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Financial Regulation and Supervision in Ethiopia

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Abstract
The Ethiopian financial sector is characterized by low level of development and relatively closed in nature than its east African neighbors. When we see the main financial development indicators in Ethiopia: branch to population ratio is 62,063[2]; percentage of adult population which has access to formal credit is 1.197% [3]and ranked 104[4] in the world in getting credit. Consequently the country's financial system is distinguished by its negative real interest rate (-22.5 for saving rate and -21.80 for lending rate)[5], 85.4% [6]of total loans required collateral and the required collateral as percentage of loan is 234%[7] which is the highest in the sub Saharan Africa. Regarding financial regulation there are two opposing theories; the financial repression school where taken financial regulation in the form interest rate control as important policy tool for developing countries and the liberalization school where considered privatization of the government owned financial institutions and financial liberalization as important policy tool for the sake of efficiency, soundness and to increase competition in the financial sector. In this regard even though the government Ethiopia acknowledges the importance of financial liberalization for the country financial development it follows gradualism approach to liberalization. For those reasons government intervention rate in the Ethiopian financial system is one of the highest (425.03%)[8]. In line with this the paper tries to analyze the trends of financial development, the mode of liberalization and type of regulation and supervision in Ethiopia financial sector.
Keywords: finical development, regulation, supervision, liberalization, Ethiopia

1. Introduction

A financial system is said to be developed if it produces and processes information on investment opportunities and challenges, allocates capital based on those information; monitoring individuals and firm's investments and puts forth corporate governance; managing risks; mobilizing and pooling savings; and easing the exchange of goods and services. When financial systems perform these functions poorly, it hampers economic growth, restrains economic opportunities, and destabilizes economies.

According to different opposing theories of finance, the financial system of a country fails to offer the allocated and governance functions of finance either due to government or market failures. According to the government failure hypothesis which is similar to the private interest view of regulation; the governments regulate banks in order to make government expenditures financing easy, direct credit to politically desirable ends, and to maximize the benefit and the decision power of politicians and bureaucrats on the economy. Whereas the market failure hypothesis states that markets fail due to: anticompetitive behavior, market misconduct, information asymmetries, and systemic instability. The first two components of the market failure (anticompetitive behavior and market misconduct) lead to inefficiencies of the financial market that requires being resolved through market regulation; however information asymmetries and systemic instability demand prudential regulation.

This market failures hypothesis is also in line with public interest view of regulation, where according to this view; governments initiated to regulate financial institutions in order to facilitate the efficient functioning of banks, insurance companies, and financial markets by reducing or eliminating market failures, for the good of the general public by allocating resources in a socially efficient manner. This socially efficient hypothesis does not necessarily mean in a Pareto Optimal manner. Rather, socially efficient entails that the financial system allocates the economy resources in a way that maximizes output, while minimizing output variation, and is

[2] NBE annual report 2011/12
[3] ADI
[4] ADI
[5] NBE annual report 2011/12
[6] ADI
[7] ADI
[8] ADI

"distributionally preferred" (Mishan, 1969).

From those opposing views one can see the difference between market and government failure, on the one hand central planning has failed, on the other hand the other opposite belief, that free markets are always good and the night watchman state is required, has been rule out because of market failure. For example Stiglitz (1989, 1993a) discusses that governments have a number of fundamental advantages and disadvantages compared with the market. The government has three advantages its ability: to tax, to punish and to ban. Regarding its disadvantages side, when compare to markets; the government may have less access to information.

When market fails to give its promises, it does not mean that the government should take over those markets. Instead, the government should take actions to correct market failure, therefore in this case government actions are complementary to, rather than a substitute for, the market. This is the essence of regulation.

When we see the Ethiopian case since financial markets rely only on banking, insurance and microfinance business whereas capital and stock markets are not developed, the government declares its role in the financial market as regulator and supervisor. Especially in its banking business Proclamation No. 592/2008 stated that "business of banking has a number of attributes which, if not managed properly, has the potential to generate financial system and macroeconomic instability; where its effect on the general public and the Government is significant." Therefore in order to guarantee safety, soundness and stability of the banking industry the government issued this proclamation.

In this paper I am trying to analyze in section II trends and performance of financial institutions in Ethiopia, in section III the paper attempts to analyze financial regulation in Ethiopia and in the last the paper analyzes the type and modes of financials supervision in Ethiopia.

