo-transaction.[765]

The internationalization and interdependence of the financial markets across the world in the post 1980s has also triggered discussion on the role of the IMF as international lender of last resort while the 2008 financial and economic crisis has also shown the use of public fund as lender of last resort (and the state takeover of the financial institutions in some cases) to assist the recovery of the financial institutions from systemic crisis and re-triggered the discussion on the use of national and international lenders of last resort during crisis situation.[766] The

756 Ibid. The OECD has also reported that the sale of financial institutions (including banks) has been the second largest area of privatisation activity next to the telecom industry in the major OECD countries (including those in central and eastern Europe) until 2001 (OECD, 2002b, at p. 51).

757 Caprio, et al., 2004, at pp. 2, 9, 13-49 & 279-313.

758 Caprio, et al., 2004, at pp. 1-9, 13-71 & 279-313.

759 Ibid.

760 Hall, 2003, at pp. 45-50 & 54-55; Lastra, 1999, at pp. 341-345, 346-350, 352-354 & 361; Möschel, 1991, at pp. 88-90; and Pfennigstorf, 1996, at pp.138-141.

761 Ibid.

762 Hall, 2003, at pp. 45-50 & 54-55; and Lastra, 1999, at pp. 341-345; 346-350, 352-354 & 361.

763 Ibid.

764 Ibid.

765 This is transaction between the central bank and the financial institutions that enables the temporary selling of claims to the central bank with promise to repurchase. Valdez, 1993, at pp.101-102.

766 The discussion has focused on the need for i) enhancing the effectiveness of the public safety net, deposit insurance and other failure resolution mechanisms; ii) addressing the moral hazard, anti-

discussions have not, however, resulted in the creation of international lender of last resort institution yet and the aftermath of the 2008 financial and economic crisis has only been towards strengthening the risk monitoring, official lending and financial stability roles of the IMF and the failure resolution regimes and capabilities of the national regulators.[767] The EU has also been considering the legality of the lender of last resort role of the European Central Bank and the use of state fund to assist the recovery of the financial institutions in crisis under the rules of state aid.[768] Its 27 member states have established a European Financial Stability Facility (EFSF) as of May 09 2010 which may issue bonds and other debt instruments on the market (on its own as well as in combination with the EU Financial Stabilization Mechanism and the IMF facilities) to raise funds that may be needed to provide loans to the 16 Euro area countries that may face financial trouble.[769] The Euro area countries are, accordingly, using the lending facilities of the EFSF, the EU and the IMF to cure the twin problems of fiscal (debt) and financial market (banking) crises in the absence of international lender of last

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competitiveness, abusive use & other side effects of the protection mechanisms (such as by introduction of risk based contributions); iii) developing a more formal framework for the public fund guarantee (safety net) mechanism; iv) sustaining the financing of the protection mechanisms by means that can balance between the use of tax payers' money and other sources; v) developing the advance planning of the protection agencies to reimburse claims; vi) coordinating the responsibilities of the protection mechanisms and agencies; vii) strengthening the international cooperation and harmonization of approaches; and viii) developing an international institution and regime for crisis resolution (i.e. for lender of last resort, deposit insurance and insolvency proceedings) (Lastra, 1999, at pp. 350-352 & 354-361; Sharma, 2000, at pp. 59-62; Yilmaz Akyüz, 2002, at pp. 17-21; Feldstein, 2003, at pp. 1-29; Alexander, et al., 2006; Su, 2007; LaBrosse, 2007; Atay, 2007; Kaufman, 2007; Blair, et al., 2007; Campbell and LaBrosse, 2007; Campbell, 2007; Lastra, 2008; Sebastian Schich, 2008; Sebastian Schich, 2008a; LaBrosse, 2008; Cariboni, et al., 2008; OECD, 2008c; Sebastian Schich, 2009; Sebastian Schich, 2009a; Gert Wehinger, 2009a; Milne and Wood, 2009; Christoph Ohler, 2009, at pp. 23-24; Hans Blommestein, 2009; Hans Blommestein, 2009a; Hans Blommestein and Arzu Gok, 2009; Hans Blommestein and Arzu Gok, 2009a; Aviram Levy and Sebastian Schich, 2010; Ayadi and Lastra, 2010; Cariboni, et al., 2010; Thorsten, 2010; Rob and Sylvester, 2010; Moschella, 2010; Olivares-Caminal, 2010; AP, 2009b; BBC, 2009b; IMF, 2009; Economic Times, 2010; and Economic Times, 2010a).