2. Trends and financial performance in Ethiopia.

Before 1992 the Ethiopian economy was characterized as a command economy whereas after 1992 when the new EPRDF government comes to power a free market economy was declared as a result several private firms have flourished. Regarding the financial sector even though it has been opened for domestic investors it remains closed for the entry of foreign national investors, for this reason it remains less developed than many developing countries including its neighbors for example; Kenya, Sudan and Uganda. Similarly the Ethiopian banking sector as it was in the past regime continued cut off from the influence of globalization and global financial crises. Even NGOs whose aim is not profits are not allowed to directly engage themselves in credit and savings activities: with this regard Proclamation No. 40/1996 allows the provision of microfinance to be share companies owned only by Ethiopian nationals.

Even though the current government of Ethiopia acknowledges that liberalization of its financial sector is important for financial development, it follows the gradualism principle in liberalizing its financial market for fear of the following reasons;

1. Since foreign banks, have more capital and more experience, they can hinder the development of domestic financial sectors because they are too young, small in numbers and inexperienced to compete. Which is the infant industry argument for protection? This argument is also supported by domestic private financial investors.
2. As Ethiopian economy is agricultural and majority of its citizens (85%) are living in the rural areas and its credit policy favored the agricultural sector, small scale industries and rural dwellers. However when foreign banks enter the country, their credit policy can be skewed towards large scale industries due to their reputation and sufficient collateral and also foreign banks will focus lending to urban dwellers and industries using foreign funds, therefore their contribution towards the development of rural areas will be less.
3. Experience from developing countries shows that foreign banks are more interested in lending their foreign capital than in mobilizing domestic savings.
4. Because foreign banks are engaged in worldwide capital markets which may create foreign exchange shortages, this can have adverse effect on the balance of payments and capital account of the give the limited capability of the National Bank of Ethiopia in regulating and supervising the financial markets.

Even though the short-term capital inflow is controlled, other modes of supply are more open. For example Cross-border financial services are permitted for selected services; Ethiopian insurance companies buy reinsurance services from foreign reinsurers and Cross-border banking services exist but are limited to: (a) borrowing abroad by the government and some state-owned enterprises (e.g., Ethiopian Airlines, Ethiopian Telecommunication and Ethiopian Electric Power Authority) and (b) foreign borrowing by exporters without a government guarantee of foreign exchange availability(Ageba and Blenen,2008)

Similarly there is no prevention of purchasing financial services abroad, as long as carry out with foreign exchange regulations. Finally, in Ethiopian till now there are no licensed actuaries, for this reason Ethiopian insurance companies have been buying actuarial services from foreign (mainly Kenyan) actuaries. With this regard, the NBE has considered the possibility to authorize actuaries, loss assessors and loss adjustors licensed abroad to provide such services in Ethiopia. Furthermore, foreign professionals have been working in Ethiopia extensively as consultants in the financial sector (Ageba and Blenen, 2008)

After 1994, when private banks were allowed to be established a number of private financial institutions was established. Currently, the Ethiopian financial system consists financial institutions such as the National Bank of Ethiopia with aim to regulate the finance industry in the country, 17 commercial Banks ; 15 insurance companies; a public and private employed workers pension scheme; 33 Micro Finance Institutions. There are less developed financial markets in Ethiopian consist of government treasury and bonds markets and its re-discount facility; inter-bank markets; and saving and credit associations (ROSCAs). The Ethiopian financial system is also distinguished from other developing countries especially from its east African neighbors by the absence of: private corporate bonds and stock markets, financial institutions such as: private investment banks, lease companies, venture capital markets, and re-insurance companies.

Regarding its set up the banking system in Ethiopia somewhat looks like H- banking (hard- budgeting banking), like that of the system in the Republic of Korea. The most important characteristic of this type of banking is that it possesses strong ex- post discipline, which means unsuccessful firms and if they cannot improve their performance are cut off from credit facilities. However, the way credit is allocated for public institutions from publicly owned banks resembles the S-banking (soft-budgeting banking) like the banking system that of China. Where the most important characteristics this type of baking is it lacks ex-post discipline, under this system of banking even public firms that are unsuccessful and did not improve their performance from time to time continue to receive financing from the state banking sector and this gives managers and workers of the public enterprises little motive to improve the performance of the firms and failed to meet the intended goal they set. The implication of this type of banking is that, since the NBE unable to maintain responsible monetary policy because loans are extended to these inefficient firms and where they cannot generate a positive economic return. Doe to this the Bank tries to finance the loss by printing currency which leads to inflation, and eventually taxing the private sector and undermining investment and growth.

The banking sector in Ethiopia is characterized by concentration in terms of ownership where the state banks are dominant though their domination diminished from time to time. The total number of banks functioning in Ethiopia in 2011/12 reaches 17, of which 14 were private, and the remaining 3 state-owned. During this period, 319 new branches were opened raising the total branch network in the country to 1,289 from 970 in 2010/11.As a result, bank branch to population ratio declined from 65,415.834 people in 2010/11 to 62,063.6 in 2011/12. However, the share of private banks branch was 50.2 percent in 2010/11 and declined to 47.6 percent at the end of 2011/12 due to the Commercial Bank of Ethiopia (CBE) expands its branch expansion aggressively.

The total capital of the banking industry reaches Birr 18 billion (increased by 12.9 percent) in 2012; the share of private banks in total capital rose to 49.3 percent in 2011/12 from 45.3 percent in 2010/11. On the other hand, the share of public banks in total capital was 50.7 percent with CBE taking up the lion share (34.6%).

The population to financial service coverage in Ethiopia is low. According to the African development indicators of the World Bank data base percentages of adults which have accesses to formal credit was only 1.197% in 2006 and has increased to 1.86% in 2011. At the same time the number of depositors in commercial banks per 1,000 people was only 65.97 in 2006 and has increased to 114.76% in 2011. In general the financial services coverage in Ethiopia is far below international as well as African standards. The population-to-branch ratio in Ethiopia was only 62,063.6 as compared to other African countries like Ghana, Uganda South Africa and Namibia was 54,000, 130,000 11,136 and 20,074, respectively.

Despite the share of the private commercial banks out of the total opened branches was only 39.81%, the share of private banks in deposit mobilization was slightly went down as to 31.9 percent from 33.3 percent last year. Central Bank of Ethiopia alone mobilized 65.9 percent of the total deposit due to its wider branch network and the government allows only depositing citizens for its huge housing programs only in the government owned commercial bank of Ethiopia. Therefore the public banks still have a dominant position in deposit mobilization, taking about 68.1% of total deposits in 2011/12.

Owing to the less tight monetary policy followed by the National Bank of Ethiopia total outstanding credit of the banking system increased by 49.8 percent and reached Birr 116.3 billion in 2012. In this fiscal year fresh loan disbursements by banks, including the government owned Development Bank of Ethiopia (DBE) showed 32.9 percent increase reached Birr 56.1 billion. Of the total new loans disbursed by the banks, only 34.1 percent was by private banks and the rest was by public banks and still the public banks are in a dominant position. The private banks ratio of new loan disbursement of to their total deposit was 32.1 percent while that of public banks was 29 percent. When we the see the overall credit performance of the Ethiopians banks the overall credit surged by 39.5% whereas credit to the private sector grew by 56.7% while credit to the public sector slowed down by 24.8%. Domestic credit to the private sector as percentage of GDP was only 10.090% in 1996 and has grown to 17.84% in 2011/12, similarly one of the criteria to evaluate financial development is the number of firms with line of credit or loans from commercial banks as percentage of firms as with this about

46% have access to credit in 2006 and this has decreased to 15.8% in 2011. According to the World Bank African development indicators 2011 Ethiopia ranked 152 in 2006 and 104 in 2011/12 in getting credit, loans requiring collateral 96.3% in 2006 and 85.4% in 2011 and value of collateral need for loan as percentage of the loan amount was 173.1% in 2006 and 234% in 2011 which is the highest if we compare with sub Saharan African countries.

Although National Bank of Ethiopia initially put credit limit on banks, after a while the Bank has lifted credit ceilings on commercial banks. Recently the Bank issued a directive obliged banks to purchase 27% of their gross loans in NBE bonds channeled to the Development Bank of Ethiopia for lending to priority projects. The gross outstanding claims on the central government surged by 65.2% and public enterprises 102.3 percent, was partly because of this directive. Whereas claims on the private sector rose by 32 and cooperatives rose 64.1 percent. Regarding the allocation of credit; the share of the new loan disbursement to real sector (agriculture, industry and housing & construction) rose from 51.2 percent last year to 63.8 percent in 2011/12 reflecting the shift in loan from trade and other short term loans towards the production sector. This is one implication of the government of Ethiopia follows directing credit. Loan collection by the banking system increased by Birr 35.2 billion 15.2 percent higher than last year 52.5 percent of the loan was collected by public banks.