767 Lastra, 1999, at pp. 350-352 & 354-361; Sharma, 2000, at pp. 59-62; Yilmaz Akyüz, 2002, at pp. 17-21; Feldstein, 2003, at pp. 1-29; Andreas Freytag & Gernot Pehnelt, 2008; Moschella, 2010; IMF & FSB, 2009; Reuters, 2009; and AP, 2009c.

768 The recent discussion in Europe has also been on the appropriateness of using taxpayers' money to save failing financial institutions. Lastra, 1999, at pp. 350-352 & 354-361; and Christoph Ohler, 2009, at pp. 23-24.

769 The EFSF is created as temporary facility to live for three years (i.e. up to 30 June 2013) and until its last obligation is fully repaid. It is headquartered in Luxembourg. It gets treasury management services and administrative support from the European Investment Bank. It is supposed to issue the bonds and other debt instruments on the market with the support of the German Debt Management Office. The bonds and debt instruments it may issue are backed by guarantees of up to €440 billion given by the 16 Euro area member states in proportion to their shares in the paid-up capital of the European Central Bank. It may also be combined with loans of up to €60 billion from the European Financial Stabilization Mechanism of the EU (which relies on funds raised by the European Commission using the EU budget as collateral) and up to €250 billion from the IMF to raise a total financial safety net of up to €750 billion. It acts when a Euro area member state is unable to borrow from the markets at acceptable rates, a support request is made to it by the member state, a country programme is negotiated by the member state with the European Commission and the IMF, the country programme is accepted unanimously by the Euro area finance ministers, and a memorandum of understanding is signed. (AP, 2010b; and Wikipedia, 2010). The transformation of the EFSF into permanent financial stability mechanism is also being discussed (Note the 2011 news from the BBC and Euronews).

resort.[770] Bilateral loans from the non-Euro area countries such as UK, Sweden and Denmark are also being used for the purpose.[771]

ii. The Case of Ethiopia

Ethiopia authorizes the NBE to engage in credit and discount transaction with the financial institutions that are solvent in principle but may face temporary liquidity problems.[772] It also authorizes the NBE to put the banks, insurers and microfinance institutions under receivership process or to takeover their management temporarily when that is necessary to rehabilitate them from a crisis situation.[773] It does not, however, authorize the NBE to be lender of last resort in the modern sense of the concept, i.e. to extend credit to a bank, insurer or microfinance institution that encountered true insolvency or systemic crisis situation. It does not also empower and require it to assume or create a fund (except for the deposit insurance fund for the banks) which can assume the loss of the financial institutions during the true insolvency or crisis situation.[774] The federal and regional governments of the country also bear *de jure* obligations only to guarantee the obligations of the banks and insurers and the microfinance institutions which they own or in which they participate to the extent of the capitals they have allocated.[775] The country does not also accept the system of repo-transaction known elsewhere to curb temporary non-liquidity problems of the financial institutions.[776] It has, instead, introduced the inter-bank money and foreign exchange markets to make the commercial banks engage in lending businesses to finance their liquidity shortages without involvement of the NBE.[777] The NBE has also introduced a discount window facility from its funds to curb the temporary non-liquidity problems of the banks in their domestic operations and a foreign exchange lending facility from its reserves to protect them from

770 Greece and Ireland have used the facilities so far. AP, 2010b; AP, 2010c; Bloomberg, 2010a; and Business Insider, 2010.

771 Bloomberg, 2010a.

772 TGE, 1994, at arts. 25, 33 & 34; and FDRE, 2008a, at arts. 13(2) & 15(1)(b) & (d).

773 TGE, 1994a, at arts. 22-25a; FDRE, 2008b, at arts. 33-48; TGE, 1994b, at arts. 27-28; FDRE, 1996g, at art. 24; and FDRE, 2009, at arts. 19 & 28(1). The takeover measure on the insurers is limited to the long-term insurers (TGE, 1994b, at arts. 27-28).

774 TGE, 1994; TGE, 1994a; TGE, 1994b; FDRE, 1996g; FDRE, 2008a, at arts. 5(18) & 25; FDRE, 2008b; and FDRE, 2009.

775 The federal government fully owns the Commercial bank of Ethiopia, the Development Bank of Ethiopia, the Construction and Business Bank S.C. and the Ethiopian Insurance Corporation and the capital of these banks and insurer is allocated, paid in cash or kind, and adjusted by the government under advice of the public financial institutions supervisory agency (TGE, 1994d; TGE, 1994e; TGE, 1994f; TGE, 1994g; FDRE, 2003; and FDRE, 2004aa). The regional governments also participate in the ownership of up to 97% of the capitals of the relatively big microfinance institutions (Table 10(Chap. 2); and the annual and quarterly reports of the NBE for 2008, 2009 and 2010).