Even though interbank money market was introduced in September 1998 its performance is very week, this partly because of the existence of excess reserves in the banking system. For this reason since April 2008 no inter-bank money market transaction has been conducted but before that twenty three transactions with a value of Birr 259.2 million were conducted with interest rates ranging between 7 to 11 percent per year and maturity period from overnight to 5 years.

Regarding Interest rates; lending rates are free whereas deposits rates are subject to a floor set by the National bank of Ethiopia it was 6% until 2000/01, then reduced to 3% and increased to 4% in 2007. In 2011/12 the actual minimum interest rate on saving deposit was 5 percent and the maximum 5.75 percent. Consequently, average interest rate on savings deposits' remained at 5.4 percent. On the other hand, the weighted annual average interest rate on time deposits increased to 5.73 percent from 5.49 percent last year. Average lending rate, however, remained at 11.88 percent. This implies that the saving rate was only 3.08% in 2003/04 and has been increased in 2011/12 to 5.40% and the lending rate is 10.5% in 2003/04 and 11.88% in 2011/12 with only 2.32% increment in saving rate and 1.38% in lending rate whereas the average inflation from 2003/04 to 2011/12 has increased to 20.9 on average on a yearly basis. Therefore with this analysis we can infer that the real interest rate on saving was negative 12.72% in 2003/04 and surge to negative 22.75% in 2011/12 and lending only negative 7.27% in 2003/04 and negative 21.80% in 2011/12 which shows the government follows financial repression.

The other financial institution which is second in its importance in the financial development of the country is insurance. The insurance industry seems more competitive than banks and microfinance institutions. Besides this, the number of insurance companies increased to 15 from 14 in 2010/11. The number of branches also rose to 243 following the opening of 22 additional branches, where 53.1 percent of the total insurance branches were located in the capital city. Ownership wise, private insurance companies dominate accounted for 81.1 percent of the total branches. At the same time, the total capital of insurance companies increased by 25.6% to Birr 1.2 billion in 2011/12 this is mainly because the government introduces forced insurance for the third party for every vehicle and forced health insurance for government employees. Capital wise private insurance companies accounted for 73.3 percent of the total capital while one public insurance company alone accounted for 26.7 percent.

Similarly, the number of Micro-finance Institutions (MFIs) operating in the country was 33. The MFI interest rates range from 12% to 24% for lending and from 3% to 8% for deposits. Their total capital and total assets remarkably increased by 27.5 and 31 percent and reached Birr 3.8 billion and Birr 13.3 billion, respectively. Similarly their deposit mobilization and credit extension have witnessed a significant growth. Compared 2010/11, in 2011/12 MFI deposits goes up by 44.2% to Birr 5.4 billion while their credit provision rose by 32.9 percent to Birr 9.3 billion.

Regarding alternative financial developments other than banking, insurance and microfinance institutions Treasury bill market is the only primary market where securities are transacted. Secondary market for the security is not available. The government of Ethiopian issue bonds occasionally to finance its expenditure and to absorb excess liquidity available in the economy in general and banks in particular. In the Treasury-bill market, although the participation of banks have been improved from time to time, non-bank institutions especially the government owned pension scheme agency continued to dominate by holding 88.1 percent of the total outstanding Treasury-bills. In the past even the Government Issue bonds, since its minimum value was Birr 2 million and two year maturity period where in the absence of secondary market, those bonds were illiquid. For this reasons governments bond in Ethiopia can't serve as alternative instruments of saving both for consumers and investors. But nowadays the Government Issue bonds to finance its huge capital project the hydroelectric dam with a value of the bond starting from 25 Birr and interest rate 5% and maturity period a minimum of three years. This bond also not attracts the people due to negative real interest rate and long maturity period.

In 2011, NBE introduced National Bank of Ethiopia Bill in order to mobilize resource from banks to financing of some priority sectors identified as the driving forces for overall economic growth. Since its introduction the banking sector purchase NBE Bills about 12.84 billion Birr in 2011. Similarly Ethiopian Electric Power Corporation, regional states and Development Bank of Ethiopia also issue bonds.

In Ethiopia there is a trend of demonetization in the economy this is because of; high growth in reserve money, negative real interest rates and a shrinking Treasury Bills market. With this regard the development in the Monterey aggregates, domestic liquidity as measured by broad money (m_2) reaches 189.4 billion in 2011/12 with 30.3%growth rate with and ratio of m_2/GDP an indicator of financial deepening rose by 13.7% from 0.25% in 2008/09 to 0.32% in 2011/12.

3. Financial regulation in Ethiopia

The structure of financial development of a country especially developing countries has been widely discussed and highly debated. On the one hand the financial repression school noted that government intervention in the financial sector, especially through subsidizing interest rates and favored allocation of credit is important for economic growth of developing countries. On the other hand following McKinnon (1973), Shaw (1973) and the World Bank and the International Monetary Fund, financial liberalization has been given great emphasis for developing countries. While liberalizing its financial sector may bring economic and social benefits it also involves certain risks. Therefore weighing its benefits and risks carefully is important in deciding whether or not to liberalize.

In Ethiopia, because of its importance for economic development, the Government has taken a cautious approach towards financial sector reform. In introducing financial liberalization the Ethiopian government adopts a strategy of (a) gradualism: gradual opening up of private banks and insurance companies, and step by step liberalization of the foreign exchange market. (b) Intensification of domestic competitive capacity before full liberalization, strengthening the regulatory and supervisory capacity of the NBE, giving the banks autonomy, and strengthening the interbank money market (Geda and Dendir 2001). However the government position in case of privatization is very strong and did not have any sign either to privatize or to decrease its influence and dominance.

3.1. Types of regulation

3.1.1. Corporate governance

Initially Corporate governance is closely related with the founding of “corporate suffrage”, where each shareholder had one vote (Dunleavy, 1998). Its aim was to create “democracy” by reducing special privilege by restraining shareholder’s number of votes irrespective of the number of shares own, but now days it was already changed into “plutocracy” by moving towards “one-share–one-vote” and thus permitted for concentrated ownership and control [Dunlavy (1998)].

Based on this, researcher has identified five alternative mechanisms to mitigate corporate governance problem:

1. Creating partial concentration of ownership and control.
2. The regulatory body make hostile takeovers and proxy voting contests, temporarily in time of concentration of ownership or voting power
3. Delegation of concentration of control in the board of directors
4. By making the compensation plan of executives clear align managerial interests with investors
5. By making CEOs to have defined fiduciary duties

Regarding concentrations of ownership the National Bank of Ethiopia issued a directive whose aim is to limit for reduction and/or relinquishing shareholdings in directive no. sbb /47/ 2010. In this directive any person was not allowed, to hold more than 2 percent of a bank’s total shares either on his own or jointly with his relatives(his spouse or with a person who is below the age of 18 related to him). Similarly the Bank has given the power to limit: proxy votes in any meeting of shareholder, shareholders voting rights (who borrowed money from the bank) and may suspend the voting rights of an influential shareholder of a bank fails to fulfill the given ethical and propriety requirements.

Consequently, in order to have a clear compensation plan and to limit the remuneration of board members and number of employees’ that can be members of the board, the Bank issued Directive No. SBB/49/2011. In this directive the annual compensation to a director is limited to 50,000 Ethiopian birr, the monthly allowance paid to a director not to exceed birr 2,000 (two thousand birr). And it did not allow an employee of the bank to be aboard member. Consequently in this directive the Bank got the power to issue directives relating to appointment and suspension of directors.

Even though those regulatory frameworks have been trying to address in the Banks directives they fails to address the full elements of corporate governance. For example as it is in the other sector of the economy, the financial sector also lacks clear law on corporate governance where if the board of directors fails to meet the requirements by the Bank it only penalizes the bank 10.000 birr not the board members therefore this leads to lack of accountability . Similarly the Bank fails to address protection of small shareholders through investor's activism by representing them in the board members. At the same time there is no mechanism to set up board standing committee which is out of the influence of board members and directly responsible to the assembly. At last the directive did not influence the board members to focus on policy issues since in the Ethiopian experience board members focus on daily activity of the bank even in directing credit.

3.1.2. Restrictions on Banks, and on Links to Commerce

3.1.2.1. What is a "bank"?

Countries may limit banks to a specific range of activities, or allow them to engage in a broad activities, because these scope of activities basically defines what the term "bank," is, therefore banks may not be the same in every country around the world.

With regard to the meaning of a bank the National Bank of Ethiopia issued proclamation **NO. 592/2008** and define bank business as: receiving funds from the public, using the funds for loans or investment at the risk of the person undertaking banking business, buying and selling of gold and silver and foreign exchange; the transfer of funds to other local and foreign persons and the discounting promissory notes, drafts, bills of exchange and other debt instruments; are some of them.