776 The introduction of repo-transactions was discussed in the country in 1997 and 1998. The discussion has not, however, led to introduction of the system for fear that the NBE may end up in financial difficulties.

777 Note the discussion under the 'interest, foreign exchange and premium regulation' subtitle above. The commercial banks have engaged in the money market in overnight up to five years lending and borrowing transactions on bilateral basis. They have also engaged in the foreign exchange market to meet their foreign exchange deficiencies on weekly basis until October 25 2001 and daily basis as of that date. See the annual and quarterly reports of the NBE for 1998 up to 2010.

similar problem in their international banking operations.[778] It has also created an export credit guarantee scheme to assist the banks in the absorption of losses that may arise in their export financing businesses.[779] It, however, seems in practice that Ethiopia pays little attention to the merits of indirect use of public fund and puts high value on direct ownership and involvement of the government in the conduct of the financial businesses.[780]

Adoption of the free market principle in the country justifies no state ownership of the financial institutions. Private ownership, competition and innovation are necessary for improvement in the financial system. Competition laws may also be adopted to correct competition as the latter may not always work. The transitory nature of the country's economy and the inadequacy of the financial institutions to meet the financing needs of the country, however, also justify direct government intervention. Such intervention is not, however, also justified in the long run as long as its objectives can be achieved through adoption of the competition mechanism and regulation. Government ownership can only be justified in such cases by ideological consideration, by need to raise public fund or by need to use the government banks, insurers and microfinance institutions as pacesetters of the operation in the financial market. Government ownership is also meaningless when it harms competition through market dominance, allows political interference in the operation of the financial institutions, puts the government in conflict of interest as owner and regulator of the financial businesses, and sustains under-performing government institutions (as this has been true in both Ethiopia and the many other developing countries).[781] It is desirable for these reasons that both the federal and the regional governments of Ethiopia withdraw from owning the banks, insurer and microfinance institutions in the long run and focus on other forms of intervention.[782] The country needs to shift its emphasis from state ownership, hence *de jure* obligation of the state, into use of forms of regulation that can equally promote the objectives that are to be promoted by state ownership of the financial institutions. The withdrawal, however, needs to be gradual to enable the building of both market and regulatory capacities since both

778 NBE BSD, 2005, at p. 72; NBE, 2005/2006 (1)), at p. 51; and the annual reports of the NBE for 2006 and thereafter.

779 The NBE has started the scheme by carrying out both the guarantee and the regulation functions by itself. It has transferred the guarantee function to the Development Bank of Ethiopia (and retained the regulation function) as of the 1st of February 2007. Directives No. ERD/001/99; ERD/002/2000; ERD/003/2001; SBB/33/2002; and SBB/41/2007.

780 Note the market dominance of the government institutions from Tables 10(Chap. 2), 19(Chap. 2) & 20(Chap. 2); and the records and annual reports of the banks, insurers, microfinance institutions and the NBE.

781 Tables 10(Chap. 2), 19(Chap. 2), 20(Chap. 2), 21(Chap. 2) & 22(Chap. 2) and the records and annual and quarterly reports of the banks, insurers, microfinance institutions and the NBE for 2008, 2009 and 2010 for comparison of the market shares and performances of the banks, insurers and microfinance institutions in Ethiopia; and Caprio, et al., 2004, at pp. 1-371 for general assessment of the situation in the other developing countries.

782 The federal government had started to process privatization of the Construction and Business Bank of Ethiopia S.C. through the Ethiopian Privatization Agency (EPressA, 2003a). The process currently seems to be aborted. Both the federal and the regional governments have not also shown interest to privatize the other banks, the insurer and the microfinance institutions they own. They seem to be determined to sustain their ownerships.

the financial institutions and the NBE currently suffer from weak capacities.[783] It may flow from de-monopolisation, to contracting out of management, to lease or affermage, and finally to divestiture.[784] The country also needs to enhance the inter-bank money market and aim at controlling the risk of financial failure through the lender of last resort mechanism along with the aforementioned and other regulatory measures.[785] It needs to enable and require the NBE expressly to exercise the role of lender of last resort during both crisis and non-crisis situations.

The use of public fund as lender of last resort has also advantages and disadvantages.[786] It can be used to minimize the direct private costs of the banks and insurers as well as the social costs involved in the loss of confidence in the banking and insurance markets. But, knowing the existence of lender of last resort may have moral hazard effect like the deposit insurance and other fund guarantee schemes. It may stimulate the banks, insurers and other participants to engage in risk-affected conduct and this tendency needs to be restrained, such as by charging punitive rate of interest, threatening that the shareholders may also lose in the event of catastrophe, and introducing a loss sharing system between the banks, insurers and creditors. The regulator should also be made responsible for the careful use of the lender of last resort measure. The operation of the means of lender of last resort can also be effective if the lender of last resort fulfils three conditions: i) the existence of capacity to assess the emergency situation and conduct a cost-benefit analysis of intervention, ii) the existence of ability to exercise control over the risk-affected conduct, and iii) the existence of necessary resource for disposal.[787] The country needs to take care of all the aforementioned in developing the lender of last resort scheme and require the NBE to cautiously regulate the adverse effects of the use of lender of last resort and fund guarantee services.[788]

783 Note the discussion under the means of enforcement chapter below.

784 De-monopolisation is a process of forcing public enterprises to compete with private firms. Contracting out is a process of allowing management of the government enterprises by domestic or foreign private firms which do not take the commercial risks. Lease or affermage is a scheme where a private firm manages public assets and accepts commercial risks that are associated with operation and maintenance, not investment. Divestiture is a process of selling public assets to the private sector. The country has already started to de-monopolize the financial market by allowing the government banks and insurer to compete with the private banks and insurers and increasing the market shares of the latter although the government banks and insurer still dominate. The government and the NBE have also generally welcomed the contracting out of management of both the private and public banks to improve their performances. These need to be enhanced. See Tables 19(Chap. 2) & 20(Chap. 2); EPRDF, 2000, at pp. 196 & 208; EPressA, 2003a; and the annual and quarterly reports of the NBE for 2008, 2009 and 2010 for the developments.

785 It may also consider the use of open market instruments such as the repo-transaction as its financial market grows to include a securities market.

786 Lastra, 1999, at pp. 340-345, 352-354 & 345-346; and Möschel, 1991, at pp. 89-90.

787 Lastra, 1999, at pp. 341-346 & 352-354; and Möschel, 1991, at p. 89.

788 The NBE has also used the punitive interest and loss sharing techniques to discourage the rise of moral hazard in the export credit guarantee scheme (Directives No. ERD/001/99; ERD/002/2000; ERD/003/2001; and SBB/33/2002). These can be extended to the lender of last resort scheme along with the other measures.

The current methods of loss absorption (i.e. the discount window and foreign exchange lending services of the NBE and the export credit guarantee scheme of the Development Bank of Ethiopia) can also only serve as solutions to temporary liquidity problems of the banks during non-crisis situation. The country needs to develop mechanisms of controlling liquidity problems during crisis situation. It also needs to expand the scope of the inter-bank money market and encourage participation of the insurers and microfinance institutions in it. The microfinance institutions can build their capacities and relationships with the banks and insurers and participate in the market both as borrowers and lenders through time. The insurers can also participate in the market both as borrowers and lenders if one considers these functions as forms of financing insurance business and investing insurance fund. The NBE needs to allow these and focus on regulation of the risk exposure of the financial institutions. The measures can also enable the NBE to encourage participation of the banks and insurers in the provision and development of microfinance and pave the way for development of a banc-assurance business in the country.

The country also needs to build the problem resolution capacity of the NBE. The NBE has not conducted a problem resolution process so far as none of the banks, insurers and microfinance institutions has become insolvent.[789] Only the bank supervision department of the NBE has been thinking about the need for preparing for this.[790] The country needs to encourage this and to make all the supervision departments of the NBE ready for curing problems of the future that may arise when the competition between the financial institutions grows to be fierce and the country liberalizes its financial market.[791] A good regulatory system should also include the following four stages of development which Ethiopia needs to take into account in developing its regulatory system:

i) a stage of developing the regulator’s capacity to enforce compliance with existing regulations;
ii) a stage of developing the regulator’s capacity to resolve problems;
iii) a stage of developing the regulated institutions’ capacity to manage risk; and
iv) a stage of developing the market’s capacity to share supervisory burdens.[792]

789 None of them has also failed by reason of the 2008 financial and economic crisis. The crisis has affected only the availability of foreign currency in the financial services sector and the price (and supply) of goods and services in the non-financial services sectors of the country (See annual and quarterly reports of the NBE, the banks, the insurers and the microfinance institutions for 2006 up to 2010).

790 NBE BSD, 2005, at pp. 13 & 73-74 as revised.

791 The non-liberalization of the financial market and the absence of fierce competition among the financial institutions of the country seem to have contributed to the current well-being of the institutions. The country's accession to WTO and the rise of the number of financial institutions in the country may, however, result in fierce national and international competition in the future and this may make financial institution insolvency inevitable.

792 Rocha, Hinz and Gutierrez, 2001, at p. 174 for detailed discussion of the stages.