3.1.2.2. **Scope of Bank Activities**

There are three regulatory variables that significantly affect the activities of banks: (a) Banks engage in **Securities**; such as underwriting, brokering, dealing, and all aspects of the mutual fund industry. (b) Banks engage in **insurance underwriting and selling**. (c) Banks engage **Real Estate** investment, development, and management.

On this issue the NBE issued **Directive No. SBB/12/1996** to limit the type of investment of banks may engage. Though the bank did not prohibit banks from engaging in securities, insurance and real estate it has put limit their level of investment. For instance the directive limits banks to invest not exceeding 20% in an insurance company, non-banking business and real estate and not to exceed 10% of the bank's equity capital, not to invest more than 10 % of its net worth in other securities and not to exceed 50% of the bank's net worth investing at any one time (excluding investment in government securities). Those limits show that the banking business in Ethiopia is highly controlled and similar point was shown in the World Bank African development indicators the central bank's intervention rate in Ethiopia was about 425%.

3.1.3. Limitations on Foreign Entry in the banking industry:

This regulation variable was captured using; if there is any restrictions placed for foreign banks to enter the domestic banking through: (1) Acquisition ;(2) Subsidiary; (3) Branch. Regarding foreign ownership of domestic banks the government clearly restricts foreign citizens or companies to; own banks fully or partially, open banks or branch offices or subsidiaries of foreign banks or purchase the shares of Ethiopian banks.

Ethiopia emerges exceptional compared to its neighbors Kenya, Tanzania, and Uganda and other developing countries in that it has not so far liberalized its banking sector. The Ethiopian banking sector still did not affect by the world's financial distress and is out of the impact of globalization. Although the ruling party understands the potential benefit of financial liberalization, believed, that liberalization may result in loss of control over the economy and may not be economically beneficial. For example the late prime minster which was the engineer of the current policy regime of Ethiopia argued that;

> "*When finance was liberalized the entry of foreign banks somewhat increased competition. The foreign banks have had to focus on the most profitable segments of the market and these happen to be the largest urban centers and the bigger corporate customers. They have therefore had a trend of reducing their presence in the smaller towns and rural areas and reducing their service to customers outside the large corporate sector. The new entrants have started with such a narrowly focused approach while the older ones have had to shift towards such a narrow focus. Clearly there has been little improvement in quality of service or range of service" (Zenawi, n.d).*

3.1.4. Interest rate regulation

Financial liberalization is closely related with interest rate deregulation and has been the agenda of various scholars of private interest view and the World Bank. On the other hand scholars of the public interest view recommend interest rate control as the main instrument of financial regulation for the following reasons:

1. Charging high interest rate on lending and low interest rate on saving is considered as exploitation therefore, according to the scholars of the public interest view, government should protect borrowers and depositors by setting a ceiling and floor on interest rates.
2. Governments must also implement interest rate controls to obtain cheap funds to finance their projects that are beneficial for the general public. On the other hand governments also control interest rates on the assumption interest rate controls can stimulate investment; this argument is based on the Keynesians notation that investment demand is decreasing in the interest rate. But this argument does not take into consideration where lower interest rates, can decrease the availability of funds for investment by decrease savings.

Regarding this the government of Ethiopia is in favor of the interest regulation. Initially the current government puts in to action both deposit and lending rate controls but after a time due to various pressures from the WB and IMF it lifts the lending rate and only limits the minimum deposit rate at 4% per year. But this interest rate is too low to attract private savers in time of high inflation experienced in the country. Similarly the NBE in its regulation also noted that in the scenario of rising interest rate, when liabilities re-price faster than assets, interest spread would fall and hence profitability of the bank would be adversely affected therefore to protect banks interest rate regulation is very important.

The main reason to implement this type of financial policy by the government of Ethiopia is that according to the late prime minster in his monograph the dead end the new beginning stated that "very high real rates of interest generated by financial liberalization depress investment. The consequence would naturally be to depress investment, reduce demand for credit and generate excess liquidity. High interest rates are also known to increase moral hazard and default risk. Therefore the country must work towards financial repression and it has succeeded admirably" (Zenawi, n.d).

3.2. **Prudential regulation**

When there is market failure due to information asymmetry and systematic instability in the financial sector demands prudential regulation. The dominant theories on prudential regulation focus on restricting banks capital structure and portfolio allocations. The most important regulation is the Basle accord which focuses on two ratios, namely; maximum leverage (equity over assets ratio) and risk weighted capital requirement. The Basel accord specifies that bank capital should not fall below 8 per cent of the weighted sum of risky assets.

3.2.1. Capital Requirements

Capital requirement is one of the areas of government regulation on banks because with limited liability, owners may have an incentive to engage in riskier ventures, and minimum capital requirements become important in determining the amount that bank owners must have at risk (Lamoreaux, 1994). Capital adequacy one of the components of capital requirement could play a crucial role in aligning the incentives of bank owners with depositors and other creditors (Berger, Herring, and Szego, 1995); The main reason for banks to have capital adequacy is if bank owners have more capital at risk, the gains that they would enjoy from risk business, would be compensated by the potential loss of their capital if their bank were to experience large losses.

Regarding the capital requirement the NBE issued various directives such as directive No. SBB/3/95 which focuses on the contribution in kind of the initial capital requirement and stated capital contribution in kind is not allowed for fulfilling minimum required capital and even if the bank fulfills its requirement the capital contributed in kind must not exceed 25% of paid up capital.

Similarly, on directive **No. SBB/4/95 the** NBE issued various requirements that after banks fulfill the initial minimum capital they are subject to the following obligations in order have sound reserves account in their NBE. This obligation is to transfer from its total annual profit 25% to its reserve account until the reserve equals its capital (if their reserve reaches the capital of the bank only 10% of profit is required to be transferred to their reserve account).

On the other hand this directive also forces banks to have provisions for loans, advances and bad or doubtful receivables; the value of any assets lodged or pledged to secure liabilities, including contingent liabilities that are not included in the calculation made to ascertain the bank's compliance with capital and reserve requirements. This directive also obliges banks to amortize its capitalized expenditure within a maximum period of five years and to fully cover its operating and accumulated losses from its annual net profit and not to pay dividend to shareholders until such losses are fully covered.

There is also another directive which forces banks to maintain 5% of their liabilities(birr and foreign exchange) and liabilities held in the form of demand deposit(currency, saving and time deposits) in its reserve account. Therefore, the above directive required to fulfill banks in case of capital requirements are very hard and can easily substitute for the deposit insurance in developed countries and can prevent savers from loss and banks from entering into risky business.

3.2.2. Limit and Directed credits

In order to avoid credit concentration of banks the NBE issued both manual and guideline. According to the banks manual credit concentration can occur when a bank's credit portfolio enclose a high level credits: to counterparties; to specific industry; to specific geography; to the type of credit (i.e. overdrafts); and to specific collateral.

In its guideline in credit concentration and risk management the NBE identifies ways of credit management strategies. In this strategy the NBE issued credit limits guideline to individual counterparties and groups of connected counterparties of banks. According to this guideline under any circumstance banks are not allowed to set credit limits higher than the limits set by NBE. This guideline also limits on specific industries, specific geographies, specific products, and group of borrowers.

Based on this guideline the NBE issued a directive dealing with limitation on Loans to Related Parties. This directive obliges banks not to extend loans to related parties on preferential terms (on; conditions, interest rate and repayment periods) than conditions usually applied to other borrowers. Similarly the regulation has put limits on banks not to expose to a single and associated borrower. With this regard any bank cannot lend more than 15% of its net worth to a single borrower, and the total sum of loans to all related parties at any one time shall not exceed 35% of the total capital of the bank.

In directing credit governments usually subsidized selected industries indirectly, the reasons for subsidization is to narrow the variance between private and social benefits that arise because of negative externalities, market failure and coordination failures. In this regard the government of Ethiopia tries to address this issue by selecting certain industries that are considered crucial for the countries overall economic development such as manufacturing industries, agriculture and tourism. In line with this the government establishes the Development Bank of Ethiopia with aim to supply credit at low interest rate which is 7.5% as compared to the market rate 11.8% and at low collateral rate which is 30:70(30% contributed by the borrower and the rest was supplied by the bank) as compared to 234% of loan required for other modes of loan and with long repayment period up to 15 years as compared 1-5 years in the other modes of loan.

But the government commitment to supply credit at low interest rate, low collateral requirement and long repayment period did not bring the desired result because of low demand for credit from the private sector which leads the DBE to have excess liquidity. And even the Bank lends to selected public institutions it result was undermined due to inefficiency public firms but continue to receive loans from the DBE. The loans give to these inefficient firms cannot generate the desire result.

4. Financial supervision in Ethiopia

In many countries, bank supervision was a more compliance-oriented activity, as the governments issued proclamations, regulations directives and manuals the supervisory duty is to follow and ensure if banks follow those restrictions.

4.1. What Powers Do the Supervisory Authorities Possess?

In some cases and countries, the authorities might be forced to take remedial action, whereas in others case and countries they may have to engage in forbearance. In some countries and serious case courts, may intervene and thereby limit, delay, or even reverse action taken by the supervisory authorities. In this regard the supervisory authority of the NBE can be evaluated on the following grounds:

1. **Official Supervisory Power**: the NBE was given the following supervisory power by PROCLAMATION NO. 592/2008:
   i. To approve, supervise and control banks: business transaction, introduction of new services; merge or take over the banking business of another bank; sale, transfer or dispose of the whole or any part of its property, redeem its own shares or effect a reduction of its capital other than through reduction due to operating losses; amend its memorandum and articles of association; and alter the name under which it is licensed to do banking business
   ii. Approval of appointment of Directors and Officers
   iii. **issued directive on:** qualification to be fulfilled by directors; number of directors in the membership of the board ; the duties, responsibilities and good corporate governance of the boards of directors of bank; number of years a director may serve in any bank and the conditions for his re-election; and the maximum remuneration of directors; and
   iv. Suspend or remove a director, a chief executive officer or a senior executive officer
   v. Direct banks to prepare financial statements in accordance with the international financial statements standards, whether their designation changes or they are replaced, from time to time.
   vi. Approval of Appointed auditors and decide the pay remunerations of the auditor.
   vii. Taking corrective measures where an inspection of a bank results in a finding that the bank has failed to comply with the relevant laws and directives the bank can take the following measures:
      - Call a meeting of its shareholders or board of directors
      - Assign one or more of its officers to watch the proceedings at any meeting of the shareholders, board of directors or any committee instruct in writing corrective measures to be taken by the bank;
      - Order the dismissal or suspension of one or more directors, the chief executive officer or senior executive officers of the bank, or impose fines on such persons in accordance with its directives prescribed for such purpose;
      - Prohibit the bank from opening new branch offices; restrict, suspend or prohibit payment of dividends by the bank;
      - Put the bank under receivership.

   Therefore by any standard the power given to the NBE is very sufficient to meet its objectives.\
2. **Independency of supervision:** the following two variables may measure the degree of independence

i. **Independence of Supervisory Authority – Political**: According to different countries experience, if the central bank is responsible to the legislative body, it is relatively said it is independent. Where as in the Ethiopian case, since the NBE of Ethiopia is responsible to the executive body especially to the prime minster it is said to be relatively not independent.
ii. **Independence of Supervisory Authority – Fixed Term**: according to different countries experience the independency of the authority was evaluated on the ground whether its service is fixed or not fixed. The basis for this demarcation is the presumption that a fixed and relatively long term affords a greater degree of independence. When we evaluate the Ethiopian experience with these criteria the governor of NBE is a political nominee where its term is not decide by a predetermined rule and can have a chance to be evaluated on a political ground and may not be in its performance.

5. Concluding remark

The main purpose of this paper is to analyze the financial sector development, regulation and supervision in Ethiopia. As a result, even though the financial development indicators of Ethiopia indicate a sign of improvement from time to time still remains far behind the East African neighbors'. According to many scholars the development of those indicators are lagged behind because the government follows and applied closed financial system. On the other hand the government acknowledges financial liberalization but it follows a gradualism approach where it opens its finance both to the private sector and to foreign ownership gradually.

For the above reasons the Ethiopian financial system remains highly controlled with an intervention rate around 425%. In order to meet its gradualism approach to liberalization the government of Ethiopia through its National Bank issued various proclamations, procedures, directives, manuals and guidelines on how to regulate and supervise the financial system.

The main regulatory and supervisory instruments applied in Ethiopia include: regulating the activities of banks, board directors, and managers, controlling foreign ownership of bank, controlling concentration of credit, credit and interest rate control, capital requirement, limiting board directors and manger benefit package limiting voting right and suspending directors and managers are some of them. The supervisory instruments focus on compliance oriented approach where the supervisory authority is given the power to follow if the regulatory instruments are fulfilled by banks otherwise punishes them.

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